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Cardinal Quarterly

Market Outlook

BY EVAN MANCER, CFA

Markets are off to a good start in 2021. Although most developed market indices have already achieved high single-digit returns in the first quarter, we believe there is still room to run higher in 2021. In fact, we cannot recall a year when so many factors were aligned for explosive GDP growth. Stimulus spending has remained at record highs, interest rates are near record lows, and consumers sitting on record savings are full of pent-up demand. Also, businesses are frantically ramping up spending in anticipation of higher demand and to replenish inventory levels that were cut last year.

Value stocks have been coming back nicely and closing the performance gap with growth stocks in the first quarter. We continue to believe that value stocks will outperform the overall market over the next couple of years based on the combination of recovering valuations, a strong economy, and increasing inflation.

One-year returns have been excellent, with most markets up between 40% to 55% from March 31, 2020. This appreciation means that most markets are now above pre-pandemic highs. In the first quarter of 2021, the German DAX-30 and the French CAC-40 were the strongest markets, up 9.4% and 8.7% respectively. The S&P TSX in Canada and Japanese Nikkei-100 were not far behind with returns of 8.1% and 7.0%. The weakest markets were the Brexit hit FTSE-100 in the UK and the Australian ASX-100, up 3.4% and 2.8%.

One of the questions that we hear regularly from clients is whether the market can continue going higher given that the overall market is trading at such high valuation levels. Our view is that average market valuations have been skewed upwards by the excessive valuations of a few large technology companies. Beneath the surface, there are many high-quality companies that trade at reasonable valuations.

For instance, despite the positive attention that the pharmaceutical industry has received from developing vaccines so

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CARDINAL CAPITAL MANAGEMENT, INC.

quickly, most pharma companies trade near record low valuations. Merck, one of the companies in our client portfolios, has roughly doubled its earnings in the past six years on the strength of its incredible cancer drug, Keytruda, which has been dubbed a pipeline in a bottle due to the steady stream of new cancer indications it has been getting approved for. Keytruda's patent does not expire for another seven or eight years and the company has a strong portfolio of new and growing drugs that should fuel double-digit earnings growth for years to come. Merck also enjoys a rock-solid balance sheet, pays a growing 3.5% dividend yield, and is largely recession proof (profits increased 15% in 2020). Despite these attributes, Merck trades at just 11.5 times earnings, barely more than half of the broader market earnings multiple. We own many high-quality companies like Merck that have been growing earnings and dividends but still trade at reasonable valuations.

The biggest growth driver for the economy has been the incredible stimulus spending from governments around the world, now well over $13 trillion as measured by excess government deficits. The U.S. alone recently passed a $1.9 trillion stimulus bill, and the Biden administration is currently pushing for another $2.3 trillion infrastructure stimulus bill. While there is some debate about whether this amount is too high, there is still bipartisan support for more stimulus spending.

This political sentiment is echoed in governments across the world, including in Canada. In fact, deliberation on fiscal responsibility is unlikely until the labour market gets back to full employment, meaning 4% unemployment in the U.S. and 6% in Canada. This would mean a 2% decline from current levels and probably will not be achieved until closer to the end of 2021.

Ultimately, we expect this combination of deficit spending and a strong economy to lead to higher inflation. The most recent numbers in the U.S. showed 2.6% year-over-year inflation growth to March 31st of 2021. The inflation target for the Federal Reserve is 2%, but Central Bankers have been clear that they will not raise rates until some time after this target is breached.

Even as vaccines have been rolling out across the world, new Covid cases have entered a third wave as faster growing variants have emerged and countries like India, Brazil and Turkey have seen caseloads spike. In addition, there have been questions raised about rare instances of blood clotting with the Astra Zeneca and Johnson and Johnson vaccines.

Nevertheless, we believe that the chance of Covid causing another bear market is decreasing. This is because overall, the global vaccine rollout is going faster than expected. The U.S., optimistically targeted a million vaccinations a day just a couple months ago. They are now over 3 million per day, with over 35% of the population having received at least one shot. In Israel, over 60% of the population has been vaccinated and the country has quickly gone from having one of the world's highest caseloads to a negligible level. Based on current daily vaccination rates, the U.S. should reach Israel's level in less than two months. Canada has lagged other countries but should catch up quickly once the U.S. has reached the 60% level.

Oil prices ended the quarter just under $60, almost triple the level of a year ago and up 22% from the start of the year. We continue to believe that an oil price spike to $70 is likely but will be short-lived as both OPEC and the shale industry still have excess capacity and could easily flood the market with new supply.

