PICTON MAHONEY
Asset Management

Q1 2021

INVESTMENT REVIEW & OUTLOOK

Building the Bubble

- GLOBAL ECONOMIC SURGE JUST AHEAD
- SHARED BULLISH OUTLOOK
- VALUATIONS: EXTENDED BUT NOT PROHIBITIVE
- ARE THE ROARING '20S AHEAD?
- AN EMERGING RISK TO MONITOR: INFLATION
- SECTOR LEADERSHIP: CHANGING OF THE GUARD

OVERVIEW

The combination of unprecedented monetary stimulus, ongoing fiscal support and the end of COVID-related lockdowns can lead to the strongest surge in global economic growth in decades. Central banks have committed to maintaining stimulus even as western economies recover, which could lead to a significant surge in stock markets and other risk assets this year. While equity markets may be "overbought" in the short run, a greater risk to their performance may be an earlier-than-expected surge in inflation once the economic expansion is well underway.

PICTON MAHONEY HOUSE VIEW

VIEW	PMAM VS. CONSENSUS
RISK Macro risk went full cycle in 2020, from peak levels in the first quarter to ending the year at very low levels. From here, we believe it can only go up, and first-quarter 2021 will likely be a bumpier ride as the world grapples with what is hopefully the final virus surge and lockdown.	**HIGHER**
MACROECONOMIC	
GLOBAL REAL GDP With much of the world in some level of renewed lockdown entering the first quarter, we expect global GDP to disappoint in the quarter, but eventually bounce back hard into the summer months and the rest of the year.	**LOWER**
U.S. REAL GDP First-quarter U.S. GDP estimates will likely be revised down as the quarter progresses and the impact of lingering lockdowns and renewed furloughs is felt. While a large fiscal package is imminent, it will not be enough to save the first quarter.	**LOWER**
CANADA REAL GDP Unlike the U.S., Canada's first-quarter GDP estimates are more realistic, given the renewed lockdowns and slow pace of vaccination. However, as we approach the summer months, we expect GDP to bounce back more intensely.	**SAME**
U.S. INFLATION U.S. inflation should remain muted in the first quarter, although we expect it to bounce higher during the rest of the year, especially with the U.S. Federal Reserve (the Fed) committed to sitting on the sidelines for a while.	**SAME**
EQUITY RETURNS	
U.S. EQUITIES We expect a sentiment-driven market correction at some point in the quarter, followed by a more robust early-cycle market rally into the rest of the year as the impact of COVID subsides and cyclical industries recover.	**SAME**
EUROPEAN EQUITIES Europe has battled through another round of economic slowdowns to contain the latest outbreaks, but we expect a combination of fiscal support and quick vaccinations will help it return to a more stable footing.	**HIGHER**
CANADIAN EQUITIES Canadian equities will likely benefit from stronger commodity prices as the year progresses and as global growth resumes.	**HIGHER**
BOND YIELDS	
TREASURIES (U.S. 10-YR) While the Fed remains committed to remaining accommodative until inflation is much higher, we expect rates to slowly inch higher as expectations for higher inflation become increasingly well established.	**HIGHER**
INVESTMENT-GRADE CORPORATE BONDS Investment grade spreads fully compressed back to pre-crisis levels and have remained in high demand, though already low treasury rates may limit their upside.	**SAME**
HIGH-YIELD CORPORATE BONDS With the U.S. Federal Reserve willing and able to step in as a buyer of last resort, tail risk has been taken out of most corporate bonds. Further upside will require continued improvement to the growth outlook.	**SAME**
OTHER	
WTI CRUDE OIL Oil fundamentals have improved dramatically, as inventory levels have been decreasing and the futures curve is in backwardation, implying a strong demand for current oil. We expect a weakening U.S. dollar and rebounding global economy will also help.	**HIGHER**
EPS GROWTH (S&P 500) Earnings growth is expected to rebound in 2021, although an extended resurgence and lockdowns may delay the bounce-back.	**HIGHER**
P/E (S&P 500) Multiples at multi-year highs is likely to drop again over time as real rates rise, particularly in the high-growth information technology sector.	**LOWER**

PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at December 2020.

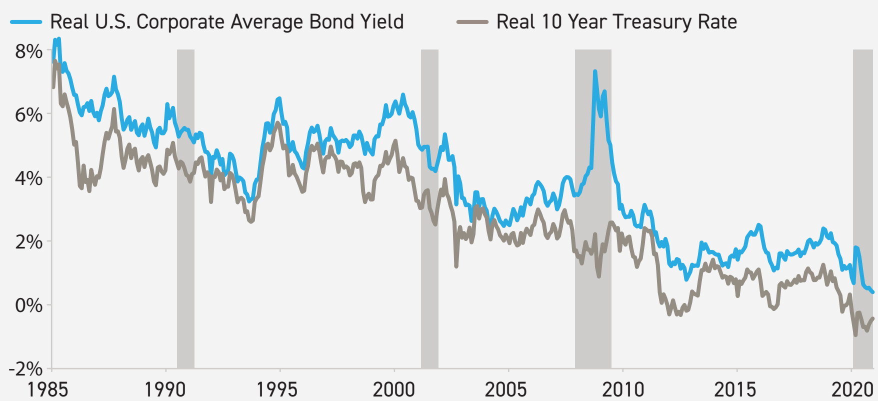
GLOBAL ECONOMIC SURGE JUST AHEAD

We expect a material reacceleration in global economic activity in 2021. The International Monetary Fund estimates point to a 5.5% expansion in global growth[1], the strongest in over a decade.

The central bank monetary stimulus supporting western economies through the pandemic remains extraordinary. The real yield on the U.S. ten-year Treasury bond is still deeply negative, hovering around record lows near -100 basis points (bps) (Fig. 1). Meanwhile, corporate debt yields remain near generational lows, allowing companies access to capital while maintaining low interest expenses.

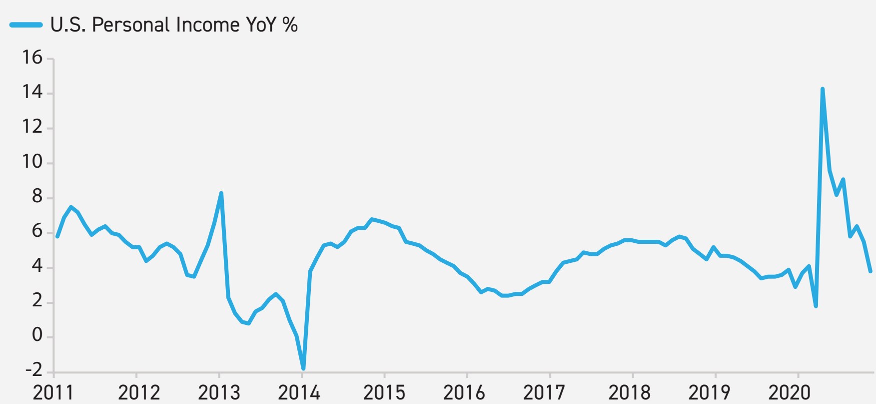
Government fiscal programs have maintained the financial health of North American consumers. Despite the pandemic, U.S. personal income growth remains positive in year-over-year terms, climbing 3.8% in November (Fig. 2). In Canada, third-quarter retail sales came in 7.5% higher than in 2019. We expect easy monetary conditions and healthy household balance sheets would lead to a consumption explosion of pent-up demand in services, entertainment, and travel as COVID-19 fades into the background later this year. New fiscal spending initiatives to be announced by incoming President Joe Biden will likely only add fuel to the fire.

FIGURE 1: GENERATIONAL LOWS IN REAL YIELDS



Source: Bloomberg, L.P., and PMAM Research. As at Nov, 2020.

