Wealth Management
Dominion Securities

RBC Dominion Securities inc.

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Market update

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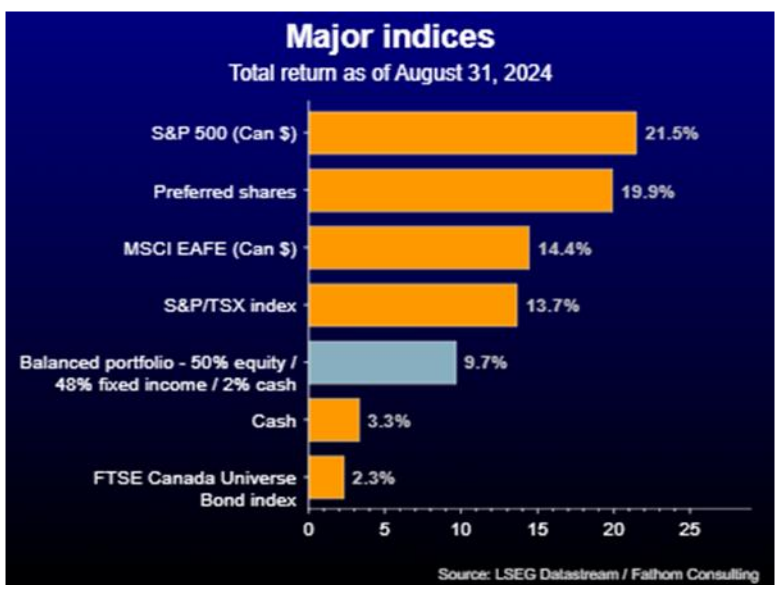
After a strong finish in 2023, stock markets around the world maintained their momentum into the new year, with cumulative returns by August 31, 2024, that exceeded the expectations of most experts. The impressive resilience of the U.S. economy in the face of high interest rates, outstanding corporate profits and inflation progressively returning toward the 2% target have boosted the confidence of investors, who now expect the Federal Reserve to start easing its monetary policy on September 18. On the other hand, fixed-income securities posted a more timid performance in that same period, with the exception of preferred shares, which have had an exceptional year so far in 2024. Chart 1 below illustrates the total returns generated by the main asset classes traditionally held by Canadian investors.

Chart 1



Outlook for the economy and the financial markets

The monetary tightening cycle that began in March 2022 has clearly been the most severe since the early 1980s, but despite this strong headwind, the U.S. economy continues to expand. In addition to this, inflation is drawing ever closer to the Federal Reserve's 2% target. The majority of strategists and economists now believe that Jerome Powell is poised to win his wager: subjugate inflationary pressures, minimize American job losses by achieving a soft landing for the economy and, finally, undertake a series of rate drops to ensure sustained economic growth through the years ahead. We are not denying that there's a chance everything will turn out for the best for the economy (it's what we are hoping for!), but we can't help noting that many of the indicators appear to predict a period of economic turbulence in the months to come.

In Table 1 below, you will see the recession indicators tracked by RBC Wealth Management. Based on this scorecard, four of the seven indicators point to a recession.

