PICTON MAHONEY
Asset Management

Q4 2020 INVESTMENT REVIEW AND OUTLOOK

- RECOVERY UNDERWAY
- NEAR-TERM UNCERTAINTY MAY PROVIDE BETTER BUYING OPPORTUNITIES
- NEW LEADERSHIP COULD EMERGE WITHIN STOCK MARKETS
- REWRITING THE TEXTBOOKS ON POLICY

OVERVIEW

The coronavirus forced a global recession. Massive monetary and fiscal stimulus was then applied around the world, most notably in the U.S., where the U.S. Federal Reserve (the Fed) succeeded in pushing real bond yields to record lows while driving investment flows into risk assets, especially growth stocks. While some segments of the economy remain quite depressed, a new economic cycle is now generally underway. While stock markets seem priced for a better future, one crucial ingredient remains before declaring an outright victory over the recession: a clear plan to open the U.S. economy that safely deals with the COVID-19 threat. We think COVID-related issues will be sorted out as 2021 progresses, leading to the new emergence of more cyclical leadership in stock market indices.

PICTON MAHONEY HOUSE VIEW

VIEW	PMAM VS. CONSENSUS
RISK After going full tilt in March, macro risk has steadily declined over the year as economies reopened and learned to live with the pandemic. A resurgence that leads to a widespread lockdown could once again send risk higher, but that would be offset by greater certainty regarding the U.S. political landscape, once the U.S. election is in the rear-view mirror.	SAME
MACROECONOMIC	
GLOBAL REAL GDP The fourth quarter will be felt differently in different parts of the world: China is back to normal and is expected to stay that way, along with most of Asia, while European economies are once again in retreat.	SAME
U.S. REAL GDP After a huge third-quarter bounce back, it will be more of a challenge to sustain the pace of recovery in the fourth quarter, especially as a virus resurgence threatens to shut down parts of the country once again. A new fiscal support package during the lame duck session will be critical to keeping the economy intact through the quarter.	SAME
CANADA REAL GDP Canada continues to thread the needle, allowing the economy to operate safely while closing down some segments in an effort to control growing infection counts.	HIGHER
U.S. INFLATION U.S. inflation should remain muted in the absence of sustained demand, but should rise in the long term, especially given the Fed's desire to run the economy hot in the next cycle.	SAME
EQUITY RETURNS	
U.S. EQUITIES Renewed bipartisan efforts to get a new fiscal package passed quickly, to bridge the gap of the next few months until a vaccine is available, will be the key to continued gains in U.S. equities.	SAME
EUROPEAN EQUITIES A rebound in European equities will likely be deferred to another quarter as Europe battles through another round of economic slowdowns to contain the latest outbreaks.	LOWER
CANADIAN EQUITIES Canadian equities continue to show resilience as the economy slowly but surely gets back to normal, while balancing the need to counter virus resurgences across the country.	SAME
BOND YIELDS	
TREASURIES (U.S. 10-YR) U.S. rates will remain depressed for some time to come, because the Fed remains committed to remaining accommodative until inflation is much higher. We expect rates to rise eventually as the global economy returns to normal, but this will take some time and will likely require additional fiscal support.	SAME
INVESTMENT-GRADE CORPORATE BONDS Investment-grade spreads compressed fully 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 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 Oil continues to remain vastly oversupplied, and balance can only be found by relying on OPEC+ countries to show production restraint. Additional hits to demand from a slowing Europe mired in new lockdowns may further reduce demand in the near term.	LOWER
EPS GROWTH (S&P 500) Earnings growth is expected to rebound in the third quarter after bottoming in the second quarter, although an extended resurgence would put this recovery in jeopardy.	HIGHER
P/E (S&P 500) Although multiples usually rise during a recession as earnings shrink, they are at multi-year highs, particularly in the high-growth sectors, and should drop again over time.	LOWER

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

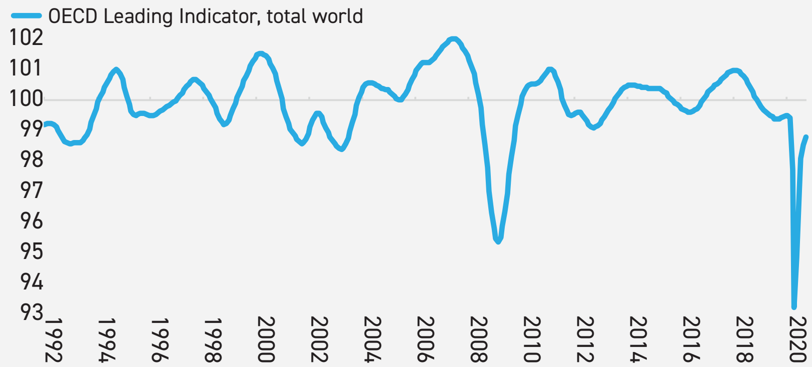
RECOVERY UNDERWAY

There is little doubt at this point that global economic growth has regained significant ground from the March lows and that a recovery is underway. Leading economic indicators for OECD countries have rebounded as sharply as they fell and are now closing in on pre-pandemic levels (Fig. 1).

The U.S. economy is showing signs of renewed momentum. Despite numerous and justified complaints about the government's handling of the health crisis, corporate leaders are feeling optimistic. The Philadelphia Fed Survey of General Business Conditions has made a full round trip, regaining early 2020 levels (Fig. 2).

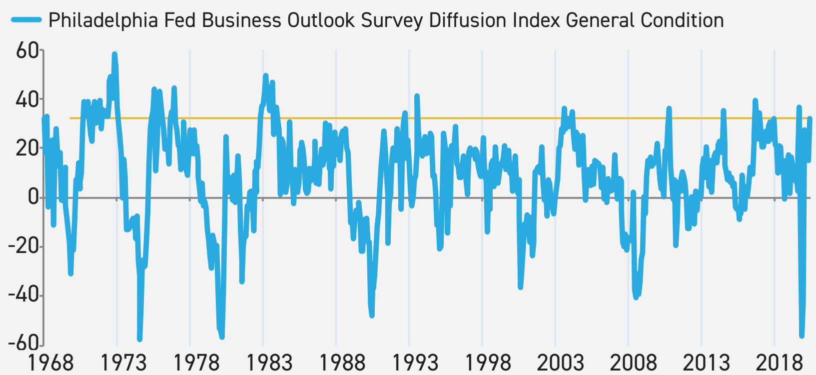
The American consumer is also in a much more confident mood. There is arguably no greater discretionary spending than on a new home. An obvious beneficiary of low rates, mortgage applications have soared to fresh highs for the past decade (Fig. 3). New home sales are booming, and residential construction is back to pre-crisis levels. The performance of homebuilder stocks, compared with the rest of the market, has also surged ahead of late.

