Quarterly Market Commentary

July 2024

In the first half of 2024, U.S. markets showed resilience with the S&P 500 and Nasdaq performing well, driven by strong corporate earnings, particularly in the tech sector. However, the Dow Jones lagged slightly due to a slower recovery in industrial and financial sectors. Interest rates remained a central focus, with the Federal Reserve maintaining a "higher for longer" stance on rates to combat inflation, which had started to moderate but remained above target.

Political events also played a role, with the upcoming presidential election in November adding a layer of uncertainty. Historically, election years tend to be positive for markets, but they can also bring short-term volatility due to policy.

Looking ahead, the U.S. markets are expected to face moderate volatility, with potential gains driven by continued corporate earnings growth and a possible re-acceleration of economic activity in the latter half of the year. The Fed is likely to stop rate hikes, which should ease some pressure on bond markets and support equity.

The Canadian markets have also shown resilience, with the TSX recovering from the declines experienced in 2022. The energy sector, a significant component of the TSX, faced some pressure due to fluctuating oil prices, but sectors like financials and technology showed strength. The Bank of Canada mirrored the Fed's stance on interest rates, maintaining high rates to control inflation, which has started to show signs of moderation.

The Canadian market outlook for the rest of 2024 remains cautiously optimistic. Analysts expect the TSX to end the year higher, potentially reaching a target of 23,500 points. This is based on expected earnings growth and the broader global economic recovery. However, volatility is anticipated due to potential economic slowdowns and global market conditions.

Both the Federal Reserve and the Bank of Canada are anticipated to hold their current rates steady for the near term, with potential rate cuts towards the end of 2024 if inflation continues to moderate. The bond markets are expected to respond positively to any signs of easing from the central banks, with yields potentially decreasing and the yield curves steepening after being inverted for a significant period.

Prior to the pandemic, the relationship between these indicators and consumer sentiment were relatively stable. These 13 economic inputs could be used to explain approximately 86% of the variations in the index, but since 2019, that is no longer the case. If these correlations had remained stable, the index in September 2023 would have come in at an extremely high 98, some 30 points above the number that was actually published.

The hard data shows that Americans are doing a lot better than they think, and what's worse, the Economist suggests that these bad vibes may be the new normal. It seems that the good news that many investors see when they peruse their banking and investment apps is quickly forgotten in the seconds it takes them to be distracted by a negative post on X, Facebook, or Instagram.

The human condition is all about harnessing reason to overcome our base instincts, which reduce every consideration down to tribalism. For us in the industry, it's our job to help dispel the false narratives all around us, and to present the facts because, while it's true that narratives may dominate over the short term, real economic facts – and ultimately earnings growth on the corporate side – are still what drive returns over the long term. It's our job to help clients move away from portfolio management based on emotion (how I feel about things) and back towards a process based on facts and reason (how I think about things). And the fact is, when we look at the environment we're moving into, it's actually pretty good.

- The clearest indication of rising business confidence can be seen in the purchasing manager indices (PMI). Recent data suggests PMIs have now bottomed.

- Inflation is approaching target. The latest core inflation data measured by the Fed fell from 2.9% in January to 2.8% in February. That's within the Fed's 1% to 3% range and they have already confirmed 3 rates cuts for 2024.

- The labour market remains very strong, but it is cooling. That might sound like bad news, but a looser labour market will help bring inflation down closer to the 2% target.

- Consumer spending has been one of the most stubborn data points, due mainly to high wage growth in the tight labour market. However, it appears the consumers are beginning to slow their spending.

- We also discussed the Magnificent Seven. There is a growing fear out there that the tech consolidation we have seen in the past two years is beginning to look a lot like the dot-com bubble that burst in 2000. Some of these stocks are expensive, but more importantly, they are strong businesses that offer exposure to solid financial metrics and attractive growth prospects. I am not saying that they are appropriately priced, or even represent opportunity right now. I am more suggesting that the current environment looks nothing like the dot-com bubble.

We all have biases. We are lovers of math and our biases are derived from empirical thinking and that can have its shortcomings. A lot of great research has been done to suggest how one feels is incredibly important to how we think. A better blend of both can lead to better, and smarter, decisions. By making investment decisions based on how you feel about the economy can have a considerable long-term impact on your financial goals.

Overall, North American markets are expected to navigate through a period of moderate growth and volatility for the remainder of 2024. The key drivers will be the central banks' monetary policies, corporate earnings growth, and political developments, particularly in the U.S. Given the mixed economic signals, investors should prepare for a bumpy ride but with opportunities for gains, especially in sectors that have lagged in the recent recovery. We feel we are well positioned.

We made some changes to the portfolio in the second quarter. We trimmed down our weightings in Restaurant Brands and Canadian Natural Resources due to strong performance. In addition, we trimmed up our weightings in Maple Leaf Foods, BCE Inc., Rogers Communication and Canadian Natural Resources.

We also added Whitecap Resources to the portfolio.

Whitecap Resources

Whitecap Resources Inc. is engaged in the acquisition, development, and production of oil and natural gas in the Western Canadian Sedimentary Basin, with a bias to light oil and Montney/Duvernay prospects.

