Weekly Trends

PRIVATE CLIENT SOLUTIONS

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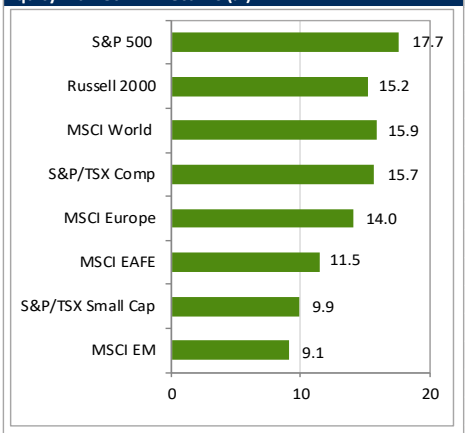
Notes from the PCS Desk

We receive many questions on the PCS desk about a variety of topics. This week we share some of the top questions we have received recently.

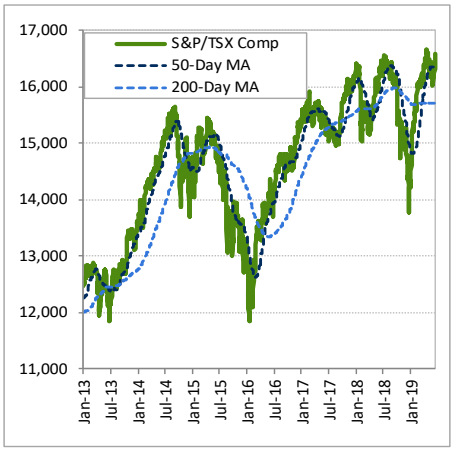
- How much should we allocate to Canada versus the US?
- What do you think about the Canadian REIT sector?
- What are rare earth metals? (On China's rare earth metals ban)
- What do we do with energy right now?
- What is the possibility of Vermilion Energy (VET-T) cutting its dividend?
- What is your take on FANG stocks in light of the Department of Justice (DoJ)/Federal Trade Commission (FTC) investigations?
- What are the team's thoughts on TELUS amid the possibility of a Huawei 5G equipment ban?
- What are a few ways to play lithium?

Equity Market YTD Returns (%)



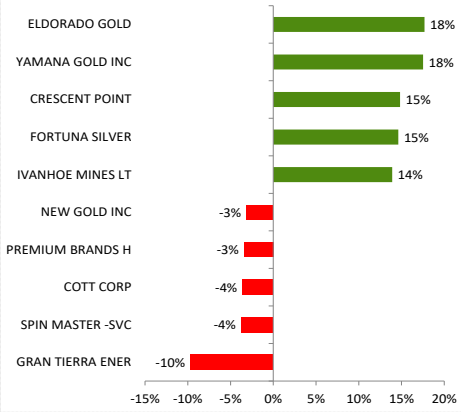
Canadian Sectors	Weight	Recommendation
Consumer Discretionary	4.2	Underweight
Consumer Staples	4.0	Overweight
Energy	17.1	Underweight
Financials	32.0	Market weight
Health Care	2.0	Underweight
Industrials	11.4	Market weight
Technology	5.2	Market weight
Materials	10.9	Market weight
Communications	5.6	Overweight
Utilities	4.3	Market weight
Real Estate	3.4	Overweight

Technical Considerations	Level	YE Target
S&P/TSX Composite	16,575	15,600



Source: Bloomberg, Raymond James Ltd.
Sectors are based on Bloomberg classifications

S&P/TSX Top 5 Gainers/Laggards*



S&P/TSX Market Internals

Weekly Advance	154	61%
Weekly Decline	85	34%
Advance-Decline	69	
New 52 wk high	26	11%
New 52 wk low	0	0%
No. Stocks Above 50-d	145	58%
No. Stocks Above 200-d	150	60%
Arms Weekly Index	1.50	Neutral
RSI (14-day)	67.3	Neutral
50-DMA	16,373	Uptrend
200-DMA	15,710	Uptrend

*Source: Bloomberg, Raymond James Ltd; * 5-day price return*

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RAYMOND JAMES

Q. How much should we allocate to Canada versus the US?

We published an *Insights & Strategies* titled *Breaking the Home Country Bias* where we discussed how much clients should consider allocating to Canada versus the US and the importance of diversification. While Canadians allocate roughly 60% to domestic holdings, the country as a whole represents only about 4% of the global equity market index while the US represents ~55%. However, since a 4% allocation is not realistic, we considered different possible allocations between just Canada and the US and found that a ~25% allocation to Canada represents the best risk/reward profile.

