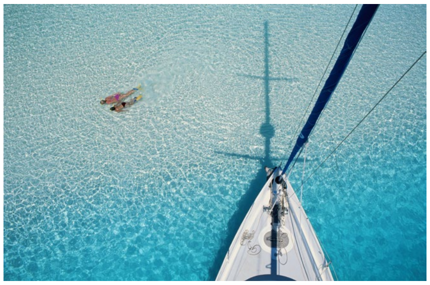
Price Private Wealth
Of RBC Dominion Securities
Investment Quarterly

Wealth Management
Dominion Securities

July 2024: Issue 20



Trees Don't Grow To The Sky

AI has propelled a "magnificent few" to trade at extremely rich valuation multiples. While a soaring S&P 500 price-to-earnings multiple by itself won't define the limits of the market advance, when combined with optimistic / complacent investor sentiment and high interest rates, a cautious, watchful approach is called for.

Price Private Wealth
Of RBC Dominion Securities Global Ltd.

Stephen Price, MBA, MPhil, CIM
Senior Portfolio Manager
stephen.price@rbc.com
345-814-8141

Christian Gollnick
Investment Advisor
christian.gollnick@rbc.com
345-814-8140

Filip Nikic, CFA
Investment Advisor
filip.nikic@rbc.com
345-814-8122

Gustavo Sancinetti, CFA
Investment Advisor Associate
gustavo.sancinetti@rbc.com
345-814-8143

Andrew Jones, CFA
Associate Portfolio Manager
andrew.jones@rbc.com
345-814-8127

RBC Dominion Securities Global Limited
3rd Floor, 9 Forum Lane
Box 1140, Camana Bay
Grand Cayman, KY1-9006
Cayman Islands
www.priceprivatewealth.com

Market Overview

Through all this upward move since the AI stocks took control, the breadth readings for the S&P 500 have been positive. While the Magnificent 7 have accounted by far for most of the value added to the index, the majority of stocks were also moving higher. If that remains the case, we believe this advance has further to run.

Longer term, unusually high market P/E ratios typically point to below-average equity returns measured over the following decade. The fact that the excessive market multiples are attributable to one overwrought sector or a handful of heavyweight favorites has not tended to mitigate that outcome.

Investors have had to contend with substantially overweighted high-fliers in the past, such as the "Nifty Fifty" in the early 1970s, the energy and commodity stocks in the late 1970s, the tech sector leading up to the "tech wreck," and the financials heading into the global financial crisis. Not just the overvalued leaders but the majority of other stocks also suffered when the tide eventually turned.

We don't believe markets are finished moving higher. But thinking about risk appetite and having a plan for becoming more defensive when conditions dictate are things to contemplate in the coming months. We believe stocks are no longer compellingly valued and investor sentiment is increasingly complacent. The combination argues for a cautious, watchful approach on the part of investors.

United States

Equities

Following an outsized rally amid unusually low volatility, we think U.S. equity market volatility could increase during the second half of the year.

The S&P 500 has surged 15.8% including dividends year to date through June 18. While the price gain is almost 1.5 times that of the average annual return of the past 40 years, the rally has been rather narrow. Just eight stocks represent 71% of the index's return, seven of which are leveraged to artificial intelligence (AI), led by chipmaker NVIDIA. This leaves the other 499 stocks in the index during this period combining for only 29% of the total return. Now is not the time to chase the biggest winners, in our view.

A small group of stocks have powered the S&P 500 higher

Percentage contribution to the S&P 500's year-to-date gain of 15.8%

* The seven stocks, from largest to smallest contribution to the S&P 500 total return, are Microsoft, Alphabet (both share classes), Meta Platforms, Amazon.com, Broadcom, Apple, and Eli Lilly.

Source - RBC Wealth Management, FactSet; year-to-date total return data (includes dividends) through 6/18/24. During the period, 507 stocks were in the S&P 500 (Alphabet counted once)

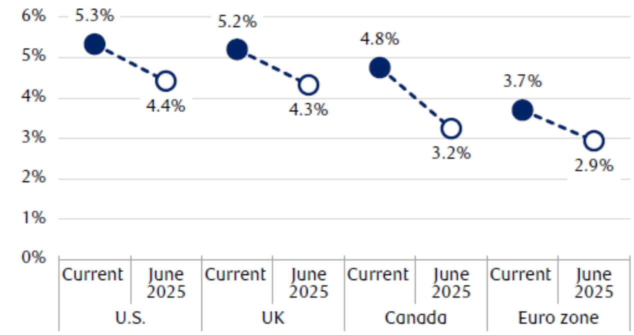
We don't view the S&P 500's relatively high 21.3x forward price-to-earnings ratio as much of a hinderance so long as consensus earnings forecasts hold up.

