TD Wealth

Quarterly Market Commentary

December 2018

The recent stock market correction was almost as severe as the 2011 correction when measured on an intraday basis. As in 2011, we consider these lower prices a buying opportunity given our belief that the eventual economic recession is still years away.

The U.S. yield curve is approaching inversion and many investors fear this means that an economic recession is imminent. There can be very long lags between yield curve inversions and an eventual recession, and the associated bear markets in stocks. Of the last eight inversions we studied, the most recent inversion (December 27, 2005) was followed by a bear market that began 21.5 months later. The economy peaked a full two years after the initial inversion (December 2005). There is a widely held belief, which we share, that the very long lead time in the last cycle (between yield curve inversion and economic recession) was because the low 'term premium' was depressing long bond yields. The term premium is a calculation of the extra yield investors demand to lock their funds away in a long-term investment. International funds flowing out of low yield countries (such as Germany and Japan) into the U.S., along with increased structural demand for risk-free assets, has taken the term premium to very low levels. For the 10-year Treasury bond, the Fed estimates the average term premium over the last 25 years has been a bit over 100 basis points. In December 2005 (the last inversion) it was very low, at about 15 basis points. With bond yields depressed, short-term rates rose above long-term yields sooner than would have been the case with an average term premium, so the lead time was extended. Today, the Fed estimates the term premium is ~66 basis points, which suggests the potential for an even longer lead time between yield curve inversion and eventual recession.

We consider the global slowdown in 2018–2019 to be a soft landing, the third in this long expansion. Recessions are typically preceded by rising inflation or significant financial excesses, which are lacking today. With the U.S. economy now finally slowing, we expect the Fed may cancel one or two of its planned 2019 rate hikes. For the first time since the 1930s, the Fed's goal is to help get inflation to rise above its targets in a clear and sustainable fashion. The Fed is not likely to achieve its inflation goals in a slowing U.S. economy, which suggests it may not resume tightening until late 2020, pushing the next recession further out in time.

MK MacDonald Konidis
Total Wealth Management Group

The momentum of global growth peaked early last year and has slowed to a more sustainable growth rate in 2018 and 2019. This slowdown will look particularly modest when compared to the global slowdown that bottomed in early 2016, and yet S&P 500 price-to-earnings multiples have dropped well below the low point seen in that slowdown as investors began to fear recession rather than soft landing.

We remained very active with our trim functions as we continued to take advantage of the market volatility. During the fourth quarter, we trimmed up Premium Brands and NFI Group Inc. and trimmed down Canadian National Railway and Alimentation Couche-Tard. We also added two new positions to the portfolio in the fourth quarter.

BROOKFIELD PROPERTY PARTNERS L.P.

Brookfield Property Partners L.P. is the largest listed real estate company in Canada and owns and operates one of the largest and strongest-quality commercial real estate portfolios in the world. Its portfolio focuses on Core Office and Core Retail properties plus a growing multifamily platform. Brookfield Property provides a global and diversified real estate platform primarily in the United States (~70% of total assets), Western Europe (~15%), Canada (~5%), Australia, and other countries.

We recommend Brookfield Property Partners L.P. for the following reasons:

1. **Best-in-class assets:** Brookfield Property represents one of the strongest-quality real estate portfolios in the world, with landmark properties in Toronto, New York, and London. Its best-known assets include First Canadian Place and Brookfield Place in Toronto, Manhattan West in New York, and Canary Wharf in London. Brookfield has strategically collected this portfolio over the past 25 years, with an intense focus on highly desirable properties in the world's gateway cities.

2. **Top-tier management team:** Brookfield has an unparalleled reputation among owners, operators, and investors in real estate. They have transacted on more properties than anyone globally for over two decades. Their track record demonstrates management's ability: since inception in 2006, Brookfield Property's private equity-like real estate investments have generated an annualized gross internal rate of return of 27%.

3. **Industry-leading growth outlook:** Brookfield forecasts funds from operation and distribution growth of 5%–8% annually, the strongest growth outlook among North American real estate peers. This growth is built on conservative forecasts of same-property rental growth and a compelling development pipeline.

4. **Attractive yield:** Brookfield's yield of 7.5% is the most attractive among peers of high-quality office or retail REITs and built on a reasonable 80% payout ratio of funds from operation.

5. **Deeply discounted valuation:** Brookfield Asset Management has been extremely active purchasing Brookfield Property units due to a record valuation discount and their understanding of its unmatched portfolio quality and growth potential.

BROOKFIELD BUSINESS PARTNERS L.P.

Brookfield Business Partners (BBU or the Company) owns and actively manages a diversified portfolio of public and private equity investments across multiple sectors, geographies and asset classes. It was initially established by Brookfield Asset Management (BAM) in 2001 under the leadership of its current CEO, Cyrus Madon, and since then has generated an enviable 17-year gross IRR of 29%.

