PICTON MAHONEY
Asset Management

Q4 2021

INVESTMENT REVIEW & OUTLOOK

Opportunities Now, Inflation Debate Later

- SOME TURMOIL EVIDENT IN Q3 2021
- THE BEGINNING OF THE MIDDLE
- NEW RISKS AFFECTING THE MID-CYCLE TRANSITION THIS TIME AROUND
- MARKETS ARE ALREADY PRICING IN SLOWER GROWTH: ADD TO CYCLICALS
- THE INFLATION DEBATE WILL UNLIKELY BEGIN IN EARNEST UNTIL NEXT YEAR
- POSITIONING IS SUPPORTIVE FOR STOCKS

OVERVIEW

Economies and markets seem to be transitioning from a high-growth, early-cycle recovery stage to a slower-growth, middle-cycle environment. In the past, this transition period of decelerating – but still positive – economic growth has often been accompanied by corrections in risk assets and changes in sector leadership, and some of this was seen to occur during the third quarter. The delta COVID variant, China's slowdown and inflation concerns contributed to significant turmoil below the surface of equity markets, creating a set-up for a bounce-back in more value-oriented/reopening plays in the near term. Stock markets and the global economy will likely continue to be buoyed for the next couple of years, given the backdrop of generally stimulative conditions, significant pent-up demand and low interest rates around the world. As COVID and supply chain issues ease around the world, inflationary pressures are expected to diminish somewhat over the next few quarters. However, inflation will likely be a key risk factor to monitor later in 2022, when base effects and supply chains normalize, and a truer gauge of pricing pressures emerges.

PICTON MAHONEY HOUSE VIEW

VIEW	PMAM VS. CONSENSUS
RISK	
Macro risk rose as expected last quarter as the delta variant wave hit certain jurisdictions, slowing down the reopening process. In addition, supply chain bottlenecks showed little sign of easing, raising the spectre of higher-for-longer inflation and a much more hawkish central bank response down the line.	HIGHER
MACROECONOMIC	
GLOBAL REAL GDP Global GDP growth will likely stay even as some regions re-accelerate, while others like China could continue to decelerate.	SAME
U.S. REAL GDP Leading indicators of growth have decelerated, but are still at healthy levels. As COVID issues continue to fade, the economy is expected to return fully back to normal, but so are fiscal and monetary support, which could offer a negative counterbalance.	SAME
CANADA REAL GDP Canada's vaccination rate is one of the highest in the world, which will allow a continued return to normal in most provinces. Higher commodity prices will also help Canada's basic materials sectors.	HIGHER
U.S. INFLATION Supply chain disruptions remain, and the delivery times for goods are as high as ever. The fix will come, but probably not this year. Rising commodity prices add to the equation, as does a home price boom that's higher than the one in 2005.	HIGHER
EQUITY RETURNS	
U.S. EQUITIES We are entering a mid-cycle environment, where broad equity market upside will be more challenging. However, underneath the hood of the index, there will likely be opportunity for rotation, especially as rates rise over time.	SAME
EUROPEAN EQUITIES Europe is also showing signs of economic deceleration. Higher inflation will continue to push historically low rates from negative to positive, and the financials sector will likely benefit the most.	SAME
CANADIAN EQUITIES Canada's recovery continues, with healthy demand and job growth seen across different sectors and regions. Commodity-related exposures should start to price in higher prices for longer.	HIGHER
BOND YIELDS	
TREASURIES (U.S. 10-YR) Higher rates and higher inflation remain themes this quarter as the U.S Federal Reserve (Fed) and other central banks end Quantitative Easing (QE) programs and signal a start to rate hikes next year.	HIGHER
INVESTMENT-GRADE CORPORATE BONDS Investment-grade spreads have fully compressed back to pre-crisis levels, and issues remain in high demand, although already low treasury rates may limit their upside.	SAME
HIGH-YIELD CORPORATE BONDS With the Fed having stepped in as a buyer of last resort, most corporate bonds remained buoyed throughout the crisis and thus are already fully valued. Further upside will require continued improvement to the growth outlook over time.	SAME
OTHER	
WTI CRUDE OIL Oil remains in short supply near-term, with lower inventory levels and the futures curve still in backwardation, implying a strong demand for current oil. A weakening U.S. dollar and a rebounding global economy will also help over time.	HIGHER
EPS GROWTH (S&P 500) Earnings growth should continue to rebound in 2021, although supply chain and labour constraints may delay available production capacity, even as demand remains robust.	HIGHER
P/E (S&P 500) Multiples at multi-year highs will likely 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 September 2021.