FIGURE 1: GLOBAL LEADING INDICATORS UP SHARPLY



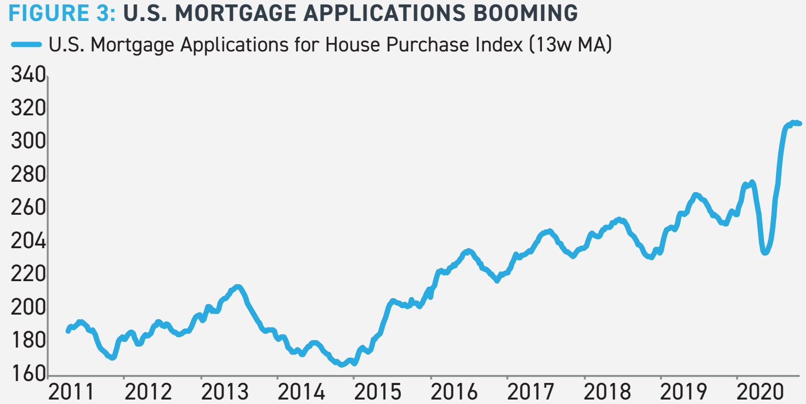
Source: Bloomberg, L.P., and PMAM Research. As at Sept 30, 2020.

FIGURE 2: A ROUND TRIP FOR U.S. BUSINESS CONDITIONS



Source: Bloomberg, L.P., and PMAM Research. As at Oct 30, 2020.

FIGURE 3: U.S. MORTGAGE APPLICATIONS BOOMING

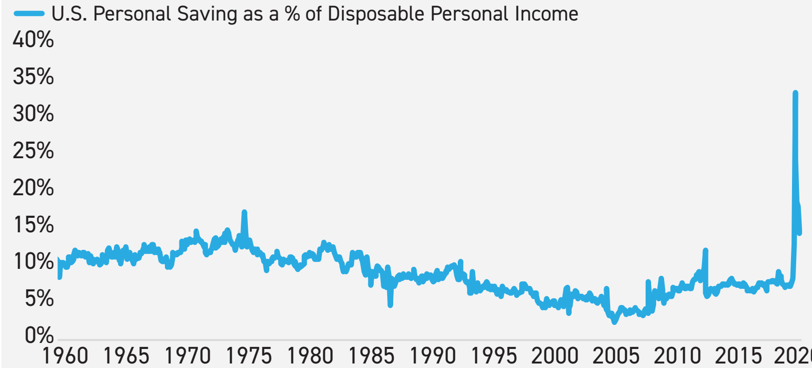


Source: Bloomberg, L.P., and PMAM Research. As at Oct 16, 2020.

While consumers are splurging on housing, there is potential pent-up demand accumulating for other sorts of goods and services. The U.S. savings rate is still in the mid-teens. This hoard of cash provides the wherewithal for a sustained spending spree once lockdown conditions ease, perhaps in areas of the economy that are currently under pressure, such as travel, lodging and entertainment.

Similarly, in Canada, by the end of June, some $100 billion had been added to deposits year-to-date, compared with $40 billion in the entire previous year. Some $85 billion of this rests in personal demand and notice deposits, rather than term ("locked in") products such as GICs – 280% more than in the previous year.[1]

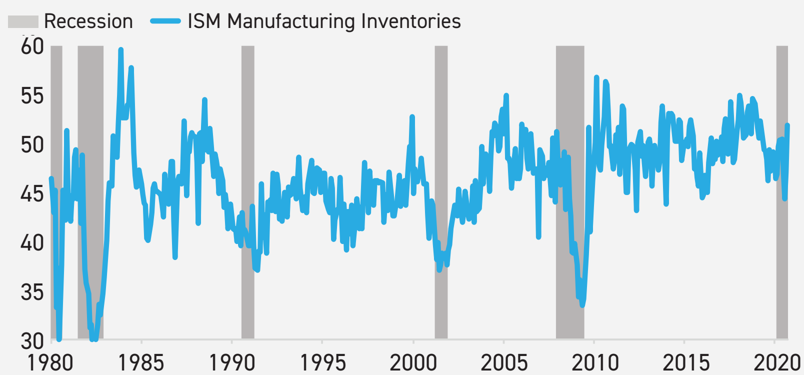
FIGURE 4: CONSUMERS ARE "FLUSH"



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

Low inventories will magnify the positive effects of renewed consumption. The Institute for Supply Management inventories index fell to 44.4 in August as production failed to keep up with stronger spending demand. This has been exacerbated by pandemic-related bottlenecks, but as Fig. 5 shows, these kinds of rapid depletion in inventories tend to set the stage for recession recoveries.

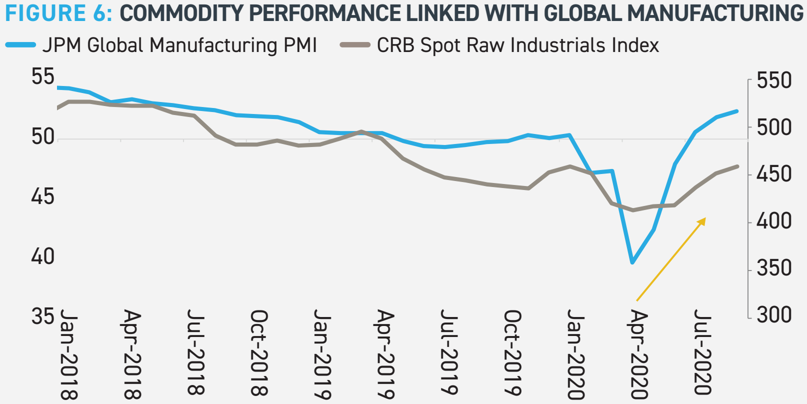
FIGURE 5: A NEW INVENTORY CYCLE COULD LEAD US OUT OF RECESSION



Source: Bloomberg, L.P., and PMAM Research. As at Sept 30, 2020.

