Weekly Trends

PRIVATE CLIENT SOLUTIONS

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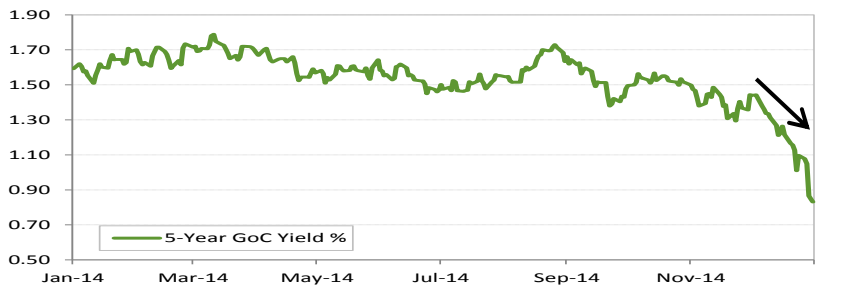
The 5% Portfolio

- A common request we field from clients is the desire for a fixed 5% rate of return. In years past, this was a fairly easy deliverable as government and high-quality corporate bonds yielded enough to meet this investment objective. However, in the "new normal" where deleveraging, disinflation, anemic economic growth, and easy central bank policies have helped to drive bond yields to record lows, it is much more difficult to meet this objective.
- If it wasn't hard enough to find attractive yields in the fixed income markets, the Bank of Canada (BoC) added to this dilemma, with the BoC surprising the markets this week by lowering the overnight rate by 25 bps to 0.75%.
- Examining the universe of Canadian fixed income securities, excluding high-yield which we remain cautious on, investors will be hard-pressed to find any higher-quality bonds yielding near the common investment objective of 5%. Clearly, an alternative approach is required to reach this level.
- To meet the 5% investment objective we would recommend investors consider creating a balanced portfolio with a mix of bonds and equities. Over the long run we believe Canadian equities can return 7 to 8%. For bond yields we see them rising, but remaining below the "normal" levels of the last few decades. This is based on the belief that the North American economy will see lower productivity gains and population growth, along with lower inflation levels. We see bonds yielding closer to 3% over the next decade. Using a 60/40 split, that would imply a potential 5.7% annual return over the next decade.
- Now this assumes market returns. Active investment management can lead to improved performance. Looking at our Guided Portfolios (Dividend and Moderate Bond portfolios) and using the same 60/40 split, they would have returned 11.4% annually since their inception in 2012.

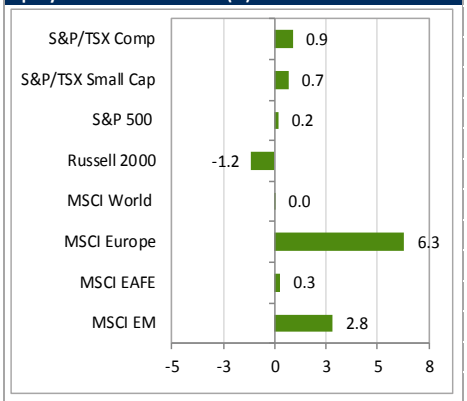
Chart of the Week

The GoC 5-Year Yield Declined 20 Bps Following BoC Surprise Announcement



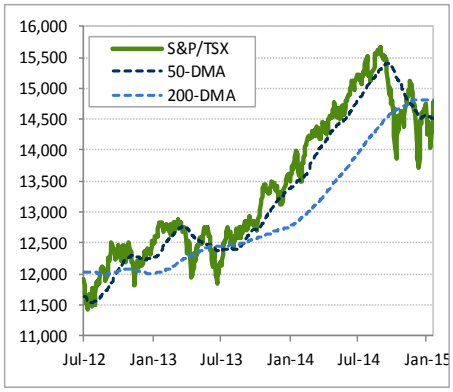
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	6.4	Overweight
Consumer Staples	3.6	Market weight
Energy	21.1	Market weight
Financials	34.2	Overweight
Health Care	4.1	Underweight
Industrials	8.7	Overweight
Information Technology	2.4	Overweight
Materials	12.1	Underweight
Telecom	5.2	Market weight
Utilities	2.3	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	14,764.0	
50-DMA	14,507.0	Uptrend
200-DMA	14,820.9	Downtrend
RSI (14-day)	61.5	Neutral



Source: Bloomberg, Raymond James Ltd.

