Wealth Management
Dominion Securities

RBC Dominion Securities inc.

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Market update

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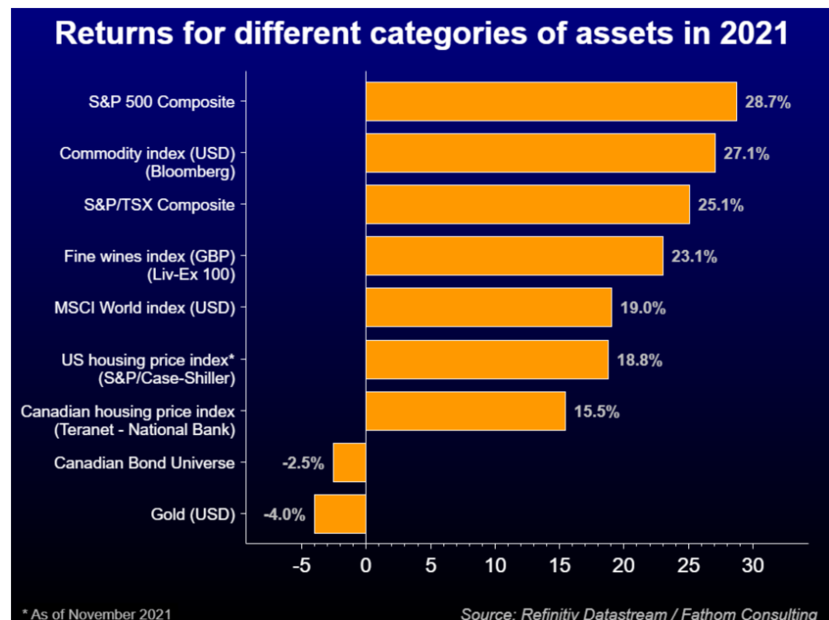
Over the course of 2021, the global economy continued to recover from the shock caused by the COVID-19 pandemic. Numerous countries, including the United States, even entered a phase of expansion, making economic activity exceed the level seen in the fourth quarter of 2019, the peak reached just before the crisis. This expansion boosted business profits, allowing stock markets worldwide to maintain their momentum and post exceptional returns despite the emergence of worrisome COVID-19 variants during the year.

Chart 1



The MSCI World index gained 19% in 2021. The Canadian S&P/TSX Composite index performed particularly well, posting 25.1%, a marked improvement compared to 2020. However, with bond yields rising around the world, the fixed-income market had a rather difficult year. Canadian bonds were not spared this global decline with a total return of -2.54%. The equity market was not alone in delivering high returns in 2021. In fact, almost all asset classes benefited from a widespread appetite for risk. 2021 was a very good year for several types of assets, from commodities to real estate and even the price of collection wines, as can be seen in Chart 1 on the previous page.

Behind this widespread risk-taking, there is a common denominator that partly explains the exceptional performance: a very accommodative monetary policy on the part of central banks and generous government assistance programs in response to the pandemic. But this environment is about to change, as evidenced by the high volatility in early 2022.

Outlook for the economy and the financial markets

The start of the new year has been proving rather eventful for the financial markets, and inflationary fears as well as the U.S. central bank's inconsistent stance are at the heart of this volatility. After describing the sharp increase in consumer prices as a temporary phenomenon, the Federal Reserve recently changed its view, now believing that inflation could persist at a higher level than originally anticipated. The Fed's new stance did not go unnoticed, and financial markets were quick to anticipate the possibility that a much tighter monetary policy will be needed to tame inflation. As a result, the yield on 10-year U.S. Treasury bonds went from 1.5% to 1.8% in a few weeks, and the S&P 500 index quickly lost nearly 10% compared to its peak. High-multiple growth stocks as well as several more speculative stocks have suffered more. On January 6, Bloomberg reported that 40% of Nasdaq stocks had already fallen by more than 40% since their peak. High-quality shares in well-established companies have weathered the general decline in stock market indexes much better. However, it is important to note that the prospect of tighter monetary policies almost always creates hesitation on the part of investors, which generally translates into increased volatility and market corrections. But as long as the economy continues to expand, these corrections remain short-lived. Below in Table 1, we have calculated the performance of the S&P 500 index in the months before and after the date of the first rate hike during the 18 periods of tightened U.S. monetary policy since 1958. Twelve months after the first rise, the bellwether U.S. index generated an average total return of 8.4%, which is still very reasonable. And 72% of the time, performance was positive.

