Points in Time: Q4 2021

"Although 2021 will be a hard year to beat for equity markets, we're still positive going into 2022 but know there are more clouds on the horizon."

The best and worst of times

One advantage of writing a monthly commentary on financial markets and the economy is that you end up with a library of real-time thoughts that you can later return to and learn from. In reviewing our 2020 year-end commentary, here's what we found interesting.

Lessons learned in 2021

The commentary, *An optimistic eye on 2021*, reflected (as the title implies) that we liked the outlook. Economists were calling for strong global growth, rates were low, and the view on corporate earnings was very robust. All great signs for equities and, indeed, the forecasts were correct. It was a great year for many global markets, and the best of times for Canadian and U.S. stocks in particular, which gained well over 20%.

Despite the strong year-end results, 2021 was full of surprises. For instance, economic growth was very robust (likely around 4.5% in Canada) but fell well short of forecasts at mid year, which called for over 6% growth. The COVID-19 vaccines were effective, but we still ended up with three waves and are now at peak case counts due to the Omicron variant (something few predicted, including us). Inflation spiked above most forecasts and supply chain issues became front-page news. The list of surprises goes on.

Our takeaway from 2021 is that the news flow is endless and easy to get caught up in. We're bombarded with data points, most of which are not very useful. Staying focussed on the big picture instead is key. In 2021, the big picture was that strong economic growth coupled with low rates would lead markets higher. The precise numbers didn't really matter.

Different year, same optimism

Although 2021 will be a hard year to beat for equity markets, we're still positive going into 2022 but know there are more clouds on the horizon.

On the positive side, economic growth is forecasted to be very robust again in 2022, with economists seeing 4% growth in developed economies like Canada and the U.S. This compares very favourably to the 2% growth rate we were experiencing pre-pandemic. Most economists believe 2023 will be a stronger-than-usual year, with Canada forecasted to grow close to a 3% rate. It's hard to be pessimistic when looking at these growth numbers.

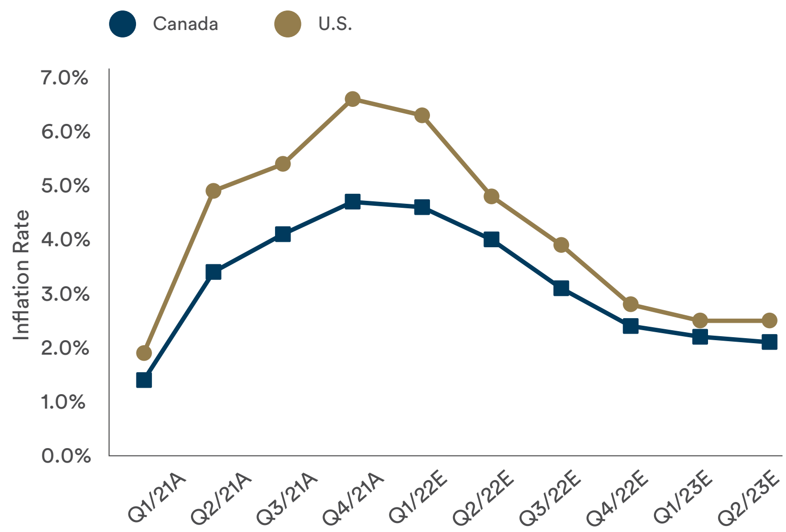
Perhaps the biggest potential headwind (outside of the pandemic) is inflation. Pre-pandemic, we were used to fairly stable prices with the annual inflation at or below 2%. Several factors have pushed prices up (supply chain issues, low rates, and government spending programs to name a few), and the debate is whether this is temporary or has become more structural.

Figure 1 shows quarterly inflation numbers from the start of 2021 to mid 2022. The first three quarters of 2021 are actuals (A) while the rest are estimates (E). Current forecasts predict that inflation will more or less peak this quarter before starting to fall back towards more "normal" levels by the end of 2022. We agree with this view and if estimates are correct, inflation will be a fading concern. We'll be watching it closely.

One reason for optimism with regards to inflation is that interest rates are going to rise back toward more normal levels after being cut to record-low levels at the start of the pandemic. This should take some of the froth out of the demand side as consumers start to deal with higher interest payments on their debt.

Higher rates could also cool down the torrid rate of price increases in the housing markets. We expect to see three rate hikes from the Bank of Canada this year, with the first being just months away. We think the economy and stock market can handle rates going back to a more normal level without too much pain.