FIGURE 2: U.S. PERSONAL INCOME GREW IN 2020 DESPITE PANDEMIC



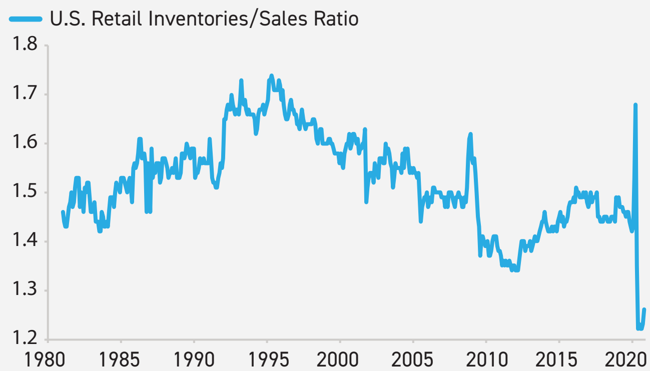
Source: Bloomberg, L.P., and PMAM Research. As at Nov, 2020.

[1] International Monetary Fund World Economic Outlook Update, January 2021, https://www.imf.org/en/~/link.aspx?_id=B52E2E0927854FC8823D98E147138A43&_z=z

Inventory Rebuild Drives Economic Momentum ...

Manufacturers are set to rebuild inventories as 2021 begins. Although somewhat insulated from quarantine restrictions, goods providers responded to global supply chain issues and potential lack of demand by drawing down inventory levels. Many of these manufacturers were likely quite surprised by the resiliency in demand for their products. The U.S. retail inventories to sales ratio has fallen to 40-year lows as a result (Fig. 3). With vaccinations ramping up and the end of the pandemic in sight, the restocking process will likely provide an early impetus for economic growth.

FIGURE 3: A GENERATIONAL LOW



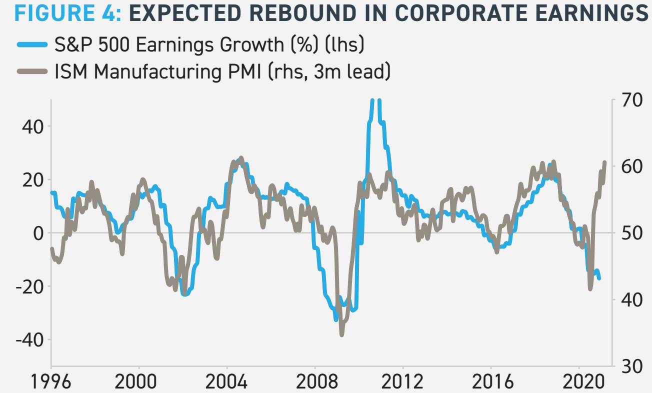
Source: Bloomberg, L.P., and PMAM Research. As at Nov, 2020.

... Leading to Corporate Profit Growth

The manufacturing bounce-back will liekly drive the Institute for Supply Management's Purchasing Managers Index (PMI) higher, and this has important positive implications for corporate profitability.

As Figure 4 highlights, S&P 500 EPS growth tracks manufacturing PMI with a three-month lag, suggesting corporate earnings will accelerate significantly through 2021.

FIGURE 4: EXPECTED REBOUND IN CORPORATE EARNINGS



Source: Bloomberg, L.P., and PMAM Research. As at Dec, 2020.

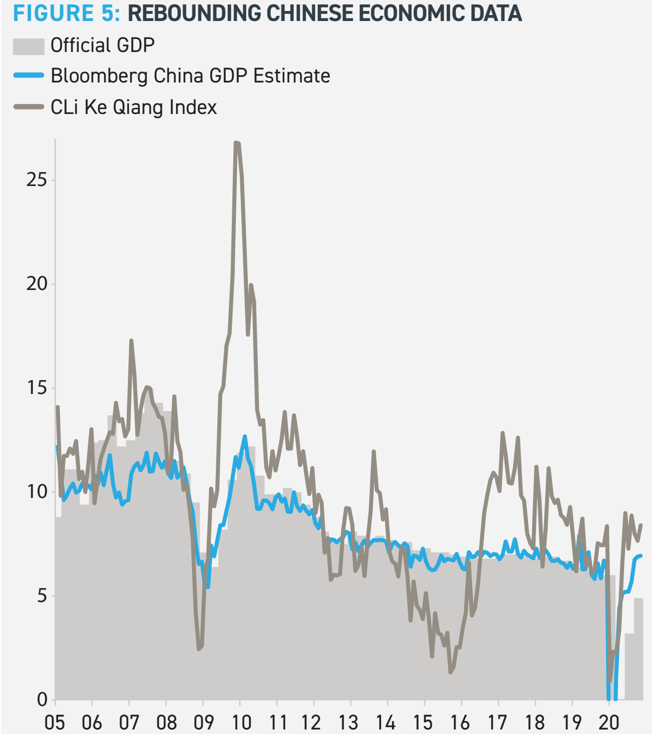
Strong Chinese Recovery Shows What's Likely Ahead for the Rest of the World

China, the first country to endure and then contain a COVID-19 outbreak, has already shown the impressive speed with which economies can recover from pandemic conditions. Western governments do not have China's more authoritarian virus-fighting options, which has contributed to a tragic second wave of viral spreads in many countries. However, if China is a precedent, a sharp economic rebound can be expected in the developed world as COVID vaccines roll out and lockdowns end.

As noted in Figure 5, China's GDP contracted by 6.8% year-over-year when the pandemic peaked there during the first quarter of 2020. However, by the third quarter its economy was growing at a 4.9% clip, and December's results were even stronger, at 6.5%, well above estimates. For 2021, economists recently raised growth estimates from 8.0% to 8.2%.

China demands about half of the world's production of most major commodities, which makes the country's import growth inarguably the most important driver of resource prices. Year-over-year, import growth in China troughed in May 2022, at -16.7%, but has since recovered to 6.5% for December, a report that again exceeded estimates.

FIGURE 5: REBOUNDING CHINESE ECONOMIC DATA



Source: Bloomberg, L.P., and PMAM Research. As at Nov, 2020.

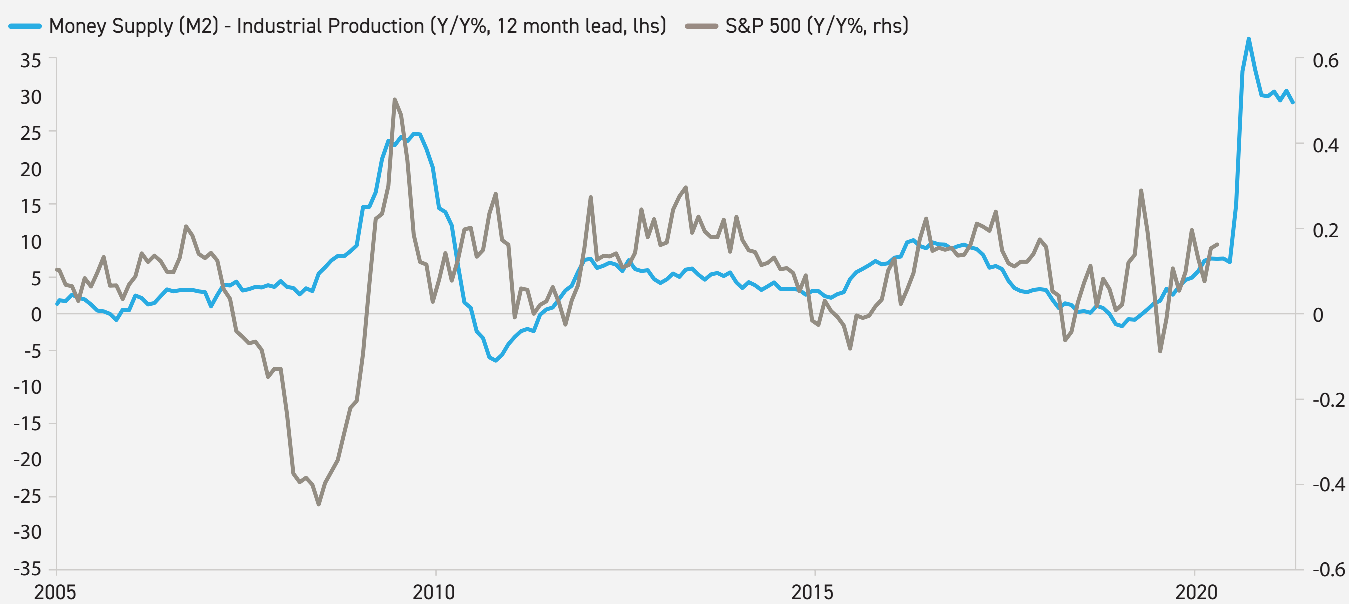
The Bull Case for Equities Is Clear...

