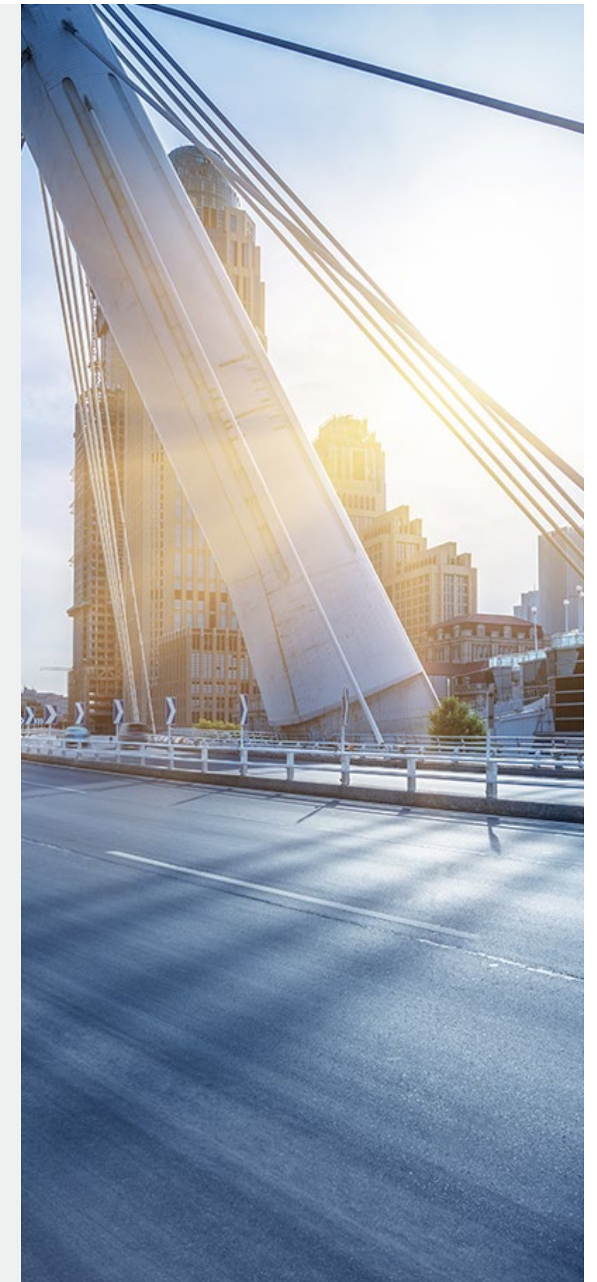
RICHARDSON GMP CONNECTED WEALTH

4 August, 2020

Investor Strategy

The Recovery Continues

Craig Basinger	Chief Investment Office	Craig.Basinger@RichardsonGMP.com
Chris Kerlow	Portfolio Manager	Chris.Kerlow@RichardsonGMP.com
Derek Benedet	Portfolio Manager	Derek.Benedet@RichardsonGMP.com
An Nguyen	Vice President, Investment Services	An.Nguyen@RichardsonGMP.com
Joey Mack	Head of Trading, Director, Fixed Income	JMack@RFSecurities.com
Alexander Tijang	Investment Analyst	Alexander.Tijang@RichardsonGMP.com



Executive Summary

- **Part 1: Market recap – Dollar stumbles and data fumbles**
  - Another great month albeit with narrow market leadership.
  - Lots of currency movements with the US dollar falling against all currencies, less so against the CAD.
- **Part 2: Asset allocation – Flipped radical**
  - Economic recovery has surprise to the upside. However we are starting to see some signs of a loss in momentum.
- **Part 3: Asset allocation – Gold & the dollar**
  - Gold and gold stocks have been on a tear fuelled by a host of factors.
  - While still positive on the metal and sector, trimming does seem prudent.
- **Part 4: Fixed income – New bank capital instruments see preferred shares rally**
  - Prefs got a boost this month as banks start to use a new capital instrument. This may reduce the supply of prefs over time.
- **Part 5: Managed Portfolios – A closer look at how we manage our currency exposure**
  - Managed portfolio investment process incorporates both the hedging activity at the individual fund/ETF level and at the aggregate portfolio level.

