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cardinal QUARTERLY

MARKET OUTLOOK

BY EVAN MANCER, CFA

After falling close to 20% in December 2018, most developed markets have experienced a V-shaped recovery and are approaching record highs. A change in interest rate policy from Central Banks has probably been the biggest factor behind the change in sentiment. Coming into the fourth quarter of 2018, the Federal Reserve seemed intent on pushing short-term rates higher to guard against higher inflation in 2019 and beyond. However, inflation has remained weak, as it has for most of the past decade, bolstering the argument for continued low interest rates through 2019.

The strongest developed market performance was from the French CAC 40, up 13.2%, with the S&P 500 and the S&P TSX close behind up 12.5%. The Australian 200 increased 11.4% while the Japanese Nikkei index, German DAX 30 and the FTSE 100 rose 9.4%, 8.9%, and 7.7% respectively.

Growth stocks led the market down in the fourth quarter of 2018, but once again were the best performing sector of the market in this quarter's rally. In fact, growth stocks like the FAANG's in the U.S., or technology and cannabis stocks in Canada, have led the market higher for most of the past decade. Netflix for example is up 50% from its December low, while in Canada Shopify is up 70% from its December low. The 10% gains in Canadian bank stocks over that period pale by comparison.

Nevertheless, we would bet heavily on value stocks like Canadian banks outperforming these types of growth stocks over the next five years. No matter how attractive a company is, at some point paying too high a price will make it a poor investment. Similarly, a decent business with reasonable growth prospects can become a fantastic investment given a low enough price.

One of the most basic questions that prospective business owners ask themselves before buying is, "How many years will it take to earn their money back?" In the case of Canadian banks trading at ten times earnings, the answer would be roughly ten years, assuming no growth in earnings. This translates to a return of about ten percent annually. In the case of Shopify and Netflix, which together trade at an average of 100 times earnings, the answer would be 100 years with no earnings growth, or about a one percent return annually.

Of course, the real question is, "What will earnings growth be?" Or to compare alternatives, how fast would a company trading at 100 times earnings have to grow earnings to reach the valuation Canadian banks are at now? Over a decade, growth would have to be 26% annually

continued on page 2...

INSIDE THIS ISSUE

Cardinal Rule #10 2
Investment Q&A 3
Cardinal Research 4

CARDINAL CAPITAL MANAGEMENT, INC.

for a stock trading at 100 times earnings to become ten times earnings if the price of the stock stayed the same. We have no special insight into Netflix or Shopify, but looking at the S&P 500 as a whole there is typically less than one out of fifty companies that achieve annual earnings growth of greater than 25% for a full decade.

This is not surprising given all of the change and competition companies have to navigate. Ten years ago, the iPhone had just been released (2007), Netflix was still selling DVD's, and Facebook was not a publicly traded company. We have no idea what the tech landscape will look like in ten years, but we are certain that it will be massively different than today. At current low prices, value stocks do not require 25% annual growth to be good investments, they just need to keep achieving the same results that they already are now, or ideally grow modestly from year to year.

Investors latch on to different themes in the market, but over the long term, value stocks have achieved better returns than growth stocks, which is why we are value investors at Cardinal. Our guess is that the shift back to value will occur when a major growth stock (we have no idea which one) runs into serious financial trouble. This tends to cause investors to re-evaluate their ability to look ten years out and instead pay more attention to the price they are paying for current results.

We continue to believe that 2019 will be an excellent year for investors and that both the U.S. and Canada will end the year at record high levels, probably up over 20% from December 31, 2018. Although valuations are roughly in line with historical averages, our view remains they are actually undervalued if interest rates continue to stay at current low levels.

We continue to be surprised that interest rates have stayed this low for this long, even as the market and the economy have recovered. Part of the reason for such low rates is the continued extreme monetary policy in Europe and Japan where Central Bank bond buying has pushed ten year bond yields back into negative territory. A $1 investment today in Japanese or German bonds would pay out about $0.99 in ten years' time, a nonsensical rate that is worse than leaving the money under your mattress!

The pricing of bonds in Japan and Europe almost certainly pulls yields down in Canada and the U.S. as investors hunt for relatively better yields. However, traditional economic theory would predict that eventually, this type of Central Bank behavior would be disciplined by inflation increases, which would in turn force interest rates higher. But inflation has really not occurred in a meaningful way in any developed market economy, a phenomenon that we have struggled to understand.

