Points in Time: Q3 2021

> "While the short-term picture might look concerning and the impact from supply chain disruptions is real, we view this as a transitory issue that will get resolved."

Supply chain pain

A year ago, we wrote an article titled, COVID-19 winners and losers in the market which mentioned a colleague who experienced an unusually long delay in receiving a pair of Adirondack chairs they'd ordered. It took eleven months, to be exact. That story highlighted how record demand for the chairs, hitting up against reduced supply due to COVID-19 protocols, affected a factory in Ontario.

Early in the pandemic, these issues seemed very unusual. How could a huge recession lead to record demand for a "nice to have" item like patio furniture? The answer, of course, was that this was like no recession we'd ever seen. On average, incomes and savings rose due to generous government programs, while the outlets to spend those dollars fell as travel and other services were – and still are – limited.

Port pains – more than just a nuisance

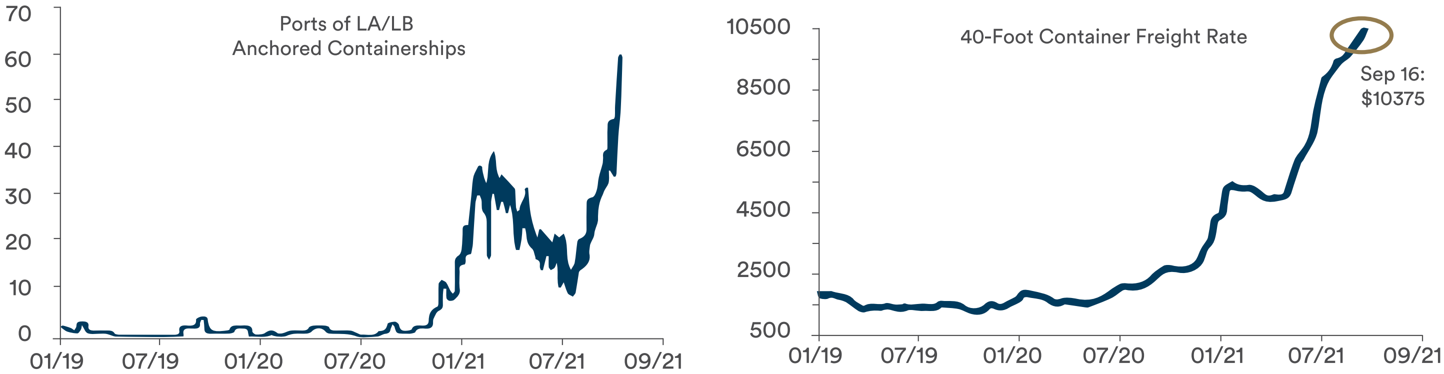
We're now eighteen months into the pandemic and supply chain issues are no longer just a nuisance – they're starting to impact our recovery. Recently, a company we own in our U.S. portfolio shared that one of their chartered containerships was denied entry into China because a crew member tested positive for COVID-19. The ship had to go back to Indonesia and change the entire crew before it could return to China. The result was a delay of more than two months from the original timeline.

Stories like these highlight the complexity of running a port during a pandemic. Not only have ports been ill equipped for the increase in demand, but they've also had to deal with worker shortages and increased complexity due to the implementation of social distancing. Occasional COVID-19 outbreaks have also caused delays. The result has been significant disruption leading to ships having to spend a lot more time at ports, and the cost of shipping (freight rates) skyrocketing.

As of mid September, there were 61 ships anchored off the two major U.S. west coast ports. In normal times, even five is considered too many. Not surprisingly, freight rates are through the roof. It used to cost $1600 to transport a container between Shanghai and Los Angeles. Today, the price is closer to $11,000 (Figure1).

Early in the pandemic, companies had inventories they could draw from to cushion the supply chain disruptions. In effect, inventories act as a shock absorber. Those inventories are now at near record lows in many categories and industries, while manufacturing facilities continue to be impacted by COVID-19. Our double whammy of surging demand for

Figure 1: Supply chain halt



Source: Cornerstone Macro

goods and reduced production capacity continues.

Short-term impacts on companies and consumers

In the short-term, the major impact is a significant increase in transportation costs. This ultimately leads to higher prices for consumers, and potentially lower profits for companies if they can't pass on the price increases.

