The Harbour Group of RBC Dominion Securities

Wealth Management
Dominion Securities

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Markets abhor a vacuum

- Markets have been shaken out of the summer doldrums by a re-escalation in the U.S.-China trade war.
- The July rate cut by the Federal Reserve is likely to be followed by more cuts given heightened uncertainty.
- Thus far this looks like a normal correction, albeit with timelines being compressed by the rise of the trading machines that sell first and ask questions later.
- Outside of trade tensions, recent fundamental indicators have been positive, including company earnings and continued strong employment.
- We continue to monitor risks to the outlook, but their mere presence is not justification enough to markedly shift asset allocation.
- An important component of our process is to identify signposts which have been reliable at discerning what is likely to come next.
- Sentiment moves markets much quicker than fundamentals and can quickly reverse, which plays into the hands of those who take a long term view.

It was Aristotle who first proposed that vacuums are impossible in nature. The thesis was essentially that other matter would immediately fill the void and therefore the vacuum would be unlikely to exist for long. Over time, man has seen technology advance to the point that we have been able to harness vacuums in products such as vintage incandescent light bulbs, but those are hardly products of nature. It has been our experience that markets are also not fans of vacuums. Absent a steady stream of good news, negative sentiment seems to find its way in as we have seen in the past week.

Markets shocked out of their summer slumber …

After an impressive start to 2019, the early days of August found markets in a bit of a news vacuum of their own. Earnings season was winding down, and July was topped off with a Federal Reserve meeting that saw the U.S. central bank cut rates for the first time in a decade. Enter Donald Trump, who, within a day of receiving the rate cut he so desired, decided to threaten more tariffs on China, snapping markets out of what had become a bit of a summer slumber. This is not the first

Continued on page 2

time Trump has taken advantage of the cushion provided by buoyant markets to launch a geopolitical offensive, nor is it likely to be the last. Not to be outdone, the Chinese quickly retaliated via a depreciation of their currency, which has led the U.S. to (finally?) label the country a currency manipulator.

Unsurprisingly, the re-emergence of the trade war has injected a dose of volatility into both the equity and fixed income markets. Bond markets are now pricing in a 100% chance that the Federal Reserve cuts interest rates again in September, given Fed Chair Powell cited "trade uncertainties" in his rationale to cut rates in July. We think the extreme volatility seen this week is another example of the rise of automated trading, which has compressed the timelines of market corrections. These strategies tend to provide liquidity to markets when it isn't particularly needed, only to step out of the way in times of market stress and perhaps even trying to sell ahead of everyone else.

… but move thus far looks like a "typical" correction …

While it is certainly early days, the current move fits right in the middle of the "mild correction" set, which occur about once a year on average as seen in Exhibit 1. Timing the end of such market moves is fraught with difficulty, especially when they can be resolved by a few taps on the mobile phone of one man. While the move was less violent, U.S. stocks underwent a six per cent correction in May that was largely caused by Trump's threat of tariffs on Mexico – delivered via Twitter. That correction started to rapidly unwind after the threat was rescinded. We often say there is no use trying to figure out what politicians are going to do, but we do have to keep in the back of our minds that corrections that commence with a tweet can also be ended with one.

… and fundamentals remain solid

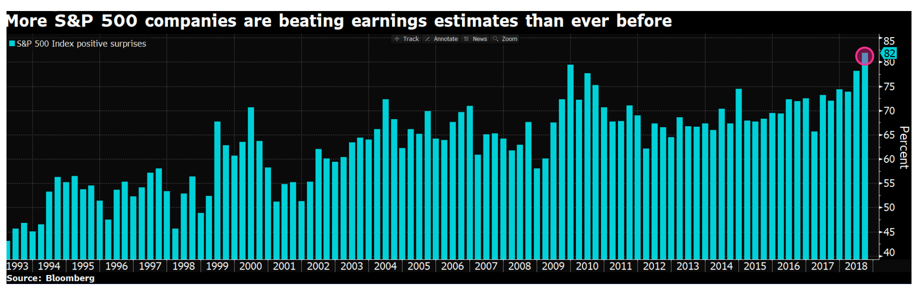
With markets down sharply in just a couple of sessions, it is easy to forget that we just concluded an earnings season that was better than expected. In fact, according to Bloomberg, we just saw more companies beat earnings estimates than we have seen in the history of the data going back to 1993. As seen in Exhibit 2, the series has been in an uptrend for a long time, suggesting analysts and companies have refined the dance of creating "beatable" expectations and then going on to do just that. However, markets still tend to trade on how companies' results compare to expectations, and by that measure they continue to do just fine.

