PICTON MAHONEY
Asset Management

Q2 2021

# INVESTMENT REVIEW & OUTLOOK

## What a Difference a Year Makes

- PANDEMIC DRAGS AS RISK ASSETS SOAR
- THE MARKET BACKDROP REMAINS UNPRECEDENTED...AND POSITIVE
- HURDLES STOCK MARKETS MAY HAVE TO OVERCOME

# OVERVIEW

Stock markets have rallied dramatically over the past year, driven by unprecedented monetary and fiscal stimulus, the beginnings of a surge in the global economy and significant asset inflows. Bullish sentiment is extended, but the optimism is warranted, given the unprecedented backdrop that currently exists for risk assets. However, over the next year stock markets will have to deal with hurdles such as rising interest rates, along with decelerating stimulus and economic growth measures. Given that we are still early in a new economic cycle, we expect that stock market pullbacks be contained, and that investors would therefore continue to buy on pullbacks. However, a significant increase in longer-term inflation expectations that would suddenly drive interest rates higher would cause us to revisit this positive outlook.

# PICTON MAHONEY HOUSE VIEW

| VIEW | PMAM VS. CONSENSUS |
|---|---|
| **RISK**<br>Macro risk remained low in the first quarter after hitting peak levels a year ago. While there is still more uncertainty ahead as the world grapples with the 3rd wave of COVID-19, new variants and more lockdowns, the finish line seems near thanks to growing levels of vaccinations. | **HIGHER** |
| **MACROECONOMIC** | |
| **GLOBAL REAL GDP**<br>As much of the world will be easing lockdowns in the second quarter as vaccination levels ramp, we expect global GDP to surprise to the upside in the quarter. | **HIGHER** |
| **U.S. REAL GDP**<br>The U.S. is ahead of most countries in its vaccination efforts, and thus will be ahead as well when it comes to reopening. The second quarter will see a surge in economic activity as most states return to normal. | **HIGHER** |
| **CANADA REAL GDP**<br>Unlike the U.S., Canada is several months behind in its vaccination effort, and the second quarter will likely be another quarter spent in some form of suppressed economic activity. | **LOWER** |
| **U.S. INFLATION**<br>U.S. inflation will likely surprise to the upside in the second quarter as pent-up demand meets decades low inventories, on top of already high base effects. | **HIGHER** |
| **EQUITY RETURNS** | |
| **U.S. EQUITIES**<br>The robust early-cycle market rally may hit some headwinds because of higher rates and while economic growth will likely remain robust in the second quarter, leading indicators already look like as high as they can get. | **SAME** |
| **EUROPEAN EQUITIES**<br>Europe's recovery has hit a snag due to the latest surge in coronavirus cases and resultant shutdowns. The vaccine rollout will likely take another quarter to fully take effect before the economy and equities can get back on track. | **SAME** |
| **CANADIAN EQUITIES**<br>Canada's recovery also hit a snag due to the latest surge in coronavirus cases and resultant shutdowns and will also likely not get back on track until the summer, though commodity-related exposures may benefit from higher manufacturing demand globally. | **SAME** |
| **BOND YIELDS** | |
| **TREASURIES (U.S. 10-YR)**<br>Rates will likely continue to head higher as expectations for higher inflation permeate the space over time, though foreign buying of treasuries from Europe may provide at least a short-term headwind. | **HIGHER** |
| **INVESTMENT-GRADE CORPORATE BONDS**<br>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**<br>With the U.S. Federal Reserve (the Fed) 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**<br>Oil fundamentals remain robust, with lower inventory levels and the futures curve still in backwardation, implying a strong demand for current oil. A weakening U.S. dollar and rebounding global economy will also help over time. | **HIGHER** |
| **EPS GROWTH (S&P 500)**<br>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)**<br>Multiples at multi-year highs is likely to drop again over time as real rates rise, particularly in the high-growth technology sector. | **LOWER** |

PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at March 2021.

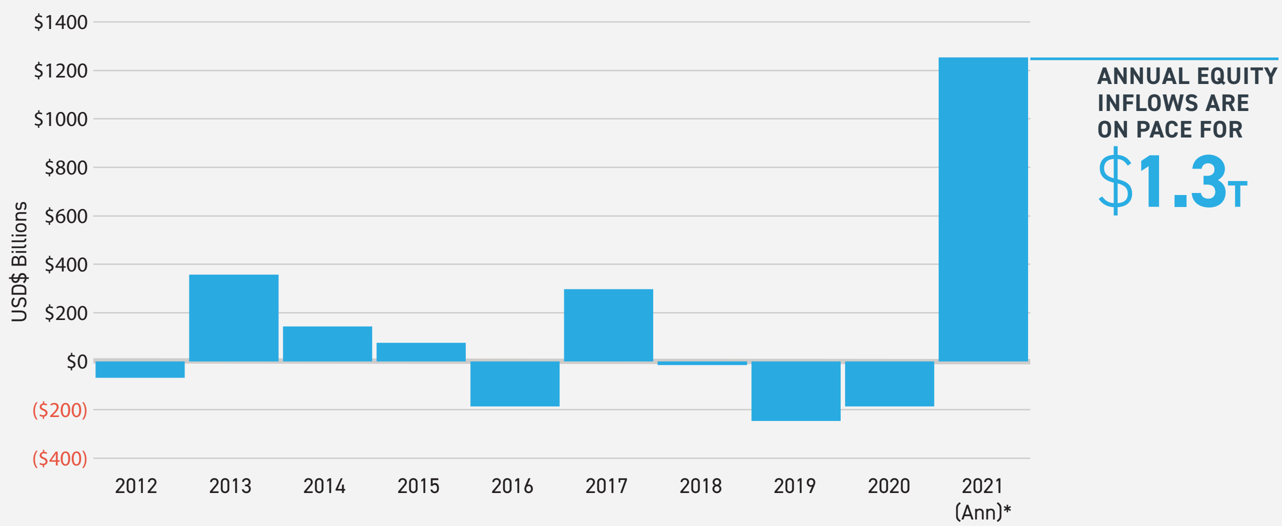
# THE PANDEMIC HAS DRAGGED ON, BUT RISK ASSETS HAVE SOARED

A year ago on March 31, 2020, the S&P 500 Index was down 12.4% for the month, and 20% for the quarter, while lockdowns were being put in place to protect citizens from a disease of then-unknown severity or infectiousness. Investor panic was an epidemic of its own. Between March 4 and April 8, 2020, investors sold off USD$286 billion in bonds and USD$45 billion in equities. Money markets saw USD$823 billion in inflows as investors sought to hide from volatility.

Twelve months later, the S&P 500 Index is higher by 52%, the Nasdaq 100 Index by 63% and the MSCI All Country World Index by 53%, and the prices for copper and oil are up by 80% and 127%, respectively.

