Points in Time: Q2 2021

"The Canadian economy could grow at a staggering rate of almost 10% in Q3 vs Q2, due to significant easing of COVID-19 restrictions."

Heat wave signals a hot economy

The end of June saw record-breaking temperatures across western Canada. According to the CBC, the village of Lytton, BC broke a new record high for temperature in Canada at 47.9°C on June 28. The CBC also noted that this is hotter than the highest temperature ever recorded in Las Vegas, and about eight degrees above Lytton's previous high prior to this year. Only about one-third of homes across Alberta and BC have air-conditioning (just over 60% of Canadians have air conditioners), causing a short-term move back to the office for some workers to escape the heat.

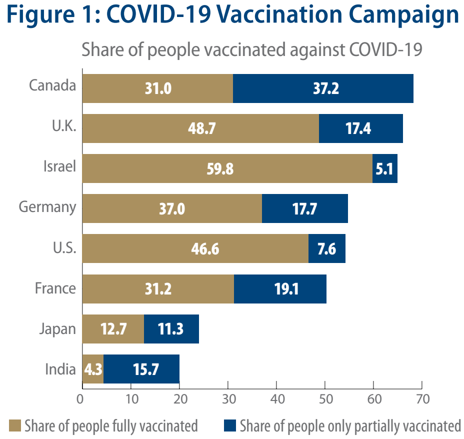
The hot economy

The heatwave is somewhat of a precursor to what's shaping up to be a scorcher of a summer from an economic standpoint. Many economists believe that the Canadian economy will grow at an almost 10% rate in Q3 vs Q2. It's a truly staggering number that reflects a significant easing of COVID-19 restrictions. Some provinces are moving quickly. For instance, Alberta's Open for Summer Plan took effect on July 1, with virtually all restrictions lifted. Other provinces, like Ontario, are moving forward at a more measured pace, but the key here is forward momentum.

The pace with which Canadians have stepped up to get vaccinated is nothing short of remarkable. As of the end of June, over 67% of Canadians had received at least one dose of the vaccine, ranking us among the world leaders. However, we still lag somewhat on *fully* vaccinated individuals with only around 30% of Canadians falling in that category, but we're quickly catching up (Figure 1).

Should this momentum continue, we can expect more restrictions to be lifted such as in-class learning, a return-to-office workday in some form, and the full reopening of the border. These will all serve as economic catalysts. Whether you're a fan of the Prime Minister or not, it's easy to see why he appears to be leaning towards a summer election.

Figure 1: COVID-19 Vaccination Campaign



Note: Data as of July 2, 2021. Source: Desjardins Capital Markets and Economic Studies.

Weaning off support programs

Early on in the pandemic, we were encouraged by the size and speed of the economic stimulus introduced by world governments and central banks, but we worried about the handoff from stimulus to the real economy. As many COVID-19-related support programs roll off in Canada over the next several months, we see many indicators that our economy is ready for it:

- **Job vacancies** are up almost 8% in Q1/21 vs Q1/20. This is the most recent data available from Stats Canada. More current data in the U.S. and business surveys supports the idea that there is no shortage of employment opportunities. Expect more job openings as the summer progresses.
- **Excess savings** are through the roof, with the savings rate in Canada coming in above 10% for five quarters in a row. By way of comparison, our savings rate is usually in the low single digits.
- **Disposable income** has recovered. According to National Bank Financial, our disposable income levels are now back to pre COVID-19 trend levels, even without factoring in COVID-19 support programs.

Virus vigilance

Although the short-term looks very positive, there are always clouds on the horizon to keep in our sights. The biggest one continues to be the virus and, more precisely, new variants. The delta variant that has caused so much pain in India, is more transmissible and deadlier than earlier variants. It's already causing reopening plans in the UK to be paused and it is rapidly becoming the dominant strain in North America. Some positive news about the variant from the spread in the UK is that fully vaccinated people are well protected; this should provide more urgency to get our second shots in order to avoid any restrictions.

