FEBRUARY 2020

Cardinal Update

Is Inflation Coming out of Hibernation?

We have been in a relatively benign inflationary environment for many years now where the Bank of Canada has, for the most part, kept inflation contained within its 1-3% target range. Last year, inflation spent most of the year very close to the midpoint of that range. The first quarter of 2019 was the low point of the year with the headline CPI posting readings in January and February of 1.4% and 1.5%, respectively. It then rebounded and spent the rest of the year around 2%. Currently, inflation is sitting at 2.2% and does not appear to be an issue, but what would happen to our portfolios should things change and inflation starts to rise?

We start by looking at the fixed income portion of the portfolio. Higher inflation would cause the central bank to increase interest rates and bond yields would rise. The inverse relationship between the yield and price of a bond means that bond prices would fall in such a scenario. On the surface, this seems negative, but there are some positives. Until you actually need to sell a bond, these are unrealized losses, and Cardinal utilizes a buy-and-hold strategy until maturity. This means that the yield you bought the bond at is essentially locked in, and once the bond matures, it can be reinvested at a higher yield. Any new portfolios would also benefit from investing at higher yields.

Turning to equities, in a scenario of higher inflation one can come up with a million different projections for its effect on overall markets. What specifically is causing higher inflation? What is the severity of the increase? How is the bond market reacting? Each of these questions have a number of possible answers and each combination of answers would have a different effect on the market making it difficult to predict. No matter what the scenario, however, one thing remains constant: the dividend and dividend growth philosophy Cardinal employs has proven to protect your cash flows from inflation.

Firstly, our stable of companies have a collective dividend yield that is attractive versus high quality government or corporate bond yields as well as versus the overall rate of inflation. The Cardinal Canadian Equity portfolio currently has a 3.5% yield and the Cardinal Foreign Equity portfolio currently has a 2.5% yield. We believe the employment of the Cardinal philosophy ensures these companies are high quality, conservative businesses that can support their current dividends through rough patches in the economy. Secondly, we focus solely on companies that have the ability to consistently increase their dividends. For the past 3 years (2017-2019) dividend growth has easily outpaced inflation. The Canadian Equity portfolio holdings had average dividend growth of 8.7%, 11.4%, and 10.9%; our Foreign Equity portfolio holdings had average dividend growth of 11.0%, 11.6%, and 11.5%. The companies we own pay dividends that are secure, have higher yields than high quality corporate bonds, and have growth rates upwards of 5x that of inflation. We believe the Cardinal focus on companies that can provide you with this secure and growing stream of income grants shelter from any threat of rising inflation.

COMPANY FOCUS: CVS

Following the recent acquisition of Aetna, CVS Health has transformed into an integrated healthcare services company with the business now spanning a retail pharmacy, pharmacy benefit manager and managed care organization. The integrated model enables the combined business to be agnostic as to which segment is generating profits, and allows for unique product offerings given the significant amount of patient data that is accumulated.

Although there has been considerable political noise surrounding the U.S. healthcare industry with the upcoming presidential election, many favorable long-term trends still exist including specialty pharmacy growth, an aging demographic, the shift toward lower-cost clinics, and growth in Medicare Advantage members.

Shares have been on a rollercoaster ride over the last few years; however, the uncertainty surrounding the Aetna acquisition is behind us and the integration of the business appears on-track. CVS took on a considerable amount of debt with the acquisition and has been repaying it at a rapid pace over the last year. CVS's cash flow generation will increase as debt is repaid – current annual interest expense is over $3 billion – and we will see a return of dividend growth and share repurchases once the balance sheet strengthens further.

DIVIDEND INCREASES

Company	Increase
Allied Properties REIT	3.4%
Canadian National Railway	7.0%
Comcast Corp.	9.5%
Intel Corp.	4.8%
Roche Holding AG	3.4%

(During the period January 1 to January 31, 2020)

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