Quarterly Market Commentary

October 2019

September was a noisy month for equity markets with the U.S.-China trade war, Brexit, slowing global growth, a spike in oil prices, a shift from growth to value, and U.S. impeachment headlines leading to increased daily market volatility. Notwithstanding these fears, however, equity markets were mostly higher through September and our platform performed very well.

The global Producer Manufacturing Index (PMI) moved higher for a second consecutive month in September led by surprising strength in China and characterized by improving breadth, as the number of countries with PMIs above 50 (of the 30 we track) increased to 11 from the cycle low of 9 countries recorded in the previous two months. As is typical at turning points, the data is mixed. This is certainly the case in the U.S., where the widely followed ISM PMI weakened further in September in contrast to a growing number of indicators suggesting the U.S. manufacturing slowdown may be bottoming. Why is this important? History shows that a cyclical turn in the manufacturing sector, once every 3.5 years on average, leads to a cyclical rise in corporate profits, inflation and bond yields, a combination we expect will unfold in the months ahead.

Industrial production (IP) data provided the first evidence that the U.S. manufacturing sector may have bottomed after a relatively short and mild period of weakness. The most recent durable goods release provides further evidence of manufacturing strength with rising shipments and orders and declining inventory-to-sales ratios as we detail below.

GM began to stockpile inventory of its most profitable vehicles weeks before the GM strike began on September 15th. As a result, auto production and shipments were temporarily boosted in June, July and August before the strike began. Therefore, manufacturing IP excluding the motor vehicle sector shows a less pronounced recovery than seen in the broader measure. The strength seen in August is a preliminary number subject to revision. So the IP data is encouraging, but not yet enough to declare the turn.

The biggest distortion to the manufacturing data is the 737 Max situation where shipments have been halted and yet Boeing is maintaining production (at 42 planes per month, down from 52 planes pre-grounding) leading to a sharp rise in finished plane inventories. Boeing is currently assuming that the grounding order will be lifted in December allowing shipments to resume, but our aerospace analyst thinks there is a better than 50% chance the grounding order won't be lifted until the first quarter. The non-defense aircraft sector accounted for 2.6% of total manufacturing shipments in 2018 (pre-grounding), but non-defense aircraft and parts inventories have now risen to almost 17% of total manufacturing inventories.

History shows that manufacturing slowdowns typically don't end until companies begin to get inventories under control evidenced by declining inventory-to-sales (I/S) ratios as inventory growth slows and sales accelerate. The I/S ratio for the durable goods sector has continued to rise in August, approaching the highest level seen in the last 10 years. However, the I/S ratio excluding the aircraft sector showed a peak in May and has now declined for three consecutive months. This is an encouraging sign that the manufacturing sector may have bottomed.

The manufacturing sector is split almost equally between durable goods and nondurable goods. The nondurable goods sector, dominated by food, chemical production, and oil refineries, tends to be less volatile than the durable goods sector primarily because the production process is much faster, so less inventory is required. The biggest distortion evident through history is the impact of price swings in the energy sector on aggregate measures of nominal sales and inventory growth. Therefore, when working with the nominal data, it is always best to exclude the energy sector from the nondurable aggregate. Data available through July shows stable I/S ratios through July when a notable tightening of inventories occurred. This added to the evidence that manufacturing may have bottomed because aircraft orders can be very volatile one month to the next, but mostly because aircraft orders are typically for delivery many years in the future and therefore don't predict shipments in the next few months. Orders for nondurable goods excluding aircraft shows three consecutive months of positive growth with 6 of the 7 sectors showing growth in August. Note that order and shipment data include exports which account for 19.5% of total manufacturing shipments.

As mentioned earlier, we are very pleased with our performance in Q3. During the quarter, we had a couple of dividend increases with our positions. Both Royal Bank and CIBC raised their dividend by 2.9%. We also trimmed our weighting in Algonquin Power due to strong performance. As you know, we engage a trim function on each position in our platform. The trim function essentially provides a safety net on the upside and downside of each position for us to review and re-evaluate. We initially invested in Algonquin Power in February 2017 at $11.78 per share. We still favour the position, but it was prudent that we follow our disciplined process and we trimmed our weighting at $17.48 per share to our initial weighting.

We also made a position change. We locked in profits with Alimentation Couche-Tard and moved these proceeds to Parkland Fuel Corp. We did very well with this position and for some, it can be emotionally difficult to sell a winner. We initially bought Alimentation Couche-Tard in May 2016 for $53.65. Last month, we locked in profits at $83.19 per share.

Parkland Fuel Corp is an independent supplier and marketer of fuel and petroleum products and c-store operator. Parkland services customers across Canada, the U.S., the Caribbean region and the Americas through Retail, Commercial and Wholesale channels. Most of you would be familiar with some of their brands that include Esso, ON the RUN, Pioneer, Ultramar and Chevron. As you can see, Parkland Fuels is a competitor to Alimentation Couche-Tard and we essentially switched an apple for an apple. However, Parkland trades at a much deeper price-to-earnings discount and we enhanced the dividend yield significantly. We see good upside to the shares as valuation increasingly reflects Parkland's strong execution, including: 1) 14 straight quarters of retail same store sales growth (rolling out new ON-the-RUN concept and expanding private label); 2) filling in product holes within its existing network (to be aided by the launch of a cross-division loyalty program in Q4/19); and 3) both the initial accretion and predictable synergies from recent acquisitions.

