Cardinal Quarterly

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MARKET OUTLOOK

The Running of The Bull Market Expands Beyond "The Magnificent Seven"

IT'S NO LONGER ALL ABOUT APPLE, MICROSOFT, AMAZON, ALPHABET, TESLA, META AND NVIDIA

BY EVAN MANCER, CFA

The bull market in equities roared higher in the third quarter with just about every major market index finishing in positive territory. We're not surprised because the combination of falling interest rates and a growing economy tends to be very positive for stocks. We expect both trends to continue over the next year, which should keep the bull market charging.

The stock market rally expanded to more sectors and companies beyond the "Magnificent Seven," which have dominated returns in the U.S. and globally over the past few years. The best-performing index was Canada's S&P/TSX, which was up 10.6% in the quarter, while the Australian ASX 200 and German DAX were next with returns of 7.8% and 6.0%. The weakest markets were the French CAC 40 and Japanese Nikkei 225, returning 2.3% and -3.5%, respectively.

With most markets up more than 25 per cent in the past year, stocks have become more expensive. However, for many sectors, including financials, pipelines and utilities, the upturn has merely resulted in a move from low to normal valuations. The technology sector has been an exception, with many of the companies we own trading at 25 to 30 times earnings, a higher level than we are normally comfortable with. However, we have mostly chosen to maintain our exposure because these companies have excellent growth prospects and are relatively cheap compared to many of their peers with similar outlooks.

The U.S. economy has continued to grow faster than its Canadian counterpart, although both countries are seeing a deceleration in employment. Growth in the U.S. continues to benefit from innovation, with new areas such as AI, creating jobs in many supporting industries. However, the other force supporting growth on both sides of the 49th parallel is government spending, which is less sustainable. Incredibly, Canada's free-spending government looks fiscally responsible compared to our neighbour to the south with a fiscal deficit of -1.3% of GDP versus -6.9% in the U.S.

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The three-year cycle of high inflation appears to be over, with housing costs being the only major sector that remains elevated in Canada and the U.S. In fact, without housing, inflation in both countries is below the central bank target of two per cent with many categories in negative territory. We think this clears the way for both the Bank of Canada and the Federal Reserve to continue lowering rates. Our expectation is the overnight interest rates will fall to about 2.5% by the end of 2025, compared to 4.25% in Canada today and 4.75% in the U.S. This is higher than the near-zero per cent rates we experienced from 2008 to 2018 but would allow the central bank to reach its goal of a neutral level for interest rates.

Further from home, China's economy is suffering from an epic property bust in which it is feeling the effects of decades of overbuilding and high leverage. The government is attempting to walk a fine line of supporting the economy and consumers while not reigniting real estate speculation. Investors were whipsawed in the third quarter by a strong statement of government support that was largely pulled back a couple of weeks later. It's difficult to predict where the Chinese economy is going and we expect this to be a wildcard for the global economy.

Oil prices fell from USD$81.50 per barrel at the end of June to just over USD$68 at the end of the quarter. As usual, there are many offsetting factors. At the top of the list is lower demand, driven by the slowing Chinese economy. (China is typically the biggest global consumer of oil.) Also, there is some fear that a lack of discipline within OPEC will lead to Saudi Arabia flooding the market, which it did in 2014, thereby inflicting pain on its own economy to restore order in OPEC and Western producers. We think that memories of the 2014 cuts, which caused oil prices to fall by more than 60 per cent, give the Saudis the credibility that threats will be sufficient.

On the flipside, we think the likelihood of war between Israel and Iran has increased dramatically. Thus far, Israel has given assurances that it's not planning to strike Iranian oil production. However, as we have seen in other conflicts, the rules can change quickly and unexpectedly.

The loonie rose by a penny in the quarter from USD$0.73 to USD$0.74. Currency traders are most focused on the relative weakness in the Canadian economy and expectations for interest rates. Clearly, the U.S. economy is growing faster than Canada's, but we expect the Fed to be slightly more aggressive with interest rate cuts, given its higher starting point. Overall, we still think the loonie is underpriced.