Table 1

S&P 500 performance around start of Fed rate hike cycle since 1958: Total returns

	Trailing returns			First Fed hike	Forward returns		
	12 months	6 months	3 months		3 months	6 months	12 months
Median	18.5%	9.3%	5.5%		1.0%	4.5%	7.0%
Average	15.3%	6.4%	5.1%		2.6%	3.5%	8.4%
Positive outcome %	83%	78%	94%		56%	67%	72%

Source: RBC Wealth Mangement, Bloomberg

Table 2 shows the results of the same study, but this time for the Canadian S&P/TSX index. In the case of the Canadian index, the total return averages 10.1% for the 12-month period following the Federal Reserve's first rate hike, and here as well, performance was positive for most cycles.

Table 2

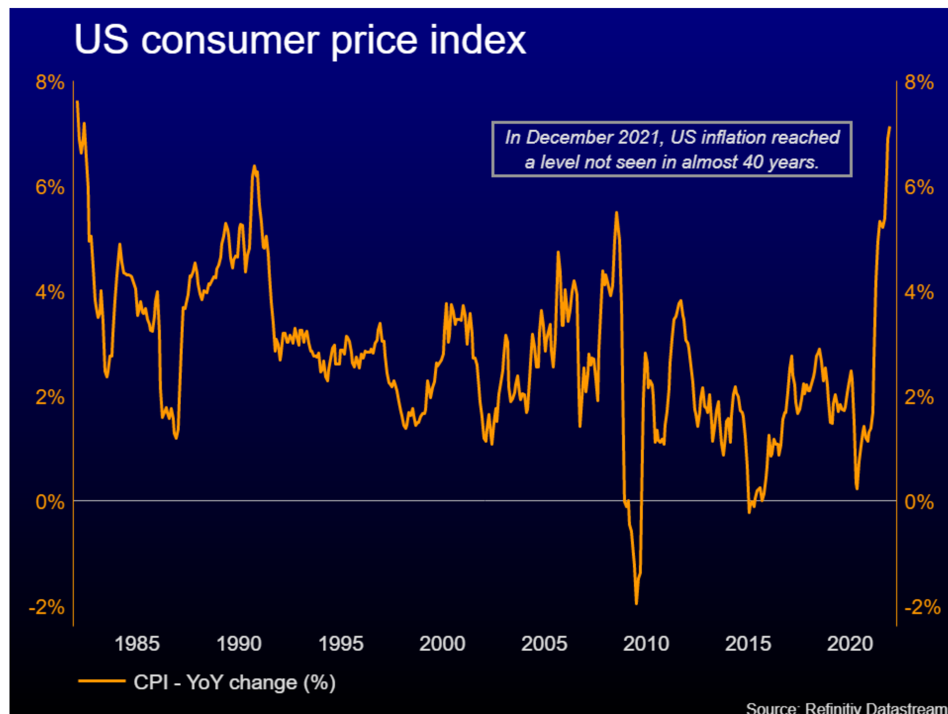
S&P/TSX performance around start of Fed rate hike cycle since 1958: Total returns

	Trailing returns			First Fed hike	Forward returns		
	12 months	6 months	3 months		3 months	6 months	12 months
Median	**10.9%**	**7.0%**	**4.3%**		**2.4%**	**4.4%**	**11.3%**
Average	**13.9%**	**5.9%**	**4.9%**		**2.2%**	**3.1%**	**10.1%**
Positive outcome %	**78%**	**72%**	**72%**		**67%**	**67%**	**72%**

