Quarterly Market Commentary

October 2022

Stocks and bonds sold off in 2022, but should rally in 2023 in our view. While 2022 was a year when a high cash exposure was warranted, we believe investors should be planning to return to a fully invested stance within the next several months. Investors should deploy cash opportunistically, buying the sort of price weakness that is typically seen as the Fed approaches the end of its tightening cycle. The September selloff in stocks and bonds has provided a good opportunity to begin that process, in our view.

A year ago, we began warning that stocks faced three problems in 2022:
1) bond yields would rise,
2) earnings growth would slow, and
3) many sectors were expensive relative to bonds.
Given these concerns, our strategy since last fall has been to hold a higher than normal cash balance to take advantage of market volatility with a series of 'buy the dip' trades.

It has been our longstanding view that it would take a fed funds rate well above 4% to shift the outlook from a soft landing to a hard landing. The economic recessions in Canada and the U.S. we now expect should be mild for several reasons. Consumers still have substantial excess savings accumulated in the first 18 months of the pandemic. Corporate balance sheets are in good shape with less debt and much more liquidity than seen in past recessions. Many companies remain understaffed and will not likely trim payrolls even as the economy slows. Canada and the U.S. are self-sufficient in energy and therefore much less affected by higher energy prices. And while higher interest rates might shorten the long line up of customers seeking a new vehicle, auto companies will continue to sell every vehicle they are able to produce suggesting auto production will remain firm rather than declining as seen with past episodes of fed tightening.

Two themes that have served us very well this year are stock buybacks and dividend increases. A stock buyback occurs when a company buys back its shares from the marketplace with its accumulated cash. Most of our current holdings have been actively buying back their stock and increasing their dividends. If a company is performing well and cash flows are improving, there is more room to pay shareholders higher dividends. In this context, a dividend hike is a positive indicator of company performance. During the past quarter, Crescent Point Energy increased their dividend again this year and they raised it by 23.1%. First Capital increased their dividend by 100%.

APPLE INC.

On September 7th, the company hosted its iPhone 14 launch event. The four new phones introduced at the event are iPhone 14 Standard, iPhone 14 Plus, iPhone 14 Pro and iPhone 14 Pro Plus. Although there was no "WOW" factor, all of the phones pack new cameras that promise greater depth of field and a brighter Retina Display. The iPhone 14 Pro phones have a 'dynamic island,' a small ellipse that expands to show media, notifications and alerts. Apple also previewed its next generation watch, which continues Apple's focus on monitoring the health of its users, and AirPods Pro 2 ear buds with improved noise cancellation.

Our biggest takeaway from the launch event is that Apple appears to be widening the distinction between iPhone 14 devices and iPhone 14 Pro models. With demand for digitalization showing signs of slowing as the pandemic recedes, Apple has a unique advantage: a perpetually refreshed roster of highly desirable products.

ALGONQUIN POWER & UTILITIES CORP.

Second quarter earnings matched our forecast, and 2022 guidance is unchanged. We believe that Algonquin offers a compelling valuation in the context of an extensive growth pipeline that includes organic development activity, acquisitions, and utility rate-base investments. Both the company's unregulated development pipeline and its future regulated "greening the fleet" initiatives should benefit from recent extensions to renewable power tax credits. As the company has a diverse growth opportunity set and comfortable leverage, we believe that above-sector-average dividend growth is realistic.

BROOKFIELD RENEWABLE PARTNERS L.P.

We believe that Brookfield Renewable Partners deserves a valuation premium based on several factors: scale; broad investment opportunity-set; consistent value-accretive track record; ability to act on large/complex transactions; operating/procurement expertise; management depth; and a strong funding platform. We remain positive on Brookfield Renewable Partner's mid-term prospects as growth continues.

COGECO INC.

We continue to believe that Cogeco is the preferred investment vehicle to gain exposure to Cogeco Cable. Although the holdco discount has come down slightly in the last month, it remains elevated versus its 10-year average. Although we are not expecting a collapse of the holdco structure in the near future, additional clarity on Rogers' plans for its Cogeco Cable and Cogeco Inc. shares should provide an opportunity for the holdco discount to revert to its mean. The extent of the current discount is large enough to justify our BUY rating.

CANADIAN IMPERIAL BANK OF COMMERCE

CIBC's strong performance reflects exceptionally strong commercial/wholesale loan growth in the last 12 months. Although the market continues to worry about CIBC's overweight in Canadian housing, we do not believe mortgages will play a significant role in the credit outlook for Canadian banks. We continue to rate CIBC BUY reflecting relative valuation and demonstrably better execution than we have seen from CIBC in the past.

CRESCENT POINT ENERGY CORP.