Exhibit 1: How corrections play out (since 1945)

	Type (% Decline)		
	Mild Corrections (5%-10%)	Intermediate Corrections (10%-20%)	Bear Markets (20%+)
Number of occurences	58	21	10
Average decline	-7%	-14%	-35%
Peak to trough (in months)	1	4	18
Recovery (in months)	2	4	26

Source: RBC Wealth Management, The Harbour Group of RBC Dominion Securities
As of July 31, 2019

Exhibit 2: Surprising season for company earnings



Source: RBC CM, The Harbour Group of RBC Dominion Securities, Bloomberg

Looking bigger picture, the risks of imminent U.S. recession continue to be low. Employment continues to grow at a steady pace, manufacturing remains in expansion mode and we have seen housing data react positively to the collapse in mortgage rates. There is no doubt that an escalation of the trade war is a negative development, but it may be reflected much more in sentiment than actual economic impact. RBC's economics department crunched the numbers and came to the conclusion that if the latest tariff threat is implemented it would have a 0.1% impact on U.S. GDP. However, they also note that the tariffs we have seen so far have been mostly offset by the devaluation of the Chinese currency, resulting in a much smaller impact than initially anticipated. To be sure, upping the ante on tariffs is by no means a growth positive, but it also has not been as bad as some have feared.

Pockets of overvaluation exist…

Much of the return in markets this year has been on expanding valuations predicated by sharply lower bond yields. This is particularly true in the case of "low volatility" stocks, which have seen valuations expand materially compared to "value" stocks, as yields have collapsed (see Exhibit 3). This is in sharp contrast to "value" stocks, which have actually seen price/earnings ratios contract. This trend has been going on for a while, but has taken on a new life in 2019. So long as economic growth and interest rates remain low, investors are likely to favour stocks with predictable earnings and growth prospects. At some point, this will likely change, and in the meantime we believe it is prudent to maintain a diversified exposure to securities that fit both of these descriptions.

Exhibit 3: Forward P/E ratio of "low volatility" stocks vs. "value" stocks

Source: The Harbour Group, Bloomberg

… but valuation is a poor timing mechanism without a breakdown in fundamentals

A big part of our role as money managers is to keep our eyes on the horizon to see if the investment winds are shifting. Some of the signposts we are looking at that would suggest the correction is in the latter stages include signs of progress between the U.S. and China (obviously!), measures of investor sentiment turning extremely bearish (which has been a great contrary indicator for nearly every correction this cycle), and a turn higher in government bond yields (which would be indicative of higher economic growth and inflation expectations). Conversely, if we were to see access to credit start to dry up, a further inversion of yield curves (short-term rates higher than long-term rates), or a new front in the trade war (tariffs on European autos, for instance) we would likely have to re-evaluate our investment stance.

Bottom line

It is important to remember that "normal and healthy" corrections feel like neither of those two adjectives when we are living through them. The key differentiator between a correction and the beginning of something more meaningful is if a breakdown in sentiment is confirmed by a deterioration in fundamentals. Sentiment tends to move much faster than fundamentals and more often than not overshoots the mark. As described above, we don't believe that fundamentals are yet under sufficient pressure to argue for a large-scale shift toward a defensive asset allocation within the context of a balance portfolio. Balanced portfolios are designed to ride out bumps in the road such as we are experiencing now, yet still maintain the flexibility to act should opportunities arise. Volatile markets have a habit of causing investors to shorten their time horizon. In reality, they reward investors who are in a position to take advantage and keep their focus on long-term results.