Related to this, Asian countries, which endured and then contained the coronavirus months ahead of the west, have seen a resurgence in manufacturing activity (Fig. 6).

FIGURE 6: COMMODITY PERFORMANCE LINKED WITH GLOBAL MANUFACTURING



Source: Bloomberg, L.P., and PMAM Research. As at Sept 30, 2020.

Not only is the global economy at the beginning of a new economic cycle, we expect that this cycle could have considerable time to run, given the considerable stimulus at play, high savings rates, significant slack in large areas of the economy and generally low inventory levels. The pandemic has also created an environment in which central bankers are unlikely to take their foot off the monetary gas pedal for a considerable time. Markets have been highly sensitive to tightening monetary policy in the era following the global financial crisis, suggesting that central banks should be less likely to raise rates prematurely, especially given that large segments of the economy have yet to participate in the early stages of this recovery.

[1] "Financial Data for Banks." Office of the Superintendent of Financial Institutions, https://www.osfi-bsif.gc.ca/Eng/wt-ow/Pages/FINDAT.aspx.

NEAR-TERM UNCERTAINTY MAY PROVIDE BETTER BUYING OPPORTUNITIES

Every day that goes by brings the world closer to an eventual resolution of the COVID-19 problem, either through a better plan to coexist with the virus, an outright cure for those who get it or a vaccine that brings it to some sort of end.

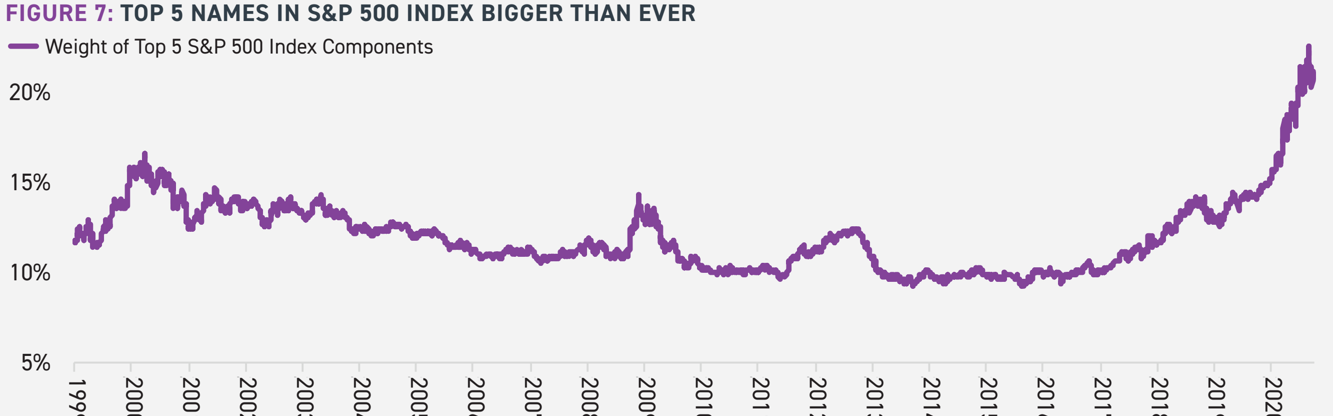
However, every day that goes by without a breakthrough on one of these three fronts sees more people run out of savings, more businesses shut down permanently, more bankruptcies and more layoffs in the industries most affected by the pandemic. It doesn't help that U.S. government efforts to devise another stimulus package appear to have become highly politicized, which has delayed and even eliminated aid for those most at risk.

Also, the oncoming cold weather, school terms and flu season in the northern hemisphere will drive worsening case counts in the second wave of coronavirus infection, especially in the U.S., which has mishandled the pandemic from the outset. Could things get so bad as to make necessary a second round of shutdowns that would undermine the economy's recovery efforts?

Finally, what sorts of unknown unknowns will the U.S. election bring? Will President Trump challenge the results of the election and refuse to leave office if the election is close? What unintended economic circumstances might result from a Democratic sweep of the presidency, House and Senate? Could a potential rise in tax rates occur more quickly than the economy can absorb it? Could an increase in capital gains taxes cause a wave of selling as taxable investors try to lock in some gains before the new tax year begins?

All these issues have the potential to force near-term uncertainty to be priced into risk assets, such as stocks, causing prices to fall. However, we think any pullbacks will be limited, for several reasons. First, while the P/E valuation of the stock market is higher than average (especially in the U.S.), the aggregate multiple is somewhat distorted by the performance of a small number of technology stocks, which masks more attractive valuations in neglected sectors. For instance, the weighting of the top five names in the S&P 500 Composite Index is the largest it has ever been by a considerable amount (Fig. 7). In Canada, Shopify Inc. eclipsed Royal Bank of Canada as the country's largest company.

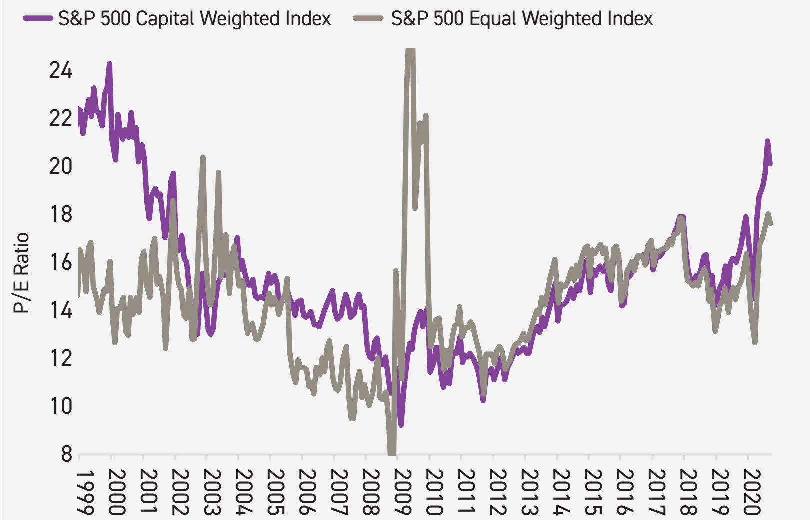
FIGURE 7: TOP 5 NAMES IN S&P 500 INDEX BIGGER THAN EVER



Source: Bloomberg, L.P., and PMAM Research. As at Sept 30, 2020.

