Wealth Management
Dominion Securities

RBC Dominion Securities inc.

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Market update

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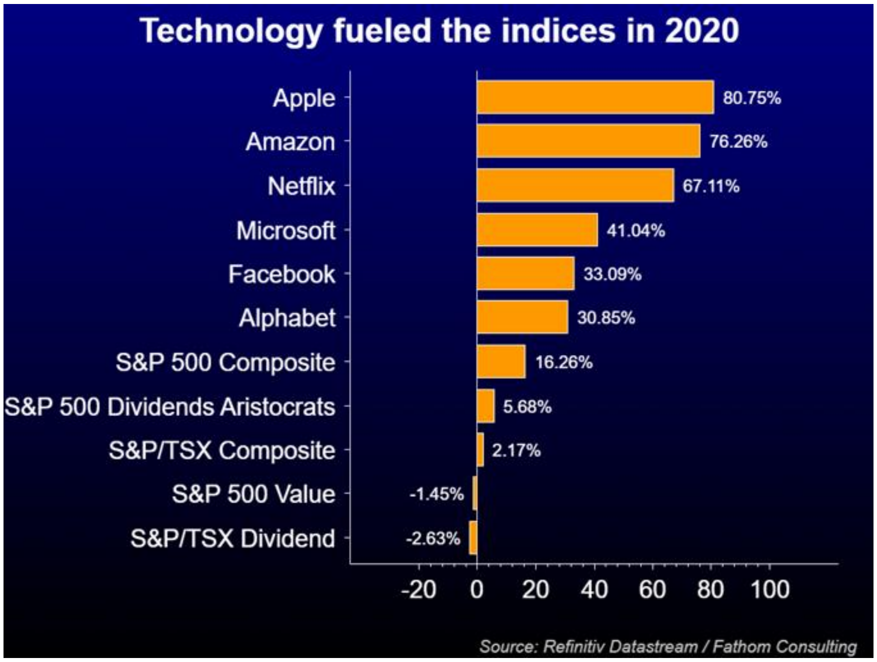
Overshadowed by a global health crisis that has already claimed too many lives, the year 2020 will remain forever etched in our memories. Although it's still too soon to look back on this crisis, there's no doubt the pandemic's impacts will be numerous and long-lasting. From an economic viewpoint, the year was marked by an acute worldwide recession as well as interventions on an unprecedented scale by governments and central banks all across the globe. And as if 2020 hadn't been chaotic enough, political agitation in conjunction with the U.S. elections and prevailing social tensions only added to the uncertainty.

Despite these extremely challenging conditions, various stock market indices ended the year on surprisingly strong notes. For example, the S&P 500 set a number of new records in the final months of the year. Despite the progress it has made, the bellwether U.S. index is masking a very different reality for many stocks. Certainly, the S&P 500 is heavily exposed to the technology sector, especially the web giants Amazon, Apple, Alphabet, Facebook, Netflix and Microsoft. Those companies and various others operating in the tech sector benefitted from the social distancing measures imposed by governments. While the increasingly widespread adoption of remote work arrangements and online shopping habits favoured those sectors, many others were pummeled by the recession. As shown in the table on the next page, the indices with the lowest tech exposure, such as the value and dividend styles, turned in much weaker performances.