The stock market backdrop at the start of 2021 is very positive. Central banks continue to support major economies with extreme levels of monetary policy and liquidity that will help buoy markets, while also contributing to both a manufacturing and corporate profit recovery. We expect fiscal stimulus programs would add to the growth. Of course, a successful rollout of vaccine programs will likely be a tremendous driver of pent-up demand in a number of industries that have been negatively affected by COVID-related shutdowns.

The amount of excess liquidity in the system, especially in the U.S., is likely to contribute to further gains in risk assets (Figure 6). Also, as the economy accelerates, ultra-low real bond yields can also compel investment flows out of fixed-income instruments and into stock markets.

Given the prospects of an economy accelerating through this year and a U.S. Fed that plans to stay the course with its easy economic policy, there is a distinct possibility that stock prices have room to "bubble" much higher this year.

FIGURE 6: MONEY SUPPLY UP ON A STICK...EQUITIES COULD BENEFIT



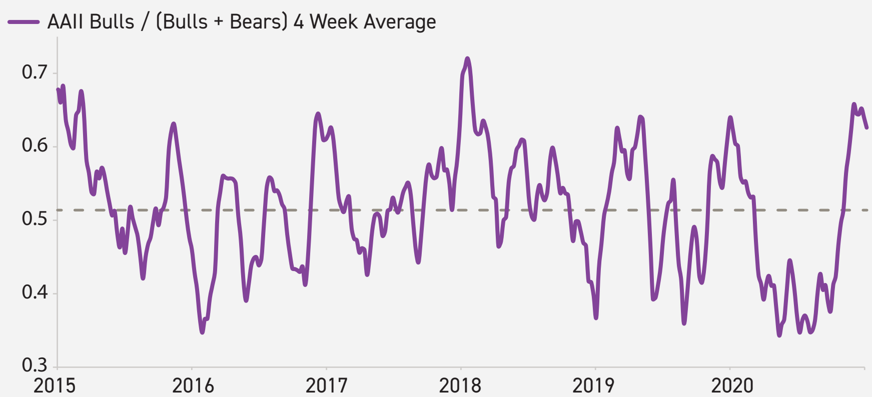
Source: Bloomberg, L.P., and PMAM Research. As at Dec, 2020.

SHARED
BULLISH OUTLOOK

Our positive market outlook is complicated by a few shorter-term risks. The new year gets underway with perhaps too many other investors already in an exuberant mood. Many major equity benchmarks are hitting new peaks, and the weekly survey by the American Association of Individual Investors (AAII) indicates that bears are few and far between. The AAII results show that bullish investors predominate to a degree that in the past has been associated with sentiment-driven market peaks (Fig. 7).

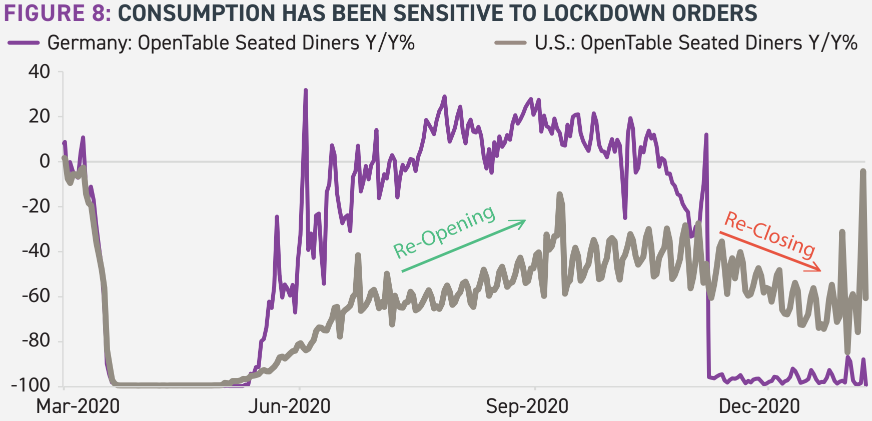
Stocks have been rallying through a new wave of COVID cases and a recent deterioration in leading indicators, providing further evidence of the underlying strength of the rally. However, this rally has left stock prices at least somewhat vulnerable to the prospects of a worse-than-expected economic recovery. The negative effects of a second wave of the pandemic are already apparent in service industries worldwide. In Germany, restaurant activity collapsed in November after staging a strong recovery through the summer months. In the U.S. the same pattern is also evident, if slightly less dramatic (Fig. 8).

FIGURE 7: LOTS OF BULLS OUT THERE



Source: Bloomberg, L.P., PMAM Research. As at Dec. 31, 2020

FIGURE 8: CONSUMPTION HAS BEEN SENSITIVE TO LOCKDOWN ORDERS



Source: Bloomberg, L.P., and PMAM Research. As at Dec. 31, 2020.

Manufacturing sectors have been somewhat insulated from the worst effects of the virus, but are now showing signs of sensitivity to "reclosing" effects. The new orders component of the Philadelphia Federal Reserve Business Outlook – the most forward-looking segment of the survey – has fallen sharply in recent weeks (Fig. 9).

Job-Related Disappointments a Possible Catalyst for Correction

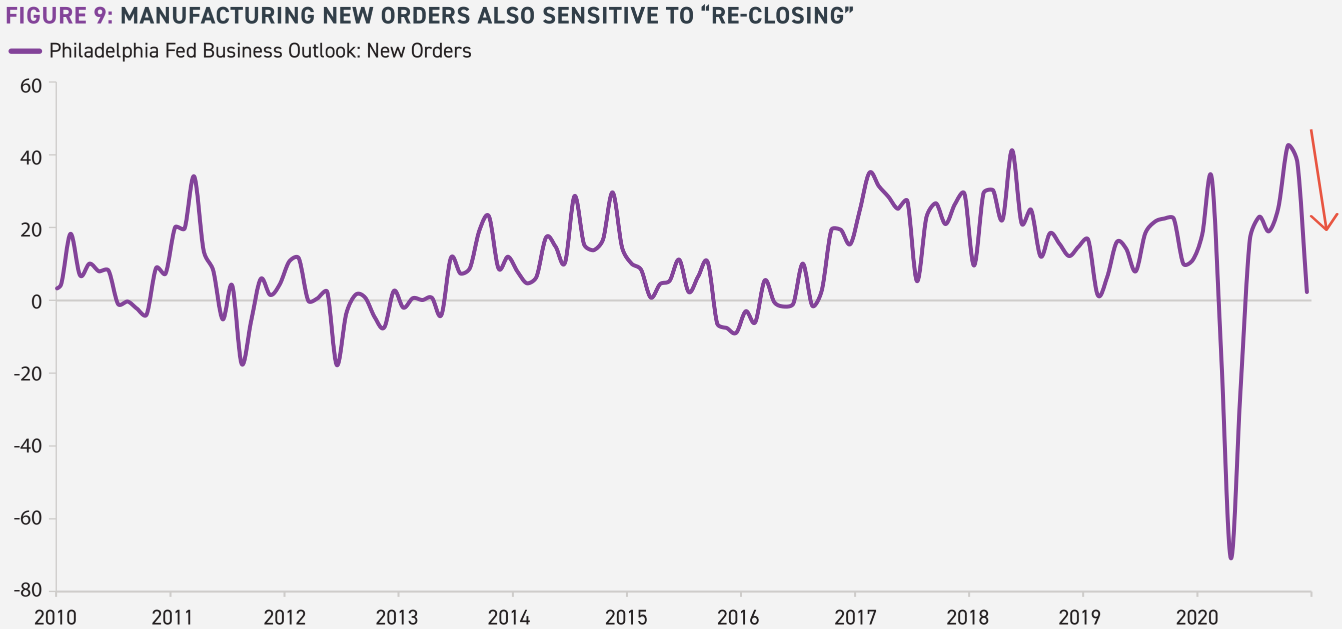
A negative surprise from U.S. employment data is becoming increasingly likely, which could cause market volatility in the near term. American workers who have recently returned from furloughs might be confronted again with forced, unpaid vacations as more lockdowns take effect.