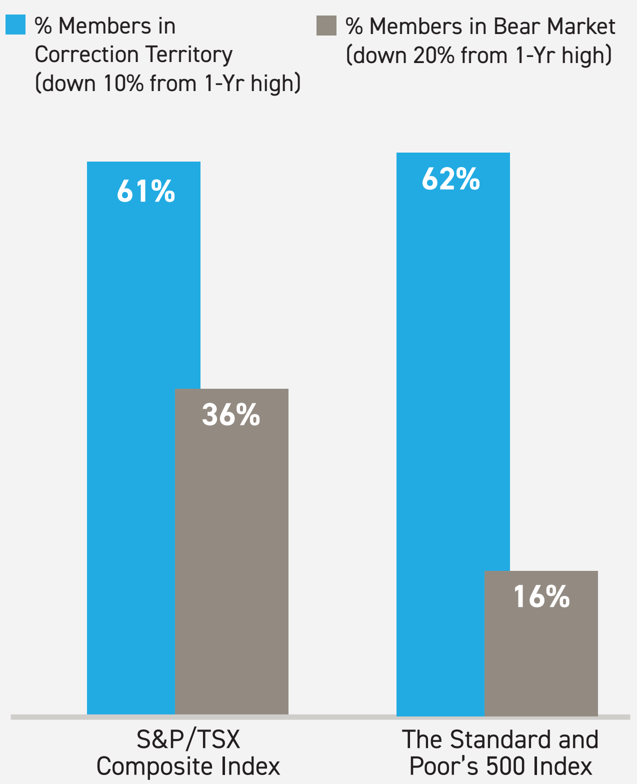
SOME TURMOIL EVIDENT IN Q3 2021

The volatility we expected was very evident in the third quarter, with the S&P 500 Index falling 5.2%, peak to trough, in the quarter, the S&P/TSX Composite Index sliding 3.7%, and the MSCI All Country World Index down 5.7%. The Russell 2000 Index of U.S. small-cap stocks, a market that historically has outperformed in the initial stage of an economic recovery, corrected 7.5% from its 2021 peak earlier in the year.

The broad index performance understates more extensive damage under the surface. Scotiabank strategist Hugo Ste-Marie estimates that 62% of U.S. stocks are trading in correction territory (a decline of 10% below their respective 52-week highs) and that 16% are in official bear market territory (down 20% from the highs).[1] A similar pattern is apparent in Canadian stocks: 61% of stocks are in correction territory, and 36% are exhibiting bear market declines (Fig. 1). The economically sensitive larger-cap stocks in the materials and financials sectors, which generally benefit from accelerating growth, have been among the worst performers since May 2021.

Flagging cyclicals and asset flows toward the relatively safe havens of quality stocks indicate a market that is preparing for a downward shift in economic growth rates to more normalized levels.

FIGURE 1: STOCK MARKET BREADTH HAS BEEN FALLING



Source: Scotiabank, Equity Research, Daily Edge, October 5, 2021

[1]Scotiabank, Equity Research, Daily Edge, October 5, 2021

THE BEGINNING
OF THE MIDDLE

Economies and markets seem to be transitioning from a high-growth, early-cycle recovery stage to a slower-growth, middle-cycle environment. This transition has historically been characterized by equity market consolidation, equity market corrections, higher volatility and bond yields, lower price-to-earnings (P/E) ratios and, perhaps most importantly in this cycle, a tightening of central bank monetary policy (Fig. 2).

FIGURE 2: SHIFTING TO A MID-CYCLE ENVIRONMENT

Early Cycle (this time around)	Mid-Cycle Environment
• Extremely accommodative monetary policy	• QE tapering underway or about to start
• Extremely large fiscal stimulus	• Less than expected stimulus/more taxes?
• Strongest economic surge in decades	• Deceleration in key data such as ISM Manufacturing Index
• Inflation measures surging higher	• Sustainability of inflation will be key 2022 debate
• Lower-volatility environment	• Increased volatility
• Broad market rallies	• Focus on quality (although commodities can rally)