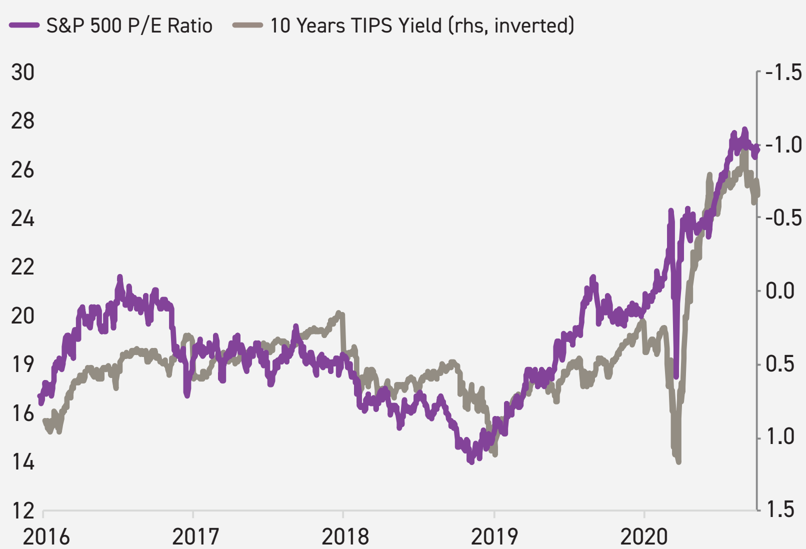
The equal-weighted S&P 500 Index tells a much different story than the conventional market cap-weighted benchmark, so far as valuations are concerned. The obvious winners during the market rally – and the FAANG stocks in particular – have pushed the S&P 500 Index into prohibitively expensive territory. But in the equal-weighted index, where the P/E ratios of large-cap tech stocks don't count for any more than those of the smaller-cap constituents, average valuations are far more palatable (Fig. 8).

FIGURE 8: PRICEY STOCKS? MOSTLY AT THE HIGH END



Source: Bloomberg, L.P., and PMAM Research. As at Sept 30, 2020.

FIGURE 9: LOW REAL YIELDS DRIVING STOCK MULTIPLES



Source: Bloomberg, L.P., and PMAM Research. As at Sept 30, 2020.

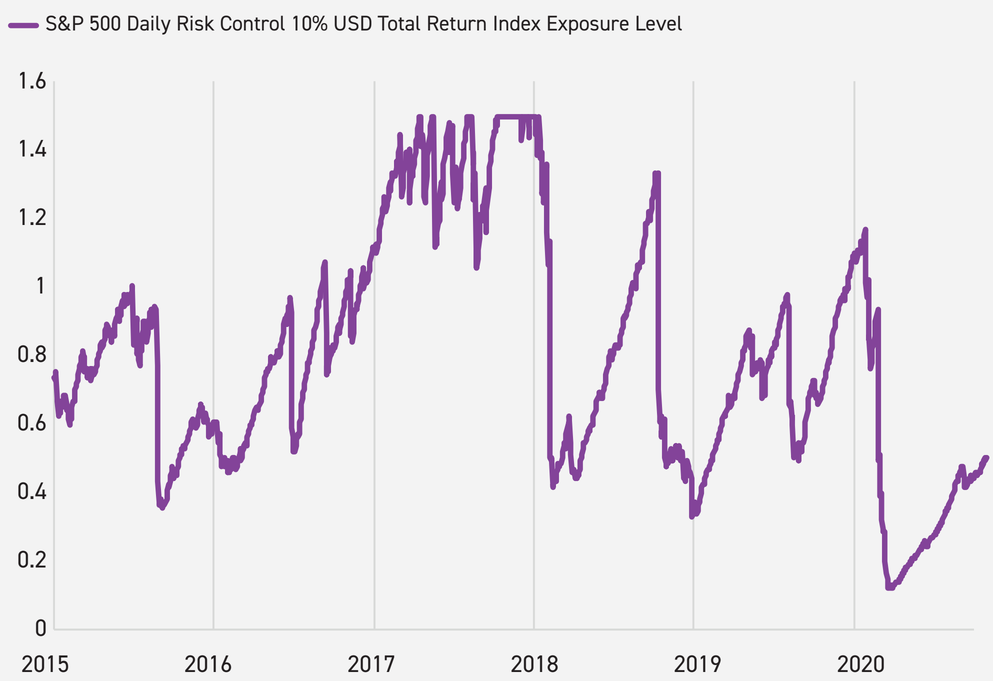
Looking at it another way, stock markets rallied through the second and third quarters as the Fed's stimulus programs pushed real yields deeply into negative territory. This made the potential earnings yield from equities more attractive by comparison. The result was an S&P 500 Index rally fuelled almost entirely by multiple expansion. Stock market valuations can be said to have moved in lockstep with the decline in real interest rates, and do not look unreasonable, given where these real rates are today (Fig. 9).

The second reason we believe that any stock market pullbacks will be somewhat limited is the generally conservative positioning of many groups of investors. Significant amounts of cash have built up on the sidelines this year and are essentially earning no return. According to UBS Research, overall equity hedge fund positioning in the U.S. has seen gross exposures fall, although net exposure is up modestly. Put another way, short positions have been closed out, at the margin, but less capital is exposed to the market, suggesting the hedge fund community is taking an "optimistically cautious" stance.