Disinheriting Canada Revenue Agency

BY JOEL BRAY, CIM, CFP, MFA-P

Philanthropy is often misunderstood, particularly when it comes to planned giving. Contrary to popular belief, planned giving is not about disinheriting your family. Instead, it's about intentionally incorporating charity into your financial planning while minimizing your tax obligations. In Canada, people have three potential beneficiaries when distributing their wealth – family and friends; charity; and the Canada Revenue Agency (CRA). In reality, only two of these need to be chosen. Through careful planning, you can ensure that charity and family benefit, while CRA is minimized.

The federal government understands that it can't support the full extent of social programs and infrastructure needs across the country on its own. This is where private philanthropy steps in and it's why the government offers various incentives for charitable giving. These incentives make it easier for people to contribute to causes they care about while receiving significant financial benefits in return. Our tax system is designed to encourage charitable donations.

One of the lesser-known advantages of planned giving is its potential to reduce taxes, both while you're alive and as part of estate planning. Charitable donations made during your lifetime can mitigate up to 75 per cent of net income and can offset up to 100% of estate taxes at death, both for that year and the previous one. For every $2 donated to charity, the government creates $1 of tax savings, which offers a way to preserve wealth while also benefiting society. This makes planned giving an attractive option for those looking to maximize the impact now and for their estate down the road while minimizing their overall tax burden.

While more than 90 per cent of Canadians make donations through cash, cheques and credit cards, there are more effective ways to give. More sophisticated options, such as donating securities in-kind or using life insurance, can enable people to make significant charitable contributions for pennies on the dollar or even on a cash-neutral basis. These strategies, however, typically require a deeper conversation with a financial advisor to fully understand the options.

Contact your Cardinal advisor to empower your family's legacy of giving and learn more about the Cardinal Foundation, a donor-advised fund that helps you craft impactful philanthropic strategies. This journey is also the perfect opportunity to engage your children and grandchildren in meaningful, multi-generational generosity.

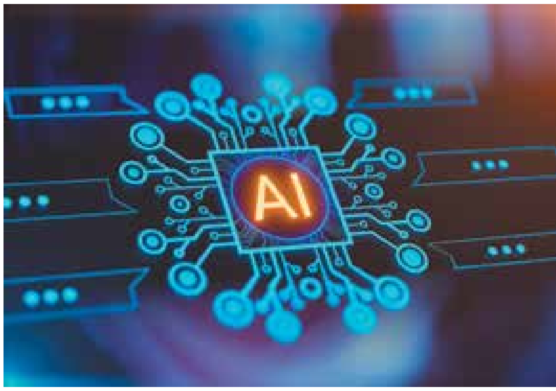
Cardinal News

We're excited to share some wonderful news from our office in Brandon. We welcome Kaia Lynne Cullen, born Sept. 10, 2024. Congratulations to Jake and Kasie as they embark on their new journey into parenthood! We are also pleased to announce that Braden Cancade has joined the team in Brandon as a client service associate. Braden is a recent graduate of Brandon University, where he earned a Bachelor of Arts, and he has also passed the Canadian Securities Course.

CARDINAL RESEARCH

The Rise – and Staying Power – of AI

BY JEFF RANCE, CFA



Artificial Intelligence (AI) continues to make waves in the technology sector and beyond. While some may view it as another passing tech fad, we continue to believe AI is here to stay. It also benefits several companies in our portfolio.

We've seen sustained strong performance from Broadcom, Applied Materials and Oracle, which are well-positioned in the AI ecosystem. Broadcom's expertise in networking silicon and custom chip design for data centres plays a crucial role in the AI infrastructure. Applied Materials provides the essential equipment for manufacturing more efficient and powerful chips needed for AI applications. Oracle, meanwhile, is capitalizing on the demand for specialized data centre infrastructure to support AI model training and deployment.

