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Canadian dividend sectors: Rising rates, rising opportunities?

A special report by the Portfolio Advisory Group

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All values in Canadian dollars and priced as of January 5, 2017, market close, unless otherwise noted.

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Canadian dividend sectors: Rising rates, rising opportunities?

Dividend investors don't need to fear an environment of rising interest rates. We think dividend investing can still work during these periods and explain how some counterintuitive opportunities can open up in the wake of rate-induced selloffs.

Rate-sensitive sectors, such as real estate investment trusts (REITs), Telecommunications, and Utilities, underperformed in the second half of 2016. The main culprit behind the weakness in these classic defensive sectors was a broad-based updraft in global bond yields, which makes their defensive characteristics, such as high dividends, less attractive, all else equal. Whether the recent episode of rising rates—in part a function of heightened expectations for rebounding growth and inflation in the coming year—proves sustainable remains an open question.

Combing through the data over the past decade, however, we observe that periods of rising rate-induced selloffs in traditional defensive sectors have tended to give rise to intriguing entry points for investors. Admittedly, we believe the greater-than-usual degree of uncertainty over the rate outlook means investors should remain selective and focus on sectors and companies that exhibit the most compelling fundamentals.

Rising rates dampen "bond proxies" but ...

Canadian bond yields have shifted higher in sympathy with U.S. bond yields. Yields on U.S. Treasuries began to tick higher in the summer of 2016 as markets anticipated an economic rebound in the U.S. following a tepid start to the year, a trend that was amplified by the election of Donald Trump as U.S. president, which ushered in renewed optimism about the U.S. economy and concerns amongst bond investors of rising budget deficits and inflation. From the summer low of 0.96%, 10-year Government of Canada bond yields rose 87 basis points (bps) to 1.83% as of mid-December. Since 2006, yields on 10-year Government of Canada bonds have soared at least 50 bps on eight separate occasions, with yields climbing on average by 82 bps during these selloffs.

While the current bout of uptick in yields was largely in line with the recent historical average, and was somewhat more muted than the 124 bps spike in U.S. 10-year Treasury yields over the same time frame, higher bond yields have roundly stifled the performance of the Canadian REIT, Utilities, Telecom, and Consumer Staples sectors, with all four lagging the S&P/TSX Composite by a wide margin since July and three of the four recording negative returns (see table on following page). Periods of rising interest rates tend to suggest a difficult environment for these so-called bond substitutes within the stock market because their dividend yields become less tantalizing relative to higher bond yields.

... Can provide timely entry points

However, despite the poor performance of these so-called bond proxy sectors in the wake of the recent move higher in rates, we contend there are three reasons why investors should consider taking a look at potential opportunities after the selloff.

First, corrections in the bond market are par for the course. The long bull market in bonds has been witness to a number of head fakes since the global financial crisis. Each time, the anticipated inflection point in growth and inflation failed to take root, which, together with central bank quantitative easing programs, sent yields back lower. This time may well be different, especially if growth and inflation in the U.S. embark on a long-awaited sustainable rebound onto to a higher plane, but the recent uptick in bond yields suggests markets have already partially priced in this scenario.

It is also unclear that Trump's ambitious policies can fully mitigate the structural growth headwinds that remain in place such as demographics and sluggish productivity. All of which is to say the current bond market selloff could conceivably take a pause, or undergo a mild reversal, in the coming quarters as investors await greater clarity on

Bond proxies tend to underperform during periods of rising rates: Look to take advantage of opportunities from selloff