Table 1

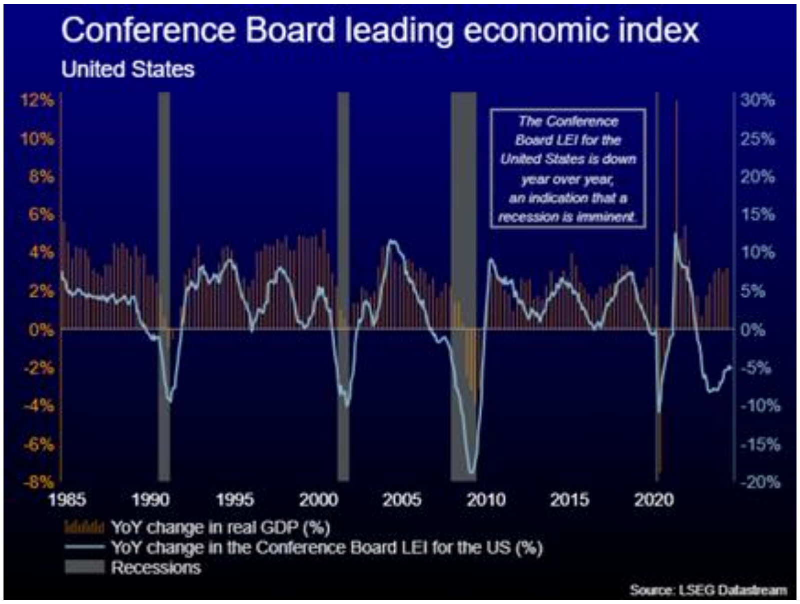
U.S. Recession Scorecard

Indicator	Status		
	Expansionary	Neutral/ Cautionary	Recessionary
Yield curve (10-year to 1-year Treasuries)			✓
Unemployment claims		✓	
Unemployment rate			✓
Conference Board Leading Economic Index			✓
Non-financial corporate cash flows	✓		
ISM New Orders minus Inventories		✓	
Fed funds rate vs. nominal GDP growth			✓

Source - RBC Wealth Management

The indicators in the recession zone include the U.S. Treasury bond yield curve, which inverted in July 2022. This indicator, which, historically, has been almost infallible, signals a recession 13 months in advance, on average, but the longest recorded interval between inversion and the start of a recession was 23 months. The Conference Board Leading Economic Index, shown in Chart 2 on the next page, is another very reliable advance indicator and has also been in the recession zone since the third quarter of 2022. Since then, two more indicators have moved into the recession zone. In spring of 2024, the Federal Reserve rate rose higher than the growth rate of nominal U.S. gross domestic product, an inflexion point that is generally an early sign of a coming recession. And more recently, unemployment data in the United States deteriorated enough to suggest that an upswing has begun, another condition that historically coincides with a setback in the level of economic activity. Having just come to light, this increase in the unemployment rate suddenly revived recessionary fears at the beginning of August when the somewhat disappointing employment statistics for July were announced. The most optimistic explanation for the upward trend in the unemployment rate is the considerable increase in the labour force, swelled by high immigration, and while this partly explains the deterioration, there are clear signs that the employment market is cooling. The data show that lay-offs are rising while the number of opportunities is in decline. As Chart 3 shows, on page 4, the number of vacant positions slid from over 12.1 million in March 2022 to 7.67 million in July 2024, according to the latest JOLT survey. This gradual deterioration can also be seen in the behaviour of workers, fewer and fewer of whom are leaving their jobs voluntarily. A declining turnover rate is generally a sign that opportunities are becoming scarcer or that the conditions offered elsewhere are not attractive enough to warrant changing employment.