Market Recap – Dollar stumbles and data fumbles

Derek Benedet

Chart 1: Recovery Continues

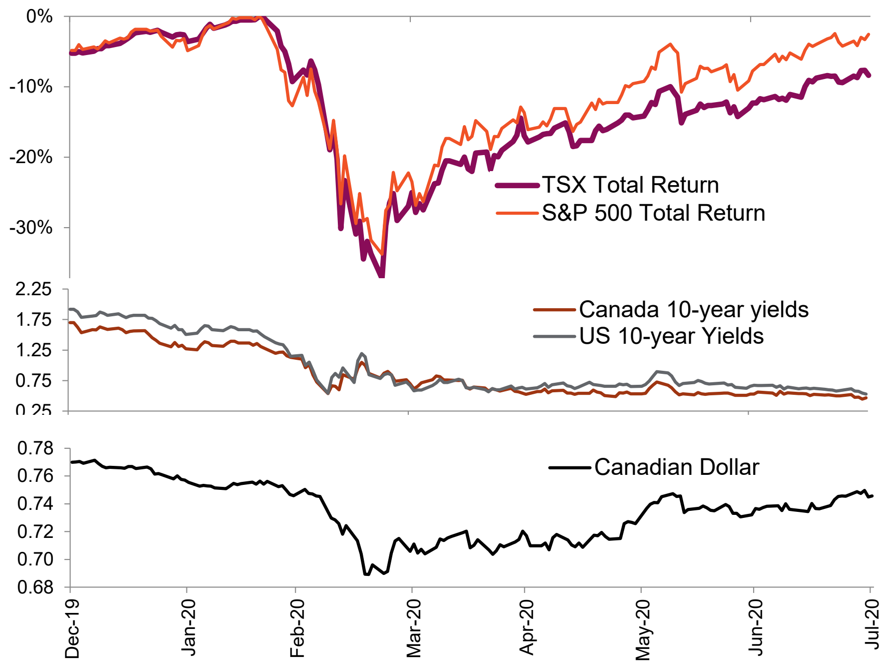
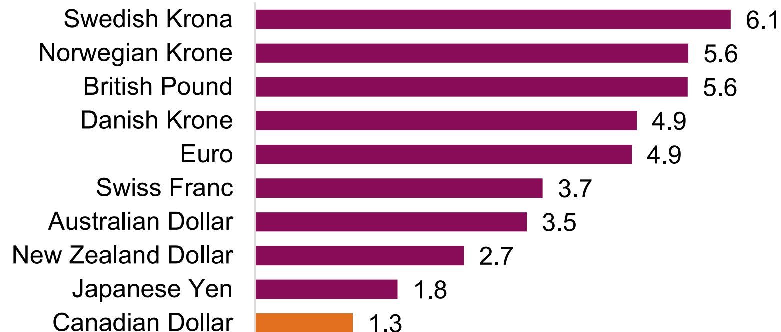


Chart 2: July currency gains against the USD (%)



- The dominating themes in July were better jobs, more mobility and higher cases. Global virus cases continue to climb, notably in emerging economies and the sunbelt states. Markets largely ignored the bad pandemic news, posting their best returns since, well, May. The S&P/TSX Composite rose 4.5%, and the S&P 500 (C$) rose 4.1%. Earnings season was a source of concern heading into the month but has been a net positive with some strong beats, albeit off low estimates. Globally, emerging markets have benefited from a weaker U.S. dollar with the MSCI Emerging Markets index rising over 6% in CAD terms. European markets were doing alright, until some poor GDP data came in at the end of the month, driving most markets lower.
- Market leadership has remained narrow. In Canada, once again it was the golds driving Materials higher and Shopify driving Information Technology. In the U.S. market, the advance was broader based. Leadership shifted from Technology (3.8%) to Consumer Discretionary (8.7%) as well as defensive sectors such as Staples (5.6%) and Utilities (6.5%).
- Equity markets have continued to rise. The bond market, that has been very rangebound, seems to have yields moving lower. The economic data bounce that has surprised most participants over the past few months may be starting to slow.
- Currency markets were quite active, with a weaker U.S. dollar the dominating theme. This resulted in a stronger loonie, but the Canadian dollar is significantly lagging most other currencies. Chart 2 reveals that the loonie is at the back of the pack compared to G10 peers.
- A weaker U.S. dollar is good news for commodities, with gold a primary beneficiary. Beyond currency weakness, plummeting real rates gave a further boost to gold, driving it up over 10% in July, to reach a new all-time high. This is quite an accomplishment after nearly nine years below the high-water mark.
- Markets have been generally optimistic, whether it's a vaccine, or hope for new stimulus, aided by reassurances from the U.S. Federal Reserve that policy remain as dovish as one can get. Fed Chair Jerome Powell reinforced the committee's extremely accommodative forward guidance during his press conference by asserting once again that the committee "*is not even thinking about thinking about raising rates*". He also highlighted that investors should not "look for us to be sending signals about cutting back facilities or anything like that for a very long time."
- Belief in near unlimited policy support has emboldened investors with an amplified sense of confidence. Shaken not stirred is the new mantra to soothe worries about economic contraction, escalating virus concerns, geopolitical risk, as well as a potential political turning point on the horizon.