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The 5% Portfolio

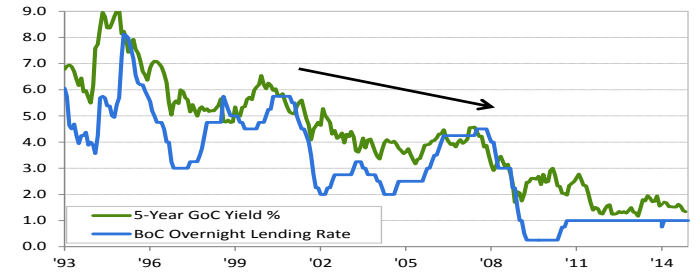
A common request we field from clients is the desire for a fixed 5% rate of return. In years past, this was a fairly easy deliverable as government and high-quality corporate bonds yielded enough to meet this investment objective. However, in the "new normal" where deleveraging, disinflation, anemic economic growth, and easy central bank policies have helped to drive bond yields to record lows, it is much more difficult to meet this objective. In effect, the US Federal Reserve (Fed) and other central banks are punishing savers and helping borrowers. Rarely in history has it been this propitious to borrow money, whether you're a first time home buyer or a large corporation. In this week's report we examine the current yields across the fixed income markets, illustrate how this simple ask of 5% is getting harder to meet, and propose an alternative to meeting this investment objective.

If it wasn't hard enough to find attractive yields in the fixed income markets, the BoC added to this dilemma, with the BoC surprising the markets by lowering the overnight rate by 25 bps to 0.75%. This sent bond yields lower across the yield curve. For example, the 5-year Canada bond yield declined 20 bps to 0.85% this week and is down roughly 40 bps year-to-date. Here's the reality in the bond markets:

- **Government bonds:** Beginning with the lowest risk bond investments, Government of Canada bonds are currently yielding from 0.58% for a one year maturity to just 2.07% for 30 year bonds. Think about that for a moment. An investor can only earn 2.0% each year, before inflation and taxes, over the next 30 years, if held to maturity. It goes to show how little investors are being rewarded for taking on long maturity/duration risk.
- **Provincials:** The next up on the risk spectrum is provincial government bonds (Ontario) which are yielding slightly higher at 0.70% for a one year term to 2.97% for 30 year maturities.
- **Corporates (high grade):** Given the extremely low yields in government bonds, investors have increasingly turned to corporate bonds, given the yield pick-up. However, even there it is difficult to find anything close to 5%. Higher quality bonds (AA and A) are currently yielding from 1.2% to 3.88% for one to 30 year terms, respectively.
- **Corporates (lower grade):** Finally, lower rated bonds (BBB) are currently only yielding from 1.85% to 4.66% for similar maturities.

Examining the universe of Canadian fixed income securities, excluding high-yield which we remain cautious on, investors will be hard-pressed to find any higher-quality bonds yielding near the common investment objective of 5%. Clearly, an alternative approach is required to reach this level.

Bond Yields Have Been In A Secular Decline



Current Yields By Fixed Income Class

Type	Term 1 yr	3 yrs	5 yrs	10 yrs	30 yrs
Government of Canada	0.58	0.58	0.85	1.43	2.07
Provincials (Ontario)	0.70	0.96	1.38	2.36	2.97
Corporates (AA)	1.20	1.55	1.80	2.65	3.64
Corporates (A)	1.80	1.82	1.93	2.87	3.88
Corporates (BBB)	1.85	2.00	2.38	3.48	4.66

Source: Bloomberg, Raymond James Ltd.

