VOLUME 20 · ISSUE 2 · JULY 2015

cardinal QUARTERLY

MARKET OUTLOOK

BY TIMOTHY E. BURT, CFA

The second quarter was a bit of a dud for the stock market with the U.S. still the best performing market for the quarter. For the 3 month period ending on June 30, 2015, the S&P 500 was off 0.2% while the S&P/TSX dropped 2.3%. Other major global stock market performance was even weaker – British FTSE-100 down 3.7%, German DAX-30 down 8.5%, French CAC-40 off 4.8%, and the Australian ASX-200 off 7.3%. The bond market performed even worse with 10-year Government of Canada bond yields rising from 1.30% to 1.70% and 10-year U.S. Treasury note yields rising from 1.90% to 2.40% during the second quarter.

Due to the continuing Greek financial crisis, most of the major European stock markets suffered corrections, after peaking in late April, to their July 7 lows. The FTSE-100 declined 9.5%, the DAX-30 dropped 13.7% and the CAC-40 fell 12.6%. Commodity price sensitive markets such as Canada's S&P/TSX fell 7.6% from April 15 to July 9 and Australia's ASX-200 fell 9.4% from April 27 to June 29. After hitting a new high on May 21, the U.S. S&P 500 has only fallen 4.0% to its recent low on July 8. We think the primary reason for the better U.S. stock market performance is stronger economic conditions.

The Canadian economy is likely in a mild recession that has been caused by the dramatic and sharp decline in energy prices. The recession started in Alberta but has spread across the country as it negatively affects other energy related sectors. Housing prices are declining in many markets and retail sales are weakening. So far, only auto sales are still strong, but they won't be for long as there have been recent declines in used auto prices.

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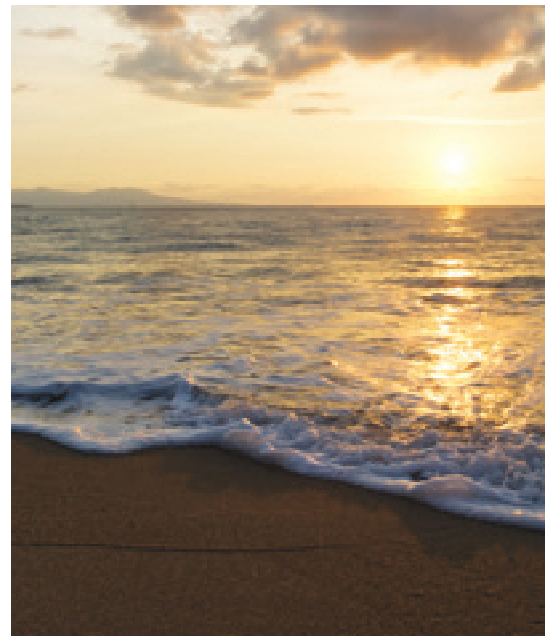

INSIDE THIS ISSUE

Announcement from the President 2
Investment Q&A 3
Cardinal Research............ 4
Cardinal News 4

CARDINAL CAPITAL MANAGEMENT, INC.

The Bank of Canada will likely be forced to further cut the bank rate in order to prevent a more serious recession from occurring and consequently, causing further weakness in the Canadian dollar, which has been trading in the $0.78 to $0.80 U.S. range for a while now.

While the current bull market is aging, it likely has another year to go before the next bear market begins. In my 42 years of investment experience, I have never seen a bull market top with this much investor skepticism and negative market sentiment. Most investors are still over-weighted in bonds and bond funds or are still sitting on a lot of cash. While some businesses are buying back their stock, many have record cash balances. As bond yields continue to rise, we think investors will begin to shift out of bonds back into stocks where returns will be better.

Although we expect that the U.S. Federal Reserve will raise its fed funds rate in September and again in December to more normal or neutral levels, we believe that the rate increases will be gradual due to zero U.S. inflation and weak economic growth (about 2.0% in the second quarter). Low energy prices have not been the boost to the economy that was expected, and retail spending has been soft. Very low interest rates have helped new auto sales and home sales, but this situation won't last much longer.

