Quarterly Market Commentary

January 2023

The Federal Reserve and other central banks have been hiking rates with the goal of engineering an economic slowdown to ensure that inflation continues to decline. Tightening by the Federal Reserve has taken short term rates above long-term rates resulting in an inverted yield curve. History shows that inverted yield curves are almost always followed by recession and therefore we should expect a recession will begin at some point in 2023. The recession will likely be quite mild, particularly in the U.S. where consumer balance sheets are in good shape and homeowners have locked in low mortgage rates. Recent strong economic data suggests the start of the U.S. recession will be pushed out at least until the spring. U.S. GDP growth in the fourth quarter is likely to be in the 2 to 3% range, aided in part by a surge of spending in October boosted by repair and replace spending after Hurricane Ian in late September. First quarter growth will be boosted when 70 million Americans receive an 8.7% boost to social security benefits due to annual CPI indexing, effective with payments made at the turn of the year.

The greater prevalence of variable rate mortgages in Canada increases interest sensitivity and most likely means the Bank of Canada has already tightened enough while the Federal Reserve still seems to be on track to reach a terminal Fed Funds rate of 5% at its March meeting. Central banks are hoping to set a terminal rate in place that is high enough to ensure inflation declines as the labour market softens, but not so restrictive that the economy declines sharply.

History shows that P/E multiples have always contracted during periods of Fed tightening. The markets first began to anticipate Fed tightening in early October 2021 so we adopted our cautious stance that month, recommending investors underweight high multiple stocks such as technology and overweight low multiple stocks such as energy, materials and financial services. We continue to recommend this stance.

Economic growth always slows after a period of Fed tightening. If the tightening inverts the yield curve, the economy slows into recession. A tightening that doesn't invert the yield curve is followed by a soft landing rather than recession (1985-86 and 1995-96). Stock prices can rise during soft landings as earnings weakness is more than offset by multiple expansion as bond yields decline, but stock prices have always declined during recessions as earnings weaken more than can be offset by declining bond yields. Forward looking stocks tend to bottom well before the recession ends when investors see 'light at the end of the tunnel'. New bull markets begin in recession. We expect a recession in 2023 so we expect a new bull market will begin in 2023.

A mild recession in 2023 means we should expect a mild economic recovery in 2024. This 'saucer shape' for the economy will also translate into relatively modest swings in stocks. The 2024 high will surely be more than 15% above the 2023 low, but the substantial bounce seen in sharp V-shaped recessions should not be expected.

We were quite active this past quarter with position changes and trims. We trimmed down Suncor and Restaurant Brands due to growth and trimmed up Maple Leaf Foods before it ran up this quarter. In addition, we added the following positions to the portfolio this quarter:

BANK OF MONTREAL

Bank of Montreal is our top pick among the banks heading into 2023, as we believe it is best positioned to capitalize on the key themes we believe will play out over the next year.

With the slowdown in capital markets activity (particularly with financial sponsors), Bank of Montreal's Pre-Tax Pre-Earnings Provisions has started to lag the industry. However, we see at least two reasons to remain bullish: a) relative valuation remains attractive and b) we believe that the Bank Of The West deal will help Bank of Montreal deliver better earnings per share growth at a time when several of its peers may not have as much earnings momentum. Upside to our target price is 25% and is the highest in the group. Furthermore, Bank of Montreal is currently trading below its long term relative price/earnings ratio.

Our positive outlook on Bank of Montreal is supported by strong performance during and after the pandemic. Additionally, we believe the bank's risk culture remains strong. In our view, relative valuation does not reflect the bank's improving performance, the benefits of the Bank Of The West deal, and business mix (commercial over residential mortgages).

CANADIAN NATURAL RESOURCES

The company hosted its annual investor day on November 30th. Strategic consistency and very significant capital flexibility shone through yet again at this year's Investor Day. Canadian Natural Resources continues to boast the most sustainable business model within our coverage—therefore, we continue to recommend it as a core energy holding. We highlight rapid deleveraging, an aggressive shareholder return framework, ratable/sustainable dividend growth, significant capital flexibility, and infrastructure dominance as key tenets of the investment thesis.