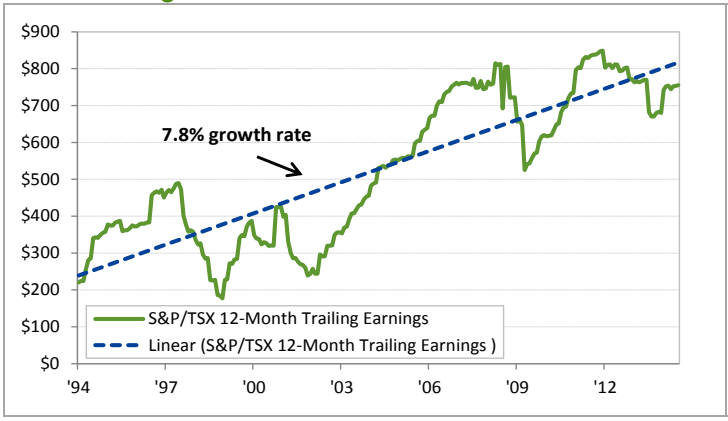
How To Meet The 5% Goal

Investors have two basic options to try to achieve this 5% goal. Option 1 is to take on increased risk in the bond portfolio by buying lower quality bonds. We would advise against this, as we do not believe investors are being compensated for this risk. Instead, we would recommend investors consider option 2, which is creating a balanced portfolio with a mix of bonds and equities. Given it's a "balanced" portfolio, risk should be minimized, so the portfolio should be largely invested in high-quality dividend paying stocks and high-quality bonds. Given our preference for stocks over bonds, we recommend an overweight in stocks. So, for clients whose typical target balanced portfolio would be 50/50 equity/bonds, we would recommend a strategic allocation of 60/40 equity/bonds at present.

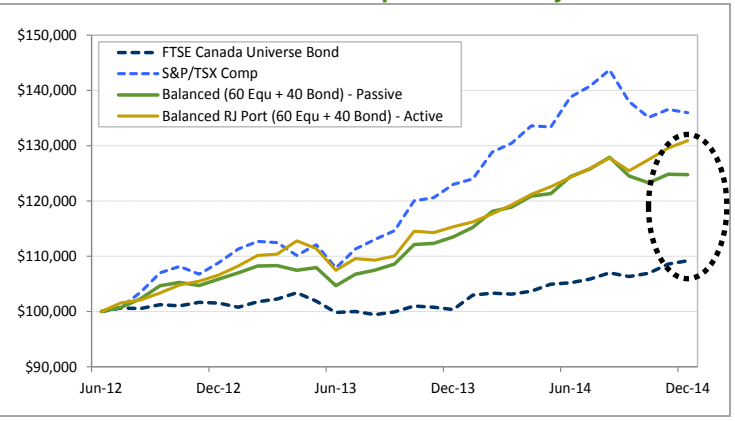
Over the long run, we believe Canadian equities can return 7 to 8%. This is based on an expected 3% dividend yield and 4-5% in corporate earnings growth. This is conservative compared to actual historical profit growth rates (7.7% since 1994), but we see lower economic growth over the next decade. For bond yields we see them rising, but remaining below the "normal" levels of the last few decades. This is based on the belief that the North American economy will see lower productivity gains and population growth, along with lower inflation levels. We see bonds (FTSE Canada Bond Index as our proxy for the Canadian bond market) yielding closer to 3% over the next decade. Using a 60/40 split that would imply a potential 5.7% return over the next decade. This is a conservative estimate of returns, but hits home the point that equities (high-quality dividend paying stocks) will be needed to meet the 5% investment objective.

Now this assumes market returns. Active investment management can lead to improved performance. Looking at our Guided Portfolios (Dividend and Moderate Bond portfolios) and using the same 60/40 split, they would have returned 11.4% annually since their inception in 2012. This is below the total return of the S&P/TSX at 13.08%; however, our portfolio includes a 40% weight to bonds and therefore helps to reduce volatility and provide steady cash flows. Relative to our benchmarks (S&P/TSX and FTSE Canada Bond Index), our 60/40 split portfolio exceeded the blended benchmark by 2.1% annually since inception. As we've conveyed earlier, we don't expect returns of 11.4% annually over the next decade, but we believe they will be more than sufficient to meet the 5% investment objective that so many investors look for.

TSX Earnings Have Grown 7.8% Per Year Since 1994



A Balanced Portfolio Can Help Meet 5% Objective



Source: Bloomberg, Raymond James Ltd.

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