RBC Dominion Securities Inc.

Wealth Management
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Higher yields present an opportunity

KEY INSIGHTS

- Higher interest rates create opportunity in fixed income and equities
- Rate hikes getting close to the end and cuts anticipated next year
- Equity markets positive in 2023 with tech giants contributing almost all of the gains
- Inflation trends remain favourable, but improvements from here to get harder
- The recession is late for dinner and hasn't even texted with an ETA

North American equity markets continue to hold on to gains in 2023. Corporate earnings remain robust, and on average, investors remain optimistic despite a raft of geopolitical concerns and economic headwinds. That investors have become somewhat desensitized does not mean that geopolitical risks have not impacted markets. Demand for safe-haven assets has increased since the Israel-Hamas war began. US Treasury prices have moved higher, and gold has increased by $100/oz since the attack.

While there are many important issues to monitor at the moment, the reality, as ever, is that interest rates drive just about everything in finance and investment. Over the past 18 months or so, risk-free government bonds have gone from yielding less than 1% to over 5%. The result is that everything else must adjust to compete. An intuitive example is GICs - if a risk-free government bond is paying 5%, an investor would rightfully demand something similar from a GIC, and slightly more from a low-risk bond issued by a

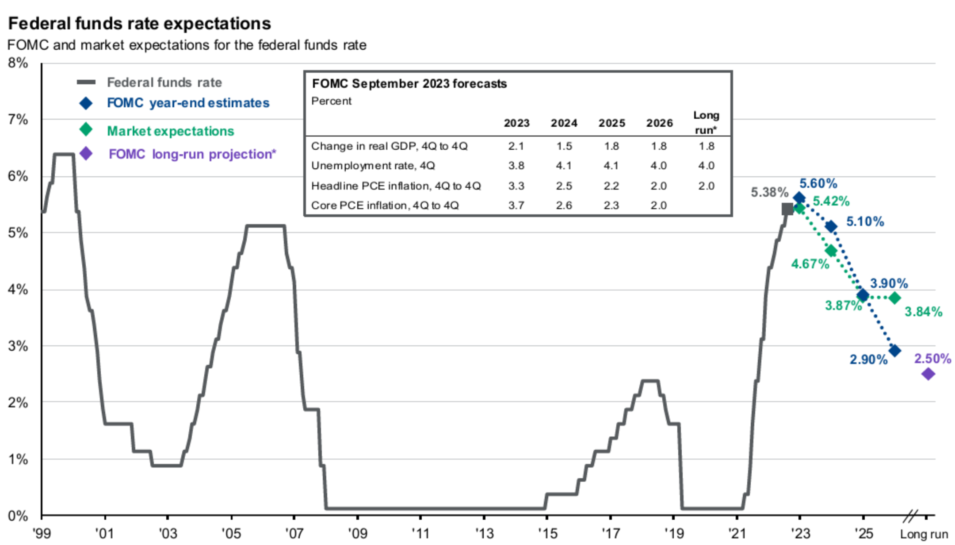

***Figure 1**: Fed Funds rate expectations (Source: JPMorgan, Bloomberg, FactSet, Federal Reserve)*

Quarterly Review
Q3 2023

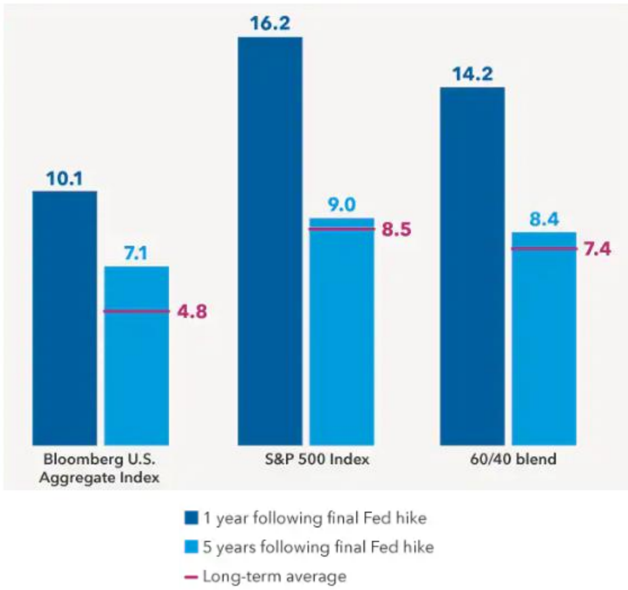

***Figure 2**: Average returns following final Fed hike (Source: Capital Group, Morningstar)*

bank or insurance company for example. Follow this line of thinking to dividend paying equities. If the shares of a public company paid a 3% dividend when risk free rates were 1%, an investor might have felt fairly compensated for taking on the risk of owning those shares. Now that the risk-free rate is 5%, market participants demand higher yields from dividend paying equities.

If the buyer of a business wants a higher dividend yield, how might they achieve that? They could ask for a higher dividend (unfortunately it's not as easy as this), or they can pay a lower price for the shares, which will make the existing dividend represent a larger yield. As a simple example, a $100 stock that pays a $3 dividend annually has a 3% yield. In the current environment of 5% risk free money, a buyer might think that they should now earn a 6% yield from that investment. The only way to achieve this in the short term is to pay $50 for the stock, which at its $3 dividend would now yield 6%.

