RBC Dominion Securities Inc.

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All for One: You™

Climbing The Wall Of Worry

Wealth Management
Dominion Securities

August, 2018

Fundamentals And Politics In A Tug of War

1. Strong Fundamentals Blunted by Trade Worries

- We are coming off one of the best earnings seasons this cycle in the U.S. as measured by companies exceeding sales and earnings expectations.
- Trade tensions continue to hold back investors from fully committing to equities

2. Fixed Income Underperforming As Rates Rise

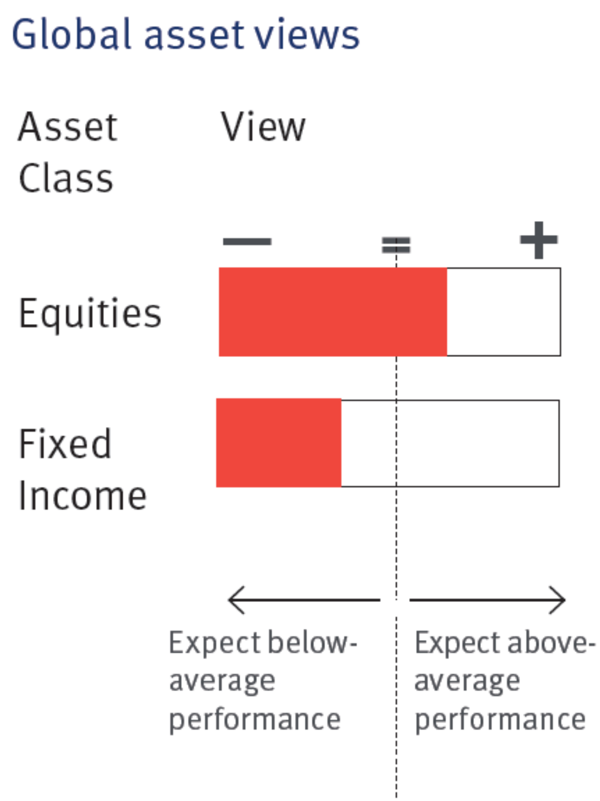
- Normalizing bond yields have been a headwind for bond returns, but we believe they are a long-term positive.
- These holdings continue to provide income and a ballast to volatility.

3. TSX Momentum Set to Continue

- Oil prices have found renewed strength, which bodes well for the TSX.
- Historically the TSX shines as inflation pressures build.

4. Oil Not Helping the Canadian Dollar

- The traditional relationship between oil and the Canadian dollar has broken down as interest rates dominate.
- We would likely need to see higher and sustained levels of oil prices to entice foreign investment back into Canada.

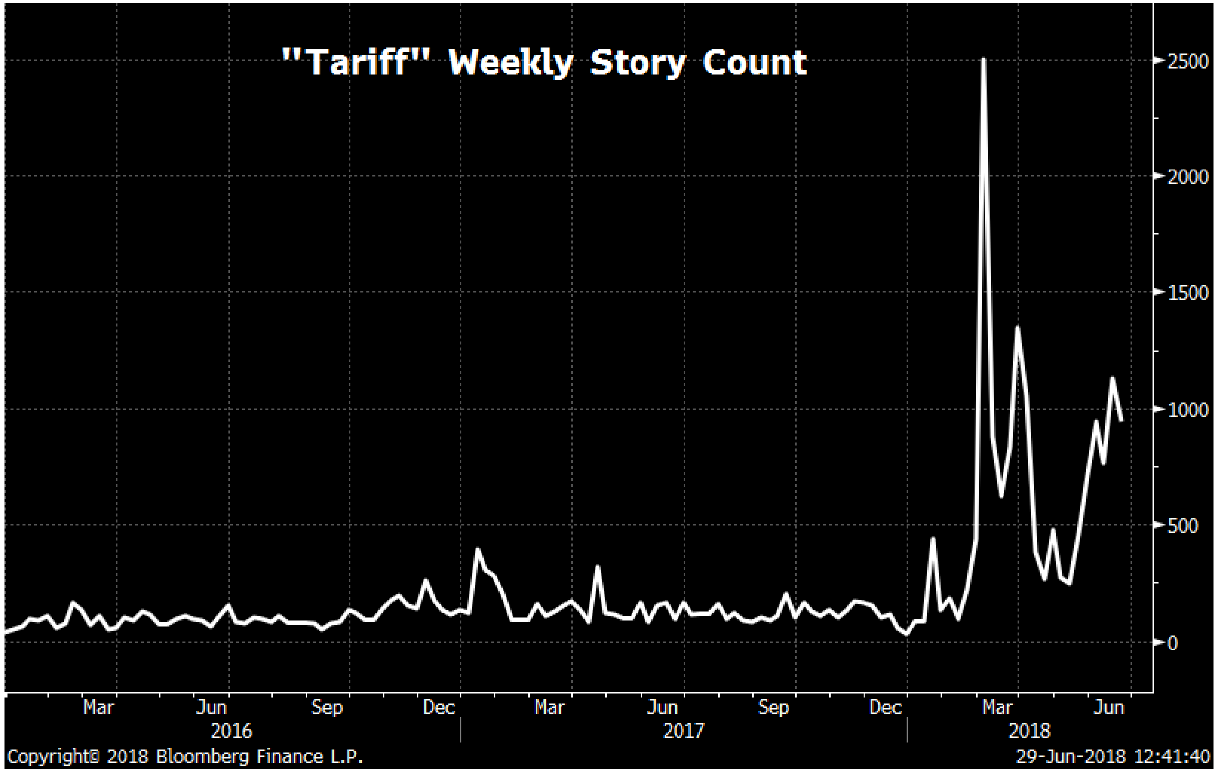


Source: RBC Wealth Management

Strong Fundamentals Blunted by Trade Worries

Uncertainty Is Challenging…

- All of the political rhetoric can make it challenging to maintain a long-term perspective, but we know that over time, markets climb a “wall of worry”.
- The prospect of losing NAFTA is troubling, but taking action ahead of something that may not happen can be nearly as damaging to portfolios.



