cardinal UPDATE

SEPTEMBER 2018

DIVIDEND INCREASES

Bank of Nova Scotia	3.7%
Canadian Imperial Bank of Commerce	2.3%
Emera Inc.	4.0%
Royal Bank of Canada	4.3%

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

CANADIAN OIL & THE TRANS MOUNTAIN PIPELINE

On August 30th, the Federal Court of Appeals (FCA) released a negative ruling pertaining to the Trans Mountain Expansion (TMX). The FCA found two major deficiencies in the report from the National Energy Board (NEB): The NEB did not include project-related tanker traffic in its review and they failed to consult Indigenous peoples and First Nations as set out by the Supreme Court. The FCA has effectively halted all construction and progress on TMX. In order for the project to proceed, there are a number of different options. First, the Canadian government could appeal the decision to the Supreme Court of Canada (12-18 months). Secondly, the NEB could conduct the additional studies and consultations necessary (6-9+ months). Or thirdly, the federal government could pursue special legislation to amend the NEB act to "force" the project to completion in the name of "national interest" (3-6 months). This would be contentious as it would require support from opposition parties. We have no crystal ball here, but the fact of the matter is that the project is *at best* delayed until 2022-2023.

Pertaining to our investments in Suncor (SU) and Canadian Natural Resources (CNQ), we believe this news ranges from slightly negative (CNQ) to neutral (SU). Generally, projections show that the Canadian industry only needs 2 of the 3 proposed pipeline expansions (ENB's Line 3 Replacement, TRP's Keystone XL, and TMX) in order to handle growth in Canadian oil production through 2025+. The Line 3 Replacement seems highly likely to occur, while Keystone XL's prospects continue to improve as it gains approvals. Further, we will see crude by rail increase to fill in transportation gaps (June volumes were a record 205,000 bbl/d). **The sky is not falling and Canadian oil will find its way to market; that said, we continue to expect Canadian oil differentials to remain wide for the foreseeable future.** Suncor is shielded from wide oil price differentials with its refining operations; it has secured pipeline capacity for its growth projects through 2020, and it has no plans for any major growth projects until pipelines are in place. CNQ is exposed to Canadian crude price differentials, however, we have incorporated this in our analysis and the company's free cash flow generation story is still very compelling versus its valuation. Both companies will continue to increase dividends and are in a position of strength versus their Canadian peers. In the end, we believe this affects sentiment more than fundamentals.

Pertaining to our investments in Enbridge (ENB) and TransCanada (TRP), we believe this to be neutral or could actually be positive, particularly for ENB. Our premise is that the TMX delay/cancellation *increases* the value of pipeline capacity in the ground and expansion capabilities as noted above. TransCanada is primarily a natural gas pipeline operation and as such, this really doesn't affect them. We continue to believe that TRP is a compelling investment whether Keystone XL proceeds or not. Enbridge, on the other hand, has much more exposure to Canadian oil. The absence of TMX ensures its mainline volumes remain strong and could allow for further expansions that do not require a brand new pipe.

COMPANY FOCUS:

SCOTIABANK

Over the past year, Scotiabank has been a noticeable negative outlier relative to the other Big 6 Canadian banks, having returned 3% versus the peer group ranging from 18% to 25%. This underperformance comes despite their earnings and dividend growth, tracking 7% for the year, a continued benign credit environment, and healthy capital levels.

So what has led to underperformance? Sentiment. First, the bank has operations in Mexico that make up 5% of overall profits, and consequently has been hurt by negative sentiment around ongoing NAFTA talks despite the low relative contribution to total profits and despite earnings from the operations continuing to grow. The second could be the $7 billion in acquisitions the bank has announced or closed over the past year, which introduces uncertainty to the name. Both fit with their strategy and are additive to earnings growth over time.

Overall, given the lower P/E and now discount to peers from their previous premium, we continue to like Scotiabank for client accounts and believe that healthy underlying fundamentals will eventually lead to better performance as negative sentiment subsides.

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