Source: RBC Wealth Mangement, Bloomberg

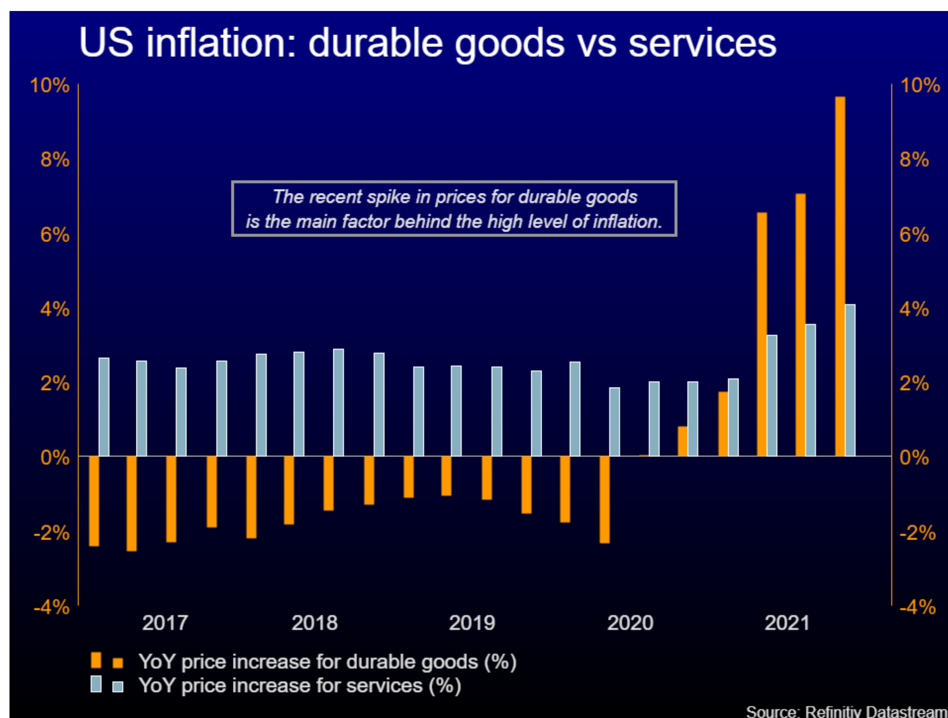
These statistics are reassuring, but they will not be enough to dispel inflationary fears. The most recent figures have certainly been getting a lot of attention. As shown in Chart 2, inflation reached 7% in December 2021, a level not seen since June 1982. And the first months of 2022 will not be much better, as economists expect inflation to climb even higher. Rising prices are a hot topic and could become an important political issue. Federal Reserve Chair Jerome Powell is in a delicate position and will have to navigate carefully over the coming months. It's essential to reverse inflation's upward trend, but tightening monetary policy too quickly could have negative consequences for the economy, employment and the stock market indexes.

Chart 2



Fortunately, there is good reason to believe that inflation will start to decelerate as early as the second quarter and drop significantly by the end of 2022. First, the supply problems caused by the pandemic are expected to gradually subside and the pressure on business costs related to transportation, logistics and inventories should ease. A second factor that should slow price increases is the normalization of demand for durable goods. Lockdowns and the closure of several service sectors of the economy helped drive demand and prices for durable goods upward in 2020 and 2021. This phenomenon largely explains the sharp rise in the total consumer price index (CPI). As can be seen in Chart 3, prices for durable goods had been on a sustained downtrend for several years (deflation of 1% to 2% annually). More recently, the increase in prices for this category of goods has been approaching the 10% mark, which is a huge leap. A return to normal should help swing consumers' budgets back to the regular balance between services and durable goods, with beneficial effects for prices in general.

