Cardinal Quarterly

VOLUME 27 · ISSUE 2 · APRIL 2022

Market Outlook

BY EVAN MANCER, CFA

Geopolitical and economic developments were mostly negative in the first quarter of 2022. Russia's invasion of Ukraine has no clear end in sight and China's COVID lockdowns in major cities such as Shanghai have slowed the world's second-biggest economy, lowering global GDP. Inflation has continued to surge, creating expectations for further interest rate increases from central banks.

As a result of these concerns, most developed market indices fell in the first quarter. Only the S&P/TSX in Canada and the FTSE 100 in the U.K. were positive, increasing 3.8% and 1.2%, respectively. The next best-performing markets were the Japanese Nikkei 225 and the Australian ASX 200, which were down -2.5% and -2.7%. The worst performers were the German DAX 30, the French CAC 40 and the S&P 500 in the U.S., falling -10.8%, -8.8% and -4.6%.

Despite the recent negative developments, we continue to believe that 2022 will be a decent year for global stock markets. While the war in Ukraine has cast a pall of uncertainty on the investment horizon, we try to keep the big picture in mind. Over the past century, very few geopolitical events have had a lasting impact on stock markets. During the current crisis, both the S&P/TSX and the S&P 500 have moved higher since Russian tanks crossed the Ukrainian border on Feb. 24. Although coverage of the war dominates much of what we read in daily newspapers, it's important to remember that Russia and Ukraine combined account for just 1.5% of the global economy and an even lower percentage of the global stock market.

China's strict lockdowns became the model for most of the world through much of the pandemic. But today, with the faster-spreading but less-severe Omnicron variant, China's strategy is under scrutiny as it continues to shut down major cities while Western countries are open for business. We can't predict China's healthcare policies, but on the economic front, we believe China will follow the Western playbook of lowering interest rates and increasing government spending to keep its economy growing.

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Our biggest worry is inflation, now near eight per cent in the U.S. and six per cent in Canada — high enough that central banks are forced to deal with it. We now expect more rapid interest rate increases on both sides of the border. Also, the Federal Reserve in the U.S. recently committed to reduce its massive bond holdings. This has caused the 10-year treasury bond to move above 2.6%, a full percentage point higher than at the start of the year.

There's no question that central banks face a difficult challenge, balancing higher interest rates to curb inflation but not high enough that they'd cause a recession. (Historically, they've overshot and caused recessions.) We believe that the hot economy will not begin to cool until rates get closer to 4.0% on the 10-year bond and 3.5% on shorter-term rates.

Most of our confidence is based on consumer spending making up more than two-thirds of GDP in North America and Europe. Consumers are in excellent shape. In addition to the huge stockpiles of cash that they've built up from government stimulus programs during the pandemic, the jobs market has rarely been stronger. Unemployment is back near record lows in Canada and the U.S. and there are nearly twice as many job openings as there are job seekers, the highest ratio in 70 years. The odds of a sudden shock in employment seems low. Companies that cut employees during the 2020 downturn have struggled with being short-staffed ever since and will be loath to do it again unless there is a major external shock. Also, rising home and stock prices will tempt many consumers to increase their personal borrowing. Banks have high capital levels and are eager to lend.

Business spending should remain strong as well. The shortages of the last two years, combined with the war in Ukraine, have caused many companies to rethink their approach to inventory and suppliers. In the past, the most popular strategy was to stay lean and find the cheapest supplier. The latest approach is to build a buffer of inventory and ensure suppliers are from trusted countries. We believe that this new strategy will keep business spending strong into 2023.

The upcoming corporate earnings season should be interesting. Given the rising costs of labour and supply chain inputs, companies were cautious when providing their 2022 outlooks. We expect first quarter results will show that companies have been able to increase prices with little resistance from consumers. The challenge with inflation, however, is that even as companies increase prices to offset higher costs, profit margins can get squeezed if companies are constantly playing catch-up as their price increases lag behind the rising costs.

Oil prices ended the quarter at just over $100 per barrel, just a few weeks after reaching a high of $124 per barrel. Russia and Ukraine play a much larger role in commodity markets. Russia for example, is the second-largest oil producing country, trailing only the U.S., and already the war and sanctions are reducing Russian supply.

While oil prices will remain volatile in the short term, we expect them to be much lower in a year. Both OPEC and U.S. shale companies can increase supply, but thus far have declined to do so. Our view is that with oil trading near $100 per barrel, the opportunity for outsized profits will become too tempting and oil production will begin to increase, pushing prices back toward the $70 per barrel level.

The loonie ended the quarter slightly above US$0.80, a level we still believe is too low. From 2011 to 2013, the last time that oil prices traded in the $100 range, the loonie was generally at par or above the US greenback. Of course, much has changed since then and there is a reasonable argument that the loonie should not be as strongly linked to oil prices as it was a decade ago. For example, the U.S. has more than doubled its own production of oil since 2011, making it less dependent on imports. Crude oil is still Canada's largest export – by far – and we don't think it makes sense that the loonie is trading at the same price as three years ago, when the price of a barrel of oil was about $50.