This is why we have seen some parts of the market, and in particular income focused equities (like telecoms, banks and utilities for example) come down in value this year. But it is also why these same shares will increase in value when talk of lower interest rates begins. When central bankers begin lowering rates in an effort to stimulate a weaker economy, that 6% yielding equity will become relatively attractive and will see buyers step in to take advantage.

Nobody knows when central bankers will stop raising interest rates and when they will begin lowering them. However, both the Federal Reserve and the broader market project rates to peak near current levels and decline by about 1% by the end of next year (see *Figure 1)*. Looking back at what has occurred after the Fed stopped raising rates in past, we see that in the last four cycles both equities and bonds have turned in strong performance following the last hike (see *Figure 2*). Over one and five-year periods outperformance versus the long-term average has occurred.

We see an opportunity in income focused equities at the moment. If rates decline as projected, dividend stocks should rally as explained above. If that does not happen over the next year the fact remains that buying a quality business today with a predictable 6% or 7% yield means that you will own that income stream into the future. There are many quality businesses like Canadian banks, telecoms and utilities that now pay 6% to 8% yields and come with a long and predictable track record of dividend increases.

For the same reason, we also believe that quality bonds are attractive at this time and we have spent the past year extending the average length of our bond portfolio to capture higher yields for a longer period. When yields were 1% we were loath to lock in those rates for long periods and chose to keep our maturities quite short in nature. Recently however, we are eager to take advantage of higher rates and the certainty of income that bonds provide. If and when interest rates start coming down, we will be thankful to have secured some longer bonds. You may have heard the term "higher for longer" used in the context of central bank interest rate policy, but we can play that game too!

Equity Market

As mentioned, equity markets remain in positive territory so far in 2023. As was the story earlier this year, a small group of tech companies have contributed most of the S&P500's positive performance year to date. Strip away the tech giants and we see returns in the low single digits; add back in the "Magnificent 7" and the return for the S&P increases by about 10% into the double digits (see *Figure 3*).

The seven largest US public companies have enjoyed huge gains from emerging trends in artificial intelligence (AI) and have seen their valuations increase as a result. This concentrated group now makes up over a quarter of the S&P500's market capitalization and as a result, their strength has been an outsized contributor to the gains.

