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cardinal QUARTERLY

MARKET OUTLOOK

BY EVAN MANCER, CFA

Global stock markets jumped higher in the second quarter of 2018, moving most markets back into positive territory for the year. The UK FTSE-100 and Australian ASX-100 were the top performing markets, up 8.6% and 7.6% respectively. Other international markets were also positive with the German DAX-30 and French CAC-40 up 2.5% and 3.3% respectively. However, U.S. dollar appreciation in the 5% range offset most of these gains. In North America, the S&P TSX and the S&P 500 gained 7.0% and 5.3% respectively with the US dollar gaining slightly on the Loonie.

Corporate earnings growth should remain strong for at least the next couple of quarters, driven by the U.S. tax cuts, which have been a direct benefit to after tax earnings and have helped spur on overall economic growth as well. Many of our Canadian companies, such as Gildan, Couche Tard, and Magna have over half their earnings in the U.S. and so are seeing a similar benefit.

Despite the sunny backdrop of strong earnings, we see a few more clouds forming on the horizon. Most concerning is that the U.S. has launched the first volley in a global trade war, slapping tariffs on essentially all of its major trading partners, who have responded with their own retaliatory tariffs. Global economic growth has remained strong but has decelerated from the start of the year outside of the U.S. Also, the Federal Reserve and Bank of Canada raised interest rates again (Canada on July 11th), and oil prices have moved higher.

Although President Trump's stance on most issues can appear to swing wildly when viewed on a week to week basis, he has actually been very consistent on his core issues over the long term, particularly on trade. While we had been hopeful that NAFTA at least could get settled without much downside, that hope is now fading. Not only have initial tariffs and retaliatory tariffs been applied, Trump has been threatening a major escalation from current levels, singling out autos in particular for potential 25% tariffs.

Ultimately, these issues will pass. The benefits of free trade are too high for all sides to not come to agreement. Continued tariff escalation would almost certainly lead to a self-inflicted recession in the U.S. sometime in 2019, and Trump will want to get past this issue in the next 18 months before campaigning begins for the 2020

continued on page 2...

INSIDE THIS ISSUE

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election. The question is how much worse will it get before it gets better? In the short term, it is reasonable to hope that the negative impact of increased tariffs will be offset by the benefit of lower taxes. But we worry that the additional burden of higher oil prices and higher interest rates will cut into consumer spending and company profits.

So what does all of this mean for the portfolios? We believe that the chance of a 10% to 25% market downturn has increased since the start of the year. However, we see very little chance of a severe bear market such as in 2000 or 2008. There are no major sectors of the economy or the stock market that are in bubble territory other than small areas like bitcoin and marijuana stocks. Overall market valuations are reasonable and getting cheaper with recent earnings growth. And trade, the scariest issue, is a solvable problem. If there is a bear market, we expect it will be short, resolved likely by a vastly increased appetite from all countries to strike trade deals should the economic outlook darken.

Also, we have positioned our portfolios defensively and expect that they will do much better than the overall market should there be a downturn. The companies we own, with very few exceptions, sell their goods and services in the same countries that they produce them. Therefore, the main risk is likely in companies with high valuations and high economic sensitivity, which we have shifted away from. Nevertheless, our current focus is on some of our remaining companies with higher economic exposure, potentially trading to less economically sensitive companies.

Looking at the Canadian dollar, the Loonie's status as a petro currency seems to have been revoked. The Loonie has stayed flat over the past year even as the price of WTI crude has soared by over 50%. Part of the explanation is that the U.S. economy has been growing faster than Canada's, which in turn has created a stronger case for interest rate increases. Investors are also likely more nervous about the effect of a trade war in Canada than in the U.S. A more pronounced trade war would definitely be a negative for the Canadian currency, but we still believe that the Loonie will end the year in the $0.80 range on the strength of oil prices.

CARDINAL RULE #4
USE COMMON SENSE

BY CLINTON REBEC, FCSI, MBA, CIM

In our last newsletter we revisited our rule on being patient and controlling your emotions and what it means for portfolio performance over time. Keeping with our psychology lessons, we are looking at how to use common sense as it pertains to your wealth.