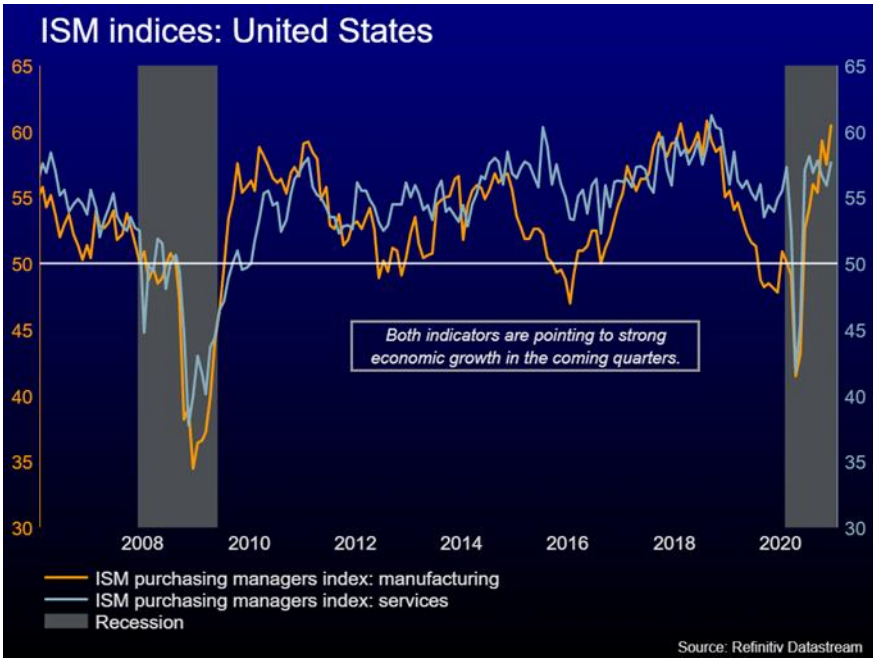


Jacked up by the tech sector, growth stocks outperformed value holdings by a margin of over 30% during the year, a situation that had never been seen before. The mad dash to tech in 2020 also had a major impact on Canada's stock market. A case in point was Shopify which, on its own, accounted for about 4% of the Canadian index's performance. That means the rest of the country's universe made almost no progress this past year.

With the vaccination campaign being rolled out almost everywhere in the world, it looks like the economic recovery will continue into 2021. In this context, we anticipate a very different year where tech and other more defensive sectors could underperform the more cyclical sectors as well as those that were knocked backward by the pandemic. This rotation seems to have been in the works for some time and the trend could pick up speed as the economy makes up for lost ground.

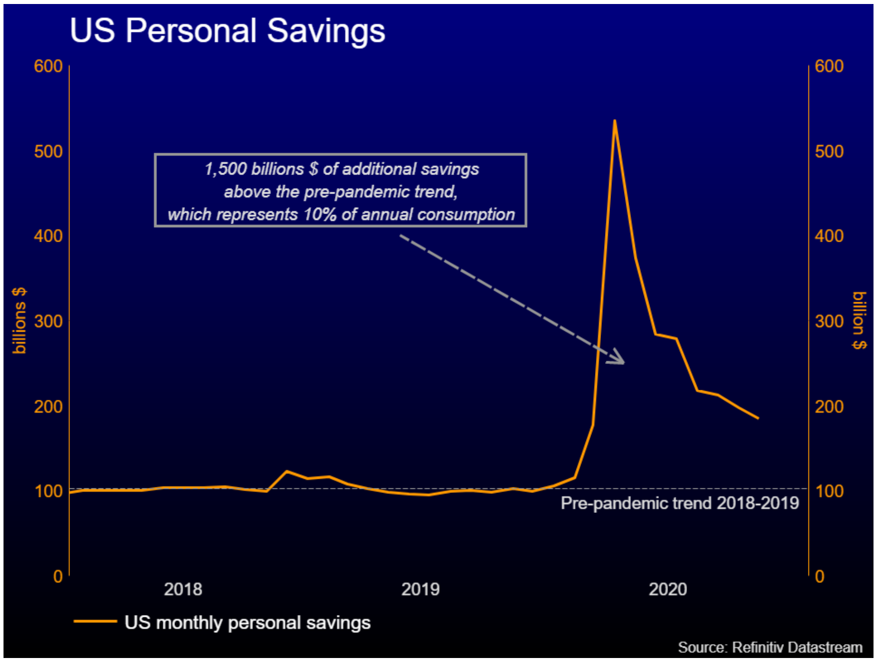
Economic outlook

After taking a deep dive in the first half of 2020, the global economy bounced back up in the remainder of the year. Third-quarter growth was robust but the fourth quarter is expected to show only a small gain once the figures have been released. This slower recovery in the final quarter was attributable to the latest wave of virus transmission that led to the imposition of new distancing measures in countries around the world. Although the upswing has been uneven, a number of economic indicators remain encouraging for 2021, as confirmed by the ISM surveys illustrated in the graph on the next page. In particular, when it comes to both manufacturing and services, the indicators are comfortably above the 50 mark, which is a sign that economic activity will continue to rev up in the coming year.

