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cardinal QUARTERLY

MARKET OUTLOOK

BY EVAN MANCER, CFA

The Federal Reserve has signaled strongly that short term interest rates will move higher, probably by at least three more hikes to 3%, and now that NAFTA worries have been put aside, we expect that the Bank of Canada will not be far behind. We expect long-term rates to move higher as well, probably over 3.5% on the U.S. 10 year.

Jamie Dimon, the CEO of JP Morgan (one of our holdings) said he is surprised when people can't believe that interest rates are rising. We share this sentiment. U.S. economic growth has been accelerating, unemployment is at record lows, and higher oil combined with tariffs are starting to push supply chain costs higher. All of these factors put pressure on the Central Banks to raise interest rates.

Strong economic growth with moderate inflation and interest rate levels is not normally a bad environment for stocks. However, since September 30th, the S&P 500 has fallen almost 7% by the date of this newsletter, raising the possibility that we have finally entered a bear market. Canada has fallen less than the U.S. but is off a similar amount from the July 2018 high. High valuations in certain U.S. sectors like technology have also been a catalyst for the recent sell-off. Although the entire market has been weaker, stocks in the technology sector have been hit the hardest, with many already down over 20% from their highs.

Global stock markets were mixed in the third quarter, with the Japanese Nikkei 225 and the U.S. S&P 500 up by 8.8% and 7.8% respectively. In Canada, the TSX fell by -0.6% and the Australian ASX fell by -0.9%. European markets were mixed with the French CAC-40 up by 3.5% while the German DAX 30 and the British FTSE 100 down -0.9% and -1.8% respectively.

Our advice is to stay the course. Corrections and bear markets are not enjoyable but most are over fairly quickly, with markets moving on to new highs in six to twelve months. Bear markets are also impossible to time. Typically, the bear market will be halfway over before you realize it has started. If we are in a bear market, we expect it will be over quickly and that markets will recover as investors refocus on corporate earnings growth. We also believe that our portfolios are well positioned

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CARDINAL CAPITAL MANAGEMENT, INC.

for a downturn given that none of the companies we own trade at excessive valuation levels, and on average they have much less economic sensitivity than the market.

There are no serious signs of a recession on the horizon. In fact, we are relieved that the U.S., Canada and Mexico have agreed in principle on a new free trade agreement. Our view is that the final agreement did not contain any serious negative changes for the Canadian economy or stock market. In fact, the new auto rules that impose a $16 minimum wage in Mexico are a positive for Canadian auto production.

The Loonie continues to hover in the high $0.70s price range, currently trading at $0.77. We have become more confident that the Canadian dollar will reach our previous forecast of $0.80 now that NAFTA fears are out of the way and there is a clearer path for the Bank of Canada to raise interest rates.

From here much will depend on oil prices, which have edged higher this quarter as investors factor in the sanctions in Iran, turmoil in Venezuela and strong demand growth. However, the big story is that the spread on Canadian oil prices (Western Canadian Select) has blown out to record highs. While WTI crude currently trades at $71 per barrel, WCS has fallen to under $20, a record spread of over $50. We expect the spread to narrow considerably in the next six months as refineries currently offline for repairs come back in service. Over the long term, the difference in price for Canadian oil relative to U.S. oil highlights the need for more pipelines, and probably more oil by rail as well, which should benefit Enbridge, TransCanada and CN Rail. ■

CARDINAL RULE #1

BUY QUALITY

BY CLINTON REBEC, FCSI, MBA, CIM

Unfortunately we don't have a crystal ball, therefore, as investors it's best to base decisions on facts and analysis rather than risky, speculative forecasts. This is likely what Benjamin Graham meant in his quote "the individual investor should act consistently as an investor and not as a speculator."

Let's educate ourselves on what quality investments in the stock market really means and why you will benefit from owning it. Top characteristics that govern quality investments would include a solid management team, strong balance sheet including low debt, competitive advantages in any economic condition, earnings and cash flow stability, dividend payments, and the ability to operate efficiently and effectively for years and decades to come.

When you compare the above criteria to that of say bitcoin or the marijuana sector, it's not hard to visualize the inherent risks. Prudent investors will remember that this is a marathon and not a race. Discussing quality investing and making it a staple in portfolios is one of the best things an investor can do to secure long-term returns.