Figure 1: Consumer Price Index (YoY%)



Source: Bloomberg

Pandemic year 3

The pandemic is truly the worst of times. COVID-19 continues to be the biggest wildcard in the economic outlook. As shocking as the Omicron case count increases are, there's reason to believe year three may be the last year of the pandemic.

The contagiousness of Omicron means that more deadly variants (like Delta) are being replaced by this less deadly variant. Some experts believe the combination of high infection levels, booster shots and new medications will turn the pandemic into something more like the flu or common cold. In other words, something that's still there but manageable in the context of normal society. We hope they're right. We think the feasibility of lockdowns is starting to wane, as each new one is more difficult to implement.

Although 2022 may not bring us fully back to normal, it should be another big step towards normalcy which is positive for the economic outlook. We continue to advocate for diversification in our client portfolios, focussing on strong and resilient businesses that can weather any storm.

Scott Blair, CFA
Chief Investment Officer

Fixed Income

WATCHING

In response to the COVID-19 pandemic, central banks in many developed nations took dramatic steps to increase liquidity in financial markets, and to lend support to a temporarily shuttered economy. As we moved through Q4, 2021, many central banks declared that their job was either done, or near to being done. The extraordinary bond purchases are either stopped or soon to be stopped. The market is, reasonably, expecting that actual bank rate hikes will occur in 2022 from Canada, the U.S., and the UK. Increased bank rates are expected to raise yields, with an emphasis on shorter term rates.

Inflation remains a concern. An argument can be made that this is simply transitory, reflecting various disruptions in the supply chain. A contrasting view is that this is more permanent, reflecting disenchantment with globalization and increased geopolitical tensions. Increased inflation is expected to raise yields.

A number of countries continue to have a challenged economy. The European Central Bank, for example, continues to see the need to provide support to the European economy. This is expected to keep their local yields suppressed, and this, in turn, can serve to limit the increase in yields in North America.

Overall, we're expecting yields to increase over the course of the next twelve months. At the same time, we expect a great deal of volatility in yields. Vaccination rates are increasing throughout the world, but there remains distinct pockets of low vaccination, and, of course, various COVID-19 mutations are arising.

Uncertainty remains a key concern in both COVID-19 and inflation.

"Overall, we're expecting yields to increase over the course of the next twelve months. At the same time, we expect a great deal of volatility in yields"

THINKING

We expect yields to move upwards over the next twelve months. As such, we're maintaining a low duration to reduce our exposure to interest rate movements. We're starting from higher yield levels as of January, 2022, so coupon yield should be higher this year than last.

We are expecting greater volatility in yields. Inflation and COVID-19 progression are difficult to forecast, and interpretations are likely to change dramatically as inflation flows in. This may present an opportunity to trade back and forth in some circumstances.

National governments have issued a large amount of debt, and are expected to need further issuance. Sub-nationals (such as our provinces) have shown less need to issue debt. A number of sub-national governments have shown better-than-expected budgets lending support to their ability to pay their existing debt. While credit spreads on sub-nationals are low, there's little to suggest these spreads will increase in the near future. We continue to like sub-national debt.

Corporate debt has also seen a lot of issuance. With strong earnings, these corporates have strong ability to pay. Indeed, some of the issuance is being used to pay back higher interest debt taken on at the height of the pandemic. Corporate credit spreads are historically somewhat low, but again, we don't see evidence of an imminent increase in spreads. We continue to like corporate debt.

