RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Pulse of Canadian equities

The outlook for Canadian equity performance in 2017 amid an evolving global backdrop.

Matt Barasch

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All values in U.S. dollars and priced as of January 31, 2017, market close, unless otherwise noted.

Focus article

Pulse of Canadian equities

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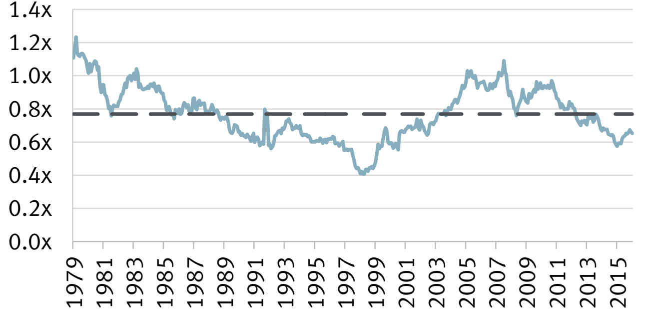
Canadian equities enjoyed a big bounce in 2016, and we turn to RBC Capital Markets' Chief Canadian Equity Strategist to gauge their prospects for the coming year. He explains how the paradigm for outperformance has changed, why he remains positive on Canadian equities, and where investors can find attractive opportunities.

Q. The Canadian equity market outperformed many global benchmarks in 2016. What underlies your continued positive view on domestic stocks?

A. Interestingly, the drivers of our Overweight recommendation have shifted quite significantly. Early last year, the recommendation was driven in large part by two dynamics. First, the presence of expanding Chinese stimulus and a more dovish Fed—factors that have coincided with windows of positive TSX performance in the past. Second, the TSX had approached an all-time low valuation relative to the S&P 500. While the confluence of these factors resulted in an Overweight call with a good deal of conviction, it was one that likely did not have a long life as macro factors shifted and the valuation discount narrowed.

Price-to-book value of S&P/TSX relative to S&P 500



Source - RBC Capital Markets Quantitative Research; data through 12/31/16

The S&P/TSX entered 2016 at nearly an all-time low valuation relative to the S&P 500.

Fast forward to today, and the Donald Trump election victory in the U.S. has really changed the dynamic for the TSX. In a low growth world dominated by monetary policy, there's not a lot to get excited about when it comes to the TSX, which tends to respond to improving economic growth, increased commodity demand, and steeper yield curves. The new backdrop offers the prospect of economic stimulus through lower taxes, increased infrastructure spending, and fewer regulations to drive a pickup in U.S. economic growth not seen with any consistency since before the financial crisis.

Q. In what sectors do you see the most opportunity at present?

A. We continue to like the energy producers. The time to own this group is when oil prices are rising while industry operating costs are contained, leading to margin expansion. We think we're in that window where there is still a lot of labour and equipment slack, which allows producers to earn a healthy return even at

US$50 oil. Furthermore, there's not a lot of pressure yet to invest in new projects, which frees up the cash generated to be directed to shareholders by way of debt repayment, share buybacks, and dividend increases.

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We also like the lifecos, which have weathered a long and difficult period of low interest rates. With rates moving higher and many of the issues that came in the aftermath of the Great Recession in the rearview mirror, we think there's a sustained opportunity.

Our other two Overweight recommendations are auto parts and gold. The auto parts recommendation is essentially a valuation call as the sector remains historically cheap despite recent strong performance. Gold is more of a hedge as we think the risks of inflation are higher than they have been in some time while U.S. policy uncertainty adds another reason to be long an asset that may zig when others are zagging.

Q. What do you see as the primary risks to your outlook?

A. Uncertainty regarding the Trump administration is the biggest risk. More specifically, anti-trade measures have the potential to be a destabilizing force globally and merits close observation.

The risk of a domestic accident also bears watching as the Canadian economy does not have a lot of drivers at present, debt levels are high, and pockets of the housing market have recently sent mixed signals.