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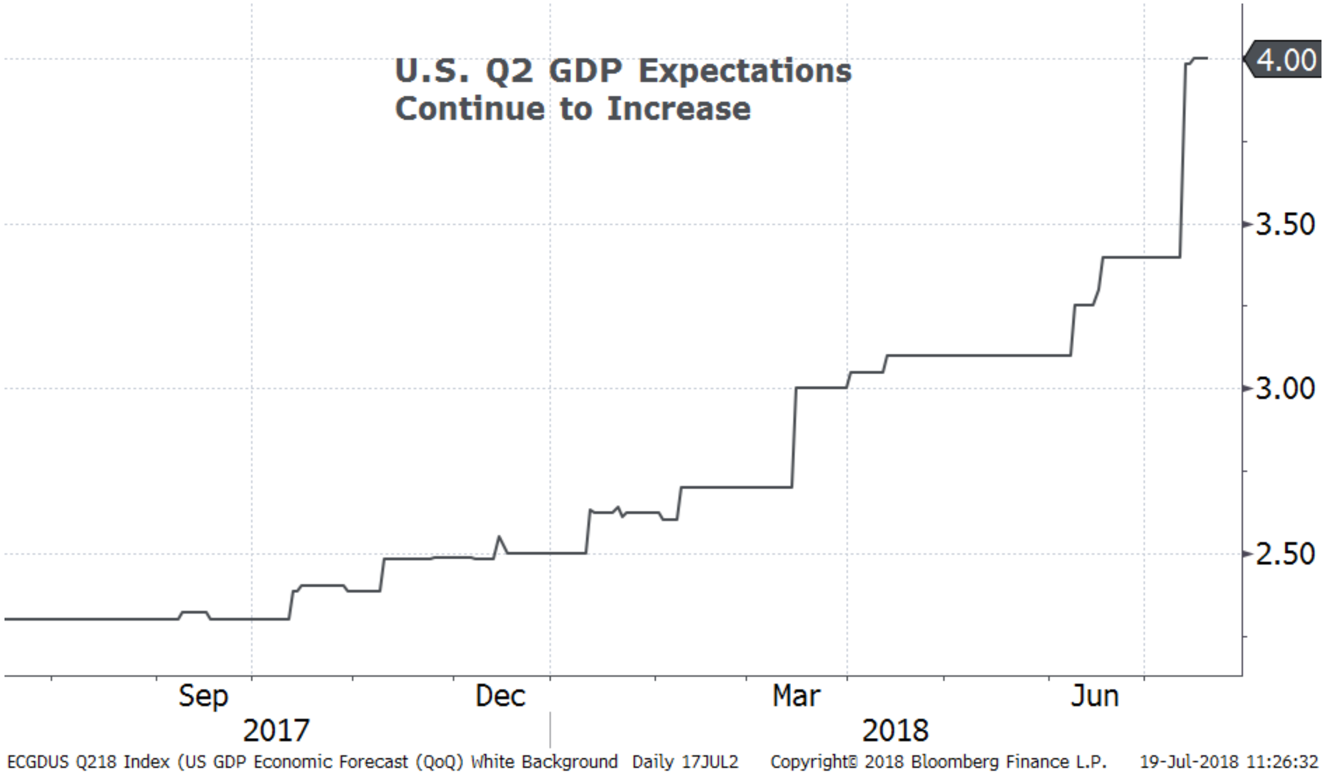
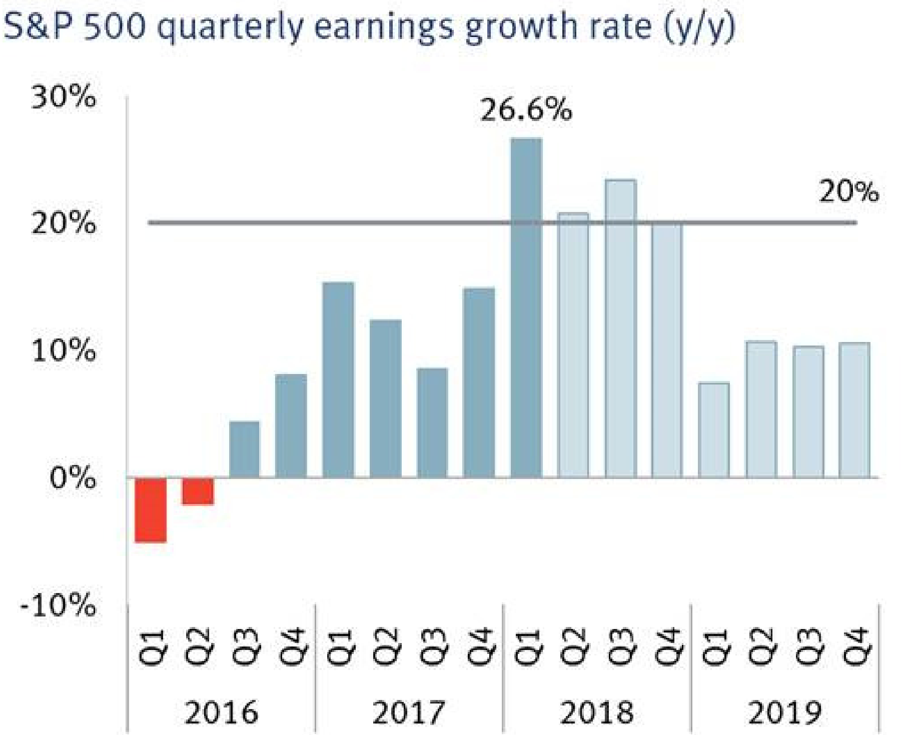
…But Economic Fundamentals Remain Robust

- 4% GDP growth isn't a "new normal" but it is an encouraging out come nonetheless.
- Company profits are leveraged to economic growth, and healthy GDP growth figures bode well for continued profit growth.



Earnings Outlook Remains Solid

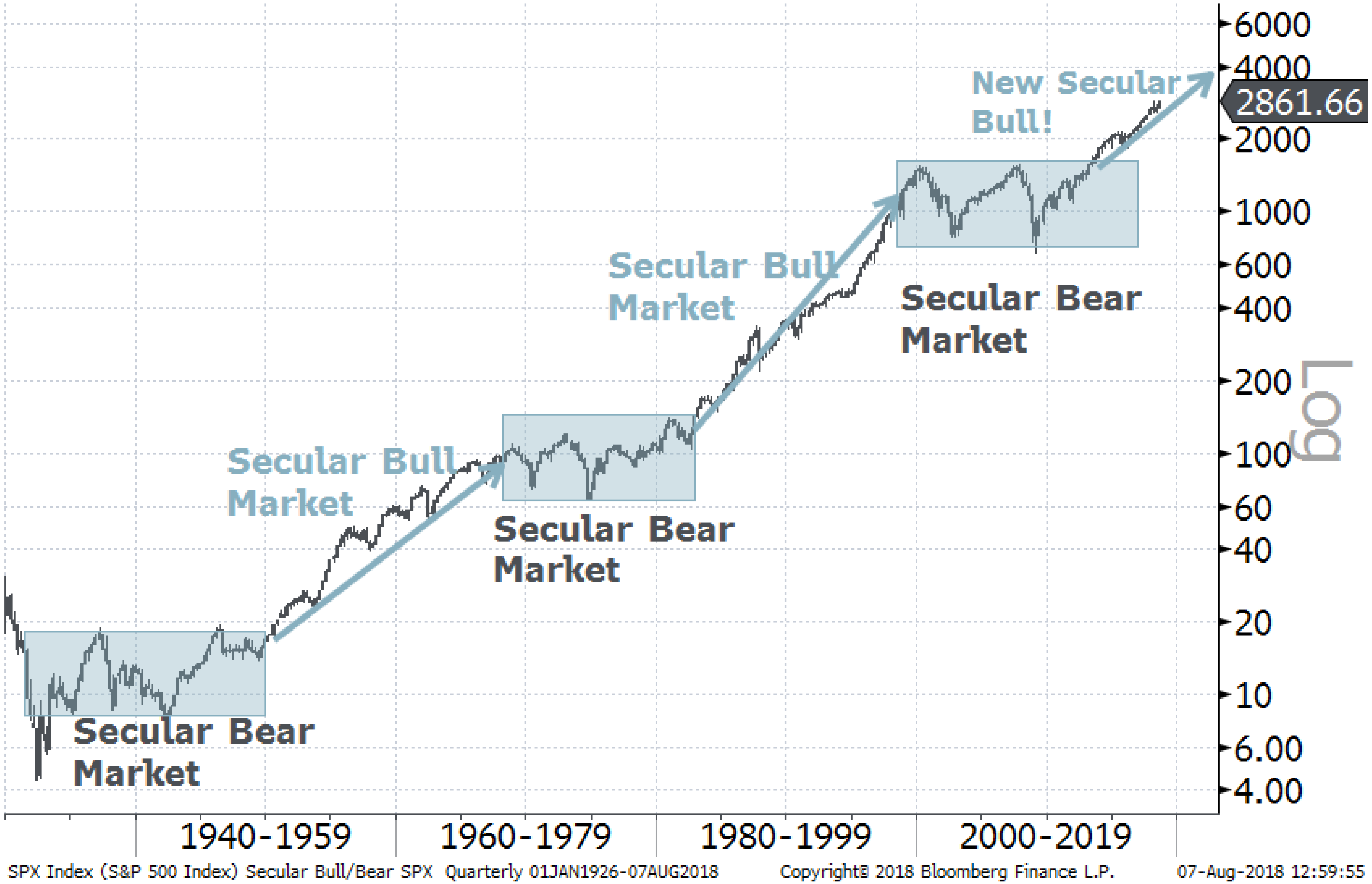
- Despite the turbulence in the headlines and markets, earnings growth has continued since volatility increased in January, and has actually accelerated as Q1 numbers started rolling in and oil prices firmed.



