Quarterly Market Commentary

December 2024

This past year has been quite interesting, and much better than investors (generally speaking) had expected entering 2024. At this time last year, we were still adjusting to a major shift in expectations. Recall that investors had been anticipating an economic slowdown and a major rate-cutting cycle as early as 2023, but as U.S. economic data continued to surprise to the upside, forecasters began pushing those expectations into the future. By late 2023, however, it was becoming quite clear that the U.S. economy — and particularly the U.S. consumer — was much more resilient than many had expected. Corporate earnings were stronger than expected, and the Fed managed to hold off on its first rate cut until September 2024.

Going into the new year, the markets are energized with the incoming U.S. administration, and promised tax cuts and deregulation. This has led to a rise in the “animal spirits” that drive market bulls from time to time. Stocks, especially cyclical sectors, have rallied following the election date. Still, it’s important to keep an open mind. At the end of the day, uncertainty is the only certainty.

For example, few predicted that the Fed would kick off its policy-easing cycle with a 50-basis point rate cut, or that gold would reach all-time-high on the backdrop of stronger dollar and rising yields.

The point is, sentiment is currently euphoric, with markets anticipating an AI and President-Elect Trump driven economic boom — so some hangover may be in the making. Risk management should be top-of-mind, and investors need to separate Fear of Missing Out (FOMO) from fundamentals as we enter the new year.

The S&P 500's strong returns are largely driven by the so-called Magnificent Seven stocks – Apple Inc, Nvidia Corp., Microsoft Corp., Amazon.com Inc., Alphabet Inc., Tesla Inc., and Meta Platforms Inc. With a combined market capitalization of about $18 trillion as of December 2024, they account for 1/3 of the S&P 500's total market capitalization. These stocks have a high average trailing price-to-earnings ratio of 52.4. A high P/E ratio can indicate that a stock is overvalued, though it can also mean investors believe the company has strong fundamentals and the stock has room to rise.

One could argue that valuations do not matter anymore. You could invest in Nvidia, which has traded at 100 times earnings, and still do well. However, that only works until it doesn't. At the end of the day, valuations do matter. When the market does come back to reality, no one is going to pay 35 times earnings or 50 times earnings for something. We have seen this, the stocks that get hit the hardest are the ones that are overvalued to begin with.

To put this in perspective, U.S. recession fears triggered a global market selloff on August 5th. The downturn was short-lived, the Magnificent Seven lost a combined US$653 billion in market capitalization.

As you know, we are value investors, and we firmly believe valuation does matter. We are comfortable and confident with our current positions, which reflect our disciplined approach to identifying value. While no one can predict what 2025 will bring, investors should not fear volatility. Instead, embrace it. Volatility presents opportunities; take advantage of it, don't run from it.

During the fourth quarter, we saw Bank of Montreal increase their dividend by 5%, National Bank by 3.6%, and Cogeco Inc. by 8.0%. Dividend increases are positive because they signal a company's financial health, consistent cash flow, and commitment to shareholder value. They offer income growth and protection against inflation. Additionally, they demonstrate disciplined capital allocation and long-term stability.

From a portfolio management perspective, we were quite active. We trimmed up Veren but trimmed down National Bank and Definity Financial due to strong share price performance. We added two new positions to the portfolio in the fourth quarter.

We added Open Text to the portfolio given the low valuation. OPEN TEXT is a world leader in enterprise information management and trades on both the TSX and the NASDAQ. We believe the potential for an improved macro environment could result in multiple expansion, given Open Text currently trades well below peers and its historical average. It is also worth noting that OPEN TEXT management has committed to return $570 million of capital to shareholders via share buybacks and dividends.

We also added HOME DEPOT to the portfolio. We view Home Depot as a best-in-class home improvement operator with leading market share. Investments across Pro, stores, supply chain, and technology position the retailer to further consolidate share over the longer term. As Home Depot's Pro ecosystem comes together, we expect Pro comps will continue to outpace DIY comps and drive greater operational productivity. Furthermore, with a more challenging macro backdrop in the near term (the industry could face its greatest pressure since the Great Financial Crisis), we recommend investors consider gravitating toward Home Depot's higher Pro mix and subsequent large Pro backlogs, provided that it aligns with their individual investment plan, that should help offset DIY pressure. Following Home Depot's $11 billion+ investment cycle across stores, technology, supply chain, and other areas, we are confident on the company's opportunity ahead to expand its EBIT margin as productivity ramps.

