Cardinal Quarterly

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June 2022 Market Outlook

BY EVAN MANCER, CFA

The first six months of 2022 was the worst start to a year for stock markets in the past half-century. Clearly, the war in Ukraine and Covid lockdowns in China have not helped.

The greatest concern, however, is that central banks will raise interest rates too high and cause a recession as they combat inflation. Judging by the plummeting prices of economically-sensitive stocks, such as Paypal and Shopify, the market is now pricing in a high probability of a recession within the next year.

All major markets fell in the second quarter. The best performers were the FTSE 100, the Japanese Nikkei 225 and the French CAC 40, down -3.8%, -5.0% and -8.9% respectively. The German DAX 30 was next, down -11.3%. However, because currencies in the U.K., Japan and Europe all fell about 10 per cent in the quarter, the actual performance for North American investors feels much worse. Excluding currency effects, the S&P 500 and the S&P/TSX were the worst performing markets, down -16.1% and -13.9%.

Historically, recessions occur every four to five years on average, so it's a matter of "when" one will occur, not "if." Therefore, our advice is for investors to focus less on predicting economic ups and downs and more on finding an investment approach they can stick with through thick and thin. The Cardinal philosophy keeps us invested in solid and predictable companies that have demonstrated an ability to not only survive recessions, but to thrive by continuing to raise dividends all the way through. Over the long term, recessions can actually be good for strong companies as weaker competitors are forced out of business.

We believe investors will look back a year from now at today's discounted valuations and see it was a buying opportunity, rather than a reason to panic. First, the Fed likely wants to increase rates as quickly as possible in the hope of not only controlling inflation but to avoid having to raise rates during the politically-sensitive U.S. mid-term elections in November. Today's tough talk on interest rate increases could easily soften in the coming months.

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Cardinal CAPITAL MANAGEMENT 30 YEARS

More importantly, inflation appears likely to drop below five per cent by September or October, enabling central banks to pause or slow interest rate hikes. Some factors that have driven inflation recently are turning around, too. For example, commodity prices skyrocketed in 2021 and early 2022, but have fallen recently with iron ore and lumber down more than 50 per cent from their highs. Copper and oil are both down more than 20 per cent and global freight costs have fallen sharply, too.

Other inflationary forces appear set to at least ease if not fall. Automobiles were responsible for nearly one-third of overall inflation last year, thanks to a 30 per cent increase in used car prices. This is unlikely to reoccur next year because the semi-conductor shortage that plagued new car production appears to be easing.

In retail, 2022 may even mark the return of summer sales. Both Walmart and Target have announced they will discount prices to blow out excess inventory. Many other retailers that sell electronics and consumer appliances are expected to follow suit.

The biggest driver of the economy is still jobs and the employment market remains strong. The harshest recessions occur when companies panic and lay people off, which causes consumers to sit on their wallets. We continue to believe that companies will be reluctant to lay off employees, particularly because it's been so tough to find them over the past two years.

We take comfort that many excellent companies are currently trading at valuations that have already priced in a recession. For example, VF Corp. is a U.S.-based apparel company in our portfolios that owns North Face, Vans and Timberland. The strength of these brands, plus VF's proven skill on the acquisition trail, should allow for an additional 10 per cent growth in earnings and dividends on top of the current dividend yield of 4.5%. So, if VF's valuation relative to its earnings remains the same, the return would be about 14.5% per year.

The company's current valuation is just 13.5 times earnings, far below its historical average of 20. Thus, VF investors would gain another 50 per cent if the valuation simply returns to normal. We own many companies with this kind of upside potential today.

Demand for oil remains strong while supply has yet to increase. Oil ended the quarter at USD$105 per barrel, up from USD$100 three months earlier. Oil prices can be difficult to predict because even a one per cent shift in supply or demand can cause prices to jump 30 per cent or more. We still expect potential profits will become too tempting and oil production will increase. Oil producers have been more cautious about adding production than at any time we can recall. While we expect oil prices to fall from current levels, we believe USD$80 per barrel is a fair price for crude,
up from our previous forecast of USD$70.

The loonie ended the quarter just above 78 cents U.S., slightly below where it was three months ago. When markets fall, investors seeking liquidity typically flock to the U.S. dollar. The greenback usually weakens as markets recover, which we expect this time as well. We believe that the loonie is undervalued considering crude oil is Canada's largest export plus the current state of oil prices. We feel the loonie should be closer to 90 cents U.S.

Fixed Income Update

BY BRETT PURDY, CFA

It has been a tumultuous time in the bond markets through the first half of 2022. Central banks are playing catch-up to stubbornly high inflation by hiking interest rates aggressively and the Canadian bond market has responded with a significant correction.