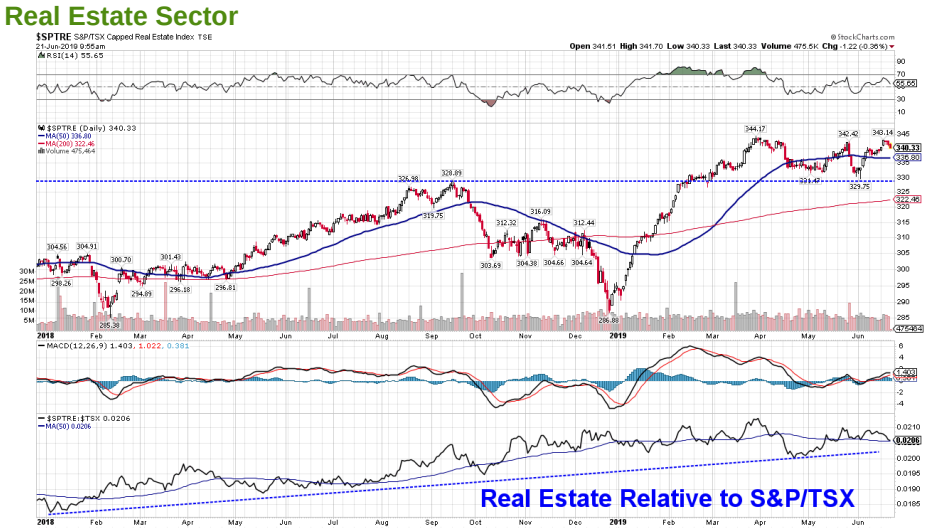
Q. What do you think about the Canadian REIT sector?

RJL analysts Ken Avalos and Johann Rodrigues downgraded the real estate sector in early June from Overweight to Market Weight due to valuation concerns. From their note titled *Move to Market Weight as Consensus Swings Around,* they highlight "*We now face valuation metrics that make the group look fairly valued in general: 1) BBB spreads - back to January levels after compressing through late April, 2) Implied cap rates - 5.6%, near all-time low, 3) AFFO Multiples - 18.1x, near all-time high, 4) NAVs - 2% discount, at the 10-year average, and 5) Distribution yields over 10 YR - now 325bp, just off a decade-low. We think the group and broader and debt/equity markets are now clearly pricing in a slowdown (if not a recession) and we believe it will be difficult to drive significant multiple expansion/ falling cap rates unless the Fed cuts more than the two or three times priced in currently. In that scenario, the US economy will be rapidly deteriorating and we think eventually Canada would follow. CDN REITs would likely outperform broader risk equities, but likely post negative returns as fundamentals slip.*"

From a fundamental perspective we agree, but given we also rely on technical analysis to make decisions we currently maintain an overweight within our sector recommendations. This is predicated on the fact that the sector continues to trend positively from an absolute and relative perspective.

We will be updating our *Sector Report* in the coming weeks and we may consider making a change if the sector were to trade below the 330 level (see chart on the next page).

In this environment, Ken and Johann like: **First Capital Realty Inc. (FCR-T), InterRent REIT (IIP.UN-T), Minto Apartment REIT (MI.UN-T), Park Lawn (PLC-CT), RioCan REIT (REI.UN-T), Sienna Senior Living (SIA-T)** and **StorageVault Canada (SVI-T)**. We hold **IIP.UN, REI.UN** and **Allied Properties REIT (AP.UN-T)** in the Dividend Plus; **MI.UN, SVI** and **PLC** in the Canadian Growth.



