Points in Time: Q1 2021

"Pent up demand should fuel strong economic growth in the months ahead."

Delayed Take-Off

One of the most frustrating things about flying is the delays. We're usually excited to get to our destination, and the last thing we want to hear is that takeoff has been pushed back by a few hours. This kind of anticipation is analogous to our current situation in Canada.

Vaccines are being distributed, the weather is getting nicer, we're excited to get out of the house and back to our regular activities, but we're now being told to wait little bit longer. At the time of writing this article, Ontario is signalling a return to lock-down; BC is once again restricting indoor dining and other jurisdictions here and abroad are again looking to tighten up amid rising COVID-19 variant cases.

Although disappointing, we view this as a detour on the return to normal road and not something that is taking us off course. We now have a template for what return to normal looks like, and that is Israel. Well over half of the population of Israel is vaccinated. Once vaccination levels neared 40%, Israel saw a lasting drop in cases. That does not mean the virus is gone today, but the waves and surges have stopped. During the recent Passover holiday, Israelis were permitted to gather in groups of 20 indoors and 50 outside. The UK is the only other major country with over 40% of the population to have received at least one dose of the COVID-19 vaccine. They too relaxed restrictions recently with groups of six allowed to meet outside, sports facilities reopening and the stay-at-home rule ending. The U.S. should come close to a 40% vaccination rate in April. Most other developed nations have 10-15% of their population vaccinated (including Canada). For these countries, June is a reasonable goal for meaningful relief of restrictions. Although the combination of increasing lock-downs now and the targeting of the most vulnerable populations for vaccinations could lead us to see significantly better days in May.

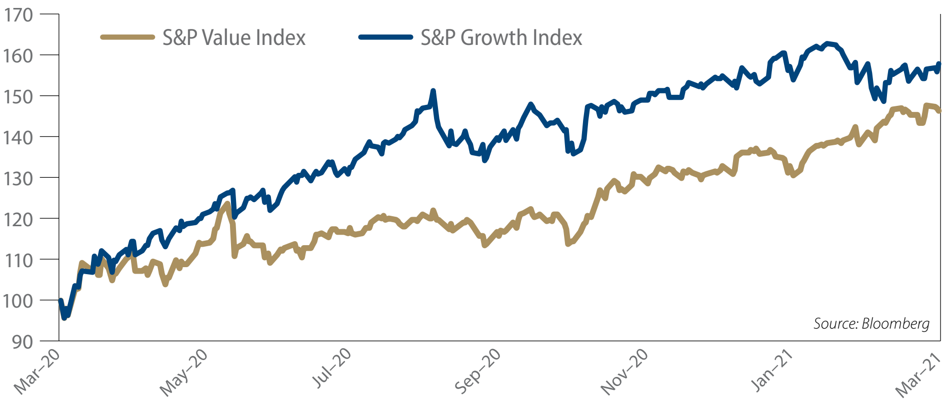
So what does all this mean for our economic recovery? We still see very strong economic growth ahead. In fact, we think that the growth this year will likely surprise to the upside. There is enormous pent up demand, low interest rates and extremely high savings levels. It is a powerful combination with the reopening being the catalyst to unleash the growth. We are already seeing businesses anticipate the recovery with Canada's major airlines announcing a more normal summer schedule for instance.

Strong growth often brings talk of inflation and of course, that is a realistic fear that is being covered a lot in the media. Undoubtedly, we will see pockets of inflation. Just like how we saw shortages of some goods over the last year, as we all demanded the same stay-at-home products, we will likely see shortages again as our demands shift to the re-opening products and services. Of course, the businesses that were hurt the most from lock-down will benefit the most from re-opening and there should be strong demand for workers in these spaces, which could lead to wage inflation. We believe any inflationary issues will be temporary and should subside as the economy rebalances to normal.

The last twelve months have been fantastic for major stock markets - many of which are up 40 or 50%. Although it is highly unlikely that we will see 50% returns in the next twelve months, we are positive on the markets and see a continuation of the move towards more economically sensitive stocks like financials and industrials. Over the last year, growth (stay-at-home tech names) performed well early in the pandemic. The spread between the S&P Growth and Value indices peaked in August and began to narrow in November once the vaccines became a reality. The spread has continued to narrow in Value's (more economically sensitive stocks) favour ever since (Figure 1).

“M&A activity heats up. Strong earnings fueling both price appreciation and dividend growth.”

Figure 1: Growth of $100 – S&P Value vs S&P Growth



The second quarter of 2021 should be a transition quarter for Canada. Hopefully one that sees easing of many restrictions as we move towards the summer. Think of it like the plane on the tarmac starting to move slowly forward at first before accelerating into takeoff.

Canada

WATCHING

The first quarter of 2021 was an eventful one. One particular bright spot were corporate earnings reports for the year-end 2020. For most companies in the portfolio, earnings were either in line or better than expected. These have given confidence to the market that a strong post COVID economic rebound is likely. One standout in particular was Magna International (MG), a best of breed auto parts and sub-assemblies manufacturer. There was concern that the move to electric vehicles may cost the company market share, however, Magna has demonstrated that it can and will participate in building this next generation of automobile. It has invested in research and development in this area for several years, and now has advanced capabilities in producing electrical car components.

