Cardinal Quarterly

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March 2023 Market Outlook

BY EVAN MANCER, CFA

Despite some surprising bank failures in the U.S. and Europe and another interest rate hike from the U.S. Federal Reserve, most developed market indices moved higher in the first quarter. Inflation, the most important factor, has continued to fall and employment has remained strong. The Chinese economy also looks set to post strong GDP growth now that it has reopened from COVID-19 lockdowns. We continue to remain positive on stock market returns in 2023.

Technology stocks led the way higher in the first quarter with the NASDAQ up 17.1%. All other markets were positive with the next best performance coming from the French CAC and German DAX, up 13.4% and 12.3% respectively. The Japanese Nikkei-100 was behind them at 8.3%. In North America, a higher tech weighting helped lift the S&P 500 by 7.5% versus 4.6% for the Canadian S&P/TSX index. The UK FTSE-100 and the Australian ASX index returned 3.6% and 3.4%.

Overall, the U.S. and global banking industry has become more resilient over the past 15 years. Capital levels are dramatically higher, the use of derivatives has been reduced and many of the riskier trading-related businesses have been eliminated. Of course, these risk controls were based on lessons from yesterday's war.

Today, the problem is higher interest rates, which reduce the value of long-term debt securities that many U.S. banks hold. (Long-term securities holdings are not significant in the Canadian banking system). Theoretically, this negative should be offset by higher interest rates increasing the value of deposits. The U.S. banks that failed had a high proportion of uninsured depositors who worried they may not be covered, causing the bank runs.

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Our large bank holdings in the U.S. have seen an influx of new business as bank customers flock to the safest places to park their money. Regulators have also moved swiftly, implying by their actions that all deposits will be guaranteed, at least during the current turmoil. However, there will certainly be negative effects. Banks will become more cautious with their lending and probably compete harder for deposits. Also, tighter regulations for medium-sized banks are a near certainty. All of this will be a drag on the economy as less lending leads to less spending.

On the other hand, the Fed is trying to engineer an economic slowdown to curb inflation and the banking issues will do some of that job. Recent U.S. figures show that inflation is trending down, falling to 5.0 per cent in March, a far cry from last June's 9.1%. Measuring more recent trends, inflation has averaged 3.6% over the past six months and 3.4% over the last four months. Our view is that interest rate increases are now over for the Fed, which means investors will soon be speculating on when rates will be cut.

China is likely to bounce back this year as one of the world's leading economies and targeting 5 per cent GDP growth. Considering the high level of pent-up demand and a greater focus on the economy, we expect actual growth to be higher. The effect should be a nice boost to the results of many global companies with ties to China.

Employment growth has begun to decelerate in both Canada and the U.S., but there are still plenty of jobs available and more people are joining the workforce every month. Many economists view employment growth as inflationary since more jobs should increase demand. But the flipside to this is that many industries such as construction, airlines, hotels and hospitality do not have enough workers. Thus, we believe that alleviating worker shortages will ultimately increase supply and lower inflation.

Business spending should rebound in the second half of 2023. Many economists and pundits have been calling for a recession for more than a year and business leaders have become cautious, causing inventory levels to fall. If consumer spending trends continue, businesses will have to start spending to meet demand. Unlike central banks, which are applying the brakes to the economy, governments around the world still have a foot firmly on the gas pedal. Much of the government spending lately has been to encourage business investment in industries like semiconductors, electric vehicles and infrastructure.

Oil prices ended the year on the north side of USD$75 per barrel but have since spiked even higher to USD$81 after OPEC announced a cut of one million barrels per day. We were a bit surprised given that oil demand has been growing and more Chinese drivers should be hitting the road this year. But the cut is consistent with a more aggressive stance from OPEC recently on oil prices. In the past, OPEC would not usually cut production until oil fell into the USD$40 range, more recent cuts have occurred with oil above USD$70. In the absence of a recession, we think the odds have gone up that oil will reach USD$100 per barrel this year.

The loonie ended the quarter at USD$0.74, unchanged from the last quarter. We continue to believe that the Canadian dollar should be higher, especially given our strong view on energy prices. The Fed has been more aggressive than the Bank of Canada on interest rate increases but we think it will also be more aggressive on the way down. If the economy dodges a recession this year, we believe the loonie will be above USD$0.80.

Market Review: PROTECTING CLIENT CAPITAL DURING MARKET VOLATILITY

BY CHRIS DANIELS, CIM

Cardinal Capital Management was built on the premise that owning high-quality companies with a long-tested track record of growing earnings and dividends can provide excellent long-term returns for clients and protect their capital during periods of volatility.

Our disciplined investment strategy has a performance history that proves this theory. In fact, all of our investment mandates are designed to operate this way.