	Duration (days)	Change in 10-year Government of Canada bond yield (basis points)	S&P/TSX Real Estate Index	S&P/TSX REIT Index	S&P/TSX Utilities Index	S&P/TSX Telecom Index	S&P/TSX Consumer Staples Index	S&P/TSX Composite Index
01/02/06 - 06/28/06	177	+ 65.8 bps	-2.3%	-1.0%	-9.5%	-2.1%	-3.7%	1.6%
03/07/07 - 06/12/07	97	+ 77.5 bps	-5.6%	-4.5%	6.8%	15.8%	0.7%	6.3%
01/14/09 - 06/10/09	147	+ 107.9 bps	6.3%	18.7%	-0.7%	2.6%	3.1%	23.8%
10/11/10 - 02/16/11	128	+ 81.2 bps	4.9%	6.1%	5.1%	2.2%	6.7%	13.1%
05/02/13 - 09/10/13	131	+ 114.5 bps	-11.6%	-14.6%	-11.0%	-5.0%	7.7%	4.7%
02/02/15 - 06/10/15	128	+ 67 bps	-4.5%	-6.9%	-8.7%	-0.8%	-0.9%	0.9%
02/10/16 - 04/26/16	76	+ 54.9 bps	12.0%	15.0%	5.6%	2.0%	4.0%	14.1%
07/08/16 - 12/15/16	160	+ 87.5 bps	-8.0%	-8.7%	-3.4%	-1.5%	3.9%	8.0%
Average	131	+ 82.0 bps	-1.1%	0.5%	-2.0%	1.7%	2.7%	9.1%

Average forward returns since peak in yields	S&P/TSX Real Estate Index	S&P/TSX REIT Index	S&P/TSX Utilities Index	S&P/TSX Telecom Index	S&P/TSX Consumer Staples Index	S&P/TSX Composite Index
3-month	4.7%	6.3%	4.7%	8.8%	3.1%	1.5%
6-month	5.9%	6.6%	9.1%	8.2%	4.6%	4.0%
12-month	13.4%	17.1%	14.6%	18.0%	8.3%	9.8%

Source - RBC Dominion Securities, Inc., Bloomberg; data as of 1/5/17

Trump's policies and their implications on the U.S. economic outlook and the Federal Reserve's inclinations on tightening monetary policy.

Second, classic dividend and defensive sectors have generally rewarded investors with compelling returns following sizable yield-induced selloffs over the past decade, with all four Canadian sectors delivering in-line or excess returns relative to the Composite over the next 12 months (see table). Interestingly, timing the peak in bond yields was not a necessary ingredient for investors to be rewarded. Even if investors had waded into the four Canadian defensive sectors when yields were 25 bps below the peak, all four sectors would still have produced in-line or excess average forward returns relative to the broader market in the first seven rate-spike episodes highlighted in the table above.

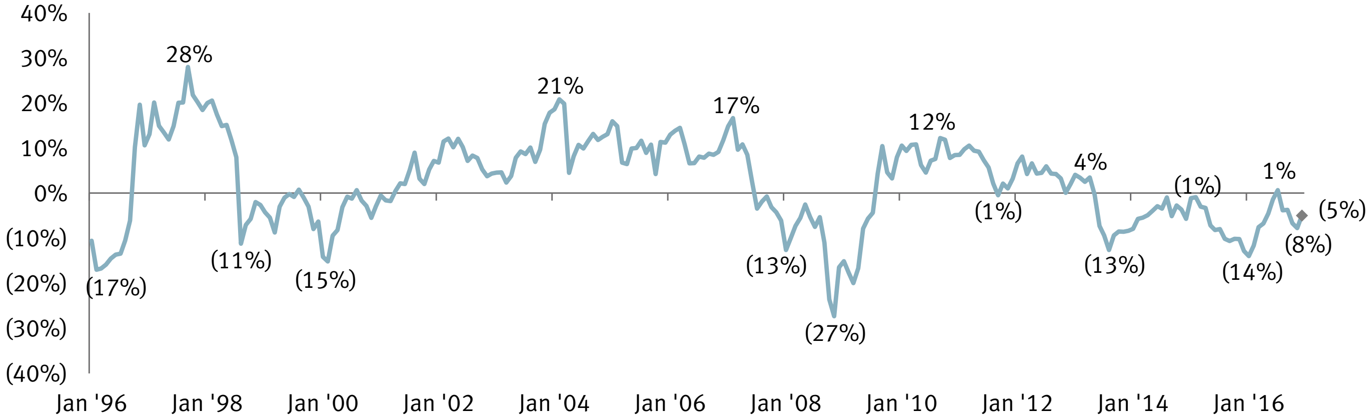
Third, these sectors continue to offer income-seeking investors a blend of desirable attributes that are likely to remain in demand amid aging demographics including stable dividends, consistent earnings and cash flow generation, and growth potential.