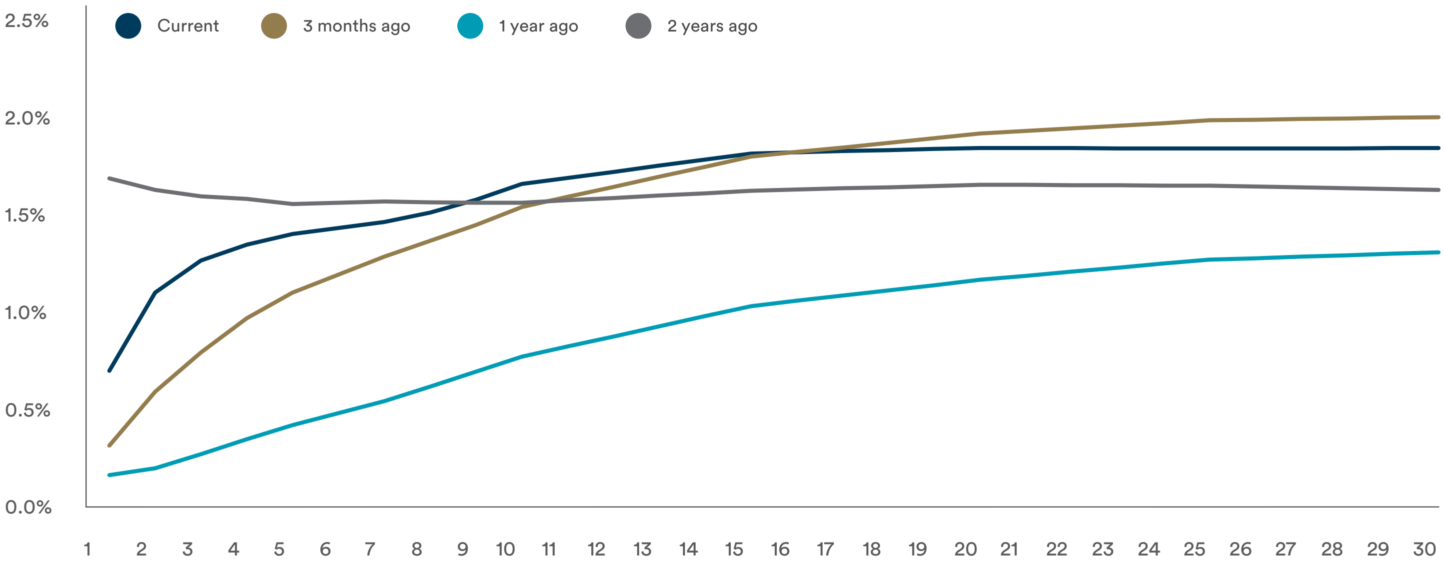
In the U.S., there's an attempt to legislate an increased spending bill, and an attempt to legislate an increase to the debt ceiling. We expect a lot of drama and exciting headlines (with a commensurate ebb and flow in market sentiment). At the end of the day, we expect neither Democrats nor Republicans will get everything they want, and neither will walk away empty handed. Depending on your political affiliation, there will be plenty of credit or blame for all parties. We do expect some increased market volatility, and this may lead to some opportunities for trading.

DOING

During the fourth quarter, we increased the duration of the Leon Frazer Bond Fund, but kept it well below the benchmark duration. We're maintaining an overweight position in credit.

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

Figure 2: Canada Curves — December 2021



Source: Bloomberg

Canada

WATCHING

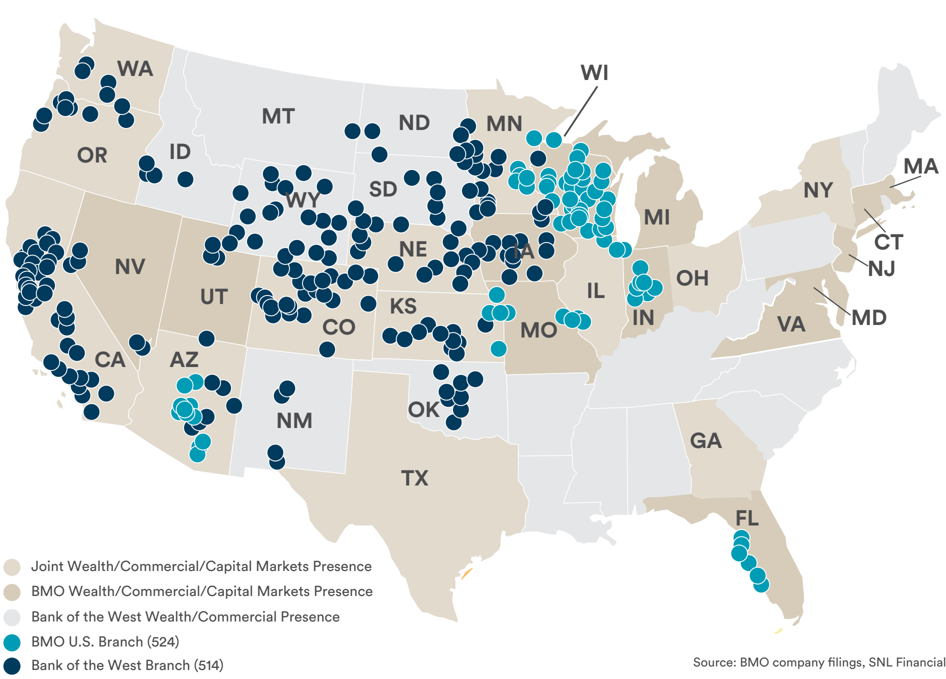
The Canadian equity markets had another great quarter in Q4 2021 with the key benchmark (S&P/TSX Composite) up 6.5% on a total return basis. The quarter capped off a fantastic year where the market gained 25.1%. Although our dividend strategies are focussed on growing income rather than beating broad benchmarks, the LFA Canadian Dividend Pool more than kept pace with the market (up 27.6%).