Whitecap offers compelling, scalable growth assets in the Montney/Duvernay with 25+ years of undeveloped locations. We expect growth to be well-funded through fiscal cash flow generation from conventional, low declining Saskatchewan assets. The company has comfortable balance sheet leverage, a robust return of capital strategy and unique ESG credentials.

Apple Inc.

The company introduced its approach to on-device gen AI, called Apple Intelligence, which builds personalized intelligence into iPhone, iPad, Mac and more. Apple Intelligence is integrated to new updates to Apple operating systems introduced at Worldwide Developers Conference (WWDC), including iOS 18 for iPhone, iPadOS for iPad, and macOS Sequoia, and new iterations for Watch and Vision Pro.

The on-device approach to AI is meant to keep user data private. In addition to a purely on-device experience, Apple hardware users will have option to dispatch tasks to OpenAI. Apple in our view has always been more of a product perfecter than a product pioneer; while it was late to enter the mobile phone market, it now has the leading revenue and profit producer (iPhone) in smartphones. Similarly, Apple is not the first to enter the gen AI space, but we expect it to be a major player in on-device gen AI. The (long-rumored) partnership with OpenAI is somewhat precedent setting, as Apple tends to go at it alone in major market opportunities.

We believe on-device Gen AI has the potential to drive the next big round of iPhone sales. Timing of product readiness and in particular customer acceptance is uncertain. Apple recently reported solid fiscal 2Q24 results, with record service revenue partly offsetting lower iPhone sales. Currently, Apple is on track for earnings per share growth over the next two years. This reflects strong appetite for Apple's hardware, and its brand loyalty in turn spurs demand for Apple's services, including iTunes, App Store, and iCloud.

Apple has entered the generative AI space after being on the sidelines for the first year and a half after ChatGPT's launch in November 2022. By mainly positioning these new enhancements on its highest-end existing iPhone and mainly on future models, the company seeks to drive a robust new upgrade cycle in 2025 and beyond.

Bank of Montreal

The bank raised their quarterly dividend by 2.6%. BMO reported second quarter earnings of $2.59 versus TD's estimate of $2.77 and consensus of $2.76. Our positive outlook on BMO is supported by our expectation that the Bank Of The West deal will support stronger Pre-Tax, Pre-Provision Earnings growth in the medium term and particularly in 2025 as the expense synergies play-out. We believe the increase in BMO's U.S. Provision for Credit Losses (PCLs) will not be unique to the bank. Historically, BMO has impaired loans and taken PCLs at a faster pace than peers leading to better recoveries as conditions improve. Finally, we believe that higher PCLs are a late cycle consequences of higher interest rates. We expect lower rates in the second half of 2024 to drive an improvement in PCLs with a two-quarter lag (early 2025).

Brookfield Renewable Partners L.P.

At the end of May, we hosted meetings Brookfield Renewable and investors. Discussions provided details regarding the framework agreement to provide 10.5 GW of clean power to Microsoft from 2026 to 2030 via a series of eventual Power Purchase Agreements and broader opportunities for growth/asset recycling to optimize returns.

Several characteristics distinguish Brookfield Renewable from its peers: scale; a broad/deep growth opportunity set; an ability to act on large/complex transactions; operating/procurement expertise; management depth; a strong funding platform; and high exposure to positive corporate Power Purchase Agreement momentum. We believe the company's relative valuation premium is poised for further expansion given an ability to self-fund its mid-term growth pipeline and exposure to positive corporate Power Purchase Agreement momentum for clean power.

Cogeco Inc.

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

Canadian Natural Resources Ltd.

During the quarter, the Board approved a 2:1 share split. A stock split is when a company's board of directors' issues more shares of stock to its current shareholders without diluting the value of their stakes. A stock split increases the number of shares outstanding and lowers the individual value of each share. We view splits as a positive signal because it is often the result of growth or the prospects of future growth.

On April 11th, we trimmed down our position at $110.98 per share. On June 17th, we trimmed up our position at $45.93 (or $91.86 pre 2:1 split).

The company boasts the most sustainable business model within our coverage, in our view, and we continue to recommend it as a core energy holding. We highlight 100% return of fiscal cash flow through buybacks plus ratable dividend increases, best-in-class capital flexibility given significant portfolio diversity, and infrastructure dominance (i.e., cost structure advantage and an abundance of drill-to-fill opportunities) as key tenets of our investment thesis.

Canadian Tire Corporation, Ltd.

We viewed the Q1/24 results as slightly positive, as earnings exceeded expectations and management is making progress on items in their control. The driver of the beat was the Retail gross margin, accounting for the entire beat. We note two items: 1) Q1 is the seasonally weakest quarter of the year, and 2) the gross margin is historically “lumpy”. We see reasons for optimism as the second half of 2024 is on the horizon. We see the potential for material share price appreciation upon an improving consumer demand environment.

Crescent Point Energy Corp. - Veren

During the quarter, Crescent Point changed the name to Veren to reflect its new identity. The new moniker of Veren is a blending of the Latin word for "truth" and the English word "energy".

