The Harbour Group
of RBC Dominion Securities

Harbour Monthly

Wealth Management
Dominion Securities

An Exclusive Newsletter for Our Clients and Friends | March 2017

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Four months after the election, it's still all about the economy

- Trump continues to make headlines, but the real story is that economic and earnings fundamentals have been improving for nearly a year.
- In our view, fundamentals have more to do with the recent strength in equities than anything happening in Washington DC.
- Valuations are not what they once were, but we think they accurately reflect a more favourable growth outlook.
- We believe the equity market is poised to deliver better returns than bonds and cash, despite the ever-present risk of a correction.
- The spoils of the rally have not been distributed equally, and we see pockets of value as sector performance diverges.
- U.S. dollar exposure does double-duty in Canadian portfolios, adding crucial diversification and a hedge against a negative performance for the TSX.

Trump gets a lot of the credit, but the less exciting fact is that fundamentals have been improving ...

It has been four months and counting since the U.S. election, and Donald Trump continues to dominate the news cycle day after day. The strength in stock markets since the election has not gone unnoticed by this crowd, with the "Trump Rally" proving a popular explanation for what has driven markets higher. It is easy to see why: talk of broad tax cuts, infrastructure spending and reduced regulations all spell higher corporate profits, but so far it is just that – talk. Where we have seen concrete action since the election is in economic fundamentals. It just so happens that economic data turned up around the election as well, continuing a trend that started earlier in the year as the oil market bottomed.

Continued on page 2

The improvement in the trajectory for economic growth has also led earnings expectations higher (Exhibit 2). After two years of stagnating due to the collapse in oil prices, markets started to price in a return to growth in 2017 ahead of the election result, sparking the rally that has continued this year.

Exhibit 1 – Economic data momentum and S&P 500

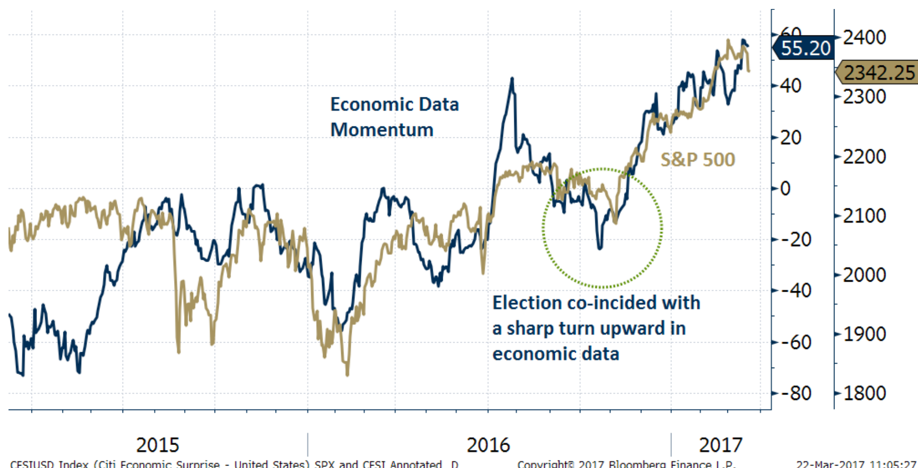
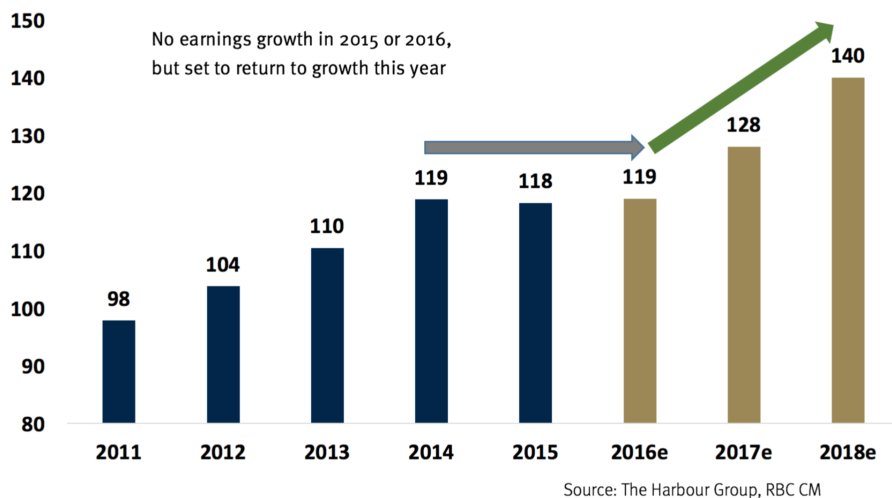