Despite potential headwinds, overall, the summer of 2021 is shaping up to be a big improvement over summer 2020. Summer months tend to be quieter for the equity markets, which have had a spectacular run so far this year. A breather would not be a huge surprise, since volumes tend to dry up while participants reassess in the fall.

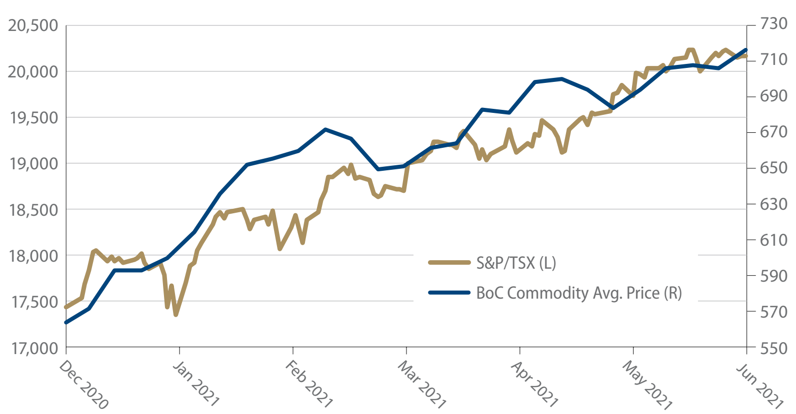
As we continue on our journey to get back to normal, one activity you may want to consider is purchasing apparel. Clothing sales were still down over 30% from pre-pandemic levels in Canada. If we return to office workspaces (even partially) or to in-class learning, clothing could replace air conditioners as the next item in short supply at the mall – although the run on sweatpants is likely over.

Canada

WATCHING

The Canadian equity markets continue to reward investors through the second quarter of 2021. The S&P/TSX index was up 8.5%. This compares favourably to global markets, including the U.S. We often see this when commodity prices are strengthening, as has been the case with base metals, oil, fertilizers and others. International investors still see Canada as a resource-based economy. As they allocate capital towards our markets, we see the benefit in terms of higher equity values (Figure 2).

Figure 2: S&P/TSX vs. Bank of Canada Commodity Avg. Price Index



Source: Bloomberg

Another noticeable effect of this movement of capital towards Canada has been in the strength of our dollar. To buy Canadian assets, you need Canadian dollars, and the demand for these has been a steady tailwind for our currency during most of 2021.

In actual fact, much of this capital flows towards our banking stocks, as proxies for our economy. Our banks have deserved these flows, as they've continued to report excellent results this quarter as well. The capital ratios they exhibit are very strong which, in our view, makes them among the best banks in the world. We're still waiting patiently for the Office of the Superintendent of Financial Institutions (OSFI), the regulator overseeing the banks and life-cos, to remove its pandemic-related dividend growth restrictions and once again allow the Canadian banks to continue growing their dividends.

The energy sector has been a strong performer. Last quarter we reported that Brookfield Infrastructure's bid to purchase Inter Pipelines (IPL) suggested that there was value in the pipeline sector. Though the oil producers have been the stronger performers year-to-date, the pipeline stocks have also done very well this quarter also. Furthermore, Pembina Pipelines (PPL) has also placed a bid that was supported by IPL management, to purchase IPL. Brookfield has since sweetened its bid in order to woo shareholder support.

Another acquisition drama is unfolding within the transportation sector — more specifically in the railways. In late March, CP Rail (CP) made a bid to purchase Kansas City Southern Railroad (KSU), an American railway that operates into Mexico. By the end of April, CN Rail (CNR) came out with a significantly higher bid for KSU. CP Rail, perhaps wisely, decided that it would not try to outbid CN, and risk overleveraging its balance sheet. Whether or not CN is successful with its bid is now in the hands of the Surface Transportation Board, the regulating body in the United States.

THINKING

We're hopeful that PPL will succeed in their bid for IPL. The company outlined a very cohesive plan for the merger. The synergies and resulting efficiencies suggest that the combined businesses would result in a more valuable single company.