While investors were piling into money market funds in 2020, many are now racing back into risk assets. Goldman Sachs estimates that global equity inflows in the first quarter of this year were the largest in their records, at USD$313 billion, more than double the previous high mark set in the first quarter of 2013. Annualized equity inflows are on pace for USD$1.3 trillion, a remarkable turnaround from outflows of USD$246 billion and USD$187 billion in 2019 and 2020, respectively (Fig. 1).

**FIGURE 1: ANNUAL EQUITY INFLOWS ARE ON PACE FOR USD$1.3T**




Source: Goldman Sachs. As at March 26, 2021.

* This is an estimate.

# MARKET SENTIMENT MAKES A FULL 180-DEGREE TURN

Investor sentiment has shifted 180 degrees over the past year. The extreme pessimism of early 2020 has been replaced by levels of euphoria normally associated with overbought markets that are likely to correct in the near term.

Institutional investors are openly bullish. A Wall Street survey of U.S. portfolio managers in February found that the percentage of managers admitting "higher than normal risk" in their funds had reached a record high (Fig. 2).

**FIGURE 2: ALL-TIME HIGH IN INVESTORS TAKING "HIGHER-THAN-NORMAL" RISK**

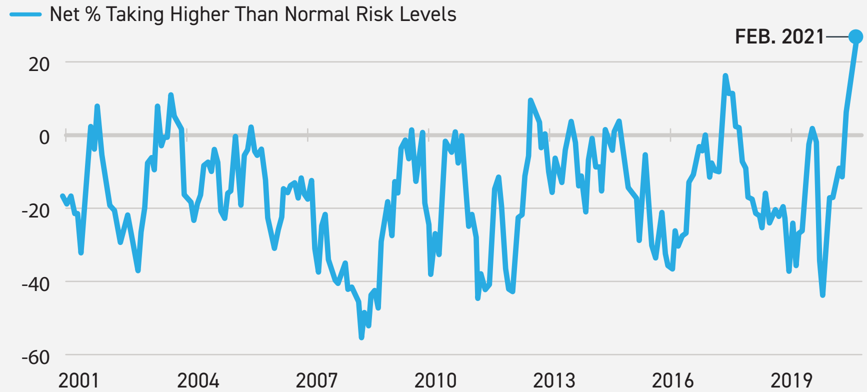



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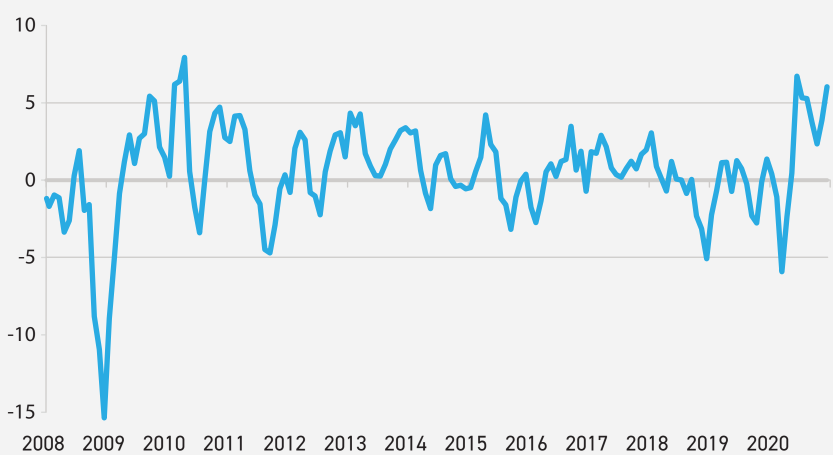
**FIGURE 3: DEBIT BALANCES IN MARGIN ACCOUNTS** (Rolling Quarterly % Change)




Source: FINRA, PMAM Research. As at Q4 2020.

As of April 1, 2021, Bank of America's widely followed "Sell-Side Indicator" (which aggregates Wall Street asset allocation recommendations to generate sentiment-based market outlooks) is bumping up against its first sell signal since 2007.

The return of the retail investor was evident in the meme-based stock trading frenzy this past quarter, which was at least partly fueled by the wide availability of margin debt on online trading platforms. The debit balances in margin accounts are now climbing at the highest rate of the past decade, in another sign of what may be investor overconfidence (Fig. 3).

# THE MARKET BACKDROP REMAINS UNPRECEDENTED... AND POSITIVE.

The investor euphoria already noted has helped drive stock market valuations to levels reminiscent of the Roaring 20s. High valuations and extensive bullishness are not normally a positive environment for risk assets. However, the current market backdrop is anything but normal. It is hard to find parallels in the past when the following conditions were all occurring at the same time:

- extremely accommodative monetary policy
- extremely large fiscal stimulus
- the impending strongest economic surge in decades as reopening begins around the world
- U.S. bank industry and household balance sheets both in great shape
- inflation measures that are moving higher and are expected to surge even higher

Many investors expect stock markets to have some sort of consolidation phase, but this unprecedented backdrop will likely limit any significant market corrections in the near term.

## FED TO KEEP ITS FOOT ON THE MONETARY GAS PEDAL

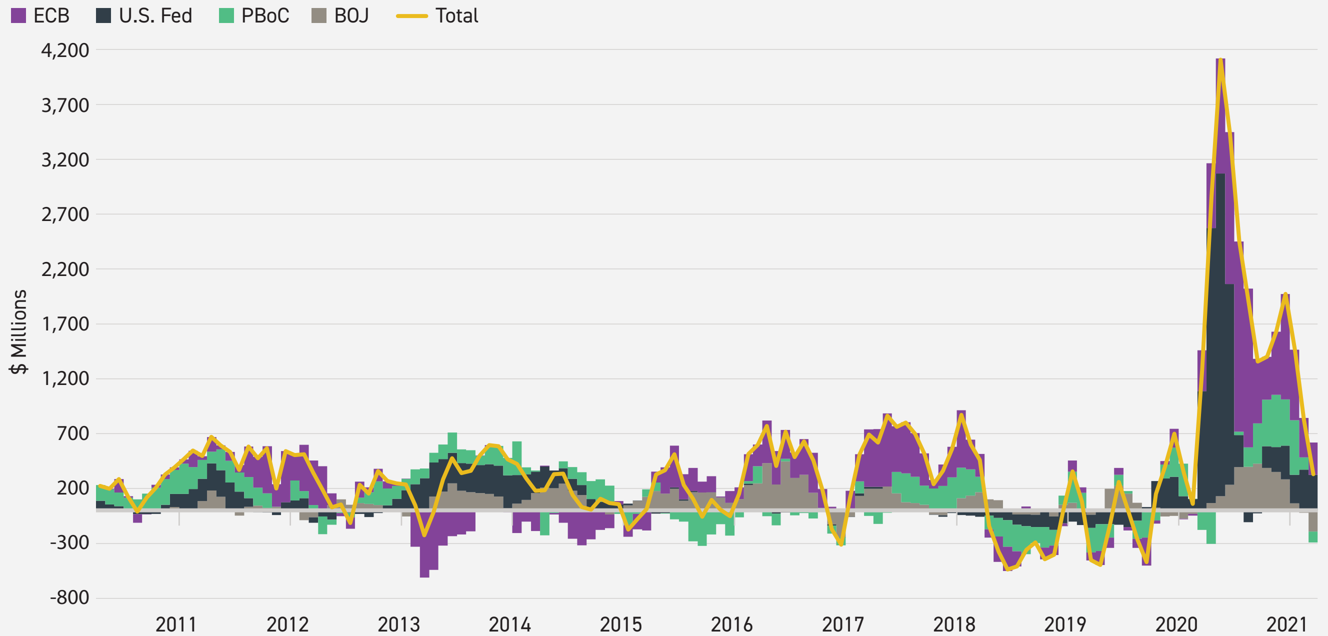
At the most recent meeting of the Federal Open Market Committee (FOMC), Federal Reserve Chair Jay Powell was unequivocal about continued monetary stimulus. He noted that the committee believed a stronger-than-expected economic recovery was underway and that it had raised economic growth estimates. However, he also reassured markets that no monetary tightening was expected until 2024.