The definition of common sense means possessing good sense and sound judgment in practical matters. So, how does one stay sane in a world of constant Trump tweeting and all the nonsense before our eyes?

Let's get back to the basics with a quote from legendary investor John Bogle. Bogle states "time is your friend; impulse is your enemy." Common sense in investing means laying a solid foundation on fact based rules, which helps avoid common investor pitfalls.

Albert Einstein has been credited with his definition of insanity. He described insanity as "doing the same thing over and over again and expecting different results". As a firm believer in behavioral investing, I've seen investors repeat the same mistakes with the same consequences. To some, these mistakes mean major setbacks and irreparable damage depending at what stage in life and/or how often these occur.

I've selected a few key ideas that if acted upon can assure insanity does not set in and common sense ultimately prevails.

- **Big Picture Thinking** – One of the most common mistakes that can affect common sense is thinking too short-term. This goes back to Bogle's quote on impulse being an enemy and losing sight of the fact that time is your friend. Investors who become fixated on short-term results, chase performance or pursue fads typically damage long-term success.
- **Buy a Stock like you'd buy a House** – At Cardinal, we akin our high-quality dividend equity portfolios to that of high-quality real estate. Most investors can digest real estate values a lot easier than the stock market. Along that line of thinking, Warren Buffett has stated "buy a stock the way you would buy a house. Understand and like it such that you'd be content to own it in the absence of any market." Since the market has an upward bias over time, you would be wise to embrace that time and compound interest are the key components that do the heavy lifting for your long-term wealth.
- **Avoid Outside Noise** – We understand this is tough some days. As we highlighted last newsletter, while it's easy to get wrapped into global economic issues, political uncertainty and the media's portrayal, it will serve as no benefit to your portfolio and the individual goals of you and your family. I have yet to see a positive correlation between those who constantly listen to the media and then make decisions for their portfolio or those of others.

At Cardinal, using common sense is a foundational rule and core value for how we invest. The home page of our website and many materials you've seen over the years highlight our mantra "The Common Sense Path to Long Term Wealth… Because it works."

INVESTMENT Q&A

Trade Conflicts – How does it Impact our portfolios?

After a period of productive NAFTA discussions, we've seen setbacks in the last month that have re-threatened the North America deal and raised the potential for a trade war with China. While this throws uncertainty into the whole market, there are specific industries that will be more affected than others. For Cardinal's portfolios, the NAFTA conflicts have the potential to hurt our two Canadian industrial companies the most, Magna and CNR. Magna, being a geographically diversified auto parts manufacturer, has tightly integrated supply chains that connect Canada and the U.S. CNR is less exposed, but with transborder traffic making up about a third of its overall rail volumes, we could see some weakness should tariffs become exorbitantly prohibitive. The Chinese tariffs could stagnate growth for companies like Honeywell or United Technologies, but their overall exposure to the region is still quite small. While we still believe that in the medium-term cooler heads will prevail, that doesn't stop short term volatility based on the latest tweet from the U.S. President. This is a good reminder of why it is important to stay focused on our strategy and ignore the noise of the market.

ANDREA HORNBY, CFA

The Government Buying Trans Mountain Pipeline – What does it mean to our Pipeline Holdings?

We do not expect any material impacts from the Canadian government's purchase of Trans Mountain as it should not affect future growth prospects of Enbridge (ENB) or Transcanada (TRP).

The Canadian oil industry needs two new pipelines by the early 2020's to avoid pipeline congestion, and by 2025, the industry would require a third new pipeline. As such, even assuming that the Trans Mountain Expansion gets built on schedule (which is a big leap of faith), there is still an eventual need for both ENB's Line 3 Replacement and TRP's Keystone XL.

The Line 3 Replacement project is by far the furthest along of all three projects. It recently passed its last major regulatory milestone in Minnesota, paving the way for the $9B project to be in-service by late 2019. This is an important project for ENB, and we were very pleased to see its approval.