But with volatility all but vanished, we think the S&P 500 seems due for a normal pause or pullback. We recommend Market Weight exposure to U.S. equities—a constructive allocation—as we don't see tangible signals that the bull market could come to an end just yet.

Fixed Income

The disappointing lack of further progress on inflation in the first quarter partially reversed over the course of the second quarter. With renewed optimism on the inflation front, markets are again pricing in multiple Fed rate cuts this year, though conviction remains low. At the June meeting, the median projection of the 19 members of the Federal Open Market Committee showed a likelihood of just one rate cut this year, but only just. Nine members expected two cuts, eight just one, and the rest foresaw no cuts. In our view, should inflation continue to come in soft over the course of the summer, a first rate cut by September remains on the table.

Markets are pricing in shallow rate cut cycles



Source - RBC Wealth Mangement, Bloomberg, Long-run market-implied policy rate based on 1-year forward contract data

Credit market valuations remain rich in the U.S., but we think it is undeniable that total yields remain historically attractive. For investors with the appropriate risk appetite, we see value in a barbell approach of allocating to short-term Treasuries where yields are still north of 5%, and to high-yield corporate bonds where index yields remain around 8%. As a sector, the high-yield corporate market has broadly refinanced its debt with most maturities not coming due until 2029, which should reduce near-term credit risks.

Canada

Equities

Ongoing vigilance on domestic consumer exposure within equity portfolios remains warranted. Fiscal second-quarter earnings from the Canadian banks suggested a relatively benign consumer backdrop, but there were pockets of stress in certain areas, with credit card and auto loan delinquencies rising. We expect that headwind to continue for the foreseeable future. However, we note that this dynamic has been well-anticipated by the market and is reflected to some degree in the banking industry's below-average valuation multiples.

The Materials sector has been a bright spot for the domestic equity market, although we struggle to reconcile certain commodity prices with near-term fundamentals. We continue to recommend resource exposure in the Energy space where the cash returns to shareholders remain attractive as producers hit targeted leverage thresholds. Recession calls have been receding as the probability of a "soft landing" grows. Should a recession materialize over the next year, we believe Canadian Energy producers are in a strong position to navigate a period of depressed commodity prices, thanks in large part to their lower debt loads and capital discipline.

Fixed Income

Over the last number of months, the Canadian economy has shown signs of weakness, growing at a slower pace than it did over the last three years, while the unemployment rate rose steadily. As macroeconomic weakness materialized and inflation moved lower, the Bank of Canada (BoC) was ultimately compelled to deliver its first interest rate cut of 2024, while guiding to additional cuts ahead. We view the potential for a BoC-induced drop in interest rates as supportive of longer-duration bonds in portfolios, i.e., those bonds with a higher price sensitivity to interest rate movements and most positively exposed to a drop in interest rates.

A tactical shift to longer-duration bonds in anticipation of additional BoC interest rate cuts is reasonable, in our view. Despite a Canadian corporate bond market that is still providing compelling yields, we view the additional yield compensation offered for the risk of default (or credit spread) as historically low. This credit spread compression has also lowered the hurdle for Government of Canada bonds to deliver higher returns on a forward-going basis. When the yield compensation for risk is this low, understanding that bond markets are vulnerable to an outlook that is anything but perfect is key. Our bond preference has shifted away from what we see as the riskier categories of the fixed income market (such as higher-yielding bonds issued by corporations with weaker balance sheets) towards categories with less risk, such as bonds issued by the Government of Canada or the U.S. Treasury.

United Kingdom

Equities

The new Labour government will likely try to stimulate growth through making it easier to acquire permits to build new homes and commercial buildings, and resetting relations with the EU, still its largest trading partner. Labour has also promised to expand the scope of responsibility of the British Business Bank, which invests in small and medium enterprises, and to look to nationalize the rail industry.

