MARCH 2020

# Cardinal Update

## When Fear Goes Viral

**Fear of the Coronavirus (Covid-19) has caused most markets around the globe to fall into correction territory, meaning a drop of 10% or more from highs.** As of this writing, the TSX has fallen by 10% from its high and the S&P 500 is down 12.5%.

Markets have probably not bottomed out yet. New Covid-19 cases are spreading rapidly outside of China and we suspect that there will be clusters of new cases in certain cities of North America, similar to what has happened in Northern Italy and in Daegu, South Korea. China has proven that it is possible to control the spread of the virus, but this has involved an almost complete quarantine in Hubei, where 90% of its infections are, as well as a fair amount of restrictions in the rest of the country.

North America and other countries will benefit from a far quicker response time than China but as infections and deaths continue to rise, the story will shift from a worry in the headlines to, at least in some cities, actual restrictions on day-to-day routines. Before the scary stream of Covid-19 headlines begin to abate, there will almost certainly be shutdowns of certain shopping malls, arenas or transit systems in some North American cities, on top of more infections and deaths.

Around the edges, we may make slight changes to the portfolios as the market reprices different companies, but we believe it would be a mistake to panic and sell out of the market. The Covid-19 virus will pass as other viruses have, almost certainly within the next year. We have no worries about the viability of any company we own and fully expect that in three years, our companies as a group will be earning higher profits, paying higher dividends, and have higher share prices than today. Risking highly likely long-term gains to try to time unpredictable short-term market movements is a poor recipe for success in investing.

Though we cannot predict how much further the market will fall, or when it will bottom out, we can predict with high certainty that the market will begin to turn positive well before the cycle of negative newsflow begins to turn. Our experience (mostly from watching the missteps of others) is that it is even harder to call the bottom of the market than the top, and that those who sell now are highly unlikely to get back in at a lower price.

We also take comfort in the fact that underneath the scary headlines, much of the actual data coming in on the Covid-19 virus suggests that it will not be nearly as lethal as initially feared. There is also good reason to be hopeful that warmer weather in late spring and summer will cause infection rates to fall dramatically, as happens with Influenza in general. In the warm weather countries of Africa, South America and India, there have been only ten reported cases, no deaths and no transmission between local residents. There are also many companies working on vaccines, some of which may be ready for next winter.

One of the biggest struggles for health authorities is the vastly different mortality numbers being reported from the most affected countries. Iran's mortality rate is 8.8%, while China's is 3.3% and South Korea is just 0.6%. Even within China, Hubei province where the virus originated had a reported death rate of 4.1% while the rest of China had a death rate of just 0.8%.

The problem is that there is no way to know how many people have actually been infected. In Hubei, it was likely that not until large numbers of patients began dying that health workers even began to realize that they should be testing for a new virus. In Iran, there is a shortage of testing equipment and probably a lack of transparency as well as the government trying not to panic the population.

We are surprised that there have not been more follow-up articles on the Diamond Princess Cruise Line Covid-19 outbreak, since its contained environment controls for so many of the variables that distort the numbers. Thus far, six deaths have been confirmed with over 700 infections, a mortality rate of 0.85%. Because every passenger and worker on the cruise was tested, these mortality numbers could be more reliable than from any country.

Passengers were released on Feb 14th so the mortality rate may increase a bit more, but our take is that the Diamond Princess Cruise Line mortality rate might represent an absolute maximum of what the global rate is. The average age on the Diamond Princess Cruise Line was much higher than the general population. While we have not been able to find a published average passenger age from the company, we do know that the average passenger age for all cruises is around 50 and this particular cruise was for 14 days, a length of time which tends to attract mainly retirees. Also, of the six deaths, four were over 80 years old, one was 78 and one is age unconfirmed. Based on this and the anecdotal media images of elderly passengers leaving the cruise, our guess is that the average age was around 65, a demographic that has multiple times the mortality rate of the general population, as is the case with the regular seasonal flu virus.

Ultimately, we believe that the end-result of Covid-19 will not be a massive loss of lives, but a temporary slowdown to the economy. In fact, with more diligent hygiene efforts aimed at preventing the spread of Covid-19, it is possible that there will be a benefit in the regular battle against seasonal influenza that will offset lives lost to Covid-19. Normally, there are thirty to forty thousand deaths from the flu each year and there was a record eighty thousand in 2018. While it is impossible to predict a bottom, we do not think it will be long before investors begin to look forward to an economic rebound as consumers restock and companies rebuild inventories.

## COMPANY FOCUS: MAGNA

Magna International is one of the world's largest automotive suppliers and has a diverse revenue base across segments, geographies and customers. Magna produces many different products including chassis, exteriors, powertrains, mirrors, lighting, and seating and its largest customers include the likes of General Motors, Ford and BMW.

While there is heightened uncertainty around the automotive industry due to emission regulations, the shift in consumer demand away from internal combustion engines, and the development of autonomous vehicles, Magna well-positioned given its focus on lightweighting, electrification, cameras and sensors. We recently attended Magna's Investor Day and came away with increased confidence on its ability to continue to outgrow global automotive production for the foreseeable future.

Magna has a strong balance sheet which has helped to protect the company during prior cyclical downturns and can also allow for opportunistic acquisitions. Magna generates a significant amount of free cash flow which has enabled the company to repurchase a large amount of shares and pay a growing dividend. Since 2010 Magna has repurchased 42% of its outstanding shares and raised its dividend at a 14% compounded annual growth rate.

## DIVIDEND INCREASES

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| Allianz SE | 6.7% |
| Brookfield Property Partners LP | 0.8% |
| CIBC | 1.4% |
| Cisco Systems Inc. | 2.9% |
| Gildan Activewear Inc. | 14.9% |
| Gilead Sciences Inc. | 7.9% |
| Intact Financial Corp. | 9.2% |
| Magna International Inc. | 9.6% |
| Royal Bank of Canada | 2.9% |
| SAP SE | 5.3% |
| Suncor Energy | 10.7% |
| TC Energy Corp. | 8.0% |
| Toronto Dominion Bank | 6.8% |

(During the period February 1 to February 29, 2020)