Keystone XL's prospects are a bit murkier, but we do not believe it is integral to the investment thesis for TRP. It has a presidential permit, an approved route in Nebraska, as well as shipper support; however, the company has yet to reach Final Investment Decision.

JEFF RANCE, CFA

What is happening with interest rates in Canada and the U.S.?

Interest rate increases in the U.S. have outpaced those in Canada across the yield curve so far this year. As a result, the interest rate differential between the U.S. and Canada has widened considerably. A large part of this can be attributed to the U.S. Federal Reserve being more aggressive than the Bank of Canada in increasing its benchmark rate. The Fed has raised rates twice so far this year to bring the overnight rate to a range of 1.75-2.0%, and will likely hike 1-2 more times before year end in order to counter the effects of rising inflation pressures. NAFTA negotiations and broader global trade uncertainties have made the Bank of Canada more cautious with rate hikes despite an economy running at near capacity and a very strong labour market. After a 25 basis point increase in January, the Bank of Canada hiked rates again at its July meeting which brings the overnight rate to 1.50%. A further 25 basis point hike later this year is partially priced in by the market currently. While the trend of rising interest rates should remain intact for both countries, the U.S. will likely continue to outpace Canada.

BRETT PURDY, CFA ■

CARDINAL NEWS

Cardinal welcomes **Taryn Page**, CFA to the team! As Manager, Business Development, Taryn works directly with advisors and private clients on all client related matters.

CARDINAL RESEARCH

WELLS FARGO

BY ROBERT LAM, CPA, CA, CFA

In mid-May, we attended the Wells Fargo investor day held in Charlotte, North Carolina. The event featured management presentations on the various operating segments, and showcased existing and pilot technology innovations ongoing at the bank. It also gave us a chance to interact with bank management team members and get an update of the ongoing initiatives in place to resolve past sales practice issues.

A key takeaway from the presentations was not only the strength of the underlying businesses, but also the extent to which the $4 billion in targeted expense saves over the next two years are expected to contribute to earnings growth. Management showed an earnings simulation where revenue levels were flat to 2017 levels and the expense saves targeted were achieved. Under this scenario, the bank's return on equity would improve by 350 basis points into the mid-teens. Notable here is that this simulation is conservative in that it excludes the expected benefit to revenues from previous and future interest rate hikes and from future asset growth.

An update was given on the resolution of ongoing sales practice issues and provided comfort on the bank's ability to have the Fed consent order (which caps the balance sheet to an approximate four-quarter average of $2 trillion) eventually lifted (though this was extended into Q1 2019). More importantly, management signaled the consent order would not impact the CCAR process – this proved subsequently to be true, as Wells Fargo increased its dividend by +43% and announced a $24.5 billion share repurchase plan in conjunction with its late-June CCAR results.

Touring the seven demonstration stations was quite interesting and included one particular highlight to me in an "Online Mortgage Application." This permits for full online application, approval, and processing of a mortgage. The process itself includes pulling information from existing customer accounts as well as external sources (e.g. IRS for income verification purposes) with customer permission, and allows for electronic signatures in order to complete documentation more conveniently. An overarching takeaway from the demonstrations is that the large U.S. banks will be able to more readily invest in features that will make banking more convenient, which will in turn attract and retain customers.

In all, the investor day helped to reinforce the reasons that we continue to hold Wells Fargo and leads us to believe that the underlying business of the bank will be able to thrive as the spectre of the sales practice issues continues to pass.

Q2 DIVIDEND INCREASES

Canada	% Increase
Bank of Montreal	3.2%
National Bank of Canada	3.3%
Sun Life Financial Inc.	4.4%
TELUS Corp.	4.0%
U.S.A.	**% Increase**
Johnson & Johnson	7.1%
Whirlpool Corp.	4.5%
JPMorgan Chase & Co.	42.9%
Walgreens Boots Alliance Inc.	10.0%
International	**% Increase**
Medtronic	8.7%