Labour's proposed budget looks to increase investment in green industries, as well as health care, schools, and childcare. While the Conservative government had been actively outsourcing services, Labour would take back control of several activities to lower the bill paid to consultants.

To fund its policies, Labour promises to close tax loopholes and increase a number of specific taxes, such as the energy profits levy. It has committed to keep the corporate tax rate at 25% for the duration of Parliament and to maintain the income tax top rate and capital gains tax. The new government will likely find that its policies will be restricted by the weak national finances, with the fiscal deficit exceeding 4% of GDP and government debt just above 100%. We believe the unique composition of the UK equity market, including its high weighting to commodities and defensive sectors, means UK equities at the index level will remain inextricably linked to either the "value" factor outperforming "growth" or defensives outperforming cyclicals, or both.

Within the UK equity market, we believe high-quality large-cap stocks that are well-placed to benefit from structural (long-term) growth tailwinds while trading on reasonable valuations, often at a discount to their global peers listed overseas, remain an attractive area of opportunity. We also see selective opportunities in domestically focused UK stocks, where, encouragingly, the economic backdrop appears to be improving. In our view, the low valuation of UK equities means that takeover interest in UK companies from international competitors and private equity is likely to remain elevated.

Fixed Income

Interest rate cuts in the UK are now likely on the horizon. Our base case still calls for an initial 25 basis point (bps) rate cut from the Bank of England (BoE) in August and a further 25 bps of easing to reach 4.75% by the end of 2024–in line with market expectations of 4.72%. That hinges on the BoE's three areas of focus, services inflation, private sector wage growth, and labour market tightness, being aligned with its forecasts. If the data surprises to the upside, the BoE might be hesitant to deliver the two cuts we expect this year. While economic growth has been more resilient than our expectations, households' sensitivity to rising mortgage costs poses a risk to future growth and could prompt more easing from the central bank. The BoE's report on mortgage lending activities in Q1 revealed that the value of mortgages in arrears rose by 4.2% q/q to £21.3 billion—a 44.5% y/y increase and the highest since Q3 2014.

UK Gilts are currently trading around their six-month averages. Therefore, we are loath to add to long-duration bonds, but we maintain our modest

Overweight allocation to Gilts. Despite record borrowing for the 2024–25 tax year and BoE bond sales, demand from investors has been robust. The Labour Party's manifesto emphasizes economic and fiscal stability and, with a Labour victory, the risk of irresponsible government spending is likely low, in our view.

Corporate spreads tightened considerably in H1 2024, but recent widening in June makes valuations appear less rich. Spreads could remain well contained in H2 with muted supply and strong inflows from institutional investors, and from corporate fundamentals having improved in Q1 thanks to stronger growth and earnings profiles. Yet we remain highly selective as growth, political, and inflationary risks remain. We prefer short-duration exposure in senior-ranking bank bonds and issues from the consumer staples and technology sectors.

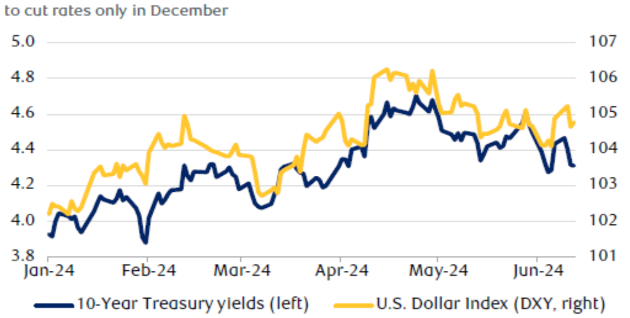
Currencies

U.S. dollar: Supported by higher U.S. yields

The U.S. Dollar Index (DXY) hit a new high for the year in late April, driven by strong U.S. economic data and investors pushing back expectations for the timing of the first rate cut from the Federal Reserve to later in 2024. We expect the DXY to remain supported in Q3 on higher relative U.S. Treasury yields, with RBC Economics expecting a Fed rate cut only later this year. However, economic data could drive broader dollar moves.