Source: Stockcharts.com, Raymond James Ltd.

Q. What are rare earth metals? (On China's rare earth metals ban)

China produces 70% of total rare earths, 17 elements used in things like electric vehicles, smartphones, jet engines and other high-tech uses; and the US imports 80% of its rare earth metals from China. The large players in this space are listed overseas including **JL Mag Rare-Earth Co. Ltd. (300748-SHE)**, which produces half of the world's heavy rare earths. The reason China is the largest producer is due to lenient environment standards, which significantly reduces the cost to refine rare earth metals. China is not the only source of the resources; in fact rare earth metals are not so rare as they can be found in many parts of the world.

The main US player is the privately-owned MP Materials (MP), which owns California's Mountain Pass mine. Since most rare earth processing capacity is in China, MP would still have to send their raw material to China and have a 10% tariff imposed on them. **Lynas Corporation Limited (LYC-AU)**, an Australian mining company, did announce they would partner with a US chemical company to develop a processing plant in Texas, but that will take some time to complete.

Q. What do we do with energy right now?

If you're a Canadian investor trying to benchmark against the S&P/TSX Composite Index (S&P/TSX) you'll notice that while the S&P/TSX is up +15% year-to-date (YTD) the energy sector has only returned 2%. While energy company fundamentals have been improving with companies cutting costs, improving profits and generating returns amid a low (Canadian) oil price environment, we feel foreign investors have simply "thrown the baby out with the bathwater". In other words, fundamentals don't matter anymore given the regulatory uncertainty. While the Feds are proceeding with the Trans Mountain Expansion Project, the approval of Bill C-48 (to restrict oil tanker movement along BC's northern coast) and Bill C-69 (to change how major infrastructure projects are reviewed and approved) raises more questions.

When foreign investors have looked at the Canadian energy space, the inability of our government to build pipelines (to get our product to market) and the time it takes to get projects approved may seem unsettling. Additionally, the upcoming International Maritime Organization (IMO) 2020 rules are also hampering sentiment regarding Canadian heavy crude. For some context here, the new IMO 2020

regulations will enforce a 0.5% sulfur emissions cap (from 3.5% today) around the globe starting January 1 next year. This is expected to have a large impact on the demand side, especially for heavier sour (high sulphur) crudes, which make up a large portion of the Canadian oil sands. So far this year we continued to reduce our exposure to the energy space, rotating capital into higher growth sectors including information technology and real estate. That said, for investors that still want exposure to the sector: 1) stick with US names 2) focus on refiners and 3) invest in companies with US and European exposure.

Q. What is the possibility of Vermilion Energy (VET-T) cutting its dividend?

At current commodity prices, VET's cash flow covers 100% of the dividend and capital program. The company's official policy is that maintenance of the dividend takes priority over production growth and ranks behind balance sheet health.

What we believe this means is that so long as the balance sheet is within their target range (which it is) they would cut growth capital *before* they would cut the dividend. Under the 2019 budget of $952mln, the allocation is:

Sustaining capital	$365mln
Growth capital	$165mln
Full dividend	$422mln

Source: June Corporate Presentation (includes current commodity price update)

That means there is $165mm in capital reductions available before they would consider a dividend cut. We are not saying that cutting the dividend is not a possibility. Our point to investors is that the stock is not getting hurt because it cannot afford its dividend, but because demand is lacking for Canadian energy names due to concerns mentioned in the previous question.

Q. What is your take on FANG stocks in light of the DoJ/FTC investigations?

Shares of **Alphabet (GOOGL-US), Facebook (FB-US)** and **Amazon.com (AMZN-US)** were all under pressure last week on increased antitrust scrutiny. The DoJ/FTC haven't launched investigations into FB or AMZN yet, but have allocated responsibilities between both agencies, which may increase the likelihood of an investigation at some point.