BBU is targeting long-term compound annual returns of 15%–20% (versus 29% historically), which is double most equity benchmark return expectations of 7%–10% over a cycle. Importantly, we believe that these market-beating returns should be achieved with less market risk and volatility.

The Company is currently in the process of raising its fifth flagship private equity fund – Brookfield Capital Partners Fund V or "BCP V" – with the help of BAM, which continues to be its largest shareholder (and also happens to be one of the most sophisticated and fastest-growing alternative asset managers in the world). We expect BCP V to close in Q1/2019 with $7 to $10 billion of commitments – significantly larger than Fund IV at $4 billion and Fund III at just $1 billion – which positions BBU for continued success and accelerated growth going forward.

In short, we think that BBU is the ideal way to give investors exposure to private equity and a unique set of opportunities not generally available to the public (without signing multi-year lock-ups), backed by an exceptional management team and a world-class financial sponsor that only "wins" when BBU's stock price goes up. We believe that the existing portfolio, together with new investments made through Fund V, should underpin significant NAV growth and share price appreciation over the near- to medium-term.

Some of the names that we continue to hold and favour include:

ENBRIDGE

The company raised its dividend 10% in the fourth quarter. 2018 was a significant year of execution for Enbridge on a strategic basis. The company was able to monetize $7.8 billion of noncore assets, simplify its corporate structure, and achieve its synergies from the Spectra transaction. Moving forward, we believe that the company should continue on its path to deliver stable and predictable returns to investors under a self-funded model, with a focus on smaller, more executable growth projects.

Enbridge announced several new projects totaling $1.8 billion. The projects include: the Gray Oak Pipeline, a pipeline from the Permian basin to Corpus Christi, where Enbridge will acquire a 22.75% interest for US$600 million; Cheecham Terminal Pipeline, a pipeline and terminal asset connected with Athabasca Oil Corporation's Leismer SAGD oil sands assets, which Enbridge will acquire for $265 million; and $800 million of investment for four gas transmission expansions to be in-service 2020–2023.

Enbridge reaffirmed its 2018 discounted cash flow/share guidance to the upper-end of the range of $4.15-$4.45. The company also reiterated its midpoint discounted cash flow/share of $4.45 for 2019 and $5.00 for 2020. Enbridge is forecasting a 10% dividend hike each in 2019 and 2020.

Over the long term, we believe that Enbridge has a strong competitive position due to its geographic positioning, scale, and diversification. We also believe that Enbridge is positioned well to play a role in North America's growing hydrocarbon export market.

CANADIAN NATIONAL RAILWAY

CN remains our top pick among the Big Five Public Class I rail stocks. We expect the company to enter 2019 with renewed momentum, and the capacity necessary to cost-effectively leverage what we see as the most visible and well-diversified revenue growth pipeline in the group.

NFI GROUP INC.

NFI is generating strong fiscal cash flow currently, and we expect this to continue in the near term, given a stable industry outlook, record backlog, and additional margin enhancement initiatives. Furthermore, management has a demonstrated track record of executing disciplined and accretive mergers and acquisitions, which we believe will continue in the future.

CANADIAN IMPERIAL BANK OF COMMERCE

Our positive outlook on the stock mostly reflects relative valuation in the context of the bank's improving top-line growth, efficiency, and more diversified growth platform. We believe that the market has more than priced in concerns surrounding CIBC's mortgage growth. While mortgage growth continues to slow, stronger margins and expense discipline continue to support good earnings-per-share growth.

NATIONAL BANK OF CANADA

National Bank reported a good quarter and we were pleased to see that the company raised the dividend by 4.8%.

TELUS CORP.

Higher cash taxes in 2019 with no reduction in capex should push fiscal cash flow down temporarily. However, management's confidence in lower capex (starting in 2021) and higher margins in the long term should support continued dividend growth guidance of 7–10%. Its leading industry pace of fibre to the home (FTTH) deployment should position TELUS well for lower costs and 5G effectiveness over the next five years. This, we believe, justifies the current premium valuation for Telus shares when we also consider the consistent track record of lower churn and higher lifetime value for its wireless business.

MAGNA INTERNATIONAL INC.

In our view, Magna is the elite parts supplier under coverage, with a strong balance sheet and a positive fiscal cash flow outlook. Moreover, the company is best positioned operationally to participate in the evolving future of mobility and weather the economic cycle.

Management remains confident in achieving strong fiscal flow generation in 2018 and potentially its approximate $6 billion target for the three-year period ending 2020. If the visibility upon Magna achieving its mid-term fiscal flow target through 2020 improves, that in combination with the share price decline in recent months, would make the risk/reward profile increasingly compelling, in our view.

CANADIAN TIRE CORPORATION, LTD.

The company increased the dividend approximately 15% in the fourth quarter and announced a commitment to repurchase $300 to $400 million of shares through year-end 2019. We view the recent results positively as initiatives invested in by Canadian Tire are clearly paying dividends. Specifically, the Triangle Rewards program is heightening participation in the credit card and loyalty program, and materially increasing customer engagement across the banners. This should be a powerful tool in retaining/expanding customer loyalty in the future, especially as Canadian Tire meshes the loyalty program together with its heightened data analytics capabilities.

