Quarterly Market Commentary

December 2023

This is the time of year when investment houses take account for the year that was and begin to consider the year that will be. Simply put, these year ahead documents, like the one you are reading, are table stakes for investment firms. This is where investment strategists summarize their thesis for the upcoming year.

It is human nature that we humans have been making predictions since the beginning of time about apocalyptic events that will lead to our extinction. The simple fact is, we don't know the future, and if we did, we still wouldn't because in the knowing we would alter its course by our actions. What we can do is frame the present and know with certainty how we will make decisions when uncertain things occur.

There is no shortage of risks and opportunities for us to frame for the year ahead. Deglobalization, climate and a commodities super-cycle, China's challenging economic prospects, the United States' daunting presidential election, inflation, interest rates and the promise of AI, to name a few. For 2024 we have prepared our top list of where we're headed.

1. **'Friend-shoring' will continue as deglobalization takes hold.** Certain countries will be net beneficiaries from the global supply-chain reorganization.
2. **Defense spending to rise amid heightened tensions.** Global leaders have increasingly pushed their nations toward protectionism and adversarial regionalism — a world where it's about us and them.
3. **Commodities to outperform.** Inflation is likely to stay above the 2% target level for longer than expected.
4. **China to recover from its economic woes.** Chinese policymakers have to balance the need to maintain growth along with domestic financial stability.
5. **A Trump win could dramatically alter the landscape.** U.S. equity markets have historically rallied 12% during election years. Could it be different this time?
6. **Hedging amid heightened geopolitical uncertainty.** Geopolitical risk is better hedged using commodities and bonds.
7. **Reaching target inflation will be a hard slog.** The battle against inflation has been a 2023 story, but the hard part back to the 2% target still ahead.
8. **Fixed income to rebound from a volatile year.** Yields remain near their historical high, a promising environment for bond investors.

9. **Higher interest costs to dampen consumer spending and borrowing.**
10. **Development of AI to power ahead, despite any slowdown.**
11. **Real estate performance will continue to diverge.** Real estate performance has run the gamut, due to divergent trends in remote working and cloud computing.

Dividends may be the strongest signal a company can send about its ability to increase profits and cash flows into the future. During the past quarter, we realized some further dividend increases. Bank of Montreal raised their dividend by 6%, National Bank by 3.9%, Canadian Natural Resources by 11.1%, Canadian Tire by 1.4%, Crescent Point Energy by 15%, Whitecap Resources by 26%, Microsoft by 10%, and Royal Bank by 2.2%. In an inflationary environment, a rising dividend is always a good asset.

Apple Inc.

During fiscal 4Q23, Apple announced record September-quarter revenue for iPhone. iPhone 15 is off to a mixed start, and average iPhone ASPs suggest consumers acquired lower-end devices in a challenging macro-environment. In the holiday quarter and beyond, we expect iPhone 15 to surpass overall industry trends in a slow growth environment for smartphones.

Apple also attained all-time quarterly revenue for services in 4Q23. The installed base of Apple products once again reached an all-time high spanning all product categories and regions. Apple followed up its September iPhone 15 launch with its 'Scary Fast' event in October. The new family of M3 processors for Mac show that Apple is well-positioned in the rapidly developing market for on-device generative AI. Amid macro-economic softness and high costs, Apple continues to relatively outperform in most hardware and services businesses.

Apple shares are ahead of the market and the compute peer group in 2023, despite a modest selloff on 4Q23 results, and relatively outperformed peers during the 2022 tech sector selloff. Even with AAPL shares off to a solid start in 2023, the current environment represents an opportunity to establish or dollar-average into positions in Apple.

Brookfield Renewable Partners L.P.

Earlier this month, TD hosted meetings with Brookfield Renewable (BEP) CFO Wyatt Hartley and institutional investors. Discussions focused on a few recurring topics: 1) factors that differentiate BEP from competitors, many of whom have faced growing pains over the past year; 2) rapid growth in the corporate power purchase agreement off-take market for renewable power and storage providers; and 3) levers available to lower the company's payout ratio.

