Wealth Management
Dominion Securities

RBC Dominion Securities inc.

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FEBRUARY 2020

Market update

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As the years come and go, we can see that each is unique. Although 2018 was challenging for stock markets, 2019 turned out to be exceptional, especially the last quarter when indexes climbed to new peaks. The acrimonious negotiations between the United States and China that started in 2018 finally led to an agreement, and the markets welcomed the good news enthusiastically. This reaction may seem surprising given that the agreement is quite limited and there is still much work to be done to normalize relations between the feuding nations. However, the conclusion of this first negotiating phase demonstrated that China and the U.S. could reach a compromise, which helped lessen the risk that trade tensions between the two countries would heat up to the point of pushing the global economy towards a recession.

New challenges for the new year

Since the start of the new year, investors have turned their attention to two new sources of risk for the economy and the markets: the coronavirus outbreak and the U.S. elections. While the World Health Organization harbours fears that the virus will spread to a number of other countries, the markets have been behaving as if the outbreak has already been reined in. In this way, they are operating according to an entirely different rationale. Even though the number of infected individuals is still rising, investors are focusing instead on the daily number of new suspected cases in China. That indicator remains encouraging.

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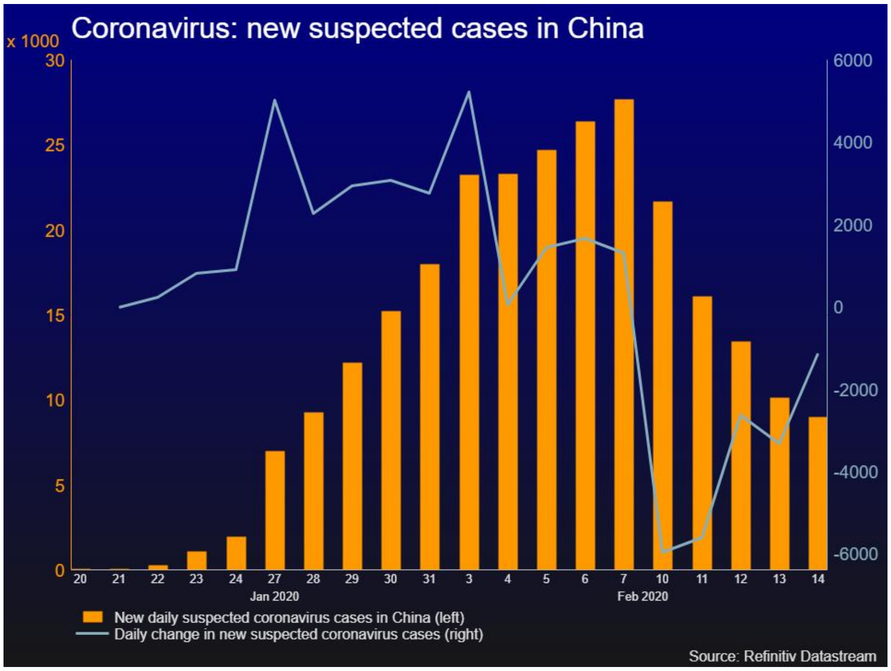


As shown in the above graph, the increase in the daily number of new suspected cases in China seems to have peaked around February 3, and the S&P 500 index has been on the upswing since then. Despite this optimism in the markets, which currently seem to be counting on a rapid resolution, it is important to keep in mind that the global economy will certainly be affected by the outbreak, and numerous companies will experience the repercussions. A number of corporations have already warned their shareholders that the virus will affect their financial results for the first quarter of 2020. Nevertheless, the impact on economic activity should be brief if the efforts to curtail the spread of the outbreak are successful. We are continuing to monitor the situation closely and we hope the news will be encouraging in the coming weeks.