THE FED, FRONT AND CENTRE

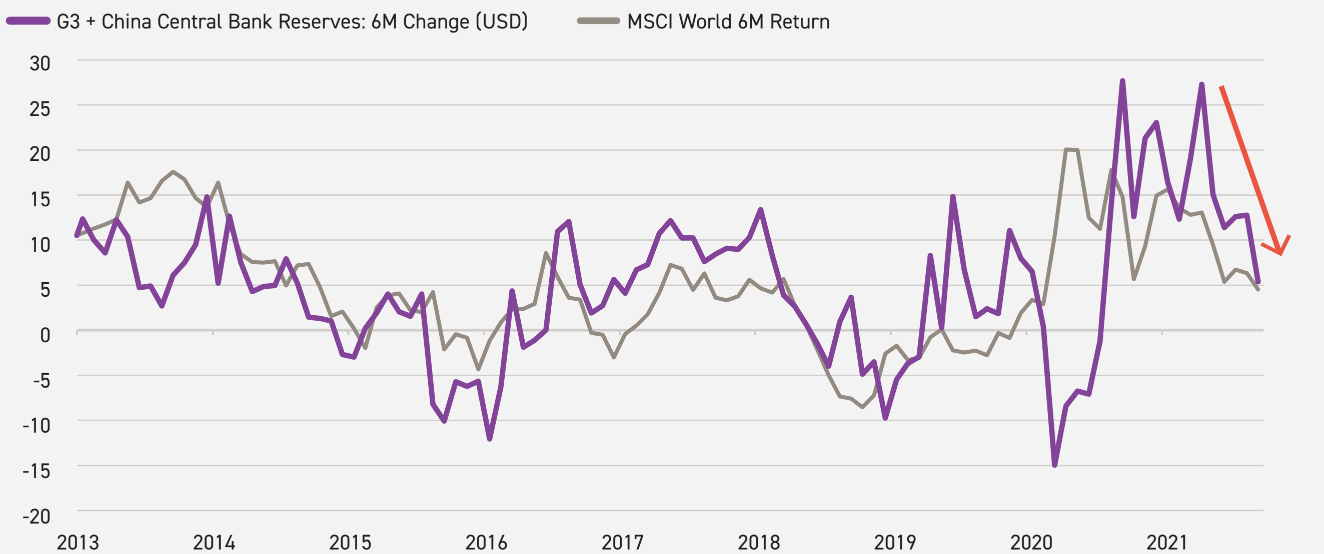
A market rally that has been heavily supported by central bank monetary expansion has made asset prices highly sensitive to "taper" talk in the near term and higher rates in the intermediate term.

The most recent meeting of the Federal Reserve Open Market Committee (FOMC) in September provided overt warnings of a more hawkish central bank. The post-meeting statement made specific reference to a reduction in quantitative easing measures: "If progress continues broadly as expected, the Committee judges that a moderation in the pace of asset purchases may soon be warranted."[2]

FOMC estimates regarding the timing of rate hikes also indicated hawkishness. The number of committee members forecasting the first rate increase in 2022 rose from nine to 11, and the median estimate for 2023 indicated a pace of four rate hikes per year. The number of FOMC members favouring no rate hikes until 2023 fell from five to one. In a previous meeting, Fed Chair Jerome Powell had indicated that the Fed's inflation goals were being met faster than expected.

Citi global strategist Matt King highlights the high correlation between central bank asset purchases and global equity returns (Fig. 3).[3] As the Fed reduces its quantitative easing, it will likely reduce fuel and mute returns for stock markets.

FIGURE 3: DIMINISHING CENTRAL BANK SUPPORT IS A HEADWIND FOR GLOBAL EQUITIES (%)



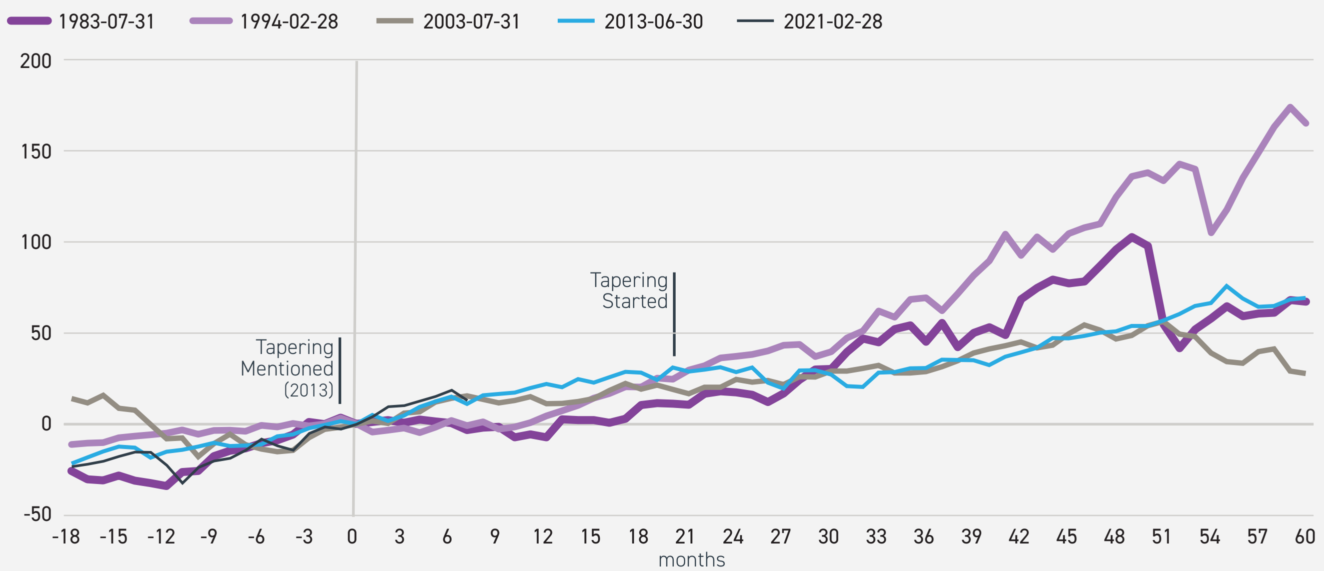
Source: Bloomberg, L.P., PMAM Research. As at September 2021.