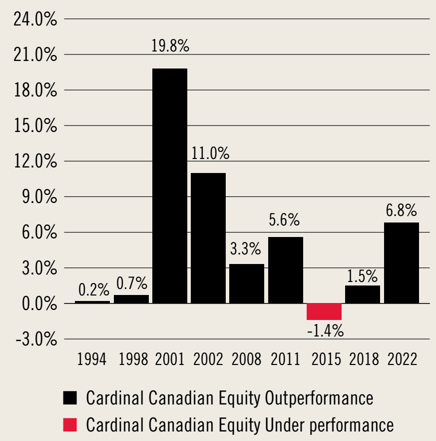
When the S&P/TSX Composite Index has had a negative return in any calendar year, Cardinal's Canadian Equity Composite has performed exceptionally well, offering significant downside protection. Since 1994, there have been nine separate years where the TSX's performance, including dividends, was negative with an average return of -10 per cent.

As you can see from the accompanying graph, Cardinal outperformed the market eight out of nine times with an average outperformance of the TSX of more than six per cent. In other volatile periods, such as the 2001 tech bubble and the 2008 financial crisis, the Cardinal Equity Composite outperformed the market by more than 19 per cent and three per cent, respectively.

Clients can be proud of this track record as it has truly protected on the downside. The main drivers of this outperformance are stock selection and diversification as well as our focus on dividend growth. Over the last 10 years, Cardinal's Canadian equities had an average dividend growth rate of more than 10 per cent. Our disciplined investment philosophy was not only constructed to weather the storms year in and year out, but also provide clients with the comfort of getting paid during challenging market periods.

Cardinal Canadian Equity Annual Gross Alpha when S&P/TSX is Negative

AS OF DECEMBER 31ST



Investment Q&A

Q: Will the U.S. banking crisis impact Cardinal?

A: It was "March Madness" last month not only because of the annual NCAA college basketball tournament south of the border but because of the chaos that reigned in the banking sector in the U.S. and Switzerland.

California-based Silicon Valley Bank saw a run on deposits sparked by reports that a venture capital firm was advising its clients to move money out of the bank. The bad vibrations quickly spread to the east coast where Signature Bank saw $18 billion of withdrawal requests in a single day before it was put into FDIC receivership. Regulators decided to step in before the situation mirrored what happened at SVB. Then across the Atlantic Ocean were the "one too many" scandals of Credit Suisse, which announced that material internal control weaknesses around financial reporting would delay its annual report filing. In the face of the U.S. banking activity and accelerating withdrawals, the Swiss government stepped in and forced a merger with UBS Group.

Here's why we think our Canadian and U.S. bank holdings differ from their counterparts that ran into trouble as well as our thoughts on the current banking crisis:

Starting in Canada, the unique market structure with the domestic oligopoly of six large banks representing more than 80 per cent marketshare creates less divergence in regulation, overall governance and market behaviour. In the U.S., the top six banks hold down about one-quarter of the total market, with the rest spread out among more than 4,000 other competitors.

This means that the funding base for our banks is well diversified and avoids the concentration of customer issues that hurt both SVB and Signature. The stricter regulatory rules around liquidity (from which SVB and Signature were exempt) means that the Canadian banks are prepared to weather one month of stressed customer withdrawal activity. For example, RBC needs to hold enough high-quality liquid assets to cover nearly $300 billion of net cash outflows over a 30-day period. So, when we look at liquidity ratios, capital ratios, deposit composition and investment portfolios, the Canadian banks are much better positioned than either of the banks that failed in the U.S. I have intentionally omitted Credit Suisse from this discussion as while it met similar regulatory requirements, it lost the trust of the public and its depositors through its own actions.

Our focus south of the border is on the larger-cap banks. While they have historically faced greater regulatory scrutiny, which hampered their growth, they have also been better equipped to navigate the current environment. Similar to the situation in Canada, being obligated to meet liquidity and capital minimums that don't apply to smaller regional players has resulted in the larger banks being perceived as bastions of safety and trusted destinations for cash outflows from smaller regional banks. As well, lower concentrations of deposits and investment portfolios mean that large-cap banks will be better insulated from the margin pressures of higher funding costs that the smaller regional banks will inevitably face.

It's unlikely that this ongoing banking turmoil is finished. We take comfort in knowing that most systemic banking crises stem from problematic underwriting that leads to system-wide losses across an asset class. This type of issue is not readily apparent to us right now, which leads us to think that it's more a crisis of confidence and liquidity, which can be more easily addressed through government intervention.

Next, while our holdings are insulated from first order effects, there could still be second order effects that could impact our holdings. We try to incorporate some weakness in margins and higher credit losses to account for this and even under these circumstances, we see current valuations as attractive across most of our coverage universe.

Finally, we continue to focus on dividend-paying, dividend-growing names and we take great comfort in our banks' abilities to continue to maintain and grow their current payouts over time.

So, even though it's possible that the impact of March Madness may linger, we remain confident in our holdings and believe that current weakness represents an opportunity for us to be paid to wait for a recovery in sentiment.