Q1 '18 may prove to have been the quarter of peak earnings growth this cycle, but the remainder of 2018 is on track to hold at or above 20% each quarter and 2019 EPS growth remains robust.

Source - RBC Wealth Management, Thomson Reuters; data through 6/29/18

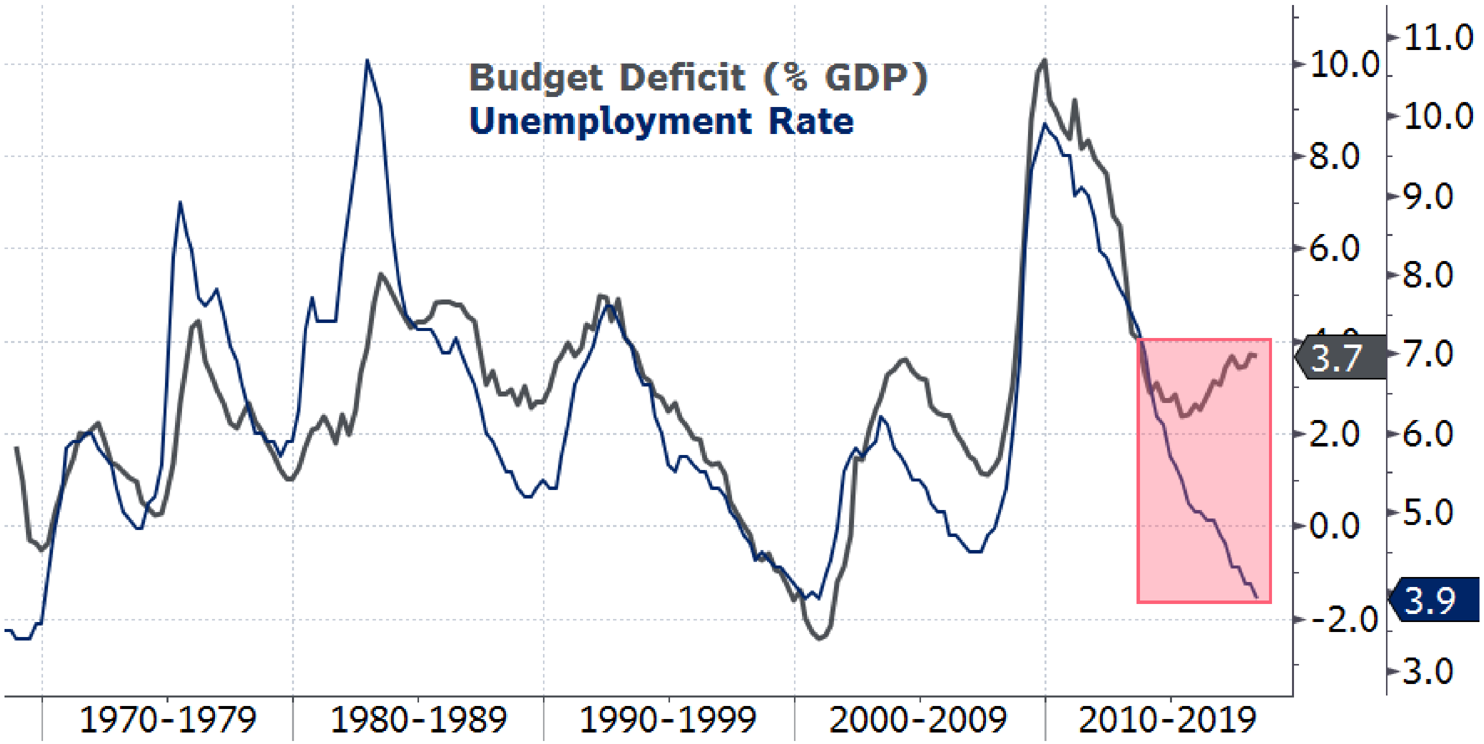
Still Firmly Entrenched In A Bull Market



Fixed Income Underperforming As Rates Rise

Large Deficits Pose Inflation Risks…

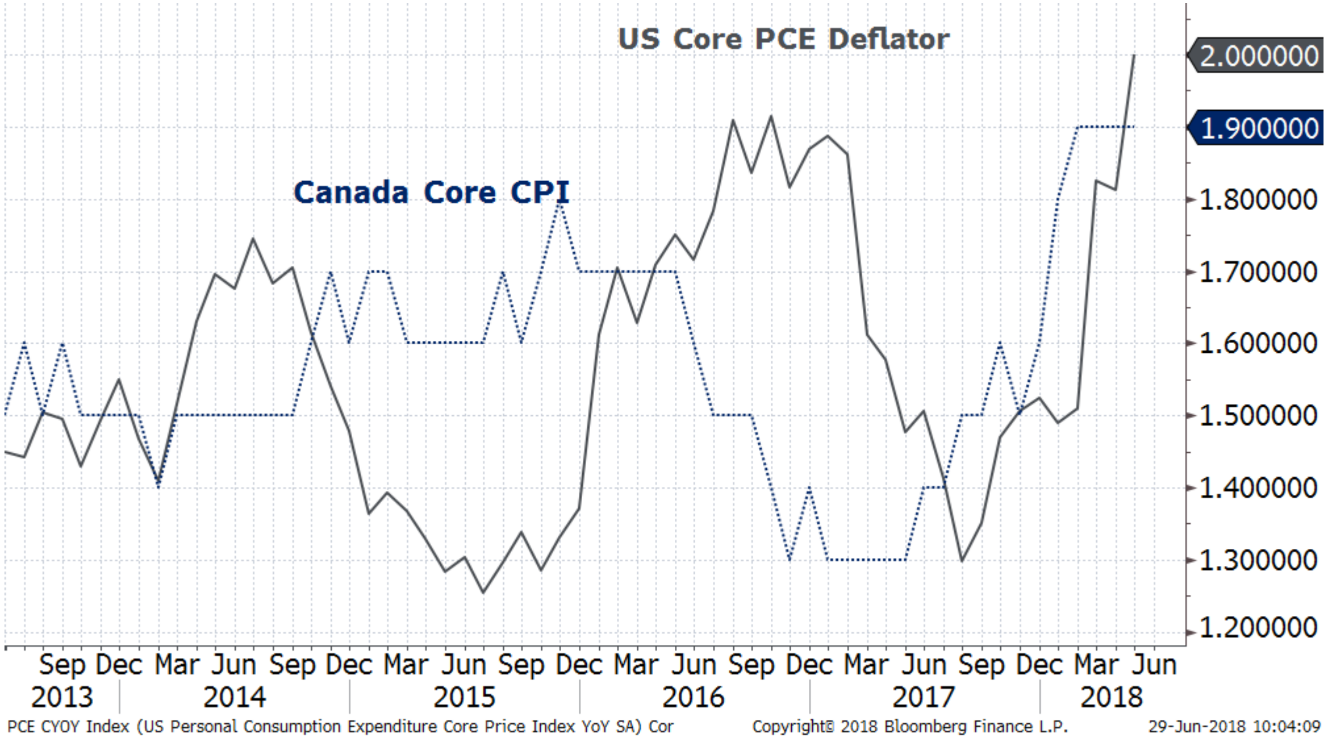
- The U.S. is running recession sized deficits just when capacity is starting to tighten.
- We continue to believe the economy is more at risk of overheating than tipping into imminent recession.