[2]https://www.federalreserve.gov/newsevents/pressreleases/monetary20210922a.htm

[3]Citi Research, The noose tightens around Goldilocks: What's holding asset prices up?, September 28, 2021

Our macro distance model attempts to find periods in past market cycles that are similar to current conditions, so as to identify a potential road map for future market behaviour. Figure 4 shows the performance of the S&P 500 Index around market environments similar to the current one. The "0" point in the graph has coincided with jumps in longer-term bond yields of approximately 100 basis points, which occurred approximately six months ago in the current cycle. During the transition from early cycle to mid-cycle, stock markets have tended to pull back or consolidate for a few quarters before beginning their next advance higher. We expect the same pattern to play out this cycle. There has only been one historical precedent for QE tapering by the Fed, back in 2013–2014. It is worth noting, however, that the S&P 500 Index actually rose during the period when the Fed was talking about tapering, until it actually did taper, and then the Index continued to rally as the rest of the economic cycle unfolded.

FIGURE 4: STOCK MARKETS TEND TO CONSOLIDATE DURING MID-CYCLE TRANSITIONS (%)



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

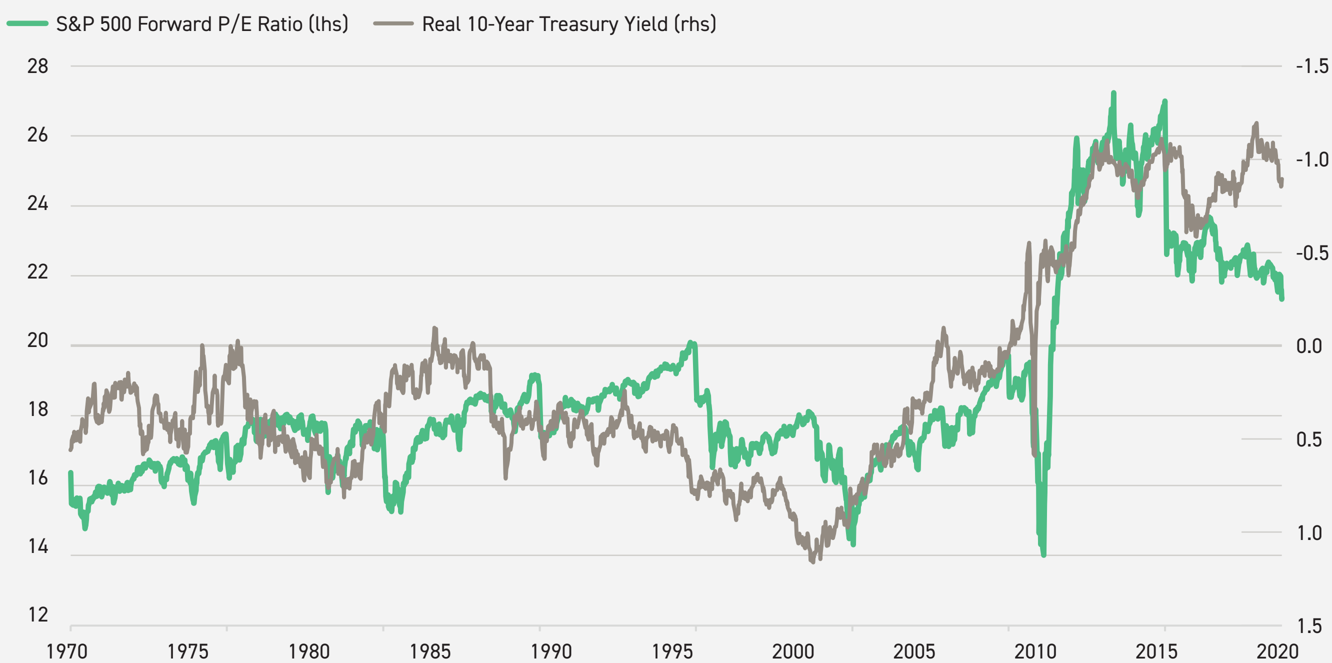
NEW RISKS
AFFECTING THE MID-CYCLE TRANSITION THIS TIME AROUND

