The Harbour Group of RBC Dominion Securities

HARBOUR MONTHLY

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AN EXCLUSIVE NEWSLETTER FOR OUR CLIENTS AND FRIENDS

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STRATEGY Q3 2015

- Dividends have saved the day so far this year
- The Canadian bond market is priced for low rates for a very long time
- We worry like everyone about the possibility of higher rates, but they will likely be slow to materialize in Canada
- REITs and Utilities trade as though higher rates in Canada are a sure thing and we see an opportunity to add exposure to high quality names
- In currencies, the risk is further CAD weakness – Bank of Canada rate cuts, Fed hikes likely, election season coming
- Maintain foreign exposure and add on episodes of C$ strength
- Foreign risks creep in again but they seem manageable at this point
- Higher volatility is the new normal – be prepared to take advantage
- TSX's concentration issues come back to the forefront but in a new form
- Market cycle has room to run – we do not see many of the excesses typically in place at "the top"

PERFORMANCE IN 2015 PROVES THAT DIVIDENDS MATTER

Equity market performance in the first half of 2015 solidified one of our long-standing themes – the importance of the return generated by dividends, particularly during turbulent markets. On a broad index basis, dividends were responsible for >100% of the total return of the TSX (without dividends the index posted a small loss), and >80% of the return for the S&P 500 came from dividends. Over the long term, dividends have been a significant contributor to total return (Exhibit 1), something that was temporarily forgotten in the go-go years of the late 1990s.

The level and trajectory of interest rates will continue to determine the course of asset allocation in the months ahead, and Canada and the U.S. appear to be on a divergent course for the next year at a minimum. The Bank of Canada cut rates again on July 15, while the U.S. Federal Reserve seems as determined as ever to start the process of raising rates. These expectations of the U.S. raising rates while

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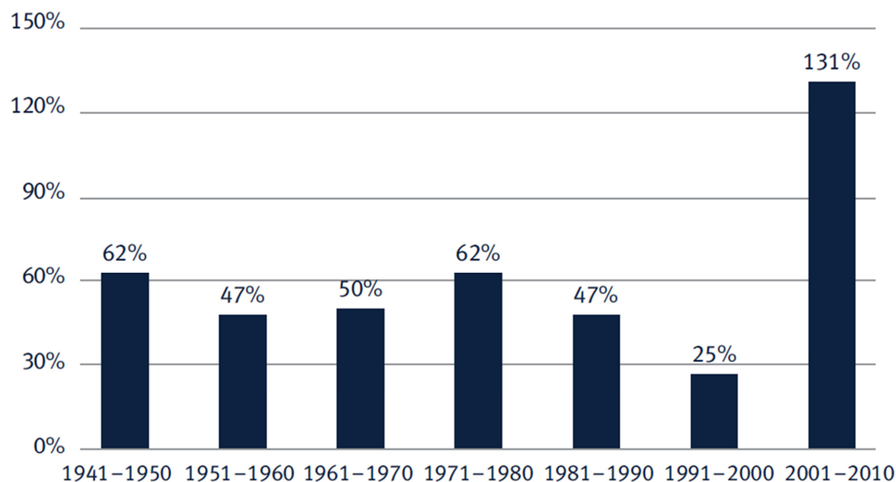
Exhibit 1



Source: RBC Capital Markets Quantative Research

Canada cuts interest rates also feed into currency markets and are one of the main reasons the Canadian dollar has lost value versus the U.S. dollar over the past few years.

Canadian Dollar to Remain on the Defensive, but Majority of Move Likely Over

The collapse in oil prices has certainly played a role, but the loonie has been heading lower ever since the Bank of Canada shifted from a view that higher rates were their next move, with this year's cuts accelerating the move lower. We feel the majority of the move in magnitude and velocity is likely behind us (RBC sees the CAD bottoming at $0.7633. this year vs. $0.77 on July 17), but see little reprieve without a shift in the commodity or interest rate environment. A further risk to watch in the fall is the Canadian federal election – we would expect global investors to take a dim view of a NDP or Liberal win, particularly a majority. It is now clear that a weaker currency is the main plank of the Bank of Canada's monetary policy, with a resurgence in exports the desired result. Unfortunately, this takes time, and we are unlikely to see results in the near term.

Maintain U.S. Dollar Exposure

All of this is to say that maintaining foreign exposure is paramount given the contribution to return from currency and continued unbalanced nature of the Canadian market. Aside from the heavy oil and gas contribution that we have mentioned in the past, we now find ourselves in a situation where one large, volatile stock is having a significant bearing on index performance. After years of a nearly non-existent health care sector, serial acquirer Valeant now finds itself challenging for the second largest company on the TSX in terms of market capitalization. After advancing 66% in the first half of 2015, Valeant alone added nearly 2% to the TSX's return. This is a company that is pursuing an aggressive growth strategy and does not pay a dividend. While it has provided high returns, we feel the risk is high as well and look to more conservative avenues globally to gain health care exposure.