While the short-term picture might look concerning and the impact from supply chain disruptions is real, we view this as a transitory issue that will get resolved. With vaccination rates increasing and stimulus running off in the U.S., ports are likely to be able to hire more workers which is a first step in eliminating some of the bottlenecks in the global supply chain.

Things are looking up in the long-term

Looking past the supply chain shock, we're seeing strong consumer demand backed by unprecedented savings, intention to increase CAPEX spending by corporations, and the need to rebuild the inventory levels. All this should provide a boost to economic activity over the next 12 to 18 months.

Of course, the biggest wild card in looking at the future continues to be COVID-19. The delta variant was a significant drag on what should have been an exceptionally strong summer of economic growth. It appears today that the delta wave is ebbing. Also, news of a new pill from Merck that might cut the risk of death or hospitalization from COVID-19 in half could be a game changer for the recovery.

As investors, we're taking the longer view. Global recovery is still strong and we anticipate robust economic growth well into next year, which should be positive for the markets. Investing in companies with reasonable leverage and resilient businesses provides good protection against all the bumps along the way

Scott Blair, CFA
Chief Investment Officer

Fixed Income

WATCHING

During the second quarter, bond yields moved around with little direction as the market tried to digest the competing forces of the economy opening up while COVID-19 mutated and staged a resurgence. As we moved through the third quarter, and particularly through September, bond yields moved up while the yield curve steepened (Figure2).

The market believes the economy is recovering. Various central banks lend credence to this idea, shown by their reduction in stimulus. The Bank of Canada (BoC) will likely stop its net bond buying completely by the end of October. The Fed has strongly hinted it will start reducing in October or November, likely being complete by summer 2022. We may also see bank rate increases in 2022 from any or all of the Fed, the BoC and the Bank of England (BoE). The market is suggesting that yields are moving upwards.

Credit spreads have been relatively stable in the third quarter. They're higher than the lows seen at the beginning of the year, but remain low relative to history.

Inflation figures have been coming in somewhat higher than expected. At present, inflation can be explained by temporary supply chain disruptions and increasing labour costs.

The U.S. is a rarity in that it has a legislated debt ceiling. Once again, the U.S. government debt load is pressing against its limit with some concern that politics will get in the way of increasing the debt ceiling.

THINKING

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Should the economy start to overheat, causing central banks to be more aggressive with bank rates, there will be more pressure on short rates.

We believe the economy will continue to recover, and feel that some of the current inflationary pressure is transitory. As such, we think the yield curve will rise overall and will steepen slightly. In other words, rates will rise in an orderly fashion such that neither the economy nor the equity markets will be substantially disrupted by these moves.

Both the Fed and BoC have indicated they wish to be finished with their respective bond buying programs before raising the bank rate. There’s a need for caution. While the economy is seen as strong enough for the bank rate to return to normal, going slowly will help avoid any disruption to the recovery.

Both governments and corporations have been issuing a lot of debt. However, credit spreads remain subdued. This suggests that the market still feels we’re in an economic recovery. As the economy recovers, revenues should increase, boosting interest coverage even with increased debt loads. We feel comfortable with an overweight position in credit bonds. While the spread may be low relative to history, it’s unlikely to surge higher. In the meantime, we can collect a higher coupon.

Supply chain issues are causing some temporary inflationary pressure. At this point, we’re not seeing excessive wage inflation. There are some anecdotes of wage increases, however, widespread wage inflation remains elusive. As the summer months end, so will government support programs and we expect to see an increase in the number of job applicants.

While we continue to monitor the situation, at this point we feel inflation is more likely to settle into the 2-3% range laid out by the central bank, rather than repeat the disruptive inflationary pressure seen in the 1970s.