On the other hand, we're somewhat less excited about the CN Rail bid for Kansas City Southern. CN is paying a premium for KSU, as well as a break fee embedded in CP's original deal with KSU ($700 million). This will impact the quality of CN's balance sheet for several years. There's also a large amount of regulatory risk involving whether – and in what form – a merger might be allowed. CN Rail previously argued that the existence of KSU provided ample competition to them, when advocating for their purchase of the Illinois Central Railway. It's difficult to see how the regulator can ignore that argument when considering whether to allow CN to remove that competitor. There's still much to unfold in this story, and we'll continue evaluating things as they evolve.

On another note, fertilizer prices have continued strengthening. Nutrien, our fertilizer stock, has indicated that it will produce 1 million tonnes more potash than it had estimated at the beginning of 2021. This would amount to approximately 13.5 million tonnes of potash sold in 2021 – a record for the company. We're cautiously optimistic that this strength will continue towards year-end, though the fertilizer market can be somewhat volatile.

DOING

There were no new stocks added to the portfolio this quarter. We're happy with the overall structure of the portfolio, as well as the dividend yield. The Bank of Montreal (BMO) has had two very good quarters and, conversely, CN Rail's share price has struggled recently in light of the uncertainty regarding their bid to purchase Kansas City Southern. This was an opportunity for us to reduce our exposure to BMO and bring our CN Rail position back to its target weight. We're very comfortable with both stocks from a dividend perspective.

Year to date, 11 of the portfolio's 31 stocks have increased their dividend. Increases ranged from 1.0% for Canadian utilities, to as much as 7.5% for Magna. We're encouraged to see this level of dividend growth and are hopeful that the OSFI (Office for the Superintendent of Financial Institutions) dividend growth restrictions on our banks and insurance companies will be lifted later this year.

U.S.

WATCHING

"Expect the unexpected" seems an appropriate adage for U.S. market performance in Q2. The whole world has been talking about recovery, cyclicals, inflation and the need for central banks to pull back their "easy money" policies sooner rather than later.

One would expect value stocks to continue to outperform in such an environment. Yet, bond yields fell (U.S. 10 year fell ~30bps (0.30%)) and growth stocks outperformed value stocks rising 11.7% versus 4.5% for the latter group during the quarter. Who would have thought that REITS and technology would be the best performing sectors in Q2 when at the end of Q1 it was all about banks, industrials and materials?

The tug-of-war between market participants continues with the ongoing debate about whether inflation is a long-term issue or whether it's just transitory. Reopening and recovery have helped certain sectors and businesses, such as banks and car companies, over the past 9–12 months. Ultimately, this led to outsized earnings growth from trough levels last year and analysts have been forced to revise earnings higher, driving stellar equity market performance. However, during the past month investors have started to think about peak levels of growth and demand, which ultimately affects earnings growth and revisions.

With over 50% of U.S. adults at least partly vaccinated and many states already re-opened, it's fair to question if the demand can continue at these unprecedented levels supported by new sectors such as restaurants and travel, while the work-from-home beneficiaries recede to normal levels.

THINKING

While all these questions are extremely important, we aren't taking our eye off the ball: we will continue to focus on investing in quality business when the risk-reward is favourable. It's easy to get lost in the debates of growth versus value or inflation versus disinflation – losing sight of the forest for the trees.

To us, the more important question is if the industry or the business that we're invested in can reinvest and grow its earnings and returns sustainably using appropriate leverage. Cycles and downturns come and go — they're a part of life — but it's the underlying businesses that survive and stay for a long period of time to ultimately reward patient investors and owners.

While we agree that macro variables and policy actions play an increasingly important role in the markets, we're also aware that they're inherently complex to predict on a consistent basis. Hence, we strive to strike a balance by investing in businesses that we expect to navigate and thrive in under various economic environments.

DOING

We trimmed a few of our positions where our thesis continued to play out and the weights became larger than warranted at current valuations – namely JPM, Texas instruments and Disney. We initiated a few new positions in the portfolio – Gentex, Wells Fargo, Accenture, Booking Holdings and Visa. We found that these businesses are amongst the leaders in their respective industries.