The 10-year Government of Canada bond yield started the year at 1.42% before more than doubling to hit 3.23% at the 6-month mark. Three-month treasury bill yields rose even more over the same period due to Bank of Canada rate hikes and were about 200 basis points higher at 2.03% by the end of June.

As a result, the yield curve has flattened. Other factors have also contributed to the rise in yields, including widening credit spreads.

The FTSE Canadian Universe Bond Index fell 5.7% in the second quarter and is down a whopping 12.2% since the beginning of the year due to the sharp increase in bond yields. Cardinal has been anticipating higher rates for some time, so we have maintained a significantly lower duration than the benchmark index to mitigate this risk. We hold shorter-term bonds with maturities of less than seven years. As interest rates increase, the decline in price has not been as severe compared to bonds with longer maturities.

This strategy has been successful so far this year as Cardinal bond portfolios have outperformed and haven't been hit as hard as the overall bond market.

Investors will be hard-pressed to remember a time when bond prices have fallen so far so quickly, so it's understandable that many people are nervous about purchasing bonds today with equities also on the decline.

We are comfortable buying and locking in prices for bonds that currently yield more than 4%. Even if yields increase further this year and prices continue to drop, bond investors receive the full face value when the bond matures. All the price movement until then is just noise.

Of course, one of the biggest topics of debate today is whether a recession is on the horizon. Recessions are an inevitable part of the business cycle but the timing is never certain. What we do know is that bonds tend to outperform during recessions as investors seek out a safe haven. This could mean a reversal of this cycle faster than some investors expect.

Bonds provide stability during a recession and help to smooth out equity returns over the full course of the business cycle. For some investors, these qualities also help ensure a good night's sleep!

Investment Q&A

Q: Why has Intact Financial been outperforming other financials?

A: Against a backdrop of rising economic concerns, Intact Financial has outclassed the S&P/TSX Financials Index over the first six months of the year; 12% versus -12%. Despite being classified as a financial company, Intact is much less sensitive to underlying macroeconomic factors – such as rates, equity market performance and economic growth – compared to banks, life insurance providers and asset management companies.

Intact's story starts at home in Canada as the market leader with double the premiums of its closest competitor. This provides advantages in driving positive underwriting outcomes, which are generally some combination of pricing, distribution, risk selection and expense management.

The sheer breadth of data from having more customers and more capabilities to analyze that data gives it a major pricing advantage. Intact has a difficult-to-replicate, multi-channel distribution strategy that includes a directly-owned channel, its own broker network, as well as deep relationships in the independent broker channel. This helps to drive opportunities for consolidation and better product distribution capabilities. Intact's size enables it to bring functions in-house that would otherwise need to be outsourced to smaller competitors. This includes an in-house team of claims adjusters, in-house law firm, in-house investment management, service centres to streamline auto repair claims and a restoration business that provides property repair claims.

Overall, a strong Canadian base and recent expansions into the U.S. and U.K. provide a good balance of defense and offense, making it less sensitive to market turbulence, helping Intact outperform its peers.

– ROBERT LAM CFA, CPA

Q: Why was Cummins added to the portfolios?

A: Cummins is the world's leading manufacturer of diesel engines in commercial trucks, off-highway equipment, Ram pick-up trucks, locomotives and power generation. If you see a delivery truck on the road, there's an excellent chance it's powered by a Cummins engine as it has nearly 90 per cent marketshare in the Class 5 – 7 space.

We believe there is pent-up demand for engines due to supply chain challenges over the past two years plus the need to replace ageing, less-efficient trucks has grown substantially over the same period. Cummins also operates a comprehensive parts business with an extensive distribution network that ensures its engines can be repaired and maintained anywhere in the world.

It also has its eye on the future of electrolyzer technology, which is used to separate hydrogen from water. Cummins believes hydrogen will eventually replace diesel in the long-haul trucking market and is investing in electrolyzers and fuel cells to ensure it will be a market leader for many years to come.

With its strong balance sheet it has been able to raise its dividend every year for the last decade at an average rate of 13.7%. It has an expected yield of 3.0% and has committed to return 50% of its operating cash back to shareholders.

– ZACH ALDERDICE

Cardinal Rule No. 2:

BUY VALUE

BY GEOFF KIRBYSON, MBA

If you can ignore the chaos of a bear market in the U.S., you may realize it's a very good time to be a value investor.

The S&P 500 has lost 21.1 per cent over the first 6 months of the year, putting it officially into bear territory. But there are a significant number of businesses on both sides of the 49th parallel that have been delivering growing revenues and dividends throughout the COVID-19 pandemic.

Many companies in the Cardinal portfolios, such as Scotiabank, have proven their ability to generate free cash flow in times of high inflation, which can provide steady monthly income to investors.

Scotiabank was recently cited by Morningstar Canada as one of the top-yielding stocks in Canada, with a forward dividend yield of 5.4 per cent.

