2nd Quarter 2021 (Q2) Market Commentary

Introduction

In this report, we begin with our macro view of the world as we see it – interest rates, currencies, commodities (inflation?) and stock prices are all part of the dynamic, which is constantly changing. Our mantra, "the market is a complex system where every change effects everything else" is worth repeating. By extension, stocks, and thus returns, defy straight line extrapolation. Post our big picture update, we give the skinny on each of our internally managed mandates and any noteworthy items that we feel are of value to you. As you know, cash inflows/outflows and different start dates mean that no two accounts are exactly alike. You will find your individual results in your personal reporting package.

The Big Picture

We start with a recap of what has worked thus far this year and for the second quarter in a row, energy (oil) leads. Our comments from the June 4th edition of The Opportunity Update are apropos, ***"most of us have yet to book a flight"***. We remain deeply convicted that we are in the beginning stages of a multi-year bull market in oil/commodities. That said, I want to caution readers that this will not be a straight line phenomena – there will be some ugly corrections which will cause you to question that thesis. For example, the Delta variant is surging amongst unvaccinated populations forcing lockdowns in Australia, New Zealand and Indonesia. Africa, where only 1% of the population has been vaccinated, has been particularly hard hit. There are obvious negative human/economic implications to lock downs and they will be reflected in the stocks, assuming the numbers are not contained. Our take is that the flare ups will be relatively short lived – we are simply better at dealing with the disease and we are getting more people vaccinated every day. For reasons outlined in Canada's Next Supercycle Is Now Underway, the real issue is the supply side, or more properly put, the lack of supply.

US Sector Returns, as of 06/30/2021

Symbol	Sector fund name	2020	YTD 2021
XLE	**Energy Sector Fund**	-32.7%	45.1%
XLF	**Financial Sector Fund**	-1.7%	25.5%
XLRE	**Real Estate Sector Fund**	-2.2%	23.2%
XLC	**Communication Services Sector Fund**	26.9%	21.4%
XLI	**Industrial Sector Fund**	10.9%	16.4%
XLB	**Materials Sector Fund**	20.5%	14.7%
XLK	**Technology Sector Fund**	43.6%	14.0%
XLV	**Health Care Sector Fund**	13.3%	11.8%
XLY	**Consumer Discretionary Sector Fund**	29.6%	11.4%
XLP	**Consumer Staples Sector Fund**	10.1%	5.0%
XLU	**Utilities Sector Fund**	0.5%	2.4%

Charts courtesy of StockCharts.com

Our favourite leading economic indicators continue to point to better economic growth for both manufacturing and service based economies - copper surged to an eye popping $4.89 per pound in early May and settled at $4.29 per pound on June 30. The semiconductor index actually closed out at yet another all time high, which should not surprise us given the global chip shortage. Note that last word, shortage – every where I turn, there is a shortage: labour, computer chips, oil, copper, nickel which translates into a shortage of almost every manufactured good you can think of. There are no quick fixes to increasing supply. I mean making babies into productive workers is at least a 20 year process☺! Developing a new copper mine takes ten years, siting and building out a new semiconductor manufacturing plant is roughly five years. The current debate on Wall Street is on inflation – is it transitionary or permanent? Interestingly enough, in a recent Bank of America survey some 73% of fund managers believe that it is transitionary. History teaches us that the consensus is more often than not, wrong. So the US Fed and apparently most money managers are in the transitionary camp. When we weigh the long lead times to fix supply driven shortages, we are certainly biased to permanent camp and will position ourselves accordingly until the evidence tells us we are wrong.

Last but not least, two major drivers of global capital markets are interest rates and the $USD – both are at a crossroads. My expectation is that their respective trends, will resume. Specifically, interest rates as measured by the yield of 10 year US government bonds (US Treasuries in industry parlance) have actually declined over the quarter, in part due to the US central bank indicating they are prepared to keep interest rates low until such time as we get back to full employment, irrespective of inflation running hot. Our take is they will be late to take away the punchbowl forcing them to increase rates faster and higher in 2022. For now, enjoy the cheap money.

The $USD rallied in June as per the chart below, but I now see it as pretty overbought and note the lower high versus its peak in April. Our take – if you have $USD's squirrelled away and you have made a decision that you are no longer going to be a snowbird, take this opportunity to convert to $CAD.