Relative to our expectation, the quarter's outperformance was attributable to the Retail segment. This was largely due to a better-than-anticipated contribution from Helly Hansen. However, it was complemented nicely by solid same-store-sales growth across each of the Retail banners.

We continue to view Canadian Tire as one of the more compelling ideas in our coverage universe. The risk/reward profile is further enhanced by the implementation of a more attractive dividend and an ongoing return of capital to shareholders through a material normal course issuer bid.

ALGONQUIN POWER & UTLITIES CORP.

We believe that Algonquin offers a compelling valuation in the context of an extensive growth pipeline that includes development activity, potential acquisitions, rate base investments, and potential international investments via Atlantica Yield and the AAGES joint venture. As the company has diverse investment opportunities, a conservative payout ratio, and manageable leverage, we are comfortable with management's 10% annual dividend growth target.

ROYAL BANK OF CANADA

Royal has consistently delivered superior earnings growth. Over the last 15 years, Royal's adjusted EPS growth has been above the group average 67% of the time. Excluding Royal Bank and TD Bank, Royal Bank's 67% compares with the group average of 37%. We expect this trend to be supported by: a) elevated investment spending in domestic retail over the last three years (points to better operating leverage in 2019); b) good momentum in the U.S. business; and c) the capacity and willingness to repurchase shares.

TRANSCONTINENTAL INC.

We believe that the shares now offer compelling value for investors taking a medium-term view. Transcontinental has a resilient legacy business (emphasizing retailer-related print and plant consolidation), its entry into flexible packaging provides a platform for future growth, and Transcontinental is a strong free-cash flow generator (19% F2019E fiscal cash flow yield), which should allow for steady deleveraging, periodic hikes in dividend, and additional acquisition activity down the road.

COGECO INC.

Cogeco's shares continue to trade at a discount to our Net Asset Value estimate at a time when we think Cogeco Cable's shares themselves are trading at an unjustifiable discount to peers. We expect the discounts to close over time. However, by buying Cogeco shares at current levels, we believe that investors are afforded a double discount. At the Cogeco level, if the current discount persists, we expect the company to remain active in attempting to close the discount itself through continued buybacks. In our view, Cogeco's shares should trade at a premium to Net Asset Value due to the company's multiple voting shares in Cogeco Cable (~82% voting interest).

PREMIUM BRANDS HOLDING CORP.

Although the past quarter did not meet expectation, we still view the bigger picture with a more optimistic lens. The delay in several high-margin sales initiatives had an approximate $40 million impact on Q3/18 revenue and accounted for the entire EBITDA miss. However, it is now confirmed that Premium Brands has picked up significant contract wins, signaling that the demand for its products/services is very strong.

Custom sandwich programs are Premium Brand's competitive advantage, in our view; however, the timing from conception to final production is hard to predict. Management has said that several big program launches are imminent.

Labour is scarce, but it is mostly affecting the protein/meat snack operations. However, mitigation efforts including: 1) using available Canadian capacity; 2) leveraging its European co-packing relationships; and 3) increased automation should alleviate some pressure.

Although it could have been communicated better, to "get it right," we believe that it was a prudent long-term decision to temporarily push back key product launches despite the unforgiving equity market. Success here should set a strong base for future growth, in our view.

ALIMENTATION COUCHE-TARD INC.

Management's latest goal is to double Couche-Tard's size over five years, with greater than 50% being organic growth led by new traffic-driving national promo campaigns, better use of data analytics, and (starting in F2020) a much-expanded fresh food offering. This we believe, will be complemented by successful acquisition integration, rapid synergy extraction, and, quite likely, more accretive acquisitions. The improved growth outlook and a defensive shift in market actions have propelled Alimentation shares higher since May and should lead to valuation expanding.

SUNCOR ENERGY INC.

Suncor is a top defensive pick as it retains one of the best fundamental outlooks within our coverage, especially given ongoing differential uncertainty. While it trades at a slight valuation premium, this is warranted, given its superior growth prospects and returns, in our view.

TRANSCANADA CORP.

TransCanada Corp. held its annual investor day in November. Management highlighted their strong business performance, visible growth from advancing $36 billion of secured projects ($20 billion of which is under development), low-risk model, financial strength, and optionality in funding.

TransCanada has a strong incumbency in the two most prolific natural gas basins in North America (the Marcellus/Utica and Montney), combined with access to large markets, in our view. The growing connectivity over time should provide customers with increasing optionality as it moves approximately a quarter of North American natural gas demand. The company's 91,900 kms of pipelines have increasing value as new pipelines become more difficult to build, in our view. We believe that TransCanada's scale, energy infrastructure expertise, low-risk business model, and financial strength are competitive advantages when pursuing new assets.

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* TD Security Analyst Reports, Jan 2018
* TD PAIR, Jan 2018