The U.S. elections in November are another major issue this year. With the races to choose presidential candidates already well under way, investors are more concerned about who will be leading the Democratic Party's ticket. If a more left-leaning candidate becomes the nominee, we are concerned that the market indexes will suffer because financial markets are not anticipating that type of scenario. The more "socialist" Democrats, such as Bernie Sanders and Elizabeth Warren, are promising stronger regulations on corporations, expanded social programs and higher income taxes. The financial markets would obviously respond fairly negatively to policies such as those. Although the candidate would have to go on to win the White House, the markets could come under pressure, especially if the poll results are still close as the election nears. The Senate elections will be watched just as closely by the financial markets because a continuing Republican majority in the upper house would considerably limit the field of action for a left-leaning Democratic president. Looking at all the possible combinations for the presidency, the Senate and the House of Representatives, the final result is very likely to be acceptable to the financial markets. But surprises are always possible, as evidenced by Donald Trump's election and the Brexit referendum vote in the United Kingdom. We will therefore need to keep a close eye on U.S. politics in 2020.

Portfolio positioning, major transactions and performance

Given that stock market valuations are quite high and bond yields are low, we prefer to remain cautious in hopes of capitalizing on opportunities that could arise in the coming months. We are therefore keeping the cash levels in our portfolios higher than our strategic target. Moreover, the fixed income portfolios have a shorter term than the benchmark index and we are focusing on holdings whose credit ratings are above average. At this point in the economic cycle, the yield spreads on lower quality corporate bonds are not sufficient to make up for the added risk. We still have a significant weighting in preferred shares, which are a fixed income category where valuations still seem attractive to us. On the equity side, we are also remaining cautious. Since the economic cycle seems to be very far along, we are holding shares in quality companies that are less dependent on the economic cycle. We are particularly concerned with debt levels at this juncture and, as a result, we are favouring businesses that are in better shape financially.

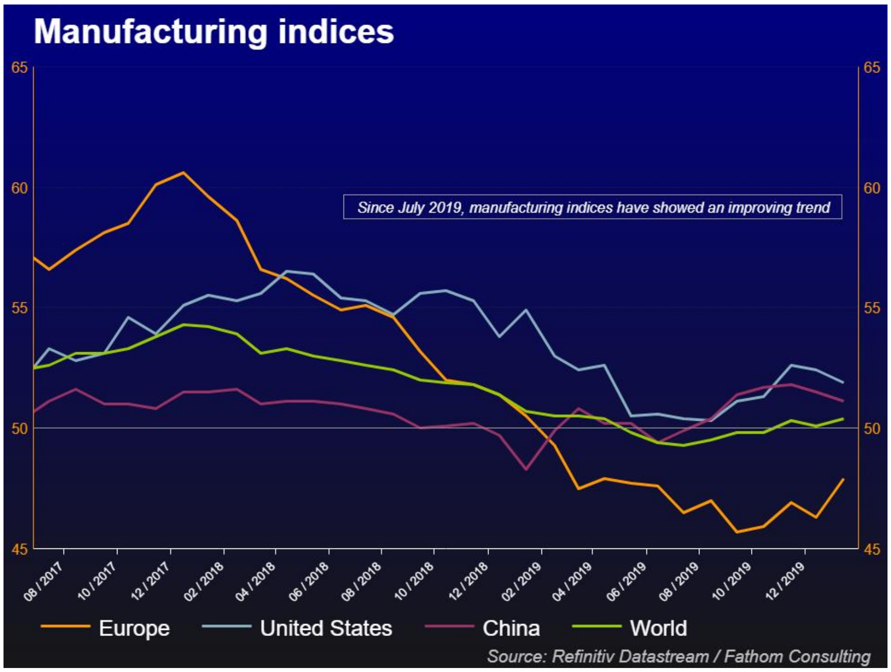
Since our last financial letter, we have made a few changes to our primary equity portfolio, as outlined below. With regard to Canada, we trimmed our weighting in Canadian banks again by selling off our National Bank of Canada holdings and we boosted our exposure to Onex Corporation. National was the best-performing bank in 2019, and its valuation in relation to the sector had become less appealing. For its part, the private fund manager Onex is trading at a discount in relation to the value of its assets, and we have noted that its investments have been performing significantly better in recent quarters. We believe the stock's valuation could shift over the next 12 months. In the energy sector, we decided to replace Husky with Canadian Natural Resources, an oil and natural gas producer that generates substantial cash flows. At the U.S. equity level, we made major changes in the healthcare segment of our primary portfolio. Because 2020 is a U.S. election year and a number of candidates vying for the Democratic nomination are promising drastic measures that could have an adverse impact on major pharmaceutical companies, we decided to sell off Pfizer and pare back Johnson & Johnson. We used part of the proceeds to buy stock in Boston Scientific, a company that would be less vulnerable if the Democrats were to take power. We also initiated a new position in Crown Castle, a real estate investment trust that owns communications towers and other infrastructures that are in high demand now that U.S. wireless phone networks are upgrading to 5G. More recently, we decided to take profits and shrink our position in Apple, which posted an exceptional performance in 2019 with an 89% return.