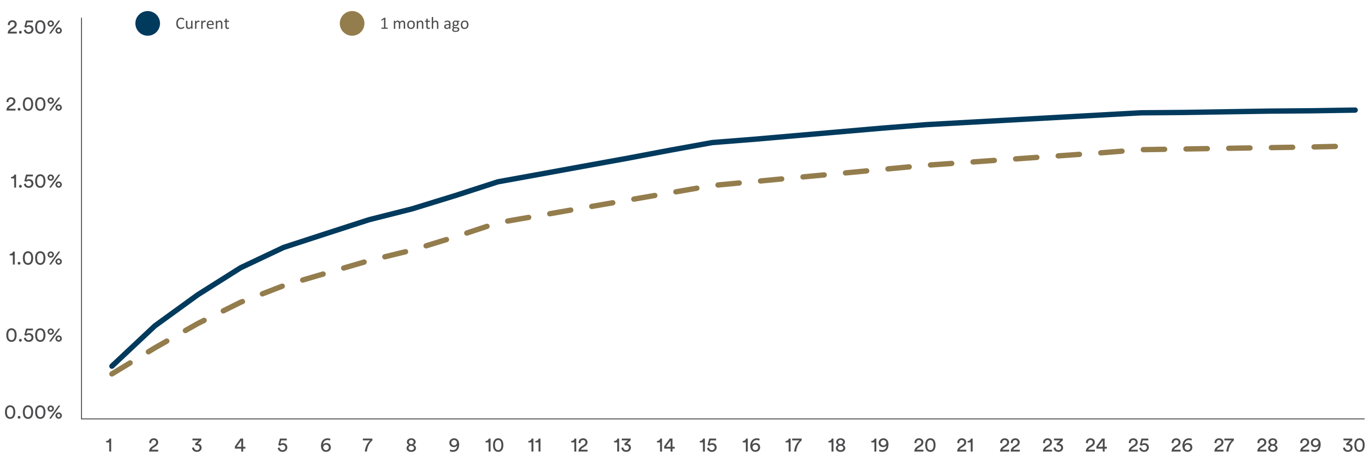
We think the U.S. debt ceiling discussion makes for exciting headlines, but that it’s ultimately more of a political issue than an economic one. This will lead to discussion continuing until the final hour, only to have the debt ceiling raised and all government bills paid in a timely manner. We will see some disruption in very short-dated US T-Bills, but otherwise the market seems to be dismissive of this issue.

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.

Malcolm Jones, MBA, CFA
Senior Portfolio Manager, Fixed Income

Figure 2: Canada Curves



Source: Bloomberg as of September 30, 2021

Canada

WATCHING

After a torrid first half of the year, the Canadian equity markets took a breather in the third quarter with the S&P TSX Composite index gaining 0.17%.

One of the more notable performers in the portfolio was Methanex, which gained over 40% in the quarter. At the outset of the pandemic in 2020, Methanex was suffering a perfect storm of very low oil prices, low methanol prices and a levered balance sheet. The company was forced to drastically cut its dividend – the first cut in over 15 years.

Today, methanol prices are strong and somewhat stable, oil prices are high, and the company is generating sufficient cash to not only address their balance sheet, but they've increased their dividend and intend to buy back stock.

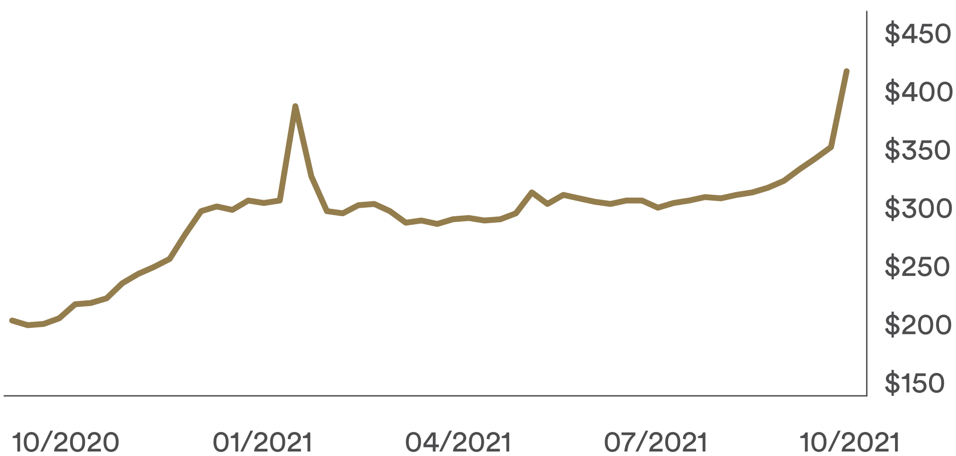
The COVID-19 delta variant has had a material effect on the speed and nature of the global recovery. Chemicals such as potash and methanol are enjoying high global prices, whereas the base metals and gold are struggling. There's strong demand for consumer goods globally, but the ability to produce and ship those goods has been impeded by a lack of labour and the necessary pandemic distancing measures – neither of which are conducive to efficiency, whether producing chips or loading ships.

