Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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Powell Pivot Complete

The US Federal Reserve delivered its first interest rate cut in over a decade amid concerns that decelerating global growth may further weigh down the US economy. The Fed justified the 'insurance' rate cut by pointing to "global developments for the economic outlook as well as muted inflation pressures," which supported the decision "to lower the target range for the federal funds rate to 2 to 2-1/4 percent." For the most part, the US economy is performing well, albeit momentum has been waning and a lack of business investment has been a source of concern. US consumers have kept their wallets open as evidenced by the contribution of consumer spending to Q2 GDP growth. Personal consumption expenditures rose to a 4.3% annual rate, the most in six quarters; durable goods spending surged to a 12.9% annual rate, the most in five years, led by vehicles and recreational goods; and nondurable goods spending jumped to a 6.0% annual rate, the most since Q3 2003, led by food and apparel. A healthy jobs market and wage gains have helped fuel consumption growth and lift consumer confidence. In fact, consumer confidence jumped close to an 18-year high this month. While we can point to areas of softness in the US economy, like manufacturing, business investment and the negative impact on multinationals of slower growth outside of the US, the key ingredients that have often exacerbated past slowdowns are not present. In particular, credit conditions remain loose, allowing corporations and consumers to continue to access credit. The Fed's most recent move will only further promote the extension of credit via lower interest rates. While US economic momentum is waning, we do not believe it has entered recession territory and the Fed's most recent move should serve to improve the near-term growth outlook. As such, we compare last month's rate cut to a similar period in the 1990s.

Non-Recessionary Rate Cut – 1995 & Today

Source: Bloomberg, Raymond James Ltd.

Please read domestic and foreign disclosure/risk information beginning on page 7.

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Looking at the most recent examples of when the Fed has cut rates in non-recessionary periods – 1995 and 1998 – can give us some insight into how the market may behave in the coming months. These non-recessionary "mini" easing cycles saw the fed funds rate lowered by 75 bps, which is a similar amount of accommodation that the market is expecting the Fed to deliver over the next 12 months. In each case, the yield curve steepened. This may sound like an immaterial fact, but to market participants, it is an important signaling about the health of the economy. Much of the US government yield curve currently is inverted which is a worrying signal for central banks. The Fed's easing cycle, if successful in stimulating growth, should cause the yield curve to steepen which should push the central bank's concerns about near-term recession concerns to the back burner.

Equity prices also reacted to the Fed's action in the 1990s. Although 1995 did not follow the typical pattern (see first page), equity markets on average typically slipped by mid-single-digits after the Fed began easing, but bottomed out rather quickly. Considering the past two non-recessionary easing cycles, the S&P 500 rose a robust 20% on average 12 months out. As such, we anticipate some volatility in the near term but would expect the US market to recover and continue to push higher into the year end.

As for Canada, our central bank will find it increasingly hard to hold rates if the US Fed continues to ease. Lower rates in the US while Canada remains on hold will widen the interest rate differential, which will strengthen the Canadian dollar. A strong Canadian dollar will negatively impact exports due to Canadian goods becoming relatively more expensive. As the Bank of Canada (BoC) is relying to some extent on export growth to support GDP, the probability of a rate cut in Canada will only increase if the Canadian dollar continues to gain.

Steepening Yield Curve

Performance During Periods of Curve Steepening

Sector	Canada	US
Health Care	36%	28%
Financials	24%	17%
Cons. Staples	24%	25%
Info Tech	19%	4%
Energy	15%	11%
Industrials	14%	15%
Cons. Disc	12%	10%
Materials	12%	14%
Utilities	9%	-5%
Real Estate	5%	-18%
Comm. Services	4%	-12%

Source: Bloomberg, Raymond James Ltd.