FDDSGDP Index (US Treasury Federal Budget Deficit Or Surplus as a % of Nominal G Copyright© 2018 Bloomberg Finance L.P. 31-Jul-2018 14:43:03

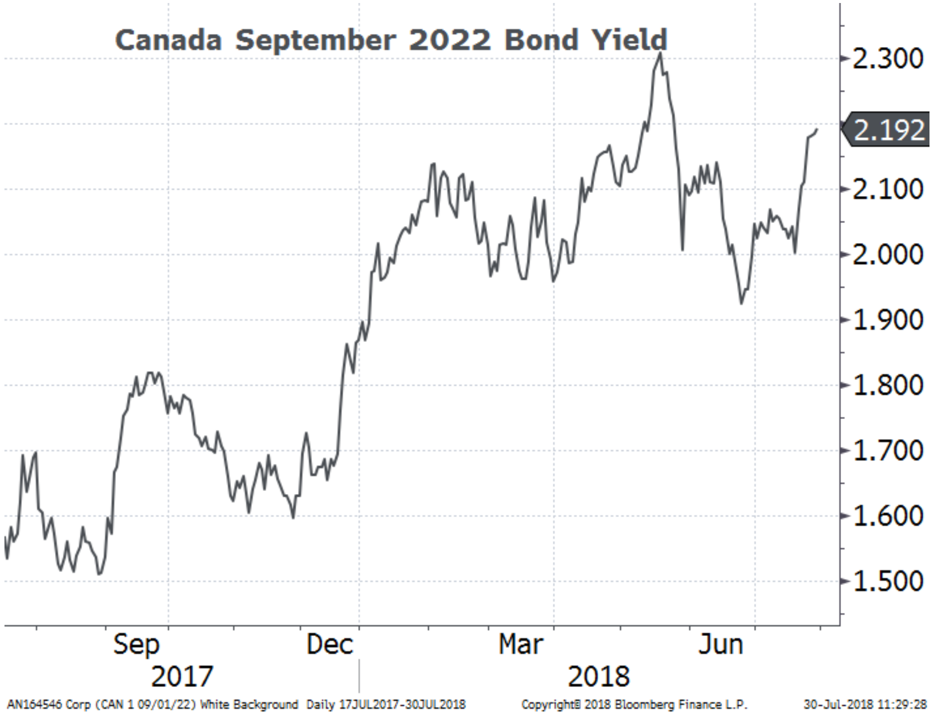
… As Core Inflation Closing In On Central Banks' Targets

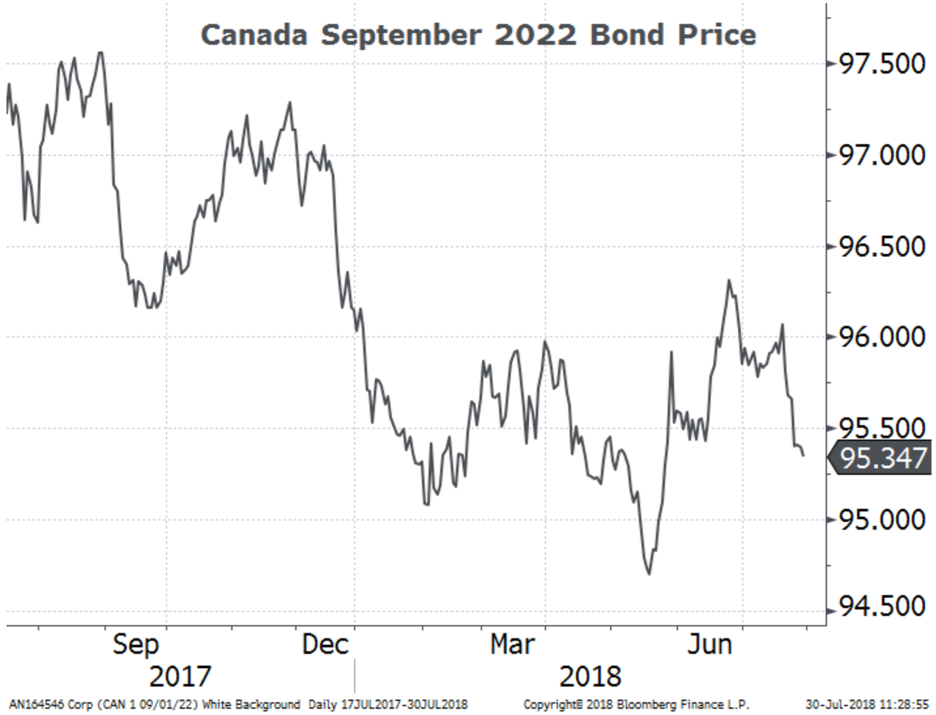
- It has been a long wait, but the Bank of Canada and Federal Reserve's inflation targets are now in sight.
- Given monetary policy acts with a lag, this suggests more interest rate increases are coming.



Higher Yields Weighing On Bond Performance

- After years of tailwinds, falling bond yields have turned around and have risen.
- This has weighed on bond performance, but at the same time sets up better future returns.