Chart 3

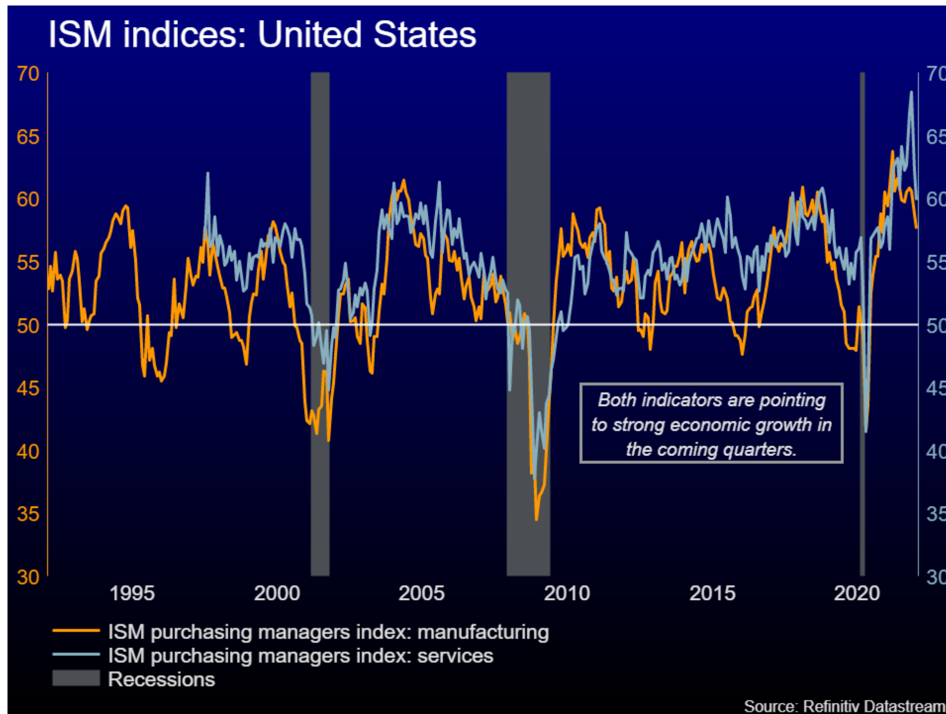


In a recent poll in the United States, millions of people said they were not working because of the pandemic. The reasons they gave vary. Many people had to take care of an infected loved one, while others were themselves sick. Of course, we will probably keep experiencing waves of COVID-19. However, it's very plausible that society will continue to adapt to this new reality and that the impact on worker availability will diminish. The labour force participation rate plunged at the beginning of the pandemic, and since then we have seen a gradual improvement in that statistic. A return to pre-crisis levels would curb wage growth and help keep inflation in check. Lastly, energy prices should not be overlooked. After ballooning over the past year, oil and natural gas prices are expected to grow at a much more reasonable pace over the next 12 months, thereby limiting pressure on the consumer price index.

Beyond the risks associated with inflation, our outlook for the global economy is good. Although economic growth is gradually normalizing, we expect it to remain above its potential over the next two years. The savings accumulated by individuals in many countries during the pandemic are astronomical. As restrictions are eased, these amounts will be available to stimulate consumption. With the rebound in profitability, companies will increase their investments. In addition, the banking system is replete with cash and banks are willing to lend. Our economic indicators confirm our optimism for 2022, as evidenced by the

Institute for Supply Management (ISM) surveys illustrated in Chart 4 just below, as well as the Conference Board leading economic index, illustrated in Chart 5 on the following page. With regard to the ISM, for both the manufacturing and services sectors, the indices remain above the 50 mark, a sign that economic activity will continue to grow over the coming year. Meanwhile, the Conference Board leading economic index for the United States continues to increase year on year, pointing to further strength in economic activity over the coming quarters.

Chart 4



Given the current context, we continue to favour equities, although the coming months may be volatile. High inflation and tighter monetary policy by several central banks will worry investors for some time to come. However, the outlook remains good for businesses. Twelve months ago, very few observers believed that publicly traded companies would quickly return to the record level of profitability achieved in 2019. Well, in 2021, not only did S&P 500 companies regain ground lost during the pandemic, their profits even shattered the previous high by more than 25%. With such a high level of profitability in 2021, the bar is high and profit growth is bound to be more subdued for 2022 and 2023. Based on analysts' expectations, profits should increase 8% this year and 10% for the following year. With regard to valuations, P/E multiples have already dropped quite a bit, but could still fall a little further, especially if inflation persists at a high level and the Federal Reserve is forced to rein it in more firmly. However, we believe that equities can still generate a total return of 5 - 10% for this year, but inflation will be an important factor to keep an eye on.

Chart 5

While our forecasts for equities may seem modest after the spectacular performance of 2021, they are still well above the returns expected on the bond market. With yields to maturity well below inflation, bonds remain unappealing. Moreover, in a context of rising rates, the market will remain difficult in 2022. Bonds obviously have a stabilizing effect in portfolios because they tend to make gains during times of crisis, while equities often undergo significant corrections. But at this stage we're reluctant to put new cash into maturities beyond 4–5 years. Preferred stocks remain more attractive to us than bonds. However, valuations are no longer as attractive as they were 12 months ago, and we believe that they will generate more modest returns, between 4% and 5%.

Portfolio Management

Over the course of 2021, we continued to invest more and more of our cash in equities, with an emphasis on those that were affected by the pandemic or whose valuations suffered excessive corrections in 2020. Beyond applying our regular investment criteria, we based many of our investment decisions on the idea of gaining exposure to the strong rebound in economic activity that we are currently experiencing.