While the BoC is on hold now, we anticipate the Canadian yield curve will move in a similar manner to that of the US, given the strong historical correlation. As such, we look at sector performance during times when the yield curve has steepened. On average, three sectors performed positively on both sides of the border: health care, consumer staples and financials. It is no surprise to see consumer staples performing well following a steepening of the yield curve since the sector does well in a risk-off environment. As for the

Growth Screen

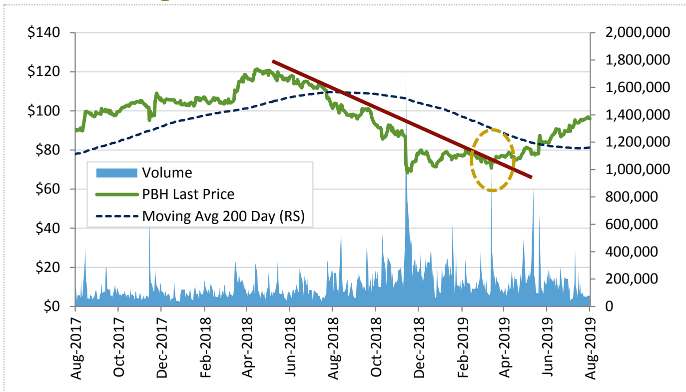
Ticker	Name	Avg Sales Growth ('19/'20)	Avg EPS Growth ('19/'20)	Avg CFPS Growth ('19/'20)	Projected 3Y Div Growth	Net Debt/EBITDA	Interest Coverage
Consumer Staples							
BCB-T	COTT CORPORATION	3.0	71.3	7.2	0.0	5.5	0.8
EMP.A-T	EMPIRE CO LTD 'A'	3.1	23.8	19.1	8.2	1.4	7.5
MRU-T	METRO INC/CN	9.4	12.5	15.3	5.8	2.2	7.4
PBH-T	PREMIUM BRANDS HOLDINGS	13.5	11.4	33.6	9.1	5.7	4.4
WN-T	WESTON (GEORGE) LTD	3.3	5.3	83.9	4.0	3.9	4.0
Financials							
BMO-T	BANK OF MONTREAL	5.6	5.6	11.5	6.1	NA	NA
NA-T	NATIONAL BANK OF CANADA	3.5	5.3	91.2	8.5	NA	NA
RY-T	ROYAL BANK OF CANADA	5.2	5.5	21.7	7.6	NA	NA
TD-T	TORONTO-DOMINION BANK	6.3	6.5	67.1	5.2	NA	NA
X-T	TMX GROUP LTD	3.2	8.0	16.4	6.5	2.2	8.4
Health Care							
BHC-T	BAUSCH HEALTH COS INC	1.9	3.6	1.3	NA	8.5	-1.4
TRST-T	CANNTRUST HOLDINGS INC	101.5	246.6	28.5	NA	NA	-18.4
WEED-T	CANOPY GROWTH CORP	135.0	60.1	99.1	NA	NA	NA

Source: Bloomberg, Raymond James Ltd. As at July 31, 2019 financial sector, which is largely comprised of banks, a steep yield curve translates into higher net interest margins and encourages more lending. On the flip side, bond proxy sectors such as utilities, communication services and real estate performed poorly.

Growth Shows Strong Relative Performance

Growth, as an investment style, also shows strong performance relative to value during periods when the yield curve is steepening. In the table on the previous page, we screen for growth stocks in the top three performing sectors by employing top line, bottom line and cash flow growth metrics. We searched for names that exhibit growth in sales, EPS and cash flow per share greater than 0 in 2019 and 2020.