Charts courtesy of StockCharts.com

The Dividend Value Discipline™ – launched in the fall of 2002, our bellwether strategy straddles the need for income and growth. It has no restrictions in terms of industry or geography, but it does have biases – i.e. our preference for acquiring "rent cheque (dividend) growers", for both income and capital gain. Why growers? Please ask me the next time we speak. In short, over long periods of time they do extremely well.

Q2 saw significant progress after an already strong start the year in Q1. Our commodities exposure certainly helped. Most balanced accounts (those with a fixed income component) saw year to date returns peg in at the +12% to 13% range, whereas accounts in the all equity version were in the +15% to 16% range.

As you would expect, our objectives remain unchanged:

- Invest in companies that evidence superior corporate culture and are disrupting/reinventing the way business is done, and/or aggregating (purchasing smaller competitors) their way to sustainable double-digit earnings and dividend growth.
- Hold such companies through the inevitable market downturns by focusing on their competitive advantage and thereby the long-term earnings/dividend growth, as opposed to the euphoria and dysphoria of the stock market.
- Generate a consistently growing income and absolute returns of 8%+ per annum over any investment cycle, i.e. peak to peak or trough to trough.

Two new companies were added to the program in Q2. Simpson Manufacturing Company, through its subsidiary, Simpson Strong-Tie Company Inc., they design, engineer and manufacturer wood construction products – things like truss plates, fastening systems for shear walls, and mechanical anchors. Simpson Strong-Tie (SSD) is a highly skilled innovator and market leader in its markets, earning industry highest gross margins. We expect construction industry overall to benefit from multiple growth drivers – favourable demographics, limited housing inventory, urban-to-rural migration.

Muller Industries (MLI) was the other addition with exposure to construction industry. MLI is a disciplined aggregator in value-added copper products, not only they have disciplined mergers & acquisitions strategy, but they also have an impressive stock buyback activity (most purchases were done at multiyear lows of 2018 and of Q1 2020). We expect MLI to benefit from the same growth drivers as SSD.

The other notable move was a doubling of our conviction to PayPal which was highlighted in our Q1 report. An interesting observation – a recent survey by J. P. Morgan asked, when presented with multiple wallet at checkout, which brand do you typically choose? PayPal pegged in at 47% - the next closest was Apple Pay at 11%. That is what I would call first mover advantage!

Rent cheque (dividend) increases? I am glad you asked:

UnitedHealth Group + 16.0%

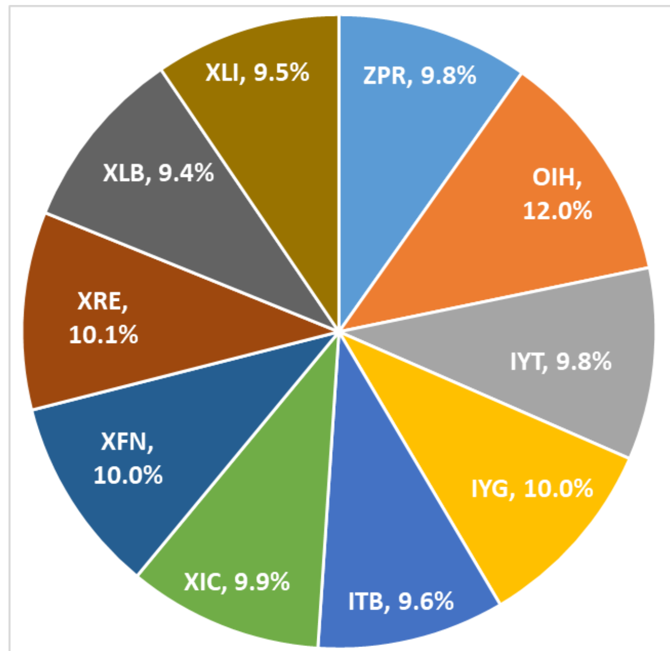
Costco Wholesale + 12.9%

Williams Sonoma California + 11.3%

Independent Bank Group + 6.7%

Dollarama + 6.4%

<u>The Global Active Macro ETF (GAME) Strategy</u> – This mandate continues to push us to sectors/ regions of the world where money is flowing to - it moves with the trend. As participants understand, the process was built to force us to own what is working, regardless of our biases, and push us off what is not working. Throughout the second quarter of 2021 we increased our allocation to broad Canadian equities (XIC.TO) and Canadian real estate (XRE.TO), while trimming some U.S. energy exposure (XOP) and exiting our U.S. bank exposure (KBE).