We believe that BEP deserves a valuation premium based on several factors: scale, broad investment opportunity-set, consistent value-accretive track record, ability to act on large/complex transactions, operating/procurement expertise, management depth, and a strong funding platform. With Brookfield-sponsored energy transition and infrastructure funds having raised substantial capital, we believe that opportunities for Brookfield to co-invest on large scale opportunities are expanding rapidly.

Bank of Montreal

Bank of Montreal (BMO) is our top pick among the banks heading into 2024, as we believe it is best positioned to capitalize on the key themes we believe will play out over the next year. BMO is trading at a 1%-2% discount to the group on a forward Price/Earnings basis (2024 EPS estimates). On 2025E EPS, the discount to the group is 5%/3% for TD/consensus estimates. This compares with its past five-year average of a 4% discount. The valuation gap narrowed materially in the last few weeks of 2023, with BMO trading near the bottom of the group on an absolute basis. We expect the recent momentum to continue given our outlook for a capital markets recovery in 2024 (and BMO being relatively overweight in capital markets) as well as contribution from the Bank Of The West (BOTW) deal.

We expect the benefits of the BOTW synergies (US$800mm), the Full-Time Equivalent (FTE) reduction of 2.5% in Q3/23, and other expense initiatives to drive solid positive operating leverage in 2024. The FTE reductions and real estate optimization is expected to drive $400mm in annualized savings in 2025. In our view, BMO, like Royal Bank, is particularly well positioned to deliver better relative expense performance in 2024.

We see at least three reasons to remain bullish: 1) relative valuation appears attractive, 2) we believe that the BOTW deal and aggressive cost cutting initiatives will help BMO deliver better PTPP growth at a time when several of its peers may not have as much earnings momentum (2024), and 3) we expect 2024 capital markets comparisons to reflect more favourably on BMO.

BCE Inc.

We believe the dividend is safe and the probability of another 5% increase in February is very high, which puts the prospective yield at 7.4%. BCE is a solid name for investors looking for income in an environment where central banks start easing and bond yields are declining. It is also a defensive name that should see minimal impact if a harder landing scenario unfolds. Media advertising is cyclical, but we have already been in an advertising recession for over a year (exacerbated by content shortages owing to labour disruptions in Hollywood) so year over year comps in that segment should be easy even if the broader economy enters recession.

Cogeco Inc.

We continue to believe that Cogeco Inc. (CGO) remains undervalued when compared with Cogeco Communications Inc. (CCA), while CCA itself has asymmetrical upside for investors relative to downside risk. A lot of negativity from U.S. broadband trends and a potentially expensive multiyear wireless network build in Canada are priced into CCA and, subsequently, CGO. We also continue to believe that a potential collapse in the CGO holdco could be a catalyst both for CGO and CCA shares to break away from very low valuation levels.

Canadian Natural Resources Ltd.

In our view, Canadian Natural Resources (CNQ) remains best positioned of the integrated producers to navigate rapidly changing Western Canadian Sedimentary Basin (WCSB) market conditions. This is a function of having the highest level of portfolio diversity (oil sands spanning in situ and mining, conventional oil, natural gas, and international), plus dominance on regional infrastructure. This drives significant capital flexibility, and it remains surprisingly nimble given its status as the largest Canadian producer.

Drilling down, Horizon and the Athabasca Oil Sands Project (AOSP) are consistently ranked top-three on the basis of utilization and cost structure. In addition, its significant footprint in the Clearwater (940,000 net acres) and Mannville provides optionality for ratable short-cycle growth (4-5 month payout timeline), while its significant natural gas footprint could eventually benefit from a more creative approach to gas marketing. Further, with ongoing Environmental, Social and Governance (ESG) headwinds, we believe CNQ is arguably best positioned to capitalize on Carbon Capture Utilization and Storage (CCUS) as the largest owner of existing capacity (Quest, North West Redwater, Horizon).

Looking to valuation and shareholder capital returns, we believe CNQ remains competitive. CNQ remains confident that it will achieve its $10bln ND target and transition to 100% return of FCF in Q1/24, on strip. It would be the first of its peers to achieve this milestone. On strip, we estimate a 2024E total cash return yield of 7% vs. peers at 7%-9%, and an unlevered 2024E FCF yield of 10% vs. peers at 13%-15%. We continue to have high conviction for a number of reasons including: 1) greater line-of-sight to transitioning to 100% return of FCF; 2) CNQ's potential to eventually benefit from a more creative approach to natural gas marketing; and 3) a significant number of identified near-term value enhancing opportunities across CNQ's upstream portfolio.

