TD Wealth

Quarterly Market Commentary

December 31, 2016

Happy New Year! As we transition from 2016 to 2017, all eyes will be on Washington, where the transfer of power from Democrats to Republicans will take place. Donald Trump's election victory reflects dissatisfaction with the current state of affairs, which we also witnessed with Brexit and the recent Italian referendum. Despite these bouts of volatility, we are very pleased with how we performed in 2016 and how the portfolios are currently positioned.

We expect the bull market in stocks to continue until after the US yield curve inverts, which we believe is at least two years away. Having said this, we expect stock market gains will slow as utilities and other 'bond proxies' drag on overall performance.

The U.S. economy has transitioned into the 'late cycle' environment, characterized by rising inflation, increased U.S. Federal Reserve (the Fed) tightening, and rising bond yields. With a new cycle of re-accelerating earnings now underway, stock markets have transitioned from 'interest rate driven' to 'earnings driven'. This creates a divergence within the stock market as some sectors follow bond prices lower while other sectors follow earnings higher. Held back by this divergence, the overall S&P 500 should be increasingly outperformed by sectors and countries (including Canada) more sensitive to late cycle drivers.

Our expectation of slower S&P 500 price gains could be conservative in the event of a liquidity driven overvaluation, as seen in the late 1990's tech bubble. We project a gradual decline in P/E multiples in both Canada and the U.S. in the years ahead as the earnings recovery has been at least partly discounted by the market, but investors should be prepared for the very real possibility that multiples rise as liquidity flows from low yielding bonds to the higher earnings yields available in the equity markets. Cyclically rising inflation shifts investor interest from 'financial assets' notably bonds, to 'real assets' notably stocks and commodities. Excess global liquidity can exaggerate this shift. We feel investors should be positioned to potentially take advantage of this overvaluation should it occur.

We have used the term 'turning point year' to describe years when economic growth is weak at the beginning of the year and strong at the end of the year. There have now been three turning point years in this economic cycle: 2009, 2013 and 2016. At the beginning of a turning point year, economic data is weak and most investors are cautious. At the end of a turning point year, economic data is much stronger and most investors are optimistic. Bears are converted into bulls during turning point years and, as seen in 2009, 2013 and 2016, stock prices rise while bond prices decline.

The stock market faces two challenges in the year after a turning point year (2010, 2014 and 2017). First, with economic data stronger and optimism widespread, there are fewer bears to convert to bulls, which reduces buying power. Stock markets corrected in January 2010 and January 2014 despite widespread bullishness in strategist 'year ahead' projections. We believe the next correction, likely quite mild, could begin as early as mid-January as equity markets 'run out of buyers' amid widespread bullishness. The second challenge for the stock market will occur when some measures of momentum start to slow after the easy year/year comparison relative to the weakness in 2016 Q1 has passed. Some investors may worry growth will disappoint the expectations implied by equity valuations that will still be cyclically elevated. This type of concern might trigger a classic 'sell in May' correction. With luck we will get both corrections, giving investors who share our long-term bullish stance two opportunities to 'buy the dip'. We believe the best time to invest in a new re-acceleration is during the turning point year when investors are so cautious. The next year gets more challenging because expectations are elevated. Our targets for year-end 2017 remain unchanged at 2400 for the S&P 500 and 16000 for the TSX.

2016 was an interesting year and our disciplined platform allowed us to deliver strong performance again. One of our notable trades in 2016 was the sale of Constellation Software. It was first purchased in our portfolios on December 9, 2013 at a price of $193.40. We sold this position on November 2, 2016 at $628.70 resulting in a return of 225.1%, not including the dividends. It can be difficult for some investors to sell such a strong winner, but Constellation Software broke one of our thresholds, which triggered the sale. As we type this commentary, Constellation is currently trading below $600 per share.

New Flyer Industries
During the fourth quarter, we added New Flyer Industries to the portfolio as it scored very high on our quantitative analysis. New Flyer is the largest heavy-duty transit bus manufacturer offering the widest range of drive systems and operates North America’s most sophisticated aftermarket parts organization. New Flyer is reasonably priced for a company with such a high growth profile. We feel that the relatively low payout ratio bodes well for future dividend increases. New Flyer is the dominant player in its market. As such, we feel that New Flyer offers an excellent opportunity.

Canadian Tire

We also added Canadian Tire from our qualitative analysis to the portfolio. The combination of its branding strategy, targeted marketing, expansion of private label brands, and focus on productivity initiatives is clearly driving results.

We believe that there remains further opportunity to continue to drive growth with this business plan looking forward, particularly as the success to-date has been achieved in a difficult retail environment. Equally important, in our view, are ongoing cost-saving/productivity initiatives within Retail (notably at Canadian Tire) that appear to be generating sustainable gross margin improvement.