Chart 2

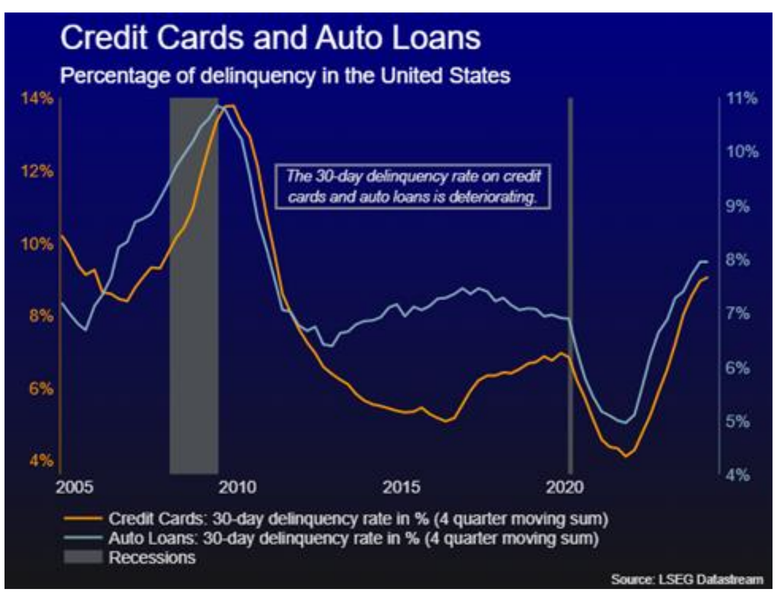


But even though the warning signals have been piling up for two years, the U.S. economy continues to astound all the sceptics by maintaining a pace of growth that exceeds its theoretical potential. If the current cycle were more closely following the experience of economic cycles past, we would already be well into a recession. Is it possible that this cycle is so different that the economy will resist the enormous monetary tightening of the last two years? Could the unique nature of the pandemic have upended all our usual reference points? Did we underestimate the economic impact of the governments' generous aid programs in response to the public health crisis? It's not impossible. Every cycle is different, and it can be challenging to try to draw conclusions based on past cycles. After all, the sample of recessions in the last hundred years is definitely not large enough to predict the course of the economy over the next few months with a high degree of confidence. Nevertheless, we do have to admit that Jerome Powell has some very good cards in his hand. Inflation is approaching the 2% target and the economy is still holding strong, despite high interest rates, which gives him some room for manoeuvre to bring the economy into a soft landing and defy many indicators.

Chart 3

One highly plausible scenario, however, is that the current cycle has been prolonged by the governments offering generous support programs to locked-down populations, meaning that U.S. households found themselves with high levels of surplus savings. These surpluses undoubtedly helped keep household consumption at high levels despite the increase in interest rates and the cost of living in general. The Federal Reserve Bank of San Francisco estimated that this surplus savings amounted to $2100 billion at its peak, but in an update in May 2024, the author of the study calculated that households had used up all those surplus savings. And, in fact, some American consumers who have exhausted their safety cushion are already starting to feel the pinch of inflation and higher interest rates. Chart 4 shows that the percentage of outstanding credit card balances and car loans is rising significantly and now exceeds pre-pandemic levels, a sign that some American households are in a more precarious financial position.

Chart 4

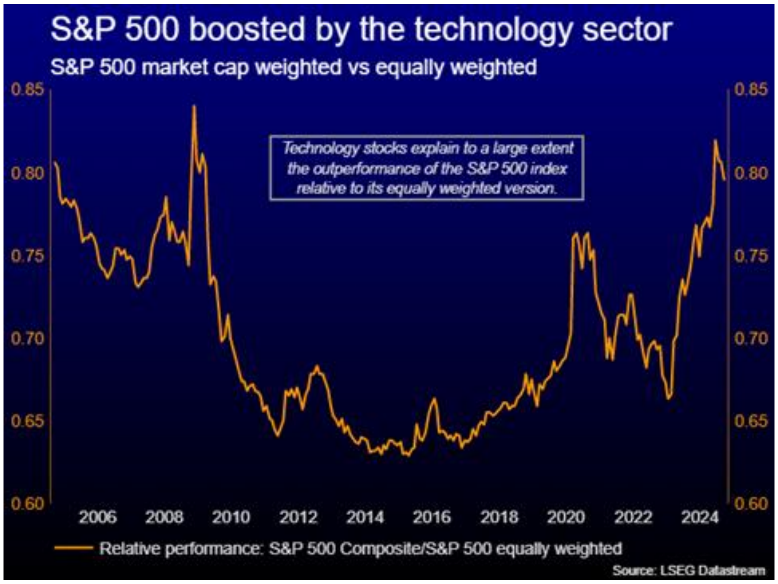


The vitality of the U.S. economy in the coming months will undoubtedly be the key factor behind the direction the financial markets take. But the economy is not the entire story. It's also important to try to identify what the markets are counting on. From this perspective, the most astonishing equity index is clearly the S&P 500. With its forward price-earnings multiple of 21x for the next 12 months, we estimate that the S&P 500 is trading at a premium of about 15% compared to its average valuation for the last 10 years, while for the rest of the planet, the current valuation is about 3% lower than the average for the last 10 years. As for our Canadian index, the S&P/TSX is trading at a discount of about 6%. In Chart 5, we show the historical differences in the valuations of the S&P 500 and the S&P/TSX. The current gap is at a peak and at a large premium relative to the average difference between these two indexes in the last 30 years. Of course, the Canadian market is not sheltered from a correction just because it is cheaper, but with its valuation lower than the historical average, we believe that investor expectations are more reasonable compared to what the S&P 500 seems to imply at current levels.