In an important policy change, the Fed also signaled that it would not pre-emptively move to contain potential inflationary pressures. Powell stated that clear, tangible evidence that inflation was threatening long-term economic harm would be required before the central bank would begin removing stimulus. The Fed went even further by noting that it would view inflation signs in 2021 as transitory.

Around the world, central banks continue to flood the financial system with liquidity through open market purchases of fixed income, also known as "quantitative easing." This stimulus continues at unprecedented levels. The combined quarter-over-quarter change in central bank purchases in China, the U.S., Japan and Europe was higher in the fourth quarter than at any point during the last decade (Fig. 4).

Real government and corporate bond yields sit near generational lows, suppressing financing costs and driving investment into higher-risk asset classes. Monetary policy stimulus will likely remain a positive force for equity markets for the foreseeable future, providing a long runway for equity prices until central banks are confident that much fuller employment has been reached.

**FIGURE 4: G3 + CHINA CENTRAL BANK LIQUIDITY: Q/Q CHANGE IN ASSETS** (USD)




Source: Bloomberg, L.P., PMAM Research. As at March 2021.

## FISCAL STIMULUS

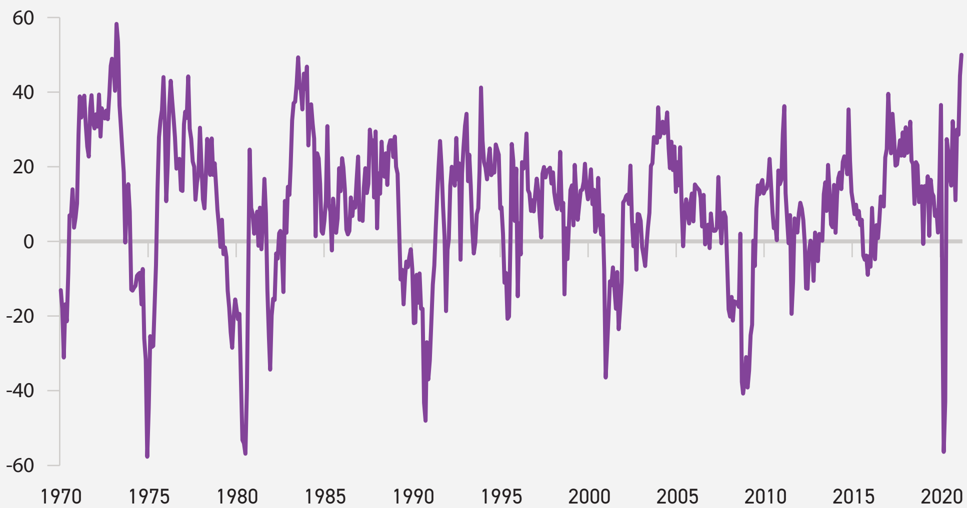
Direct government support to Main Street has been an ongoing feature of the pandemic. Consumers financially displaced by COVID-19, especially in developed economies, have received multiple rounds of financial support. Despite slower economic growth, the year-over-year change in U.S. disposable income and savings is a significant increase.

The newest positive development in fiscal support is President Joe Biden's proposed USD$1.9 trillion infrastructure spending bill. If passed, this legislation would bring the total U.S. fiscal response to 27% of GDP.

# RAPID RECOVERY IN GROWTH (AND EARNINGS) IS NEAR

China's post-quarantine growth surge indicates how quickly developed world economies could recover as vaccinations roll out and businesses reopen. Indeed, there are already numerous signs that U.S. activity is ramping up. The most recent survey of manufacturers by the Philadelphia Federal Reserve saw the business outlook index hit 50-year highs, climbing sharply from February results (Fig. 5).

**FIGURE 5: PHILADELPHIA FED BUSINESS OUTLOOK SURVEY DIFFUSION INDEX**




Source: Bloomberg, L.P., PMAM Research. As at April 2021.

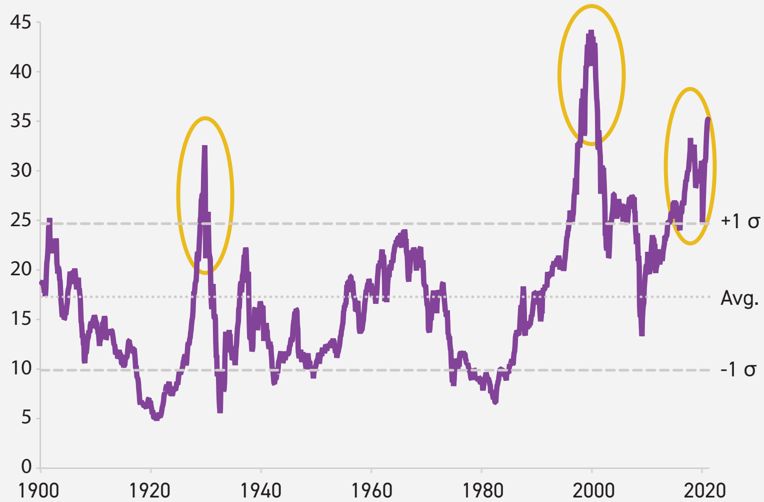
The initial stages of the U.S. economic recovery will likely be driven by a U.S. inventory restocking. The uncertainty around the abrupt shutdown in the economy last year depleted inventories to levels last seen a decade ago in the wake of the financial crisis. As lockdown conditions end, manufacturing activity is struggling to meet improving consumer demand, given low inventory levels. Significant production increases are likely. Rising manufacturing activity will translate into future corporate profit growth.

The inventory of experiences is even more depleted. There is tremendous pent-up demand for experiences we took for granted before the pandemic, such as travel, leisure, dining out and entertainment. We expect a surge in these activities into this summer that should ignite large parts of the economy that were hardest hit by COVID-19. Labour shortages are a distinct possibility in many of these "reopening" industries, especially given the disincentives from generous unemployment benefits that have been temporarily put in place to help those most affected by the pandemic.