Combining this forecast operational success with our view that the Retail balance sheet remains over-capitalized, we are comfortable that management will maintain its commitment to its active Normal Course Issuer Bid, resulting in value creation over the mid-term.

Overall, with the valuation of the Retail operations trading toward the lower-end of its historical range and our positive operational outlook, we continue to view Canadian Tire as one of the most compelling opportunities in our coverage universe. As the company achieves future financial results in line with our forecasts and surfaces the value inherent in its surplus real estate portfolio, we believe that the applied Retail valuation should improve further. Until such time, we believe that the material share buybacks that management has committed to should provide a degree of downside support for the share price.

Some of our names that we continue to hold and favour for 2017 include:

Alimentation Couche Tard

Anticipated organic growth and recent material acquisitions have us forecasting approximately 37% EPS growth in calendar 2017, yet Couche-Tard is one of the only companies in our coverage that is currently trading below its 5-year average forward Price / Earnings ratio. It is also trading well below its peer group average. We expect strong share performance to resume in 2017 allowing it to outperform the sector as attractive valuation makes the market more willing to pay up for the company's solid organic growth trends, recent acquisitions — Topaz's 444 Ireland sites (closed February 1, 2016), Shell's 127 Denmark sites (50 transferred in Q1/F17 and the remaining in Q2/F17), 278 Canadian Esso sites (transferred from September 12 through October 27), and CST's ~1,300 sites (expected to close in early-2017) — and synergies, in addition to potential additional acquisition announcements as the balance sheet de-levers.

Premium Brands

Looking out to 2017, we believe that the company will continue to deliver solid double-digit earnings growth driven by a combination of organic growth across all business lines (we are particularly bullish on the sandwich segment industry fundamentals and the sales opportunities available with the addition of more capacity in 2017) and further efficiency improvements. 2016 was a banner year on the acquisition front with the company completing ~$230mm in deals which are expected to contribute $400mm and $31mm to the top line and EBITDA respectively.

Suncor Energy

We believe this name offers high growth visibility with in-flight projects adding ~120 mbbl/d of incremental production over the next 18 months. On this basis, we calculate 2017E-2019E debt-adjusted production per share growth of 7.3% vs. the peer group at 5.7%. By our forecasts, Suncor also offers the lowest base declines globally for companies with an Enterprise Value of >$50 billion. We calculate a 6% decline for 2017, which should drive free cash flow yields of 6-8% into 2019E and beyond.

With respect to breakeven oil prices, we estimate that Suncor requires only US$35/bbl WTI to fund sustaining capital and the dividend. However, even if oil prices were to fall below this threshold, it has a strong balance sheet to lean on with a 2016E net debt/total cap ratio of only 23%.

We would also argue that its torque to a recovery is broadly underestimated by the Street. One has to remember that it is 99% oil weighted - we estimate a 2.5% boost to 2017 cash flow for every US$1/bbl increase in WTI.

Finally, we highlight potential upside associated with its Syncrude position where its working interest has increased from 12% to 54% through the acquisition of Canadian Oil Sands (acquired) and the Murphy Oil Corp. (MUR-N) stake. This project has clearly been challenged for a long time but with Suncor taking on a greater role, we believe execution will improve (with the potential to eventually assume operatorship). We note that Suncor surrounds Syncrude on three sides and for this reason, there should be many opportunities to integrate the projects. We expect Suncor and the operator to roll-out the 'game-plan' for synergies and improved execution by February - this has the potential to be a catalyst for the stock, in our view.

TransCanada Corp

TransCanada is our strongest conviction BUY for 2017. Our investment thesis is informed by the following views:

- Its effective 10% dividend CAGR through 2020 is underpinned by its $25 billion of near-term capital projects.
- Driven by strong cash flows and a conservative payout, TransCanada has a high degree of financial strength and expertise which we believe position the company well to benefit from opportunities in North American energy infrastructure.
- The transformative acquisition of CPG will contribute on a full-year basis in 2017, and in our view will be accretive to cash flow. Revenue synergies could bolster accretion.
- TransCanada is Canada's incumbent natural gas pipeline company which should translate into a role in bringing unconventional gas to market.
- The backlog of contracted projects, such as Energy East and Keystone XL, offer the potential for upside and are compelling market access solutions.
- The current share price reflects relatively low expectations, in our view.

Overall, we do not think TransCanada's share price is reflecting the company's high quality, long-life, low-risk assets and long-term growth outlook. Over the next year we expect TransCanada to continue to make new investments that leverage its broad and deep energy infrastructure expertise, scale, and financial strength.

Again, we are very pleased with our performance for 2016 and we are cautiously optimistic with how we are positioned for 2017. If you should have any questions, or comments, we welcome any feedback. Finally, we are accepting new clients. If you know of any family, friends or colleagues who could benefit from our complete offering, we would be most grateful if you would pass our names on to them.

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