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cardinal QUARTERLY

MARKET OUTLOOK

BY EVAN MANCER, CFA

The global economy continued to strengthen in the second quarter with Canada's GDP leading the pack at 3.7%. The Canadian economy has been boosted by continued strength in the housing market, the weak Loonie, and decent economic growth in the U.S. The long-struggling European economy has also been showing signs of life after consistently weak growth for most of the past decade. Sooner or later, improving growth in the global economy will lead to higher inflation, which is causing most central banks to reconsider their loose monetary policies.

Global market performance was choppy in the second quarter as resource based economies like Canada and Australia were negative while other global stock markets eked out slight gains. The TSX total return index fell 1.6%, almost wiping out its gains for the year to date and the Australian ASX-200 declined by -0.9%. The S&P 500 gained 3.1% while in Europe the FTSE-100 and the DAX gained 1.0% and 0.4% respectively. The strongest performer was the Japanese Nikkei which gained 5.3%. On a year over year basis, all of the global stock markets are up by double-digit percentages, though Canada has still been the weakest performer.

The S&P TSX has been roughly flat in the first half of 2017 and we expect much better performance in the second half. Part of the explanation for the weaker relative performance of the TSX is that the Canadian stock market is far more weighted toward oil and other commodities than the overall Canadian economy. Eventually, this sector should rebound as oil prices return to more normal levels. However, there are also many other Canadian companies trading at valuation multiples that are lower than U.S. peers in the same sectors, probably due to investor fears over upcoming NAFTA renegotiations.

We believe that the NAFTA discount in many Canadian stocks presents opportunities to pick up strong companies at low or reasonable

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valuations. Though there will certainly be a few surprises, neither side will want to put policies in place that harm job growth. Large Canadian companies such as the banks, pipelines, rails, auto parts companies and many others with significant revenues in the U.S. have similarly large U.S. workforces.

Despite strong global GDP growth, investors are nervous about potential shifts in Central bank policy. Canada increased interest rates by 25bps to 0.75% on July 12, its first increase since 2010 while the U.S. has already increased rates a couple of times. Both Central banks will likely increase rates at least one more time this year. More important is that the massive bond buying programs (Quantitative Easing) that were put in place to boost growth and inflation will likely soon be reversed in the U.S. and slowed or stopped in Europe. This will boost long-term interest rates.

Typically, rising interest rates are positive for stock markets in the short term, but eventually lead to recessions. In fact, long-term bond yields globally hit their bottom a year ago in July of 2016, when the US ten year bond yield dipped below 1.5% and the majority of European 10-year bonds were yielding below zero. Interest rates have been low across developed markets for many years now, and it is easy to envision a market correction with any surprise move in interest rates.

However, this type of correction is common and we think markets would recover from any downturn relatively quickly. We would become much more concerned should short-term rates rise above long term rates, but we do not see that happening this year.

Ultimately, stock prices are driven by earnings growth, which was excellent in the first quarter. We expect similarly strong earnings growth in second and third quarter results as economic growth, low unemployment and improving consumer spending boost companies' bottom lines.

The Canadian dollar moved above $0.78 following the Bank of Canada interest rate increase. We now think it will end the year over $0.80 as investors adjust their expectations to the possibility of further interest rate increases. Oil prices have remained stubbornly low as U.S. shale oil producers have continued to ramp up production, but there have been signs that oil inventories have started to decline, indicating that demand is finally catching up to supply. We still believe oil prices will strengthen in the back of the year which could push the Loonie into the low $0.80s range.

CARDINAL RULES

DON'T OVERTRADE

BY HENRY HUDEK, MBA, FCSI, CFA

We seem to live in interesting times. If it's not one thing it's another. Recently "Trump on Trade" has been an issue along with the Federal Reserve's increases in interest rates. Now we are seeing headlines about the Bank of Canada following suit, and the loonie heading north of 78 cents. OPEC struggles to manage crude oil supplies while oil prices react strongly to any short-term data that gets released in the news. Surely we should be adjusting our portfolios to account for all these events? Actually, probably not. In fact, you are likely too late, and the market has already priced in these events. It is quite likely that the market has over-reacted to these events and joining the herd now could mean losing money, rather than making. And recall that transactions still drive a large portion of revenue in the financial industry. The more accounts are traded, the more money flows to the intermediaries. The more you trade, the more you pay. Avoid trading on headline news.