A decline in market P/E ratios is a common feature of mid-cycle conditions, with stocks climbing and P/E ratios expanding as real rates fall. Now, however, it appears that market P/E ratios are already lower than current levels of real interest rates (Fig. 5).

Stock markets may be factoring in more worries than just the removal of excess liquidity by central banks. Other concerns that are likely affecting stock prices include:

- COVID-19
- supply chain disruptions
- Chinese economic growth concerns
- worse-than-expected inflationary pressures

FIGURE 5: P/E RATIOS HAVE ALREADY FALLEN EVEN BEFORE REAL RATES RISE

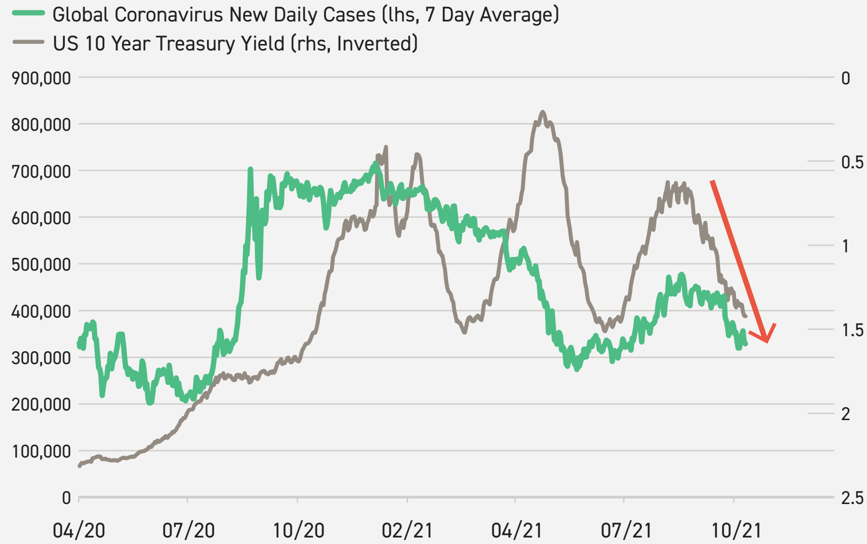


Source: Bloomberg, L.P., PMAM Research. As at September 30 2021.

COVID-19

The COVID-19 pandemic has been an obviously abnormal cyclical occurrence, and the steps taken to fight it, and then rescue the economy, have heavily distorted the global economic landscape. This past spring, just when the improved deployment of vaccines appeared to set the stage for a dramatic recovery in the global economy, the Delta variant reared its ugly head and sapped the strength of the recovery. A significant decline in bond yields occurred that surprised most market participants (Fig. 6).

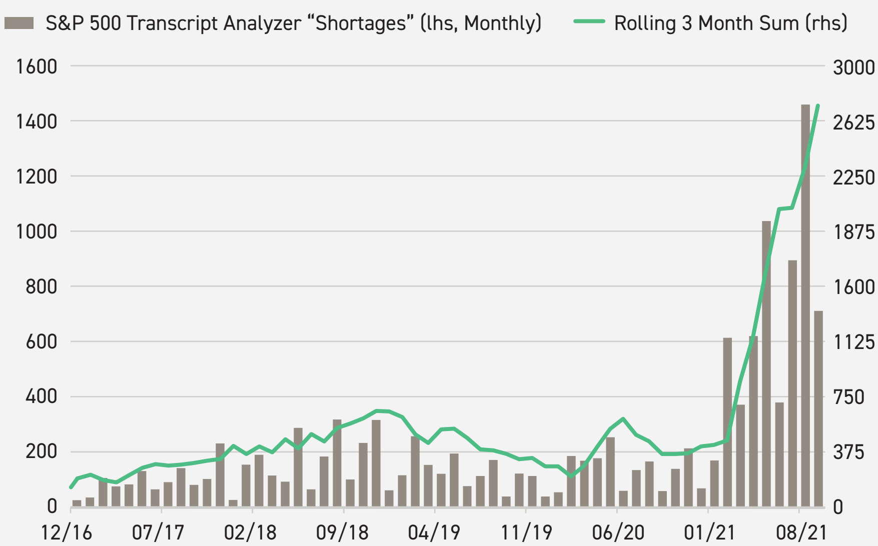
FIGURE 6: DISSIPATING DELTA WAVE SHOULD ALLOW RATES TO RISE



Source: Bloomberg, L.P., PMAM Research. As at October 10 2021.