Perhaps, the biggest risk to the global stock market is whether the recent Chinese stock market collapse will result in a recession in the Chinese economy. This would reduce China's need for foreign goods and industrial commodities. China's largest trading partner is Europe, which until recently was beginning to climb out of its own long recession. In January, the European Central Bank (ECB) began its own set of quantitative easing (QE) which is beginning to have a positive impact. The weakening euro is also helping European exports.

We think the biggest uncertainty for the Canadian stock market is the prospect of a federal NDP majority government after October 19, something that could very well happen, especially after the recent Alberta provincial election on May 5. Canada will also need a sustained recovery in energy prices in order to prevent a more serious recession. We still believe that energy prices will gradually move higher over the next 12 months as global economic growth improves.

ANNOUNCEMENT FROM THE PRESIDENT

BY TIMOTHY E. BURT, CFA

As part of my plan to eventually retire, I have started a process to transfer some of my regular duties to others within the Cardinal team. Effective July 1, 2015, I have appointed Evan Mancer, CFA to the position of Chief Investment Officer. Evan joined Cardinal in November 2003 and served as a Research Analyst until June 2011 when he became a Portfolio Manager. Evan was appointed to Senior Vice-President, Investments in January 2014. Evan's analytical background and proven capabilities make him uniquely qualified for his new role as Cardinal's CIO. Of course, I will continue to mentor him and others as I continue this process. Many of our clients and business partners have come to know and respect Evan's capabilities over the years and I believe they will all agree with me on his suitability for this position. For now, I remain President and CEO of the firm and am thrilled to begin transitioning aspects of the firm to the next generation.

INVESTMENT Q&A

How might the Greek exit from the Euro affect my portfolio?

Greece has lurched from one economic crisis to another over the past few years and in fact for many generations. We cannot see any clear solution to the current situation, which we believe will draw attention to the fragilities of the European Union whether Greece ultimately stays or goes. Forgiving Greek debt creates an incentive for other weak European countries to threaten to leave. But keeping Greece in the European Union, trapped in economic purgatory, will be a deterrent for a weak country to stay.

So how should investors react? First, keep in mind that the Greek economy is very small at only about 2% of European GDP. More important is that since the Euro crisis in 2012, the vast majority of Greek debt is now held by other European governments and is thus very unlikely to ripple through the financial system. Thus, our perspective is that the magnitude of the current Greek crisis is fairly typical of the normal worries faced by equity markets each year.

EVAN MANCER, CFA

I've noticed some recent additions of Verizon and SunTrust Bank. Could you tell me about these?

Verizon Communications and SunTrust Bank were recently added to our Canada Plus and U.S. portfolios. By making these additions we increased the defensiveness of the portfolios, and clients will also receive a greater dividend income stream overall.

Verizon is the largest U.S. telecommunications company with a strong national wireless business that most people now consider an essential service. The telecommunications industry is less economically sensitive with the added benefit of increasing data usage contributing to solid cash flows. Verizon shares yield over 4.7% and valuation is inexpensive.

SunTrust Bank is one of the largest U.S. regional banks with operations in Southeastern states. These regions are experiencing faster population and GDP growth, which we expect will help the bank outperform other peers. SunTrust, along with our other U.S. bank holdings, will also eventually benefit from rising U.S. interest rates. SunTrust is trading at a reasonable valuation and has a 2.2% dividend yield that was recently increased by 20.0%.

SHEILA WILSON-KOWAL, CFA

Why has Cardinal decided to exit positions in the railroad sector?

Cardinal's rail sector exposure included one stake in a Canadian railway, Canadian National Railway, and two stakes in the U.S. Eastern railways, CSX Corporation and Norfolk Southern Corporation. As Cardinal has moved to position the portfolios more defensively, it became important to reduce railway exposure as these companies are cyclical in nature and economically sensitive. In addition, particularly with the U.S. Eastern rails, a large portion of business is tied to the coal market which has been weak in recent history. Cardinal now views the coal market to have negative underlying fundamentals that we believe will be a drag on profitability in the long term. These reasons, coupled with elevated valuation metrics of the shares, resulted in the decision to sell our position in the railroad sector.

ANDREA CHAPUT

Where can clients find good yields in Canada?