U.S. job market weakness is already evident in recent data. The economy lost 140,000 jobs in December, when economists expected a gain of 50,000. The newly unemployed were almost entirely from the leisure and hospitality industries, after workers returning from furloughs were sent home again.

Weekly jobless claims data are also disquieting. For the week ending January 9, 965,000 Americans filed for jobless benefits, when 789,000 were expected. Continuing claims came in at 5.3 million, above the 5.0 million expected.

Market euphoria combined with weakening economic data is a mix that seems destined to cause market volatility in the near term; however, we expect that any market pullback will be brief and shallow. By mid-summer 2021, we expect the virus to be contained, at least to the point that further large outbreaks are highly unlikely. This will allow all industries, and notably the leisure sectors hit hardest by the pandemic, to resume normal activity. Any pullbacks in equity markets in the near term would relieve overbuying pressures and, potentially, reduce some of the excess bullishness we see in equity markets today.

FIGURE 9: MANUFACTURING NEW ORDERS ALSO SENSITIVE TO "RE-CLOSING"

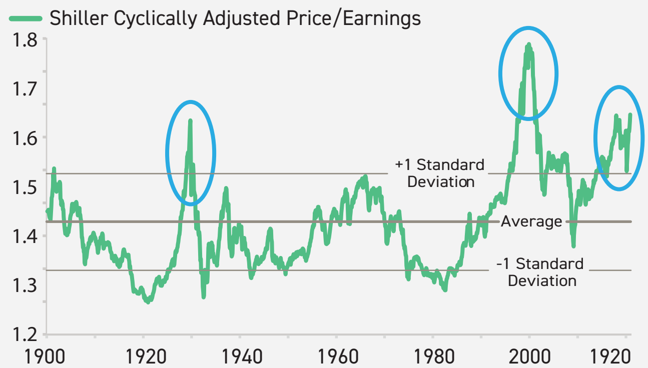


Source: Bloomberg, L.P., and PMAM Research. As at Dec, 2020.

VALUATIONS:
EXTENDED BUT NOT PROHIBITIVE

IIn 2020, massive central bank liquidity injections helped stabilize global financial markets, which then rallied back aggressively from their lows as the global economy regained some of its footing. Investment assets poured into technology companies, like Amazon.com Inc., Shopify Inc. and Alphabet Inc., that benefited from quarantine conditions and the pulling forward of their business models. As a result, the oft-quoted Shiller Cyclically Adjusted Price/Earnings (CAPE) ratio leapt well above the long-term historical average. The current CAPE ratio resembles that which existed during the pre-Great Depression peak, although it remains well below the excesses of early 2000 (for now at least) (Fig. 10).

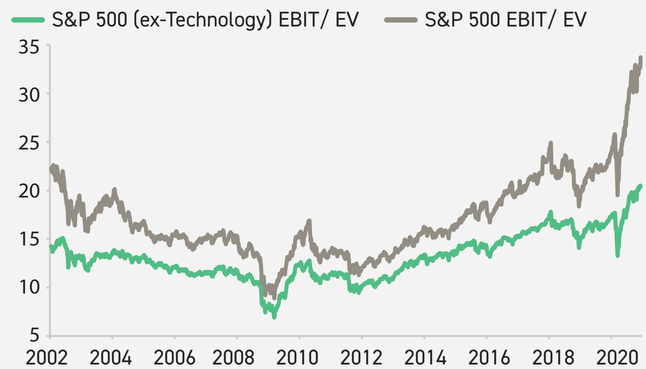
FIGURE 10: LONG-TERM VALUATIONS LOOKING RICH



Source: Robert Shiller, PMAM Research. As at Dec, 2020.

However, a look beneath the surface finds valuation levels more palatable than at first glance. The S&P's aggregate multiple has been skewed higher by the dominance of a handful of expensive technology stocks – the FAANG group – that grew to 25% of the Index's market cap in 2020. It is evident from Figure 11 that with technology stocks excluded, the U.S. stock market is far cheaper than the headline numbers would suggest.

FIGURE 11: VALUATIONS, EX-TECHNOLOGY, NOT AS STRETCHED

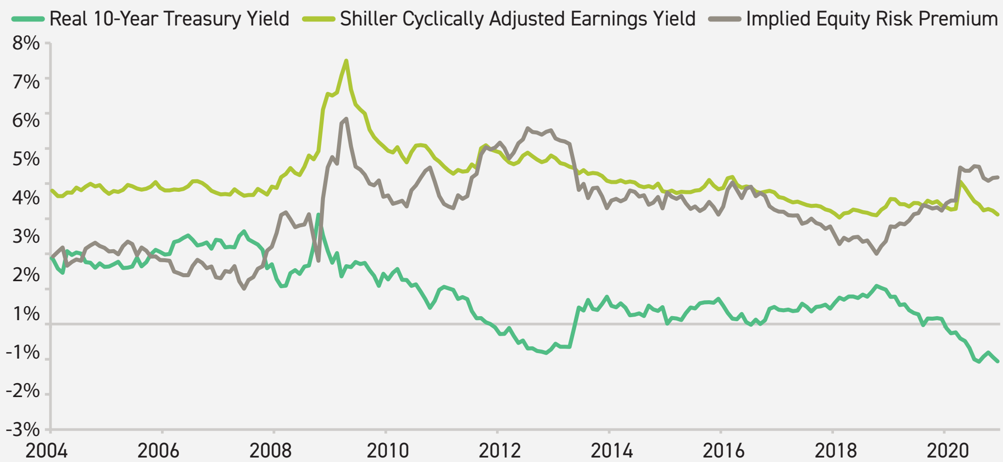


Source: Bloomberg, L.P., PMAM Research. As at Dec. 18, 2020.

It is true, though, that most sectors outside of technology are expensive relative to history. We believe they should be. Seemingly "lofty" valuations are supported by the very low real yields noted earlier. How so? In simple finance terms, there still exists a significant equity risk premium (ERP), or relative attractiveness, when the earnings yield on the S&P 500 Index is compared with real Treasury yields.

The ERP can be thought of as a potential reward for taking equity risk, as compared with the returns available on supposedly risk-free government securities. Figure 12 inverts the Shiller Cyclically Adjusted Price/Earnings ratio mentioned earlier to create an earnings yield measure, and then compares this yield to the negative real yields available from U.S. ten-year bonds. The difference between these two yields is a way to measure the ERP that exists in the stock market today. On this measure, the U.S. equity market appears reasonably attractive (especially in more inflation-sensitive and/or cheaper non-technology equities).

FIGURE 12: ACCOUNTING FOR REAL YIELDS, EQUITY VALUATIONS "NOT TOO BAD"



Source: Bloomberg, L.P., and PMAM Research. As at Dec, 2020.