Crescent Point Energy Corp.
On November 6th, Crescent Point announced the acquisition of Hammerhead Energy for ~$2.55 billion including $1.5 billion in cash, the issuance of 53.2 million shares to Hammerhead shareholders (~$548 million), and ~$455 million of assumed debt. In conjunction with the acquisition, Crescent Point issued 48.6 million shares ($500 million) via a bought deal.

Now that the transaction has been completed, the company released formal 2024 guidance which has been enhanced from preliminary guidance released in conjunction with the transaction announcement. In addition, the company increased the dividend by 15%. Crescent Point continues to execute on its plan to streamline its assets through further non-core monetization. The company offers exposure to world-class high impact Montney and Duvernay assets, strong organic production growth, significant return of capital and modest financial leverage which we see improving through FCF growth.

Canadian Tire Corporation, Ltd.
The company reported a messy quarter. The normalized earnings per share is a miss, however upon digesting, they are not as weak as the headline would suggest. The earnings per share miss is a combination of weak retail same-store sales growth comparables/earnings, partially offset by a stronger-than-anticipated contribution from the Financial Services ("CTFS") segment. A large component of the Retail miss is a lower-than-anticipated contribution from the Margin Sharing Arrangement ("MSA"), and to a lesser extent a mark-to-market one time compensation expense. Overall, our summary of the quarter is mixed. We'll call it in line with consensus but believe the demand environment will continue to be challenged going forward. We see attractive value at the current share price.

Definity Financial Corp.
The company reported an earnings beat that was driven by strong commercial results. Definity Financial is the seventh largest P&C company in Canada by Gross Premiums Written. Definity sells personal insurance (home, auto and pet insurance) and commercial insurance throughout Canada directly and through brokers. The company operates under Economical, Sonnet Family and Petline.

We believe an investment in Definity continues to offer exposure to a stable business model with good upside potential, if the company can grow through acquisitions.

Enbridge Inc.
Enbridge entered into a definitive agreement this quarter to sell its 50% stake in Alliance Pipeline and NRGreen, as well as its 42.7% stake in Aux Sable to Pembina Pipeline Corporation for $3.1 billion, including approximately $300 million of assumed debt.

Although the divestiture allows for meaningful progress to be made towards closing the funding gap associated with Enbridge's large utilities acquisitions that were announced earlier this year, we had not previously incorporated asset sales in our assumptions, considering we viewed the other financing levers more favourably. Regardless, we believe the divestiture demonstrates Enbridge's ability to effectively execute on its financing initiatives and provides further confidence in Enbridge's ability to close the remainder of the funding gap through the levers at its disposal.

First Capital REIT
With strong property-level demographics and a high concentration (~85%) in necessity-based tenants (versus its two closest retail REIT peers: RioCan at ~62% and SmartCentres at ~60%), we see First Capital (FCR) being set up relatively well to manage through any upcoming economic slowdown. Management continues to see strong demand for its space, noting the volume and number of lease transactions through Q3/23 being the deepest that it has ever been with no signs of a slowdown. FCR continues to make progress on its target of $1bln of asset monetization ("portfolio optimization plan") by year-end 2024 with $520mm or 52% completed or committed thus far. We believe this will help drive Funds From Operation/unit growth and reduce leverage, while also reducing exposure to redevelopment sites with low current yields. This disposition progress is noteworthy, in our view, given the overall slower transaction market seen in 2023. FCR continues to trade at a valuation discount vs pre-pandemic levels and to its Canadian retail peers.

Maple Leaf Foods Inc.
We believe Maple Leaf is at the precipice of breaking out. Even without any improvement in pork market fundamentals (currently at unsustainably low levels), we would still expect returns on its massive poultry and bacon investments alone to push Meat EBITDA margins to 13%+ (as early as Q1/24 on seasonally adjusted basis), fiscal cash flow yields to 10%/13% in 2024E/2025E and leverage falling sub-3x by Q4/24. We believe this alone should push the shares comfortably into the $30s and a recovery in market fundamentals — currently a 300bps hit to margins — could add much more.