Now that new daily cases of the virus have rolled over, bond yields are beginning to recover, and we expect the economy to follow suit as the reopening once again gains momentum. Vaccines are becoming more available, which should allow for booster shots in developed countries and greater rollouts in the developing world. Combined with improving COVID therapeutics, such as the Merck pill, these developments will hopefully push COVID-19 toward "endemic" status, allowing the global economy to push along a path of normalization.

FIGURE 7: SUPPLY CHAIN DISRUPTIONS HAVE LED TO WIDESPREAD SHORTAGES



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

SUPPLY CHAIN DISRUPTIONS

There has been significant discussion and fear regarding supply chain disruptions around the world, and how they may affect the availability of goods and create additional margin pressures for companies producing and selling those goods. September saw a new high in the mention of "shortages" in transcripts of S&P 500 company communications, and the three-month average of transcripts of S&P 500 company communications also set a new record (Fig. 7).

The development of just-in-time manufacturing practices in recent decades accomplished its goal, by improving corporate accounting and reducing the need for both inventory and working capital. However, it also made the global supply chain vulnerable to a major disruption such as the COVID-19 pandemic and its repercussions.

The pandemic has determined multiple factors driving supply chain issues, including production problems overseas, backups at ports and the inability to move goods from the ports. Manufacturers and transportation industries are now confronted with new quarantine, vaccination and testing requirements that vary across trading nations. Delays have severely disrupted complex logistic strategies and slowed production activity, notably in the auto sector, where semiconductors are scarce. The International Chamber of Shipping, in a letter to the United Nations General Assembly, warned of a "global transport system collapse" if global workers were not prioritized for vaccines and freedom of movement for trade was not re-established. The letter was also signed by road and air transport industry groups.[4]

Vietnam illustrates how COVID turned the benefits of globalization and low-wage manufacturing into a threat to corporate profits. The country's competitiveness as an investment destination was boosted by rising costs in China; Vietnam now accounts for 51% of Nike footwear production and roughly one-third of Lululemon's and The Gap's merchandise. Unfortunately, Vietnam has been hit hard by the coronavirus delta variant, which has forced factory closures and reduced capacity, and confined staff to on-site bubbles. Only 30–40% of production capacity is now permitted by health officials, with hopes of 60–70% by the end of October, pending new case data. The risks that retailer supply will not meet holiday season demand are climbing, and this adds to financial pressures for retailers already dealing with surging transportation costs.

It seems very likely, then, that reduced COVID-19 concerns should lead to reduced supply chain issues. The process of vaccinating the world's population is continuing at the impressive pace of 40 million doses per day. While only 40% of the global population has been fully vaccinated as of November 1, 2021, estimates suggest it will take nine months to fully vaccinate the world.[5] Vaccinating the vast majority of the populace, especially in developing countries from which developed world companies source goods, will help the global supply catch up with demand and reduce the costs of getting goods to consumers.

On a longer-term basis, however, we would expect much more duplication of supply lines, to ensure that future disruptions do not have the same negative impact.

CHINESE GROWTH FEARS

China's new "common prosperity" goals, along with government measures to limit credit creation in the real estate sector, have taken the country from a reliable contributor to global GDP growth and the dominant source of demand for most major commodities to a potential investment risk.

The Chinese growth miracle has been fuelled by debt and construction. Real estate investment, in particular, has had a significant contribution to the economy, accounting for as much as 25% of GDP. This trend resulted in various distortions, including severe overbuilding: urban housing vacancy rates are now above 20%. China's Evergrande is the world's most indebted real estate developer, with balance sheet liabilities amounting to 2% of the country's GDP. The company has been desperately attempting to stave off bankruptcy with asset sales, after regulators imposed strict limits on debt-to-asset and debt-to-equity ratios. Government agencies have provided liquidity to the financial system as a whole, but the lack of a direct bailout for Evergrande is a clear sign that Chinese leaders have become more serious about restructuring the country's economy.