Yield Curve Making Headlines Again

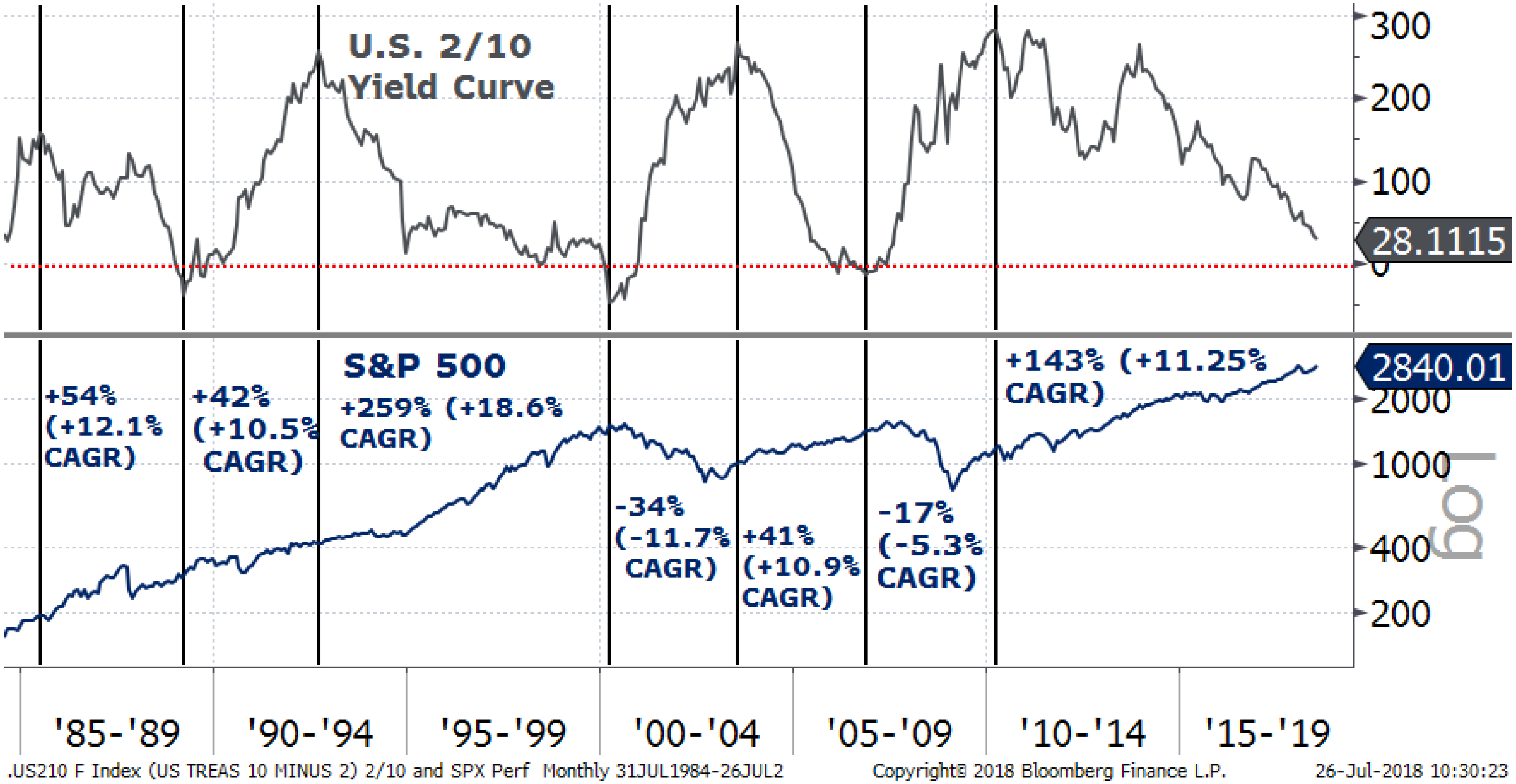
- As central banks continue to raise interest rates, the yield curve (differential between short and long-term yields) will continue to flatten.
- This is a normal outcome, and the real concern comes once it inverts as short-term interest rates eclipse longer term ones.
- Even then, there are long and variable lags between inversion and market turmoil.

first inversion	recession start (months after first inversion)	S&P after 1s/10s inversion +6 months	+1 year
Dec-56	9	2%	-13%
Sep-59	8	-4%	-4%
Dec-65	49	-6%	-11%
Mar-73	9	-6%	-13%
Sep-78	17	-4%	5%
Sep-80	12	5%	-7%
Feb-89	18	18%	12%
Apr-00	12	-5%	-19%
Jan-06	24	-1%	11%
		average	-4.3%
		avg no recession	4.2%
		avg with recession	-11.1%

Source: RBC Capital Markets US Economics, Haver

Historically, A Flatter Curve Has Meant Higher Stocks

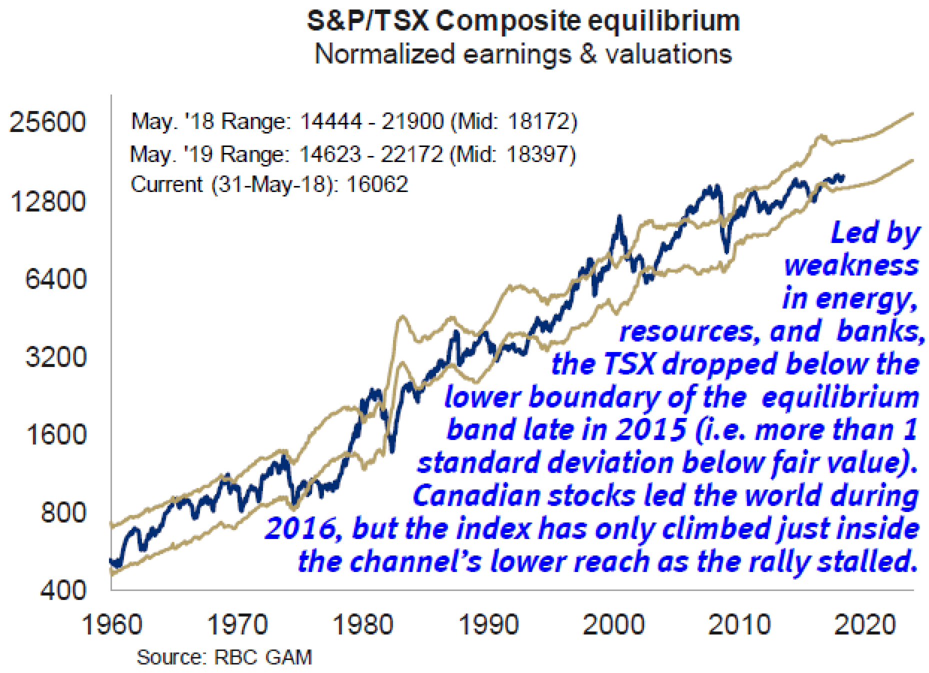
- Despite all of the noise in the media, the data shows that the majority of positive stock performance over the past 30 year has come as the yield curve has flattened!



TSX Momentum Set To Continue

After Leading the World in 2016, the TSX Still Screens Among the Cheapest Developed Markets!

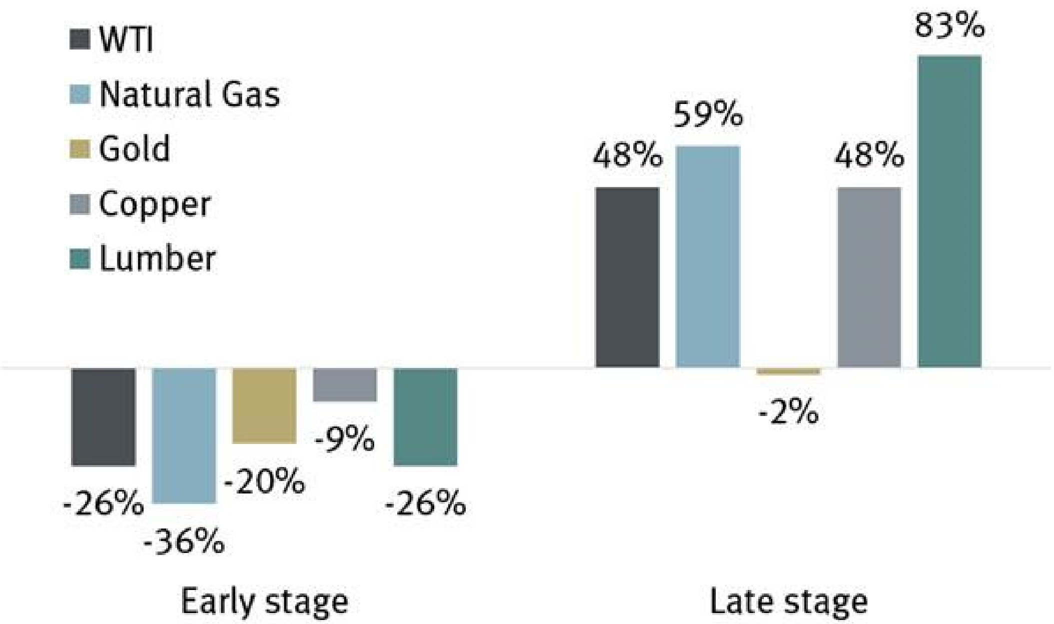
- An analysis of RBC Asset Management's fair value calculations suggest that the U.S. market requires earnings growth to maintain upward momentum.
- The TSX would also benefit from earnings growth, but has attractive valuations on its side, providing two avenues for price appreciation.