What was once the well-oiled and functioning globalization trade machine, now has some gears with broken teeth. The good news is that demand is strong and this will fuel the rebuilding of the trade machine as the pandemic eases over the coming months.

On the M&A front, there have been a few developments in the quarter. The CN Rail and Canadian Pacific (CP) tussle over the purchase of the Kansas City Southern railway, which would allow access into Mexico, turned abruptly into CP's favour. The U.S. regulator, the Surface Transportation Board, ruled against CN establishing a trust in which to hold the acquired railway. This is a necessary element to any deal approval, and as CP's trust proposal had already been approved, they were essentially the only viable bid.

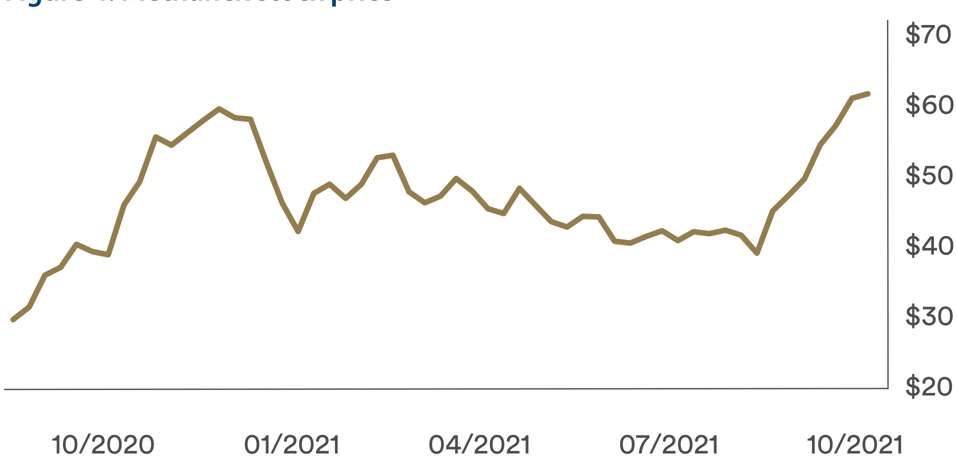
Late in the quarter, Agnico Eagle announced the proposed merger-of-equals of itself with Kirkland Lake Gold (KL). This gold miner has operations in Canada and Australia, both politically stable jurisdictions, which we see as a strong positive. The new Agnico Eagle would be run with senior management from both companies, as well as 13 board members, six of whom would come from KL's existing board. There is the possibility of another suitor emerging, so we may be in for another merger saga on Canadian soil.

Figure 3: Methanex price per ton



Source: Bloomberg

Figure 4: Methanex stock price



Source: Bloomberg

THINKING

It's now clear that the global supply disruptions related to COVID-19 are expected to extend well into 2022. That said, equity markets continue to move steadily higher, as it appears that persistently strong demand is also likely to continue. This may be a recipe for

> "One potential area of concern in Canada has been the recent federal election result, where the Liberal Party had campaigned on a platform which included a surtax on the major banks and insurance companies."

increased volatility as news regarding either the supply or demand side, in the form of economic statistics or actual events, makes headlines.

As long-term investors, we see this disruption lasting just two to three quarters, which makes it a short-term event. As such, weakness related to this, whether market wide or company specific, should be seen as an opportunity.

From a dividend perspective, we don't see any particular risks here. However, one area of concern in Canada has been the recent federal election result, where the Liberal Party had campaigned on a platform which included a surtax on the major banks and insurance companies. The OSFI restriction preventing these companies from increasing their dividends, put in place in early 2020, has resulted in very strong capital positions in this sector.

The expectation was that the restriction would be lifted this fall, and the banks and insurance companies would play catch-up with their dividend increases. Our concern now is how that may play out with the possibility of a future surtax.

Oil prices have been strong. Again, the supply side is constrained after years of low prices resulting in very little investment in production. We do have some direct and associated exposures to stronger oil prices in the portfolio, and expect to maintain those as this unfolds.

DOING

There have been no significant changes to the portfolio this quarter. Overall, we've been participating in the upward move of the market, which is encouraging. So far this year, 15 of the companies in the portfolio have increased their dividend with an average increase of 5.7%. We're hopeful that this number improves into year end, particularly if the OSFI dividend increase restrictions on the banks and insurance companies are lifted.