Businesses such as Accenture continue to execute well, while others like Wells Fargo have faced temporary setbacks due to company-specific events. Meanwhile, Booking, Visa and Gentex were affected disproportionately due to COVID-19. We deemed that all of these offered lucrative investment opportunities.

Fixed Income

WATCHING

The past three months have seen a lot of volatility in the yield curve, with very little net movement. Numerous central banks provided stimulus and support through the COVID-19 crisis. As we begin to emerge from this pandemic, central banks are looking at the path for them to remove this stimulus. The speed of the recovery and the speed of central bank response differs across regions.

Inflation concerns are definitely topical. During this quarter, we saw some large inflation headline numbers. Some of this can be explained away by the base effect. A year ago, economic figures were unusually depressed. Beyond this base effect, there are other factors at play, including supply chain issues, wage inflation, demographics and geopolitical tension.

Credit spreads remain relatively narrow when compared to historic norms. There does not appear to be imminent forces to drive these spreads back to normal levels. We're watching the market's ability to absorb a forecasted higher-than-normal level of debt issuance. We're also watching for signs of a robust recovery.

THINKING

Currently, we expect Canada and U.S. yield curves to continue to move upwards and to steepen. Given that we're going into the summer months, it's entirely possible that another three months will pass without a significant move in the yield curves.

Both the U.S.' and Canada's central banks have argued against expecting increased bank rates any time soon. The definition of "soon", however, is subject to change. Both central banks are starting to talk in a manner that will encourage market watchers to bring forward their expectations of the next rate hike. Current expectations are for early 2023 or even late 2022.

The Bank of Canada (BoC) has already moved to reduce its pace of bond purchases, and the Federal Reserve Bank (Fed) hinted at doing the same, possibly as early as their next meeting (July 2021). The European Central Bank (ECB) notes that it feels Europe is recovering, but at a slower pace than is seen in North America. As such, the ECB feels that central bank accommodation is likely to continue for an extended period of time.

The Fed and BoC have suggested that they're content to let inflation run above their 2% target for a period of time in order for the long-term average to meet their 2% target. Higher inflation expectations, less accommodating central banks and a potential increase in the bank rate suggest that yield curves should rise.

We do see two main factors pushing yield in the opposite direction. Demographic changes and advances in technology are serving to push inflation expectations down, which will have a downward effect on yields. It's important to note that this effect will only be felt over a very long term.

A second factor has been a flight to safety. A number of emerging market countries have struggled with COVID-19. This is due to poor healthcare infrastructure and overall lack of resources. At the margin, this has caused some investment money to be diverted away from emerging market debt and into the safety of U.S. Treasuries (and to a lesser extent, Canadian government bonds). Recent upward revision in emerging market debt suggests that this flight to safety might be abating. The risk in these countries has not abated, but the compensation for taking on the risk has risen.

DOING

The LFA bond pool maintains a low duration style. We're marginally below the benchmark duration for this pool.

We feel we can add value by maintaining an overweight position in credit product. There were no material changes to the portfolio in the quarter, outside of maturities being reinvested.

> "The Fed and the BoC are likely to let inflation run above the 2% level for a period of time, in order to achieve their long term targets of 2%."

Q2 2021 Dividend Performance Summary

Canadian Dividend Portfolio

Number of companies in the equity portfolio	31
Number of companies that declared an increased dividend	11
% of companies that declared an increased dividend	35.5%
Weighted average of dividend increase	1.9%
Consumer Price Index Increase (YoY*)	3.6%
Equity portfolio dividend yield**	3.7%
S&P/TSX dividend yield	2.6%

Income Stability Portfolio

Number of companies in the equity portfolio	29
Number of companies that declared an increased dividend	10
% of companies that declared an increased dividend	34.5%
Weighted average of dividend increase	1.7%
Consumer Price Index Increase (YoY*)	3.6%
Equity portfolio dividend yield***	3.6%
S&P/TSX dividend yield	2.6%

* Estimate from Bank of Canada, May 31 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, June 30, 2021

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