Perspectives on the Canadian Market

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Our core strategy for the RBC Canadian Dividend Fund remains unchanged: to own a diversified portfolio of high-quality businesses with a dividend yield and dividend growth prospects that are greater than market averages. We believe this is a sensible way for conservative investors to gain exposure to the stock market over an investing lifetime.

Current market outlook

Sustainable dividends are paid from free cash flow – the cash flow that's "left over" after all investments are made. As we look forward to 2019, it's this outlook that informs our strategy and positioning for the fund.

Stock prices and cash flow outlooks are under some pressure as we exit 2018. In Canada, these pressures come from a variety of sources. First, there is concern that rising interest rates could slow economic activity in the corporate sector and restrain consumer spending. There is the related concern over how Canada's housing market will handle rising mortgage rates after years of declines.

We have spent a lot of time over the past year stress-testing the balance sheets and income statements of Canadian banks for an environment where a slowing economy and rising rates have a negative impact on the banks' lending operations. At the current time, we believe the large banks should be able to withstand a negative credit cycle in Canada. With adequate capital ratios, growing dividends and resilient business models, we see the banks as fairly attractive long-term investments. However, investors may need to see them weather a downturn before rewarding them with more normal multiples.

Share prices of Canadian consumer companies have been under pressure recently as investors consider the impact of higher lending rates and restrained housing activity on consumer spending. This may have further to run, and our investments in the sector have been made very selectively.

In Summary

- The Canadian stock market is facing pressure from several sources including rising interest rates and concerns over the domestic housing market.
- While these challenges are likely to persist into 2019, the stock market is beginning to discount their impact, making us more optimistic about the outlook for Canadian equities.
- While 2019 may be a challenging year economically, the potential for some of the clouds to clear is real and stocks should react well to any signs of improvement.

On the trade front, "tit-for-tat" tariff implementations between the U.S. and China and growing nationalist tendencies in recent elections are threatening what had been an increasing trend towards open trade. The tariffs hurt profits by raising costs in global supply chains and making markets harder to access.

Canada's energy industry has become hamstrung by challenges in accessing markets for its growing production, lowering the prices that companies receive for their products, despite a general trend towards better prices globally. While 2018 may have seen the worst of these discounts, the price gaps are likely to remain volatile and wider than average for some time to come.

In the face of these pressures, larger companies with integrated business models and better access to global product pricing have held up the best. We prefer these types of companies that have long-lived production, good free cash flow profiles and long-term dividend growth potential.

Outlook for 2019

As we look into 2019, it is likely that all of these challenges will persist to some degree. It's equally clear that the stock market is beginning to discount their impact on cash flows, making us more optimistic about the outlook for Canadian equities. Further, if the challenges to growth noted above accumulate in a manner that meaningfully slows the economy, it's likely there would be some reaction from monetary authorities. The plausibility of a pause in administered interest rate increases should be seen as a potential bolster for share prices.

In sum, the outlook for 2019 has already been reflected in part by weaker share prices in the latter part of 2018. Valuations are now becoming attractive in some parts of the market. While 2019 may be a challenging year economically, the potential for some of the clouds to clear is real and stocks should react well to any signs of improvement.

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