ROGERS COMMUNICATION

Rogers shares continue to trade at atypically low levels both on an absolute basis and relative to BCE/TELUS, in spite of industry leading wireless metrics. Rogers is well hedged to offset the impacts of potentially tougher wireless competition going forward through increased scale, cost synergies and bundling capabilities. If/when the focus shifts from regulatory uncertainty to synergies and scale benefits, we believe that Rogers shares will meaningfully outperform its key peers. Rogers has assets that are typically resilient to both recessionary and inflationary headwinds, and it is insulated from the risk of rising interest rates by minimal near-term bond maturities and a long average duration for its debt. The company has minimal exposure to cyclical advertising revenues or business telecom spending.

DIVIDEND INCREASES

As you know, our platform will only invest in companies that pay a dividend. We strongly believe that every investment should compensate an investor. In addition, dividends can hedge against market downturns and inflation. This past quarter, we saw many of our holdings increase their dividend:

Enbridge Inc.	+3.2%	Crescent Point Energy	+25%
Bank of Montreal	+8%	National Bank of Canada	+5%
Cogeco Inc.	+10%	Suncor Energy Inc.	+11%
First Capital REIT	+100%	Canadian Tire	+33%
Canadian Natural Resources	+13%	TD Bank	+5%

We continue to favour our other holdings.

APPLE INC

The company posted fourth quarter revenue and earnings that topped consensus expectations. Apple has relatively outperformed peers during the 2022 Tech sector selloff, while still being down; and it had a rare sector-matching performance in 2021. In our view, Apple's so-so performance for the past two years mainly reflects sector rotation, not misfires in Apple's leadership franchises. We believe that the current environment represents an opportunity to establish or dollar-average into positions in Apple.

BCE INC.

Our target price increases to $65.00 from $64.00, and we are maintaining our BUY rating. BCE shares are up 12% since we upgraded the stock on October 13, and the forecast total return over 12 months is now slightly below our normal threshold of 10%. But we continue to view this as a low-risk name with an attractive yield (5.8%), and we expect 5% dividend growth again in 2023.

BROOKFIELD RENEWABLE PARTNERS L.P.

The company reported Q3 results that were slightly above our estimate and the consensus forecast. The share-price decline is consistent with the average sell-off for Canadian renewable Independent Power Producers. Over this period, Brookfield's valuation premium has narrowed. We believe Brookfield deserves a valuation premium based on several factors: scale; broad investment opportunity-set; consistent value-accretive track record; operating / procurement expertise; management depth; and a strong funding platform.

CANADIAN TIRE

The company reported a third quarter that was softer than anticipated due to greater than forecast retail gross margin and operating expense pressures. This was due to elevated freight costs that are now showing signs of easing. Canadian Tire raised its annual dividend to $6.90 per/share (+33% year over year, 4.7% yield) and increased its normal course issuer bid to $500mm-to-$700mm ($400mm in 2022). We maintain that the decline in the share price presents a compelling opportunity for investors that can look through near-term temporary headwinds to reacceleration of growth in the second half of 2023.

CRESCENT POINT ENERGY CORP.

We expect the company to provide an outsized return of capital to shareholders through our forecast period. We estimate total 2023 cash return to shareholders of 13% of the current market capitalization which is top quartile in our coverage universe (4% from base dividends and 9% from normal course issuer bid).

Crescent Point has committed to returning 50% of fiscal cash flow to shareholders (post base dividends). By our estimate, Crescent Point's normal course issuer bid should have sufficient capacity to allow it to meet this commitment. However, should commodity prices exceed our forecast, we believe it is likely the base dividend and normal course issuer bid could be supplemented by special dividends.

We feel the company's entry into the Kaybob Duvernay was well timed. Results from Crescent Point's first five pads in the play have been at or above the company's original expectations, with IP30 rates of ~860 BOE/d (~80% liquids). Combined with material cost reductions, this demonstrates the company's ability to execute in the play, in our view. With subsequent inventory-building transactions recently announced, we believe that investor concerns of large additional transactions should be eased.

The company has shown its capital restraint and discipline. Since the refreshed management assumed control, total net debt has been reduced by 70% since 2018. Furthermore, with significant tax pools, Crescent Point is one of only a few companies in our coverage universe that is not cash taxable through our forecast period. Crescent Point offers significant and outsized return of capital, low financial leverage metrics, growing exposure to a high-impact, liquids-rich play, and a relatively low valuation.