The pace of advancement in AI models shows no sign of slowing down. As these models scale up with increased computing resources, we're seeing a continuing surge in capital spending from established cloud providers and new market entrants. Since our last AI update in the summer of 2023, this trend has led us to add Equinix to our portfolio, a company we believe stands to benefit from the growing demand for data centre and interconnection services.

The impact of AI, however, is increasingly extending beyond the tech sector. The energy appetite of large AI clusters is monumental, with new AI clusters requiring upwards of one gigawatt of power. That's equal to the electricity needs of a small city. NextEra Energy, the largest wind and solar developer in the nation, is poised to capitalize on the power needs. Similarly, Cummins is seeing accelerated growth in its power systems business, driven by the increased demand for reliable power solutions in data centres.

The next phase of AI will involve wider adoption of its technologies. This broader implementation is needed to justify the substantial investments being made in AI development and infrastructure.

One example from our portfolio that illustrates this potential is T-Mobile US. At the company's recent investor day, it outlined plans to leverage AI to revolutionize its network operations and customer experience. Its goal is to use AI for precision network upgrades to maintain its leadership position and improve the customer experience through preventative measures. T-Mobile's AI-powered digital customer service aims to reduce inbound customer service contacts by 75 per cent.

While these developments are promising, we maintain a measured outlook. The AI landscape is evolving rapidly and it's crucial to assess on an ongoing basis how these advancements may impact our portfolio companies and their long-term prospects. We remain committed to a disciplined investment approach, focusing on companies with strong fundamentals and sustainable competitive advantages that are trading at reasonable valuations.

Do Elections Impact Long-Term Market Returns?

BY SHEILA WILSON-KOWAL, CFA

With the U.S. election around the corner and Canadians going to the voting booth by next October or sooner, political banter and debate is making for plenty of headlines.

Despite the non-stop media coverage, the impact of who wins elections is negligible in both Canada and the U.S. As markets digest and reflect the latest news, there could be some day-to-day volatility attributed to uncertainty over who will occupy the White House or 24 Sussex Drive. But once the dust has settled after election day, equity markets continue to do what they have done over four- and eight-year periods – move higher! Over the long run, equity returns are driven by economic growth and the health of the businesses in which you're invested.

Trying to position investment portfolios for an election outcome is very difficult. In the U.S., you not only need to predict the winner in what's shaping up to be one of the tightest presidential races in history, you also need to forecast if the same party will win control of both the House and Senate.

If not, the political gridlock will continue. (Markets actually prefer the status quo.) Even if you predicted everything correctly, will the markets react as expected? We only have to look back to 2016 when Donald Trump was elected to see that markets don't always behave as we think they will. Leading up to election day, the markets fell whenever Trump pulled ahead in the polls and stock futures plunged the night of his victory. The following day markets actually closed higher.

How does Cardinal position portfolios around elections? We stay invested in high-quality companies with long track records that have grown their businesses through both Republican and Democratic administrations in the U.S. and various iterations of minority and majority governments at the federal level in Canada. These are companies that have demonstrated resiliency and a history of adapting and pivoting to deal with an always-changing environment. We follow political developments as they reflect society's ever-changing values, but as long-term investors, we make decisions based on company fundamentals.

Enjoy the election drama but tune it out when it comes to your portfolio.

Falling Interest Rates and Cardinal's Investment Portfolio

BY ROBERT LAM, CFA, CPA, CA

The Bank of Canada increased its policy rate from 0.25% to 5.00% from March 2022 to July 2023 in an effort to combat high levels of inflation. The speed and magnitude of the increases was unprecedented.

A byproduct of this monetary policy tightening was a number of fixed income alternatives, such as GICs, money market funds and ETFs, as well as high-interest savings vehicles, suddenly went from unattractive to offering attractive yields of more than five per cent. That rivalled dividend yields of Canadian equities, with less tax efficiency, of course.

This led to a surge of funds moving into these income products, particularly fixed-term deposits, at the expense of both everyday chequing account balances and, seemingly, Canadian dividend-yielding equities.

With the Bank of Canada having lowered interest rates by 75 basis points – and counting – since June, we believe that our value-oriented, dividend-focused strategy is well positioned to capture any potential upside from continuing rate cuts.