Our banks reported their Q1 2021 quarter, and it was all systems go. Excess provisions for anticipated bad loans as a result of the pandemic are now being reversed. As it turned out, loan repayments and credit are good. Furthermore, the banks saw growth in most or all of their retail banking, wealth management and capital markets businesses. The banks share price performance had been lagging the other sectors through 2020 but now appear to be playing catch-up as their high quality is becoming apparent. We are still on hold as to dividend increases in this sector due to government restrictions put in place early in 2020. We hope and expect that as the pandemic eases, the regulator will ease this restriction.

On the mergers and acquisitions (M&A) front, we saw Brookfield Asset Management (BAM.A) make an unsolicited offer to purchase Inter Pipeline (IPL). We also saw Shaw Communications (SJR.B) agree to be purchased by Rogers Communications (RCI.B). This proposed merger is a political hot potato as it threatens to reduce the number of wireless carriers from four to three.

THINKING

The proposed purchase of IPL by Brookfield has a positive read-through to our portfolio. The Brookfield management team has a well-established track record in identifying value in the market place. Their interest in IPL underscores the value to be found in the Canadian pipelines group to which we have exposure through TC Energy, Enbridge, and Pembina Pipelines.

In the case of the Rogers/Shaw transaction, it is likely that Rogers will have to divest the Shaw wireless assets as regulators are concerned with the effect this deal will have on competition. What is driving this deal is not so much the quest for ever-higher profits, but the reality that a large capital investment in 5G technology is necessary. Shaw would have a difficult time making this investment, which affects both the wireless and wireline networks. We own both of these stocks in the portfolio. Shaw has indicated it will continue paying its dividend as this deal works its way through the regulatory process. Rogers has agreed to pay $40.50/share for SJR.B, which is trading well below that level currently. As such, we will continue to hold the positions and await further developments.

One segment that has been under-represented in the portfolio is the consumer staples sector. These include grocers and convenience stores, as well as food producers. The absolute dividend yield in the space is generally lower than the market average, however, there are some great companies within the sector, and getting exposure here to further diversify our portfolio has been on the to-do list for some time.

DOING

The opportunity to add consumer staples to the portfolio has been realized with the addition of Saputo Inc. (SAP). Saputo manufactures dairy products, primarily cheeses. It also produces milk and yogurt under the Nielson and Dairyland brands. Saputo has been an international consolidator of the dairy products industry, and has operations in Canada, the U.S., the U.K, Argentina and Australia. The company has grown its dividend each year for the past ten years, and by an average of 5.3% over the last five years.

U.S.

WATCHING

The U.S. economy outperformed most developed markets in Q1 thanks to aggressive vaccination campaigns and additional fiscal support. The U.S. is ahead of most countries on the vaccination front and its fiscal policy has been more generous than elsewhere. Many states saw some form of easing in lockdown measures and the $1.9 billion relief package signed into law on March 11 has already resulted in uptick in consumer spending and confidence. Retail, dining, and hospitality businesses that have recently reopened saw significant increase in demand with restaurant occupancy getting closer to pre-pandemic levels.

Turning to the equity markets, the rally continued into 2021, with the S&P 500 up 5.8% (4.4% in CAD) in Q1. The rally that started a bit over a year ago has been extraordinary, and while stock participation was initially more focused in certain stocks and sectors (FANGs, Technology), we are now witnessing much broader equity participation. The rotation into cyclicals from defensives and into value from growth started in November of last year, and continued throughout the first quarter. For the first time since 2016, we have seen a long stretch of value outperforming growth (and to clarify, all we are talking about is six months).

All sectors finished in positive territory in Q1. Leading sectors were Energy, Financials, and Industrials – value sectors that underperformed for most of last year. The worst sectors were Defensives (Consumer Staples, Utilities and Health Care) and Technology. We saw a large increase in the U.S. 10-year government bond yields, and Energy and Commodities ex-Gold rallied.

THINKING

We continue to expect a strong economic recovery throughout the year barring any hiccups due to variant strains of COVID-19 or other external shocks. The Q4 earnings season was strong with earnings and sales both increasing 4% year over year, significantly higher than what was expected with a large share of companies beating expectations. Furthermore, comments from management teams were largely positive and supportive of strong growth. The market is expecting earnings per share (EPS) to grow 24% and 15% in the next two years. This bodes well for U.S. Equities and we expect stocks to do well, especially if the Fed stays put and does not increase interest rates, which is what they have telegraphed.

The rotation from defensives to cyclicals is not surprising considering these sectors will benefit the most as expansion advances. These sectors also lagged last year, and for some, even longer. We expect this rotation to continue with valuations remaining attractive. If the economic recovery proves to be stronger than anticipated it will likely mean stronger earnings than expected for value/cyclical stocks which is positive for share prices. With significant increase in long-term government yields, the yield curve has steepened, which is bullish for banks earnings and returns.