Veren has successfully transitioned to a Montney/Duvernay high-impact producer, with growth supported by a low-decline legacy asset base in Saskatchewan. The company now has ample quality inventory to support 20 years of strong organic volume growth, and more importantly, fiscal cash flow per share growth, while increasing returns to shareholders.

Definity Financial Corp.

Q1/24 operating earnings per share of $0.65 was up 19% year over year, reflecting strong net earned premium growth of 8% (in line with estimate), 39% growth in underwriting income, supported by 93.9% combined ratio (better than our forecast) and solid net investment income (up 18%, in line).

We continue to believe that the most appropriate way to value the stock is to apply a probability-weighted valuation tied into several possible scenarios. We believe an investment in Definity continues to offer exposure to a stable business model experiencing solid fundamentals with upside if Definity grows through acquisitions.

Enbridge Inc.

In our view, Enbridge is better equipped than most energy infrastructure companies in this current energy environment, given its minimal commodity and volume exposure, diverse set of crude oil and natural gas pipelines, and growing utility business.

We see Enbridge as a leader in the midstream energy industry, and expect it to benefit from its extensive infrastructure network for both crude oil and natural gas transportation. Enbridge should also benefit from plans to increase capacity on its main shipping line and from its 2017 merger with Spectra Energy.

Enbridge also generates stable cash flow and has the resources to buy back its stock. We also believe that the dividend is safe and sustainable. Enbridge has increased its dividend for 29 straight years, with average annual growth of nearly 12% over the past 20 years.

First Capital REIT

First Capital delivered overall solid Q1/24 results that were slightly ahead of management's internal budget, with both occupancy and renewal rent spreads benefiting from market tailwinds. Paired with a sizeable improvement in debt/EBITDA, the quarter brings into much clearer focus both First Capital's targets for year-end 2024 and also 2026. First Capital remains among our top picks for this sector.

Maple Leaf Foods Inc.

Upside to earnings is significant following scale investments in plant automation, but market factors and consumer weakness has prevented much of this from showing up in results. We see reasons to believe that both of these headwinds will diminish gradually through YE25, resulting in much higher earnings and, when combined with more normal capex spending, significant fiscal cash flow generation and balance sheet deleveraging. If Maple Leaf Foods hits (and sustains) its margin targets, it should also eventually earn a much higher valuation multiple, overcoming the shaky market confidence created by the volatility/lack of visibility in recent years.

Microsoft Inc.

Microsoft continues to pursue long-term growth through its AI and cloud investments, and may just hold the premier position in business technology. Although not immune from macroeconomic challenges (such as declines in the PC OEM market and in digital advertising), Microsoft has about as diversified and strong a set of assets as any company in the technology industry - and may even be seen as a haven by investors in uncertain times. The company is one of just a few with a complete, 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.

While Microsoft shares were hit by the 2022 Technology sector selloffs, they recovered in 2023 as the company has retaken its rightful place as an industry leader, though this has also driven the valuation modestly higher. Microsoft is also one of the few Tech companies in our coverage group that pays a dividend that we consider safe.

National Bank of Canada

On June 11, National Bank announced that it had reached an agreement to acquire Canadian Western Bank. Management estimates pre-tax cost and funding synergies at $270mm or ~ $200mm after tax. Concurrent with the deal, National Bank is issuing $1 billion in stock, $500 million through a bought deal, and $500 million in a private placement with Caisse de Depot.

National Bank's solid results (2021-H2/24) reflect strong capital markets performance, growth in ABA (a subsidiary of National Bank of Canada), and stronger capital levels.

Restaurant Brands Inc.

On April 30th, the company reported adjusted 1Q24 EPS of $0.73, above the consensus estimate of $0.72. Better-than-expected results reflected higher operating income in all five of the company's divisions and higher interest income.

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 announced deals with NBCUniversal and Warner Bros. Discovery to acquire regional rights to television content and brand names related to many existing lifestyle and factual specialty channels. Rogers indicates that it will launch the Bravo channel in Canada in September 2024, and then in January 2025, it will launch approximately 10 channels including Discovery, HGTV and The Food Network. No financial details were released. Corus Entertainment also announced that it has been informed by Warner Bros. Discovery, Inc. that some of its programming and trademark output arrangements will not be renewed upon their expiry on December 31, 2024. The release from Rogers states that: “We are evolving our business to reflect where consumers are going, bringing the best mix of U.S. and Canadian content to audiences in the way they want to watch it. This investment also advances our position as a strong Canadian broadcaster that can compete with foreign streamers.”

TC Energy Corp.

At the annual and special meeting of common shareholders held June 4th, approximately 97% of shareholders voted in favour of the Liquids Pipelines spin-off, satisfying the two-thirds requirement and will create two separate publicly listed entities. The spinoff is expected to be completed between late Q3 2024 and mid Q4 2024.

Tourmaline Oil Corp.

The company increased the dividend 7% this quarter. Tourmaline is one of our top picks in the Canadian natural-gas space given its industry dominant position, large Montney growth potential, global-market exposure, near-term fiscal cash flow, and low debt. We believe Tourmaline should be a core Canadian energy holding. The quarter was as expected, with no material revisions to our outlook through 2025.

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