## “THERE IS NO ALTERNATIVE” EFFECT

The oft-quoted Shiller Cyclically Adjusted Price/Earnings (CAPE) is elevated relative to its history, at over 30× trailing 10-year earnings (Fig. 6). The current CAPE ratio resembles the one that existed at the peak preceding the Great Depression in 1929, although it remains well below the excesses of early 2000 (for now, at least). The S&P's aggregate multiple has been skewed higher by the dominance of expensive technology stocks, which grew to 25% of the Index's market cap in 2020. The U.S. stock market ex technology stocks is elevated, but cheaper than the headline numbers would suggest.

**FIGURE 6: SHILLER CYCLICALLY ADJUSTED PRICE/EARNINGS**



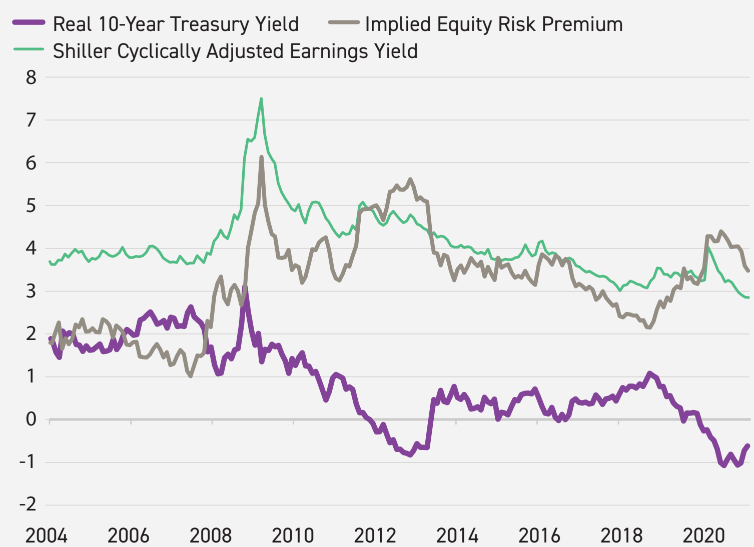

Source: Robert Shiller, Bloomberg, l.p., PMAM Research. As at Mar, 2021.

However, these “lofty” valuations are supported by very low real yields. There still exists a significant equity risk premium (ERP), or relative attractiveness when comparing the earnings yield on the S&P 500 to real Treasury yields. The ERP can be thought of as a potential reward for taking equity risk, compared with the returns available on supposedly risk-free government securities. Fig. 7 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 on U.S. 10-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).

This chart would suggest there is still significant incentive for at least some of the massive flows that have poured into bond funds over the past couple decades to move into equities, especially if the underperformance in bonds picks up as the economy mends and accelerates.

So while investor sentiment is more bullish and stock prices are more elevated than most investors prefer, the stock market likely has considerable room to run, even from current levels. A new cycle is underway, with an unprecedented bullish backdrop in place. Some of the bullish elements of this backdrop will fade over time (as they always do), but alternatives to the stock market are sorely lacking for now.

**FIGURE 7: ERP HIGH BUT STARTING TO FALL AS REAL RATES RISE** (%)




Source: Robert Shiller, Bloomberg, L.P., PMAM Research. As at March 2021.

# HURDLES STOCK MARKETS MAY HAVE TO OVERCOME

We believe that a new economic cycle is just getting underway and that a multi-year rally in equities is likely to occur. However, given the current elevated levels for stocks, today's starting point is not an ideal entry point for new money. Overly bullish sentiment measures suggest a pullback could be imminent, but we expect any declines to be limited in the near term.

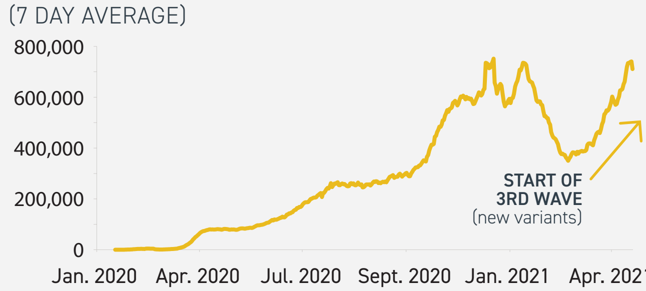
However, over the next year, stock markets will likely have to deal with new hurdles that could lead to higher volatility and deeper pullbacks in equity prices.

## HURDLE 1: COVID-19 VARIANTS AND SUB-PAR VACCINE ROLLOUTS

China's economy is in expansion mode, given its strong response to the initial COVID-19 virus. The U.S. is just now getting a handle on the virus, through a strong vaccine rollout program, and the U.S. economy is poised to improve dramatically. However, there are worrying trends occurring around the world with regards to the rollout, safety and/or efficacy of certain vaccines. Meanwhile, new variants of the virus are emerging that are either more sinister or less responsive to current vaccines. For the world to reopen fully and deliver the strong global GDP growth that is now expected, a vast majority of countries need to get a strong handle on the virus as soon as possible. Otherwise, new variants could arise that keep the world's economy performing below potential, or that at least could lead to significant regional shutdowns that have a negative impact on the economy and risk assets.

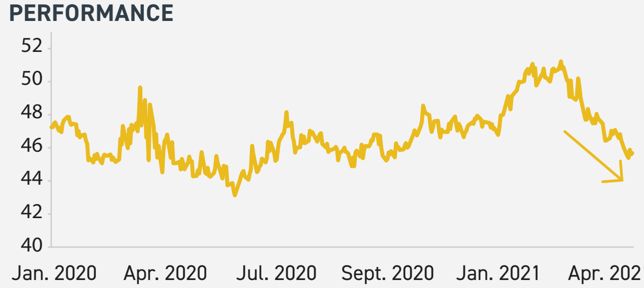
Markets may already be sensing something is amiss. New daily cases of the coronavirus are accelerating on a global basis as a third wave kicks in (Fig. 8). New variants of the virus are emerging and are contributing to this wave. Many developing countries do not have the infrastructure, resources or even access to the best vaccines to help cope with this. Perhaps this helps explain why emerging markets have pulled back significantly, relative to the overall global market, over the past few months (Fig. 9). If the U.S. and/or China were now to see a sudden spike in cases, it would likely pressure the entire global equity market, given the current expectations of a successful reopening.

**FIGURE 8: GLOBAL CORONAVIRUS NEW DAILY CASES** (7 DAY AVERAGE)




Source: Bloomberg, L.P., PMAM Research. As at April 16, 2021.