Here's why: First, the funds invested in these fixed income alternatives are starting to mature and the new reinvestment yields are significantly lower. Defensive, dividend-paying sectors, such as utilities and pipelines, have historically done well in falling rate environments as the attractive, growing dividend payouts and steady earnings profiles attract investment dollars. Companies such as Enbridge, TC Energy and Fortis have done well since rates started falling and we believe they will continue to do well.

Second, Canadian banks should benefit from better operating fundamentals, which should lead to rising share prices. Falling rates tend to be stimulative for the economy as they spur business investment on the commercial side and mortgages among consumers, which can lead to loan growth. As well, lower rates should alleviate some payment pressures on loans, which can help stabilize credit losses. Lastly, as rates fall, there should still be continuing benefit to net interest margins as deposit pricing pressures abate and lagged asset repricing at higher yields continues.

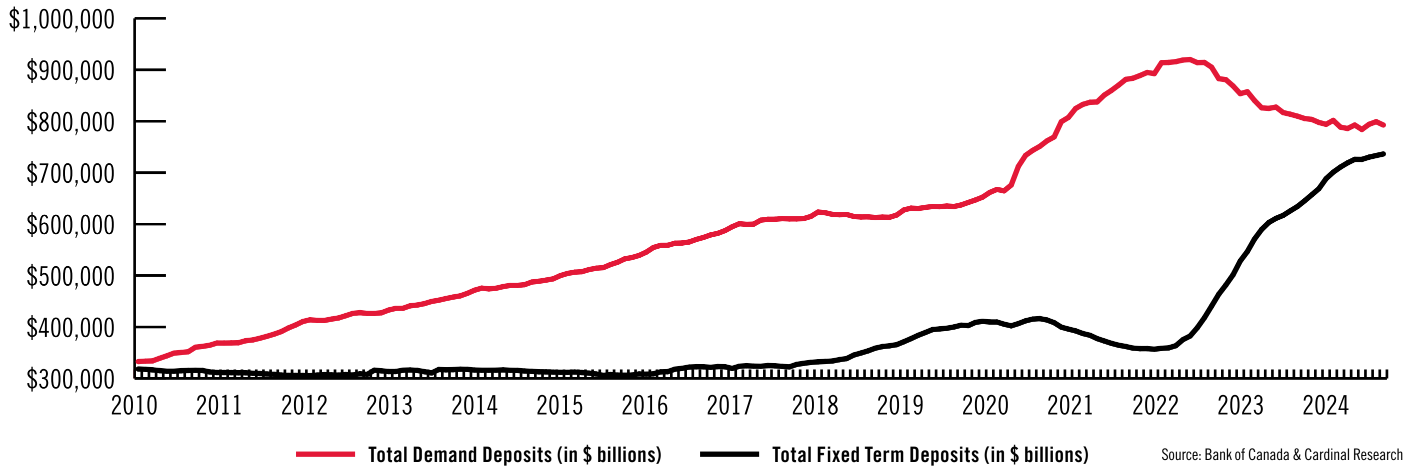
As the Bank of Canada proceeds with rate cuts – Statistics Canada announced that inflation fell to 1.6 per cent in September, raising the probably of a larger rate cut at its next meeting – we believe that the combination of fund flows back into dividend-paying equities and better company operating fundamentals from lower rates should benefit our portfolio.

Q3 DIVIDEND INCREASES:

	% Increase
Canada	
Fortis	4.2%
North West Company	2.6%
Saputo	2.7%
U.S.	
Cummins	8.3%
Honeywell	4.6%
Stanley Black & Decker	1.2%
T-Mobile	35.4%
U.S. Bancorp	2.0%
Wells Fargo	14.3%
INTERNATIONAL	
Sony Group	18.8%
Unilever	3.0%

For the period ended Sept. 30, 2024

BREAK DOWN OF CANADIAN BANKING PERSONAL DEPOSITS



Source: Bank of Canada & Cardinal Research