The Harbour Group
of RBC Dominion Securities

Wealth Management
Dominion Securities

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TSX has turned the corner – can the momentum continue?

- The TSX's performance has been frustrating for much of the past year, but trends have started to improve in recent weeks.
- Current trends suggest that outperformance could continue as 2018 rolls on.
- A turn in oil prices has breathed some life into the TSX, despite this sector only making up a minority of the market.
- Earnings trends have mirrored those in the U.S., as earnings per share expectations for the TSX continue to rise despite volatile markets.
- Canada continues to boast attractive valuations and late-cycle characteristics that should serve the TSX well in coming quarters.

Rough start to the year in Canada ...

Canadian investors started 2018 in a dour mood, and who could blame them? While U.S. tech stocks soared, taking the S&P 500 to a 7% gain inside of a month, the TSX languished. A solid run in crude oil prices from the mid-2017 lows was not enough to get Canadian stocks moving, and with the fireworks south of the border there was little reason for international investors to see what Canada had to offer. My how quickly things can change! While the U.S. market still leads the TSX year-to-date, the TSX has made up a lot of ground since March, and it looks like the historical trends seen in Exhibit 1 may be coming back into play. Going back over 20 years, the TSX has outperformed the S&P 500 (measured in Canadian dollars) when crude oil prices (measured by West Texas Intermediate or WTI) show an annual gain of 10%+, with the glaring exception of 2017. At the time of writing, WTI crude is up 18%.

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… but the tables have turned …

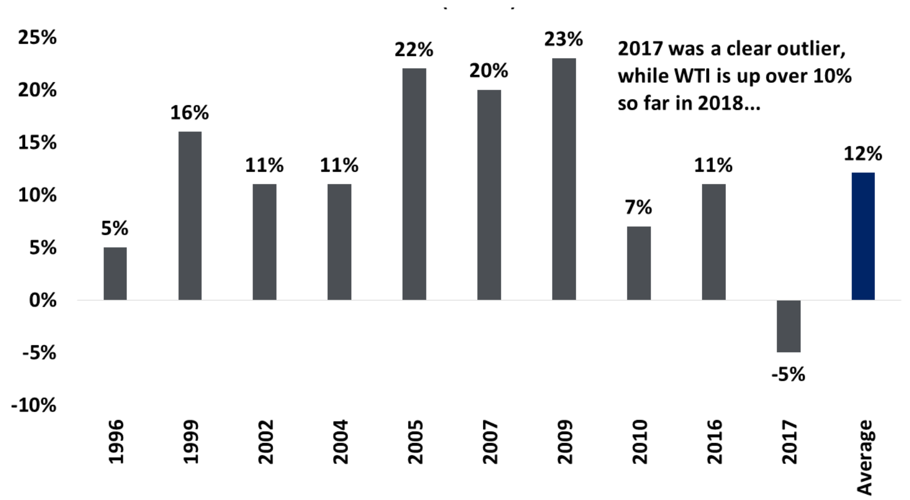
One of the reasons Canadian stocks lagged the U.S. was the relative underperformance of Canadian oil compared to WTI. By mid-March, the Western Canadian Select benchmark turned higher and now trades at a normalized level in relation to WTI. This has materially improved the cash flow prospects for many Canadian producers, and it seemed to be the push that international investors needed to start allocating capital to Canada once again. Our experience has been that once international funds start flowing into Canada it tends to have a virtuous impact on the entire market, and as of this writing the TSX has enjoyed its longest string of gains since 2014.

… and we remain well positioned for a world of higher bond yields and commodity prices

We have mentioned in the past that the TSX is well positioned for late-cycle investing due to its composition that overweights sectors that tend to do better as interest rates and inflation pressures are rising, as seen in Exhibit 3. (See our recent blog post for our view on what the bond market is telling us about the cycle.)