Asset allocation – Flipped Radical

Chart 3: More timely economic indicators clearly point to a sizeable recovery, but the pace of some indicators is slowing of late.

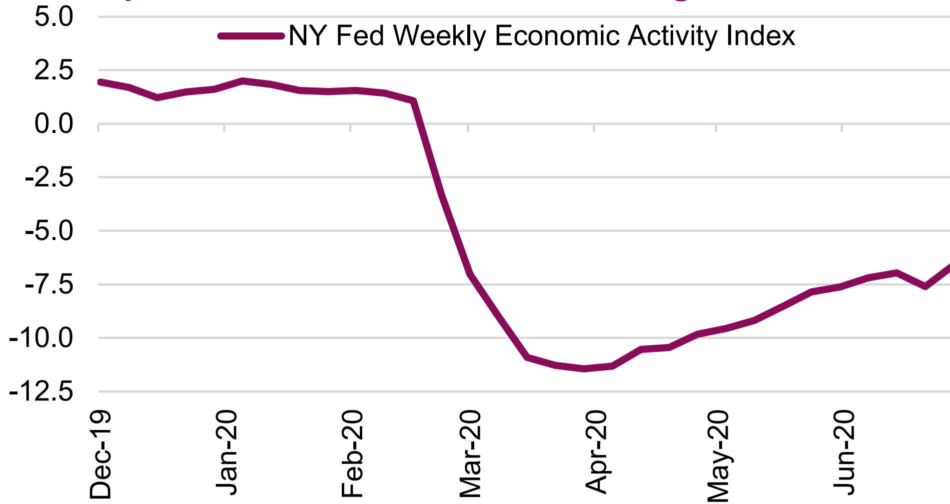
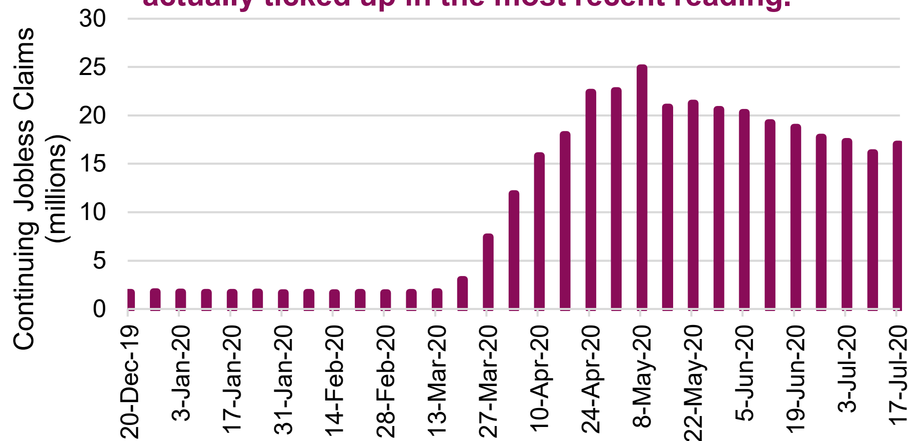


Chart 4: Continuing Jobless Claims in the US have actually ticked up in the most recent reading.