Ultimately, as results improve, we believe valuation (currently 6.8x/7.6x our/consensus NTM EBITDA, the lowest among its comps) should return to and eventually surpass its 10-year average of ~9.3x.

Microsoft Corp

Key Microsoft partner generative AI startup OpenAI decided to fire its iconic CEO and Co-Founder Sam Altman on November 17th. OpenAI's governing board issued a cryptic statement noting that Mr. Altman 'was not consistently candid in his communications with the board,' and that 'the board no longer has confidence in his ability to continue leading OpenAI.' The firing and cryptic statement led to a raft of speculative theories on the real reason for the firing and much consternation across the Tech industry including virtually all of OpenAI's staff threatening to quit the company. The situation reached the point where Microsoft was willing to hire Mr. Altman and any other OpenAI staff for a new AI research division. Mr. Altman returned as CEO on November 22nd and almost all of the Open AI Board resigned.

While the OpenAI soap opera made for many headlines and tech news site clicks, for Microsoft, the issue was about being blindsided by a key technology partner in which it had invested a reported $13 billion and is a minority owner. CEO Satya Nadella was one of the few calming figures in the OpenAI kerfuffle. His focus was, as always, on the technology and he expressed an indifference to whether the basic tech would continue to be developed at OpenAI or at the new Microsoft research division. Mr. Nadella openly spoke of seeking board observer status at OpenAI and it looks as if Microsoft will get that now that a new OpenAI board has been empaneled.

Continued turmoil at OpenAI may have created an opening for its competitors Anthropic, Alphabet/Google, Meta Platforms and the rest of the rapidly expanding AI industry to catch up on OpenAI's technology lead. The turmoil could justifiably scare its customers who might opt for a more stable competitor or enabled competitors to readily poach disgruntled OpenAI employees to spur their own AI research efforts, given the glaring talent shortage in the field. However, the swift resolution and return of Mr. Altman keeps the Microsoft relationship intact and probably will have little impact on OpenAI's research other than the five-day distraction. While OpenAI's advances in the generative AI field are clearly critical to Microsoft's effort to productize generative AI for its customers, Microsoft is also both building its own proprietary large language models and has relationships with other key player.

Restaurant Brands Inc

We expect the company's e-commerce capabilities, investments in its franchises, strong loyalty program, and international expansion to benefit earnings. We also look for menu simplification to improve order accuracy and increase throughput, boosting restaurant-level margins. We believe that Restaurant Brands International can reach its long-term target of 40,000 restaurants.

Rogers Communication Inc.

Rogers has continued to be the best-in-class operationally since Q3/21, in our view. During the past quarter, Rogers led the group in sub adds, revenue growth, Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) growth and EPS growth but continues to trade at an 11% discount to BCE/Telus on 2024E EBITDA (this gap is even wider on a P/E basis). Rogers is currently more heavily levered than its peers, but we expect three meaningful catalysts to erase those fears over the next following months. We continue to anticipate non-core asset sales with management targeting $1 billion of sales, although we include only $500 million in our model. Additionally, Shaw opex synergies of $1 billion are being realized faster than expected so EBITDA/FCF should continue to lower leverage. Finally, we believe that 2024 guidance from management will continue to make it more clear to investors that debt/EBITDA will decline to almost 4x by the end of FY24, versus 5.2x when the Shaw deal closed.

Note that these potential catalysts follow events such as the Cogeco shares sale and the lower than expected 3800 MHz spectrum auction spend that has already helped allay fears related to leverage. With all that said, the additional leverage in the Rogers' capital structure means that Rogers does not need to significantly close the gap to BCE/Telus on an EV/EBITDA basis in order to significantly outperform the sector in the near term in our view.

Royal Bank of Canada

Over the past 5-10 years, Royal has traded at a 6-8% premium to the group. Although Net Income Margins advantages have faded, we expect expense actions, the HSBC deal, and business mix (large, dominate positions in several business lines) to continue to drive superior pre-tax pre-provision growth and higher relative Return On Equity (ROE), and ultimately support Royal's premium valuation.

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