Similarly, systematic risk control strategies currently have a lower-than-usual exposure to the equity market. Fig. 10 shows an index that proxies what an S&P 500 Index exposure would be if risk was capped at a 10% volatility limit. This index reached its lowest exposure to the market in five years during the March 2020 sell-off. However, despite the rebound in equities (which normally allows these types of strategies to take on more market risk), volatility control funds remain significantly underexposed to the equity market, compared with recent history. Given that volatility is used by many risk managers to ratchet risk up and down in their portfolios, this suggests a significant number of institutional portfolios are likely underexposed to equity risk and could become large buyers once the volatility environment normalizes.

While any further financial stress on individuals is clearly regrettable from a humanitarian perspective, the resulting market volatility from near-term issues such as the second COVID-19 wave or unintended consequences of the U.S. election would provide a good opportunity to position portfolios for further stock market gains, and perhaps new market leadership opportunities, in 2021.

FIGURE 10: RISK CONTROL STRATEGIES UNDEREXPOSED TO THE MARKET



Source: Bloomberg, L.P., and PMAM Research. As at Sept 30, 2020.

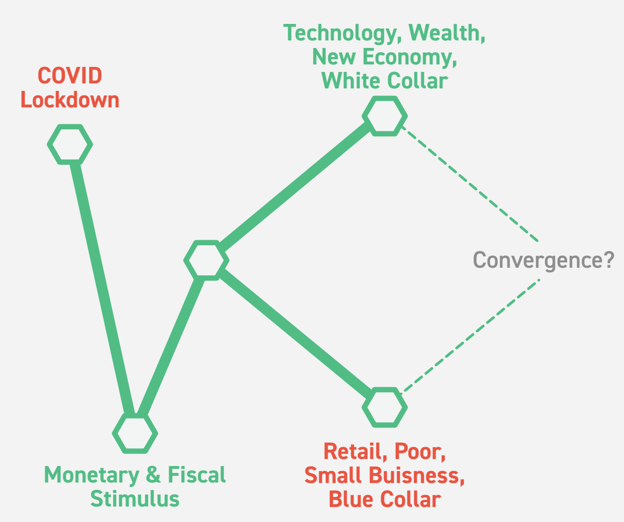
NEW LEADERSHIP
COULD EMERGE WITHIN STOCK MARKETS

In 2020, the remarkable concentration of investment capital in large-cap technology made perfect sense, with investors crowding into secular growth stocks that benefited from the COVID-19 fallout, while avoiding more cyclical companies and those most exposed to the economic shutdowns.

In sector terms, the benefits of massive stimulus and receding pandemic fears were not spread evenly, but instead resembled what is being described as a “K-shaped recovery.” Technology franchises, which were largely undisturbed by the pandemic, formed the upwardly sloping part of the K, attracting so much capital that by the end of the third quarter, the largest five stocks in the S&P 500 Index made up almost a quarter of the benchmark's entire market cap, as noted earlier (see too Fig. 11).

Underperforming cyclical stocks made up the majority of the downward sloping moving part of the K. The stall in global economic activity slashed revenues for every company except those profiting from online shopping and working from home

FIGURE 11: THE “K” RECOVERY...WHERE TO FROM HERE?



However, as near-term COVID-19 concerns begin to dissipate and global economic growth returns, we expect market leadership at least to broaden out, and perhaps even to change considerably. Recent polls suggest the increasing likelihood of a “blue wave” Democratic sweep, which has engineering and construction company CEOs salivating, as it would bring Joe Biden's proposed $2 trillion infrastructure spending bill closer to fruition. Additional fiscal support in the U.S. could take many forms, but civil unrest arising from economic inequality makes significant stimulus measures a political priority, whether they are taken now or after the election.

There are some early signs that some sort of rotation is already underway. While earnings revisions for Financials and Real Estate are still falling, Materials, Industrials and even Energy companies are seeing positive revisions to analysts' earnings estimates. The case for specific commodities grows stronger by the day (this is discussed in the next section).

September provided hints of change in actual stock price performance patterns. Thanks to improving economic data worldwide, cyclical sectors gained traction, while technology stocks fell back. In the U.S., Industrials, for instance, outperformed Information Technology by 540 basis points, and the S&P 500 Index by 280 basis points, for the month.

We think it is too early to completely abandon technology and other secular growth leaders. However, we also think that the easy money has already been made, and that the dominance of the sector has disquieting similarities to the situation at the end of the 1990s tech bubble. The key difference, of course, between today and the 1999–2000 period is that today's tech giants are largely profitable, show consistent growth and have fairly strong balance sheets. Most of the dot-com darlings of yesteryear simply never grew into their lofty multiples. We will be watching the tech sector quite closely, since it could become a source of cash for many investors who could move to more cyclical areas once the economy reaccelerates.

REWRITING THE TEXTBOOKS ON POLICY

The dawn of this new market cycle brings with it the potential for a risk that investors have been able to safely ignore since 1982: increasing inflation rates. So far, the unprecedented degree of central bank monetary stimulus in the past decade has yet to generate the inflation pressure that economic textbooks would have predicted. We think this could change in the next few years.

At the recent Jackson Hole symposium, Fed Chair Jerome Powell reiterated deflationary concerns, noting the bank's concern regarding the "persistent undershoot" of 2% inflation targets. This is why the Fed has shifted to an average inflation target of 2% over the long term, suggesting that once the recovery takes hold, the Fed will be more willing to allow inflation to overshoot the 2% target range for short periods.