**FIGURE 9: MSCI EM VS. MSCI WORLD RELATIVE PERFORMANCE**



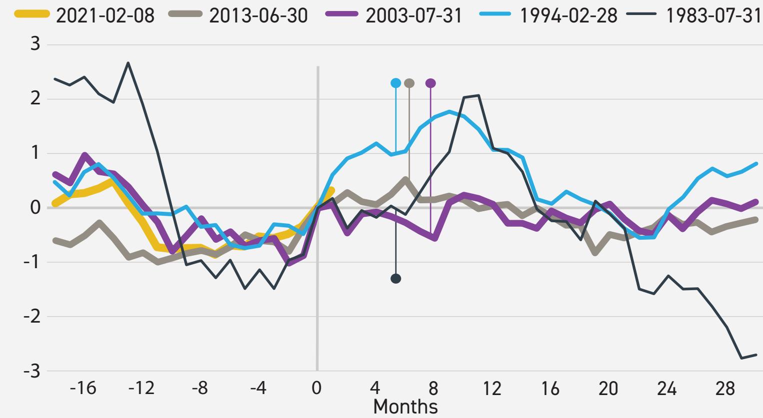

Source: Bloomberg, L.P., PMAM Research. As at April 15, 2021.

# HURDLE 2:
# INTEREST RATE PRESSURES AND TAPER TANTRUMS

As the global economy began to mend, it was natural to expect bond yields to rise from the all-time low levels they reached during the global pandemic-related shutdown. Equity investors became edgy as U.S. bond yields rose 100 basis points (bps) from September to the end of March. The recent surge in yields had a negative impact on the highest-flying growth stocks that had been market leaders over the past number of years. It seems fair to assume that another 100 bps increase in yields in short order would put added pressure on equity markets, especially given the high valuations discussed earlier.

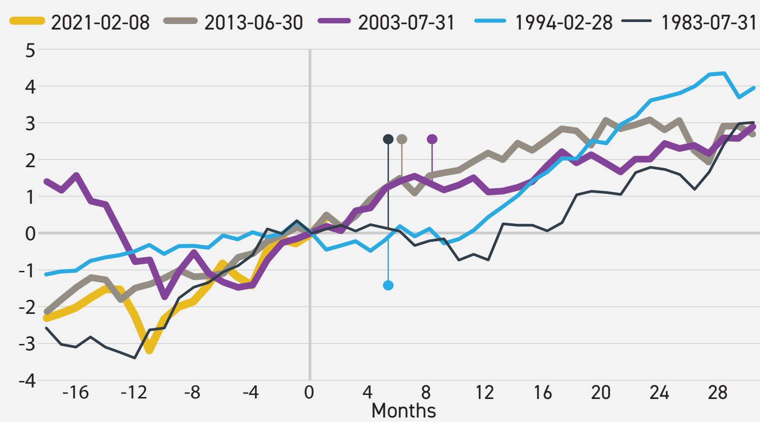
However, it is common for bond yields to increase early in a new cycle in much the same way we have just seen. Figure 10 compares bond yield moves in the early stages of the past four major cycles. Month 0 in each cycle corresponds to the month when bond yields increased 100 bps from their lows in each cycle.

**FIGURE 10: 10-YEAR TREASURY YIELD CHANGE AROUND PERIODS OF RISING INTEREST RATES** (%) (PINS INDICATE POINT OF ISM PMI PEAK)




Source: Bloomberg, L.P., PMAM Research. As at March 2021.

**FIGURE 11: S&P 500 PERFORMANCE AROUND PERIODS OF RISING INTEREST RATES** (%) (PINS INDICATE POINT OF ISM PMI PEAK)




Source: Bloomberg, L.P., PMAM Research. As at April 16, 2021.

Figure 11 shows the performance of the S&P 500 Index during those same episodes. There are signs that stock markets generally consolidate at some point in the year following the initial 100 bps increase in yields, especially if yields continue to move higher. These early-cycle equity consolidations don't seem to last long and are followed by renewed rallies as yields peak, especially if central bank policies remain accommodative. Fed Chair Powell has definitively signaled that no monetary tightening is imminent, and that policy rates will remain near historic lows. Barring a significant change in inflation expectations, we expect the same historical pattern to occur again in this cycle.

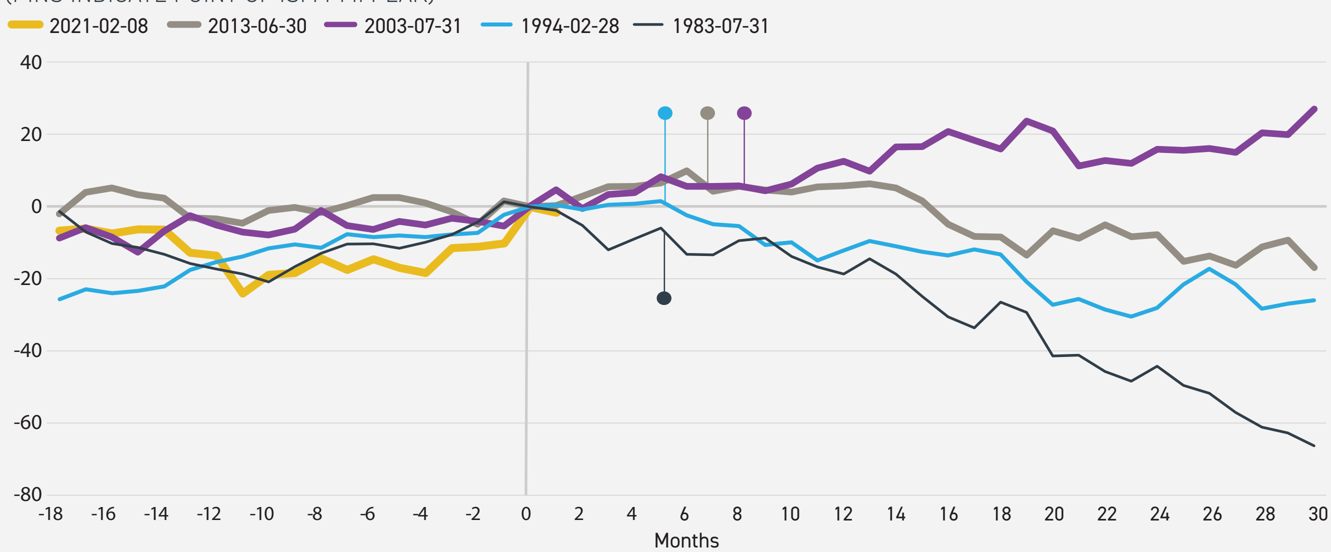
# HURDLE 3:
# THE INEVITABLE DECELERATION IN GROWTH

In the next twelve months, will likely see the strongest global economic expansion since the early 1980s, assuming a proper vaccine rollout program allows most countries to successfully reopen. However, markets are already anticipating most of this near-term rebound and will soon be facing annual rates of growth that are slowing as the easy comparable of 2020 becomes the tough comparable of 2021.

The pins in Figures 10 and 11 on the previous page correspond to peak Institute of Supply Management purchasing managers' index (ISM PMI) readings in the first stage of new economic cycle expansions. This history suggests that some weakness in stock markets could be expected as these peaks occur, even if the economic cycle remains intact.