Late Stage of Cycle Bodes Well For Commodities

- Late in the economic cycle, commodities tend to shine as inflation pressures build.
- As seen below, commodity price performance can be quite meaningful, which is encouraging for the TSX.

Early vs. late stage commodity performance



Commodities tend to outperform in late economic cycles.

Source - RBC Capital Markets, Bloomberg; data as of 6/14/18

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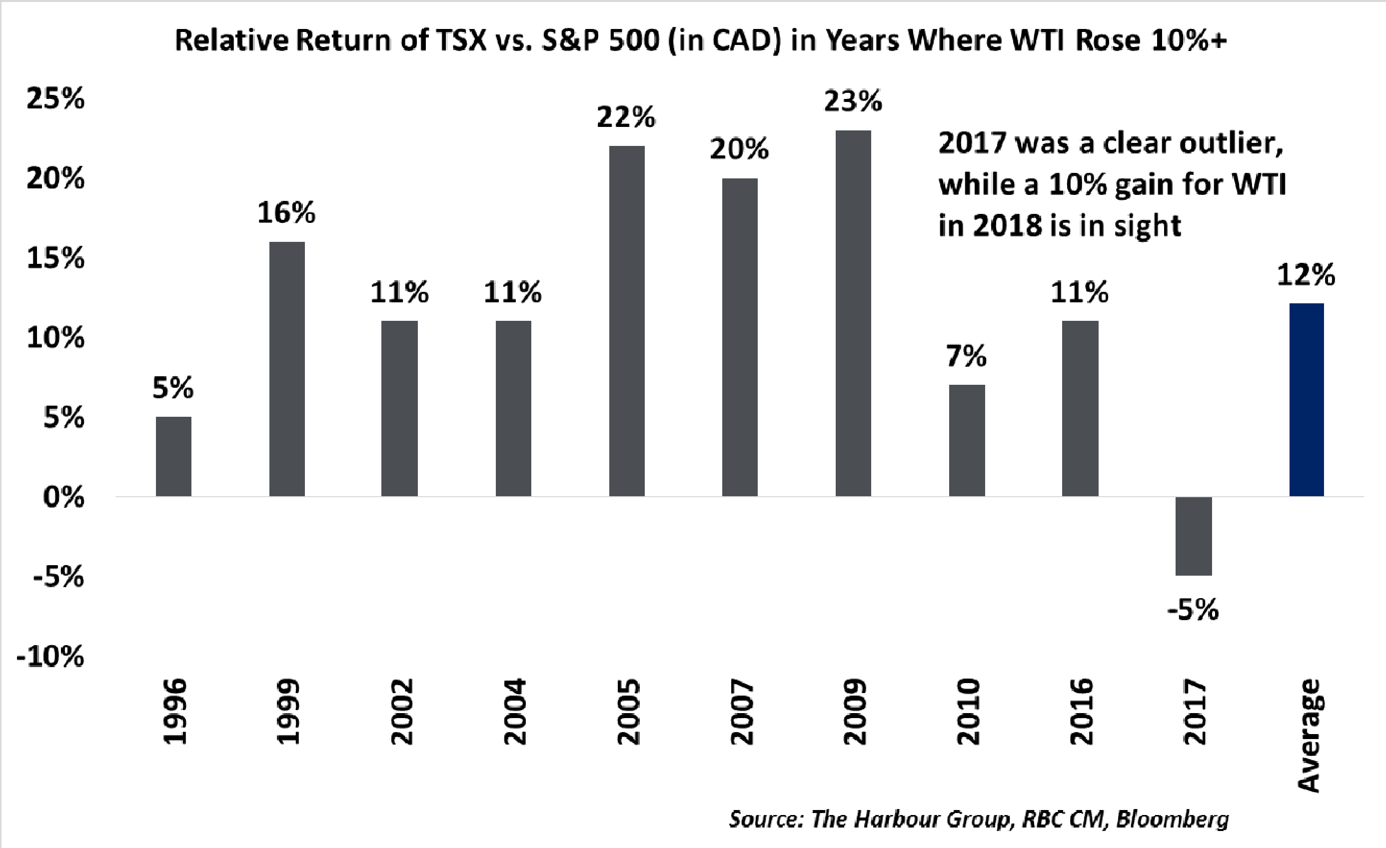
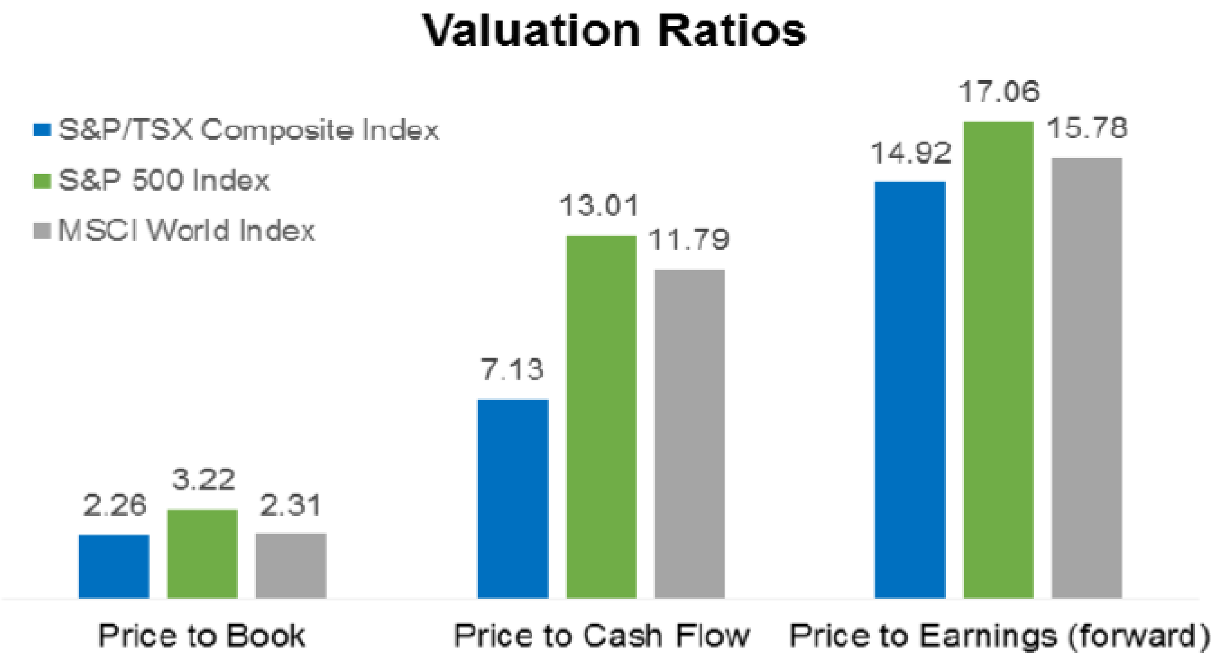
TSX Typically Outperforms When Oil Rallies

- The TSX has a strong track record of outperforming in years that see oil rise by more than 10%



TSX Screens Well On A Number Of Metrics

- Disappointing performance from the TSX has left it with some desirable characteristics, as valuations now screen as attractive versus U.S. and global markets on a number of different metrics.