PBH Breaking Downtrend

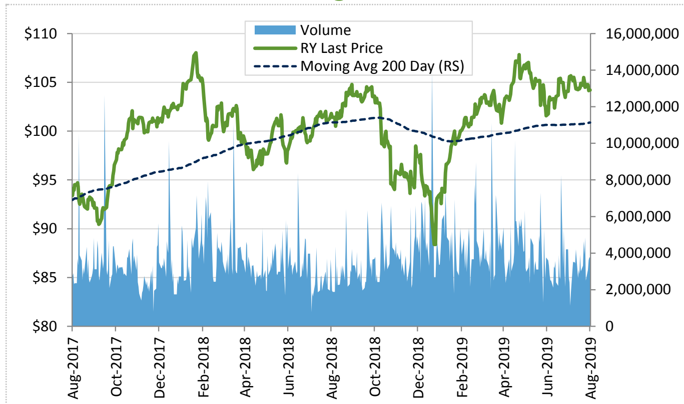


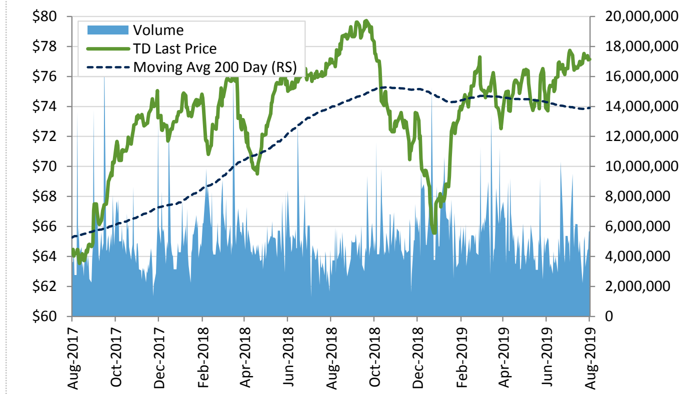
Source: Bloomberg, Raymond James Ltd.

Among the screened stocks, we favour companies with attractive dividend growth along with stable balance sheets. Within consumer staples, Premium Brands Holdings (PBH-T) is a name that continues to exhibit an attractive growth profile with double digit sales, EPS and cash flow growth. The company has various organic growth initiatives along with M&A optionality to drive upside. While we view the balance sheet as slightly extended, we feel the company's interest coverage ratio is adequate for this level of debt. The stock's technical profile has also improved since the beginning of the year, breaking its short-term downtrend on positive momentum, but it is facing resistance in the $95-97 range. We also note the stock is trading above its sell-side average target price of ~$95, presenting 2% downside from current levels.

Within financials, the screen is largely comprised of bank stocks, which tend to do well in an environment when the yield curve steepens. Given Royal Bank of Canada (RY-T) and Toronto-Dominion Bank's (TD-T) exposure to the US, solid growth profile and reasonable valuation, we would anticipate both to continue to outperform their peers.

RBC & TD Prices Recovering from 2018 Lows





	Forward PE	10yr PE	Yld
RBC-T	11.0x	11.6x	3.9%
TD-T	10.7x	11.4x	3.8%

Source: Bloomberg, FactSet, Raymond James Ltd.

As for the health care sector, our growth screen picked up two companies in the cannabis industry along with Bausch Health Companies (BHC-T), formerly Valeant Pharmaceuticals, Stryker (SYK-US), Zoetis (ZTS-US) and Merck & Co. (MRK-US). Health care could be the wildcard as US election rhetoric may inject unwarranted volatility into a sector that has historically done well during periods of a steepening yield curve. However, this may present buying opportunities for those who can tolerate wild swings.

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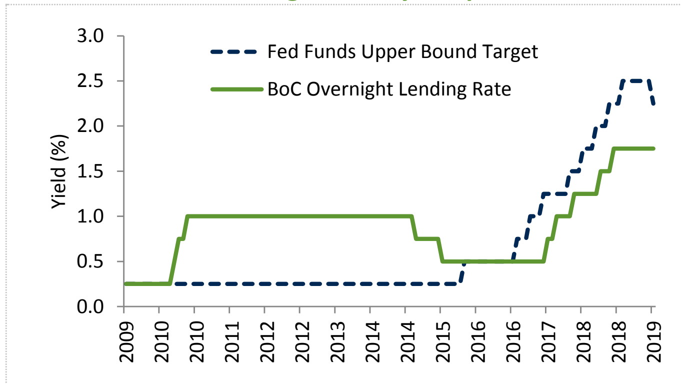
What To Do When The Tide Has Turned

Entering the back half of our short-lived Canadian summer, it has become apparent that "Mr. Market's" attitude has changed drastically since the beginning of the year. As proof, we can look at consensus expectations for some of the world's major central banks. Expectations were for the European Central Bank (ECB) to tighten monetary policy by eliminating its asset purchase programme by the fall with a potential rate hike in the mix. Meanwhile in Japan, already persistently tepid inflation expectations mean the Bank of Japan (BoJ) is highly unlikely to increase its overnight lending rate; however, expectations point to monetary tightening in way of reduced asset purchases. So, what has happened since then? In Europe this year, GDP growth continues to lag estimates as manufacturing activity subsides, while at the same time concerns over a hard Brexit and slowing growth in China, another major trading partner, threaten consumer and manufacturing sentiment. As such, the ECB has reversed course and now admits that additional stimulus is needed, which would likely come in the form of increased asset purchases and possibly another rate cut. The story is very similar in Japan, where inflation expectations have decreased from already extremely low levels. In North America, central banks have been tightening monetary conditions over recent years; however, we are now witnessing a similar central bank pivot.