Value stocks were punished severely when the first pandemic lockdowns hit in March 2020. Many digital companies flourished in the new online world while a significant portion of the physical economy was forced to shut down. Compounding the situation for value investors was the Federal Reserve slashing interest rates to near zero to support the economy, prompting many investors to seek returns in higher-risk vehicles. They plowed their money into growth stocks of all kinds, propelling the growth index to a 37 per cent return in 2020. The value index, meanwhile, inched up by 0.1 per cent.

The return of value stocks to investors' good books isn't news to our portfolio manager Terry Wong, who has watched growth stocks outperform their value counterparts for many years.

From 2009 through 2021, the Russell 1000 Value Index beat the Russell 1000 Growth index just twice – in 2012 and 2016 – and lagged behind the other 11 years.

"In the latter half of 2020, we thought value was in the early stages of a multi-year outperformance over growth. The gap between value and growth widened considerably in the fall of 2020 after growth stocks ran up so much after the pandemic started the previous March," he said.

"With valuations on higher-growth, higher-multiple stocks starting to compress, value stocks looked attractive. The outperformance of our Canadian portfolio versus the benchmark is driven by us sticking to our investment philosophy. Today, stocks in the U.S. are showing some extremely attractive prices that fit in our wheelhouse. We're adding to U.S. stocks as we believe that they provide excellent upside to our portfolios."

One such U.S.-based company, Wong says, is Comcast Corp., a Philadelphia-based telecommunications giant, whose shares have become increasingly attractive over the past nine months.

We believe better valuations, rising interest rates and greater attention to corporate fundamentals are supporting a strong return to value investing.

Cardinal Research:

INFLATION NAVIGATION

BY DAVID AIME, CFA

Companies have raised prices considerably over the last two years to offset cost inflation for commodities, labour and logistics. Inflationary pressures have been widespread across most categories with food, energy and housing prices consistently making the headlines.

Inflation, as measured by the Consumer Price Index, rose 8.6% and 7.7% in the U.S. and Canada respectively in May. Companies with pricing power can navigate rampant inflation more easily than those without it.

Some companies have cost offset mechanisms built into customer contracts while others rely on market positioning, industry structure or brand strength to pass along price increases. The Canadian railway companies, Intact Financial and Fortis are examples of Cardinal portfolio holdings that have leveraged their pricing power during this difficult cost environment.

The railroad industry, for example, has been able to increase prices ahead of cost inflation consistently over the long-term, even during the recession of 2008-09 when freight demand fell sharply. The sources of the industry's pricing power are the significant barriers to entry and the fact that most regions have just two options to ship freight by rail. Railway companies use fuel cost adjustment programs to respond to fuel price fluctuations and the surcharges are able to offset the heightened costs, albeit with a bit of a lag.

Intact Financial is the leader in the fragmented Canadian property and casualty insurance industry. Intact's scale provides it with a significant amount of data which it can then use to price its product offerings optimally. Contract pricing is constantly updated to reflect current market conditions and Intact has been able to build inflation into its contracts as they come up for renewal.

Fortis is a regulated utility that has most of its earnings tied to the transmission and distribution of electricity and natural gas. Commodity prices are passed on directly to customers, so Fortis's earnings have been insulated from the surge in natural gas prices. Fortis is also in a position to raise its customers' rates to make up for cost overruns.

These companies are representative of many high-quality businesses in our portfolios that have leveraged their competitive advantages to navigate this challenging period of high inflation.

Cardinal News

Cardinal first spread its wings in August 1992 under founder Tim Burt. This summer we celebrate our 30th anniversary and all that we have accomplished for our clients and our community. We thank all of our staff, business partners and, of course, our clients who have placed their trust in us over the past three decades. We look forward to doing even greater things over the next 30 years.

We have some new faces at our head office. Samantha Kostyniuk has joined as an account administrator. She came to us from the Don Vito Automotive Group, where she was its finance manager.

Karen Guerrero has also recently started in the role of client service administrator. She brings nearly 15 years of experience in the financial industry, most recently as an office administrator at Investia. Welcome to the nest Sam and Karen!

We are also thrilled to welcome Matthew Robinson back to our investment team for the summer. He recently completed a Bachelor of Commerce at the Asper School at the University of Manitoba.

DIVIDEND INCREASES:

	Q2 – 2022
CANADA	
Canadian Tire	25.0%
Suncor Energy	11.9%
Royal Bank of Canada	6.7%
National Bank of Canada	5.7%
Bank of Montreal	4.5%
Sun Life Financial	4.5%
TELUS	3.4%
CIBC	3.1%
Bank of Nova Scotia	3.0%
U.S.	
UnitedHealth Group	13.8%
INTERNATIONAL	
Medtronic	7.9%

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