On the banking side of things, we initiated a position in U.S. Bancorp and increased our weighting in Toronto Dominion Bank. We believe that U.S. and Canadian banks are trading at reasonable multiples. Furthermore, both banks are in very good financial health and are now authorized to buy back shares and ramp up dividends once again. Turning to the insurance industry, we completed our position in Manulife while its stock was still trading at an attractive valuation. To fund that purchase, we reduced our position in Sunlife. To derive further benefit from the strong economic upswing, we increased our exposure to cyclical stocks. First, on the materials front, we added to our position in Teck Resources. Not only is Teck Resources expected to enjoy an increase in base metal and coal prices, but it is also about to enter a major growth phase in its copper production over the next

few years, which will lead to significantly enhanced cash flow. After making some profitable trades related to the saga between Canadian Pacific (CP) and Canadian National (CN), we went with CP, as it won the battle and will acquire Kansas City Southern in the United States. We believe that this combination will transform Canadian Pacific, placing it in a very advantageous strategic position in the freight transportation sector in North America. Also in the industrial sector, we initiated an investment in CCL Industries, whose stock will benefit from the economic recovery. CCL Industries is also expected to accelerate its growth strategy through acquisitions in the coming years. Once again with the aim of positioning our portfolio to gain from the economic recovery, we hiked our weighting in Enbridge and in the Energy index fund in the United States. The outlook on oil prices is excellent, as OPEC is remaining disciplined and is successfully controlling the increase in supply for the moment. As far as the real estate sector was concerned, we added to our position in Allied Properties, a quality real estate company that has been trading at a discount in relation to the value of its assets. To fund that investment, we sold our position in Choice Properties. Choice has been one of the most stable real estate investment trusts during the pandemic and therefore offered little potential for appreciation in a return-to-normal situation compared to its peers. In the technology sector, we reduced Apple and Amazon and added to our positions in Adobe and Visa. We think that Visa will eventually benefit from the resumption of tourism and inter-country travel, while Adobe's transition to a subscription-based model allows for good visibility of its future cash flow. In telecommunications, we replaced Quebecor with Telus. The major changes in Quebecor's management were a concern for us in the short term, and we will revisit the situation at a later time. Lastly, to fund our many purchases, we decided to reduce our exposure to Dollarama and Brookfield Asset Management and eliminate positions in Loblaws and Restaurant Brands.

It is important to remember that our philosophy focuses on quality and that our portfolios are made up of shares of well-established companies. In general, during favourable times like 2021 when the appetite for risk is great, high-quality securities struggle to keep pace with indexes. Despite this less favourable environment for quality, our core equity portfolio ended 2021 slightly ahead of its index, which fully satisfies us given the moderate level of risk in our portfolios. This strong performance can primarily be attributed to the Canadian equity portfolio, which generated excellent returns during the year.

It was a good year for our fixed-income holdings as well. The increase in bond yields has had a limited impact on the value of the bonds in our portfolios since we maintain a relatively short average maturity compared to the benchmark index. In addition, the bond weighting of our portfolios is below our strategic target, which turned out to be a good decision in 2021. It's also important to mention that our heavy weighting of preferred equity, the fixed-income segment that performed the best, has served the portfolios well.

As you know, we continue to look for alternatives to bonds, as their expected returns remain below inflation. We are looking at a few opportunities and we hope to make some additions this year in the alternative investments category. It is impossible to perfectly replicate the risk profile of bonds, but there are alternatives that have worthy characteristics. The RBC Canadian Core Real Estate Fund is a good example, and we have initiated that position for most of our client mandates. With its tax-efficient distribution of around 3.5% and its low volatility, we consider this fund to be a good alternative. In addition to offering the potential for long-term growth, private real estate has little correlation with equities. The fund suffered a slight setback due to the pandemic in 2020, but in 2021, the total return was 9.1%, which is good. In comparison, bonds ended the year with a total return of -2.54%. Obviously, these alternative investments are not very liquid and require a longer-term commitment, so we limit the weighting of this asset class in portfolios to reasonable levels. But in our view, in the current economic climate, alternative investments are attractive and could represent up to 10% of a portfolio with a long-term investment horizon.

We hope that this account of our management has been useful to you, and we invite you to contact us for any questions or clarifications.

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