Craig Basinger

- The economy has tumbled into the abys, posting contractionary data that has no historical comparisons and only marginally comparable to war-time mobilization economic impacts. In Q2, the U.S. economy shrank by -10% year-over-year, Eurozone -15%. But this was self induced to combat the pandemic, and now those inducement measures are being lifted. Not uniformly by either geography or pace, but the broader trend is towards less social distancing, creeping towards normalcy.
- Q2 appears to be the economic trough. Traditional economic measures are less useful in this environment given how fast things are changing, causing economists to turn more to higher frequency (HF) data. The good news is we have seen a big bounce off the bottom.
- This bounce has been bigger than just about anyone's expectations. Retail sales, the return of millions of lost jobs, traffic, the list goes on. The big question is how far will this economic bounce go?
- The V-shaped recovery implies it keeps going until we are roughly back to where we started. The equity markets appear to be pricing in this scenario. The bond market less so. We continue to believe in the flipped radical recovery (a big drop in economic activity, a big bounce off the bottom which slows as the recovery continues).
- Restarting many components of the economy is relatively easy and quick. However, beneath the surface there is a sizeable cohort of jobs that won't come back or businesses that won't restart or will do so after adjusting for changes in behaviour. Government support can help mitigate but only temporarily.
- After big improvements in U.S. foot traffic for most industries in May and June, July saw this improvement roll over somewhat. This is likely due to the increase in cases of COVID-19, as some jurisdictions slowed or walked back reopening. It could be evidence we are nearing the slowing of growth on the right side of our flipped radical.
- This loss of economic momentum can also be seen in continuing jobless claims. Many components of the economy were turned off abruptly and many were turned back on almost as fast. But after this initial bounce, future improvements in jobs will likely prove slower and more difficult.
- While we do not believe the bounce is over, as more parts of the global economy return to normal, this will help the recovery. However the rate of change is key, and we believe it will continually decelerate in the coming months.
- At some point this will weigh on equity markets and given this outlook, we retain a mild underweight in equities.

Asset Allocation: Gold & the Dollar

Chris Kerlow

Chart 5: Gold Prices Have Risen On The Back of Falling Real Yields

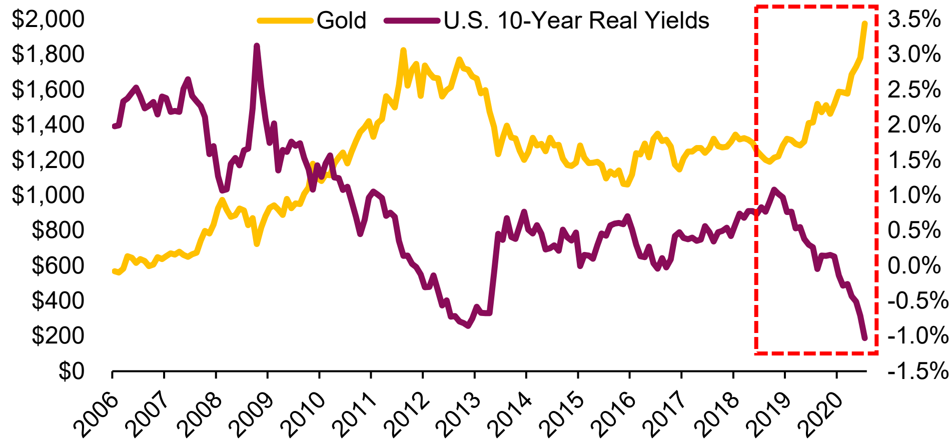
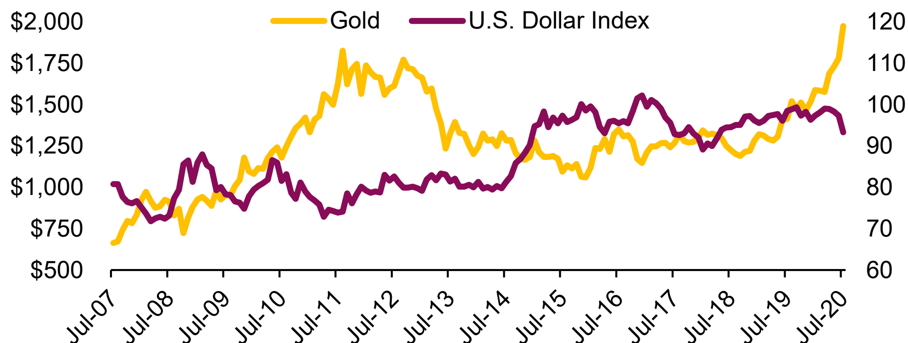