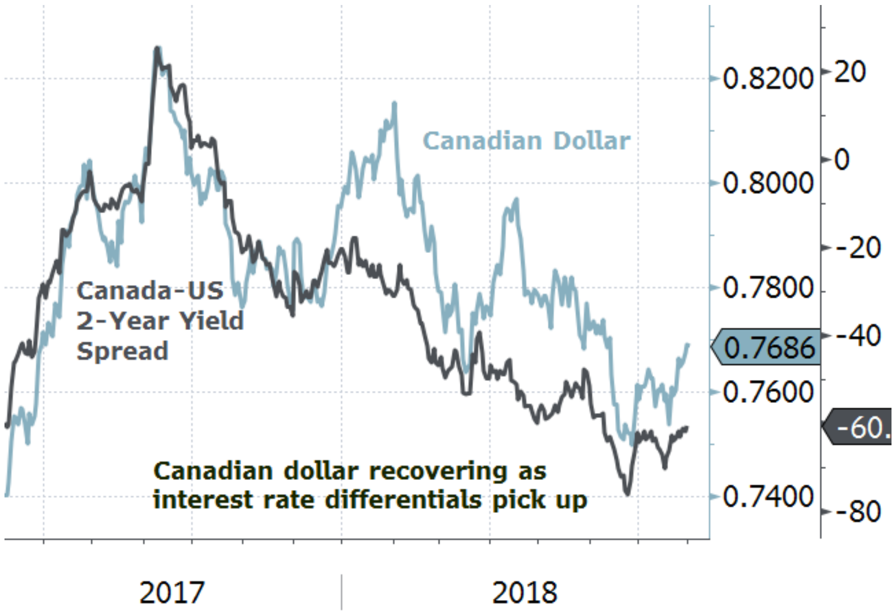


Source: Franklin Templeton Investments, as of March 31, 2018

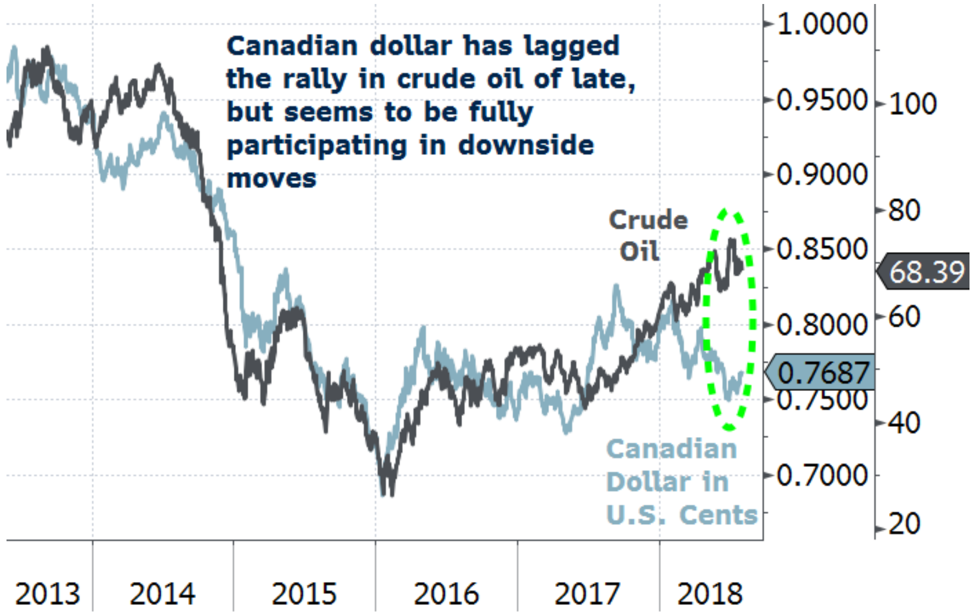
Oil Not Helping the Canadian Dollar

Canadian Dollar Lagging Oil As Interest Rates Dominate

- The relationship between the Canadian dollar and crude oil has broken down recently but continued oil strength should bolster the CAD in time.
- For now, the currency continues to closely track interest rates as the Bank of Canada has lagged the Federal Reserve on the pace of rate increases.



.CNUS2 U Index (CNUS2) cad and 2y spd Daily 07JUN2017-31JUL2018 Copyright© 2018 Bloomberg Finance L.P. 31-Jul-2018



CADUSD Curncy (CAD-USD X-RATE) CAD and Crude Daily 26MAY2013-31JUL2018 Copyright© 2018 Bloomberg Finance L.P. 31-Jul-2018 17:07:55

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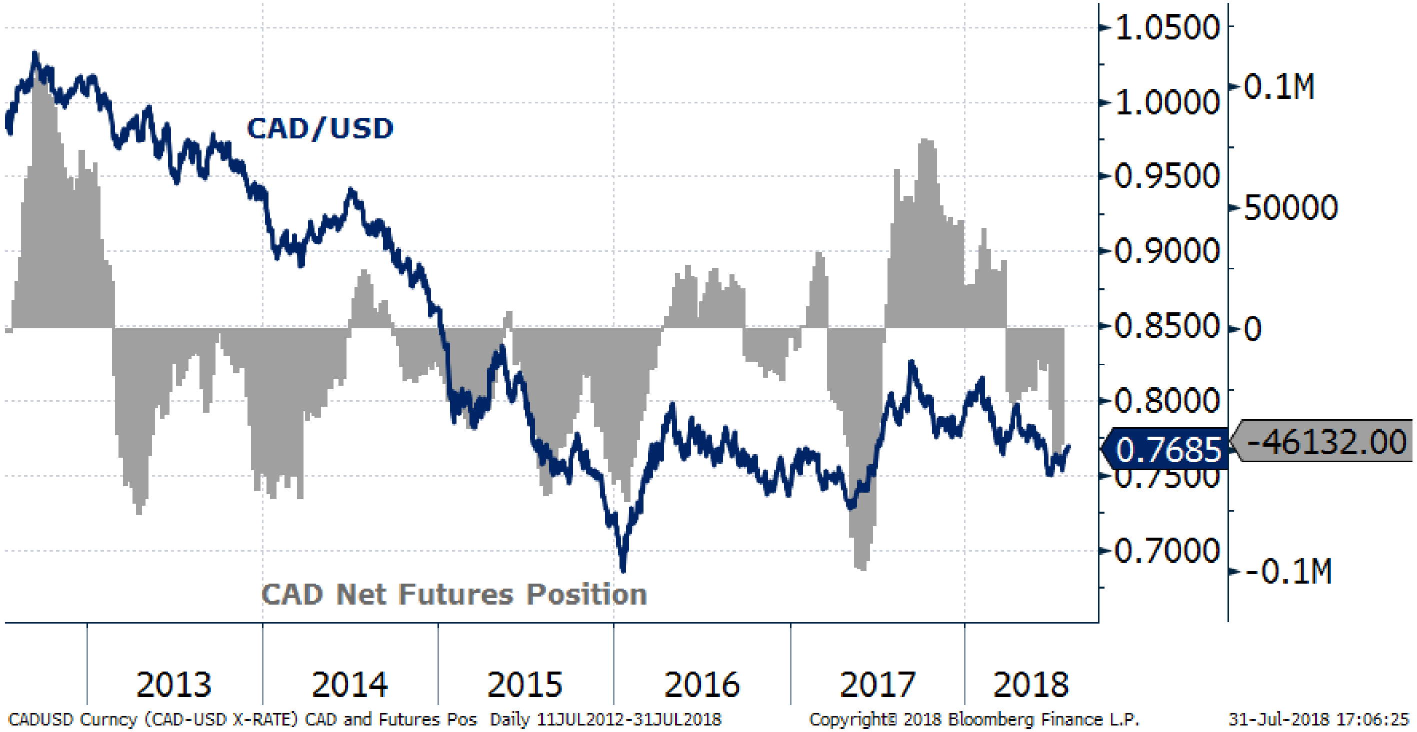
Positioning Suggests Inflection Point Approaching