International Risks Causing Turbulence Again

After a few years of relative geopolitical calm, an old favourite popped back up as Greece overtook the headlines again. This combined with the massive rise and fall of Chinese stocks caused investors to start looking for parallels to Lehman Brothers and the 2008 crash. We covered these issues in more detail in a Special Market Note published July 10, but suffice it to say the evidence we have seen thus far does not suggest either of these issues is likely to cause a recession in the U.S. As we have mentioned for several quarters, an uptick in volatility (see Exhibit 2) is something we expect as the cycle goes on. It has been nearly 1400 days since we have seen a 10% correction in the S&P 500 (though we got very close in October 2014) and while historically one takes place every year or so, this current run is not the longest stretch.

Fed Back on the Table

While it is too soon to declare victory on this summer's flare ups in Greece and China, the market is likely to zero right back in on the Federal Reserve. Through all the volatility their message hasn't changed - they want to raise rates at least once this year, while markets continue to doubt it will happen. This sets up opportunities for investors who are prepared. One sector where we are looking to get more active is the investment grade bond market. Many bonds issued in recent years have had incredibly low coupons, commensurate with their low yields at issue. As bond yields go higher, older, low coupon bonds trade down in price to compensate investors for the low coupon. It has been rare to see high quality bonds trade at discounts in recent years, but we think there is a good possibility we see this happen again.

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BANK OF CANADA TO LAG THE FED

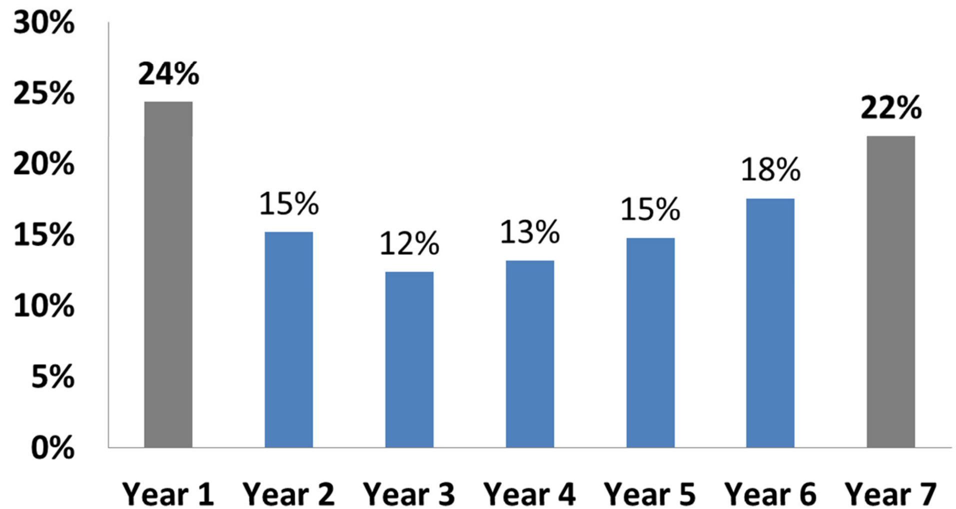
The Canadian bond market is now priced for low rates for a very long time, with market pricing suggesting the overnight rate won't return to January levels (1%) for at least three years (Exhibit 3). Is this possible? Anything is possible, but in our view the Canadian bond market is pricing in a worst case scenario that includes no recovery in commodity prices, weak U.S. growth, no import price inflation and a lack of export growth due to the weaker Canadian dollar. We think there is a possibility that one or two of those happen, but over time we would expect growth to recover either via a rebound in commodities or export driven growth. The main risk we see for the Bank of Canada is that import price inflation takes inflation to uncomfortable levels, putting pressure on the Bank to take rates higher to keep inflation in check, which is its primary mandate.

VOLATILITY CREATES OPPORTUNITY

An interesting phenomenon has taken place as interest rates have declined to historic lows – government bonds are no longer the answer to those seeking income from their portfolios. These securities now provide capital protection (if held to maturity), negative correlation to equities, and not much else. One of the ironies of the era of ultra-low interest rates is that while "safe" yield is incredibly hard to find, there is plenty of yield available for those willing to take a little bit more risk. Income in the form of dividends from blue chip companies (banks, insurance, REITs, utilities, telcos, etc.) is as abundant as it has ever been, particularly in relation to the prevailing level of interest rates and inflation. The fear of rising interest rates has led the income oriented sectors such as REITs, Telecom, and Utilities to underperform the market. As mentioned earlier,