The Loonie was relatively flat from the start of the year, declining slightly to just below $0.80. Given that oil prices have moved up strongly from the start of the year, and U.S. deficit spending has been even greater than expected, we are gaining conviction that the Loonie should reach $0.85 before the end of 2021.

Cardinal Research: CIBC RETAIL AND CONSUMER CONFERENCE

BY DAVID AIME, CFA

We recently attended the CIBC Retail and Consumer Conference which was held virtually this year. Empire, Canadian Tire, and Saputo highlighted the Cardinal portfolio holdings in attendance and the conference consisted of company presentations and meetings with senior management. The accelerated shift to e-commerce and stickiness of new consumer spending patterns were two themes noted by most companies presenting at the event.

The grocers have been beneficiaries during the pandemic as restaurants closed and people were forced to eat at home. Empire (EMP) has been aided by this shift and has also taken market share via strong supply chain execution and continuous progress on its 3-year strategic plan. EMP's new online offering, Voila, has been operational in the Greater Toronto Area for 9 months and continues to grow its sales week-over-week. Voila is a grocery delivery offering which utilizes automated fulfillment centers and additional facilities will be built in Montreal, Calgary, and British Columbia. EMP's management believes that a portion of the shift away from restaurant eating will be retained as working from home becomes a long-term option for some of the workforce.

Prior to the pandemic, Canadian Tire's (CTC) e-commerce offering had been slow to develop and there were concerns that it was only a matter of time before CTC began losing market share to

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Investment Q&A

When will we see capital restrictions lifted on U.S. and Canadian banks?

The COVID-19 health crisis created a great deal of uncertainty early on, as there was no recent precedent to map out the path of the sudden recession. To preserve the safety and soundness of the financial system, OSFI in Canada and the Federal Reserve in the U.S. relaxed regulatory capital rules, and restricted buybacks and dividends.

Fast forward to today and financial institutions in Canada and U.S. have outperformed all expectations and exited 2020 with higher capital levels than going into the pandemic. As a result, the Federal Reserve recently announced that it would be lifting their capital restrictions as of June 30, 2021 – having previously had a soft lifting of restrictions which permitted buyback activity in Q1 2021 – in conjunction with the annual stress tests. While in Canada no announcement has officially been made by OSFI, we believe they will follow suit with a lifting of restrictions in Q3 or Q4 of 2021 that will permit buybacks and dividend increases.

Given bank capital levels are sitting at large excess positions and profitability has not been permanently impaired by the effects of the health crisis, we expect some catch-up dividend increases for the U.S. banks and Canadian financials. For the Canadian banks and insurers, this translates into an expectation for mid-single-digit to low-teen increases in annual dividends, while U.S. banks should see low-double digit to high-teens increases to annual dividends.

BY ROBERT LAM, CA, CPA, CFA

Is the rotation into value occurring in the technology sector?

Company X has tripled its revenues and earnings over the last three years. It is the market leader in software and equipment that facilitates the growth in Internet traffic. In the coming 20 years, its earnings will compound over 9%/year and be 6x higher. Should you buy this stock?

The answer turned out to be "No". Company X is Cisco. Its stock price started the year 2000 at \$53 and peaked at \$80. Its current price is ~\$51. Since the tech bubble burst, Cisco's P/E ratio declined from 53x-80x to as low as 9x and is currently ~15x. While the company went on to do very well, growth has slowed as technology evolved and competitors were attracted into the space.

Markets can be heavily driven by narratives: if a company is exposed to a growth trend, then investors buy it regardless of valuation. We see this form of investing as dangerous as it ignores nuanced views of competition, long-term economics, and valuation. While this has been frustrating given our value philosophy, we also know that over the long-term water finds its level, and the Cisco story is a good reminder that valuation matters.

The vaccine news in November triggered a rotation in the markets back to companies that have low valuations. We are seeing it in the relative performance of our technology holdings. For example, on October 31, 2020 work from home winner, Zoom, was trading at 175x forward P/E. Since then, shares have declined 30%. On the other hand, Oracle was trading at 13x P/E and is up 26%. Cisco was trading at 12x P/E and is up 45%. Intel was trading at 10x P/E and is up 47%. Lastly, there is Applied Materials which is the holy grail of both growth and value. It was trading at 13x P/E and is up 127%.

