cardinal UPDATE

JUNE 2018

DIVIDEND INCREASES

Company	Increase
Bank of Montreal	3.2%
National Bank of Canada	3.3%
Sun Life Financial Inc.	4.4%
TELUS Corp.	4.0%

(During the period May 1 to May 31, 2018)

THE CANADIAN BANKS

The Canadian banks have been consistent operators over the last several years, (even through a severe oil and gas downturn) yet remain largely underappreciated. This is partly attributable to the media's focus on the slowdown in Canadian housing, due in part to new mortgage rules and high consumer leverage, and the potential concerns these raise for the banks. With the Canadian banks having recently completed another quarterly reporting season, it is worthwhile to look at the data points that help to assess the concerns, as well as some broader trends supporting the investment thesis.

The first question is whether recent mortgage rule changes aimed to curb housing prices have negatively impacted loan growth and thereby earnings growth. Overall residential mortgage loans were still tracking +5% year-over-year growth, so this has not materialized as an actual concern despite slowing home sales. Further, it is important to remember that mortgages are typically lower margin products given their risk profile, so slowing mortgage growth does not in fact have a dramatic effect on earnings growth.

The second question is whether softer housing prices (and high consumer leverage) are materializing as outsized credit losses. The recent quarter's data shows that residential mortgage losses in particular only amounted to 0.01%-0.02% of loan balances, which is a miniscule amount. It is important to note that housing price increases over the past several years have created a cushion to soften the impact of a potential sharp housing price decline evidenced by the 54% average loan-to-value on the Canadian banks' uninsured mortgage loan book.

Moving to the broader trends supporting our investment thesis, we cannot ignore that rising interest rates should benefit earnings. Both Canadian and U.S. net interest margins have seen expansion in tandem with the rate hikes that have occurred – this benefit is seen both on extending loans as well as the investing of excess deposits. This margin expansion should continue with further rate hikes.

The banks are taking advantage of the shifting landscape in how banking is performed to deliver services at a lower cost. A specific example of this transformation is the reduction of physical bank branches as more customers adopt online and mobile banking for their day-to-day transactions; this helps bring down infrastructure costs while still meeting customer expectations. The recently reported quarter helped confirm this efficiency trend, as the banks reported positive operating leverage across the board.

Finally, the banks are operating at strong capital levels that are more than double what they were during the financial crisis, even while being calculated under tougher rules. This improves the banks' ability to withstand a softening economic environment, and provides optionality to deploy excess capital.

In short, reported bank results continue to show that these businesses are growing in spite of Canadian housing concerns, and they should have the ability to continue to do so.

COMPANY FOCUS:

JOHNSON & JOHNSON

Johnson & Johnson (JNJ) is the world's largest healthcare company measured by market capitalization and is well-diversified across three distinct business segments: pharmaceuticals, medical devices, and consumer healthcare. This diversification reduces product and segment-specific risk, allows for cross-segment idea collaboration, and has helped drive strong, long-term performance and returns to shareholders.

We recently attended JNJ's Investor Day in New Jersey, which provided an in-depth overview of the consumer healthcare and medical devices businesses. On the consumer healthcare side, the focus was on continuing to expand mega-brands like Neutrogena, Listerine, and Johnson's Baby while also collaborating with small start-ups to remain relevant with today's consumer. With regards to the medical devices business, newly launched and future products in the pipeline were showcased and anticipation continues to build for JNJ's robotic surgery systems, expected to be in the market sometime in 2020.

The stability of JNJ's earnings growth over the long-term has allowed the company to raise its dividend for 56 consecutive years, including the 7.1% hike announced in late-April, and should drive continued dividend increases into the future.

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