APPLE

We continue to favour Apple given (1) Services is a long-term investable theme growing at an 8% revenue compound annual growth rate with 70%+ gross margins. (2) iPhone units could be a long-term annuity as the active installed base is over 1.4 billion units and average age is 6-7 years – implying annualized replacement demand of ~220 million. (3) Subscription content offerings around Video, Gaming, premium News, and Fitness, if successful, could further accelerate the Services growth trajectory. (4) Expect capital returns of approximately 100% of fiscal cash flow given the long-term goal to reach net cash neutral. (5) Expect recurring revenue within Services grows at a 9% driven by App Store, Music, Licensing, TV+, Arcade, Fitness+, and News+ subscriptions, digital payments, potentially driving multiple expansion.

BROOKFIELD RENEWABLE RESOURCES

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 (PPA) momentum. We believe Brookfield'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 PPA momentum for clean power.

COGECO INC.

We believe that Cogeco Inc. (CGO) remains undervalued when compared with Cogeco Communications (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 multi-year 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.

The company boasts one of the most sustainable business models within our coverage, and we continue to recommend it, where appropriate, as a core energy holding. We highlight significant capital flexibility given best-in-class portfolio diversity and infrastructure dominance as key tenets of our investment thesis. Infrastructure dominance, in particular, drives a material cost structure advantage, and an abundance of highly economic, half-cycle, drill-to-fill opportunities. We also see significant momentum on its high-margin synthetic crude oil volumes into 2025, given a triple-tailwind (no Horizon turnaround, 90% of the Athabasca Oil Sands Project post-Chevron, and completion of the Scotford Upgrader Debottleneck). While a return to 100% of fiscal cash flow (from 60% post-Chevron transaction) extends beyond 2026 on a back dated WTI strip, return of capital in absolute dollar terms is expected to be similar on a pre-and-post-deal basis given the dividend hike (concurrent with the Chevron deal) and fiscal cash flow generation from the acquired assets.

CANADIAN TIRE

We remain confident upon Canadian Tire, as we see key catalysts of easing Canadian interest rates, the need for dealer replenishment, operating leverage, and stabilizing consumer credit taking hold. This should result in sustained earnings per share growth through 2025 supportive of valuation multiple expansion from what we view as trough levels. We also see a degree of upside to applied multiples from a potential Canadian Tire Financial Services sale resulting in a “cleaner” reporting structure, and a degree of downside protection from its renewed Normal Course Issuer Bid/increased dividend.

CENOVUS ENERGY INC.

While we understand why the market continues to fixate on U.S. downstream profitability given numerous setbacks, it may ultimately prove overblown given downstream's relatively modest mid-cycle EBITDA contribution, and current trough EBITDA generation. As a reminder, Cenovus is now returning 100% of fiscal cash flow all through buybacks at an increasingly attractive entry point, in our view. We also expect it to post best-in-class per share growth over the next 24-30 months as its upstream expansions come online, even if it were to fall a bit short on growth targets and/or capex reductions in 2026+. For now, all growth projects appear to be on track. When combined with a discounted valuation on 2025E estimates (and even more discounted on 2026E), Cenovus remains a compelling name.

ENBRIDGE INC.

We believe that 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.

FIRST CAPITAL REIT

The company delivered another quarter of operational strength with occupancy just 40 basis points shy of the historic high, widened rent spreads, and no signs of any meaningful tenant weakness. The tone of the market — particularly for urban grocery-anchored shopping centres — suggests that well-located retail space is increasingly considered scarce. We believe that First Capital REIT remains among our ideas to play this theme.

MAPLE LEAF FOODS INC.

Upside to earnings is significant following scale investments in plant automation, but consumer weakness and soft Japan markets have prevented much of this from showing up in results. There has been improvements and the EBITDA margin hit seven-year highs in Q2/Q3. We see reasons to believe that remaining headwinds will diminish gradually, resulting in much higher earnings and, when combined with more normal capex spending, significant fiscal cash flow generation and balance-sheet deleveraging. Although we believe investors will allocate a low multiple (~5x) to the more volatile hog production and slaughtering business once it is spun out, we would expect a much more reasonable valuation (9-10x and possible higher long-term) to be awarded to the remaining protein-focused consumer packaged goods business, particularly once the company reaches its margin targets and displays greater consistency in results.