DXY has closely tracked 10-year Treasury yields in 2024

We expect the USD to remain supported until the end of 2024, as we expect the Fed to cut rates only in December



Source - Bloomberg, RBC Wealth Management, data through 6/13/24

Canadian dollar: USD/CAD target at 1.40 in Q4

The Bank of Canada (BoC) cut rates in June, driven by what it stated was "continued evidence that underlying inflation is easing." With economic data slowing down in Canada, we look for weakness in the Canadian dollar throughout 2024. RBC Economics expects three more BoC rate cuts this year, versus the market's expectation for only two.

British pound: Weaker on a constrained UK fiscal backdrop

The pound has outperformed most G10 currencies in 2024 so far, on the back of stubborn inflation in the UK that pushed back the timing of interest rate cuts from the Bank of England (BoE). The announcement of a July UK general election did not move the pound much. However, we think it remains vulnerable due to a constrained fiscal backdrop that the next government will face, and the BoE's inability to quickly cut interest rates to help an economy at a nascent stage of recovery.

Commodities

Gold

Gold has rallied to record highs this past year, driven by a softening economy and a spree of central bank purchases. In our view, as some central banks reported no purchases in May, a pause in gold price appreciation may take place in the near term, with the potential for reacceleration as interest rates come down over the year ahead.

Copper

Despite recent weakness in copper prices, the commodity is still up double digits on a year-to□date basis. Improving demand in China and the increasing potential of Federal Reserve rate cuts have kept copper prices elevated. RBC Capital Markets expects prices to remain elevated for the remainder of the year but to potentially soften by improving supply in the back half of the year.

It's Gold's Time To Shine

With inflation making a comeback and no signs of fiscal restraint, gold deserves a second look

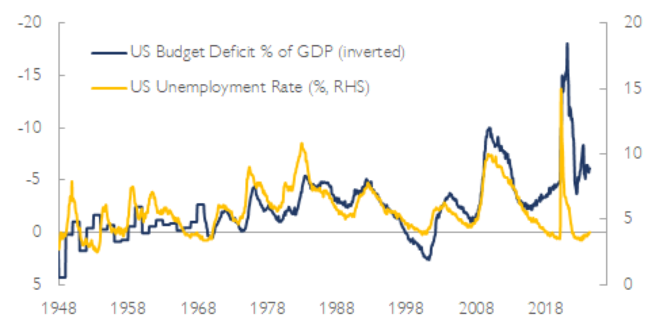
Source: RBC DS; Bloomberg; data through 06/30/24

The risks to government funding costs and mounting pressure on liquidity are likely to tilt the Fed in favor of cutting rates, even as inflation again rears its head. The market is waking up to the realization that fiscal deficits are unlikely to go back to non-recessionary norms anytime soon. U.S. funding costs are therefore at risk of moving higher. Higher U.S. Treasury yields will lead to the government having to borrow more to pay for its spiraling interest bill on existing outstanding debt. In the short-to-medium term, it is hard to see how this doesn't lead to quantitative easing, where the Fed monetizes the government's debt by printing money. This, in turn, is one of the factors that we see contributing to our outlook for higher-than-expected inflation going forward.

The U.S. Treasury has borrowed nearly $28 trillion, or just under 100% of GDP. If Social Security and similar obligations are included, the total easily balloons to over $33 trillion. The Treasury will borrow over $1 trillion in the second and third quarter of this year alone. Combined, the "must fund" programs Social Security, Medicare/Medicaid, and Defense now exceed the federal government's tax receipts. Interest expense on existing debt is an increasingly important addition to this required annual outflow at almost $1 trillion.

Against this backdrop, it is almost a given that the federal debt will continue to rise for the foreseeable future. After all, it's unreasonable to expect politicians to meaningfully raise taxes or cut popular programs without some sort of external impetus. Voter support for debt reduction only lasts as long as someone else pays for it. Politics is the art of the possible, and balancing the budget without shared sacrifice is effectively impossible. We should therefore expect the budget deficit to remain and likely grow, with federal debt increasing over time.