Chart 6: Gold Soars to New Heights while USD Struggles to Continue



- The price of gold, and gold-related equities, have enjoyed a very strong run over the past few quarters. This is almost a perfect environment for gold, benefiting from real yields, a falling U.S. dollar and demand for safe-haven assets. Of course, the question remains after a +30 rise in bullion prices and +53% in gold stocks so far in 2020, where to next?
- Real yields, that is nominal bond yields less consumer prices (CPI or inflation), have a strong negative correlation with gold prices. With real yields in the U.S. now at -1%, gold has broken through its previous 2011 high set when real yields were at similar levels. (**Chart 5**).
- There is also a common feeling that the Fed will allow inflation to run above its 2% target to justify ultra-accommodative monetary policy. As this will continue to suppress nominal yields, and should we see a rise in inflation as the recovery takes hold, real yields could fall even further.
- When yields do rise, we would expect to see gold head lower. Gold works like an inflation-adjusted risk-free asset; when real yields are low or negative and risk-free bonds are yielding less than inflation, gold is priced higher (and the opposite is true). However, this is not our near-term expectation at this point.
- Gold has also been benefiting from structural flows. Even today, among Canadian funds & ETFs, the Materials sector which is about 50% comprised of gold companies, remains one of the biggest underweight in portfolios. This may be changing as demand for safe-haven assets continues to rise.
- Another reason to own some gold or gold stocks is the U.S. dollar. There is a strong long-term inverse correlation between the U.S. dollar and gold prices.
- The U.S. dollar continues to be under pressure due to the Trump administration's (mis)handling of the pandemic, election risk and narrowing interest rate differentials. Gold provides a good hedge for investors against a falling U.S. dollar.
- Momentum is certainly working against the dollar currently. We would likely need to see a reversal in equity markets and sentiment to buck that trend. However, that is exactly why adding to your USD positions across asset classes is a prudent portfolio protection strategy given where the dollar is trading.
- Holding gold should also help mitigate portfolio volatility. However, if you had a healthy weight coming into the crisis, you would have a large position now. Given how aggressive the move has been higher it could be time to book some gains and trim your positions.

