The Harbour Group
of RBC Dominion Securities

Wealth Management
Dominion Securities

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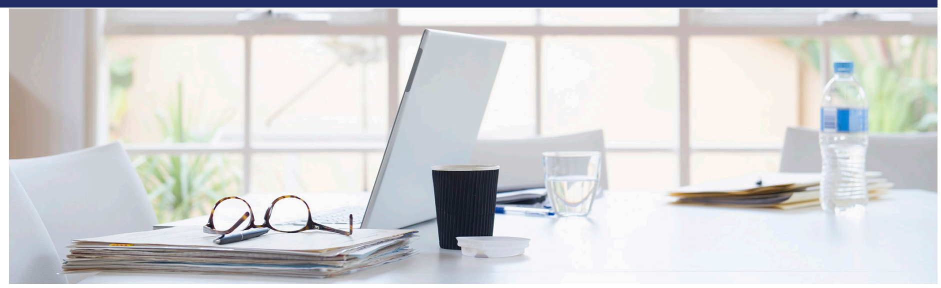

The glass is mostly full

- For the first time in years, the global economy is experiencing synchronized growth.
- Stronger growth has fed through to earnings, which have surprised to the upside in 2017.
- At this point, an overheating economy is a larger risk than imminent recession.
- Should growth continue to surprise to the upside and inflation follow, expect other central banks to follow the Bank of Canada's lead and raise interest rates more aggressively.
- Canadian bond yields have already moved markedly higher, and if global yields follow we could see opportunities in the bond market.
- Sharply higher yields would also have an impact on sector performance, hurting growth stocks but boosting value stocks, a positive for the TSX.
- The TSX has started to pick up its socks in recent weeks but we see scope for further reversion to the mean in key sectors such as banks and energy.
- The Bank of Canada appears to have seen the error of its ways, notably backing off talk of higher rates, and the Canadian dollar has reacted.

Things that keep us awake at night

- NAFTA negotations and high consumer debt levels in Canada are top of mind.
- An uncompetitive economy due to high minimum wages and high taxation are also a risk for Canada.
- Volatilty has been extremely low, and this is unlikely to last forever.
- A sharp uptick in inflation rates around the world could cause central banks to raise interest rates quicker than expected.
- Equity valuations have been underpinned by low interest rates, and a sharp move higher would likely lead to volatility.

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As we enter the fourth quarter of 2017, things are looking up for Canadian investors. For most of the third quarter, the twin forces of a slow-burning correction in the TSX (6% drop from February's highs) and a surging Canadian dollar weighed on portfolios and investor sentiment. In our August Monthly Note we suggested that simple reversion to the mean for sectors such as energy and banks would get us a long way toward normalizing the performance of the TSX and that is what we have seen take place over the past few weeks.

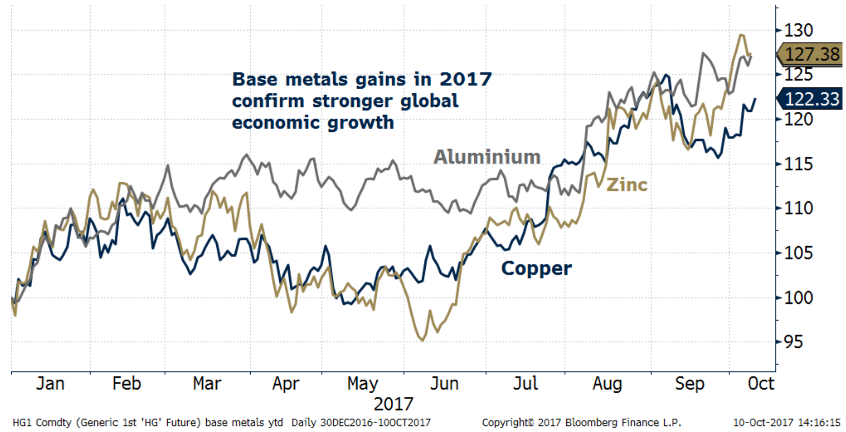
Global growth is accelerating...

One factor that has helped the TSX is the fact that we are now seeing synchronized global economic growth for the first time in years, and this is being reflected in commodity prices. While oil remains in a stubborn trading range capped in the low $50s per barrel, commodities commonly used in industrial production such as copper, zinc and aluminium are all sporting gains north of 20% in 2017 (Exhibit 1), suggesting real underlying demand from end users of these metals. When we combine this hard demand data with manufacturing surveys such as the ISM Manufacturing index at the highest level seen in over a decade, it becomes clear that global growth remains on track and the conditions usually seen at the outset of recession look some way off yet.