Decelerating economic data can have an even bigger impact on sector leadership in the stock market. Figure 12 shows that in three of these last four cycles, peaking PMI readings corresponded with cyclical stocks beginning to underperform more defensive stocks. This did not occur in the 2003–2004 period, however, as China's big growth surge at that time was enough to drive more cyclical activity, especially in commodity-centric stocks. A strong commodity cycle could contribute to "stronger for longer" cyclical leadership in the early stages of this cycle as well, although some of this is already being built into stock markets.

**FIGURE 12 S&P CYCLICALS/DEFENSIVES PERFORMANCE AROUND PERIODS OF RISING RATES** (%)
(PINS INDICATE POINT OF ISM PMI PEAK)




Source: Bloomberg, L.P., PMAM Research. As at March 2021.

# HURDLE 4:
# INFLATION

A number of indicators are pointing to a surge in inflation starting as early as the second quarter of this year. Some increase is to be expected, given the easy pricing comparisons between now and the worst point of the COVID-19-related deflationary mini-environment that existed one year ago. We expect these base effects alone should contribute to a headline inflation print of at least 2.5% in the second quarter, which should then drop back to a more moderate 1.5% contribution in the third quarter.

However, these base effects are being augmented by other factors that can boost inflation even higher in the near term. March's official Consumer Price Index (CPI) figure has already come out at 2.6%, well ahead of the 1.9% attributable to base effects. Business inventories are as lean as ever, allowing better pricing power to occur for new goods; global supply chains remain strained, with costs also increasing as commodity prices surge higher. Leading indicators of CPI from the ISM and NFIB surveys point to inflation reaching as high as 5–7% this year.

This situation will likely persist at least through 2021, with further pressure coming as pent-up demand (especially for experiences and services) is released as the world reopens. 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 enough to be able to handle the flow. Labour scarcity is also a possibility, given the generous government benefits that are being provided to help those most affected by the pandemic, and by an inability to hire back employees who have had to find work elsewhere.

Consensus expectations are factoring in some shorter-term boost to inflation. However, we believe many market participants are perhaps overconfident that inflation pressures will be mostly temporary, will be well understood and will not derail the early-cycle market rally that is underway. After all, developed world economies are still running well below full capacity, technological innovation will likely continue to limit wage growth and pricing power, and an aging population will likely continue to focus more on saving than consumption.

However, it has been decades since investors were confronted with real inflation and its negative effects on securities' prices. New factors may force them to refamiliarize themselves with inflationary market environments in the coming years. For instance, globalization was a main driving force of deflation in the last two decades, but this trend may abate somewhat, given growing geopolitical tensions, especially between the U.S. and China. In addition, many countries are now bringing domestic manufacturing back for some industries, as a security measure in response to being caught off guard during the pandemic.

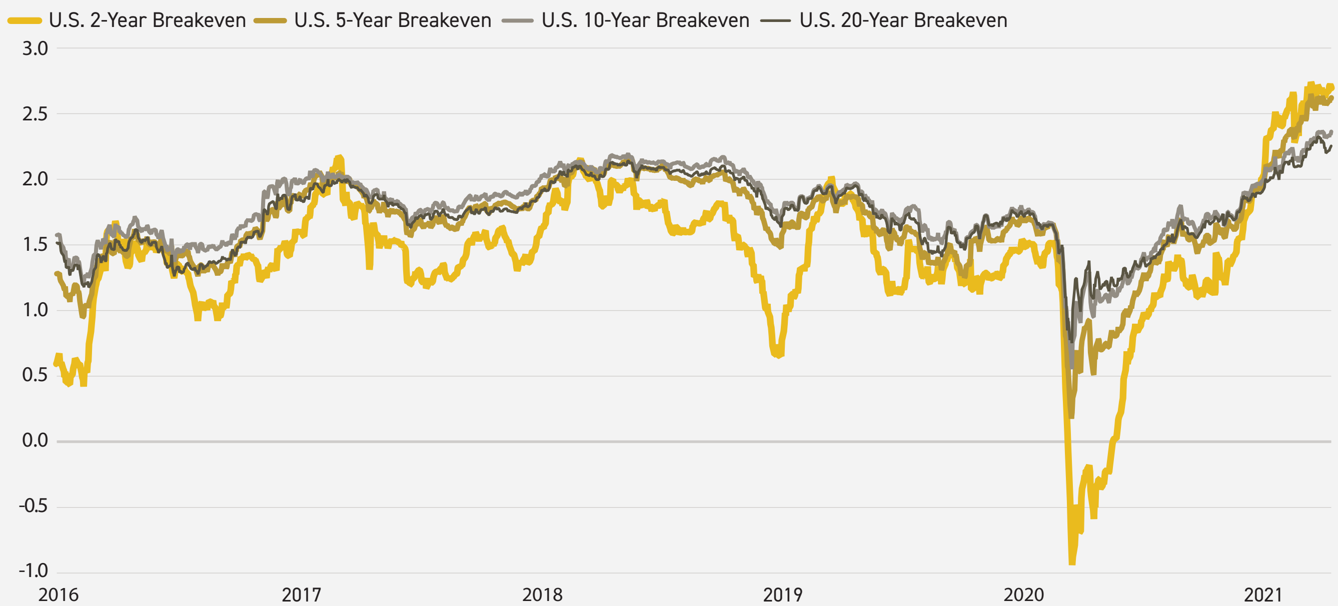
The loose monetary policy of the past decade occurred against a backdrop of balance sheets in need of repair at both the consumer and the banking level. It also occurred during a period of excess capacity being ramped up in many commodities, such as copper and oil. However, this cycle is beginning with very strong consumer and banking balance sheets, especially in the U.S., meaning personal consumption will not be as limited as it was in the last cycle. Large debt loads have now been transferred to governments around the world – governments that would not mind some inflation to help erode the real value of their massive debt burdens. We also believe that many commodities are beginning longer-term price uptrends. After more than a decade of falling commodity prices and lack of investment, supply-demand dynamics are shifting once again in favour of higher prices. Lastly, the technology boom that contributed so much to deflationary pressures may not have the same impact, especially after so much disruption was pulled forward in 2020.

Certain areas of the market are already implying that inflation in this cycle could be significantly stronger than in the last cycle. The Treasury Inflation-Protected Securities (TIPS) breakeven implied inflation values can be used to gauge the market's inflation expectations. Figure 12 shows that this market is already expecting inflation two years out to approach 3%. This is not entirely surprising, as the Fed has pledged to sit on the sidelines until the average inflation rate is above 2%. Since inflation has been below 2% for so long, it may take several years to get the average back up to 2%.

However, what is more concerning is that some of the longer-term TIPS breakeven levels are also now well above 2%, even up to 10 years out into the future. One cannot ignore the possibility that once inflation is let out of the bottle, it may not be so easy to contain again.