Fixed Income: New Bank Capital instruments see Preferred Shares rally

Joey Mack

Chart 7: Prefs continue to recover and get a boost

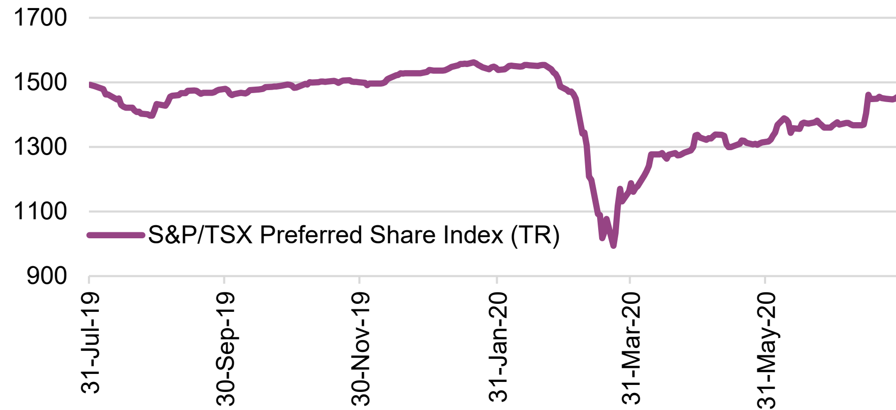


Chart 8: Bank Issued Rate Reset Preferred Shares with High Reset Rates

Issuer	Symbol	Reset Rate	Price 30-Jun	Price 30-Jul	Call Date	Yield to Call
Bank of Montreal	BMO.PR.B	4.06%	$ 22.94	$ 25.39	25-Feb-22	3.64%
Bank of Nova Scotia	BNS.PR.E	4.51%	$ 24.30	$ 25.31	23-Apr-21	3.95%
	BNS.PR.G	4.72%	$ 25.10	$ 25.51	26-Jul-21	3.51%
	BNS.PR.H	4.19%	$ 23.40	$ 25.16	27-Jan-22	4.48%
National Bank of Canada	NA.PR.A	4.66%	$ 24.44	$ 25.06	15-Aug-21	5.01%
	NA.PR.X	4.90%	$ 24.76	$ 25.16	15-May-21	3.98%
Royal Bank of Canada	RY.PR.Q	4.53%	$ 24.35	$ 25.37	24-May-21	3.26%
	RY.PR.R	4.80%	$ 25.16	$ 25.50	24-Aug-21	3.28%
Toronto-Dominion Bank	TD.PF.G	4.66%	$ 25.06	$ 25.40	30-Apr-21	3.38%
	TD.PF.H	4.12%	$ 23.22	$ 25.00	31-Oct-21	4.90%

- Royal Bank of Canada issued $1.75 billion of new Limited Recourse Capital Notes (LRCNs) in July. These notes have a 60-year maturity, with the coupon resetting every 5 years, if the issue is not called. The issue was priced at 100.00/4.50%, representing a spread of +413.7 basis points over Canada bonds
- This is the inaugural additional Tier 1 capital notes in the domestic market, and opens the door for more issuance for the Big Five banks
- The issue was well received, with initial orders of over $4 billion. The issue rallied as soon as trading began, and at the time of writing was offered at 101.85/4.11% (representing a spread of 380 basis points over Canada bonds)
- We expect the spread on LRCNs will continue to narrow in the coming months, as they offer a substantial yield pick up over similarly rated instruments.
- However, they are complex instruments that rank close to the bottom of the capital structure (inline with preferred shares), have a minimum initial purchase of $200,000, and are available to accredited investors only.
- The preferred share market rallied following the successful deal, with the S&P/TSX Preferred Share Total Return Index up 6.2% in July, versus 5.3% for the S&P/TSX Composite and 1.2% for the FTSE Canada Universe Bond Index (as of July 30).
- LRCNs do provide a cheaper source of capital for the banks than preferred or common shares – interest rates are lower, and interest payments are tax deductible, unlike dividends. With the ability to raise significant funds in bond markets, Canadian banks will not need to issue preferred shares in the near term, reducing potential new issue supply.
- Given the lower cost of funding, this also increases the likelihood that bank rate reset preferred shares with high reset rates will be called. **Chart 8** shows some of the outstanding issues with higher reset spreads, and their price performance over the month of July.

Managed Portfolios – a closer look at how we manage our currency exposures

An Nguyen

Chart 9: FX impact on C$ returns of US$ investments

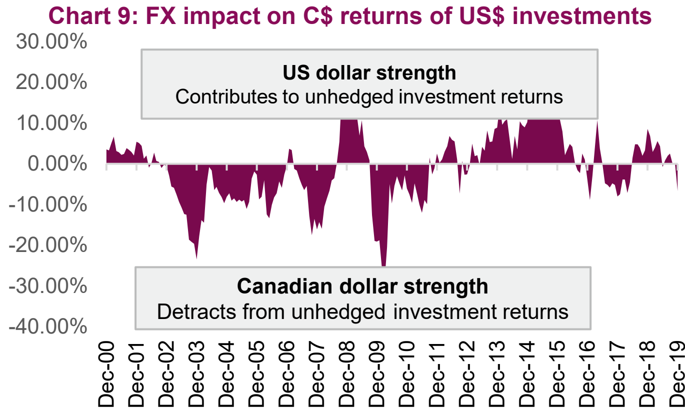
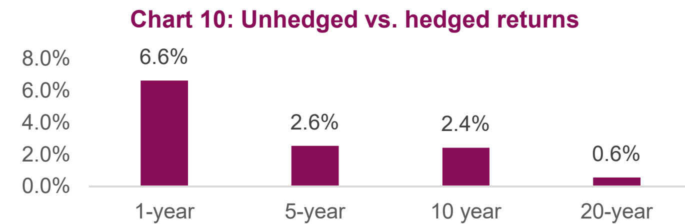


Chart 10: Unhedged vs. hedged returns



As of December 31, 2019. Returns are based on the S&P 500 CAD and S&P 500 USD.