The average dividend yield in our Canadian equity portfolio is the highest it has ever been, notwithstanding short stints during market corrections. The yield is a function of the share price (dividends divided by share price), and the current yield on our portfolios is not due to lower share prices but is instead the by-product of our value-oriented, dividend-focused investment philosophy. Our income-oriented approach is not a fit for everyone – some investors are willing to take on a lot more risk investing in low-yielding stocks or stocks that do not pay any dividends in the hopes of achieving high returns, while others chase very high yielding stocks which may be trading at these levels for the wrong reasons – an expectation of a dividend cut or lack of growth in their underlying business. We seek out high quality companies paying healthy, safe dividends at attractive prices with the prospects of growing those dividends in the future as supported by strong business fundamentals. This strategy has performed well over time, and our strong track record of returns while taking less risk than the market as a whole, has served our clients well. Investors that focus more on the growing stream of dividend income they are earning and less on the market value of the portfolio at any given time understand our philosophy well. ■

JAMES MCINNIS, CFA

CARDINAL RESEARCH: TELECOM SUMMIT

BY JEFF RANCE, CFA

We attended the 14th annual Canadian Telecom Summit in early June. Each year a wide array of industry professionals from vendors, to service providers, to regulators, and everyone in-between, gather to discuss the past, present, and future of the information and communications technology (ICT) sector. It was a great place for us to deepen our knowledge of recent portfolio additions Telus Corp. and BCE Inc.

The theme of the conference was, *Hyper Connectivity: Shaping Personal & Business Digital Relationships*, which sounds about as clear as mud, but is in fact quite simple. The Internet is important and its importance is only increasing. The CEO of Ericsson Canada spoke of North American mobile data traffic octupling by 2020 because of faster networks, 120 million more smartphones, and a 13X increase in video traffic. Experts on network technology discussed the challenges of the growth of Netflix and Youtube, which now account for over 50% of peak Internet traffic. Telus' EVP, Technology Strategy introduced the notion of the "industrialized Internet" – the need for 24/7/365 Internet reliability with the shift to software as a service and the Internet of Things.

Essentially, access to fast and reliable Internet access is not a "want", but a "need". Some refer to the Internet as the "new landline", but one could argue its greater utility places its importance closer to electricity. These trends will require extensive investment in wireless (spectrum, towers, etc.) and in wireline (fiber). The ability to earn an attractive return on these investments and fend off competition is both an opportunity and a risk for service providers.

In Canada, most wireline markets only have two service providers and BCE, Telus, and Rogers control over 90% of the wireless market. There are no major differences between offerings. From a *customer* perspective, much like with your local utility, the lack of choice can be frustrating.

However, from an *investment* perspective, this industry structure has been lucrative to investors over time. Telus, BCE, Rogers, and Shaw have all outperformed the TSX over 5, 10, and 15 year periods. The lack of competition has resulted in pricing power, high margins, and strong dividend and earnings growth. With the capital investment opportunities ahead and apparent barriers to competition, we believe the future is bright. ■

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Q2 DIVIDEND INCREASES

Canada	% Increase
Agrium Inc.	12.2%
Bank of Montreal	2.5%
CIBC	2.8%
Canadian REIT	2.9%
Empire Co. Ltd.	11.1%
National Bank of Canada	4.0%
Sun Life Financial Inc.	5.6%
Telus Corp.	5.0%
U.S.A.	**% Increase**
Johnson & Johnson	7.1%
PNC Financial Services	6.3%
SunTrust Banks Inc.	20.0%
US Bancorp	4.1%
Wells Fargo & Co	7.1%

Source: Bloomberg
Reported in domestic currency

CARDINAL NEWS

Effective July 1st Mancer has taken on the role of Chief Investment Officer. Evan will be working closely with Tim and the investment team as he assumes his new responsibilities. One of our longest standing employees, Evan has been with Cardinal for 12 years, 5 of which as a Portfolio Manager. We also wish to congratulate Sheila Wilson-Kowal who has been appointed to Portfolio Manager, and Vice-President, Investments.

We give a warm welcome to the newest member of our investment team, David Aime, who joined Cardinal in April as a Financial Analyst. David came to us from TD Bank where he was a Commercial Banking Associate. Cardinal extends our congratulations to Annalyn and Joe Camia who welcomed their 3rd child, Easton Rei on July 6th. ■