... while inflation is benign for now

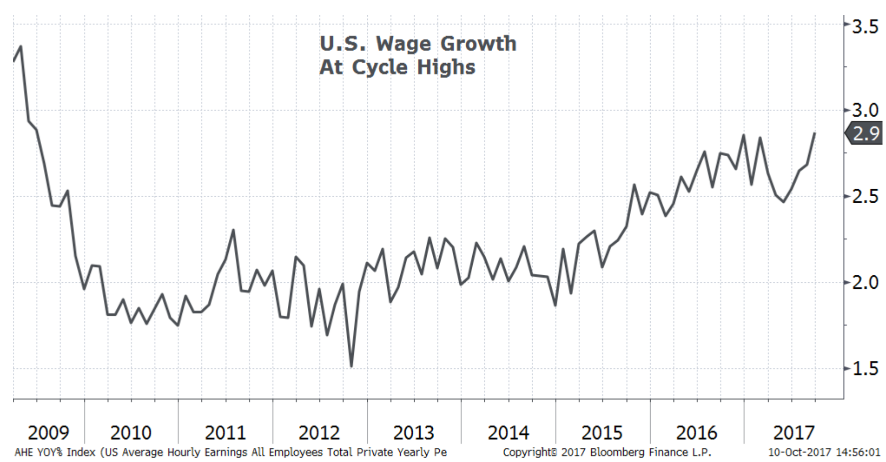
One of the hallmarks of the post-crisis global economy has been benign inflation readings around most of the developed world, and that continues to be the case today. The missing piece of the puzzle for higher inflation has been wages, and on that front we are starting to see some traction in the U.S., with wage growth now at its highs for the cycle (Exhibit 2). Should this trend continue, we would expect markets to start pricing in higher inflation in the future, as the wage growth metric has become a focus for inflation-fearing bond investors.

Exhibit 1



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 2



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Overheating is a bigger risk than recession ...

Synchronized global growth has been a rarity in a post-2008 world in which investors became accustomed to slow economic growth and record low interest rates. Paradoxically, with the risk of recession looking quite low, the bigger risk to equity markets may be economic growth and inflation that cause central banks to accelerate their interest rate normalization plans.

... and could lead to higher interest rates ...

Should central banks abruptly reverse the long-standing policy of ultra-low interest rates and continued bond purchases, we may see a true bear market in bonds for the first time in years. Policy makers are well aware of this and most of them (the Bank of Canada being a glaring exception) have taken great pains to foreshadow their actions, but a series of higher than expected inflation readings could force their hand. With U.S. interest rate markets constantly underpricing the Federal Reserve's own forecast for interest rates, them not only meeting but exceeding them could be quite disruptive for the bond market.

... which would create an opportunity for bond investors...

The sharp and sizeable rise in bond yields in Canada this year serves as a reminder that yields often go up faster than they come down, and this has been a welcome development for fixed-income investors. Should bond markets around the globe start to follow Canada's lead, we believe opportunities to increase allocations to bonds would present themselves, something we have been waiting a long time for.

... but pose a risk to growth stocks and a boost to value

While bond investors cheer higher yields, a sharp rise could also pose a risk to equity market valuations. The competition for investment dollars from bonds has been anything but fierce in the last few years, leading many income investors to where cash flow has been readily available – dividend payments! That wouldn't necessarily change if yields were to go higher, but with many growth stocks and "safe" high-yielding stocks fetching the prices they do because of the low level growth, we could see a shift into the value sectors of the market if rates rise sharply (Exhibit 3). The TSX is much more of a value-oriented index, while lacking many of the secular growth companies that have led the S&P 500 this year, so a turn higher in bond yields and inflation would be a welcome sign for the TSX.

Currency – Bank of Canada backing down

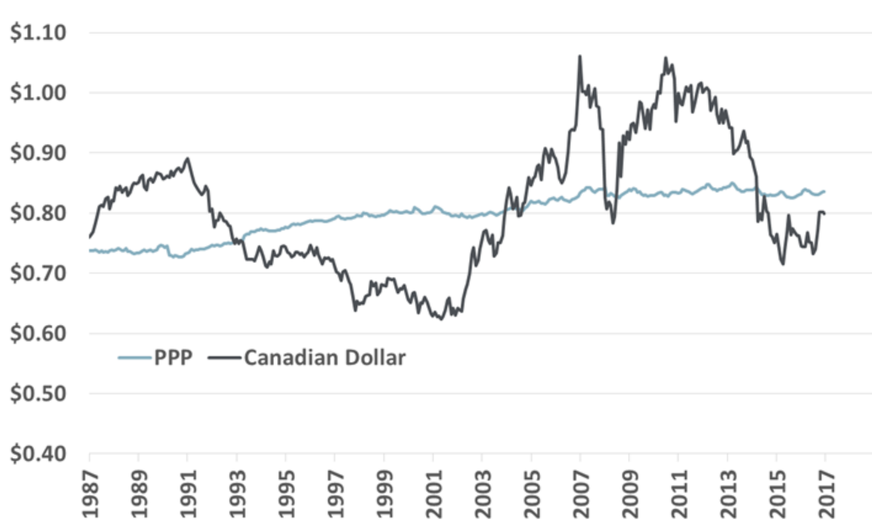
As we detailed in our [September Market Note](), the interest rate environment in Canada has changed markedly in 2017 with talk of rate cuts replaced by two rate hikes in succession and a surge in the Canadian dollar. In recent weeks, the Bank of Canada has calmed its rhetoric, suggesting the next rate hike is not imminent. Canadian economic data has also come off the boil following world-beating numbers in the first half of 2017, and we suspect the major fireworks are behind us for now. More important will be the long-term outlook for Canada's economy in the face of record household debt, elevated housing prices, and an increasingly uncompetitive tax and labour regime.