U.S. Budget Deficit vs. Unemployment Rate

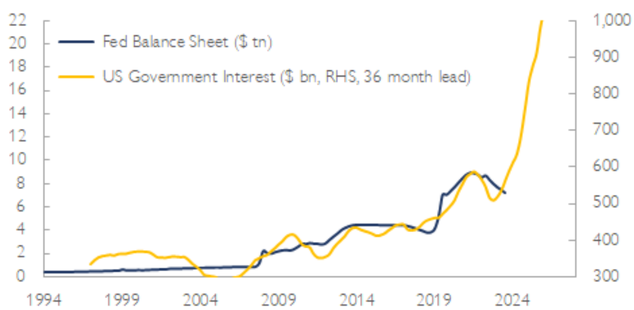


Source: RBC DS; Bloomberg; data through 06/30/24

When the U.S. government spends more than it brings in via taxes, it adds to near-term demand, which creates an inflationary impulse. For the past several decades, the inflationary impact of government borrowing was largely offset by other *deflationary* factors: growing low-cost supply from China, the debt deflation of the global financial crisis, and declines in household borrowing. These factors are largely played out, leading to more visual inflation from deficit financing.

Fiscal balance can, of course, come from some combination of cutting government spending, increasing taxes, and allowing higher inflation to reduce some of the real cost of repayment. The federal government is not a typical borrower. Its debt is issued in its own currency under its own laws, giving it debt management tools such as taxing interest payments or forcing the Fed to buy bonds via money printing, also known as quantitative easing. At a certain point, of course, this all becomes a headwind to growth – some of what is currently private wealth will need to be used to pay down national borrowings.

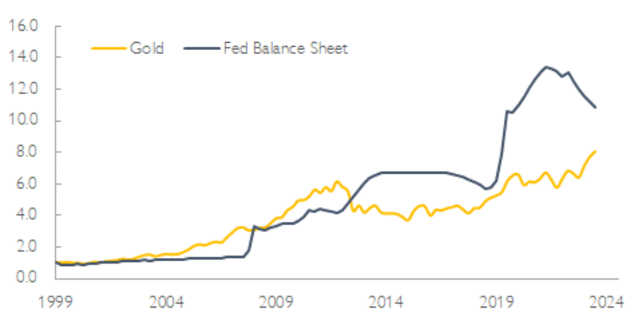
Fed Balance Sheet vs. Government Interest Payments



Source: RBC DS; Bloomberg; data through 06/30/24

The gold market appears to have begun to sniff this out, with the price of gold up 13% year to date and 21% in the past year. Over the long-term, gold is one of the best protectors against monetary debasement and inflation. Since 1999, the price of gold has advanced over seven times. Meanwhile, the S&P 500 Index is up only five times while the Fed's balance sheet has grown at over nine times, as global central banks have undertaken radical monetary policies in the wake of the Global Financial Crisis. We expect structural forces to keep inflation above levels seen for most of the past two decades, and we believe gold is one of the best defenses against high inflation.

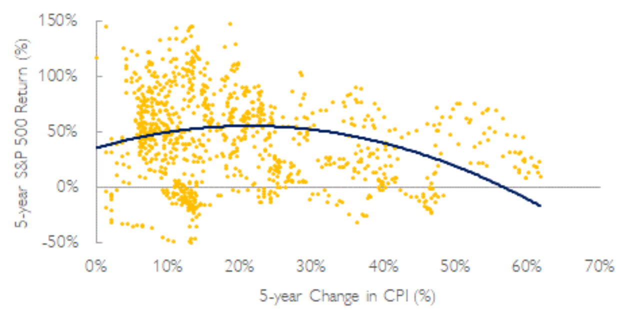
Cumulative Return of Gold vs. Fed Balance Sheet



Source: RBC DS; Bloomberg; data through 06/30/24

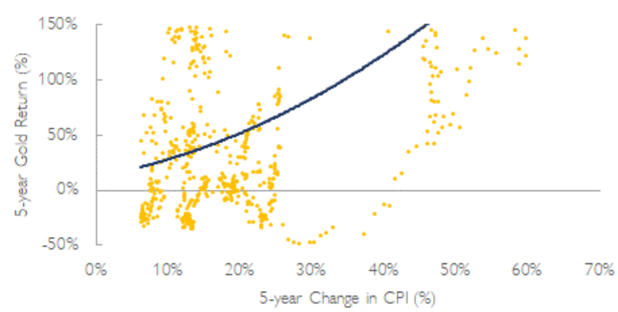
High inflation typically benefits stocks, but only after valuations have first been crushed. The fact is that while stocks have been decent inflation hedges over time, the best inflation-associated returns for the S&P 500 have occurred when the inflation rate was trending lower, typically starting from lower valuations. Gold, on the other hand, is highly correlated with long-term inflation. While gold protects well against monetary debasement, unlike equities it provides little real return. However, if an investor can identify periods when gold becomes extremely undervalued, it can offer exceptional excess returns, often uncorrelated with other assets. As financial turmoil increases this decade, we expect investors to aggressively buy gold as an asset class that provides both wealth protection and the opportunity for real returns.