Investment Q&A

Q: With oil prices skyrocketing, why isn't the loonie appreciating more against the U.S. dollar?

A: The Canadian dollar is sometimes referred to as a "petro" currency because its value often rises when oil prices increase. Oil, however, is far from the only factor influencing the loonie. Others include interest rates, inflation, trade flows, sovereign debt loads and economic outlooks. With so many factors at play – don't forget exchange rates are relative to the currencies of other countries – predicting future exchange rates is one of the trickiest things to do.

Let's explore a few of the factors.

- Interest rate differentials, also known as the difference between interest rates in two countries. Investors are attracted to countries with higher interest rates, so foreign money flows into that country's currency, driving up its value. The U.S. had the edge on higher interest rates until recently.
- When oil prices are high, Canadian oil producers bring in more revenue. Because Canada is a net exporter of oil, which is priced in U.S. dollars, the value of Canada's exports rises and the extra U.S. dollars are converted to Canadian dollars, pushing up the loonie's value.
- Foreign investors may also be attracted to Canada's energy sector, meaning more demand for Canadian dollars. In general, as net exports of Canadian goods and services increase, the Canadian dollar benefits. But there's a sweet spot here – if the loonie appreciates too much, our goods become relatively expensive and exports decline.
- In times of conflict, money flows to safe havens, such as the U.S. dollar. We've seen that during Russia's invasion of Ukraine. While the Canadian dollar benefited from higher oil prices, it was held back by a flight to safety south of the border and higher U.S. interest rates.

– SHEILA WILSON-KOWAL, CFA

In Memoriam

Our Cardinal family mourns the loss of one of our dearest members, Kate McNeil. Kate waged a brave battle with cancer for the past year. Her sense of humor was second to none and she was as compassionate as she was funny. Even when she was sick, she consistently found the silver lining to keep pushing forward. We will never forget the impact she made on all of our lives and wonder how the office will manage to run without her.

We love you dearly Kate and will miss you every day!

Cardinal Rule No. 8:

AVOID MARKET TIMING

BY GEOFF KIRBYSON, MBA

Everybody wants to buy low and sell high but how are you supposed to do that if the market churns out positive returns each year?

Answer: You can't.

But that doesn't mean investors haven't been trying to time the market ever since, well, ever.

Sure, the market doesn't rise in a straight line and there are ups and downs along the way, but for decades, North American stock markets have returned about 10 per cent annually.

Jumping in and out might be feasible if stock markets acted rationally all the time. But they don't. They've been described as irrational, emotional and with the psychology of a mob.

With those character traits, it's amazing that any of us put our money in the market at all.

Let's not forget, it was only a few months ago that Peloton saw its shares plummet after a fictional television character had a heart attack and died. The actor, of course, was fine.

You might also be successful using a market timing strategy if you had loads of investing experience and did nothing all day but watch stock tickers and read earnings reports.

Oh, you'd also need to predict geo-political events around the globe, too. You know, so you could have sold on February 24, shortly before Russia invaded Ukraine, an attack that sent markets down to their lowest level in nine months?

So, you'd have to spend all of your waking hours in a high-stress environment while at the mercy of an irrational, emotional mob. What could second prize be?

Let's think about things in sporting terms for a moment. If you want to be a great golfer, you'd emulate what the world's greatest golfers do, right? You'd watch videos of Tiger Woods' drive and Brooke Henderson's short game. You might even watch the mini-golf scene in *Happy Gilmore*. (It's all in the hips.)

You certainly won't go down to the local driving range and take notes on those hackers.

So, why wouldn't you do the same with your investments?

We've all heard of Warren Buffett, the world's most famous investor. The Oracle of Omaha is worth more than USD$125 billion. His advice? Don't watch the market closely.

"The money is made in investments by investing," he said a few years ago. "And by owning good companies for long periods of time. If you buy good companies, buy them over time, you're going to do fine 10, 20 and 30 years from now."

Cardinal has long advocated a buy-and-hold strategy. Market timing is effectively the exact opposite of that.

So, what should you do if you can't time the market? Simple. Buy a diversified group of high-quality, dividend-paying stocks and hold them. And hold them. And hold them some more.

We might not be able to golf like the world's best but we can invest like them.

Energy Q&A

BY JEFF RANCE, CFA

Q: Why are prices at the pump so high even though Canada produces its own oil?

A: Crude oil and refined products follow global pricing because of their fungibility and transportability. There is a global infrastructure of storage tanks, pipelines, rail cars, trucks, barges and tankers that move millions of barrels around the world daily. Trading operations of major oil producers, refiners, and marketers buy products where they are cheapest and move them to markets where they can make the highest profits. It's the invisible hand of the free market, balancing supply and demand.

Q: Will pipelines get more support in the future?