Surveying the landscape for "value"

Investors can take some solace in the fact that the outlook for Canadian interest rates appears to be benign in the foreseeable future. The Bank of Canada has repeatedly reiterated its intention to keep monetary policy accommodative in the face of economic uncertainty. Whether U.S. growth and inflation achieve the elusive "breakout speed" represents a crucial unknown that will help determine the direction of bond yields throughout 2017, with spillover effects for Canadian bond yields. In the face of an uncertain outlook for rates, investors should thus remain selective and focus on sectors and companies that demonstrate the most attractive fundamentals.

Amongst the four bond proxy sectors, REITs stand out as the most intriguing opportunity from a valuation perspective, in our view.

Canadian REIT sector price-to-net asset value



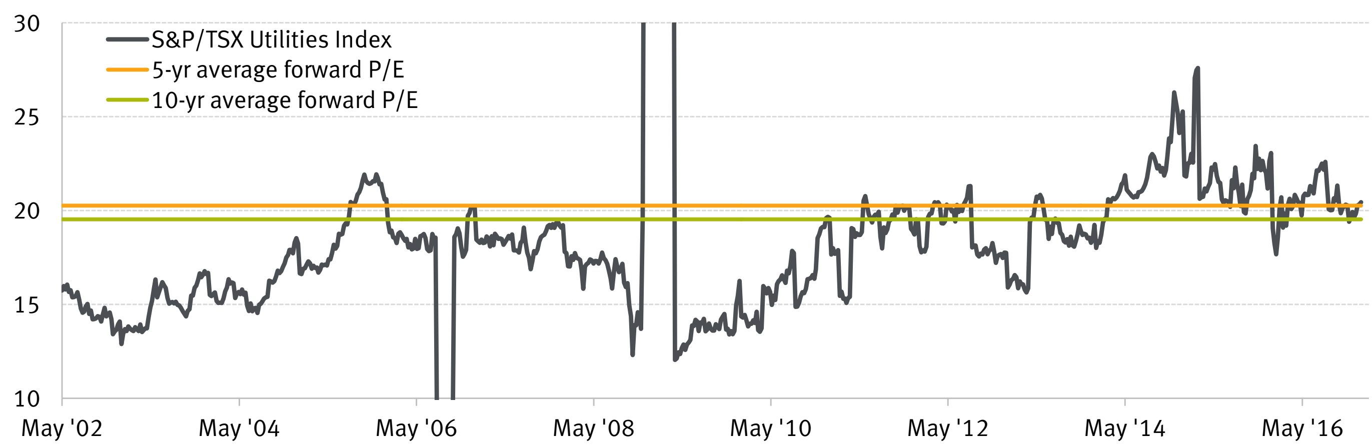
Source - RBC Capital Markets, Bloomberg; data through 12/31/16

REITs are trading at a 5% discount relative to net asset value, versus the long-term average premium of approximately 2% (see top chart). While the sector's current price-to-adjusted funds from operations multiple of 15.3x is modestly above the long-term average of around 14x, it is still offering a generous premium of around 480 bps over the 10-year Government of Canada bond yield, a comfortable cushion over the long-term average of approximately 370 bps. REITs can also provide some degree of protection against the effects of inflation over long time periods. Over the long term, rents typically readjust as the price levels in the broader economy change.

Utilities is another sector where investors are likely to find some timelier dividend ideas, in our view. The sector's forward price-to-earnings (P/E) multiple has de-rated from 22.5x in July to 20.4x, compared with the 5- and 10-year averages of 20.3x and 19.5x, respectively (see bottom chart).

In contrast to REITs and Utilities, valuations in the Telecom and Consumer Staples sectors leave relatively less margin for error. The forward P/E multiple for the Consumer Staples sector has receded from 20.5x in August to 19.2x, but remains expensive compared with the 5- and 10-year averages of 17.5x and 16.3x, respectively. Meanwhile, the forward P/E multiple for the Telecom sector has barely budged, inching down from 20.2x in July to 19.1x, as the industry remains richly valued compared with the 5- and 10-year averages of 16.1x and 15.1x, respectively. Investors will need to be far more discerning when scouring for opportunities within the Telecom and Consumer Staples sectors, which weathered the latest storm of rising rates more resiliently than their other bond proxy counterparts.

Canadian Utilities sector forward P/E



Source - RBC Dominion Securities, Inc., Bloomberg; data through 12/31/16

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