Should these increased inflation expectations become more rooted as the boom takes hold, there is a growing possibility that the Fed will have to start tightening monetary policy more quickly and/or aggressively than market participants currently expect. Should this occur, it might lead to suddenly higher interest rates that pop the inflating stock market bubble. We do not view this as a near-term risk for equity markets, but it could become a larger risk as the full-blown economic acceleration gets underway.

**FIGURE 13: TIPS IMPLIED INFLATION**




Source: Bloomberg, L.P., PMAM Research. As at April 16, 2021.

# IN CONCLUSION

## We expect any pullbacks to be shallow and brief – for now.

After the dramatic run-up in stock prices, bullish sentiment is extended, which could lead to bouts of market weakness that help alleviate overbought conditions. We expect any pullbacks to be shallow for now, unless bad news arises around the world on the COVID-19 front. However, over the next year, stock markets will likely have to deal with other hurdles, such as rising interest rates and/or decelerating stimulus and economic growth measures. Given that we are still early in a new economic cycle, we expect that stock market pullbacks related to these events will be contained. However, a significant increase in longer-term inflation expectations that suddenly drove interest rates higher would cause us to revisit this positive outlook.

# SECTOR OUTLOOKS

## INDUSTRIALS

The demand for freight, construction and machinery continues to improve at the margin, with profit forecasts still steadily rising. We are poised to reap the benefits of shored-up weightings in our high-conviction compounders and early entries into cyclical names with secular stories. We are confident the businesses we like – including those that have run with cyclical exposure – will continue to meet our long-term return thresholds over time.

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 Deere & Co. (NYSE:DE) 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 a position last 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 once again lagged during the quarter, down 7%, primarily reflecting weakness in gold equities, which were down 14%, after rising real rates and limited safe-haven demand weighed on precious metals. However, there continued to be significant divergence in subindustry performance, with cyclical areas, including copper and forest products, outperforming.

In Materials, our preference remains for base metals, particularly copper, given its leverage to the economic cycle, as well as secular demand tailwinds from global decarbonization trends. While we expect some normalization in cyclical commodities later this year when COVID-19 disruptions start to ease, marginal supply is brought back online, and consumer spending shifts more toward services, we believe copper prices will remain strong, due to a more muted medium-term supply outlook that reflects constrained capital spending over the past few years and limited development pipelines. We continue to hold First Quantum Materials Ltd. (TSX:FM) and Hudbay Minerals Inc. (TSX:HBM).

## INFORMATION TECHNOLOGY

The MSCI World Information Technology Index increased 1.2% for the first quarter of 2021, while the Information Technology Sector within the S&P/TSX Composite index decreased 1.1%. Communications equipment and electronic equipment were the two strongest subsectors as investors continued to shift toward lower-valuation, cyclically exposed stocks. Technology hardware was the worst-performing subsector, mainly due to the outsized influence of Apple Inc. (NASDAQ:AAPL).

Looking ahead to the second quarter, semiconductors will likely continue to be a strong subsector as the industrial economy recovers, and with supply constrained for most of the year. We like Lam Research Corp (NASDAQ:LRCX) as the semiconductor industry significantly increases capital expenditures over the next several years. Taiwan Semiconductor Manufacturing Company, Ltd. (NYSE:TSM) is increasing spending to alleviate capacity constraints and maintain its lead in advanced processing. Intel Corp. (NASDAQ:INTC) will also be investing to build out a bigger foundry business in the U.S., and the U.S. government is expected to provide subsidies. There is renewed interest in building out more capacity for the industry in the U.S. and Europe, so as not to be overly exposed to semiconductor manufacturing in Taiwan.

In the software subsector, valuations were compressed due to a rapid rise in real interest rates. Spending remains strong, however, as companies prioritize investments in digital transformation projects. We will be opportunistic in determining appropriate entry points for structural winners in this area.

## HEALTH CARE

In the first quarter of 2021, the Health Care sector (up 3.17%) underperformed the S&P 500 Index (up 6.16%). The best subsector performers were laboratories (up about 15%), retailers (up about 14.5%), distributors (up about 14%), hospitals (up about 11.3%) and managed care (up about 6.3%), all outperforming the S&P 500 Index. The pharmaceuticals (up about 1.5%), medical technology (up 0.94%) and life sciences and tools (up about 1.1%) subsectors underperformed.

As in the last quarter, the underperformance of the Health Care sector was largely driven by the COVID-19 pandemic and policy-related noise. In the U.S. and the developed European countries, COVID-19 vaccines are now available from three companies: Moderna Inc. (NASDAQ:MRNA); BioNtech SE (Germany:BNTX), partnered with Pfizer Inc. (NYSE:PFE); and Johnson & Johnson (NYSE:JNJ). A fourth (University of Oxford, partnered with AstraZeneca PLC (London:AZN)) is expected to be approved by mid- to late April in the U.S.; it has already been approved in the E.U. and Canada. Vaccination rates have improved markedly in the U.S., with nearly one-third of the population having received one dose and approximately 19% being fully vaccinated. By May, the U.S. is expected to have enough vaccine for its entire population above the age of 16. Globally, vaccination rates vary greatly, mostly because of vaccine availability. Among developed countries, the U.K. and Israel have the highest vaccination rate, at nearly 50%, while many European countries, at 4.6–6.7%, and Canada, at 1.9%, have some of the lowest rates. Spotty rates of global vaccination will potentially delay a full economic recovery to the latter half of 2021, particularly because resurgent infections are again being seen in many parts of the world.

With increasing vaccination rates, the focus has shifted to base business and cyclical (academic and industrial end markets) recovery across all Health Care subsectors. However, several companies will likely be seeing material declines in revenues related to COVID testing, such as Thermo Fisher Scientific Inc. (NYSE:TMO), Quidel Corp. (NYSE:QDEL) and diagnostic laboratories generally, once testing rates decline and the methods of testing shift to rapid antigen testing. That, in turn, will benefit companies such as Abbott Laboratories (NYSE:ABT) and PerkinElmer Inc. (NYSE:PKI).

On the policy front, the issue of drug pricing has resurfaced, and will likely remain an overhang as long as there is no clarity as to how far any drug pricing proposal will go. There are a number of proposals on the table that span the spectrum from government negotiation for drug prices to some form of Medicare rebate. The S&P Biotechnology Index, a U.S. biotechnology index, lost 1.5%; small to mid cap biotech companies were the most affected, because of their high valuations, while large-cap therapeutics continued to trade better, as the uncertainty is already reflected in their multiples.

Subsectors that are insulated from policy-related volatility, and positively leveraged to the reopening theme, include medical technology, tools and medical equipment. Managed care performance has continued to stagnate despite positive management commentary on reduced utilization. Reopening of the economy is potentially a negative for this subsector because of the return of deferred care, the redetermination of enrolled members and potential policy changes.