As it stands today, the Canadian dollar sits fairly close to fair value when measured by purchasing power parity ("PPP", Exhibit 4). PPP suggests that a basket of goods should cost the same in either country once the exchange rate is taken into account, and the Canadian dollar is currently slightly below fair value on that measure. As seen above, this is a very long term time series and factors such as central bank interest rates tend to have a much larger influence on the currency in the short term.

Exhibit 3

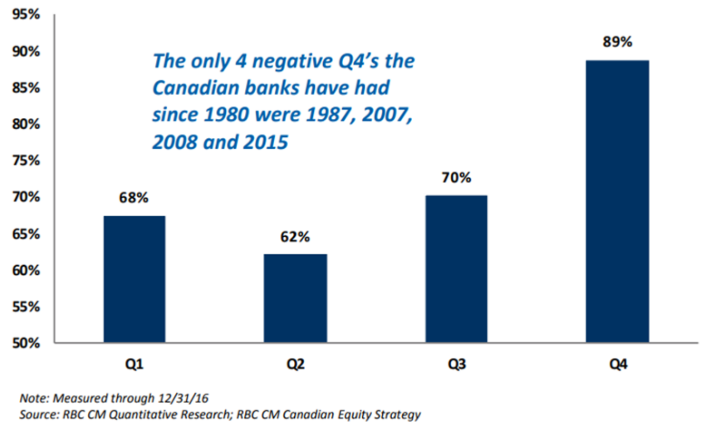
Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 4 – Canadian dollar and purchasing power parity



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 5 – % Positive outcomes for the S&P/TSX banks by quarter (1979-2016)



Source: RBC CM Quantitative Research; RBC CM Canadian Equity Strategy

The outlook is not without risk

Within our positive outlook there are nevertheless risks we are watching. While the risk of global recession remains low, we see some longer-term risks brewing at home. The NAFTA negotiations and high consumer debt levels are top of mind, and Canada's economy is rapidly becoming uncompetitive due to high minimum wages and high taxation. Without any obvious offsets, the risk is a weaker Canadian dollar becomes the equalizer.

Volatilty in most markets has been extremely low this year, and this is unlikely to last forever. Given how long markets have been calm, what once passed for normal volatility could come as a shock to investors who have become complacent. Should inflation tick up sharply, central banks are likely to get more aggressive in their interest rate normalization, which would be a headwind for stocks given the role that low interest rates have played in valuations.

We still see opportunities in the TSX

As mentioned above, the TSX has come off the mat but is by no means punching at full strength. Valuations still represent a healthy discount to the U.S. market and two of our largest index weights continue to trade at below-average valuations. We discussed the energy sector in our August Monthly Note and the points raised there still ring true – valuations are at multi-decade lows ex-2016 and any sort of reversion to the mean should generate healthy returns. Canadian banks have seen their share prices perk up in recent weeks but we still see value in this sector and would point out that we are entering a strong seasonal period (Exhibit 5). Since 1979, the TSX banks have posted a positive return in the fourth quarter an impressive 89% of the time.

Bottom line

For the first time in years, we are experiencing synchronized global growth, which has fed through to strong earnings growth in 2017, driving global equities higher. While Canada has been a laggard, recent weeks have been encouraging as are signs that growth is broadening out to commodity sectors, which have been challenged in recent years. At this stage in the cycle, we are starting to keep a closer eye on inflation and interest rates, for both the opportunities that may present themselves and signals that the cycle is about to turn. Should inflation and bond yields turn higher, we would expect the TSX to return to form as Canadian stocks are much more leveraged to those two factors than the U.S. market. The slow-growth environment of the past nine years has been kind to a U.S. market that is rich in low-volatility consumer staples and secular-growth technology names. Many years of outperformance have left valuation well north of the TSX, and with growth potentially taking a leg higher it may be the TSX's time to shine.

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