The upside to investing in the highest tier of quality stocks goes hand in hand with our rule on common sense. However, holding quality stocks can serve as a risk management benefit during bear markets and tough economic environments.

Most would acknowledge that we have been on a major bull market run for nearly a decade and bear markets don't vanish forever. We would agree. The reality is when markets began to bottom, ultimately in March 2009, the previous month saw the largest amount of money ever pulled out of managed products such as mutual funds.

What we witnessed in February of 2009 was capitulation. Capitulation is the action of surrendering or ceasing to resist an opponent or demand. As applied to the financial market, capitulation nearly 10 years ago saw investors unload, sell and redeem their assets at the bottom of the bear market, at the peak of everyone's fear. In essence it was the retail market throwing in the towel, which signaled that a turning point could be in sight.

In March 2009, if you owned high quality stocks such as the banks, railroad companies or technology firms, they all started moving off their lows quite quickly. However, with mutual funds essentially liquidated a month earlier and investor confidence so weak, it took several months and even into early 2010 before fund managers received new money to invest. Another reason mutual funds underperform the index and peer group is not just the embedded fees, but a lack of focus on quality holdings.

Our rationale is simple, but very important based on where we are in this market cycle. If you're holding cash, you should buy quality stocks. If you hold products such as mutual funds, you need to look into what you are holding, so that you don't get caught up in the tidal wave of selling that happens in a rough market.

Owning only the highest quality stocks inside your portfolio is a time-tested, proven strategy for wealth creation and risk protection. Buying quality is a core principle that has guided us to a long history of outperformance in bull and bear markets. ■

INVESTMENT Q&A

Are the Canadian Banks still a good value?

We are confident on three standpoints with the Canadian banking group: revenue growth prospects, expense efficiency prospects, and current valuation.

Starting with revenues, there are a few areas that have us optimistic.

- We are excited with the prospect of rising rates being a tailwind rather than the hindrance rates have been over the last several years. Given the assets on the books (both securities and loans) are repriced over time as they mature, the benefit from recent (and future) rate hikes has yet to fully materialize in results.
- Canadian banks are not just exposed to the Canadian consumer. We see strong growth prospects in the Canadian banks' operations in the U.S., Latin America, and Asia. Not only are these regions benefitting from a strong economic backdrop, but the Canadian banks are continually improving their competitive positioning and growing market share in these markets.

Moving to expenses, we believe that the banks are currently undergoing a structural expense efficiency story that has more room to run. Specifically, technology is improving efficiencies on a couple of fronts:

- Consumers are transacting more online and through mobile, which results in a cheaper per transaction cost. This also enables downsizing of the real estate footprint and frees up branch space to be used for sales and advice rather than transactional banking.
- Digitization and automation of back office functions provides a cost benefit both from a reduction in head count and from a reduction in costly errors that are more prevalent in manual processes.

Finally on valuation, the banking group is trading at an average 10.7x on forward earnings at today's levels, which is below the historical average of around 11.5x. This discount is curious given the positive drivers we forecast on the top- and bottom-line, and we believe that it is mainly reflective of concerns on the credit cycle. We disagree with those concerns, as on a normalized view of credit losses, we believe the group is trading at a very reasonable valuation.

All in all, we continue to see good value in the Canadian banks and continue to view them as a cornerstone of the overall portfolio.

ROBERT LAM, CPA, CA, CFA

Are the current tariffs impacting my portfolio?

Tariff announcements from the Trump administration have caused numerous industries to see increased costs. The biggest of these impacts have been from steel and aluminum tariffs, which affects industrial companies, as often these commodities are a large part of their production inputs. While most economists agreed that the impact of these tariffs would be a net harm to the U.S. economy, the 25% on steel and 10% on aluminum tariffs were enacted earlier this year. Most of Cardinal's industrial companies have small exposures to these metals (<5% of costs), with the exception of Whirlpool which has been hit hard by the changes. Honeywell and United Technologies have very small purchases programs for these materials, and have largely been able to offset the costs by a 1-2% pricing increase. However, the story at Whirlpool is much more clouded. Steel is its largest input cost and recently U.S. steel has risen over 30%. This makes it almost impossible to overcome through price increases. Washer & dryer prices have increased close to 20% over last year as all manufacturers try to make up some of the difference. This is an industry wide story as the sector works out how to best re-coup these costs until a time when there is a change to the tariff policy.

