Cardinal Quarterly

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Market Outlook

BY EVAN MANCER, CFA

Stock markets across the globe have continued to climb a wall of worry, with most major indices near record highs despite consistent fears that a downturn is imminent. We still believe that investors will be rewarded far more for optimism than pessimism. Given headline grabbing risks such as the China trade war, a number of military hotspots like Iran where tensions are escalating, and now the threat of Presidential impeachment, being optimistic is not easy. However, the more fundamental factors of a decent U.S. and global economy, continued low interest rates, and average valuations translate to a greater chance of markets setting more record highs. Should a bear market occur, we expect that it would be short, as was the case in the fourth quarter of 2018 and at the end of 2015.

The strongest market in the third quarter was the Japanese Nikkei 225, up 3.1%, while the weakest market was the Shanghai Composite, down -1.4% on worries about the ongoing U.S./China trade war. The Canadian stock market has finally started to post better returns than the U.S. after many years of lagging behind, with the TSX up 2.5% in the quarter and 7.1% for the year, versus 1.7% and 4.3% for the S&P 500. Elsewhere, the French CAC was up 2.7% while the export oriented German DAX advanced only 0.2% and the UK FTSE-100 was up by 1%. Markets were broadly positive on a year over year basis.

Global GDP growth has decelerated slightly in the third quarter, with a few large economies such as Germany, China and India slowing more than expected. Investors are on alert for signs that this weakness will seep into the North American economy as well. Thus far, the biggest worries have come from the manufacturing sector, which has been weak of late, mainly as a result of the tariffs from the ongoing trade war with China.

Many investors are beginning to fear that as the trade war drags on without

a resolution, China may choose to delay the talks until after the U.S. election in November. But we still think an agreement will be reached sometime in the next six months or so. The risk for China is that even if Trump is not re-elected, there are quite a few Democratic contenders that are also taking a tough on China stance. In the meantime, China's economy is continuing to be negatively affected.

We expect a strong holiday shopping season in the fourth quarter, which should provide a boost to corporate earnings and investor optimism going into 2020.

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CARDINAL CAPITAL MANAGEMENT, INC.

Consumer spending accounts for two thirds of GDP in the U.S. and Canada and with wages growing and unemployment near 50-year lows, shoppers should be in the mood to spend.

Also giving us confidence is that we struggle to find any of the traditional bubbles in the North American economy. Housing and auto sales have still not reached normal investment levels in any year of the past decade. We think a return to average levels that provides a boost to the economy is more likely than a fall to record lows that slows the economy.

The Fed will likely feel the pressure to make another interest rate cut at its next meeting. Even though the economy is in decent shape, a decision to cut rates too close to the U.S. election next year will appear political. And given that inflation has been low for most of the past decade, there does not appear to be much risk to lowering short term rates.

Oil prices declined slightly in the quarter after a brief spike when Iran allegedly bombed a Saudi oil field. However, production was brought back online sooner than expected, causing investors to refocus on demand fears. On the positive side for oil prices, there have been increasing signs that the shale revolution in the U.S. may be getting closer to a peak than previously thought. Many companies are reporting slower than expected production gains and shareholders have pressured management to prioritize making money over increasing production.

The Loonie has traded in a very tight range of $0.74 to $0.77 this year and has recently been hovering around $0.75. We continue to believe that the Loonie is undervalued and should be closer to $0.80 based on a decent Canadian economy, more steady oil prices and the recent cuts to interest rates in the U.S.

Cardinal Rule #1

BUY QUALITY

BY SHEILA WILSON-KOWAL, CFA

The odds of a recession and accompanying market downturn are rising. However, by buying a portfolio of quality companies, you can confidently hold that portfolio through economic cycles. Quality companies will continue to pay dividends and generate earnings while riding out the inevitable recessions. Even though the share price assigned by the market might decline, their long-term business fundamentals are still sound.