Exhibit 2 – S&P 500 operating earnings per share



Source: The Harbour Group, RBC CM

Far be it for us to say that there is zero Trump-related enthusiasm reflected in equity prices, but if one didn't know that there was an election in November and looked at Exhibit 1, it would be pretty easy to conclude that the stock market is driven by the outlook for the economy and earnings. A quick look at international equity markets would suggest the same thing – Trump's proposals are certainly a positive for U.S. business, but are mixed at best for the rest of the world. Nonetheless, equity benchmarks in Europe and Japan are up more than the S&P 500 since Election Day in local currency terms, suggesting something larger has been at play.

… leading to valuations that reflect anticipated upturn in earnings …

One of the most common questions we are getting from investors is regarding valuations, particularly in the United States. As we have all learned many times in the past, valuation is a poor timing mechanism, though that doesn't mean it should be ignored. We will be the first to admit that the valuation of the market is no longer cheap, but considering stronger earnings, low interest rates and potential earnings upside on market-friendly U.S. policy on taxes and infrastructure we think valuations are reasonable.

We would add that not all securities have participated equally in the most recent phase of the rally. Many high-quality, income-generating securities are unchanged over the last year while dividends have continued to grow, which has led to higher dividend yields. As we move away from an environment where all stocks move together, we see a world of opportunities to buy great companies that go out of favour.

… and concerns that we are at heightened risk of a correction

Is a correction just around the corner? Given the lack of volatility in recent months, one might assume the answer is "yes" but the truth is we don't know. Periods of low volatility can persist for some time and typically change without warning. After watching the S&P 500 go four months without a 1% daily decline, the inevitable happened on March 21 with the index falling 1.24%. Whether this is typical market "noise" or the start of a corrective process remains to be seen. Many investors are consumed with predicting and avoiding corrections, but we find the best strategy is to continue to focus on the long term and be prepared to take action when opportunity eventually presents itself.

Timing corrections is difficult, but longer term we have a positive view ...

Whether the next correction takes place six weeks from now or six months from now, we still think the outlook for equities is positive until the economic outlook tells us otherwise. Cash pays next to nothing, and looks like it will remain that way for a while in Canada, while the Federal Reserve seems determined to lead global interest rates higher, placing a governor on returns from traditional fixed income. The outlook for a U.S. recession continues to be benign (Exhibit 3) and until that changes we are biased toward an overweight position in equities.

... while keeping our eyes on the risks...

What are the risks to the outlook? Markets have given the new U.S. administration a long leash to implement the "big three" of tax reform, regulatory reform and infrastructure spending. If it appears these initiatives are falling behind, markets may lose their enthusiasm about future growth and place a lower multiple on expected earnings.

Conversely, if they get everything they want and we return to strong growth and inflation, the Fed may have to raise rates quicker than it otherwise would, increasing the risk of a recession. The silver lining is that in this scenario we would likely have interest rates at a level where we would feel more comfortable shifting our asset allocation toward high-quality bonds.

... and taking steps to manage them

One of the best risk management tools Canadian investors have at their disposal is exposure to the U.S. dollar. We recently did a study on the typical return of the U.S. dollar in years the TSX posts a negative return. As one would expect, the USD tends to do well, in some years actually returning a positive return larger than the TSX's negative return. Just as important, historically holding the USD has never caused any significant damage in a year the TSX is down, with a maximum loss of 1.3%.

This hedging capability is a bonus on top of the significant diversification benefits we receive by being in the U.S., as that market is strong where the TSX is weak (Exhibit 4). Sectors such as healthcare, technology and consumer staples and discretionary are all much better represented in the U.S. than in Canada, and often at more attractive valuations.