What Goes Up Must Come Down

After nine decisive Fed rate hikes, markets believed Jerome Powell and his team had overextended themselves with respect to tightening. While economic data south of the border has been fairly robust overall during the past 12 months, with both output growth and labour market strength being specific highlights, inflation figures

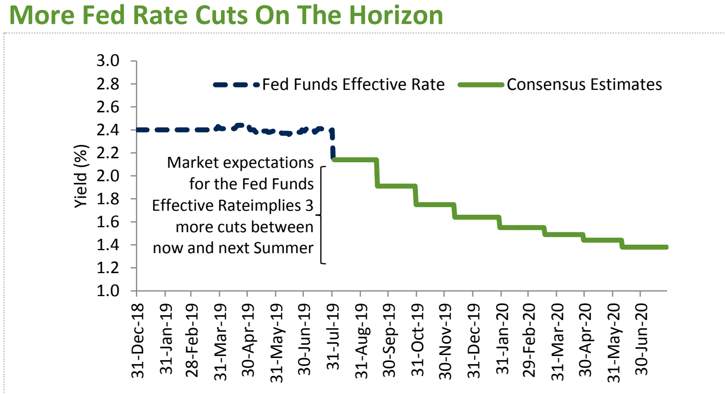
Fed Rate Hikes Have Significantly Outpaced BoC



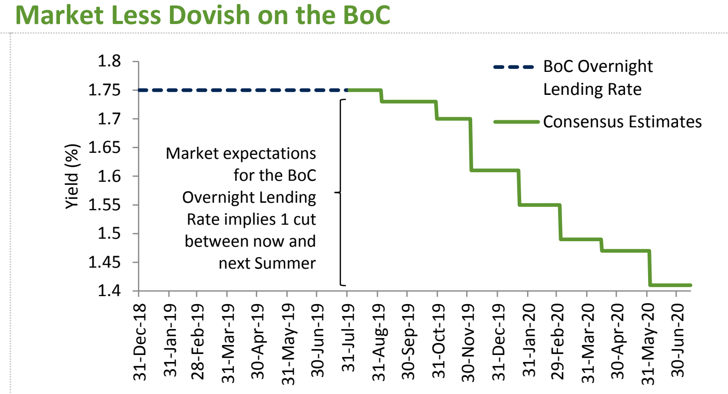
Source: Bloomberg, Raymond James Ltd.

have remained subdued. The market has long been fixated on struggling inflation data, and when the Fed signalled further monetary tightening in December, the collective action of the market caused near-inversion between the 10-year and 2-year segments of the US treasury curve. This is significant given that an inversion of this section of the yield curve has been a widely used indicator of economic recessions. The Fed has seemingly admitted (without outright doing so) that they may have moved too quickly given increasingly worrisome global growth concerns and still lagging inflation, and as such in July, it cut its overnight lending rate for the first time since 2008. Given that the economy hasn't shown clear signs of slowing down, many investors viewed the rate cut as an insurance policy to maintain the current economic expansion. Mr. Powell noted that this cut was simply a "mid-cycle adjustment" rather than the start of a long-term cutting cycle that many had been looking for. Markets are still pricing in at least one more rate cut this year but the probability of facing several more cuts has somewhat faded.

More Fed Rate Cuts On The Horizon



Market Less Dovish on the BoC



Source: Bloomberg. Raymond James Ltd. As at August 2, 2019.