The strongest performing sectors in Q4 were Materials and Financials. In the Materials space, our holding in Nutrien was up 16.4%. The strong global demand for fertilizer is continuing and looks to extend into 2022. Within the Financials sector, the Canadian banks had a strong showing in the quarter. Bank of Nova Scotia and Toronto Dominion led the way, up 17.5% and 16.7% respectively. Another Financials contributor was Brookfield Asset Management, which went up 12.8%.

The big story for dividend investors was the removal of the restriction on Canadian banks and insurance companies from increasing their dividends or repurchasing their shares. At the outset of the pandemic, the Office of the Supervisor of Financial Institutions (OSFI) implemented this restriction as a capital safeguard in what was an uncertain environment. Our larger financial companies have since demonstrated their resilience and quality, and the restrictions were lifted in November. As a result, we saw dividend increases from all of our banks and insurance companies. While the average increase was in the 10-12% range, BMO surprised with an increase to its dividend of just over 25%. All announced the intention to continue repurchasing their shares, in amounts of 2-3% of outstanding shares.

Another noteworthy event was the board-level dispute at Rogers Communications. When the dust had settled, Edward Rogers showed that he has de-facto voting control of the company through his control of the trust, wherein lie the majority of Rogers Communications' voting class shares.

Figure 3: BMO greatly extends their U.S. presence through Bank of the West purchase



Source: BMO company filings, SNL Financial

While the dispute and its resolution didn't put the proposed merger of Rogers and Shaw Communications at risk, it did demonstrate that one individual does indeed control the ultimate fortunes of the company.

Omicron came to the forefront last quarter. The market reaction late in November was decidedly negative, but as it became clearer that this variant was less harsh than Delta, the market recovered somewhat by year end.

THINKING

At a high level, our thinking hasn't changed much over the past six months. We still believe the pandemic will continue to subside through 2022. This latest variant, Omicron, may actually help speed up that process as it is both more transmissible and milder than the Delta variant. This, combined with the wide availability of booster vaccines, has had a positive effect on the stock market's outlook. We still view the recent higher inflation as transitory in nature, being largely driven by accelerated consumer demand following the strict lockdowns earlier this year. As demand normalizes, there should be an alleviation on prices as well as less pressure on manufacturing and supply chain capacity.

Of greater importance to your portfolio was the Rogers Communications imbroglio. It's now clear that one individual controls the company, and while Ted Rogers Sr. had proven himself an effective manager in building the company with that level of control, we're uncertain as to Edward Rogers' abilities. While we feel the dividend is secure and there's no imminent risk here, it's something we will pay close attention to going forward.

Another important development in the quarter was BMO's announcement of the purchase of Bank of the West from BNP Paribus. Bank of the West is headquartered

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in San Francisco, with branches in the central and western United States. At US$16.3 billion, this is a large transaction for BMO, greatly extending their presence in the U.S. from Illinois westward to California, and virtually doubling the number of branches they have in that country (Figure 3). This is a bold move in the bank's U.S. growth strategy, and one which we like the look of. What remains to be seen is whether the price tag was too high, given the opportunities.

DOING

During the quarter, we added Brookfield Renewable Corp. (BEPC) to the portfolio. This limited partnership within the Brookfield family of companies owns and operates hydro, wind, and solar electric generation facilities around the globe. The company currently has over 20,000 megawatts of capacity from these sources, with development plans for a further 30,000. Renewable energy has continued to gain importance around the world from consumers, governments, and investors. We think Brookfield Renewable is a best-in-class operator in this field.

