WEEKLY
MARKET INSIGHTS

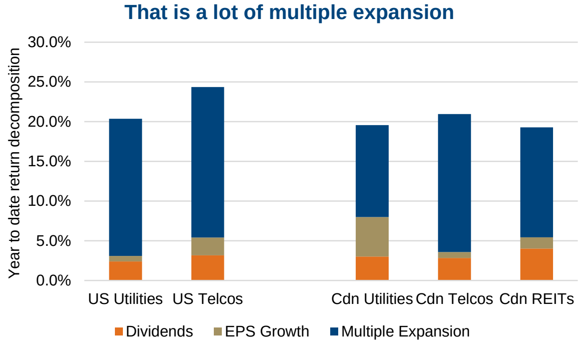
August 15, 2016

THE LATEST MARKET INSIGHTS
FROM THE RICHARDSON GMP TEAM

Careful how much you pay

The two best performing sectors of the S&P 500 so far this year are Telecom and Utilities. In Canada, these sectors have done very well too, only trailing the recovery in Materials and Energy. Of course this flight to high-yielding stocks, such as those found in the Telecom and Utilities sectors, is primarily in response to bond yields dropping to all-time lows. A 1% yield on a 10-year Canada government bond certainly makes dividend paying equities more valuable as more investors reach for yield in the equity markets. However, the rise in prices of 'bond proxies' has come largely from multiple expansion as earnings growth has been tepid. And this comes with risks.

That is a lot of multiple expansion



The chart on the right breaks down the year-to-date returns of U.S. Utilities and Telcos as well as Canadian Utilities, Telcos and REITs. All these sectors are up about 20% so far this year and almost all of these gains have come from multiple expansion. Each bar breaks down how much the return came from dividends, earnings growth and multiple expansion. The problem with multiple expansion is it is very volatile and often experiences mean reversion. The risk of such rapid multiple expansion is it has made these sectors even more expensive.

Yields could continue to move lower, supporting these valuations. They may even push a bit more multiple expansion to lift the share prices. However, we believe the risk vs return trade-off will more likely go the other way. Given the elevated valuations, even a small uptick in yields will have a dramatic effect on these so-called "bond proxies." Based on this view, we have gone no-weight utilities across all our Canadian portfolios and underweight in our U.S. mandate.

We are also underweight REITs across our mandates. There has been some recent weakness in the space over the past few weeks with many Canadian REITs reporting earnings. Growth in the space is becoming increasingly difficult to come by and we're seeing some concerning trends coming out of western Canada. Names with significant western exposure are beginning to write-down some properties and guide lower. Lower yields have typically been a positive driver for REITs but that has not been the case recently, with the correlation between REITs and bond yields becoming weaker.

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On a separate note, the big news for the REIT space is that they will be broken out of Financials effective August 31st, 2016 and be listed as their own GICS sector. This is the first change at the sector level since GICS was created in 1999. The addition of this sector has a number of positive implications for the space, including:

- Asserting that real estate is a distinct asset class and that REITs are a part of it
- Increases the visibility of the sector, as well as institutional positioning within investment products such as mutual funds and ETFs. Pie charts will get slightly more crowded and you might see an extra sector bar on fund literature.

So the main question is, will simply adding a new sector result in increased flows? Initially we might see some increased volume, though this date has been a long time coming and fund managers have had plenty of time to buy in before the official changes. Up until now, REIT exposure has always been hidden within the larger Financials weight. Fund managers don't typically like to stand out (herding mentality), and they have generally been underweight the space.

While we think that REITs are expensive and worry about the likelihood of continued multiple expansion, we do expect the reclassification to have a generally positive impact. Just don't expect it to move the market in any material way. Despite being reclassified, the fact remains that the space is no longer cheap (though on a relative standpoint it is slightly cheaper than Utilities).

Not all high-yielding sectors seem expensive: one area of the market we find attractive is large cap pharmaceutical companies. Year-to-date, Health Care is the only bond proxy sector that has actually seen multiple contraction. In Pharma specifically the contraction in the multiple in has actually detracted -14% from the return, while earnings growth has added +9%. Political rhetoric has undoubtedly been a headwind for the sector as both the Republican and Democratic nominees have weighed in on drug pricing overhauls. At this point, we think the news is about as bad as it will get and that actual pricing regimes implemented by either elected party will not be as rigorous as what is currently being priced into the market. With major patent expiries now behind most of the constituents in the sector the market is focusing on growth in new and exciting treatments. We are overweight the sector in the Connected Wealth Core Income Fund (CWC200) with holdings in Pfizer and Merck.