Structural Inflows: More Fuel for the Fire

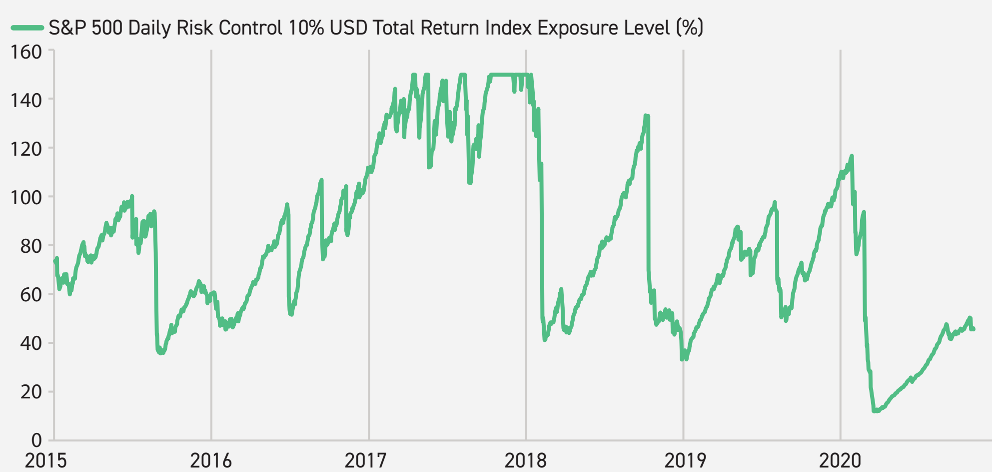
The current sub-zero real yield on ten-year Treasuries can mean that bond investors will likely experience a loss of spending power when their bonds mature. Bond yields are simply not attractive in comparison with the earnings yield on equities. Negative inflation-adjusted bond yields, combined with lower market volatility, will promote significant equity inflows from certain more systematic asset managers, and this should contribute to driving stock prices even higher in 2021.

The early 2020 COVID-related surge in volatility saw the CBOE Volatility (VIX) Index jump from 15 in mid-February to 86 in March. Control processes for volatility-driven risk kicked in, causing an almost robot-like shift out of equities for systematic strategies such as risk parity, volatility control and CTAs (commodity trading advisors). These deleveraging flows helped drive markets sharply lower during the panic. These funds eventually began reversing their selling once stock markets had bottomed and had rallied somewhat. However, many of these systematic strategies remain underexposed to equities as 2021 begins.

Barclay's forecasts that between US$250 and US$500 billion of hedge fund assets are set to move to equities from other asset classes.[2] Volatility control funds, for example, ended the year with just less than 60% of assets allocated to stocks, when 90% is their historical average (Fig. 13).

[2] Barclays U.S. Equity Trading Color, December 18, 2020.

FIGURE 13: SYSTEMATIC INVESTORS NOWHERE CLOSE TO "ALL IN"



Source: Bloomberg, L.P., and PMAM Research. As at Dec, 2020.

ARE THE ROARING '20S AHEAD

Markets begin 2021 in a euphoric mood, with pockets of excess causing some investors to worry that a year 2000-like implosion for technology stocks and the broader equity market lies ahead. The strong performance of technology stocks in 2020, and their dominance of U.S. equity benchmarks, is admittedly reminiscent of the late 1990s bubble, but there are important differences.

The most important difference is that the Federal Reserve monetary tightening that pricked the bubble in 2000 is unlikely to commence any time soon. Federal Reserve Chair Jerome Powell has committed the Fed to extremely loose monetary policy until the economy moves toward full employment, with inflation "averaging" 2%. This suggests that inflation would have to exceed 2% for a sustained period in order to bring the averages up to this 2% level. In other words, barring a significant shock to the economic system, there is ample time for stock prices to move higher (and maybe considerably higher).

Could we be entering a period like the Roaring '20s? After the first world war and the end of the Spanish flu epidemic, consumption soared, driven by pent-up demand and perhaps a release of exuberance following the suffering and restraint of previous years. Similarly, the COVID-19 pandemic has created elevated levels of household savings and a desire to spend some of those savings to enjoy life when things return to "normal."

The 1920s was a period of technological change that would transform the economy and create unbridled growth. The proliferation of electrical power allowed Henry Ford's process innovation to create a transportation revolution. Affordable basic appliances for the masses then followed. Radio was the media disruptor of the period, rewriting entertainment and news consumption habits.

A similar wide-reaching technological transformation is underway now. The COVID economy and working from home have accelerated the digitization of the economy, pulling forward trends that otherwise would have taken years to unfold. The impacts of artificial intelligence and machine learning are only just beginning.

The Roaring '20s were eventually infamous for speculative excess. Spurred by financial innovations that included margin debt, "playing the market" became rampant. Similarly, there are certainly pockets of speculation that are alive and well today. Many individual investors (or "Robinhood" traders) have taken up stock trading as a pastime and have enjoyed considerable returns since the market lows in March. Many of them have now graduated to buying short-dated call options in large numbers, or even banding together to cause "short squeezes" in stocks into which the hedge fund community has crowded. One should not underestimate the potential effects of the retail investor's return to stock market speculation, a trend Goldman Sachs called "the most important change to market structure dynamics."[3] This speculation may not end well, but it could distort the prices of popular trends, pushing them upwards before the music eventually stops (or the bubble eventually pops).

[3] GS Research Division, December 18, 2020.

AN EMERGING RISK TO MONITOR: INFLATION

It's been decades since investors were confronted with inflation pressure and its negative effects on risk asset prices, but they may have to refamiliarize themselves with inflationary market environments in the coming years.

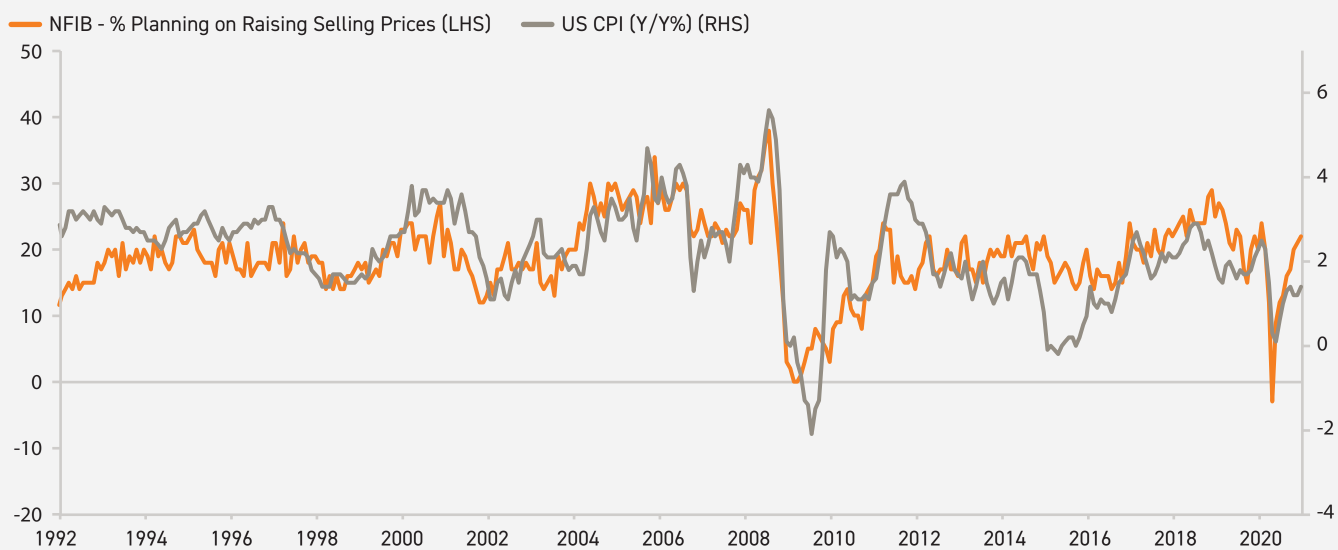
To be clear, there are no imminent signs of rampant, 1970s-style wage and price inflation. Economic growth in developed economies remains well below full potential, thanks to the pandemic, and the damage will take some time to repair. This should serve to keep wage and price pressures suppressed. The deflationary effects of technology also remain in place, and an aging population in most major economies will keep help GDP growth rates in check.