Gil Lamothe, CFA
Senior Portfolio Manager, Canadian Equities

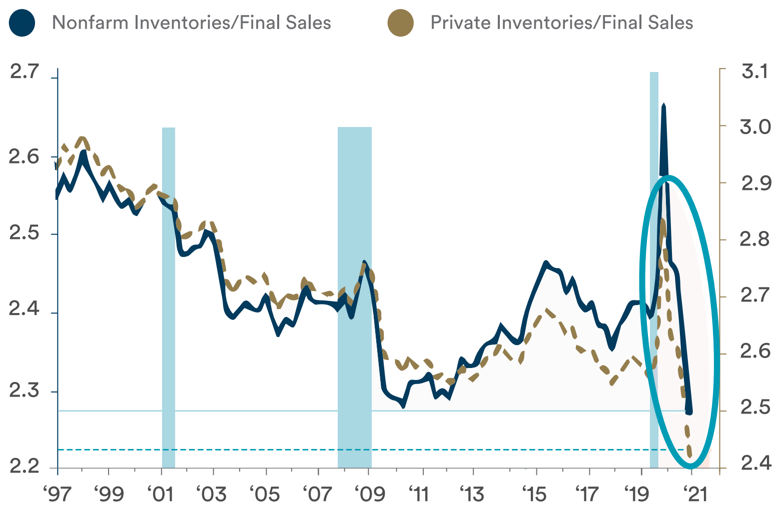
U.S.

WATCHING

The third quarter of 2021 started on a positive note. Stellar performance in both July and August was helped by another strong reporting season, where a record number of companies beat earnings expectations by a significant margin. However, with the quick spread of the delta variant towards the end of summer, sentiment changed and equities declined by more than 4% in September. U.S. equities ended the quarter up slightly.

Recent economic data disappointed and the U.S.CITY economic surprise index, which measures the degree to which economic data is either beating or missing expectations, is currently in negative territory. Supply chain disruptions and their far-reaching impact was a hot topic throughout the past three months, with the two biggest impacts being a significant increase in transportation cost and delays in product deliveries. More companies are warning about the negative impact this could have on near-term earnings.

Figure5: Inventory levels near record lows?



Source: J.P. Morgan

Finally, towards quarter end the Fed hinted that it might start reducing its bond buying program in October or November, and we could potentially see rate increases as early as in 2022, which also put pressure on market returns.

From a sector perspective, the returns were mixed with half of the sectors in negative territory and the rest finishing up in Q3. Cyclical sectors suffered, being heavily dependant on the global economic recovery and China. Consumer Discretionary also lagged with Amazon being a big drag on the sector. Leading sectors this quarter were Financials, Health Care and Technology. Financials were helped by an increase in interest rates towards the end of the quarter. Growth outperformed value with large tech companies performing well.