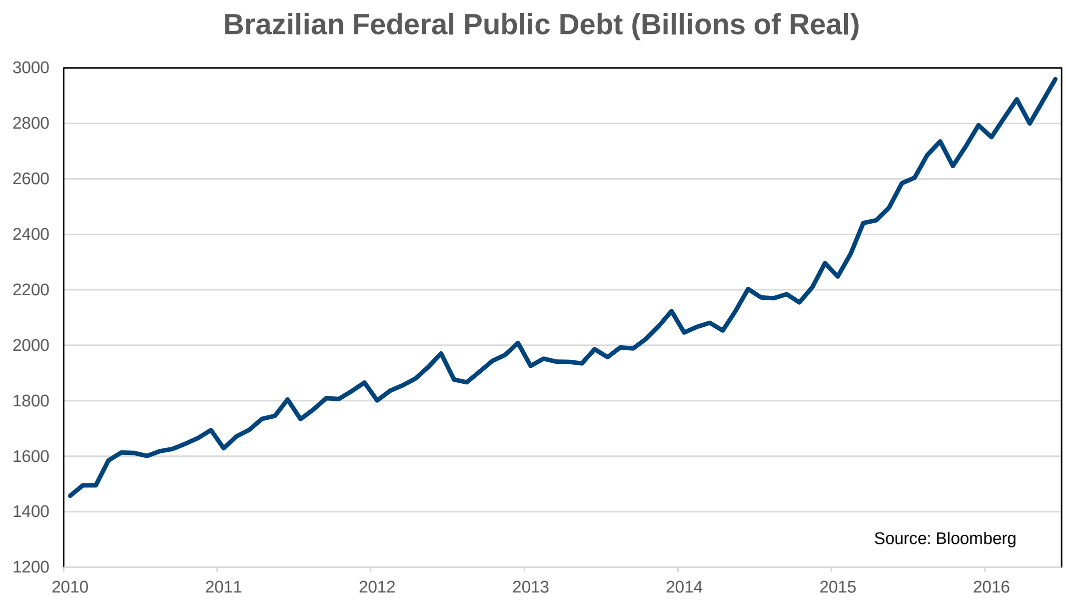
Question of the week

What has been going on with the Brazilian economy and does it compare to Canada since both countries have commodity-based economies?

Last Friday night the eyes of the world turned to Rio de Janeiro with the start of the Summer Olympic Games. Attention had turned to the athletes and sport and away from every other negative headline you could image including the Zika virus, favela poverty and political strife. Lost in all of these headlines is the fact that the Brazilian economy has struggled for some time – many investors understand that Brazil's commodity-based economy has weakened like many other similar economies worldwide, but the Brazilian decline has been particularly bad with that country now in recession since 2014 with the economy contracting 3.8% in 2015. We also saw a year-over-year decline of 5.4% in Q1/16 and economists estimate a contraction of 3.5% overall in 2016. Canada is also a commodity-based economy, but we certainly haven't had the same experience as Brazil for a variety of reasons, including fiscal policy, industry structure, interest rates and politics.

We'll start off with politics since it's the elephant in the room with President Dilma Rousseff currently in the midst of possible impeachment proceedings. Simply put: the political situation is stable in Canada and unstable in Brazil. We won't dwell on the details of the impeachment story, but will simply add that impeaching your President for alleged corruption never bodes well for foreign investment or investor confidence.

With politics at play, fiscal policy is always manipulated and Brazil has been no exception. Yes, Canada has loosened the strings of its fiscal purse with the election of the Trudeau Liberal government, but President Rousseff has been playing with the Brazilian piggy bank to help her in the last election and to garner support before impeachment proceedings started. Public sector debt has been rapidly expanding in Brazil with it reaching almost 70% of GDP at the end of 2015, up from 53% in 2013 and 59% in 2014. Canada's spending is also increasing, but certainly not at a similar rate to what has been spent in Brazil. Economists expect the Brazilian spending rate to grow which causes many to worry that Brazil's debt levels could spiral out of control, no matter who is President going forward.



You may have heard of ZIRP before? Zero Interest Rate Policy, which is basically what we've had in the United States for years and continue to see in Europe and Japan. Canada also has historically low interest rates, but Brazil is a completely different story as the short term interest rate targeted by its central bank, otherwise known as the Selic rate, currently sits at 14.25% as high rates have been required to keep inflation under control. Financing debt at cheap rates is obviously a simpler task in Canada to help support the increased spending we'll see here at home in the coming years.

Lastly we come to industry structure, especially when it comes to the oil and gas industry where Brazil basically controls energy production through its approximate 64% state control of Petrobras. Such control has led to mismanagement (and, of course, corruption) which is one of the reasons why Dilma Rousseff is currently being impeached. In Canada, while the government provides regulation over the industry, there is no direct government ownership in oil & gas companies.

We could highlight a number of other differences between our countries, but these are some of the key elements which would explain why Brazil has stumbled economically for so long. We're not saying the economic outlook for Canada is a slam dunk, but certainly our country is in a better financial position and likely could be for some time unless commodity markets dramatically improve in short order.

For those wondering if hosting the Olympics will make a difference to the Brazilian economy, the answer is likely yes, but in a bad way. Vancouver and London have shown that Olympics can be held within financial means, but Rio has encountered a number of problems which will no doubt leave the games in the red. While the Rio Olympics may not end up being financial disasters like Athens and the $50 billion Sochi boondoggle, it's hard to see how any economic benefit from the games can help Brazil overcome its current financial challenges.

Charts are sourced to Bloomberg unless otherwise noted.