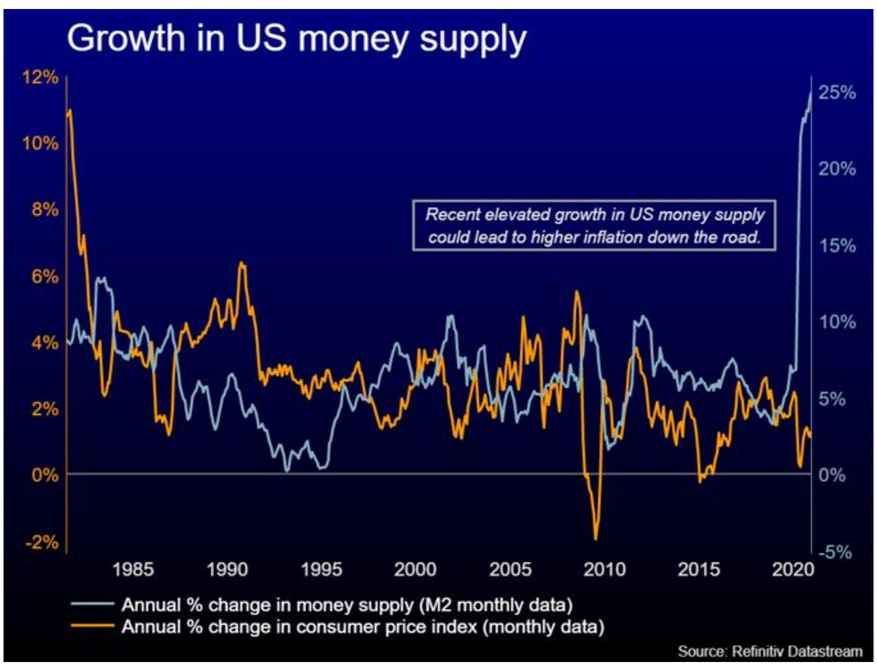


In the months ahead, vaccination programs will be expanded and the likelihood that we'll be able to get back to some kind of normal in 2021 will continue to increase. As the risks associated with the coronavirus diminish, the economy will benefit from the progressive revival of a number of sectors that are currently treading water. Moreover, it's possible that various areas will have some catching up to do before the economy can return to its pre-crisis cruising speed. For instance, in reaction to the uncertainty created by the pandemic, numerous companies underinvested in their means of production and will eventually have to make those essential investments. Another factor is that inventories across the entire supply chain are very low and will have to be built back up so the economy can run more smoothly. A similar phenomenon has occurred in terms of spending by consumers, who postponed many purchases during the crisis while at the same time receiving emergency assistance from governments. The high personal savings rates in various countries since the start of the pandemic are a good indicator of this pent-up demand that could have a powerful impact on the economy. As shown in the chart at the top of page 4, Americans' additional savings since the pandemic began stood at $1,500 billion compared to their pre-pandemic pace. Representing about 10% of annual consumption in the U.S., that amount is significant. It's worth noting that those additional savings don't even include the $900 billion support plan approved by the U.S. Congress in late 2020. If the $1.9 trillion program proposed by President-Elect Joe Biden is added to those already approved amounts, a scenario where the inflation rate exceeds the Federal Reserve's 2.0% target is plausible in the near future.

For its part, the Fed doesn't seem to be considering any changes to its monetary policy in 2021. There is every indication that it will keep rates very low and continue to buy up massive bond holdings in the market. In a statement released last September, the Fed said that with inflation running persistently below its target in recent years, the central bank's decision-makers would now "aim to achieve inflation moderately above 2 percent for some time." The Fed's expansionary monetary policy in conjunction with the government's generous assistance programs could lead to accelerating inflation during 2021.

