Smoothing the Bumps

Equity Markets

North American equity markets posted respectable gains in the second quarter, with the domestic S&P/TSX Composite index rising 7%, spurred by strength in cyclical sectors such as Energy and Materials. Additionally, outsized returns were produced by the relatively small domestic Health Care sector, rising 16% as the date for legalized marijuana approaches in Canada.

South of the border, the S&P 500 rose 3% in local currency terms, although strength in the US dollar resulted in better gains of 5% for Canadian investors.

Markets were weaker internationally, with the MSCI EAFE index dropping 1% in US dollar terms but managing to rise 1% once converted into Canadian dollars. Across all markets, investor demand was high for Information Technology stocks, and this preference for cyclicals also parlayed into gains for many Consumer Discretionary and Industrial companies. Conversely, ongoing concerns about rising interest rates led to weakness in traditionally slower growth, high dividend-paying sectors such as Consumer Staples, Telecommunications and Utilities.

Fixed Income Markets

North American fixed income market returns were mixed in the second quarter; Canadian bonds were largely unchanged, while US Treasury bonds were all offered at higher yields. Canadian fixed income performed remarkably well despite the Canadian dollar weakening nearly 2% in the quarter, with domestic buying holding the market level.

The Canadian fixed income market traded wider for most of the second quarter, offering slightly higher yield in anticipation of continuing Bank of Canada action. As recently as mid-June, the Canadian bond market was pricing in at least one 25 basis point hike in the Bank of Canada policy rate, but by the close of the quarter the markets were far less certain of the need for the Bank's immediate intervention, the ensuing tightening left fixed income prices largely unchanged for the quarter.

The US bond market offered higher yields at the close of the quarter, with the US Federal Reserve (Fed) continuing to move their overnight lending rate higher, with many viewing four rate hikes in 2018 as a distinct possibility. The Federal Reserve's mandate is to gear monetary policy towards an expanding economy with an inflation target of ~2% per annum. Given the uncertainty surrounding trade and tariffs, the Fed may choose a more cautious path and the policy of hiking rates towards 'normal' may begin to slow. Market observers took notice of the flatness of the US treasury curve. While the curve has not yet inverted, there is the potential for shorter duration debt to offer higher yields than long-term debt and yield-curve inversion has been a bellwether for recession since World War II.

As an asset class, High Yield bonds performed well in the quarter, continuing to tighten in towards treasury debt and reducing the premium association with holding the basket of non-investment grade debt. Interestingly, while investor demand for high income-yielding equities has markedly diminished this year, appetite for this category of the highest income yielding bonds has remained strong.

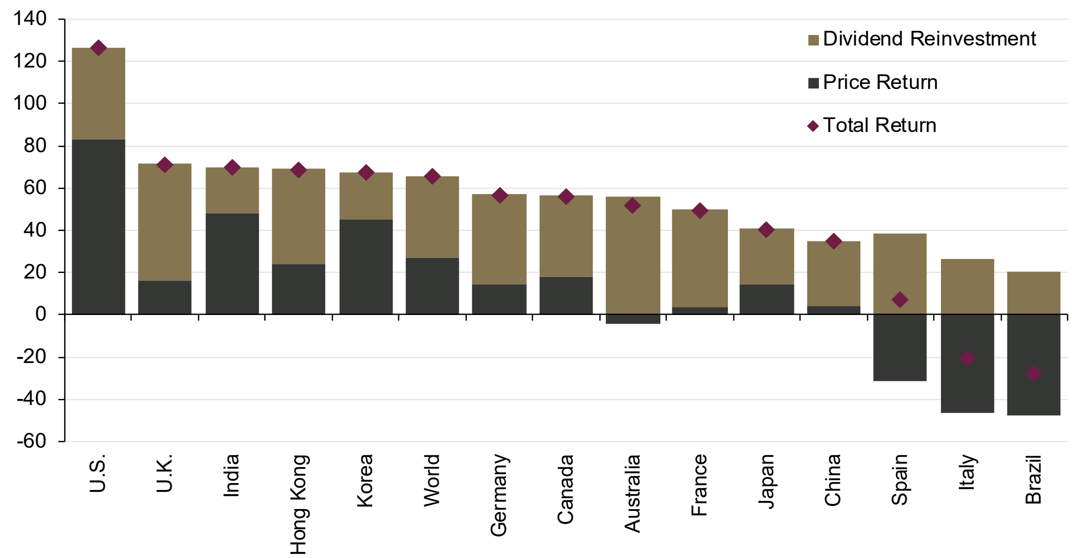
Commentary

Political chatter continued to bombard market participants over the second quarter, with speculation on the future of NAFTA and escalating tariffs between the US and China an almost daily affair. At the same time, central banks around the world remain collectively focused on reversing the massive financial stimulus provided since the Financial Crisis. In response, interest rates look to be on the rise: one year ago the US 10-year bond was yielding roughly 2.3% but now offers 2.9%, and the equivalent in Canada has moved from 1.8% to 2.2%.