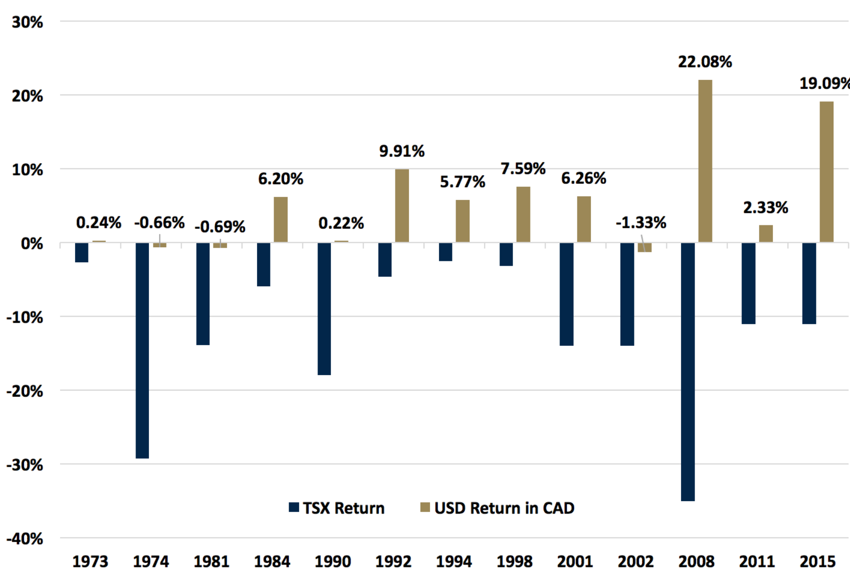
Exhibit 3 – Recessionary indicator scorecard

Start of recession	Yield curve	ISM Mfg.	Inflation trends	Capacity utilization	Housing market	Labour market
Dec-69	x	x	x	x	x	x
Nov-73	x	x	x	x	x	x
Jan-80	x	x	x	x	x	x
Jul-81	x	x	✓	✓	x	✓
Jul-90	x	x	x	x	x	x
Mar-01	x	x	x	x	x	x
Dec-07	x	x	x	x	x	x
Present	✓	✓	–	–	✓	✓

x Recessionary territory ✓ Expansionary territory – Neutral

Source: S&P, NBER, Federal Reserve, BLS, ISM, Census Bureau, Haver, and RBC Capital Markets

Exhibit 4 – U.S. dollar return vs CAD in negative TSX years

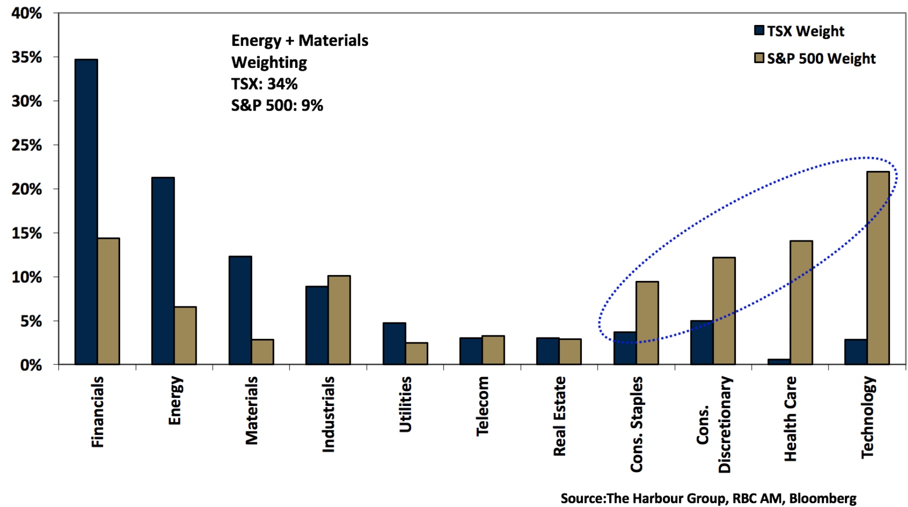


Source: The Harbour Group, Bloomberg

Hedging purposes aside, we like the USD on a fundamental basis as the Federal Reserve is set to raise short-term interest rates while the Bank of Canada stays on hold, and unless that dynamic changes, it is hard to see the Canadian dollar making up a lot of ground. RBC continues to forecast the Canadian dollar trading down to $0.725 by year end from $0.75 as of March 21, 2016. We believe we would need to see the Federal Reserve walk back its forecast of three rate hikes this year or see a significant move higher in oil for the Canadian dollar to strengthen materially.

Bottom line: While the media has a field day with the early days of a Trump presidency, the ability to ignore the noise and focus on the fundamentals has been paramount. It will be a long four (or possibly eight?) years for all of us as investors if we let the media distract us from what really matters to our portfolios. Keeping a keen eye on the outlook for earnings and dividend growth and the probability of a bull market-killing recession have served us well so far. Corrections are inevitable and unavoidable, but leaning against the grain when uncertainty temporarily reigns is the key to benefitting from the eventual upswing.

Exhibit 5 – Sectors: Canada is weak where the U.S. is strong



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