At the same time, there are a growing number of inflation drivers on the horizon. The sudden rush of post-quarantine consumption could very well create scarcities and upwards price momentum for goods and services. Low inventories could exacerbate this problem. This risk could become even more acute if ongoing disruptions to global supply chain continue.

Business closures in many travel, leisure and entertainment-related industries will have reduced capacity, leaving the survivors with the enviable but difficult task of coping with a sudden surge in renewed consumer demand. This imbalance between capacity and demand will give many businesses the power to raise prices, to try to moderate demand so as to be able to handle the flow.

Morgan Stanley has grown more adamant about the prospects for higher inflation. Pundits have unsuccessfully predicted inflation over the past decade, but Morgan's U.S. equity strategist Michael Wilson believes that the difference

FIGURE 14: BUSINESSES ARE ALREADY PLANNING PRICE INCREASES



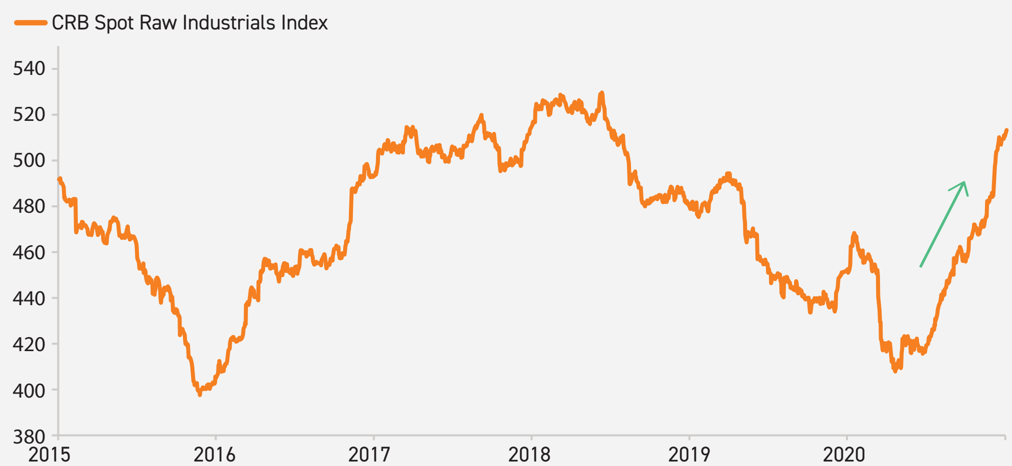
Source: Bloomberg, L.P., and PMAM Research. As at Dec, 2020.

this time is that monetary stimulus has been joined by fiscal support, such as government funds being sent directly to Main Street consumers. Wilson writes, "the Fed may no longer be in control of the velocity of money, and that is exactly the kind of sea change that can lead to unexpected outcomes in the financial markets."[4]

Some degree of inflationary pressure is already evident in U.S. economic data: November's NFIB Survey showed that small businesses are already planning on increasing prices in the next three months. Currency and commodity trends are also pointing to higher inflation. The U.S. dollar continues to weaken, while inflation break-evens and swaps are converging on the magic 2% level. Even non-market tradable commodities (as detailed by the CRB spot raw industrials index) have recovered from their pandemic lows and are nearing 2018 highs. The U.S. yield curve is steeper than at any point since 2017.

There is a small but growing possibility, then, that the U.S. Federal Reserve will have to start tightening monetary policy more quickly and/or more aggressively than market participants currently believe. Should this occur, it might suddenly lead to higher interest rates that could pop the stock market bubble that is currently inflating. This should not be a near-term risk for equity markets, but it will be well worth monitoring as the economic acceleration gets underway.

FIGURE 15: BROAD INDUSTRIAL COMMODITIES SIGNALING INFLATION



Source: Bloomberg, L.P., and PMAM Research. As at Dec, 2020.

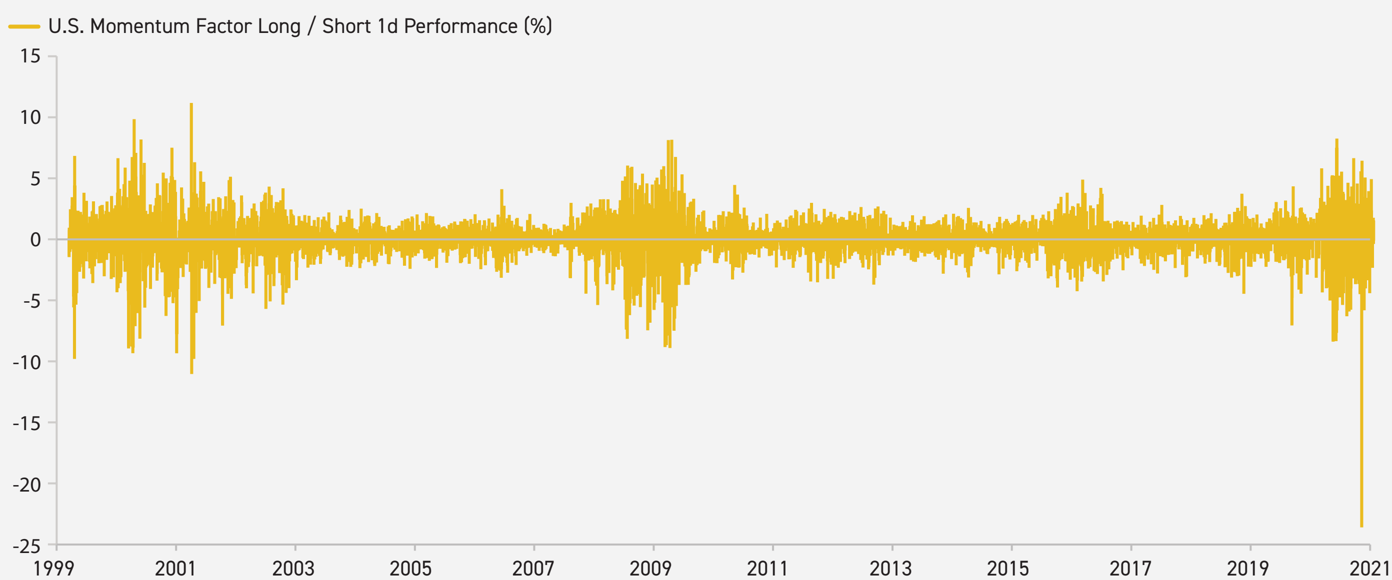
[4] Morgan Stanley Research, US Equity Strategy, North America, "Weekly Warm-up A New Year of Opportunities and Risks," January 4, 2021, p. 3.

SECTOR LEADERSHIP:
CHANGING OF THE GUARD

The November 9 announcement of the Pfizer vaccine contributed to a changing of the guard in markets that we expect will continue through 2021. The previous market leaders – technology and other growth companies benefiting from the work-from-home trend – gave way dramatically in favour of economically-sensitive and/or value stocks. The U.S. Momentum Factor dropped a record 24% on November 9 alone (Fig. 16).

Commodity-related investments should be among the biggest beneficiaries of the new market environment. Commodity cycles of underperformance or outperformance have tended to last about a decade in the past, and it has been almost that long since the China-driven resource boom ended. Capital investment in new production has been low for many years, raising the odds of scarcities and higher commodity prices that would spur renewed capex in many commodity sectors.