DEFINITY FINANCIAL CORP.

For Definity specifically, we envision one of three scenarios playing out over the next few years. The most likely, in our view, is that the company makes an acquisition given the fragmented industry the company operates in (announced minority interest in Apollo in March 2022). Definity's scalable systems, unleveraged balance sheet, experienced management team, and access to capital position the company well to complete a deal, in our view. The other scenarios include: 2) the company grows its direct written premiums at an above-average rate and continues to refine its business model resulting in an ~200bps improvement in operating return on equity; or 3) the company largely remains as is (limited improvement in profitability and operating return on equity). We believe an investment in Definity offers exposure to a stable business model with good upside potential if the company is able to grow through acquisition and/or be acquired (long term scenario).

ENBRDIGE INC.

The company reported strong results and reaffirmed 2022 guidance. In our view, the company's resilient business model, long-life assets, and ability to pivot to meet continued industry changes, including a transition to a lower-carbon future, should warrant a premium valuation. Over the long term, we expect Enbridge to continue to have a strong competitive incumbency due to its geographic footprint, scale, connectivity, and diversification, and we believe that this positions it to play a role in North America's contracted and regulated energy infrastructure evolution to support global long-term climate-change goals, continued security for energy demand, and exports.

FIRST CAPITAL REIT

We believe First Capital REIT has one of the largest valuation upsides within our retail coverage universe and is well positioned to navigate any economic headwinds. First Capital has a significantly higher concentration in necessity-based tenants (~80% of rents) versus its two closest retail REIT peers (RioCan at ~60% and SmartCentres at ~61%). While smaller-business tenancies can pose some risk during a recession, First Capital has the lowest exposure to other potentially vulnerable sectors such as department stores and fashion. The company announced plans to target $1bln+ of asset monetization by yearend 2024, which we believe will help drive funds from operation/unit growth and reduce leverage, while also at the cost of reducing exposure to some top-tier assets. First Capital recently received unit holder push for board changes on three separate occasions from institutional investors

Sandpiper (link) and Ewing Morris (link), along with former CEO Dori Segal (link), which we believe should help to raise investor awareness and shed light on First Capital's undervalued unit price.

MAPLE LEAF FOODS

We believe Maple Leaf has a lot going for it as an industry leader in ESG, well above average Meat revenue growth, the largest branded Canadian market shares in fresh and prepared meats, and dominant leadership positions in Raised Without Antibiotics (RWA) pork (North America) and RWA poultry (Canada). Maple Leaf Food's share price underperformed in 2022 on earnings pressure from poor pork industry market fundamentals and labour shortages, which have prevented margins from reaching what management states is now a 14% structural level (with returns on Poultry and Bacon investments expected to add up to ~260bps more to the run-rate by year-end 2023). We expect Maple Leaf to deliver sequential margin improvements through Q4/23 as labour availability increases (on track to fill the remaining ~600 vacancies by year-end 2022), mix improves, the pork complex normalizes, benefits from the poultry and bacon facilities materialize, and Protein Based Products returns to breakeven (by Q4/23). This should lead to meaningful fiscal cash flow generation for the first time since 2017/18 and move the shares materially higher over the next 12 months.

MICROSOFT CORP

Microsoft may just hold the premiere position in business technology. Though not immune from macroeconomic pressures, Microsoft may have the strongest, most diversified set of assets in the Tech sector – and may be seen by investors as a safe haven in uncertain times. The company is one of a few with an integrated product set aimed at enterprise efficiency, cloud transformation, collaboration, and business intelligence. It also has a large and loyal customer base, a large cash cushion, and a rock-solid balance sheet.

RESTAURANT BRANDS

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.

The shares have done very well this quarter driven by prospects for strong same-store sales as consumers trade down to less expensive menu items. We expect further gains, helped by strong same-store sales growth at Burger King and Tim Hortons. On November 16, the company named the former CEO of Domino's Pizza, J. Patrick Doyle, as executive chairman. The company also said that Mr. Doyle would invest about $30 million in QSR stock, and that he had agreed to hold the shares for five years. In the nine years that Mr. Doyle served as CEO, Domino's became a leader in the digital space and reported 29 consecutive quarters of higher same-store sales. We think that he will help to improve customer satisfaction, increase franchisee earnings, and raise digital sales.