## CONSUMER DISCRETIONARY

It was a strange quarter for Consumer Discretionary stocks, particularly in the U.S., where retail trading drove incredible moves in names such as GameStop (NYSE: GME), AMC Entertainment (NYSE: AMC) and Bed Bath & Beyond (NASDAQ: BBBY). Additionally, inflation concerns led to rising rates, which drove a significant rotation out of popular growth companies and into less widely owned value stocks and underperforming COVID beneficiaries.

Despite stricter lockdowns in Canada and Europe, we continue to believe that the widespread availability of vaccines in the U.S. will drive strong performance from more cyclical names in the near to medium term, as well as from 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, should also continue to outperform.

In Canada, we remain focused on positive change stories exposed to these themes, including BRP Inc. (TSX:DOO), Magna International Inc. (TSX:MG) and AutoCanada Inc. (TSX:ACQ). Looking forward, we continue to view the underlying conditions, including record low interest rates, depleted inventories and pent-up demand, as favourable for a rebound in activity. In the U.S. – as in Canada – we remain selective in our stock choices, preferring structural winners and cyclical businesses that we believe should outperform in an early-cycle recovery. These include stocks such as D.R. Horton Inc. (NYSE:DHI), Foot Locker Inc. (NYSE: FL) and NIKE Inc. (NYSE:NKE).

## CONSUMER STAPLES

Consumer Staples lagged the broad market by about 5% in both Canada and U.S. for the first quarter of 2021. The sector remains out of favour with investors and is generally viewed as having hit peak earnings in 2020, while consumers are set to leave grocery stores and return to their pre-pandemic habits once vaccines are widely administered and restrictions are eased globally. We expect further underperformance for Consumer Staples in 2021: the group faces tough comparables, growth is decelerating, and costs are rising, while multiples are near a peak.

We have positioned ourselves for an economic recovery in Consumer Staples, and see Simply Good Foods Co. (NYSE: SMPL), Saputo Inc. (TSX: SAP) and Coca-Cola Co. (NYSE: KO) as best positioned to succeed in this scenario. These companies all share exposure to mobility trends, while the latter two have significant foodservice exposure. We expect a normalization of both mobility and the foodservice channel as the vaccines roll out and people can return to their normal lives, and we also believe these companies will emerge from the pandemic better than when they went in.

## FINANCIALS

The Financials sector continued to build momentum in the first quarter, outperforming the S&P/TSX Composite Index by another 5% as ongoing positive changes in economic data led to continued yield curve steepening and outperformance in cyclicals such as banks and insurance.

In Canada, the life insurance group led Financials higher (up 17% in the quarter), followed by the banks, up 14%. We have been positive on banks since the group began to post positive returns in the fourth quarter of 2020. We believe many of the headwinds the group has faced for the better part of three years are now set to become tailwinds, and the group appears adequately provisioned, well capitalized and in the early innings of 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 economic expansion, and we believe banks can outperform the broader index after nearly three years of underperformance. As for name selection, we continue to prefer banks that are exposed to consumer lending, rather than commercial lending, as well as 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 of a few positive change stories exhibiting strong growth, including Trisura Group Ltd. (TSX:TSU) and Element Fleet Management Corp. (TSX:EFN). We also believe that Intact Financial Corporation (TSX:IFC) offers significant upside following the announcement of its joint purchase of RSA Insurance Group (LSE:RSA).

## COMMUNICATION SERVICES

It was a big quarter for Canadian telcos: Rogers Communications Inc. (TSX: RCI/B) announced the largest M&A in Canadian telco history with its planned CAD$26 billion acquisition of Shaw Communications (TSX: SJR/B)

During the quarter, we initiated a position in RCI/B, for two reasons. First, we view the deal announcement as positive for Rogers, as it would bring together Canada's two largest cable providers, providing increased scale and significant operating synergies (with a CAD$1 billion synergy target). The increase in scale will make it easier to make substantial investments in 5G. While we do not expect smooth sailing on the regulatory front, given the lack of overlap in cable, we believe that remedies are more likely to be focused on wireless operations. The second reason is connected to the upcoming reopening of the economy. Rogers has been hit hard due by the lockdowns, owing to loss of revenues from roaming, overages and above all a lack of immigration (where Rogers' exposure to wireless is about two-thirds). With reopening on the cards, we believe Rogers is better positioned than its peers.

## UTILITIES

For a second straight quarter, Utilities underperformed the S&P/TSX Composite Index, up just 3%, compared with 8% for the Index. Also for a second straight quarter, the headline number masked the material dispersion of returns in the sector: while traditional regulated utilities were strong, green trades took a pause and gave back some of their gains.

It was another stellar quarter for our top pick in the space, AltaGas Ltd. (TSX: ALA), which delivered a 13% quarterly return. We have viewed ALA as a turnaround story, and that was on display in 2020. The company bridged about half of its ROE gap (earned vs. allowed) and surpassed its guidance for 2020, notwithstanding the pandemic. Strong pricing in the natural gas liquid market also provided ALA's midstream operations with a tailwind. Looking ahead at the remainder of 2021, we continue to see ALA further bridging that ROE gap, and increasing its proportion of tolling (vs. merchant/spot) in its midstream operations.

## REAL ESTATE

REITs outperformed the broader market for a second straight quarter, rising 9%, compared with 8% for the TSX Composite Index, led primarily by retail REITs as vaccine optimism continued throughout the quarter.

We have long highlighted we like Colliers International Group Inc. (TSX:CIGI), and there is no change to that. Our positive view on CIGI was based on two aspects: at the industry level, real estate ownership continues to become more institutionalized, which favours global brokers. And more importantly, the business mix of commercial real estate brokers has improved dramatically in favour of defensive sources of revenue, such as advisory and asset management; markets should rerate these brokers to reflect the change in business composition (and lower leverage compared with 2007–08). Our view was vindicated, with CIGI handily beating estimates for the fourth quarter of 2020, a tough time for commercial real estate. We believe that CIGI remains well positioned to take advantage of the rebound in global economy, continue its market share gains and deliver on the inorganic growth side, given its excellent balance sheet.

## ENERGY

The S&P/TSX Energy sector was up 20% for the quarter, outperforming the S&P/TSX Composite Index. While we recognize the long-term structural challenges to oil demand, given the adoption of alternative energy sources, the current backdrop is still favourable. On the supply side, capital expenditures of the top 60 North American producers were cut by nearly 50% in 2020, leading to production declines. Meanwhile, as economies reopen, global oil demand is exceeding supply and inventories are rapidly being drawn down. We continue to monitor key risks for oil, including the response of OPEC to higher oil prices and discipline by shale producers.

In the portfolio, we continue to have a positive view of Suncor Energy (TSX:SU): we see several positive change events in 2021, including aggressive cost cutting, conservative production guidance and upside from SU's downstream operations. In addition, we have a positive view on energy infrastructure. With new pipeline construction facing a more challenging regulatory and political environment, we see companies with existing operating energy infrastructure assets as more valuable.

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