As is always the case with markets, there are looming risks that could cause the market rally to reverse again. Most prominent of these is the risk that U.S. trade negotiations with China get derailed. As meeting dates with ever more senior officials occur, investors have become more optimistic about a deal being reached in the near term. While we remain confident that a deal will eventually be reached, we would certainly not be surprised to see talks fall apart in the short term.

Oil prices have rallied by 34% in the first quarter, one of the strongest gains of any major asset class as OPEC continues to show its resolve on limiting production, and other traditional hotspots such as Libya and Venezuela struggle with instability. Global demand has remained healthy as well, but we would expect that further gains in oil will likely encourage shale companies to boost production, putting a cap on oil prices at $75 a barrel or so.

Investor sentiment toward Canada continues to be extremely weak and so despite the rally in oil prices, the Loonie has not budged from the $0.75 level of three months ago. Canada's inability to build pipelines has spooked energy investors, and probably caused investors to view our high consumer debt levels and therefore our financial sector, with more alarm. Canada is now one of the cheapest stock markets in the world.

We still see the Loonie progressing closer to $0.80. While we share some of the same concerns listed above, we are more confident that we will start to see improvement. Politics, like technology, is subject to rapid change and we see the economy becoming much more of an issue in the next election. In addition, we believe that regardless of which party wins power, Enbridge's line 3 will begin service next year. There has been a renewed push to get TransCanada's Keystone XL built, which depends on the U.S. government and its legal system, not Canada's. ■

CARDINAL RULE #10

BUILD WEALTH

BY CLINTON REBEC, FCSI, MBA, CIM

Vital to Cardinal's success is building wealth for our clients. Building wealth is a construction project that will span one's lifetime.

The time period for building is ongoing and indefinite, as we look to build wealth not only for this generation, but for future generations.

It goes without saying, but we will say it anyway: the core to building anything is a sound, secure foundation. Having a time-tested, long-term strategy, guided by our core rules and entrenched in our discipline of value investing is just that type of platform where wealth can prosper.

With Cardinal prudently managing and building wealth, there are habits, or rules, that anyone can follow to fast-track this process.

Here are six key healthy habits one can incorporate to accelerate building wealth:

1. **Start early**. While we have clients in various stages of life, one cannot stress the importance of starting early. Allow time and compound interest to always be your friends.
2. **Focus on savings not income.** As Robert Kiyosaki stated "it's not how much money you make, but how much money you keep, how hard it works for you, and how many generations you keep it for".
3. **Make savings routine and an automated part of your overall financial plan.** For example, have a monthly and annual contribution process in place.
4. **Take advantage of registered accounts.** These include tax deferred and tax sheltered accounts such as RRSPs, LIRAs, TFSA's.
5. **Allowing your money to work for you.** Whether pre or post retirement, your wealth will need some form of continued growth to ensure needs are met in future years and/or for those funds to be there for future generations.
6. **Don't chase fads, watch out for fraud.** Holding quality investments and knowing what you own and why is the key.

Cardinal's conservative, common sense strategy, combined with time and compound interest will help to maximize your wealth. Having Cardinal guide the investment process allows you to focus on your habits. For decades, we have watched our clients build wealth with this simple recipe, and we fully expect to see that continue for decades to come. ■

INVESTMENT Q&A

Why was Roche selected as Cardinal's newest International addition?

Based in Switzerland, Roche is one of the world's largest pharmaceutical companies and also has a strong diagnostics business. Roche has one of the most highly-regarded drug development track records in the industry and is a leading player in the oncology space. Roche's largest drugs – Herceptin, Avastin, and Rituxan – are three of the most successful oncology treatments in the world. Currently there are fears over upcoming declines in these drugs as they face competition from cheaper biosimilars. These fears pushed Roche's P/E valuation below its historical average and its peers, creating an opportunity to own a high-quality company.

Despite the expected upcoming declines in the company's older legacy drugs, Roche has a stable of recently launched drugs which, although currently small from a sales perspective, are growing at a significant rate and should drive the next leg of growth at the company. Ocrevus, a treatment for multiple sclerosis, is off to the fastest launch in the company's history and still only treats a fraction of eligible patients, leaving ample room for future growth. Roche also has a number of new oncology treatments such as Perjeta, Kadcyla, Tecentriq, and Alecensa, which are off to promising starts.

Roche has a long track record of success, generates strong cash flows, and has a very solid balance sheet. This success has allowed Roche to raise its dividend for 32 consecutive years, and the current dividend yield sits at 3.2%.

DAVID AIME, CFA

What is the outlook for Couche-Tard?