Prior to the commodity tariffs, Trump had also imposed a tariff on imported washing machines. This was good news for Whirlpool, as the competitive playing field between itself, LG and Samsung would have been leveled. However, now with both of Whirlpool's peers building new production facilities on American soil, the benefits are slowly eroding while Whirlpool continues to fight cost inflation.

All of this macroeconomic turmoil has overshadowed many positives within Whirlpool at a company level. Cash flow generation is gaining strength and South American sales are beginning to rebound. The company has also taken a large amount of costs out of their supply chain that is completely overshadowed by the material price increases. Whirlpool remains a strong brand with #1 and #2 market share positions in most countries in the world. As global penetration for appliances rises with the emerging middle class of developing economies, the company is well positioned to benefit. So while the short-term is clouded with factors outside of management's control, our core thesis for owning Whirlpool remains intact, and we remain patient as the company navigates the difficult macro environment.

ANDREA HORNBY, CFA

CARDINAL RESEARCH

HONEYWELL

BY ANDREA HORNBY, CFA

Honeywell International is a core Cardinal industrial holding. Its aerospace businesses are benefiting from strong airline trends that have allowed the company to realize robust top-line growth while expanding their margins. Its industrials offerings have been focused on pushing their products into the digital age by employing more software engineers than mechanical engineers to develop connected solutions. The result will help customers better optimize maintenance schedules, production efficiencies and have better lines of communication with the markets it serves. This has been paying off as organic growth numbers have been at the highest level in five years. A great example of this is Honeywell's relationship with Amazon. Honeywell is taking advantage of the booming e-commerce market by servicing Amazon's new warehouses for material handling equipment design, installation and support. Honeywell has also been a champion dividend grower, committed to increasing its dividend faster than earnings as its cash flows have strengthened. At an average annual rate over the last five years, it has grown by double digits every year, topped off by a 10% increase in late September 2018.

Recently, Honeywell has moved to streamline its portfolio to focus on its main commercial and industrial businesses. As a result, it is spinning off two of its business units. The first, which will be called Garrett Motion (NYSE:GTX), is an automotive based business that offers turbo-chargers, serving primarily the diesel market. This spin-off was completed as of October 1st when shareholders of Honeywell each received one new share of Garrett Motion for every 10 shares of Honeywell owned. The new company is smaller than we would typically hold, higher leverage and does not pay a dividend. Therefore, it does not fit our core criteria and will be sold from client portfolios. The second spinoff, a home products business that encompasses Honeywell's iconic thermostat, will trade under the name Resideo (NYSE: REZI). The timing for the distribution of these spin-off shares to clients will occur later in the fourth quarter of 2018. Once the full profile is known for Resideo, our investment team will be conducting a review for suitability in our portfolios. Due to size and liquidity concerns, it is likely to also be sold. Once these two spin-offs are complete, the portfolio of businesses that remain will be better able to share costs and focus on the same long-term macro trends, creating efficiencies in how the company can invest for the future.

CARDINAL NEWS

Cardinal is pleased to welcome **Chad Wiebe**, CFP! Chad joined Cardinal on July 30th as Assistant Vice-President, Business Development and will be working closely with Ron Malech and Shelly Thomson.

Business Development is thrilled that **Jodee McIntosh** has moved from the Administration team to now provide direct support to Emily Burt, Leanne Thiessen, and the external advisor group.

Q3 DIVIDEND INCREASES

Canada	% Increase
Alimentation Couche-Tard Inc.	11.1%
Bank of Nova Scotia	3.7%
CIBC	2.3%
Emera Inc.	4.0%
Royal Bank of Canada	4.3%

U.S.A.	% Increase
Honeywell International Inc.	10.1%
JM Smucker Co.	9.0%
JPMorgan Chase & Co.	42.9%
PNC Financial Services Group Inc.	26.7%
Simon Property Group Inc.	2.6%
US Bancorp	23.3%
Wells Fargo & Co.	10.3%