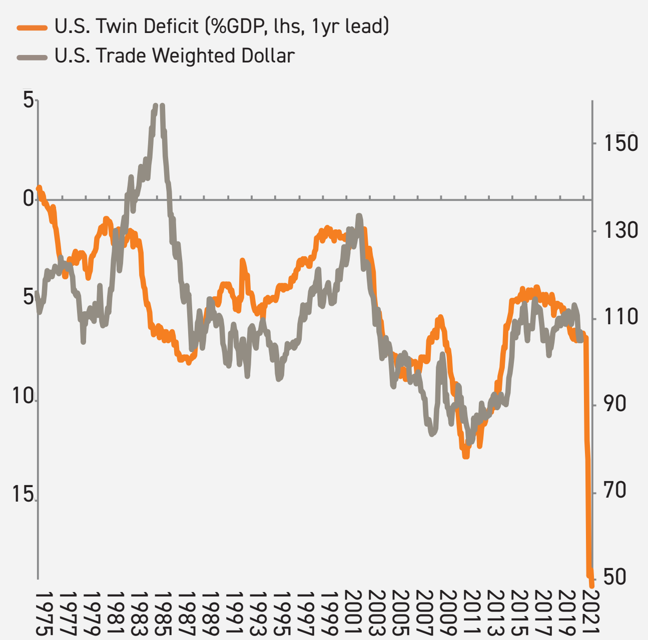
Powell was also resolute on the second leg of the Fed's dual mandate: full employment. A further comment from Jackson Hole was that "One of the clear messages we heard was that the strong labor market that prevailed before the pandemic was generating employment opportunities for many Americans who in the past had not found jobs readily available."[1]

Thus, the Fed funds rate is likely to remain near zero for the foreseeable future. Presumably, most global policy rates will also be anchored near zero, even if economic momentum, and eventually inflation expectations, continue to build.

At the same time, there are various deflationary pressures that might reverse themselves, starting with commodity pressures. It has been almost a decade since the peak of the structural boom in commodity demand from China and other developing nations. The period since has been characterized by significant reductions in capital spending intentions by most commodity producers. There is evidence building that China is entering another phase of structural commodity deficit. This combination could lead to a surging commodity price cycle that would contribute to driving inflationary pressures higher.

The potential for a weaker U.S. dollar could further feed this new commodity cycle, given the U.S. dollar is used to denominate many global commodities. While all major currencies seem to be in a "debasement" mode as countries vie for any easy competitive advantage available, U.S. deficit pressures could put additional pressure on the U.S. dollar. A historic twin deficit (trade and budget) could spell a materially weaker U.S. dollar over time, as Fig. 12 suggests.

FIGURE 12: DOLLAR PATH TIED TO DEFICITS



Source: Bloomberg, L.P., and PMAM Research. As at Sept 30, 2020.

[1] Federal Reserve Chair Jerome H. Powell, "New Economic Challenges and the Fed's Monetary Policy Review," August 27, 2020. Accessed at https://www.federalreserve.gov/newsevents/speech/powell20200827a.htm

Continuing trade tensions and the COVID-related upheaval of global supply chains also raise the possibility of a deglobalization trend that could reverse some of the costs savings/deflationary pressures that have accrued in the past.

Of course, rising inflation rates are even more palatable than usual for government leaders, since they would help to "inflate away" at least some portion of the vast amounts of national debt accumulated to support spending and employment during the pandemic.

The bottom line is that this new economic cycle could have considerable room to run, but could eventually be affected by a different inflationary backdrop than the one that followed the global financial crisis of 2008.

IN CONCLUSION

We believe that the massive policy response to the COVID-19 pandemic has sown the seeds of a new economic and monetary/fiscal policy cycle. Of course, at the zero-bound of interest rates, the policy toolkit wielded by global central banks is becoming more limited. However, markets have known that a hand-off to fiscal policy, as imperative as it is, requires the political will to do whatever it takes to maintain the momentum already underway.

An all-important U.S. election is an "event risk" that the market will be keen to put behind it. Clearing that hurdle will leave COVID-19 as the significant headwind; without question, a vaccine would put the new cycle firmly in gear. Overall, we remain positive on risk assets, given the evidence available from a host of leading indicators. Shorter-term pullbacks related to rising COVID-19 case counts and periods of "lockdown lite" may provide buying opportunities for risk assets, but we believe a more meaningful opportunity to add value could be in aligning portfolios with new leadership themes in the marketplace. Disciplined, evidence-based allocations should be worth further discussion as we move forward.

SECTOR OUTLOOKS

INDUSTRIALS

Despite the effects of COVID-19, demand for freight, construction and machinery is improving at the margin, with valuations generally more or less factoring in a full recovery. The severity and timing of the pandemic are impossible to predict, but we're 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 valuation 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 Roper Technologies Inc. (NYSE:ROP) 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 United Rentals Inc. (NYSE:URI), an equipment rental company serving industrial and construction end markets across North America. It maintains an entrenched market position and has a long runway for growth. We have added to our stake in modular office solution provider Willscot Corp. (NASDAQ:WSC), predicated on the free cash-flow story, 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 Materials sector continued to outperform during the quarter, with strength in lumber, fertilizer and base metal companies. Lumber stocks benefited from strength in U.S. home sales and renovations fuelled by record lower interest rates. Meanwhile, fertilizer companies' outlooks improved as crop prices strengthened, leading to better farmer economics. Gold equities were up modestly as gold prices crept higher during the period, with gold perceived as a safe haven due to uncertainty regarding COVID-19 and concerns about the secondary impact of massive global monetary stimulus.

In Materials, our preference is exposure to copper. We have a favourable long-term view on copper, as the market is reaching an inflection point resulting in a supply deficit. We expect the market to tighten further, given limited new supply over the past few years; most copper producers have been constrained as to capital and have halted new growth projects. In following this theme, we prefer First Quantum Minerals Ltd. (TSX:FM); the company is one of the few copper companies that will be growing production over the next few years as its brings forward its Cobre Panama project.

During the quarter, we introduced a position in CCL Industries Inc. (TSX: CCL/B), a global leader in label and packaging solutions. We believe the cadence of recovery of CCL/B's business is outpacing expectations, and the company's strong balance sheet provides upside optionality through M&A.

INFORMATION TECHNOLOGY

The MSCI World Information Technology Index and the S&P/TSX Composite Information Technology Sector Index increased by 11.6% and 3.6%, respectively, in the third quarter of 2020. Technology hardware was the strongest subsector, led by Apple Inc. (NASDAQ:AAPL), due to strong services demand and anticipation of the upcoming iPhone 5G launch. Semiconductors were also strong, led by Nvidia Corp (NASDAQ:NVDA) as it ramped up new product cycles for both the data centre and gaming markets. Communications equipment continued to be the worst-performing subsector. Looking ahead to the fourth quarter, the demand environment should remain strong for e-commerce, due to Prime Day sales for Amazon.com, Inc. (NASDAQ:AMZN) and the holiday buying season. The software sector should also perform well as companies continue to prioritize the digitization of their systems.