Chart 11: Hedging strategy for actively managed funds

Fund	Asset Class	Hedging Strategy	Current* Positioning
Lysander-Canso Corporate Value	Fixed Income	Dynamic	Hedged
Manulife Strategic Income	Fixed Income	Dynamic	Hedged
Dynamic Preferred Yield Class	Pref. Shares	Hedged	Hedged
Purpose Core Equity Income	Equity	Dynamic	Partially hedged
Sun Life MFS International Value	Equity	Unhedged	Unhedged
Purpose Tactical Asset Allocation	Tactical	Unhedged	Unhedged

*Current positioning refers to US$ exposure

- The impact of currency on investment returns will vary greatly from year to year. **Chart 9** shows the difference between the rolling 1-year returns (calculated monthly) of the S&P 500 (CAD) and the S&P 500 (USD) over the last 20 years.
- While the impact of currency is prominent over shorter periods of time, over longer periods of time, currency is usually a zero-sum game. **Chart 10** shows the difference in returns (in absolute terms) between the S&P 500 (CAD) and the S&P 500 (USD) over 1, 5, 10, and 20-year annualized periods. The difference between the unhedged and hedged returns gets smaller as the time period gets progressively longer. After 20 years, the FX impact is negligible.
- As investment time horizons will vary, investors with shorter investment time horizons must carefully manage their portfolio's currency positioning to minimize unintended exposures that could potentially contribute to their portfolio's risk and volatility.
- In **Managed Portfolios**, we analyze and manage the portfolio's currency exposure in two ways: *at the fund level*, and *at the portfolio level*.
- **At the fund level**. As part of our screening process, we look at each fund's hedging strategy to determine if it is appropriate for the asset class and if it will complement existing funds in the portfolio. We take a diversified approach to managing the portfolio's currency exposure by investing in funds that use different hedging strategies. We invest in funds that are fully hedged, unhedged, and funds that are dynamically hedged. This allows the portfolio to have varying exposure to currencies over time.
- Once a fund meets our criteria and is added to the portfolio, our focus shifts to looking at each fund's current currency exposure relative to its historical positioning, as it may differ significantly. This ongoing analysis allows us to determine whether currency has contributed to or detracted significantly from a fund's return, and whether the fund has performed as we would have expected. **Chart 11** summarizes the hedging strategies and current positioning of each active fund in Managed Portfolios.
- **At the portfolio level.** We monitor the portfolio's aggregate currency exposure to ensure it has not deviated significantly relative to our baseline expectations and is aligned with our current views of the market. The currency exposure of the portfolio will be adjusted for one of the following reasons: (1) If the portfolio's aggregate exposure is not aligned with our market outlook; (2) If we want to improve the defensive posture of the portfolio (via a safe-haven currency); or (3) If there have been significant dislocations in the currency market (FX changes stemming from liquidity, and volatility concerns versus fundamental reasons such as interest rate, and inflation differentials and economic performance, etc.).

Disclaimer

Source: All charts are sourced to Bloomberg L.P. and Richardson GMP unless otherwise stated.

The opinions expressed in this report are the opinions of the author and readers should not assume they reflect the opinions or recommendations of Richardson GMP Limited or its affiliates. Assumptions, opinions and estimates constitute the author's judgment as of the date of this material and are subject to change without notice. We do not warrant the completeness or accuracy of this material, and it should not be relied upon as such. Before acting on any recommendation, you should consider whether it is suitable for your particular circumstances and, if necessary, seek professional advice. Past performance is not indicative of future results. The comments contained herein are general in nature and are not intended to be, nor should be construed to be, legal or tax advice to any particular individual. Accordingly, individuals should consult their own legal or tax advisors for advice with respect to the tax consequences to them, having regard to their own particular circumstances. Insurance services are offered through Richardson GMP Insurance Services Limited in BC, AB, SK, MB, NWT, ON, QC, NB, NS, NL and PEI. Additional administrative support and policy management are provided by PPI Partners. Insurance products are not covered by the Canadian Investor Protection Fund.

Richardson GMP Limited, Member Canadian Investor Protection Fund. Richardson and GMP are registered trademarks of their respective owners used under license by Richardson GMP Limited.

©Copyright August 4, 2020. All rights reserved.