Where does it fit? The turnover in GAME is fairly high and for that reason, we like to see this mandate within registered accounts (i.e. RSP, RIF, TFSA, IRA). This is a go anywhere strategy an thus is especially appealing to investors that want to move with the market and not get locked into a specific mandate “box”, i.e. U.S. equities or emerging markets debt. When I site periods in history where the S&P 500 has actually been negative on a 10-year rolling basis, most people understand why not getting locked in is so important. That is one of the reasons for our generally negative biases towards mutual funds – they have their place, sparingly, in our view.

The Tax Advantaged Preferred Share (TAPS) Strategy – The Canadian preferred share market backed off ever so slightly in the month of June following interest rates south. What has not changed is the shrinking supply of Canadian preferred shares due to limited recourse capital notes (LRCNs) now being the cheapest option for banks and insurance issuers.

The strategy will appeal to investors where the primary focus is on income, and want maximum tax advantage. It is not appropriate for registered accounts as you would nullify the tax advantages.

The adjacent image shows a snapshot of our current model issuers as of June 30, 2021. The current portfolio yield is ~4.5% (or 4.0% net), but recall that the interest equivalent due to the dividend tax credit is north of 6% assuming you are in the highest marginal tax bracket, and if you are not, it only gets better.

PREFERRED SHARES ISSUERS
BCE INC
BANK OF NOVA SCOTIA
BROOKFIELD ASSET MANAGEMENT INC
ENBRIDGE INC
FAIRFAX FINANICAL HOLDINGS LTD
GREAT WEST LIFECO INC
MANULIFE FINANCIAL CORP
PEMBINA PIPELINE CORP
POWER CORP OF CANADA
ROYAL BANK OF CANADA
TORONTO-DOMINION BANK

The Keep More Income (KMI) Strategy – This mandate was developed for a very specific niche – a resident of Canada, whose primary concern is after tax income and yet wants some growth, over time. Thus, it is only suitable for non-registered/taxable accounts.

At the risk of ad nausea, prior to the market meltdown of 2008/09, Canada was the place to be for most of the previous decade, in terms of investment returns. Post that crisis, the U.S. has been the place to be for most of the past 12+ years. Historically speaking, it is extremely unlikely that the U.S. will continue to be the place to be for the next decade. In our view, the $USD is still in a downtrend and there is plenty of evidence that investors are returning to the X-USA space. The best opportunities tend to come from sectors/regions where investors have thrown in the towel and yet, the fundamentals have changed for the better – that certainly describes Canada's resources sector and if the resources are doing well, most Canadian companies will do well, ergo stocks.

For participants, yes this has done even better than I expected – far better. Again, please temper your expectations, prolonged periods of performance at these levels are doubtful. For non-participants, because the formalized program has been in existence for less than one year, we cannot make the results public.

The Next Cycle Resource Fund (NCRF) – Like the KMI strategy above, the tenure of this program is insufficient for us to be able to share the results publicly. Our latest take on the secular view is best looked at here: Canada's Next Supercycle Is Now Underway. In short, we remain in the bullish camp.

Throughout the quarter there was a notable trend to more oil allocation at the expense of wood and power producers.

Who is it for? Investors with a higher risk tolerance and a specific interest in owning some of Canada's top resource producers. Due to turnover, it is better suited to a non-taxable account or slice thereof.

Conclusion

By any measure, the Q2 2021 performance was outstanding across all of our internally managed mandates. It bears repeating – we must expect pullbacks, notwithstanding our bullish long term view. If you are currently in the spend/distribution cycle of life, this is a great time to be adding to your safe pile. If you are still in the accumulation stage, there is nothing to do other than enjoy the ride. When the inevitable pullback happens, turn the couch upside down and find some money to invest. Investor behaviour remains the number one determinant of lifetime returns.

On behalf of the team and me, happy summer – enjoy your loved ones,

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