BoC Holds its Ground for the Time Being

The BoC has kept its overnight lending rate on hold since October and has signalled that, for the time being, it has no intention of breaking out of its current holding pattern. The Canadian economy has shown strength in similar segments to the US economy, specifically robust labour data with unemployment at its lowest level since at least the mid-1970s. Unlike our US neighbours, inflation readings have generally been in line with expectations. During the past two years, core CPI has averaged just below the BoC's 2% target. While it is true that inflation has lacked a consistent path or direction, the BoC has given itself more breathing room to weather some softness in economic data. The Fed has hiked rates nine times in the past four years while the BoC has hiked only five times. This slower pace has allowed our domestic markets more time to digest the moves and adapt as needed. In addition, we would be remiss not to consider that the BoC cut rates twice in the first half of 2015 largely in response to the impact of sliding crude oil prices. Markets do believe that the next move by the BoC will likely be a cut rather than a hike, but they are pricing a low probability of this move as a mid-2020 occurrence.

Market Impact and Positioning Recommendations

Based on expectations for the Fed to lower their overnight interest rate further (even if by not as much as the market would like), we can expect the US treasury yield curve to steepen, or at least flatten further along points of the curve that are currently inverted. In particular, we anticipate some modest steepening in the belly of the curve, specifically for three to five year tenors. Furthermore, we expect a supportive Fed to help ease market concerns that the economic expansion will sputter out. This would help boost yields across the curve modestly, which has been a trend over the past month in anticipation of the Fed's recent rate cut. Considering steepening across the belly of the curve and an overall rise in the yield curve, we recommend investors remain short duration by investing in one to three year corporate bonds. We recommend the same positioning when considering the Canadian bond market. Despite our expectations that the BoC won't budge over the next year, we do believe the next move will likely be a cut given their willingness and ability to adjust monetary policy ahead of potentially sticky economic issues. Important to note is that, from a portfolio perspective, we remain steadfast in recommending a laddered approach in order to hedge interest rate exposure over the next several years. However, when adding to portfolios now, we believe a slight overweight to the short-end of the curve would provide some defense and flexibility.

Enhancing Yield with Preferred Shares

Looking at fixed-reset preferred shares, there is a "sweet spot", represented by the shaded area of the following table. These fixed-resets were either issued or their dividends were reset when the GoC 5-year was at record lows in 2015-2016. We believe there is an excellent opportunity to purchase these preferred shares as their dividends should reset higher at the next reset date with an assumed GoC 5-year yield of 1.50%. Do delve a little deeper in each 6 month bracket, looking at credit quality, reset spreads and company sector, and select a fixed-reset appropriate for your risk profile. It is also recommended to add some perpetuals into a preferred shares portfolio to help mitigate impacts if yields should fall.

Fixed-Reset Dividends at GoC 5-Year Yield = 1.50%

Reset Date (# Yrs Out)	# Issues	Avg Div Change	Increasing Dividends	
			# Issues	% of Issues
<1.0 yrs	42	$0.04	19	45%
1.0 – 1.5	21	$0.15	20	95%
1.5 – 2.0	28	$0.19	28	100%
2.0 – 2.5	16	$0.18	16	100%
2.5 – 3.0	25	$0.12	25	100%
3.0 – 3.5	16	-$0.01	4	25%
3.5 – 4.0	32	-$0.07	4	13%
4.0 – 5.0	31	-$0.17	-2	-6%
5.0+	8	-$0.02	1	13%
All Fixed-Resets	219	$0.04	115	53%

Source: Bloomberg, Raymond James Ltd. As at July 17, 2019. Fixed-reset without an absolute reset spread to the GoC 5-yr yield were not included in this analysis (some BCE prefs).

FX Effects

We also expect some impacts to the foreign exchange space. One of the primary determinants used in valuing any currency pair is the short-term interest rate differential between the two. The positive difference between short-term rates in the US versus Canada has decreased over the past few months as the expectations for a Fed rate cut slowly blossomed and currently the differential is trending below its five-year average. As the rhetoric on Fed policy continues to grow more dovish, and thus weigh on short-end rates in the US while the BoC remains on hold, the USDCAD currency pair should weaken (i.e., Loonie strengthens). So, in the near term, we expect further Loonie strengthening but we caution that this could unravel mid-next year if the BoC is forced to begin cutting again.