Trying to time the market is futile and we prefer to own great businesses that keep paying a steady income stream through a downturn.

We are constantly evaluating portfolios, which becomes even more paramount in a slowdown or recession. We look for companies that live within their cash flow means and have not taken on excessive debt. Having a solid balance sheet allows a company to manage through slowdowns. We also want companies that are industry leaders with sustainable competitive advantages that could include a technology or brand advantage. Another important characteristic is having an experienced, strong management team to guide companies through difficult times and avoid value destroying decisions.

RBC and Medtronic are two companies passing the quality test. Founded in 1864, RBC has been through multiple recessions, the Great Depression and also two World Wars. Through the good and bad times, RBC has paid a dividend since 1870. Medtronic is another example of a company with a long history. Established in 1949, Medtronic has grown into a leading global, medical technology company that provides life saving devices. Healthcare needs often cannot be put off during downturns and with an aging population, demand for cardiac devices and surgical equipment will keep growing. These companies are winners that are capable of managing through tough times and will be well positioned for the next cycle.

Recessions also present opportunities. Recessions are like a tide that goes out and exposes those companies that are 'swimming naked' or in other words – have taken on too much debt or risk. These companies struggle in a recession and become opportunities for stronger companies to either buy them at a cheap valuation or face less competition if weaker competitors go out of business. An example is the acquisition of The Northface brand by VF Corp in 2000 for just over US$150 million. The North Face now generates over US$2.5 BILLION per year in sales.

Recessions are only known after the fact. Trying to determine the peak and bottom is near impossible and you risk missing out on further market appreciation. Knowing when to buy back shares is also difficult as the market can turn quickly and it can be emotionally challenging to get back into the market once it starts to run up again. Given the uncertainty in predicting the exact timing of a recession, we have found that holding a portfolio of high quality companies will protect you on the downside, let you sleep better at night and outperform the market over the long run. The quality businesses that you own will continue rewarding you with dividends while taking advantage of opportunities that come along.

Investment Q&A

What is the growth outlook for Medtronic?

Medtronic (MDT) has been a consistent long-term grower and its product portfolio has a solid balance between new high-growth areas and older, highly profitable, low-growth segments.

MDT has many upcoming product launches which should allow the company to continue growing revenue at a mid-single digit rate.

In MDT's Cardiac and Vascular Group, the transcatheter aortic valve replacement should continue its strong double-digit growth as the treatment was recently approved in a lower-risk patient setting. The Micra AV leadless pacemaker is expected to be launched in early 2020 and new sensors will allow it to address 55% of the overall pacemaker market versus only 15% today.

We have seen a shift away from open surgeries toward minimally invasive procedures given an enhanced safety profile and less recovery time. This shift continues and we are also seeing an increase in robotically-assisted surgeries. MDT currently has a robotic system in development and aims to bring it to market sometime in 2021.

MDT is a leader in diabetes and in 2020 the MiniMed 780G advanced hybrid closed loop pump is expected to reach the market. This second-generation pump offers an expected time in closed-loop or automatic mode of 99% versus 85% today and is the closest we have come to an artificial pancreas.

Putting it all together, we believe the growth outlook remains strong for MDT. The above-noted revenue drivers plus a bit of margin expansion should drive high-single digit earnings growth and dividend growth should be of a similar magnitude.

DAVID AIME, CFA

What's driving Taiwan Semiconductor's recent strong performance?