GOOGL faced scrutiny in Europe in recent history; FB has been under investigation for privacy issues. GOOGL seems to be the most at risk here since the DoJ announced an antitrust probe last Friday – taking into account fines the company was hit with from Europe, these shouldn't be material to the company's fundamentals going forward especially for a +$700 bln company. It's hard to tell the level of scrutiny or when an investigation may begin at this point, but the focus seems to have shifted. We believe antitrust scrutiny may remain an overhang for the large cap tech names given their size/activity in the M&A space.

RJF analysts Aaron Kessler and Ed Mills have published notes on the topic titled "*Thoughts on DOJ/FTC Investigations of Google, Facebook, Amazon*" and "*DC Goes All-In on Tech Antitrust Scrutiny; Decision Time for Mexico Tariffs*", respectively.

Q. What are the team's thoughts on TELUS amid the possibility of a Huawei 5G equipment ban?

Huawei concerns continue to be at the top of mind for TELUS (T-T) investors. As we mentioned in our February 22, 2019 *Guided Portfolio Update*:

"*TELUS stock took a hit when Canadian authorities arrested the Huawei VP in Vancouver, fearing it signaled that the Canadian government could be relenting to US pressure and joining other western governments in implementing a full or partial ban of Huawei products in Canadian wireless infrastructure. The rationale is due to concerns that the Chinese government is closely tied to Huawei and its products, especially for 5G, could create a conduit for Chinese spying. Huawei is a major hardware supplier to TELUS and BCE's (BCE-T) 3/4G wireless networks and it is anticipated that Huawei would be its lead hardware provider in developing both companies' 5G networks (Huawei is currently partnering with T on a pilot project). A ban on their technology could impact costs and schedules for bringing 5G networks to consumers starting in 2020. The federal government is investigating the Huawei issue but it does not seem like any kind of decision is imminent.*"

Part of the concern we see here is that if there were to be a ban on Huawei equipment, would this be retroactive? As in, would the ban include 3 and 4G tech as well? Or would the ban be limited to 5G tech only? We imagine that the dollar cost of replacing all of Huawei equipment (including 3 and 4G) would be in the 100s of millions of dollars and would present a much bigger issue. Reassuring comments came out of BCE (BCE-T), stating that Huawei equipment has only been used in its 3G and 4G build, but not in its core network and that their 5G deployment would not be impacted if the government were to ban Huawei equipment.

Rogers Communications (RCI.B-T) will not be using Huawei's 5G tech. At this point we do not think the ban will include 3 and 4G tech. If it is the 5G tech only, then we imagine it to be much easier for TELUS to change course. To add to the above, the government may also be liable since the telecom companies had to obtain federal approval in order to go forward with their investments in Huawei's 3, 4 or 5G technology. So the government could also share in any pains experienced by TELUS or BCE. We continue to monitor the situation and are still conducting further due diligence on the matter.

Q. What are a few ways to play lithium?

We published a *Trends & Ideas* note on lithium on March 27, 2017 titled the *The "White Gold" Rush* discussing the demand and supply side dynamics of the lithium commodity along with ways to play lithium. Clients looking to gain exposure to lithium as a way to play the electric vehicle space may look into **FMC (FMC-US)**, **Sociedad Quimica Y Minera De Chile (SQM-US)** and **Albemarle (ALB-US)** as these companies have direct exposure to the lithium commodity. For those interested in a basket approach in order to gain exposure to the space without taking any company-specific risk may look into the **Global X Lithium & Battery Tech ETF (LIT-US)**, which tracks the Solactive Global Lithium Index. LIT's top 10 holdings are copied to the right.

Top 10 LIT Holdings Represent Three Quarters of the ETF

FMC Corporation	17.84%
Albemarle Corporation	14.86%
Sociedad Quimica y Minera de Chile SA Pfd Series B	8.32%
LG Chem Ltd.	5.52%
BYD Company Limited Class H	5.49%
GS Yuasa Corporation	4.77%
Simplo Technology Co. Ltd.	4.74%
Samsung SDI Co., Ltd	4.69%
Tesla Inc	4.44%
Panasonic Corporation	4.31%
Total Top 10 Weighting	74.99%

Source: FactSet

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