Remember that the key principle we at Cardinal adhere to is that "wealth is built through the ownership of companies" – not by trading stocks. The daily headline events are generally not meaningful enough to materially change the real value of our companies, and predicting how and when the market is going to react to a certain event is virtually impossible. In spite of that, the media and the financial industry are full of ideas and suggestions for what we should buy and sell to "position" our portfolios for these events. Each possible event is presented in the news as history-making and a "game-changer" and its *urgency* is paramount. I can assure you, when you reach a certain age, you start to realize that most events don't change history or make history, they simply are history. Life goes on and this too shall pass.

Do not mistake this approach for lethargy or laziness. Cardinal portfolios have long been positioned for rising interest rates and a better loonie. By not being distracted by the headline of the day, we can maintain a broader, strategic outlook, and therefore can make better long-term decisions. Our companies have a certain intrinsic value, predicated on cash flows that we expect to see in a gradually expanding U.S. economy, gradually spreading to other parts of the globe. For a few years now, our view presumed quantitative easing ending in the U.S. and U.S. interest rates continuing to rise, with that policy spreading, first to Canada, and then to Europe and other parts of the globe. Trump's expansionary policies may occur somewhere in that time horizon, but the end result will be that we see the economy expand until it is gradually choked off by tighter monetary policy. We are seeing this scenario begin to unfold. Considering that more active trading tactics can run the risk of errors in timing market reactions, we avoid overtrading – no matter how compelling the events, or the headlines.

INVESTMENT Q&A:

Is there a conservative way to take advantage of the growth in tech?

Investing in tech companies doesn't need to be highly volatile or focused on boom and bust products. When Cardinal looks at the technology sector, we are looking for stability and longevity in earnings. That can be a tall order for tech companies after you add criteria such as dividend payouts, valuation and market cap restrictions. However, finding the right investment is possible by identifying a company's earnings profile that has two main factors –core revenues from the sale of essential products or services and customer diversity.

The recent addition to Cardinal's portfolio, Taiwan Semiconductor (TSM), meets all of the above criteria. It is the world's largest dedicated independent semiconductor foundry that caters to the tech giants (Apple, Qualcomm, etc.) to provide chips that power a wide variety of electronics. Its strong customer relationships will drive sales by capitalizing on the growing need for semi-conductor chips used in a wide variety of connected devices. As it supplies all the major players in the industry, it is immune from product popularity with one particular company or brand. The stock currently trades at a discount to its peer group, yet has superior sales growth metrics and margins. It generates a free cash flow yield of over 5% and pristine balance sheet with a positive net cash position. TSM is well positioned to invest in its business to continue to grow earnings and reward shareholders.

ANDREA CHAPUT

Why has Cardinal been adding to the healthcare sector?

Healthcare industry trends remain favorable as developed economies experience an aging demographic and the associated increase in healthcare utilization rates and spending that go along with it. Despite long-term positive trends, valuations still remain attractive in the sector, leading us to increase our exposure with the recent additions of CVS Health and Medtronic.

CVS is the second largest retail pharmacy network in the U.S., with over 9,500 locations, and the second largest pharmacy benefits manager based on prescription volume. CVS generates significant free cash flow, allowing the company to increase its dividend at a 25% compounded annual growth rate over the last 5 years. CVS is currently trading at an attractive valuation, providing a good entry point.

Medtronic is a leader in the medical devices industry and is a company that we are familiar with at Cardinal. After a soft quarter in late-2016, Medtronic shares sold off, which created an opportunity to take a position in a high-quality company at a reasonable valuation. Medtronic has exposure to high-growth categories such as heart valve replacement, diabetes and atrial fibrillation, and the company is expecting to introduce a robotic surgery offering by mid-2018.