In Canada, we continue to like Shopify Inc. (TSX:SHOP), a provider of cloud-based e-commerce platforms that enable merchants of any size to easily and quickly sell online. Due to the rapid shift of consumer buying demand to e-commerce channels, the company has essentially pulled forward demand, which supports its high valuation. The ongoing increase in e-commerce penetration, coupled with better-than-expected new merchant acquisition, should lead to sustained growth over time.

Internationally, we like ServiceNow Inc (NYSE:NOW), a leading provider of cloud-based software for automated workflow management throughout an enterprise. The company has successfully broadened its product offering from IT service management and IT operations management to include other use cases, including HR service management and customer service management. ServiceNow is increasingly becoming a strategic vendor for the largest enterprises and is seeing consistent growth in large deals.

HEALTH CARE

The Health Care sector (6.08%) marginally underperformed the S&P 500 Index (6.86%) on year-to-date basis, but lagged significantly in the third quarter (5.12%, compared with 8.38% for the S&P 500 Index). Portfolio construction has been challenging because of several issues, including 1) the accelerated spread of the SARS-CoV-2 infection; 2) delays in COVID-19 vaccine timelines; and 3) the U.S. presidential election and health care policy uncertainties. The increasing probability of a Democratic sweep, and a potential agenda that would include stabilizing the Affordable Care Act (ACA), enacting drug price controls and perhaps partially reversing Trump tax cuts, is complicating how to think about the Health Care portfolio in the second half of 2020. With the increasing likelihood of vaccines for COVID-19 prevention and therapeutics for treatment before the end of the year, investors are increasingly focused on the speed of sector normalization in 2021.

Subsector performance during the quarter has been book-ended by retailers (-7.1%) and distributors (-5.3%) toward the bottom and life sciences, tools and diagnostics (9.6%) and medical technology (8%) at the top. The performance of the facilities (19%) and dental (7%) subsectors improved meaningfully, as patients have once again begun to seek medical and dental care.

Managed care organization (MCO) subsector performance rolled over following the death of Ruth Bader Ginsberg (-1.41%) in mid-September, which allowed the appointment of another conservative judge to the Supreme Court and increased the likelihood that the Affordable Care Act will be overturned. However, MCO performance improved meaningfully (12.7% since September 20) as the odds that Democrat candidate Joe Biden will win the presidency increased. Biden has explicitly stated his support for private health insurance, and he has also clarified that his public option plan would focus on expanding Medicaid and strengthening the ACA, and not on a Medicare-for-All plan. The investors are increasingly reassured that a Biden win would not pose an existential threat to the MCO subsector.

The biopharma subsector has struggled (1.3%); a potential Democratic win could increase the possibility of drug pricing reform and corporate tax increases. The large-cap pharmaceutical sector's lagging performance also reflects expectations of a reflationary macroeconomic environment.

On the vaccine front, there is cautious optimism about success. Four different programs (Moderna Inc. (NASDAQ:MRNA); BioNtech SE (Germany:BNTX), partnered with Pfizer Inc. (NYSE:PFE); University of Oxford, partnered with AstraZeneca PLC (London:AZN); and Johnson & Johnson (NYSE:JNJ) have begun late-phase studies. Vaccine progress has been a significant focus, with investors trying to understand the timing of data disclosure, likelihood of success, regulatory requirements and distribution. Pfizer Inc. is expected to release its results imminently, with Moderna Inc. to follow soon after. Two of the trials (JNJ and AZN) were halted due to safety concerns, and resumed enrolment by late October. Assuming successful Phase III studies, at least two of these vaccines are expected to be approved before year-end. Two antibody therapeutics (Regeneron Pharmaceuticals Inc. (NYSE:REGN) and Eli Lilly and Company (NYSE:LLY) are also expected to be approved by year-end. With the resurgence of COVID-19 infections, the risks for public health and the economy are increasing; therefore, the development of effective treatments and vaccines for prevention has taken on even greater importance. The direct financial benefit for companies developing treatments remain uncertain, but their efforts appear to have generated some good will among legislators, and could moderate their efforts to cut and control drug prices.

CONSUMER DISCRETIONARY

Consumer Discretionary stocks outperformed the market in the third quarter as stronger-than-expected consumer spending and U.S. retail sales added to the economic recovery. We continued to see some rotation out of higher-quality, secular growth stocks into more cyclical, value-type names as investors became increasingly comfortable with the potential for a more “normal” 2021. 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. In the near term, however, we are also prepared for greater-than-usual volatility due to the U.S. federal elections and the long wait for a new government stimulus plan to support households facing temporary unemployment.

In the sector, we remain focused on positive change stories in the industries that are benefiting most from the conditions mentioned above, including autos, homebuilding and powersports. We believe that stocks such as BRP Inc. (TSX:DOO), Magna International Inc. (TSX:MG), AutoCanada Inc. (TSX:ACQ) and D.R. Horton Inc. (NYSE:DHI) all fall into this category; they are also cyclical businesses that should outperform in an early-cycle recovery.

CONSUMER STAPLES

After lagging the broad market in the second quarter, Consumer Staples in both Canada and the U.S. outperformed the broad markets in the third quarter. Outperformance was led by impressively strong fundamentals during the quarter; companies found themselves coming in well ahead of estimates, because consumers had been forced to consume more at home than ever before.

In Canada, the sector was led higher by Alimentation Couche-Tard Inc (TSX:ATD/B), a name we continue to favour. Even when accounting for much lower U.S. fuel volumes, U.S. convenience store fundamentals are still better than they were last year, which shows the resilience of the U.S. convenience store industry. In-store sales remain elevated, because the stores remained open throughout lockdowns, and convenience store operators adapted to an increased need for PPE. Convenience store and fuel operators have been able to more than offset the decline in U.S. fuel volumes through higher fuel margins. Fuel prices remain elevated, while oil prices (input costs) have dropped. We remain positive on ATD/B, given a solid backdrop, along with about $10 billion in liquidity in a highly fragmented industry. We believe ATD/B is primed to gain market share coming out of the pandemic.