- Speculative positioning in the futures market can be a useful timing signal for the Canadian dollar.
- Typically net short positions >50,000 contracts have coincided with a near-term low for the Canadian dollar, and we recently breached that threshold.



Final Thoughts

Risks We Are Thinking About

- Like most other market participants, trade tops the list – not just NAFTA but the threat of auto tariffs is something we are concerned about, as a re-orientation of the global auto industry would be immensely disruptive.
- Rising inflation is something we are watching particularly as the U.S. posts recession-sized deficits while spare capacity is tightening rapidly. An upside surprise to inflation would likely force the Fed to act and push interest rates higher than expected.
- Consumer debt in Canada and debt levels globally have been a concern for years and that hasn't changed. Despite some striking numbers, debt problems can persist for some time before markets take notice.
- Trump's recent attempts to influence the Federal Reserve pose risks, but the direction is unclear. Either he is unsuccessful and the Fed raises rates more aggressively to prove its independence, or he is successful in keeping rates lower than they otherwise should be and markets start to price in higher inflation.
- The upcoming U.S. elections are likely to see many political machinations ahead of the vote, and if Democrats gain control of one or both houses, volatility may increase as investors react to the possibility of impeachment for Trump.

Volatility Is The Price Of Admission for Equity Returns

- Recent market volatility provides a reminder that even though 2017 was remarkably calm, that environment is not typical.
- It is absolutely normal for markets to be volatile, and almost each and every year we get a 5 - 10% correction that shakes out marginal investors.
- These have proved near-impossible to time, and in our experience the most profitable course of action has been to focus on the long term and use volatility to one's advantage.

How Corrections Play Out (Since 1945)

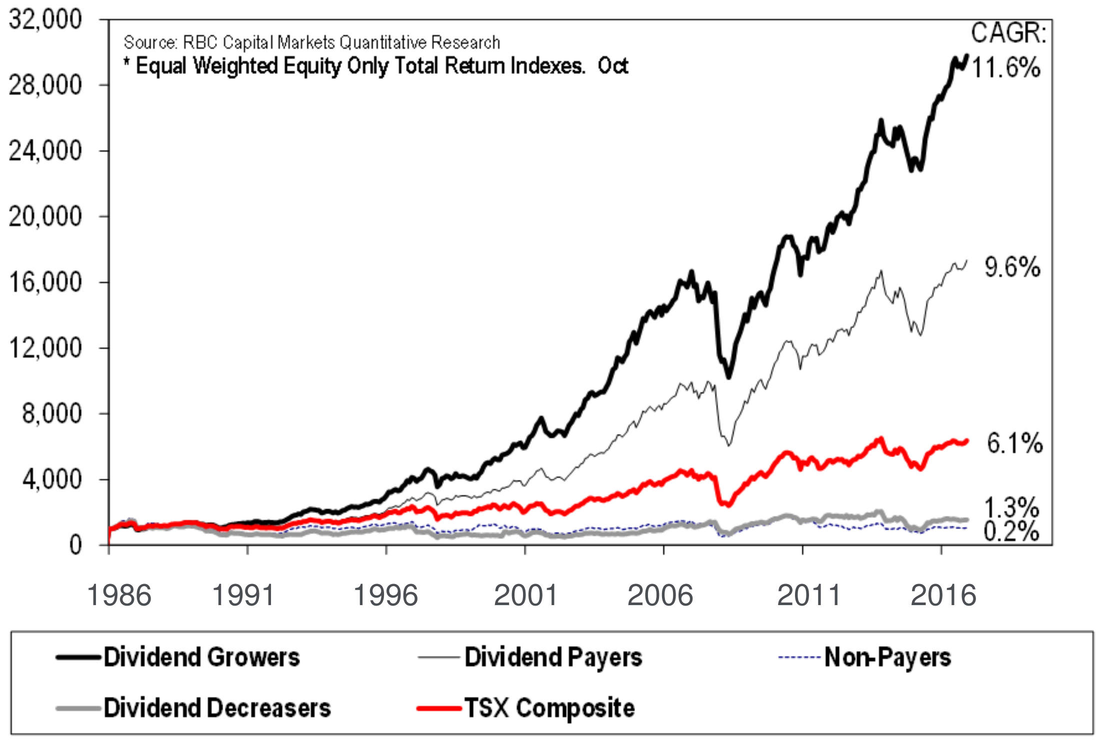
	Type (% Decline)		
	Mild Corrections (5% to 10%)	Intermediate Corrections (10% to 20%)	Bear Markets (20%+)
Number of occurrences	57	19	10
Average decline	-7%	-14%	-35%
Peak to trough (in months)	1	4	18
Recovery (in months)	2	4	26

Source: RBC Wealth Management

Be prepared to lean against the grain in periods of unexpected turbulence.

Continue To Focus On Dividends And Dividend Growth

- Dividend growth has outperformed in Canada over the long term, as demonstrated below.
- Outside of recessions, the inevitable dips have proven opportunities to buy quality on sale



Value of $1000

$29,756 – Div. Growers

$17,012 – Div. Payers

$6,237 – TSX
$1,490 – Div. Cutters
$1,064 – Non-Payers

As of September 30, 2017

In Summary

- 2018 has lived up to the promise of higher volatility, but so far the returns we would expect to see accompanying double digit earnings growth have been elusive.
- Economic fundamentals continue to point upward, taking earnings expectations with them. A clean resolution on trade could take global stocks to new highs.
- Higher interest rates have put a governor on fixed income returns, but the trend to higher rates sets investors up for better bond returns in the future.
- Canada got off to a rough start but the strength in oil prices has breathed new life into the TSX and valuations continue to be attractive.
- Holding U.S. currency has been one of the best performing asset classes year to date for Canadian investors, and with trade uncertainty persisting, the USD still holds appeal.
- Watching markets climb the “wall of worry” created by the news and politics that surrounds us every day can be stressful. Conversely, we have seen many “sure things” inflict long term damage on portfolios, and we would take the possible upside surprises of an uncertain environment than one priced for perfection.

Disclaimer

There are many opportunities and solutions available to assist you in meeting your investment and estate planning goals. However, because of the complexity of integrating your corporate and personal goals, considering the different tax systems, it is essential that you involve the appropriate professionals in order to maximize these opportunities and accomplish your goals in the most tax-effective manner.

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