BY JEFF RANCE, CFA

online retailers. Despite a few hiccups early on, CTC was able to accelerate the development of its e-commerce platform as it rolled out a curbside pickup offering and made significant improvements to its website and app. Curbside pickup has been a huge success. The Canadian Tire retail store network puts \$3 billion of inventory and millions of square feet of store warehouse space within a 10-minute drive for 90% of all Canadians. CTC is equipped to handle over 100,000 online orders per day compared to its pre-COVID infrastructure that could process a mere 5,000. CTC's management believes that spending on the home will remain elevated as people continue to work from home.

Saputo (SAP) has faced significant pandemic-related operating challenges in its foodservice business, which primarily serves the restaurant and hospitality industries. The retail business, which serves the grocery industry, has experienced unprecedented demand and SAP had to optimize its manufacturing network to ensure it could fill these heightened orders. SAP recently developed a direct-to-consumer offering called The Saputo Fridge where limited shelf-life products are available online at discounted prices. This new offering has been popular in Quebec and Ontario and is now being rolled out across Canada. While SAP continues to view the long-term prospects of the dairy industry positively, it has also begun co-packing plant-based beverages for retailers and brands and is committed to being a leader in the plant-based cheese alternative space.

Overall, the conference provided a great opportunity to hear from and meet with a number of current and prospective Cardinal holdings.

CARDINAL NEWS

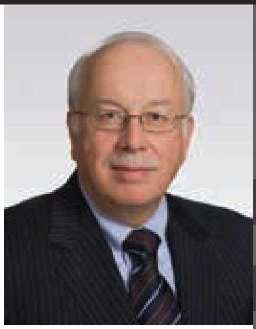
We welcomed a new team member to our Brandon office in March. A huge welcome to Tracy Baker, who came to us from IG Private Wealth. Tracy has over 25 years of experience in financial services.

A warm welcome to our newest IT staff member, Ryan Strong, who has joined as our Systems Expert. Also in Winnipeg we welcomed Sandy Malech to the team on a term basis as an Executive Assistant. In Calgary, Jessie Seigler joined the team as their new Client Services Manager.

On March 31st, our founder and original Cardinal, Tim Burt, flew off into the sunset of his retirement after a successful career in the industry. The Cardinal family would not exist without him, and we look forward to a day where we can celebrate his accomplishments properly and hope that a big retirement bash can be planned for 2022, in conjunction with the firm's 30th anniversary party. On behalf of the entire Cardinal family, good luck and enjoy a well deserved retirement Tim!

Founder's Farewell

BY TIMOTHY E. BURT, CFA

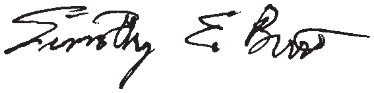


Almost 29 years ago, I started Cardinal at the age of 42, because I wanted to be in charge of my own destiny and I didn't want to be forced into early retirement before I was ready. I knew that working for the big banks, insurance companies and brokerage firms would all force me into retirement by the age of 62, if not even earlier. I loved the investment business and I didn't plan to retire until I had close to 50 years of service. After 47 years in my career and in the midst of the Covid-19 pandemic, I decided that the time was now right.

Cardinal has never been stronger or better positioned than it is today. With 68 employees working out of 4 offices across Canada, the firm has grown to embody my original visions of a premiere, independent, national firm. With over 2,100 clients residing in nearly all provinces and territories in Canada and across many of the United States, we manage close to $3.5 billion of investments for institutions and families. While the pandemic continues to impact the globe, stock markets are at record highs and there is no bear market on the horizon. I feel that this is as good a time as any to leave the business in the capable hands that have been managing it well for several years now.

The investment philosophy at Cardinal will continue to focus on a conservative, disciplined, value-oriented approach where we seek out stocks that have a history of paying and growing their dividends. We have always held the strong belief that stocks will out-perform all other asset classes in the long-run and that portfolios with dividend-growth oriented stocks can offer excellent long-term performance. For those that are retired or others that will someday retire, there really is no better way to get an inflation protected stream of income. We have certainly proven that over the last 28 years. I look forward to watching the dividend stream in my own retirement portfolio continue to grow for years to come.

Thank-you for putting your trust in me and in Cardinal. It has been an honour to serve you all.



DIVIDENDS

CANADA	% Increase
Allied Properties REIT	3.1%
Canadian National Railway	7.0%
TC Energy	7.8%
U.S.A	
Comcast	8.7%
Intel	5.3%
Cisco Systems	2.8%
Deere & Co	18.4%
Gilead Sciences	4.4%
Applied Materials	9.1%
Oracle	33.3%
INTERNATIONAL	
Novartis	1.7%
Roche Holding	1.1%
SAP SE	17.1%
Unilever	4.0%
Enel SpA	9.1%