The Case for Real Assets

(2017: The Year of Feeling "Uncomfortable")

I attended an investment conference last week in Toronto and had an opportunity to talk with and listen to a variety of money managers, analysts, and economists from both Canada and the USA. One interesting observation I made was that specifically with those people presenting from the USA. If they were Republican supporters, they were very bullish, but if they were Democrats, they were extremely bearish.

Republicans think Trump is going to send the markets into orbit. Democrats think Trump is going to tank markets to the bottom of the ocean.

At the conference it seemed like people's opinion on the markets depended entirely on their political orientation. Let me tell readers one thing I whole heartedly believe: The markets don't give a darn about your political orientation.

Republicans in 2008 were convinced Obama was a communist, and the markets have had one of their best runs…..ever. Sure, they were down almost 50% when he took the chair, so they were due, but you can't argue with the numbers.

Right now it looks like President Trump has appointed a capitalists dream team in the Cabinet, but I think it's unlikely the markets repeat the 2009-2016 run, mainly because we've already had the run and markets in many measurements are nowhere as cheap as they were in 2009. The Fed has already begun raising interest rates after being the most dovish in history for the past 8 years.

That is the crux at this point in the cycle, that rates are rising and if Mr. Trump is successful in his policies, they will rise faster and go higher. The experiment with negative rates (which probably has caused more harm than good) will most likely come to an end in Japan and Europe as well. Reasonable people can debate and disagree on how many rate increase or how high, but the 35-year cycle of declining interest rates has likely come to an end.

Rising rates are obviously bad for bonds, but once they reach a certain level, can be bad for stocks as well.

So we want to build portfolios around the possibility of rising rates:

1) Reduce longer term bonds, low yielding preferred, etc
2) Floating rate, shorter-term corporates are ok.
3) Reduce utilities, defensive names which usually work opposite to rates
4) Financials do well with a steepening yield curve (esp. US banks here)
5) Careful on currencies- USA at highs, Yen/Euro at lows- will it reverse?
And last but not least….
6) Real Assets [real estate (outside Canada), commodities, energy]

The price of "real assets" relative to "financial assets" (ie: stocks and bonds) hit their lowest level since 1928 last fall. The policy of central banks the last decade or so have forced investors to discount higher inflation and interest rates, accept slower growth, and be more defensive and focus on high dividend yielding stocks as proxies for lower bond yields.

The central bank policy shift which is being led by the US Federal Reserve, combined with a populist shift in electorates, will force a rethink of those beliefs, and since Donald Trump's election, the markets have been led by financials, cyclicals, material and energy names. That shift doesn't end after only 6 weeks. It might be overdone a bit short term, but I think it's the start of something bigger. The trade which had actually started <u>before</u> the results of the US election have shifted as follows:

1. Cyclical Growth Names > Defensive Names
2. Value > Growth
3. Small Cap > Large Cap
4. Deflationary to Inflationary
5. Wall Street to Main Street

Real assets positively correlate with inflation, as Central Banks withdraw stimulus and deflation fears subside, real assets provide a hedge against

inflation and monetary tightening. Since 1950, they have 82% correlation to the Fed funds rate.

In late October, the 10-year rolling return for commodities was the lowest since 1933. **Read that line again.**

I would suspect that the larger sources of assets (pension funds, mutual funds, hedge funds) are at a relative underweight position to the sector and have little exposure, and will rise. To proof: of all the ETF market cap in Canada, just over 8% is exposed to real assets (source: BNN Oct 24, 2016)

The USA is a clear driver of both the global economy and the world political arena. The election of Donald J Trump is a game changer. There are also elections this year in Germany and France, and the implementation of Brexit. If Mr Trump is just 50% successful in his policies (boost spending, infrastructure, lower regulations, lower corporate taxes, repatriation of corporate capital offshore, etc…), then I would guess US economic growth will explode and the 2% ceiling US GDP has been stuck in, will shatter.

This past cycle was very unique. Most economic recoveries have historically taken two years, and after 8 years and moving at a snail's pace, we are only <u>now</u> back to where the last cycle ended, and just <u>beginning</u> an expansion phase. Things are starting to "normalize"

Last summer, the narrative was low rates forever, no inflation and a chase for yield. Now, we have completely flip flopped on those beliefs and the animal spirits are awakening. Earnings should grow, and for the first time in a while, we might actually get a global synchronized recovery.

The expansion phase of the cycle could last another 5-6 years.   Canada should do well in a global growth environment thanks to our abundance of commodities. If the US dollar ever lost some steam, it would be an additional boost to commodity prices, all of which bodes well for Canada. One thing I do know: There has <u>not</u> been a cycle since the 1970s that the Fed increased rates and the US dollar didn't roll over (despite conventional thinking).

We've had monetary stimulus from Global Central Banks doing all the heavy lifting for the past 8 years. Fiscal stimulus has quickly become the new dynamic. Will it be straight up? Of course not. Will there be bumps in the road? 100% guaranteed. While President Trump brings a pro-growth agenda, risks of trade wars or increased protectionism could create issues.

What can go wrong?

1) President Trump bites off more than he can chew (ie tries to do too much all at once)
2) Nothing happens
3) Gets too much done too fast, and then the economy and markets explode, forcing the Fed to raise rates faster
4) Trade and border taxes become an issue

There is massive uncertainly in many areas for 2017. It could be a year that ends up flat but markets could be up 20% at one point or down 20% at another.

It's going to feel very uncomfortable at many points in 2017 would be my guess for markets right now.

Stay tuned,

Vito Finucci, B.COMM, KIM, FCSI
Vice President and Director, Investment Advisor
Associate Portfolio Manager

This information is not intended as nor does it constitute tax or legal advice. Readers should consult their own lawyer, accountant or other professional advisor when planning to implement a strategy. This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. This commentary is based on information that is believed to be accurate at the time of writing, and is subject to change. All opinions and estimates contained in this report constitute RBC Dominion Securities Inc.'s judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. Interest rates, market conditions and other investment factors are subject to change. Past performance may not be repeated. The information provided is intended only to illustrate certain historical returns and is not intended to reflect future values or returns. RBC Dominion Securities Inc. and its affiliates may have an investment banking or other relationship with some or all of the issuers mentioned herein and may trade in any of the securities mentioned herein either for their own account or the accounts of their customers. RBC Dominion Securities Inc. and its affiliates also may issue options on securities mentioned herein and may trade in options issued by others. Accordingly, RBC Dominion Securities Inc. or its affiliates may at any time have a long or short position in any such security or option thereon. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ®Registered trademarks of Royal Bank of Canada. Used under licence. © 2015 Royal Bank of Canada. All rights reserved.