Chart 5

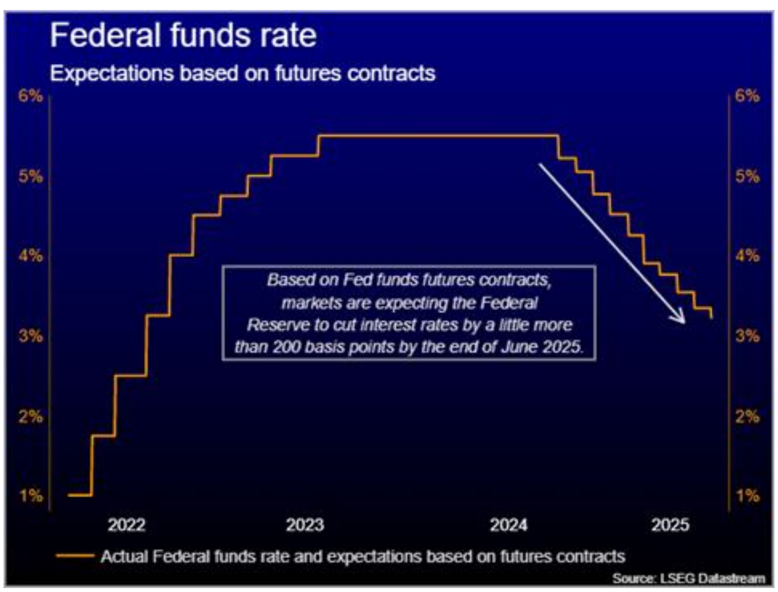
The S&P 500's high price-earnings ratio can be partly explained by the influence of the tech sector, which accounts for about 40% of the index's total market capitalization. Tech stocks, with their prices boosted by enthusiasm about artificial intelligence, are trading at higher multiples and pulling the valuation of the index upward, but many sectors are still trading at more reasonable valuations. In fact, in the last few months, technology has not been the top-performing sector. Is this simply a break before it retakes the leadership position or are we witnessing the start of a sector rotation? We'll know more in the next few months, but lately we have noticed that several sectors are outperforming technology, including healthcare, public services, banks, pipelines and real estate. Chart 6 on the next page shows the performance of the S&P 500 compared to its equal-weighted form, a version of the index that offers a more accurate picture of the average performance of securities in the index.

Chart 6



On the bond side, our opinion has not changed, because we believe that the yields to maturity offered by these securities are still fairly attractive. Furthermore, with inflationary pressures fading, the stance of the central bankers has drastically changed since the beginning of 2024. On our side of the border, the Bank of Canada has already lowered its key rate three times, and the Federal Reserve is preparing to announce an initial decrease in its key rate on September 18. If we can believe players on the futures market, several more rate drops by the Federal Reserve may follow in the coming year, as shown below in Chart 7. Historically, bonds behave very well in the year following the start of monetary easing, and the economic context (recession or soft landing) has far less impact on their performance than on asset classes that are more sensitive to economic conditions, such as equities.

Chart 7



As for preferred shares, our opinion has changed, and we are feeling far less favourable than we did in early 2024. These securities have generated a remarkable performance in the last 12 months, and the valuations are less appealing than at the beginning of the year.

Portfolio management

In 2024, we maintained a cautious approach, focused on the quality of the portfolio securities. We believe there are still risks in the current context that are not accurately reflected by the markets. From the perspective of asset allocation, we stayed with our slight under-weight in equities and kept liquidity at levels higher than the target. Finally, our exposure to fixed-income securities and high-quality alternative investments is slightly above the overall target for those two asset classes combined.

In the fixed-income portion of the portfolio, we have continued to extend the duration by purchasing quality bonds with longer maturities, and we recently reduced the proportion of preferred shares, which have become less attractive after their excellent performance since the beginning of 2024. For the bonds that were added to the portfolios, we leaned toward those that are trading at a discount, for the tax advantage they offer. In a more pessimistic scenario, where economic conditions deteriorate more than anticipated, longer-term bonds can serve as a counterweight, reducing the overall volatility of the portfolios. With regard to preferred shares, we want to point out that they can be particularly volatile during periods of economic uncertainty, and we will continue to closely monitor our exposure to them and focus on the highest-rated securities in this asset class.