– ROBERT LAM, CPA, CFA

Company Profile

CANADIAN PACIFIC

BY DAVID AIME, CFA

The Canadian Pacific Kansas City era has officially begun.

Canadian Pacific's acquisition of Kansas City Southern was given regulatory approval on March 15 following a two-year review.

The strategic benefits of the USD$31-billion acquisition – the combined company will be known as CPKC for short – are quite clear as it creates a best-in-class network with access to the Pacific and Atlantic coasts, the U.S. Gulf Coast and Mexico. The two companies already share a railyard in Kansas City and their networks fit very well with one another. The localization of supply chains and the U.S.-Mexico-Canada free trade agreement (USMCA) create a favorable environment for companies to make investments in North America, which should benefit CPKC.

Most North American freight is still moved via trucks but there is an opportunity to convert a portion of this to rail. Railroads are four times more fuel efficient than trucks and moving freight by rail instead of truck can reduce greenhouse gas emissions by about 75 per cent. With companies increasingly focused on reducing their environmental footprints, this should help drive freight traffic to railroads.

We have always been impressed with CP's management team. The company has been one of the fastest growers in the industry despite its inferior network. The combination of a top-tier management team and a best-in-class network creates exciting future possibilities for the company.

Cardinal News

We received a double dose of great news recently when we were recognized not only as one of the Top Employers in Manitoba but one of Canada's Top Small & Medium Employers by Mediacorp Canada.

These designations recognize a select number of employers that offer exceptional places to work and we should all be proud of the role we've played in creating such an amazing home away from home.

- After more than 10 years in the Cardinal family, we wish to congratulate Kim Gibson on his retirement. Kim was instrumental in opening our Calgary office, and subsequent growth in Alberta. We appreciate everything you have done for Cardinal and for your clients Kim! We wish you all the best.
- A warm welcome to Jessica Patacz, Client Services Administrator and Khrystyna Los, Client Service Manager who both recently joined our Business Development team in Winnipeg.
- Congratulations to Taryn Page and Dustin Liebrecht on the birth of their first boy, Tage Dane, on Jan. 31.

Cardinal Rule #11: STAY BALANCED

BY GEOFF KIRBYSON, MBA

It's easy to look at the long history of stocks that have gone to the moon and kick yourself for not going all-in when you had the chance.

Remember K-Tel? The Winnipeg-based company made a name for itself in the 1970s and '80s selling compilation albums such as *Goofy Greats, Looney Tunes* and *Mini Pops* as well as must-have household products such as the *Miracle Brush*, the *Patty Stacker* and the *Veg-O-Matic*. Its 30-second TV commercials were seemingly everywhere, particularly late at night, with the popular hook line, "But wait! There's more!"

Then, in the spring of 1998 K-Tel announced plans to sell music over the (gasp!) Internet. Almost immediately, its stock spiked from about US$4 to more than US$30 and a select few people, primarily the founder's family, made a lot of money by selling some of their shares at and around the peak.

A lot of investors piled on the K-Tel stock rocket ship, hoping for a similar windfall. We didn't hear nearly as much about them as K-Tel subsequently plunged to penny-stock status and was eventually delisted from the NASDAQ exchange.

We're reminding you of this rags-to-riches-to-rags story to illustrate Cardinal Rule No. 11 – Stay Balanced.

If you think the performance of certain stocks such as K-Tel, Research In Motion or Zoom was predictable, then you're likely suffering from hindsight bias. The chances of finding the next to-the-moon stock on its own is essentially zero.

Portfolio manager Sheila Wilson-Kowal says investors may favour one company, sector or part of the world, consciously or unconsciously, based on past performance. The Canadian market, for example, is highly concentrated in energy, financials, railways and materials and represents just three per cent of the global investing universe. It can often make sense to look to the U.S. and elsewhere for opportunities in healthcare, technology and industrials.

"Events around the world will happen and significant news flow might prompt questions like, 'should I make a dramatic change to my portfolio?' We never recommend dramatic moves. We might review a sector after events such as Brexit, an unexpected election result or military action but our focus is always on long-term fundamentals," Wilson-Kowal says.

"We recommend our clients stay balanced."

Q1 DIVIDEND INCREASES:

	% Increase
CANADA	
Allied Properties REIT	2.9%
CN Railway	7.8%
Manulife Financial	10.6%
TC Energy	3.3%
Intact Financial	10.0%
CCL Industries	10.4%
Gildan Activewear	10.0%
Boardwalk REIT	8.3%
U.S.	
Comcast	7.4%
Cisco Systems	2.6%
Gilead Sciences	2.7%
Applied Materials	23.1%
Oracle	25.0%
INTERNATIONAL	
NXP Semiconductors	20.0%
Novartis	3.2%
Roche Holding	2.2%
SAP SE	5.0%
Iberdrola	9.1%
Enel	5.3%