S&P 500 vs. Inflation



Source: RBC DS; Bloomberg; data through 06/30/24

Gold vs. Inflation



Source: RBC DS; Bloomberg; data through 06/30/24

The gold market is currently locked in a near-term tug-of-war between Western investors, who continue to aggressively sell their gold holdings via ETFs, and Central Banks and Eastern investors, who continue to aggressively buy physical gold. Gold ETFs have net sold large amounts of gold so far this year. Stubbornly high inflation combined with hawkish Fed rhetoric has caused investors to abandon their expectations for aggressive rate cuts. The result, rising real interest rates, always leads Western investors to liquidate their gold holdings. Despite this, gold continues to make new all-time highs. Central banks, led by China, have become massive gold buyers, more than offsetting Western liquidation, as inflation remains elevated, government deficits balloon, and the U.S. weaponizes the dollar.

The last gold bull market lasted from 1999 to 2011, during which time gold quintupled in price from $253 to $1,900 per ounce. During that time, Western participants, led by European Central Banks, were net sellers of gold throughout the bull market. The entire five-fold increase in the gold price occurred despite the West's aggressive liquidation. Chinese and Indian investors bought every ounce, and them some, sold by the West.

When Eastern buyers drive a precious metals rally, it tends to advance in an orderly fashion. For Eastern investors, gold is a fundamental part of their cultural identity. Wester and Eastern markets tend to see contrasting trends in gold investment: typically, Eastern investors are more responsive to price ad tend to sit out sharp increases in gold prices waiting for a pause or pullback, or by taking profits on their holdings. Western investors have historically been attracted by rising prices and tend to buy into a rally. So far this year, those roles have been reversed. Western investors are likely to step into the market once real rates fall, driven by either a Fed rate cut or a reacceleration of inflation.

Despite gold trading at all-time highs, Western investors have been equally bearish on gold related equities. Gold mining stocks recently reached a 52-week low, as measured by the NYSE ARCA Gold Miners Index, even as the commodity price of gold sits at all-time highs. Gold mining stocks have consistently underperformed the commodity over the last 15 years. There are valid reasons, of course, for gold miners' underperformance of the gold price, including high operational risk and a history of management teams making poor capital allocation decisions at the top of past cycles.

Current industry and macroeconomic conditions have created a positive environment for gold miner outperformance. Elevated per-ounce prices are supportive of healthy net asset values (NAV), earnings growth, and profitability for gold companies. According to RBC Capital Markets, every 10% change in the price of gold results in an average change in NAV of 25% and an average change in free cash flow (FCF) of 17%.

History shows that gold and gold miners tend to outperform the stock market during problematic extremes, such as high inflation and rising rates or declining economic activity and rising unemployment. While the U.S. economy is still chugging along, the economic data are beginning to deteriorate. Meanwhile, underlying measures of inflation appear to have bottomed and are moving higher.

Gold mining stocks have also historically played a useful role in portfolio diversification since their underlying fundamentals often move opposite to those of most companies. This can help smooth out portfolio returns, which mathematically increases portfolio returns over time, because lower volatility increases wealth generation, all else equal. This is a fact that has largely been ignored over the past decade-plus, as growth stocks have outperformed all other assets to a degree where diversification away from them has actually hurt portfolio returns. In times when the stock market is gripped by intoxicating narratives, such as those currently surrounding artificial intelligence (A.I.), it is particularly important to maintain a disciplined and diversified approach within portfolios. With gold mining equities recently touching an all-time low relative to the price of gold, miners look to be one of the most undervalued asset classes in the world today.

NYSE ARCA Gold Miners Index as % of Gold Price

Source: RBC DS; Bloomberg; data through 06/30/24