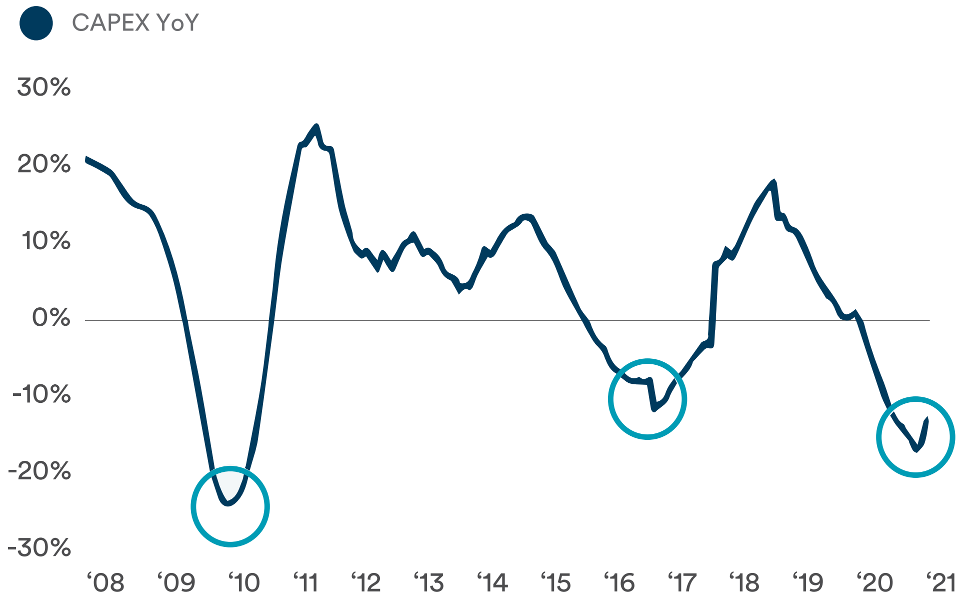
THINKING

We acknowledge that inflation pressure and growth constraints from the supply chain disruptions are real. It will impact both the economy and corporate earnings in the short term – but don't want to lose sight of the big picture. We continue to see strength in both consumers and corporations. The government transfer payments and decreased spending on services during the pandemic has resulted in households amassing more than $2 trillion of excess savings. That's roughly 15% of annual consumption.

With strong pent-up demand – especially in certain areas – we expect at least some of these savings to be spent in the next 12 to 18 months. Wages are also rising which should further boost consumer confidence and spending. As for corporations, balance sheets are in great shape with cash balances near record highs, and interest coverage (interest payments/earnings) the lowest it's ever been (Figure5).

Another thing factor that makes us optimistic on the economic recovery is the current level of CAPEX and inventories. Both are close to all-time lows. The COVID-19 pandemic caused many disruptions in the inventory cycle that are taking longer than usual to resolve. However, we expect that once bottlenecks in the supply chain get resolved we'll see businesses rebuilding depleted inventories. This, coupled with companies' intention to ramp up CAPEX spending in the coming years, should support the economic recovery in 2022 and 2023 (Figure5).

Figure 6: Upward trend in CAPEX spending



Source: J.P. Morgan

We think we might continue to see earnings surprising to the upside. During the first two quarters of 2021, we had huge earnings surprises with the market underestimating the recovery of the earnings substantially. With economic data being disappointing lately, we saw upward revisions in earnings stalling. With expectations already reflecting current headwinds, we could see a continuation of earnings surprises into the second half of the year, which should be positive for markets.

DOING

During the quarter, we exited Verizon and Honeywell – two of our positions wherein our thesis either played out or had less probability of materializing. We redeployed the capital in several high-quality businesses that were trading at attractive valuations and offered compelling risk reward.

Some of the names that we initiated during the quarter are Lockheed Martin, Deere, and Amazon. Our thesis on these names is based on continuation of revenue and earnings growth which is not yet being priced in by the market. Amazon deserves special mention as it's a stock that we've stayed away from in the past, mostly due to valuation. With the pandemic, there's been a pull-forward demand for its products – e-commerce and cloud business. This pull-forward, which we deem sustainable, led to earnings growth while the stock has done little in the last year, resulting in an attractive entry point for this high-quality business. We also added Dollar Tree, a turnaround situation where we see a significant upside if the management team execute well on the existing strategy.

In our U.S. portfolio, 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.

Liliana Tzvetkova, CFA
Portfolio Manager, U.S. Equities

Saket Mundra, CFA, MBA
Portfolio Manager, U.S. Equities

"The Fed hinted that it might start reducing its bond buying program in October or November, and we could potentially see rate increases as early as in 2022, which also put pressure on market returns."

Q3 2021 Dividend Performance Summary

Canadian Dividend Portfolio

Number of companies in the equity portfolio	31
Number of companies that declared an increased dividend	15
% of companies that declared an increased dividend	48.4%
Weighted average of dividend increase	5.7%
Consumer Price Index Increase (YoY*)	4.1%
Equity portfolio dividend yield**	3.7%
S&P/TSX dividend yield	2.6%

Top 10 Dividend Growers, 2021

Methanex Corporation***	233.3%
Canadian Natural Resources	10.6%
Open Text	10.0%
Brookfield Asset Management	8.3%
Magna International	7.5%
TC Energy Corporation	7.4%
Canadian National Railway	7.0%
Bell Canada	5.1%
Emera Incorporated	3.9%
Canadian Tire	3.3%

* Estimate from Statistics Canada Aug 31 2021
** The dividend yield is based on the Leon Frazer Canadian Dividend Fund using the target weight for cash
*** MX annual dividend increase of 233.3% is defined as the increase in the annualized most recent dividend from 2020 to 2021 from $0.15 to $0.50.

Source: Leon Frazer & Associates, September 30, 2021

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