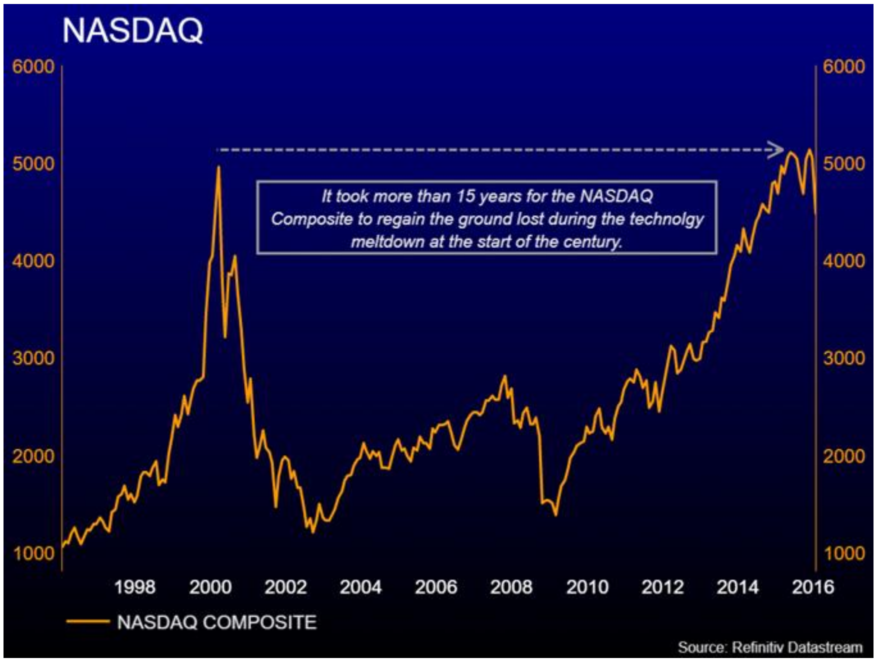


As evidenced by the following graph, inflation and an expanding money supply are quite closely correlated on a historical basis. The record growth in the U.S. money supply may signal an environment where inflation rises above the 2.0% target for an extended period. However, the virus will have to be brought under control before all that money can start flowing again.



Market outlook

When investing in financial markets, we still favour equities over fixed income securities. Against a backdrop where economic activity is returning to normal, we believe business profitability will be greatly improved. On average, strategists are forecasting that profitability for the S&P 500 index will grow by approximately 23% in 2021 and about 10% in 2022. It's interesting that even though the economy won't be running on all cylinders in the first months of 2021, profit levels for that year will be slightly higher than in 2019, prior to the pandemic. We're well aware that equity valuations are high at the current moment but this situation is justified in part by very low interest rates. With brisk economic growth expected in 2021 and 2022, we believe the market is ripe for sector rotation. A shift in the leading positions seems to be in the cards. The more cyclical industries and those that have suffered during the pandemic should perform better. Meanwhile, tech stocks and defensive sectors such as utilities and communications won't be as popular. Value holdings should make a comeback after experiencing a tough year in comparison to growth stocks. Keep in mind that many segments of the tech sector are showing signs of excessive speculation and we're especially concerned about that trend. Even though the sector seems very promising, there are sure to be winners and losers in the various tech fields. All you have to do is think back to all the promising companies that disappeared in the early 2000s (Worldcom, etoys.com, 360networks, etc.) or else those that survived but were worth only a small fraction of their earlier values when they were bought out (AOL, Yahoo, etc.) and you'll realize this remains a risky sector where the vast array of tech innovations can quickly transform the landscape. The graph below confirms that it took more than 15 years for the NASDAQ to regain the territory it lost when the tech bubble burst.



Nevertheless, not all the tech sector companies should be put in the same basket. There are plenty of very high quality companies, including the ones we invest in. They generate enormous cash flows, deliver outstanding returns on investment and are in great financial shape. For those companies, the issue isn't whether they'll survive but rather how to determine their true value. Every company has a price regardless of the quality of its operations and we closely monitor the valuations of our portfolio holdings.

Our opinion about the bond market hasn't changed. With anticipated returns barely exceeding inflation, bonds don't seem very appealing to us. Moreover, we think the ingredients are there for inflation to flare up later this year, which is far from ideal for the bond market and especially not for bonds with longer maturities. Bonds obviously have a stabilizing effect in portfolios because they tend to make gains during times of crisis while equities often correct significantly. But at this stage we're not very inclined to put new cash into maturities beyond 2-3 years. When it comes to preferred shares, we consider them to still be attractive. In fact, we upped our exposure to that asset class during 2020.

Portfolio management

Since last spring, we have progressively redirected a portion of our cash towards equities. Many of our investment choices targeted names that had been affected by the pandemic or whose valuations had severely overcorrected. In addition to making sure they met our usual investment criteria (low debt level, high cash flows, superior return on investment, strong management team, etc.), we analyzed those companies' business models. We're therefore confident they'll emerge from this recession intact and some of them may even be in a better position. What's more, taking our cue from encouraging signs that the economic recovery was well under way, we gradually turned our attention to stocks that are more sensitive to the economy.