While we anticipate a strong 2021, there are always reasons for caution. We expect an inflation uptick in the near term due to strong pent-up demand, especially in certain areas such as services. Although our current expectation is that this will likely prove to be transient rather than a structural change, it might still have a short-term negative impact on equity markets. On the vaccine front, if there is anything we learned last year, it is to not underestimate the virus. If more variants emerge and vaccines are less effective, growth might be less robust than forecasted.

DOING

We increased our weight in economically sensitive sectors and trimmed our exposure in more defensive sectors. We sold our Pepsi, Kroger and Newmont positions and added cyclical exposure through Alphabet, AutoZone, TJX and Cintas. We also increased our Healthcare weight by adding United Health and Waters. Finally, we also sold Morgan Stanley and invested the proceedings in Berkshire Hathaway. The portfolio is well positioned with our medium-term outlook of cyclical outperforming defensives.

We focus on long-term investing in high quality companies with strong returns, healthy balance sheets, and stable cash flows. While different factors may work during different periods, we believe that buying fundamentally strong businesses at lucrative prices and owning them over long periods will lead to superior returns for the portfolio.

Fixed Income

WATCHING

Understandably, investor sentiment is biased towards a strong recovery to return to normal. Investors feel that there is a point where central bankers will be able to stop being accommodative. Central bankers are echoing this sentiment, although with some regional disparity about when accommodation can be removed.

The European Central Bank is forecasting a slower recovery in Europe, and thus sees accommodation staying in place for longer. The Fed is seeing good growth in US. They have expressed a desire to allow the economy to "run hot" in order to see some inflation. In particular, they have noted a desire to make sure the recovery benefits all Americans including those more vulnerable citizens who saw a higher economic burden from COVID. The Bank of Canada (BoC) is seeing good growth, and a potentially troubling high level of central bank ownership of Canadian bonds. They have spoken of starting to reduce their bond purchases, and may be the first central bank to start removing accommodation. Note that the BoC is talking about slowing its buying program rather than reversing it.

Inflation is currently tame. Further, there are few immediate signs of friction in labour markets or base commodity markets. As we progress through a post-vaccination recovery, inflation is likely to emerge. We are seeing increases in market expectations of future inflation. Increased inflation expectations put upwards pressure on yields.

Credit spreads are relatively narrow when compared to historic norms.

THINKING

We currently are expecting Canada and U.S. yield curves to continue to move upwards, and to steepen. Both central banks have expressed reservations on raising the respective bank rates any time soon. At the same time, they are noting increasing long term economic activity. Long term rates are likely to rise based on long term inflation expectations. Short term rates are likely anchored reflecting no change in the bank rate.

With Canada and U.S. showing strong relative economic growth, and with high yields (relative to other developed nations) there is pressure for international investment money to flow towards North America. This can manifest itself in any combination of higher bond prices, higher currency or higher equity prices. Given strong economic growth and rising inflation expectations, we feel that it is unlikely that bonds will see much appreciation.

We are concerned about the current narrowness of credit spreads. However, in a growing economy we would expect debtors to have increasing capacity to service their debts. As such, narrow credit spreads are expected to remain narrow in the near term. The credit spread does offer us some extra return, although we would not expect to see much in the way of outsized gains from further narrowing like we saw in the latter part of 2020.

DOING

Three bonds matured over the quarter. We replaced these with one mid-term provincial bond and one mid-term corporate bond. The objective of these trades was to slightly increase the average coupon on the portfolio.

The portfolio remains very short duration in alignment with its mandate. It has good exposure to credit product. We feel this offers some room for extra return. We feel that there is limited room for credit spread to narrow substantially from here, and we are not expecting any outsized gains like we saw in 2020.

> "YTD over 30% of companies have increased dividends despite restrictions on banks."

Q1 2021 Dividend Performance Summary

Canadian Dividend Portfolio

Number of companies in the equity portfolio	31
Number of companies that declared an increased dividend	10
% of companies that declared an increased dividend	32.3%
Weighted average of dividend increase	1.8%
Consumer Price Index Increase (YoY*)	1.1%
Equity portfolio dividend yield**	3.9%
S&P/TSX dividend yield	2.8%

Income Stability Portfolio

Number of companies in the equity portfolio	29
Number of companies that declared an increased dividend	9
% of companies that declared an increased dividend	31%
Weighted average of dividend increase	1.6%
Consumer Price Index Increase (YoY*)	1.1%
Equity portfolio dividend yield***	3.9%
S&P/TSX dividend yield	2.8%

* Estimate from Bank of Canada, , February 26 2021
** The dividend yield is based on the Leon Frazer Canadian Dividend Fund using the target weight for cash
*** The dividend yield is based on the Leon Frazer Income Stability Fund using the target weight for cash

Top 10 Dividend Growers, 2021

Canadian Natural Resources	10.6%
Brookfield Asset Management	8.3%
Magna International	7.5%
TC Energy Corporation	7.4%
Canadian National Railway	7.0%
Bell Canada	5.1%
Canadian Tire	3.3%
Enbridge	3.1%
Allied Properties	3.1%
Nutrien	2.2%

Source: Leon Frazer & Associates, March 31, 2021

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