By year end, we saw 26 of the 33 (79%) of the companies in the portfolio increase their dividend. The weighted average dividend increase of the portfolio was over 14%, which amounts to a significant increase in income to our clients. We believe that growing dividends is the ultimate hedge against inflation, and as such, has been the cornerstone of our investment strategy for over 80 years.

Gil Lamothe, CFA
Senior Portfolio Manager,
Canadian Equities

U.S.

WATCHING

US equities finished the year strong, outperforming most global markets with the S&P 500 up 10.7% in Q4 and 26.7% for 2021. These returns are even more impressive considering the uncertainty around the impact of Omicron, multi-decade high inflation, supply chain disruptions and the expectation of Fed's monetary tightening. That aside, we saw an unabated strength in the US consumer, improving labour markets and very accommodative monetary policy continuing during the quarter. US corporations also managed to post another strong earnings season with year-over-year (y/y) earnings growth of nearly 40%, exceeding expectations once again and surprising the market with resilient margins despite persistent inflation.

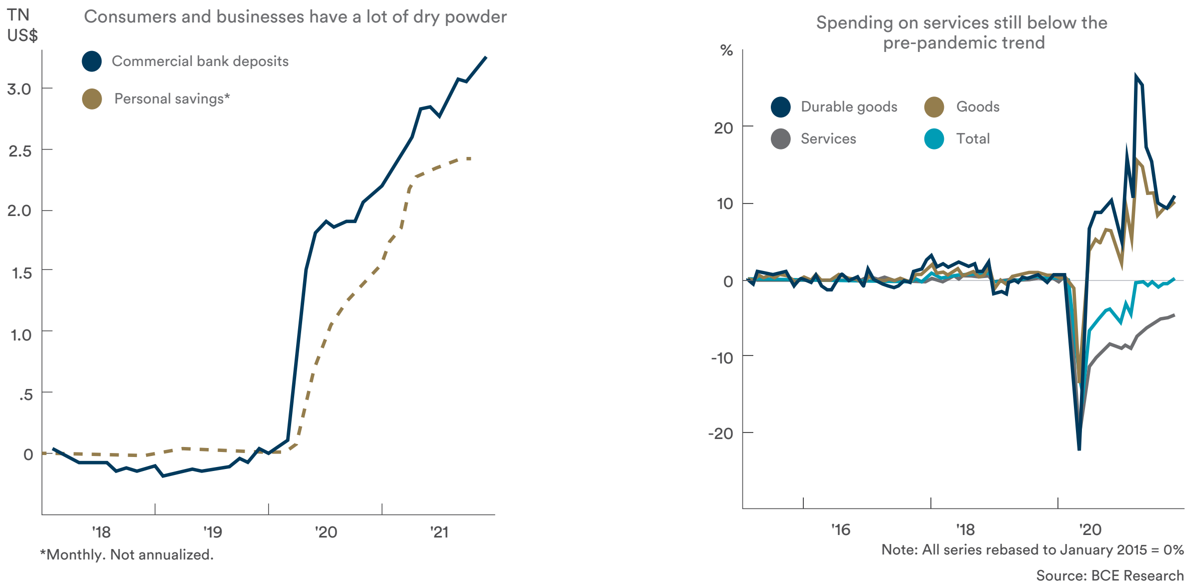
Omicron was the biggest negative surprise during the last quarter. What we know so far is this strain has a higher rate of transmission, but it also appears to be less severe than its predecessor. Preliminary data also suggest that it might be able to evade immunity more easily. Another hot topic in Q4 and in 2021 was inflation, which remained high with supply issues persisting, while demand did not abate. Headline CPI rose 6.8% y/y in November, the highest annual increase in decades, putting into question the transitory nature of inflation and evoking bad memories of the 1970s inflationary period.

From a sector perspective, we saw a wide divergence in performance but the only sector to decline in Q4 was Communication Services with weakness across the telecom, media, and entertainment industries. After Omicron emerged later in the quarter, there was a flight to safety and more cyclical sectors such as Energy and Industrials underperformed. Financials was also a laggard hurt by falling yields. REITs were the best performing sector, followed by Information Technology with strength across the board.