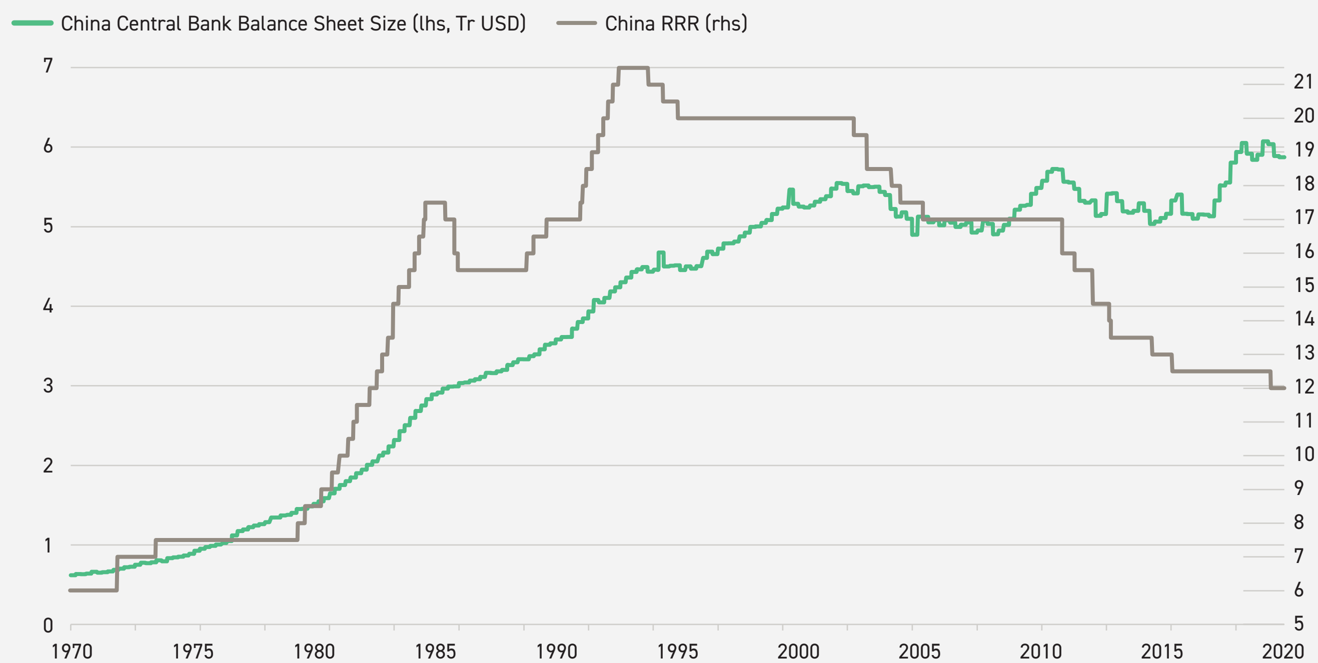
[4]https://www.ics-shipping.org/press-release/joint-open-letter-transport-heads-call-on-world-leaders-to-secure-global-supply-chains/

[5]https://www.pharmaceutical-technology.com/covid-19-vaccination-tracker

An essay published by Chinese leader Xi Jinping earlier this year signalled the government's plan to shift the economy from "fictional" debt-fuelled growth to 'genuine growth' resulting from increasing incomes and consumption.[6] The problem, according to University of Peking finance professor Michael Pettis, is that "'genuine growth" cannot generate enough economic activity to allow China to hit its GDP growth targets."[7] It appears that growth in the world's second-largest economy is set to slow in the longer term.

However, China is now acting to deal with shorter-term growth concerns. There has already been a significant amount of stimulus provided to the economy. The recent US$400 billion injection of market liquidity, bank reserve requirement ratio (RRR) and the announcement of a relending facility to commercial banks are just a few examples of measures that can be implemented by Chinese authorities if conditions worsen. In addition, Chinese officials have sufficient financial options to prevent a disorderly credit event (Fig. 8).

