The Harbour Group
of RBC Dominion Securities

Harbour Monthly

Wealth Management
Dominion Securities

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Turbulence continues, but fundamentals remain on track

- After the sharp jump in volatility that began in February, markets continue to regain their footing.
- While news out of Washington continues to dominate the headlines, what the media ignores is that fundamentals continue to carry on upward.
- This feels like yet another market "panic attack," whereby markets correct based on news or political events that end up having little impact on earnings.
- Higher bond yields are one factor that has taken the rap for the uptick in volatility, but we believe higher yields are a long-term positive for investors.
- U.S. dollar exposure proved frustrating for much of 2017, but so far in 2018 this natural diversifier has proven its worth.

Volatility has declined, but not vanished ...

Since the dramatic volatility in markets erupted in early February, equity markets have worked to regain their footing. Despite bond yields remaining near their highs and a renewed protectionist bent from the White House, equity markets have sustained levels above the dramatic lows put in at the height of the correction. The fact that markets have weathered these factors reinforces our belief that the worst of the selloff was driven by technical factors described in our February Market Note.

... while fundamentals continue to flash green ...

A funny thing happened when market volatility picked up this year – earnings expectations continued to rise! As seen in Exhibit 1 on the next page, S&P 500 earning expectations for the next 12 months continued to tick higher even as markets jumped around in February and early March.

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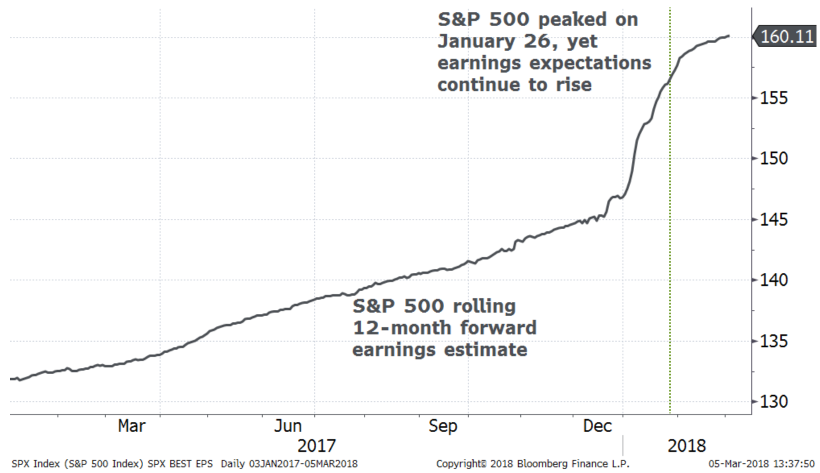
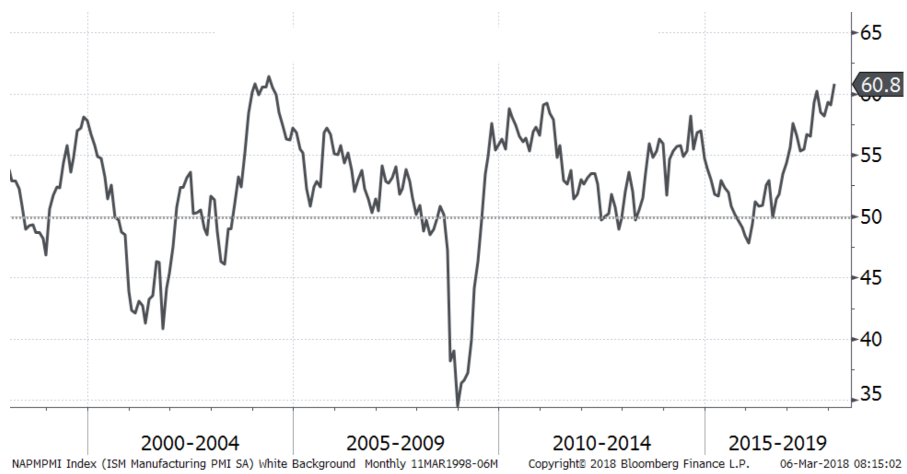
At the same time, forward-looking indicators like the ISM Manufacturing Index (Exhibit 2) have hit the highest levels in a decade and unemployment remains extremely low. All of this suggests that the underlying economic environment remains robust, with the 2018 earnings growth story firmly intact.

Exhibit 1 – S&P 500 12-month earnings estimate



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 2 – ISM Manufacturing Index



Source: RBC Dominion Wealth Management

… suggests this was just another "panic attack"

One of our favourite market strategists has a clever name for this type of market event. He calls them "panic attacks," and we have seen dozens of them since the 2008/09 crisis market bottomed nearly nine years ago to the day. Most of the time these "panic attacks" are prompted by political events (remember the seemingly never-ending Euro crisis?) or growth scares that get investors worried about a recession and bear market in stocks. This latest episode is one of the few we can remember in recent history that was sparked by concerns that economic growth was too strong. While many investors have warned and worried about sharply higher bond yields for some time, it seems the rise in yields seen in recent months has nonetheless taken markets by surprise.

Higher interest rates – friend or foe?