FIGURE 16: POSITIVE VACCINE NEWS KILLS MOMENTUM FACTOR



Source: Bloomberg, L.P., and PMAM Research. As at Dec. 21, 2020.

IN CONCLUSION

We expect markets to rally considerably in 2021. A successful rollout of vaccine programs will be a tremendous driver of pent-up demand in a number of industries that have been negatively affected by COVID-related shutdowns. Central bank stimulus is aggressive, and fiscal stimulus programs should add to the growth. The combination of accelerating and powerful economic growth and easy money policies could lead to bubble conditions spreading across stock markets, especially as individual retail investors become more and more emboldened. The challenge will be to enjoy enough of the boom before risks such as inflation take the wind out of its sails.

SECTOR
OUTLOOKS

INDUSTRIALS

Despite the effects of COVID-19, demand for freight, construction and machinery has been consistently improving at the margin, with valuations largely factoring in a full recovery. The severity and timing of the pandemic are impossible to predict, but we are confident the businesses we like, including those most affected, will continue to meet our long-term return thresholds over time. We have used this opportunity to shore up weightings in our high-conviction names, to buy a few cyclical names with upside and to offset exposures with the appropriate hedges.

We continue to favour companies with a history of compounding, idiosyncratic growth angles and/or opportunities to improve returns on invested capital. Canadian Pacific Railway Limited (TSX:CP), Waste Connections Inc. (TSX:WCN) and Copart Inc. (NYSE:CPRT) remain preferred names, given their high rates of internal return and their ability to grow free cash flow through cycles. We have also recently initiated a position in Triton International Limited (NYSE:TRTN), an intermodal rental company serving shippers across the globe. It has an entrenched market position and a long runway for growth. Our stake in modular office solution provider Willscot Corp. (NASDAQ:WSC) has significantly outperformed the market since we initiated the position this summer. The investment thesis is predicated on its free cash flow-generating potential, bolstered by its merger with portable storage solutions provider Mobile Mini Inc. (NASDAQ: MINI). We also remain bullish on longer-term air traffic demand in Canada. Companies exposed to air traffic, such as Air Canada (TSX:AC) and CAE Inc. (TSX:CAE), should be able to weather this storm and gradually benefit from improving demand trends in the coming years.

MATERIALS

The S&P/TSX Materials sector lagged during the quarter, down 4%; however, there was significant variation in subindustry performance, with gold equities down 15% and copper equities up 68%. Following the positive vaccine data in November, there was a significant rotation into more cyclical areas of the Material sector, including base metals, chemicals, fertilizers and forest products.

In Materials, we continue to have a positive view on base metals, with a preference for copper, for which both the economic and commodity cycles are favorably aligned. In terms of the economic cycle, we believe that following the sharp global recession triggered by COVID-19, we have entered a new cycle; historically that favours early cyclicals, including copper companies. As for the copper commodity cycle, we expect demand to improve while new supply is limited; most copper producers have been constrained for capital for the past few years, which put a halt to new growth projects and led to a multi-year period of deficits. We continue to hold First Quantum Materials Ltd. (FM) and recently added Hudbay Minerals Inc. (HBM) to the portfolios. Hudbay Minerals Inc. is a diversified miner with a focus on low-cost, long-life assets in mining-friendly jurisdictions in the Americas. The company had a recent CEO change in 2020, which we see as a positive change event, and its asset base has the potential to crystallize value with increasing gold production from its Canadian assets.

INFORMATION TECHNOLOGY

The MSCI World Information Technology Index and the S&P/TSX Composite Information Technology Sector Index increased by 12.7% and 7.6%, respectively, in the fourth quarter of 2020. Electronic equipment and technology hardware were the two strongest subsectors, benefiting from an investor shift to lower-valuation stocks with higher exposure to cyclical end-markets. Apple Inc. (NASDAQ:AAPL) continued to perform well during the quarter, due to strong demand for services, wearables and new 5G iPhones. Internet and catalog retail was the worst-performing subsector as e-commerce stocks stalled out and investors shifted assets to more cyclically exposed stocks. Looking ahead to the first quarter, semiconductors should be a strong subsector as the industrial economy recovers. We like Micron Technology Inc. (NASDAQ:MU) as the memory pricing environment begins to improve in 2021. Capacity additions in DRAM have been lower than historical trends, leading to lower supply growth. Inventories across end-markets are declining, and memory content increases across several applications will help drive consumption.

In the software subsector, despite some high valuations, select names in the group can continue to perform well, given increased demand for digital transformation projects, especially from vertical industries most impacted by the pandemic. We highlight Twilio Inc. (NYSE:TWLO) as a strong beneficiary, given its communications platform, which enables companies to communicate seamlessly with their customers through digital channels. Twilio Inc. significantly expanded its use cases to applications such as mass notifications, remote contact centres, distance learning, telehealth, contactless delivery and customer service appointments. As the economy recovers, Twilio Inc. should also see a recovery in demand from customers in the travel, hospitality and ride-sharing industries, which were historically large users of the notifications function. Even through the pandemic, the company has been increasing its installed customer base, which provides a solid foundation for further market penetration.

HEALTH CARE

In 2020, the Health Care sector (up 13.20%) underperformed the S&P 500 Index (up 17.80%). The underperformance was largely driven by the COVID-19 pandemic and policy-related noise. During the fourth quarter, two COVID-19 vaccines, one from Moderna Inc. (NASDAQ:MRNA) and one from BioNTech SE (Germany:BNTX) partnered with Pfizer Inc. (NYSE:PFE), were approved in the U.S.. Several other counties have also approved the BNTX/PFE vaccine. Distribution of the vaccines was initiated almost immediately; however, the rollout in the U.S. has not been smooth, which could potentially delay a full economic recovery to the latter half of 2021. The end of 2020 also saw another resurgence of COVID-19 infections; compounding the problem has been the emergence of two new, more infectious variants. This has raised questions about the effectiveness of the current vaccines; however, the manufacturers believe that the existing vaccines will continue to be effective against the new variants. Two additional vaccines (from the University of Oxford, partnered with AstraZeneca PLC (London:AZN), and from Johnson & Johnson (NYSE:JNJ) are expected to release data and be approved sometime in the first quarter of 2021, and it is expected that vaccines will be available for everyone by spring 2021. Two antibody therapeutics (from Regeneron Pharmaceuticals Inc. (NYSE:REGN) and Eli Lilly and Company (NYSE:LLY) were also given emergency use authorization, and are expected to reduce the severity of the disease in infected patients. The direct financial benefits for companies developing treatments remain uncertain, but their efforts appear to have generated some goodwill among legislators, and could moderate government attempts to cut and control drug prices.

The U.S. election and the Senate run-off has resulted in a Democratic sweep. The potential Democratic agenda includes stabilizing the Affordable Care Act (ACA), enacting drug price controls and, perhaps, partially reversing Trump's tax cuts. However, President Joe Biden is initially expected to focus on the management of the raging COVID-19 infections, improving the vaccine rollout and providing economic stimulus, rather than enacting drug price controls or carrying out any other significant health care policies.

Before the election, subsector performance during the quarter was bookended by large-cap biopharma (-8%), retailers (-3%) and distributors (-3%) toward the bottom and dental (21%), diagnostics (10%) and life sciences, tools and diagnostics (10%) at the top. Following the election, hospitals, retailers and pharma outperformed, while life sciences and tools, large-cap biotech and diagnostics underperformed. The recovery of the managed care subsector has stalled (up 4%, compared with 12.7% late in the third quarter of 2020). It started rolling over following positive vaccine news in late November and triggered increased investment in recovery/utilization health care verticals (e.g., hospitals, distributors, retailers, dental and med tech, as vaccine implementation beneficiaries). The pandemic has also accelerated several structural changes in how the care is delivered and its potential impact on efficiency of health care delivery: telehealth and online pharmacies are now a permanent part of the health care infrastructure.