Rather than going into detail about all the transactions in 2020, we've outlined the highlights for our main strategy below. On the banking side, we expanded our position in JP Morgan and initiated a new position in National Bank of Canada (that position was later sold at a profit). The sector took a big hit because of expected increases in loan losses but we were confident those two banks would quickly move back to their profitability levels in a more normal environment. In the insurance industry, we initiated a new position in Manulife while its stock was trading below book value. We also added to our investment in Intact after it announced the acquisition of RSA. Synergies, especially in Canada, will be very significant and we believe the stock will more accurately reflect the true value of that acquisition as integration progresses. Turning to consumer goods, we initiated a new position in Coca-Cola and boosted our existing position in Diageo. Those companies' earnings were dampened when countless bars and restaurants were shut down but the businesses remain very profitable. Plus, they pay good dividends and our view is that with a bit of patience, their stocks will eventually climb back to their respective peaks. In the industrial sector, we added Emerson Electric, a quality company paying a good dividend. They had started cutting costs and improving margins well before the crisis began and the company is now in an excellent position to amp up profits as the economy regains its footing. As far as the real estate sector was concerned, we initiated a new position in Allied Properties, a quality operation that was trading at a discount in relation to the value of its assets. Also in that sector, we brought the Prologis real estate investment trust into the portfolio. That REIT has a very big presence in distribution centres and will benefit from accelerating online shopping in the years ahead. On the materials front, we hiked our weighting in Dow, Corteva and Nutrien and initiated a new position in Teck Resources. Dow is very sensitive to a rebound in economic activity and its stock should continue to gain traction in that scenario. Corteva and Nutrien are well positioned to capitalize on higher prices for agricultural products such as corn, soybeans and wheat. Vigorous economic growth in 2021 could be beneficial for raw materials and petroleum products. The Canadian index, which is full of small mining, petroleum and gas companies, could attract more attention from investors. That environment is difficult for investors like us who want quality, larger-cap names. Nevertheless, by adding mining company Teck Resources and energy transmission company Enbridge, we've enhanced our exposure to a surge in commodity prices. To fund part of our new investments, we sold Costco and pared back Microsoft, Apple and Amazon. Those four stocks performed extremely well during the crisis and their return potential had become relatively less impressive.

In 2020, our primary U.S. equity portfolio outperformed its benchmark index. That strong performance was partly attributable to Amazon, Honeywell, Prologis, Crown Castle and Abbott Labs, which did very well in their respective sectors. On the Canadian side, our primary portfolio underperformed the S&P/TSX index. That lag was due essentially to our absence from the gold sector and the explosive run-up of Shopify, which we don't hold and which now accounts for over 6% of the Canadian index! It's important to keep in mind that gold companies generally do not meet our selection criteria. And looking specifically at Shopify, its valuation is at a dizzying height. Besides, our U.S. equity portfolio is already well invested in tech.

Turning our focus to fixed income, we gradually raised our exposure to corporate bonds with superior credit ratings as well as better quality preferred shares. We believe the returns on those holdings will outpace government bonds, which are currently trading at unappealing levels. In general, our fixed income portfolio has gained ground as rates have fallen across the board. However, since our bond maturities are shorter than the benchmark universe, our portfolio didn't benefit to the same extent. We're still comfortable with our current positioning because we're concerned bonds with longer maturities will suffer even more if inflationary expectations are realized later this year or next year. With interest rates so low, we're continuing to scout out alternatives to replace part of our fixed income holdings. Where appropriate, we were able to make certain investments in real estate and structured products and we'll look into other opportunities over the year ahead.

In such a low interest rate environment, expected returns for fixed income securities aren't very attractive at this point. To sustain the returns from previous years, investors will have to review their portfolios' asset allocations and perhaps proceed by taking on more risk. For investors whose investment horizons are long enough, corporate bonds, preferred shares and common shares could play a greater role in their portfolios at the expense of government bonds. Of course, changes in strategy should only be made after considering risk tolerance and various other factors specific to each investor.

We would be pleased to discuss your needs with you during our next meeting.

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