MICROSOFT

Microsoft appears well positioned in key secular growth markets, particularly Public Cloud with its Azure platform, which we expect to be the company's main growth driver. TD Cowen's proprietary Public Cloud survey work gives us confidence in Azure's position in the market and our robust growth forecasts. Office 365 Commercial has been a major success, and we believe is the largest Software As A Service (SaaS) business globally. Digital transformation efforts should continue to benefit every facet of Microsoft's Commercial Cloud.

RESTAURANT BRANDS INTERNATIONAL

We are bullish on Burger King U.S. share gains persisting in a challenged quick service backdrop, under Executive Chairman Patrick Doyle while CEO Josh Kobza grants more autonomy to Burger King U.S. & Canada President Tom Curtis, who previously worked with Mr. Doyle during their successful tenure at Domino's. Burger King has a well-rounded plan focused on value, menu innovation & operational enhancements. Meanwhile, Tim's Canada robust comps have been driven by a clear and proven strategy focused on digital, cold beverages and PM food attachment that have all proven successful at Starbucks U.S. Restaurant Brands is marching towards 5% net restaurant growth in 2025E & beyond, to better align with quick service peers, that we are optimistic will help the multiple if & when achieved.

ROGERS COMMUNICATION INC.

Rogers expects annual consolidated service revenue growth just over 7% compared to its guidance range of 8% - 10% issued in February of 2024, driven by weakness in media revenue during the fourth quarter. Missing EBITDA guidance was likely a bigger concern, and a partial cause of the share price weakness in December, so the fact that there was no mention of EBITDA or FCF guidance being lowered could actually be a positive for the stock near-term. Investors generally attribute less weight to the lumpy Media/Sports segment, versus core wireless and cable.

VEREN INC.

The company 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.

WHITECAP RESOURCES INC.

The company provided yet another update surrounding operational outperformance across several core areas which has led to another increase in volume guidance. Whitecap has made this a trend through 2024 and this is the third time the company has provided an increase to guidance/beat our quarterly expectations this year.

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.

MK Total Wealth Management Group
TD Wealth Private Investment Advice
5140 Yonge Street, Suite 1600,
North York, ON M2N 6L7
T: 416 279 1455
TDMKGRP@td.com

MK MacDonald Konidis
Total Wealth Management Group

TD Wealth

Sources:

(AAPL) iPhone Returns to Y/Y Rev Growth, Release of AI Features Could Spur Upgrades – Nov 1st, 2024
(BMO-T) Q4/24: Growth Could Suffer As BMO Adjusts Credit Risk Appetite – Dec 5th, 2024
(BEP-N) Management Provides Context Around U.S. Development Pipeline – Nov 11th, 2024
Best Ideas 2025: Strong High-Margin SCO Momentum In '25 + Nat Gas Optionality – Dec 3rd, 2024
(CTC.A-T) Q3/24 Results: Positioned for Accelerated Growth Upon a Consumer Recovery – Nov 8, 2024
(CVE-T) No Surprises in 2025 Budget; Expect Material Growth/FCF Acceleration in H2/25+ - Dec 12th, 2024
(CGO-T) Holdco Discount Remains Attractive – Nov 4th, 2024
(DFY-T) Q3/24: Earned Through Record CATs on Elevated PYD and Lower Expenses – Nov 8th, 2024
(FCR.UN-T) Q3/24: Outlook Raised Again as Tight Market Sees Rents Push Higher – Oct 30th, 2024
(HD) Solid Results In Tough Macro As Wait For The Eventual Turn – Nov 13th, 2024
(MFI-T) Weak Consumer Pushes Anticipated Margin Expansion Out A Quarter – Nov 14th, 2024
(MSFT) Slight 1Q Azure Beat But Lower 2Q Guide as Capacity Still Weighing on NT Growth – Oct 31st, 2024
(NA-T) Q4/24: Weaker Credit Conditions at ABA; Mgt. Contemplating Monetization – Dec 4th, 2024
(OTEX-Q) Q1/F25: Favourable Risk/Reward – Oct 31st, 2024
(QSR) We Expect Patience Will Ultimately Be Rewarded – Nov 5th, 2024
(RCI.B-T) Taking a More Cautious Stance on 2025E – Oct 25th, 2024
(VRN-T) Weaker 2025 Outlook Spooks Investors – Oct 31st, 2024
(WCP-T) WCP Update Shows Robust Q4 Production Beat – Dec 16th, 2024
(ENB) Argus Analyst Report – Nov 6th, 2024
(FLCP) Morningstar Analyst Report – Dec 20th, 2024
(PMIF) Morningstar Analyst Report – Dec 20th, 2024