CONSUMER DISCRETIONARY

In Canada, Consumer Discretionary stocks again outperformed the market in the fourth quarter, with positive vaccine news driving increased confidence in a return to more "normalized" life – and consumer spending – in 2021. Accordingly, we continued to see a strong rotation into more cyclical, value-type names, as well as stocks set to benefit disproportionately from an end to lockdowns and a full reopening of the global economy. Companies benefiting from secular changes in their industries, such as the shift toward electric and autonomous vehicles, also performed well in the fourth quarter. We remain focused on positive change stories exposed to these themes, including BRP Inc. (TSX:DOO), Magna International Inc. (TSX:MG), AutoCanada Inc. (TSX:ACQ) and Gildan Activewear Inc. (TSX: GIL). Looking forward, we continue to view underlying conditions, including record low interest rates, depleted inventories and pent-up demand, as favourable for a rebound in activity.

The story was much the same in the U.S., although the broader Consumer Discretionary sector was held back by Amazon.Com Inc. (NASDAQ:AMZN), which in the fourth quarter consolidated its significant gains from earlier in the year. As in Canada, we remain selective in our stock selection, preferring structural winners and cyclical businesses that we expect will outperform in an early-cycle recovery. These include stocks such as D.R. Horton Inc. (NYSE:DHI), The Cheesecake Factory Inc. (NASDAQ:CAKE) and NIKE Inc. (NYSE:NKE).

CONSUMER STAPLES

Consumer Staples lagged the broad market by about 15% in Canada and about 6% in the U.S. for the fourth quarter of 2020. Once the vaccines were announced in November, the market quickly shifted from defensive/ growth to value/recovery trades, which led to the sector's underperformance. The market currently views 2020 as a peak earnings year for the Consumer Staples sector, generating little incremental buying, with the sector also being used as a funding space. We expect Consumer Staples to continue to underperform the broad market in 2021 as growth decelerates and costs start to rise (commodities, freight, normalization of promotions/ad spend).

While we expect the sector to underperform, we still see opportunities to generate alpha. We currently prefer positive change stories that also have exposure to a recovery. These include Simply Good Foods Co. (NYSE: SMPL), Sysco Corp. (NYSE: SYY) and Coca-Cola Co. (NYSE: KO). All these companies have direct exposure to mobility of consumers, while the latter two have high exposure to the foodservice channel. We expect a sharp recovery in both mobility and foodservice in 2021, while we view all these companies as likely to better companies coming out of the pandemic than when they went in.

FINANCIALS

The Financials sector staged a nice recovery in the fourth quarter, outperforming the S&P/TSX Index by about 5% as positive vaccine announcements led to yield curve steepening and a "risk on" tone in markets, with outperformance in cyclicals such as banks and insurance.

In Canada, the banks group led Financials higher (up 14% in the quarter), followed by the life insurance, asset managers and diversified financials group (all up about 9% in the quarter). We have become more positive on the banks group, as we believe many of the headwinds the group has faced for the better part of three years are now set to become tailwinds. We view the group as adequately provisioned, well capitalized and set to enter a positive earnings revisions cycle supported by a strong economic recovery and increased consumer and business confidence. Returns are expected to improve for the group alongside the economic expansion, and we believe banks can outperform the broader index after nearly three years of underperformance. As for name selection, we continue to have a preference for banks that are exposed to consumer lending, rather than commercial lending, and banks with strong fee income streams that are less reliant on net interest income, with structurally higher ROEs.

Outside of the banks, we have a favourable view on a few positive change stories exhibiting strong growth, including Trisura Group Ltd. (TSX:TSU) and Element Fleet Management Corp. (TSX:EFN). Additionally, we believe Intact Financial Corporation (TSX:IFC) has significant upside following the announcement of its joint purchase of RSA Insurance Group (LSE:RSA).

COMMUNICATION SERVICES

Looking through the lens of individual performance, the fourth quarter was all over the map: while Shaw Communications Inc. (TSX: SJR/B) and Quebecor Inc. (TSX: QBR/B) delivered negative returns, BCE Inc. (TSX: BCE) was flat, Telus Corporation (TSX:T) delivered 9%, matching the returns of the S&P/TSX Composite, and Rogers Communications Inc. (TSX: RCI) topped out with a 13% return. In aggregate, the sector underperformed the broader market, consistent with our underweight positioning.

Looking ahead, we believe that we are nearing the time to get more positive on the sector, but we are not there yet. As of now, we maintain our overweight in Telus Corporation. We continue to believe that both Telus International and Telus Health are significantly undervalued within Telus Corporation, and we are confident that the IPO of Telus International (expected in 2021) will prove our case. Besides the surfacing of value in these divisions, we also like Telus Corporation's positioning as best in class, globally, in its wireless and wireline operations.

UTILITIES

At a high level, Utilities underperformed the broader market considerably (up 5.4%, compared with 9% for the S&P/TSX Index). However, the aggregate number masks a lot of dispersion. While the green trade continued unabated, with all the delivering double-digit returns, it was a quarter to forget for the regulated utilities, which delivered modestly negative returns.

One of our high-conviction names, AltaGas Ltd. (TSX: ALA), had an excellent quarter (up 18%) as concerns over counterparties (related to its midstream operations) faded away, thanks to growing consolidation in the upstream space. We would like to emphasize that the concerns about counterparty risk seem to be overblown, and increasing consolidation will likely indeed go a long way in putting those concerns to rest. We continue to like the fact that AltaGas Ltd.'s larger utility business is still under-earning, by about 250 basis points, and in 2021 we expect to see a bridging of that gap (at least partially). While it was a quiet quarter for Brookfield Infrastructure Partners L.P. (TSX:BIP-U) (0%), we remain positive on its long-term prospects, and believe that BIP will likely compound earnings at a materially higher rate (about 10%, compared with 5–6% for regulated utilities).

REAL ESTATE

REITs bucked two straight quarters of underperformance by delivering 11.6% and outperforming the broader market by about 250 basis points. Optimism about vaccines helped retail REITs deliver strong returns in the fourth quarter, and helped the group outperform the S&P/TSX Composite Index.

We have highlighted Colliers International Group Inc. (TSX:CIGI) as a story that provides a healthy combination of offence and defense, given the changes to the business mix, a conservative balance sheet and the potential opportunity to gain market share globally. Offence was in display in the fourth quarter, as CIGI posted 28%. We continue to believe that the growing institutionalization of real estate will raise the platform value of a global player like CIGI. Add to that double-digit earnings growth and exposure to global recovery, and we expect CIGI to post a solid 2021. Our other high-conviction name, Granite REIT (TSX: GRT-U), had a relatively quiet fourth quarter (up 2%). Notwithstanding the muted returns in the fourth quarter, we remain positive on Granite REIT, given its top-quality management, excellent balance sheet and an asset class that is a structural winner.

ENERGY

The S&P/TSX Energy sector rebounded during the quarter, up 15%, as global oil prices rose on news of positive vaccine trial data. Exploration and production and integrated oil companies led the sector higher, returning 41% and 39%, respectively. Meanwhile, storage and transportation lagged, up just 2%.

During the period, we added Suncor Energy Inc. (TSX: SU) to the portfolios. After a challenging 2020, we see several positive change events on the horizon for Suncor Energy Inc. In addition to higher oil prices, Suncor Energy Inc. will likely benefit from its recently announced aggressive cost-cutting program and from full operatorship of the Syncrude asset, which will provide an opportunity for operational synergies with its base oil sands operation. Further, production guidance seems very conservative, with the potential for upside surprises throughout 2021. Lastly, given the low decline rate on the company's base oil sands operation, we believe Suncor generates one of the highest free cash-flow yields in the sector.

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