During a time when high-growth sectors are trading at lofty valuations, healthcare represents an intriguing opportunity as secular tailwinds should be a long-term growth driver.

DAVID AIME

What has been causing the Canadian dollar to appreciate?

After dropping below 73 cents at the beginning of May, the Canadian dollar has been on a roll lately and currently sits around 78 cents. We see two causes. The main reason for the surge is that the Bank of Canada signalled that it would raise interest rates, and subsequently did by 25 bps on July 12. There were two rate cuts in 2015 to help cushion the blow of the oil price shock. Now economic growth appears to be on stronger footing as growth in the last three quarters has averaged over 3.5%. Recent data shows that business investment and trade are finally picking up, combined with strong consumer spending and employment. The Bank of Canada has been waiting for signs of strength for some time, and is ready to gradually unwind the extra stimulus the rate cuts provided. Because this will reduce the interest rate differential between Canada and the United States, the Canadian dollar has appreciated.

A second reason could be related to Home Capital's troubles and associated fears about contagion to the broader housing market. When this issue was headline news, the perceived increase in risks to the broader financial system contributed to the dollar's decline in May. These fears have largely dissipated as the Home Capital saga appears to be a company-specific event and has not spread to the housing market as a whole. The dollar has since recovered that weakness. ■

BRETT PURDY, CFA

CARDINAL RESEARCH

GILDAN SITE VISIT

BY DAVID AIME

The Gildan name may not be well known, but chances are you own at least one of their t-shirts. Gildan (GIL) manufactures basic apparel and has a dominant market share in printwear, where blank t-shirts are sold to screen printers and embroiderers, decorated, and then sold into a range of end-use markets including: educational institutions, event merchandisers, and entertainment promoters. GIL sells its products under a diversified portfolio of company-owned brands, including Gold Toe, Anvil, Comfort Colors, Alstyle, Silks, Peds, MediPeds, and Secret. GIL also has a U.S. sock license with UnderArmour and a global license with the Mossy Oak brand. Prior to adding GIL to portfolios earlier this year we had the opportunity to sit down with management at their headquarters in Montreal.

The key advantage for GIL is its manufacturing facilities. Through significant capital investment, GIL has created a best-in-class network that allows it to be the low-cost producer of basic apparel while still offering a high-quality product. The combination of low-cost and high-quality generates higher profitability for retailers as product turns quicker, and thus leads to expanded shelf-space. GIL's manufacturing expertise was on full-display in the 2016 acquisition of Alstyle as GIL not only created a presence in Mexico, but with minimal investment was able to more than double the capacity utilization at the acquired facilities.

Key growth areas for GIL include international expansion of the printwear business and continued market share gains in their branded business. Although GIL has a relatively small international presence, sales have been growing at a 15-20% rate over the last couple of years. A significant international opportunity exists and GIL is investing in its Bangladesh manufacturing facility to support this growth. Despite what has been a challenging retail environment in the U.S., GIL has been able to steadily grow its market share in branded apparel. GIL recently reached a double-digit market share in U.S. men's underwear for the first time, surpassing 11% in the last reported quarter.

Strong cash flows and a solid balance sheet have allowed GIL to also drive growth via acquisitions, with American Apparel being the most recent. Although GIL's dividend yield of 1.3% is on the low-end, the dividend has been raised by 20% annually since it was first initiated in 2011. With a dividend payout ratio in the low-20% range there is ample room for further dividend hikes at a rate that exceeds earnings growth. ■

Q2 DIVIDEND INCREASES

Canada	% Increase
Bank of Montreal	2.3%
Canadian REIT	2.2%
Enbridge	4.6%
George Weston Ltd.	3.4%
National Bank of Canada	3.6%
Sun Life Financial Inc.	3.6%
Telus Corp.	2.6%
U.S.A.	**% Increase**
Johnson & Johnson	5.0%
United Technologies Corp.	6.1%
International	**% Increase**
Medtronic PLC	7.0%

Source: Bloomberg
Reported in domestic currency

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