Alimentation Couche-Tard (ATD) is a premier convenience store operator with a top-tier management team that has delivered a very good acquisition track record over its history. ATD has done an excellent job of acquiring companies at reasonable valuations and then by applying best practices is able to get even more out of these businesses once they are in ATD's hands. This has been the recipe for success over the long-run and we expect it to continue going forward as the U.S. convenience store industry remains highly fragmented and expansion into new European countries and Asia present further global expansion opportunities.

On top of the acquisition strategy, ATD consistently works on growing sales at their existing store base by continuously evolving their product and service offerings. As a global company ATD is able to share best practices from one region and apply it across their entire store network. ATD also has a strong presence in Norway, the country with the highest electric vehicle penetration rate in the world. As electric vehicle demand increases in other countries, ATD should be well-equipped to apply their learnings from Norway to help offset any declines in fuel demand.

ATD's dividend yield is below 1% as the company has historically had a very modest dividend payout ratio in order to maximize capital available for acquisitions. Over the last 5 years, ATD has made growing the dividend a higher priority, and has raised the dividend at a 30.5% compound annual growth rate over that time.

DAVID AIME, CFA ■

CARDINAL RESEARCH

DISNEY

BY JEFF RANCE, CFA

Disney Investor Day

We had the opportunity to attend the Disney Investor Day in sunny Burbank, California. It was Disney's first investor event since 2011 and it was arranged to showoff the launch of the company's direct-to-consumer streaming service Disney+ and to talk about its recently closed acquisition of Fox's TV and movie assets.

Disney+ is the company's forthcoming streaming service. Think Netflix, but instead of the mishmash of content, it will contain the most popular content on the planet including Disney's animated classics, Pixar, Marvel, and Lucasfilm. If that is not enough, Disney is also producing exclusive content for the service including a live action Star Wars TV show created by Jon Favreau, a live action remake of Lady and the Tramp, and content from the Monsters and High School Musical franchises. The product will launch in the U.S. on November 12, 2019 for $6.99/month and in a number of international markets shortly after.

The Fox acquisition, which closed mid-March, goes hand in hand with Disney+ as it beefs up Disney's content creation machine. In movies, it consolidates the X-Men properties back into Marvel and also adds franchises like Avatar, which fit well with Disney. The acquisition also comes with considerable TV assets, including National Geographic and the Simpsons, which will be included in Disney+.

We are of the belief that Disney+ will be a success for fanatics and investors alike. No other media property has relationships with customers as deep and ingrained as Disney. One area to measure the potential success of Disney+ is that Disney theme park global attendance was 120M in 2017. This is equivalent to ~30 million potential household subscribers in a given year who are willing to pay hundreds of dollars for the Disney experience. This is just a single year of attendance. Only a fraction of people go every year, so you can extrapolate this to 50+M Disney fanatics. If someone is willing to pay hundreds of dollars for the Disney experience, it's safe to say they'll be willing to pay $7/month for Disney+. The company provided guidance of 60-90 million subscribers within 5 years.

Alongside the longer-term prospects of Disney+, there are still a lot of positives in the near term. The studio continues to regularly dominate the box office as Disney "plays the hits" with the upcoming finale of the Avengers, live action remakes of Aladdin and Lion King, Toy Story 4, Frozen 2, and Star Wars Episode IX. The theme park continues to be the quintessential family vacation. This is furthered by the largest expansion of the domestic parks in decades with Star Wars lands opening in both Florida and California this year, which will drive considerable traffic.

The House of Mouse is one of the few traditional media companies in the world that not only will survive the competitive threats of the internet giants, but will thrive. We believe the market is caught up in the short-term uncertainty of Disney's transition to Disney+ allowing us to invest at the ground floor of this long-term opportunity. ■

Q1 DIVIDEND INCREASES

Canada	% Increase
Alimentation Couche-Tard	25.0%
Bank of Nova Scotia	2.4%
Canadian National Railway Co.	18.1%
Canadian Natural Resources	11.9%
CIBC	2.9%
Gildan Activewear	19.6%
Intact Financial	8.6%
Magna International	10.6%
Royal Bank of Canada	4.1%
Suncor Energy	16.7%
Toronto-Dominion Bank	10.4%
TransCanada	8.7%
U.S.A.	
Cisco Systems	6.1%
Comcast Corp.	10.5%
Intel Corp.	5.0%
Oracle Corp.	26.3%
Simon Property Group	2.5%
Wells Fargo & Co.	4.7%
International	
Novartis AG	1.8%
Roche Holding AG	4.8%
SAP SE	7.1%

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