The question above is something all investors have on their minds in 2018. All conservative investors (us included) would love to see bond yields at levels that can provide a return well ahead of inflation. The path to get there can be rocky, though, particularly after so many years of yields being depressed by central bank activity. The spark for the correction that began in earnest in early February was a strong January employment report and wage figure that pushed 10-year U.S. Treasury yields to multi-year highs, which spooked stock investors used to low yields. A great example of this is what happened in 1994 (as shown in Exhibit 3 on the next page). Back then, surprise interest rate hikes from the Federal Reserve sent bond yields soaring, and stocks initially wobbled. Once it was clear that the rise in rates was over and economic growth remained on track, the market continued its upward trajectory. This is the pattern we would expect to play out this year as well.

We think 10-year Treasury yields breaching 3% would likely lead to more short-term volatility for stocks. Many companies have been valued on the view that yields would stay low for a long time and a disruption to this view could cause a revaluation for some companies, but perhaps not where one would think. Many of the most yield-sensitive industries (telecommunications, utilities, REITs, etc.) have already revalued fairly significantly, and that may be where the opportunity lies. Formerly high-flying dividend payers now carry yields significantly higher than they did just a couple of years ago as the market frets about higher yields. Should bond yields rise much further, we could also have an opportunity to increase exposure to high-quality bonds, a sector that has been near-uninvestible for many years. The ability to generate good income combined with the risk management impact of these securities is something we will look to gain exposure to should the opportunity present itself.

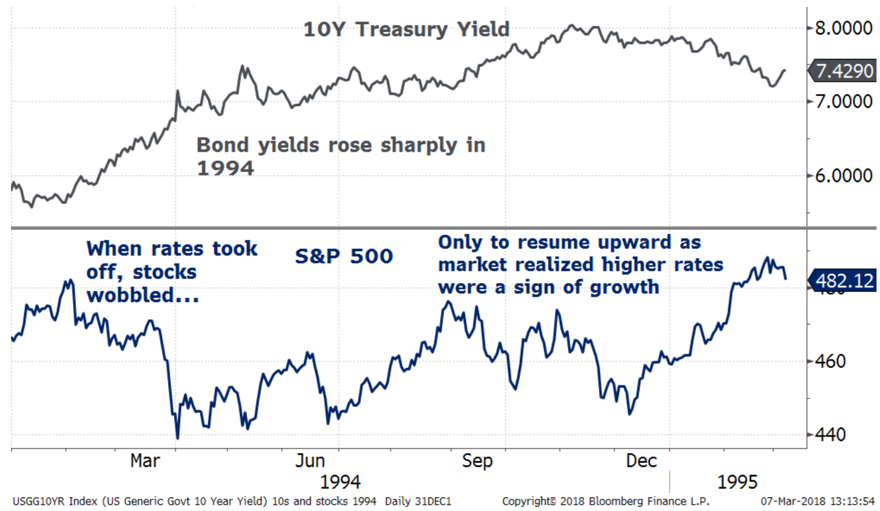
U.S. dollar doing its job

Speaking of risk management, our good friend the U.S. dollar has come back into Canadian investors' good graces in February. After what proved to be a frustrating 2017 (and January 2018) for U.S. dollar holders, the hedging properties of the dollar kicked in right on schedule as volatility returned to equity markets last month. With the threats to the Canadian economy from NAFTA, housing and an overburdened consumer not going away anytime soon, it is reasonable to think the Bank of Canada may lag the Federal Reserve in raising rates. If this comes to pass, we would expect further U.S. dollar strength, and all the while investors should continue to get the "volatility offset" that the U.S. dollar has become known for to Canadian investors.

Bottom line

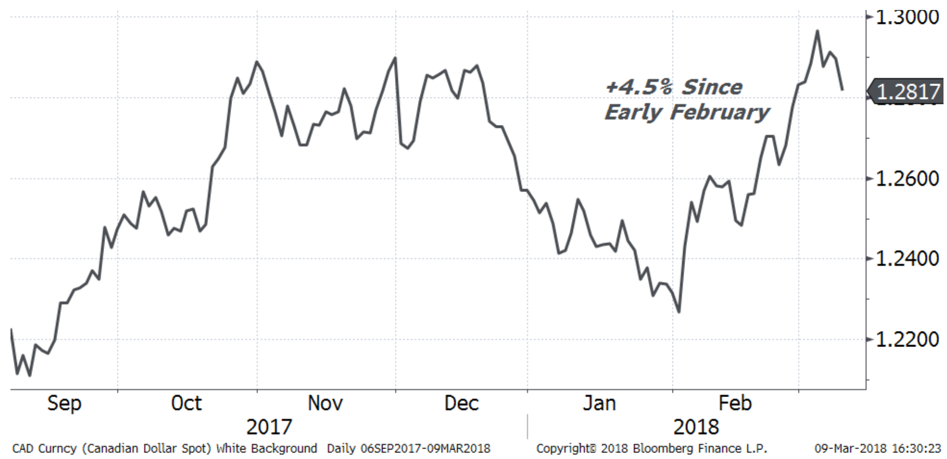
The timeline for corrections of the magnitude experienced so far this year suggests a return to new highs is more likely to be measured in weeks instead of days. So long as we continue to make progress on earnings, we are happy to be patient and embrace the inevitable flare-ups in volatility along the way. While painful at times, the net result has been that a lot of high-quality businesses (in Canada in particular) are trading at their most attractive valuations (and dividend yields) in years. Meanwhile, as bond yields creep higher, we get closer to the day where we can revisit what has historically been a large weight and return generator in portfolios.

Exhibit 3 – Bond yields and stocks in 1994/95



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 4 – U.S. dollar hedge kicked in right on schedule



Source: Harbour Group of RBC Dominion Securities, Bloomberg

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