We continue to favour Crescent Point based on several key factors. Firstly, we forecast the company will generate (and return) a significant amount of fiscal cash flow to shareholders through our forecast period. Crescent Point provided its long-awaited formulaic return of capital framework in June and is targeting to return 50% of free cash flow (post base dividends) through share buybacks and potential special dividends. We forecast the company will generate $1.9 billion in fiscal cash flow through the end of 2023, representing approximately 40% of the current market capitalization. We also estimate the company will use this fiscal cash flow to buyback approximately 80 million shares during this period and payout $250 million in base dividends. Furthermore due to limitations on normal course issuer bid volumes, we currently forecast a special dividend of $115 million in 2023 ($0.22/share). We see this all being accomplished while already low financial leverage moves even lower.

In addition to significant and sustainable return of capital, we feel the company's Duvernay acquisition last year (and subsequent commodity price strength) should continue to provide value. So far, Crescent has provided robust well results, while efficiency improvements should help offset some inflationary pressures, in our view. Furthermore, with significant tax pools, Crescent Point is one of only a few companies in our coverage universe that is not cash taxable through our forecast period (on strip pricing).

CANADIAN TIRE CORPORATION, LTD.

Second quarter earnings were below our forecast and consensus. However, we argue that the results were essentially as anticipated. We state this as items that we typically classify as one-time when they are benefits, were actually detrimental to earnings in the second quarter. This includes a foreign exchange loss at Helly Hansen and a build in the allowance provision within Financial Services due to accounting requirements for new account growth. Excluding these items, we estimate EPS of $3.53 compared to our $3.56 forecast. While we see few immediate catalysts to the share price we maintain there is attractive mid-term value at the current level.

DEFINITY FINANCIAL CORP.

We envision one of three scenarios playing out over the next few years. The most likely, in our view, is that the company makes an acquisition given the fragmented industry the company operates in (announced minority interest in Apollo in March 2022). Definity's scalable systems, unleveraged balance sheet, experienced management team, and access to capital position the company well to complete a deal, in our view. The other scenarios include: 2) the company grows its Direct Written Premium at an above-average rate and continues to refine its business model resulting in an approximately 200 basis points improvement in operating return on equity; or 3) the company largely remains as is (limited improvement in profitability and operating return on equity). We believe an investment in Definity offers exposure to a stable business model with good upside potential if the company is able to grow through acquisition and/or be acquired (long term scenario).

ENBRIDGE INC.

In our view, the company's resilient business model, long-life assets, and ability to pivot to meet continued industry changes, including a transition to a lower-carbon future, should warrant a premium valuation. Over the long term, we expect Enbridge to continue to have a strong competitive incumbency due to its geographic footprint, scale, connectivity, and diversification, and we believe that this positions it to play a role in North America's contracted and regulated energy infrastructure evolution to support global long-term climate-change goals, continued security for energy demand, and exports.

FIRST CAPITAL REIT

We remain optimistic on the rebound in First Capital's trading valuation. First Capital should deliver strong operating performance in the long term, and in our view, represents one of the largest valuation upside opportunities within our retail property-focused coverage universe.

First Capital has a significantly higher concentration in necessity-based tenants (at ~80% of rents) versus its two closest retail REIT peers (RioCan at ~60% and SmartCentres at ~61%). The REIT also has by far the lowest exposure to retail's sectors that may be the most negatively impacted during a recession (e.g., department stores, fashion, theatres). First Capital continues to trade at a significant valuation discount vs. pre-pandemic levels, and is also trading at a steep discount to its Canadian retail peers.

We believe the current valuation overly discounts concerns of economic weakness. High leverage concerns have also been alleviated, with credit rating agencies affirming First Capital's ratings. Although higher interest rates have slowed down overall transaction market activity, First Capital's focus on grocery-anchored open-air plazas and high population density neighborhoods should bode well for future dispositions and help reduce leverage metrics. Assets held for sale remain elevated at $243 million, which align with management's plans to aggressively pursue disposition activities.

First Capital recently increased its distribution back to $0.86/unit (the distribution was reduced by 50% in January 2021), which we believe should be an immediate catalyst to help narrow First Capital's trading valuation versus peers. In our view, the distribution increase reflects stronger operational and financial performance that is in-line with pre-pandemic levels and should improve investor sentiment.