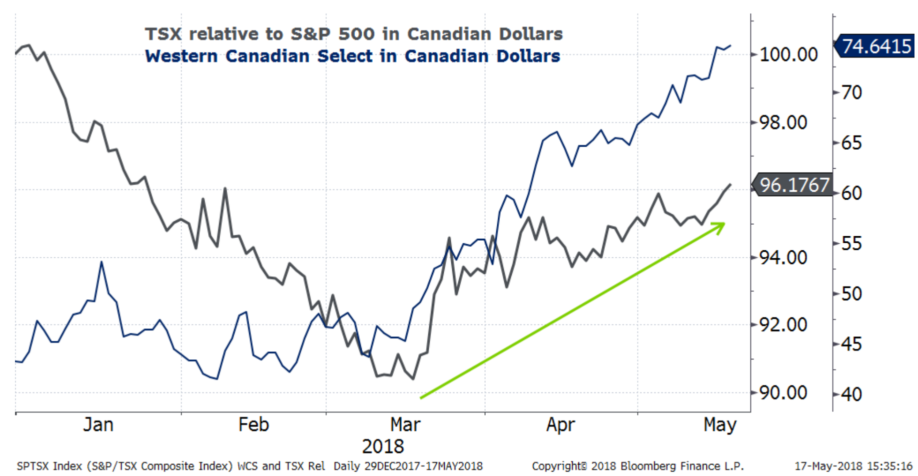
For much of the past few years, these sector overweights have been an anchor on the TSX, but as oil and commodity prices turn higher it is quickly lifting. We would note that we are by no means dyed-in-the-wool commodity bulls, but we think most fair-minded people would look at Exhibit 4 and determine that the risks to the upside are much greater than those to the downside. Throw in the growing possibility that central bankers let the economy run a bit "hot" and allow inflation to run above target, and we can easily envision a scenario where investors seek out inflation hedges in earnest, with Canada being a primary beneficiary of these fund flows.

Exhibit 1 – Relative return of TSX vs. S&P 500 (in CAD) in years where WTI rose 10%+



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 2 – TSX relative to S&P 500 in Canadian dollars



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Bottom line

After a challenging start to the year for the TSX, the "green shoots" we described in our April Market Note look to be going into full bloom. Oil prices recovering to 2014 levels have opened investors' eyes to the value we have espoused in recent months, which has led to a 5% recovery in relative performance for the TSX from March 16 to May 18. Interestingly, the Canadian dollar has not taken notice as interest rate dynamics are trumping (sorry) oil price movements, the opposite of what we often see when the TSX does well. We are optimistic that this momentum in the Canadian market can continue as other previously-lagging sectors such as the banks and rails regain momentum while large cap energy stocks are breaking to multi-year highs. Should it fade, the U.S. dollars and securities in portfolios stand by to act as a ready hedge. Being diversified is unlikely to provide the highest possible return in all environments, but has a great track record of solid long-term returns with less risk compared to all-in bets on one sector or market.

Exhibit 3 – Canada has much higher exposure to late cycle sectors than its global peers

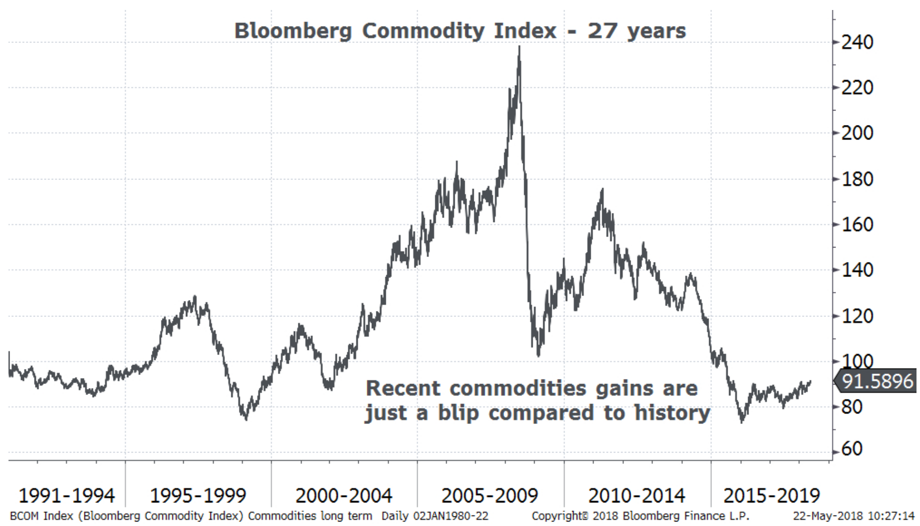
	Canada	USA	Global	Int'l
Early Cycle	**12.9%**	**57.8%**	**49.7%**	**40.3%**
Consumer	9.0%	20.1%	21.2%	23.4%
Technology	3.3%	23.2%	16.2%	6.3%
Health Care	0.6%	14.5%	12.3%	10.6%

	Canada	USA	Global	Int'l
Late Cycle	**78.5%**	**33.9%**	**41.1%**	**48.8%**
Energy	20.4%	6.1%	6.3%	5.1%
Financials	37.2%	14.6%	18.1%	21.5%
Industrials	9.5%	10.2%	11.5%	14.4%
Materials	11.5%	3.0%	5.1%	7.9%

As of September 30, 2017

Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 4 – Bloomberg Commodity Index – 27 years



Source: Harbour Group of RBC Dominion Securities, Bloomberg

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