Looking at how the holdings in our portfolio performed, Canadian equities fared better than the benchmark index, while U.S. equities ended the year slightly behind the S&P 500 index. Despite our cautious approach, we were able to keep pace with the market indexes, something that tends to be difficult in a year like 2019 when the market powered ahead. With respect to fixed income securities, bond portfolios benefited from the widespread drop in interest rates. However, given that we maintain a term relatively shorter than the index (approximately 8 years), our bond portfolios were not able to match the performance of the benchmark (Canadian Universe Bond Index). In the preferred share category, performance lagged until August 2019 but then picked up nicely. Against a backdrop of low rates, the dividend yield for preferred shares is still good and receives favourable tax treatment. We believe that preferred shares remain a good value in comparison with bonds.

Our outlook for the coming months

U.S. economic activity remains buoyant, and household spending, which accounts for nearly 70% of the country's economy, is continuing to grow at a fast pace. Since our last financial letter in July 2019, job creation has been robust and wages have continued to rise more quickly than inflation. Thanks to a relatively high savings rate, U.S. households are still in a favourable financial position. By cutting rates three times in the second half of 2019, the Federal Reserve has ensured that this trend will continue in 2020. The likelihood of a recession has in fact waned recently according to a number of indicators.

During the past year, investors have been most concerned about the manufacturing sector. The trade war between the U.S. and China created considerable uncertainty and was a drag on trade. However, since July 2019, the manufacturing indicators for the major economic regions have rebounded, as shown in the chart below. Even though this turnaround is still weak, the trend is encouraging. The coronavirus will have an impact on the manufacturing sector, and it would not be surprising for those indicators to slip again. If the outbreak is kept under control, the situation will be temporary. The next few months will shed more light on the scope of this challenge.



After falling in 2019, profit growth should recover over the course of this year. Expectations for growth are in the 6-7% range, which is not inconsequential. However, stock market index valuations are still relatively high against the average for the past 10 years, owing in part to very low interest rates. It is therefore difficult for us to foresee multiples expanding as they did in 2019, and for that reason we believe the potential returns on equities will be in the 5-10% range in 2020.

The U.S. equity market has been outperforming for a number of years and that trend has carried over into 2020. As a phenomenon, it can partly be attributed to sectoral differences among the world's regional indexes, but the performance gap is starting to be large enough that we are interested in taking a closer look at the situation. For example, the European market's valuation is at its lowest in 10 years in relation to the U.S. market, as seen in the graph below. On the basis of price/earnings ratios, the MSCI Europe index is at a major discount compared to the S&P 500. Our hope is to be able to identify securities that are trading at more attractive valuations without compromising our quality-focused selection criteria.

In conclusion, we remain cautious in both the selection of our securities and in asset allocation. In light of the fairly high valuations, uncertainty about the coronavirus outbreak and the upcoming U.S. elections, we think the months ahead could offer some good opportunities to redeploy our cash holdings. We trust our update has been useful to you, and we encourage you to contact us if you have any questions about our strategy or about your portfolio.

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