EXHIBIT 2

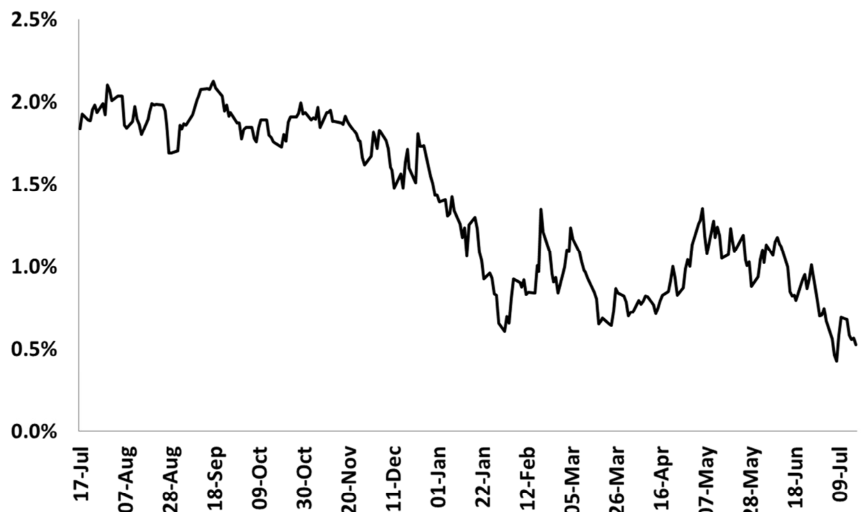
Percent of Days S&P 500 Moves More Than 1% Per Day in Bull Markets Since 1949



Source: The Harbour Group of RBC Dominion Securities, S&P Capital IQ

EXHIBIT 3

Market Pricing of Canadian 3-Month Rate 3-Years' Time



Source: The Harbour Group of RBC Dominion Securities, Bloomberg

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while higher rates are likely in the U.S., Canada is likely to lag and our long-term rates sit near historic lows. Many of these securities have come off stretched valuation levels to what we now see as more reasonable while offering solid income and in many cases opportunities for dividend growth. Given the dearth of yield available elsewhere, we would expect investors to revisit these sectors to meet income needs.

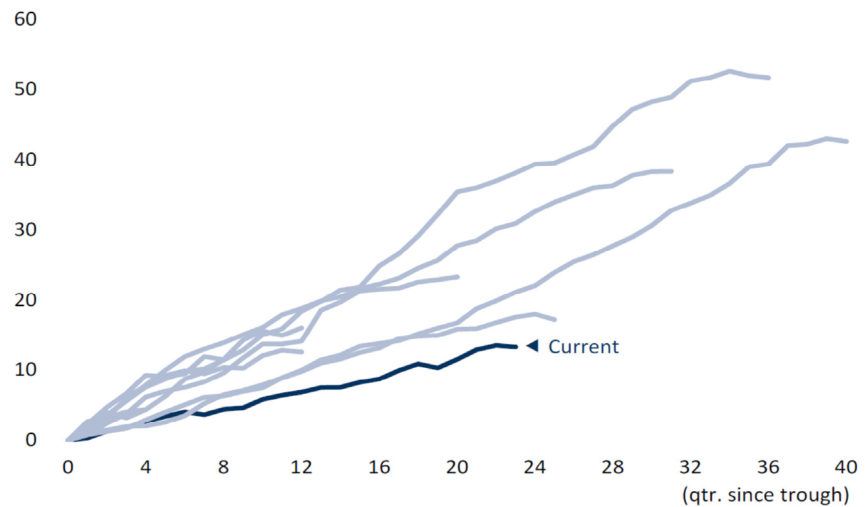
Another area of interest is the rate reset preferred share market, as performance has been severely challenged on fears that low interest rates will result in markedly lower dividends for these securities going forward. For issues coming up for reset this year, that is certainly true, but the market is now pricing the entire market as though it faces this risk, resulting in the ability to lock in attractive yields for 4+ years until reset risk arises. In the meantime, these shares are one of the few asset classes that have leverage to higher interest rates as the price decline has broadly been due to interest rate expectations as opposed to credit risk.

Market Cycle Has Room to Run

Most would agree that this cycle has been anything but normal, from how it began to the monetary policy that has propelled it. We also do not think it will be of "normal" length, as the weaker growth we have seen suggests a longer cycle (Exhibit 4). Typically it is excesses in the form of asset prices and inflation that lead central banks to push hard enough on the brakes to tip the economy into recession. We do not see that happening in the U.S. currently, and our empirical work shows that it is typically U.S. recessions that cause bear markets. In fact, if we look at the U.S. as the bellwether for the world, we see a lot of room for improvement.

Exhibit 4

Cumulative GDP Growth Following Recessions (Post-War Period)



Source: BEA, Haver, NBER, and RBC Capital Markets

When we think of a typical "peak", it is at a point where there is little room for things to get better. The late 1990s in the U.S. come to mind: GDP growth was strong, unemployment was at 4%; the stock market was booming; the government was earning a surplus (prior to 1998 we hadn't seen one since the 1970s and haven't seen one since 2002); we were basking in the glow of a post-Cold War world and people were optimistic (to say the least) about the equity market. From that point, how much better could things get? As it turned out, not much.

From our vantage point, we still have some way to go until conditions are in place for a long-term market top, as today every minor crisis is hailed as the "next global financial crisis" and investors continue to be wary about growth prospects and equity investing in general. The muted return profile year-to-date has had the effect of making valuations more attractive as earnings expectations have turned higher in recent months after initially turning lower due to the sharp decline in the energy sector. As we have said in past publications, volatility going into the first Fed hike is completely normal and expected. So long as the economy continues to perform, we think associated volatility is an opportunity to buy high quality businesses "on sale".

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