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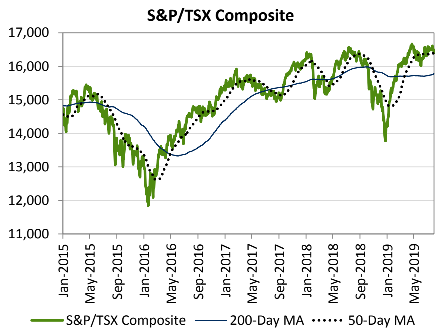
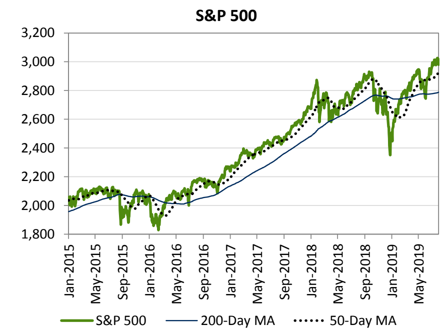
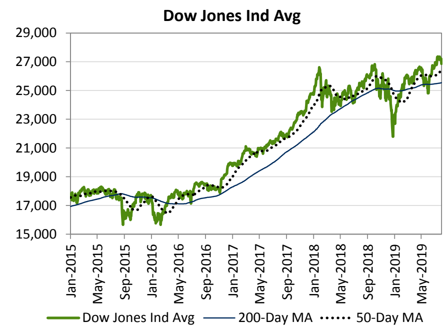
Charts of Interest

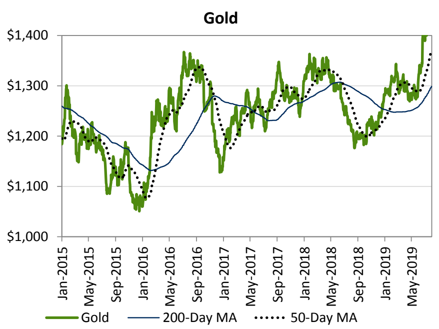
Markets

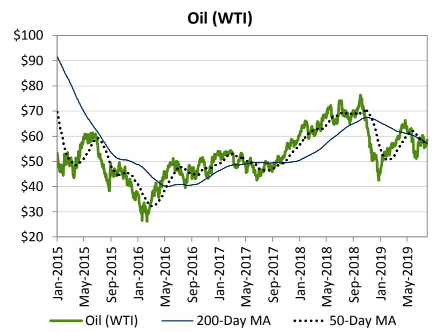


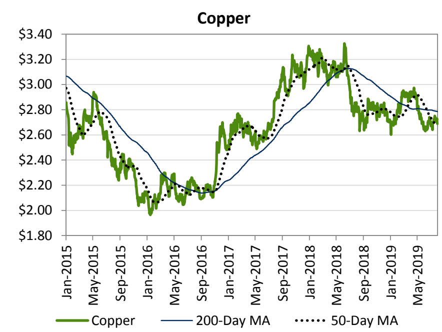




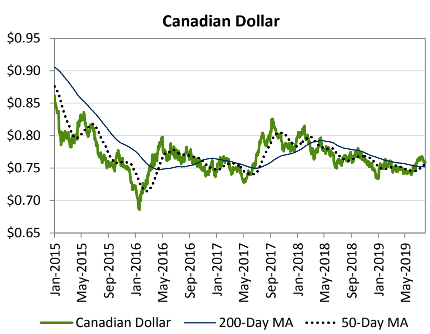
Commodities

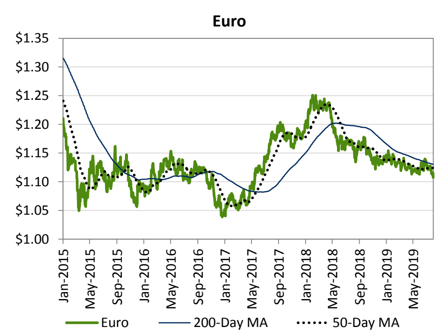


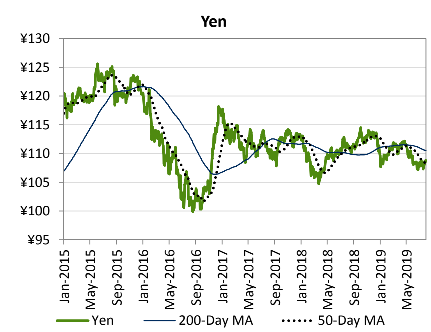




Currencies







Source: Bloomberg, Raymond James Ltd. Performance as at July 31, 2019.

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