ROYAL BANK OF CANADA

The bank reported fourth quarter earnings that beat our estimate and consensus. In addition, Royal raised the dividend by 10%. Over the past 5-10 years, Royal has traded at a 5-7% premium to the group. In our view, the bank's structural advantages and track-record continue to support a healthy premium. We believe the bank is particularly well positioned for the themes that we believe will favour bank stock performance in 2023. Consequently, we expect Royal Bank to be among the leaders in terms of Pre-Tax Pre-Provision growth in 2023.

SUNCOR ENERGY INC.

The company had a very strong quarter. In addition, they hosted their Investor Day at the end of November. We thought that they did a good job of addressing many of the key investor questions like its decision to retain its retail portfolio (we strongly support the decision), safety initiatives, and the mid-term outlook for Fort Hills. Now it's all about execution, in our view. We see upside in the shares on the basis of relative value, but consistency on operational performance and safety will prove critical to bridging the multiple gap, in our view.

TC ENERGY CORP

We believe TC Energy's incumbency in prolific natural gas producing regions in North America, combined with access to large markets, the company's scale, energy infrastructure expertise, low-risk business model, and financial strength position it well as societies transition to using lower-carbon energy sources over the long term, while ensuring energy security for North America and its global counterparties. TC Energy's 5-year strategic priorities are to focus on enhancing financial strength and flexibility, as well as on project execution, operational excellence, increase asset returns through revenue enhancements and cost savings, as well as decarbonize operations and capitalize on low-carbon opportunities.

We believe the additional cost headwinds that Coastal GasLink (CGL) is facing are likely priced into the stock, and while we recognize that each project faces unique circumstances, we believe the company's other significant capital projects will be more closely monitored and not be subject to nearly the level of headwinds CGL experienced. The recent challenges a number of the industry's linear infrastructure projects have been facing reinforce the relatively high barriers to entry for large-scale North American pipeline franchises, in our view, reinforcing TC Energy's incumbency. The company is planning to sell $5bln+ of either discrete assets or minority interests through 2023 to fund additional growth projects and could accelerate achieving its deleveraging target. We view the stock as attractively valued relative to its peers and expect its stock to rerate upwards as it progresses its asset sales and large capital projects.

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Sources:
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(BCE-T) 2023 Outlook: Estimates and Valuation Adjusted – Dec 14, 2022
(BEP-N) Slight Q3/22 FFO Beat; Development Pipeline Expanding – Nov 07, 2022
(CCA-T) Q1/23 Preview and Slight Estimate Changes – Dec 06, 2022
(BMO-T) Reinstating Coverage Following Equity Raise – Dec 16th, 2022
(CPG-T) Acquires More Duvernay in Sizable Transaction. Bumps Dividend – Dec 09, 2022
(DFY-T) Q3/22: Personal Auto Deteriorating in Line with Expectations – Nov 11th, 2022
(CTC.A-T) Q3/22 Results: Opportunity Despite Near-Term Headwinds – Nov 11th, 2022
(CNQ-T) Investor Day Highlights Numerous Key Structural Advantages – Dec 01, 2022
(MFI-T) Expecting Relatively Steady (and Material) Improvement from Here – Nov 09, 2022
(RCI.B-T) 2023 Outlook: Estimates and Valuation Adjusted – Dec 14th, 2022
(RY-T) Q4/22: Deposits Are Key Advantage; But Betas Are Rising – Nov 30th, 2022
(SU-T) Investor Day Answers Many Key Questions; No Overnight Fix for FH – Nov 30th, 2022
(FCR.UN-T) Robust Trends in Grocery-Anchored Properties, with Optionality – Nov 03, 2022
(NA-T) Q4/22: Higher GIL formations; Expense Growth Less Troubling – Nov 30th, 2022
(TRP-T) 2022 Investor Day Highlights – Nov 30th, 2022
Apple (AAPL) – Argus Analyst Report – Oct 28th, 2022
Restaurant Brands Intl (QSR) – Argus Analyst Report – Dec 20th. 2022
Microsoft (MSFT) – Argus Analyst Report – Dec 16th, 2022
TD Bank (TD) – Argus A6 Quantitative Universe of Coverage – Dec 14th, 2022

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