Quarterly Review
Q3 2023

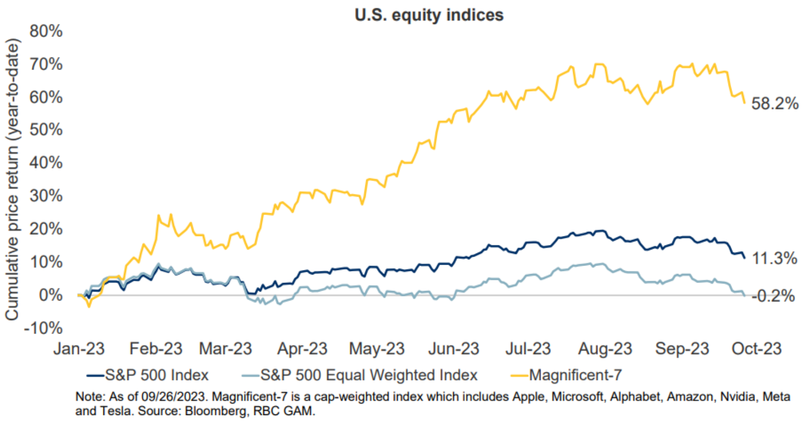

Figure 3*: S&P500 vs. S&P500 equal-weight vs. Magnificent-7 (Source: RBC Wealth Management, Bloomberg)*

We have exposure to this group via our holdings in Apple, Amazon and Alphabet (Google). Like most things we do, we have chosen to own these positions in moderation. It's fun when they are flying high but not so much when they are down more than 50%, as Amazon was in 2022. Risk management is always first and foremost.

These higher growth companies typically come with lower (or no) dividends as they opt to reinvest earnings to grow their business. This is clearly in contrast to the more mature, high dividend telecoms and utilities discussed earlier. Holding a diversified group of income and growth equities along with some higher-for-longer yielding bonds seems to us the appropriate strategy as we face the uncertainty of the coming quarters.

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	Q3	YTD
Indices		
S&P/TSX	-3.05%	0.81%
Dow Jones	-2.62%	1.09%
S&P 500	-3.65%	11.68%
Nasdaq	-4.12%	26.30%
Euro Stoxx	-5.10%	10.04%
Japan Nikkei	10.65%	22.09%
India Sensex	1.71%	8.20%
VIX (Volatility)	28.92%	-19.15%
Commodities		
Gold	-3.68%	1.35%
Silver	-2.61%	-7.41%
Copper	-1.32%	-1.82%
Oil	28.52%	13.12%
Natural Gas	8.06%	-23.86%
Currency		
CAD	-2.48%	-0.18%
EUR	-3.08%	-1.23%
JPY	-3.39%	-12.22%
AUD	-3.44%	-5.55%
GBP	-3.97%	0.96%

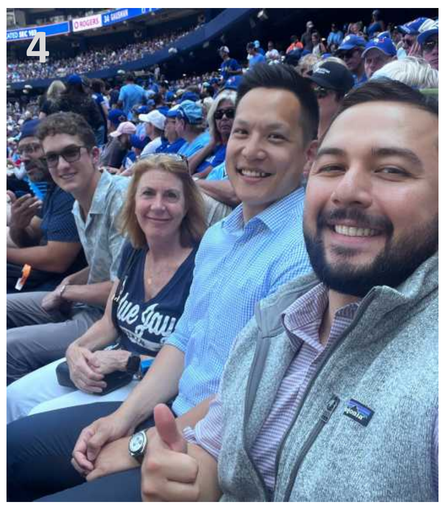
Values as of September 30th, 2023

Fun Stuff – Summer / Fall Team Events

Q3 2023

1 – Supporting youth mental health at RBC Race for the Kids with RBC CEO Dave McKay and Scott's son Arrow

2 – Ronan and Scott in the Big Seat!



3 – The team celebrates Ronan's 50th…..Josh, Brendan, Ronan, Heath, Steve, Michelle, Gary, Alisa (and Scott behind the camera)

4 – Heath (the intern), Michelle, Gary and Josh at the Jays game

5 – Who knew they made you breakfast on your 50th?

6 – Josh, Heath, Michelle and Steve volunteering at The Daily Bread Foodbank

Fun Stuff – Summer / Fall Team Events

Q3 2023

1 – Ross Deacon popped in for the party!

2 – Thanksgiving at the Sandler's with master chef Steve

3 – Happy to see our past interns hanging out – Heath (2023), Adrian (2022), Aidan (2021)

4 – Brendan, Josh, Scott and Heath with branch management team, Scott and Oriana (far left and right)

5 – Heath's last day before he heads back to school at Western

6 – Summer Social