In the U.S., the sector was led by Walmart Inc. (NYSE:WMT) and The Procter & Gamble Co (NYSE:PG), two of our top holdings during the second quarter. Walmart Inc. continues to be a secular winner, as no grocer can compete on the same scale with its low-price offering. In addition, Walmart Inc. continues to take steps in the right direction to become a major e-commerce player (as evidenced by its Walmart+ offering and TikTok investment). We do not believe the company's e-commerce investments are reflected in the share price.

While the current environment remains favourable to Consumer Staples fundamentals, we are cautious in the sector, given an expected return to normal consumer patterns (with less time at home) over the next couple years, while the sector trades at peak valuation.

FINANCIALS

Financials performed in line with the S&P/TSX Index in the quarter: strength in life insurance offset weakness in diversified financials, while banks traded in line. We remain selective in our Canadian Financials exposure, preferring a number of positive change stories facing structural growth, including Element Fleet Management Corp. (TSX:EFN), Trisura Group Ltd. (TSX:TSU) and Brookfield Asset Management Inc. (TSX:BAM/A).

Governments, banks and regulators globally continue to work very closely to help bridge the economy to a recovery. Regulators continue to look to the banks and their balance sheets to serve as a mechanism for getting money into the real economy, and especially to those who need access to liquidity, such as small and mid-sized businesses and industries that are coming under both direct and indirect stress. We have a more balanced view on the banking sector at this time, with a preference for banks that are more exposed to consumer lending than to commercial lending, as well as banks with strong fee income streams and less reliance on net interest income. We continue to expect a structural decline in bank profitability, because net interest margins will be negatively affected by zero-interest-rate policies, core commercial loan growth should moderate with demand, and loan modifications over the coming quarters will drive higher levels of non-performing loans, and will likely take time to work out – a process we believe will take years, not quarters. To put this in perspective, we don't believe the banking group will generate the same core profitability it did in 2019 until 2022 at the earliest, and buybacks and dividend increases are years away. Our preferred Canadian bank holding remains Royal Bank of Canada (TSX:RY).

In life insurance, we continue to favour Sun Life Financial Inc. (TSX:SLF); we believe its strong free cash-flow generation, conservative balance sheet and capital strength clearly differentiate it from its peers, and that it will be able to pivot to growth ahead of its peers.

COMMUNICATION SERVICES

It was an interesting quarter from the standpoint of performance. While the Big Three, as a group, underperformed the broader index by about 500 basis points, Quebecor Inc. (TSX: QBR/B) and Shaw Communications Inc. (TSX: SJR/B) both delivered double-digit returns. We attribute the strength in QBR/B to investors' relief that QBR/B made no bid for Cirque du Soleil, and SJR/B's strength to rational competition on wireline in Western Canada.

There has been no change to our underweight stance. We don't view the valuations and growth in this sector as particularly compelling. Our top pick remains Telus Corporation (TSX:T); we like the optionality that Telus Corporation provides, in the form of Telus International and Telus Health, particularly in a post–COVID-19 world, which is valued around seven times EV/EBITDA as part of its wireline operation (compared with double-digit valuations for similar names in the marketplace). We also like Telus Corporation's positioning as arguably the best operator in today's environment (as evidenced by having the lowest churn), where customer reliance on wireless and Internet has grown in importance by an order of magnitude since COVID-19.

UTILITIES

Anticipation of a Democratic sweep in the U.S. and the consequent bid for green stocks was the primary driver of the outperformance of Utilities (10.7%, compared with 4.7% for the S&P/ TSX Composite). We are not experts at political prediction and will wait, with everyone else, to see the outcome of the election.

Generally, our preferences are unchanged. We think Brookfield Infrastructure Partners L.P. (TSX:BIP) is a secular winner in a "need for yield" environment. We believe that BIP's global platform, and its expertise across many verticals within the infrastructure segment, puts it in the pole position to take advantage of current trends. We expect BIP will deliver about 10% per share FFO growth (6–9% organic and 1–5% acquisitions), which puts it comfortably above the 5–6% range for regulated utilities.

Our positive view on AltaGas Ltd. (TSX: ALA) is also unchanged, given its strong rate base growth profile (8–10%) and its room to grow ROE (by about 250 basis points). We also consider ALA's decision to own the majority of PetroGas Company (PTCO) (74% with the announced acquisition) as a positive, as it would likely help ALA maximize the value of its midstream business.

REAL ESTATE

Real estate continued to underperform the broader index for a second straight quarter. Following a 10-percentage-point underperformance in the second quarter, REITs underperformed the broader market by about 600 basis points (-1.5%, compared with 4.7%). For a second straight quarter, retail REITs were the culprits behind the underperformance.

We view industrial REITs as a structural winner, driven by the secular e-commerce trend. Consequently, we like Granite REIT (TSX:GRT-U), a high-quality industrial REIT with an excellent tenant profile, strong balance sheet and proven management team, led by Kevan Gorrie. The other name we like is Colliers International Group Inc. (TSX:CIGI); we view CIGI as providing a healthy combination of offence and defence. While acknowledging the cyclical component in CIGI's business, we would also note that the business has become more recurring; balance sheets have become stronger vs. GFC; and real estate continues to become more institutionalized. The stock also trades at an attractive valuation (roughly a six times discount to the broader market).

ENERGY

While the oil price was relatively flat during the quarter, around $40 (WTI), oil-related equities continued to fall, with Canadian integrated oil companies down over 25%. Multiple concerns continue to weigh on oil-related equities, including a second wave of COVID-19, the U.S. election and Biden's environmental platform, negative ESG flows and tax loss selling. In response to depressed equity prices, consolidation started to heat up, with several North American equity deals announced that focused on creating value through expense synergies. Meanwhile, large European integrated companies are pivoting their focus towards renewables.

One area of strength in the sector was natural gas equities, with Tourmaline Oil Corp. (TOU) up 38% as gas prices strengthened due to a fall in production from associated gas from oil wells and increased demand from liquefied natural gas exports. While we continue to prefer natural gas companies, we have reduced our weight in these companies, given their outperformance.

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