MAPLE LEAF FOODS

We believe Maple Leaf has a lot going for it as an industry leader in ESG (environmental, social, and corporate governance), well above average Meat revenue growth, the largest branded Canadian market shares in fresh and prepared meats, and dominant leadership positions in Raised Without Antibiotics - RWA pork (North America) and RWA poultry (Canada). But Maple Leaf's year-to-date returns were poor relative to the sector average based on what we believe is earnings pressure from poor pork industry market fundamentals and labour shortages, which have prevented margins from reaching what management states is now a 14% structural level (with returns on Poultry and Bacon investments expected to add up to approximately 260 basis points more to the run-rate by year-end 2023). We are convinced this is a transitory problem that will get resolved via a combination of improved labour markets/hiring initiatives and either 1) increased pork purchases from China, or 2) a reduction in U.S. pork processing capacity (pork processors will not want to keep losing money on every hog slaughtered).

Over the next 12 months, we see the shares moving materially higher toward our $39 target. Despite some headwinds in second half of 2022 — i.e., challenging labour markets and unfavourable pork market conditions — we remain confident in Maple Leaf's ability to boost run-rate Meat EBITDA margin (excluding duplicate overhead and start-up costs in the new London poultry facility) to its target 14% run rate, although we expect it by Q2/23 rather than Q4/22 (and close to 16% run rate by Q4/23). This, coupled with a commitment to return the Plant Based Protien business to breakeven by Q4/23, and a substantial reduction in capex (now that the poultry, bacon and tempeh facilities projects are all completed), should lead to meaningful fiscal cash flow generation for the first time since 2017/18, in our view.

MICROSOFT CORP.

Microsoft's fiscal fourth quarter results were rather bumpy given macroeconomic and other issues, with 8% earnings per share growth on 16% revenue growth, but it had a much stronger June quarter than many of its peers. Microsoft may just hold the premiere position in business technology. Although obviously not immune from macroeconomic factors (like the decline in the PC OEM market, supply-chain disruptions, Chinese COVID lockdowns, or the decline in digital advertising), Microsoft has about as diversified and strong a set of assets as any company in the Technology industry -- and may even be looked at as a haven by investors looking for a flight to quality in uncertain times and market conditions. The company is one of a few with a complete and integrated product set aimed at enterprise efficiency, cloud transformation, collaboration, and business intelligence. It also has a large and loyal customer base, a large cash cushion, and a rock-solid balance sheet. Microsoft shares have been hit by the Technology sector selloffs in the last year and trade below the historical average but a little above its peers, perhaps again reflecting its relative quality. Microsoft is also one of the few tech companies in our coverage group that pays a dividend that we consider safe.

NATIONAL BANK OF CANADA

NA's solid 2021 and YTD-2022 results reflect strong execution as well as an advantageous business mix relative to the group.

PARKLAND CORP.

Parkland's shares remain undervalued, at approximately 6.5 times next twelve months EBITDA, well below the 8.1 times weighted-average of its peers. The strong 23%/33% growth in EBITDA/Distributable Cash Flow Per Share this year, and approximately 10% fiscal cash flow yield going forward should help Parkland deleverage and boost valuation closer to Parkland's historical average of approximately 8.3 times once the energy bull run fades and/or investors widen their horizons.

RESTAURANT BRANDS INTERNATIONAL INC.

We expect the company's e-commerce capabilities, investments in its franchises, strong loyalty program, and international expansion to benefit earnings. We also look for menu simplification to improve order accuracy and increase throughput, boosting restaurant-level margins. We believe that Restaurant Brands International can reach its long-term target of 40,000 restaurants.

ROYAL BANK OF CANADA

Over the past 5-10 years, Royal has traded at a 5-7% premium to the group. In our view, the bank's structural advantages and track-record continue to support a healthy premium. We believe the bank is particularly well positioned for the themes we believe will favour bank stock performance in 2022. Consequently, we expect Royal Bank to be among the leaders in terms of pre-tax provision earnings growth in 2023. Finally, return of capital also supports a positive outlook on the bank.

SUNCOR ENERGY INC.

We continue to see relative upside in Suncor shares and shareholder returns, while 2022 guidance revisions have set the bar lower through at least year-end. However, operational consistency will prove critical to bridging the multiple gap, and we may be in a holding pattern pending the outcome/implications of the retail strategic review/CEO search.

TC ENERGY CORP.

We believe the TGNH Southeast Gateway Pipeline project demonstrates TC Energy's ability and competitive positioning in securing new investments and increases and extends visibility for growth. While our view is that there are high barriers to entry in competing for large linear pipeline infrastructure projects due to a number of factors including above average execution risk, TC Energy in our view has taken measures to mitigate the risks associated with this project. Given TC Energy's strong incumbency in prolific natural-gas-producing regions in North America, combined with access to large markets, we believe combined with the company's scale, energy-infrastructure expertise, low-risk business model, and financial strength position it well as societies transition to using lower-carbon energy sources over the long term, while ensuring energy security for North America and its global counterparties.

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