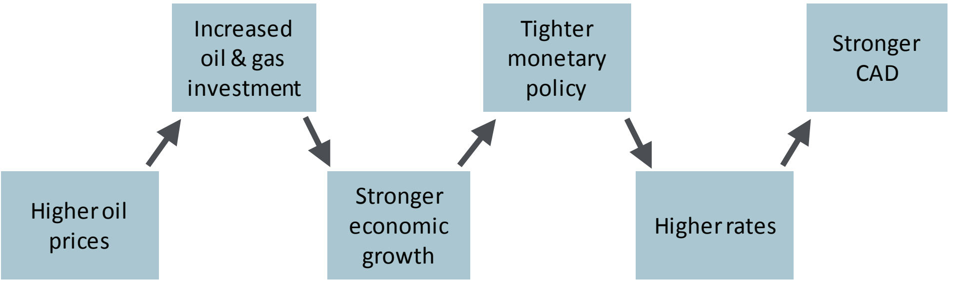
Q. Many market observers have pointed to a weak Canadian dollar as key to boosting the competitiveness of the country's non-commodity exports. Is it reasonable to expect the loonie to remain weak in light of the strong rally in crude oil prices and consensus expectations for further crude strength?

A. The main reason the loonie and oil have tended to be linked is that when oil prices rise it tends to attract investment dollars to new projects, which in turn leads to better economic growth and correspondingly tighter monetary policy in the form of higher interest rates.

The problem for Canada is that much of the country's oil resources are essentially the opposite of the types of projects that companies want to invest in these days. Oil sands projects take several years of development and a huge amount of upfront

Traditional mechanism driving the relationship between oil and CAD

Significantly higher oil prices may be needed to spur investment and upward pressure on CAD



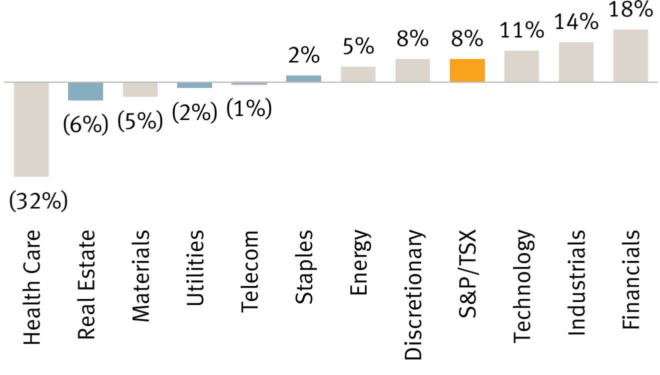
Source - RBC Capital Markets Canadian Equity Strategy

investment, which will keep companies from sanctioning fresh investments absent a very large and sustained move in oil prices. Until we see these investment dollars return, the mechanism described above really breaks down and probably keeps a lid on the Canadian dollar.

Q. Valuations in traditionally defensive, rate-sensitive sectors, such as Telecommunications, Utilities, and Real Estate, have compressed recently as long-term interest rates have risen. Is a buying opportunity at hand?

A. Investors need to ask themselves what they are seeking; if it is to outperform a benchmark, then probably not. Interest rates have broken some long-term trend lines, and we are potentially going to be living in a higher rate world for a while. Demographics and low growth (by historical standards) probably keep a lid on how high rates eventually go, but, that said, the world does seem to have shifted.

Price performance since July lows in Canadian and U.S. 10-year bond yields



Traditionally defensive, dividend-paying sectors have underperformed.

Source - RBC Dominion Securities Inc., Bloomberg

On the flipside, if investors want to own good businesses that pay a reasonable dividend that can grow over time, then buying these names say 10% cheaper than they were six months ago is not a bad strategy. You might underperform a benchmark, but I'm not really sure why that should matter so much to most individual investors.

Q. Given their significance in the benchmark, the outlook for bank stocks is inextricably linked to that of the domestic equity market as a whole. With the valuation expansion enjoyed by the group over the past year, what are your expectations for the remainder of 2017?

A. The Canadian banks are great businesses that have managed through some really rough times better than most of their global peers. We are Market Weight (rather than Overweight) largely on today's higher valuations and some concerns over growth in Canada, but we are pretty confident that the banks will navigate through any headwinds.

I would add that the steepening of the yield curve will help bank earnings so while valuations have moved up, this is partially attributable to the market anticipating a pickup in earnings growth as roughly half of bank earnings come from net interest margins.

Research resources

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