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

Enbridge Inc.
We are optimistic that the L3R and Line 5 legal, regulatory, and political challenges can be constructively resolved without materially negatively affecting Enbridge's profitable Mainline. Obtaining regulatory approval for Mainline contracts will also be a focus for the company in 2020, and we expect the process to be drawn-out and contentious, given the characteristics of the Mainline shippers. Athough these regulatory and legal challenges could create a bit of an overhang on the stock in the near term, over the long term, we believe that Enbridge has a strong competitive incumbency due to its geographical footprint, scale and diversification. We also believe that Enbridge is well-positioned to play a role in North America's growing hydrocarbon export market.

Canadian National Railway
In September, TD's analyst had an opportunity to meet with CN management. In the short term, CN, like

its peers, is coping with a somewhat challenging macro environment, and volumes have been lower-than-expected. In CN's case, the key headwinds are: 1) crude-by-rail; 2) B.C. lumber; and 3) U.S. coal. The company is actively managing costs to protect earnings, as it did in Q2/19. Over the medium to long term, we believe that CN's geographic franchise supports a visible multi-year growth pipeline.

We believe that CN's unique franchise provides the most visible and well-diversified multi-year revenue growth pipeline in the group.

BCE Inc.
We continue to favour BCE because we like the stable, long-life cash flow characteristics of its wireless and wireline infrastructure assets. We view BCE as a low-risk name with an industry-leading dividend yield.

TC Energy Corp. (formerly TransCanada Pipeline)
TC Energy 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 increasingly optionality, as it moves approximately a quarter of North American natural gas demand. The company's 92,000 km of pipelines have increasing value as new pipelines become more difficult to build, in our view. We believe that TRP's scale energy infrastructure expertise, low-risk business model, and financial strength are competitive advantages when pursuing new assets.

Telus Corporation
We like Canadian wireless assets today and we think this business will get even better in 2020/21 with 5G. Add-in the long-life cash flow prospects from fibre to the home and we believe Telus shares are well positioned to get re-rated higher as more of an infrastructure play over the next couple of years. Industry-leading multi-year dividend growth (+7%-10% through 2022) is great while one waits for this re-rating.

Canadian Tire Corporation Ltd.
Last quarter, Canadian Tire acquired Party City Canada. We view the acquisition positively as the valuation and strategic rationale appear reasonable. Bolting the business into Canadian Tire should magnify operations in short order and optimize inefficient floor space, in our view. This is in addition to attracting a younger customer base, driving traffic/basket size across the chain, and expanding the presence of its private label offering.

Royal Bank of Canada
Applying a premium of 10% to our group target price to earnings multiple of 11.0 times to 11.5 times, we still see good upside from current levels. Over the past 5-10years, Royal has traded at a 5% premium to the group. In our view, the bank's structural advantages and track-record support a higher premium going into what we believe will be a more challenging period for the banks.

Transcontinental Inc.
The share price continues to offer compelling value for investors taking a medium-term view. Transcontinental has a resilient legacy business (emphasis on retailer-related print and plant consolidation) and its flexible packaging offers a source of potential future growth. Transcontinental is also a strong free-cash-flow generator (23% yield estimated for 2020), which should allow for steady deleveraging, periodic dividend hikes, and additional acquisition activity down the road.

Brookfield Property Partners
Last month, the company hosted an investor day presentation that focused on developing properties and developing businesses. The property developments deserve highlighting as a near-term growth catalyst. The impact of low rates and re-tenanting in retail stand out as the next largest growth drivers.

Brookfield Property Partners has a record development pipeline of approximately $7.2 billion at cost, currently under construction. Most of these developments will begin producing funds from operation over just the next two years. So far, these projects have merely created a funds from operation headwind because not all costs can be capitalized, so the record activity has dampened funds from operation growth over what it would be otherwise.

We continue to favour Brookfield Property Partners because the yield is backed by cashflow from a portfolio of high-quality assets, the share price trades at a discount to the net asset value, and there is the potential for significant appreciation.

Premium Brands

It has been two years since Premium Brands last met/beat street expectations. The second quarter was a solid beat, in our view, with results exceeding consensus. Premium Brands is at another key inflection point similar to 2015, except off of a now bigger and stronger platform, where a number of key investments (which have temporarily pressured its EBITDA margin) have been completed and should start to be reflected in earnings and cash flow. We see Premium Brands shares continuing their strong recovery.

Inter Pipeline Ltd.

During the past quarter, Inter Pipeline confirmed that it “received an unsolicited, non-binding, conditional and indicative proposal to purchase the company”; however, not agreement, understanding, or negotiation is ongoing with any third-party. Inter Pipeline did not quote the price offered, which was speculated at $30 per share in the media.

We believe that the emergence of an unsolicited offer is a salient data point for investors about how the recent Inter Pipeline share price was undervaluing the company. Even if an offer does not crystallize, we believe that the equity markets will reflect more growth and less risk into Inter Pipeline than it did before this offer surfaced. Our base-case thesis values Inter Pipeline as a continuing independent company, and any sale of the storage business or sale of the company could potentially surface even more value. The Heartland facility is Inter Pipeline’s largest growth driver, and we expect investors to become increasingly comfortable with the risk/return profile of the project.

Toronto Dominion Bank

The company reported a strong second quarter that beat expectations and consensus. Management continues to believe that the bank can achieve the low end of the 7-10% guidance range. We believe that the expense outlook, at least in part, supports the guidance. Specifically, the bank is guiding for moderating expense growth in the second half, reflecting elevated spending in the second half of 2018, as well as the benefits of scale. We expect the expense/scale theme to be an important point of differentiation for TD and Royal Bank relative to their smaller peers as/if revenue growth slows. We continue to favour TD and it’s US exposure.

If you should have any questions or comments, we welcome the opportunity to hear from you.

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* TD Security Analyst Reports, 2019
* TD PAIR, 2019