Since the beginning of the year, new funds have been deployed to alternative investments through the infrastructure fund, which made new acquisitions and completed its first deployment phase (please note that not all mandates hold the infrastructure fund). We believe that high-quality alternative solutions are still worthwhile because they offer significant diversification and help reduce the overall volatility of the portfolios.

In recent years, we have gradually increased the quality and reduced the risk of our equity portfolio. We also adopted a more defensive approach by selecting companies that are less sensitive to the pace of economic growth. We maintained course in 2024 and we're keeping the risk in this part of the portfolio lower than the benchmark indexes. In the energy sector, we once again reduced our exposure to oil and natural gas producers by shrinking our position in Canadian Natural Resources. We maintained our exposure to pipelines, however, keeping the Pembina and Enbridge stocks in the portfolio. Pipelines are less risky than producers and offer an excellent dividend yield. In the industrial sector, we increased our position in WSP to take advantage of the temporary weakness of the stock after the announcement of the acquisition of Power Engineers, a U.S. leader in the energy transition sector. We believe that this acquisition will accelerate the pace of WSP's growth in the years ahead. Still in the industrial sector, we reduced our position in Toromont, the largest holder of Caterpillar dealerships in Canada, after strong gains in its stock price in recent years. We also reduced Thomson Reuters because, in our opinion, the stock was approaching its fair value. Finally, we initiated a position in Bombardier. After a very long period of restructuring, the company can now focus solely on the production and sale of business jets, a niche with excellent prospects. With a rapidly improving financial balance sheet, the stock is expected to benefit from a favourable revaluation of its operations. In the financials sector, we eliminated our position in the KBWB index fund after an increase of over 40% since the purchase in November 2023. We also initiated a position in the regional bank US Bancorp. We believe that, after underperforming its peers in 2024, this very high-quality bank offers a good potential return at this stage. We also increased our exposure to the National Bank when the stock was under pressure last June after the announcement of a major share issue to fund the acquisition of Canadian Western Bank. We believe that this acquisition within our borders is promising and of little risk. In the same sector, we also decided to reduce Brookfield Corp. The stock has performed very well recently and is trading closer to the fair value of its assets. Over in telecommunications, we increased our exposure to BCE. Investors are worried about the fierce competition in the wireless telephone sector in Canada and about the high investments required to extend fibre optic cable directly to the clients' premises, but we think that BCE's share price already reflects these issues and offers a reasonable potential for return given the risk. In the consumer discretionary sector, we reduced our exposure to Costco. Although its outlook is still excellent, our decision was motivated by the valuation, which reached levels that significantly exceed historical standards. As such, we decided it was prudent to scale back our position. Also in the consumer discretionary sector, we increased our position in Magna. This stock continues to suffer from the slowing demand for electric vehicles, but for the patient investor, the valuation is still very attractive. Finally, after a big hike in its stock price related to very good financial results in the second quarter, we took the opportunity to reduce Shopify, a highly volatile stock.

In terms of our alternative solutions, the infrastructure fund has been very active in 2024 and has completed the deployment of its first investment phase. It is now present in Canada, the United States, Australia and Great Britain, with broader sector diversification (including toll highways, port operations, electrical transmission lines and airports), and we are very pleased with what has been accomplished since the fund was launched. During the next deployment phase, the fund will invest between $800 and $900 million more, further enhancing diversification for the investors.

In closing, we want to reiterate that despite investors' enthusiasm in the stock market, we believe that the challenges are still very real and that the months ahead may be volatile, presenting buying opportunities at more attractive valuations. We are closely monitoring our economic indicators and especially employment in the United States, which seems to be weakening along with the inflation rate, which is expected to continue to move toward the 2% target. These two factors will dictate the scope and speed of the Federal Reserve's actions as it prepares to ease its monetary policy.

We hope that our portfolio management overview has been useful to you, and we invite you to contact us for any questions or clarification. We also want to take this opportunity to thank you for your trust in us.