A: Our extensive, high-functioning pipeline system in North America ensures a steady supply, lower prices and domestic production growth of oil and natural gas. We believe the current geopolitical crisis highlights the value of this critical and often misunderstood infrastructure. Building pipelines to facilitate the export of Canadian oil sands is not a black and white issue. It is a more carbon-intensive source of oil, has a multi-decade reserve life and is located in a democratic country with a strong rule of law and extensive regulations. That's the devil we know. We hope this helps remove barriers to oil pipeline construction, but we believe it's unlikely that a brand-new pipeline, such as KeystoneXL, will be built. We see our three pipeline holdings benefiting from the expansion of their existing infrastructure.

Q: Are there opportunities in natural gas?

A: Unlike oil, natural gas is more difficult to transport. Before being loaded on a tanker, it's cooled to -160 degrees Celsius to create liquefied natural gas (LNG). LNG infrastructure is only a fraction of oil export infrastructure. Natural gas is still primarily a domestic market, as European prices are currently five times higher than in North America. The demand for LNG exports from North America is growing quickly, led by U.S. Gulf Coast infrastructure. The war in Ukraine will result in a bigger push for the continued expansion of export terminals to supply Europe, lessening its dependence on Russian imports. In Canada, our first LNG export terminal, LNG Canada, is expected to be completed in 2025.

Cardinal Research:

CANADIAN TIRE

BY DAVID AIME, CFA

Canadian Tire is celebrating its centennial and its performance during the COVID-19 pandemic suggests the company is more relevant than ever with consumers.

E-commerce was supposed to be the death of traditional retailers like Canadian Tire. Instead, it has evolved its business model by investing in its e-commerce capabilities and rolling out new options such as "buy online, pick up in-store." The company generated about $2 billion of e-commerce revenue in 2021, which makes it one of the largest e-commerce companies in Canada.

Sales from its own in-house brands, including Motomaster, Mastercraft, Noma and Yardworks, make up nearly 40 per cent of total sales at Canadian Tire stores. In fact, each of its nine in-house brands generated more than $100 million in sales last year.

Another five brands, including Woods, Paderno, and Raleigh, have the potential to hit $100 million by 2025, just three years from now.

Not only do in-house brands contribute to a differentiated product offering but they also come with significantly higher profit margins. Selling its own brands was a significant advantage during the first two years of the pandemic as it gave Canadian Tire strong visibility across its supply chain during a time of great volatility and uncertainty.

The company's loyalty program, Triangle Rewards, is a key growth driver as it arms the company with detailed consumer data as well as the ability to offer personalized promotions. Last year, 2.4 million Canadians joined Triangle, boosting the company's total loyalty members up to 11 million. For context, there are 14 million households and 31 million adults across Canada.

Triangle Rewards members spend an average of 75 per cent more per year than non-members at Canadian Tire stores. Just as importantly, the loyalty program also drives the adoption of the Canadian Tire credit card. These 2.2 million credit card holders contribute even more to the company's coffers, spending 50 per cent more than Triangle Rewards members.

Although there was likely some acceleration of goods sold during the pandemic lockdowns, we do not believe this is reflected in Canadian Tire's current valuation. The share price is only slightly above 2018 levels, when the company was generating earnings per share of $13.

The company earned $18.91 per share in 2021 and it recently put out a target of $26 per share that it believes can be reached by 2025. We expect the key market share drivers over the next four years to be Triangle Rewards and continued investment in both the digital offering and store footprint.

We believe Canadian Tire is an attractive investment that is not getting its due for the recent improvements it has made as a retailer. Its dividend yield is 2.7% today and we believe the company should be able to increase its dividend by double digits annually over the next few years.

Cardinal News

We would like to extend a warm welcome to three new team members at Cardinal.

Taryn Leblond has joined our Toronto office, coming to us from Leon Frazer & Associates. We know that the Toronto team and clients are thrilled to be working with Taryn once again.

Ola Alli-Oke has joined our Winnipeg office as our newest Systems Expert, bringing with him 10 years of technical expertise.

Jenny Wildeman is our new receptionist at head office. Most recently at Remax, she is our director of first impressions both in-person and on the phone.

We also have a few people who have taken on new positions.

Juanita Gielen, our long-time receptionist extraordinaire, has taken on the role of Office Manager and Executive Assistant; Jodee McIntosh is our first-ever Manager of Training and Development; and Hannah Watts is moving from our Client Service team to fill Jodee's previous post as Business Development Assistant to Emily Burt and Leanne Thiessen.

Congratulations to you all on your new appointments!

DIVIDEND INCREASES:

	Q1 – 2022
CANADA	
Canadian National Railway	19.1%
Intact Financial	9.9%
Boardwalk REIT	8.0%
TC Energy	3.4%
Allied Properties REIT	2.9%
U.S.	
Wells Fargo	25.0%
Applied Materials	8.3%
Comcast	8.0%
Digital Realty Trust	5.2%
Gilead Sciences	2.8%
Cisco Systems	2.7%
INTERNATIONAL	
Enel Spa	6.1%
SAP	5.1%
Iberdrola	4.8%
Novartis	3.3%
Roche Holding	2.2%