It is understandable for investors to be concerned about what this all means for stock market returns. So far in 2018 it has translated into poor performance for income-oriented strategies: Consumer Staples, Telecommunications and Utilities stocks, typically held to provide slow but steady returns, have proven much less defensive than many expected as investors key in on cyclical growth exposure rather than staid income generation.

This is a good juncture to provide a reminder to stay the course with dividend-oriented strategies. Dividends, paid as a prudent portion of annual profits, serve as a smoothing mechanism for shareholders. They frequently seem to lack significance when markets are strong, dwarfed by price returns, but provide a welcome buffer to performance at the bottom of the business cycle. Over time, the benefit of this ongoing income becomes more apparent: over the past decade (a period that includes the financial crisis), dividends accounted for 68% of total stock market returns in Canada. The contributions were even higher in France (92%), the UK (78%) and Germany (75%) while even the top performing US market saw dividends make up a third of the overall performance over the last 10 years. Moreover, the likes of Australia, and Spain would have seen negative performance in the absence of dividends.

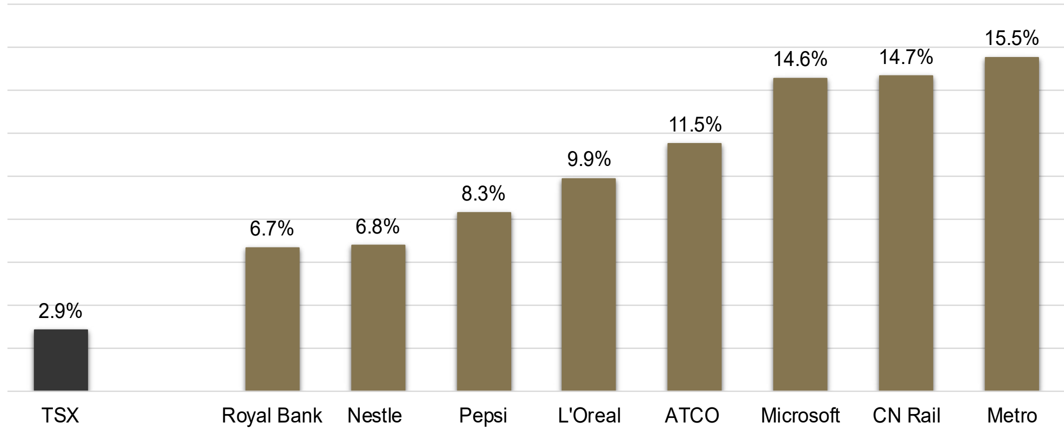
MSCI Country Index Total Return Decomposition
(percent)



Data for the period from December 31, 2007 to December 31, 2017
Source: Bloomberg, Guardian Capital

Dividends can serve as hard evidence of a cash-generating business, and a track record of dividend growth often correlates with a prospering franchise. If bought at a reasonable valuation, a diversified mix of dividend growing stocks stands to offer attractive total returns to clients over the fullness of an investment cycle, with price performance at the forefront during bull markets, and dividend contribution paramount during tougher times. Commonly held stocks for our private clients offer this potential, with exemplary track records in dividend growth, and after a dose of neglect so far in 2018, now valued at enticing levels.

Dividend Growth Rate of Some Commonly Held Guardian Private Client Stocks
(Annualized dividend per share growth)



Data for the period from December 31, 2007 to December 31, 2017
Source: FactSet, local currency, CAGR

While these growth rates do not necessarily have to continue, all of these companies have business advantages that provide every opportunity for them to successfully navigate competitive threats and continue to prosper. The recent unpopularity of dividend-growing companies has little bearing on whether Pepsi sells more snacks and beverages in developing nations, or L'Oréal expands its portfolio of leading cosmetics brands, or CN Rail hauls more freight.

For investors unhappy with the recent performance of their income-oriented stocks, a simple reminder: investors continue to get paid as we navigate over this speed bump and these dividends will ultimately serve to smooth the bumps in the road and, in the long run, provide ample fuel to total returns. In the meantime, relax and try to enjoy the ride.