Taiwan Semiconductor (TSMC) is the world's largest dedicated semiconductor foundry. This means that they do not design chips, they only manufacture them. TSMC has a strong long-term record of market beating returns and has also performed very well recently with the shares up over 30% year to date and a 25% dividend increase. We attribute this to three things:

1. **The semiconductor cycle is bottoming.** There continue to be positive signs that the recent downturn in semiconductor sales and high inventories is nearing its end. 2019 industry sales are expected to decline 15.4% and 5.6% excluding memory. 2020 is expected to rebound with sales up 5.5% and 8.5% excluding memory.
2. **Firmly establishing technological leadership.** Many experts now believe that TSMC is modestly ahead of Intel with respect to next generation semiconductor manufacturing and has the potential to build on this lead. A technological edge is important for customers as it delivers higher performance with lower power use. For TSMC, it drives stronger volumes and pricing power. The company's 7nm product is growing from 9% of revenues to 25% in 2019. The 5nm product is scheduled for 2020, a full year ahead of Intel.
3. **Armed with the cycle turning and belief in the company's competitive advantage, it's easy to be excited about the future.** TSMC is helping drive its customers into the leading edge of computing. It enables your iPhone to get faster, video game graphics to get better, virtual reality, autonomous driving, artificial intelligence, and the Internet of Things.

JEFF RANCE, CFA

Cardinal Research

SCOTIABANK FINANCIAL SUMMIT

BY ROBERT LAM, CPA, CA, CFA

At the beginning of September, we had the opportunity to attend the Scotia Financial Summit where we partook in general session presentations and meetings with the management teams of our Financial sector holdings. The event is always a great forum to gather thoughts from management on some of the ongoing challenges and concerns, as well as the opportunities that exist.

Some of the focal points for discussion this year included the return of the low interest rate environment and the impact on operations, mitigants to revenue headwinds, and potential uses of excess capital.

On the impact of the low rate environment, the impact differs by geography and business type.

- For the banks, U.S. operations will reflect the impact of lower rates sooner in its margins, with moderating impact from incremental rate cuts as deposit repricing and loan growth serve as offsets going forward. In Canada, the impact on margins is more protracted due to the laddered nature of larger components of the loan book – e.g. mortgages.
- For Sun Life Financial, the impact is fairly quick through mark-to-market adjustments that reflect lower interest rates going forward. The second order effects are less evident and impact some product demand and gains on new business.
- For Intact Financial, the impact is much more minimal and flows through gradually as portfolio investments mature and require reinvestment.

In the event of a slowing revenue growth environment, we came away from our discussions comfortable with the ability of our portfolio companies to manage the expense line to generate flat to positive operating leverage. We continue to believe that digitization and business process changes drive meaningful and lasting expense benefits that are underappreciated, which was echoed in our discussions with management.

Lastly, the banks and insurance companies in our portfolio are very well capitalized. Our discussions on uses of excess capital highlighted the importance of continuing to grow and pay the dividend, augmenting shareholder returns through buybacks, and, where appropriate, taking advantage of acquisition opportunities afforded by the market while remaining disciplined.

Overall, the meetings this year once again help to reinforce our confidence that the Financial companies we hold will be able to grow earnings, manage emerging challenges, and most importantly, continue to grow the dividends to shareholders for the foreseeable future.

CARDINAL NEWS

Cardinal has expanded in the east! We are thrilled to announce the addition of Dona Eull-Schultz, Pat Manahan and Douglas Kee to our new Toronto office. All three have worked together for over a decade. Dona, Pat, and Douglas join us as Senior Portfolio Managers and bring over 100 years of financial and investment experience to Cardinal. Their main focus will be working with private clients and managing their portfolios. Dil Rajendr also joins as our Director of Finance for the Toronto office and brings a wealth of experience in the financial services industry. Welcome to the team!

Q3 DIVIDEND INCREASES

Canada	% Increase
Bank of Nova Scotia	3.4%
Canadian Imperial Bank of Commerce	2.9%
Fortis Inc.	6.1%
Royal Bank of Canada	2.9%
U.S.A.	**% Increase**
Bank of America Corp.	20.0%
Honeywell International Inc.	9.8%
JPMorgan Chase & Co.	12.5%
PNC Financial Services Group	21.1%
Simon Property Group	2.4%
US Bancorp.	13.5%
Walgreens Boots Alliance	4.0%
Wells Fargo & Co.	13.3%