THINKING

The recent increase in COVID cases and associated restrictions will surely have a negative impact on growth in the short term, especially in certain areas like travel. Looking past that hurdle, we see a strong case for a continued economic recovery in 2022 supported by strength in both consumers and corporations with the Fed being the wild card, as usual. Consumers are flush with cash saved during the pandemic and there is still pent-up demand especially in the service industries (Figure 4). Businesses are ready to replenish inventories and invest in capital spending now that supply chain disruptions are easing, and the labour market is improving. All that should support the ongoing recovery, despite the pace of growth slowing. Inflation is also not necessarily bad for equities, especially for certain sectors and for companies with pricing power. As for valuation, we think the US market looks fairly valued at a benchmark level, but we still see lots of good opportunities within the market.

Figure 4: Consumers are flush with cash saved during the pandemic and there is still pent-up demand, especially in the services industry



That said, the most recent developments in the markets and the economy have been another reminder to investors to expect the unexpected. Shortly before Omicron emerged, it seemed as though the market had almost forgotten about the risk associated with COVID, hence the initial selloff. Today, it seems that the market is pricing in a quick resolution partly due to the supposedly less severe outcome from this variant and partly due to the high transmissibility, meaning it would pass the population quicker and lead to herd immunity. But the reality is this scenario might not play out (Figure 5).

For instance we could have another more deadly variant or maybe Omicron proves to be more severe than currently thought. We, as investors, are not willing to bet on any one outcome. Rather, we prefer to invest in a balanced portfolio of high-quality stocks exposed to different drivers so that the portfolio can fair well in the variety of scenarios that could play out in 2022.

DOING

Our US Equity strategy had a very good year, posting strong absolute and relative performance to the S&P 500. While we're aware of the quarterly and annual numbers, we give less importance to short-term numbers and instead focus on executing our investment process to enhance the portfolio for the long run.

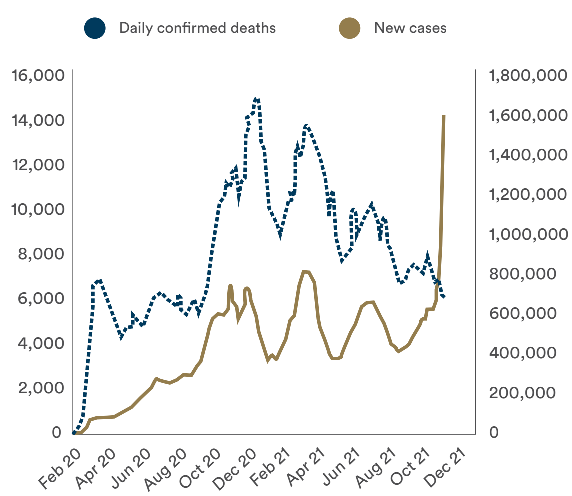
As has been the trend during the year, we further concentrated the portfolio by exiting few of our positions wherein our thesis either played out or the risk/reward wasn't as lucrative as other opportunities. During the quarter, we exited our positions in Disney, Nike, and Lockheed Martin and redeployed the capital in several high-quality businesses that were trading at attractive valuations and offered better risk/reward. Some positions we added to were Amazon, MasterCard, Visa, Booking and TJX etc. Our thesis on these names is based on continuation of revenue and earnings growth, which is not yet being priced in by the market. With respect to the names that we exited, we'll continue to monitor them and, should the risk/reward become lucrative again, we will not hesitate in taking a position.

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. Staying truthful to our process, we continued to deploy capital in such businesses whenever risk-reward was in our favor.

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

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

Figure 5: Global COVID-19 new cases & deaths



Source: Scotiabank GBM Portfolio Strategy, Bloomberg

> "Businesses are ready to replenish inventories and invest in capital spending now that supply chain disruptions are easing, and the labour market is improving."

Q4 2021 Dividend Performance Summary

Canadian Dividend Portfolio

Number of companies in the equity portfolio	32
Number of companies that declared an increased dividend	25
% of companies that declared an increased dividend	78.1%
Weighted average of dividend increase	14.2%
Consumer Price Index Increase (YoY*)	4.7%
Equity portfolio dividend yield**	3.8%
S&P/TSX dividend yield	2.6%

Top 10 Dividend Growers, 2021

Methanex Corporation***	233.3%
Suncor Energy	100%
Canadian Natural Resources	38.2%
Bank of Montreal	25.5%
Sun Life Financial	20.0%
Manulife Financial	17.9%
Toronto Dominion Bank	12.7%
Bank of Nova Scotia	11.1%
Royal Bank of Canada	11.1%
Canadian Tire	10.6%

* Estimate from Statistics Canada November 30 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, December 31, 2021

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