FIGURE 8: CHINA HAS EASED MONETARY POLICY RECENTLY BUT CAN STILL DO MORE IF NEEDED



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

[6]http://en.qstheory.cn/2021-07/08/c_641137.htm

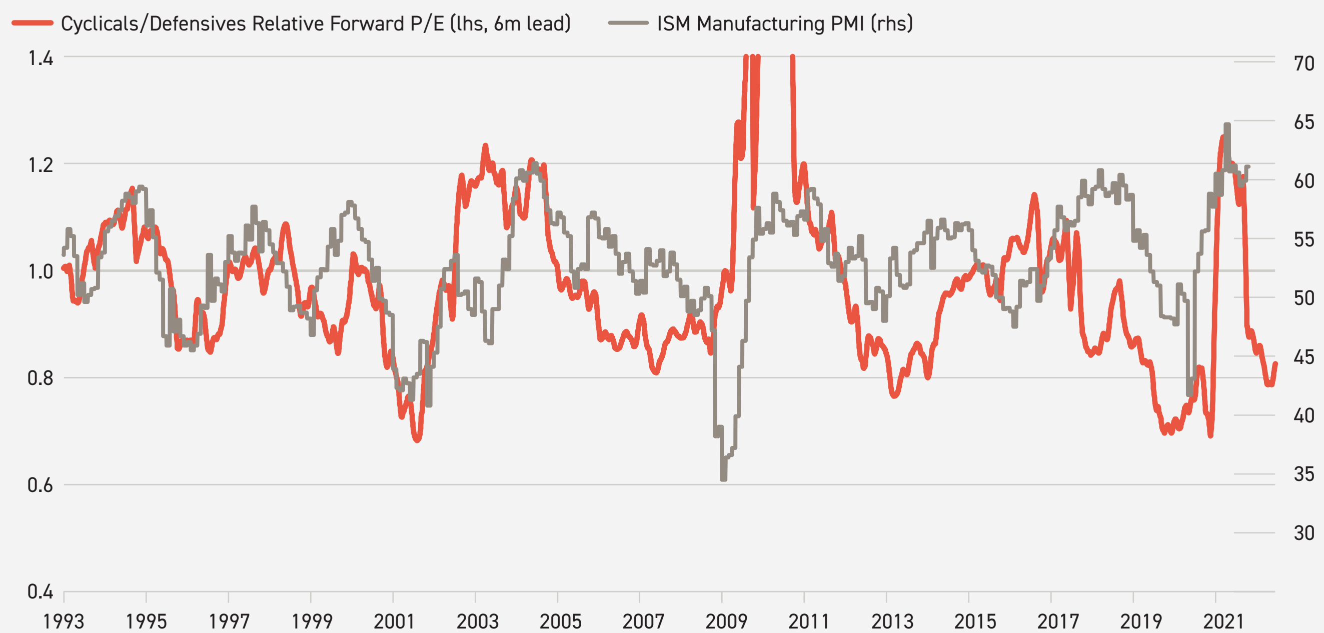
[7]https://carnegieendowment.org/chinafinancialmarkets/85391

MARKETS ARE ALREADY PRICING IN SLOWER GROWTH: ADD TO CYCLICALS

With all these concerns, it is no wonder that pockets of the equity market have begun to price in a significant slowdown in the global economy. The recent underperformance of economically-sensitive sectors has led their P/E ratios lower, while the popularity of interest rate-sensitive sectors has driven their valuations higher.

According to Exane BNP Paribas, the relative P/E ratios of cyclical and defensive stocks has accurately predicted manufacturing activity, with a six-month lag. While the ISM manufacturing index has begun to moderate from its multi-decade high of 64.7 in March, falling to 61.1 more recently, cyclical and defensive relative valuations are already pricing in a deep contraction in manufacturing activity (Fig. 9). This seems extreme to us, and perhaps provides a near-term opportunity to profit from more economically-sensitive exposures in portfolios as some of the concerns discussed above began to moderate.

FIGURE 9: CYCLICAL AND DEFENSIVE RELATIVE VALUATIONS ALREADY PRICING IN A DEEP CONTRACTION IN MANUFACTURING ACTIVITY



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

THE INFLATION DEBATE WILL LIKELY BEGIN IN EARNEST UNTIL NEXT YEAR

U.S. core inflation peaked at a yearly growth rate of 4.5% over the past 12 months, the highest in three decades. Broad inflation measures remained stable at 0.4% in September, relative to August, while core CPI (excluding food and energy) jumped 4.0% year-over-year in September.

Delta variant-related supply shortages continue to push producer prices higher, but we expect this to ease as vaccination efforts proceed. Still, even Fed Chair Powell expressed exasperation with trade frictions that refuse to ease: "It's also frustrating to see the bottlenecks and supply chain problems not getting better — in fact at the margins apparently getting a little bit worse. We see that continuing into next year probably, and holding up inflation longer than we had thought."[8]

The Fed continues to maintain that these elevated inflation rates are a temporary phenomenon, driven by supply constraints meeting the accelerating demand of recovering economies. BCA Research agrees, noting that inflation is focused on a few hot spots, such as autos, where pricing is extreme relative to history. "Unless their spaces have undergone lasting structural changes," wrote BCA's chief U.S. investment strategist, Doug Peta, "we expect their two-plus standard deviation moves will not be sustained ."[9]

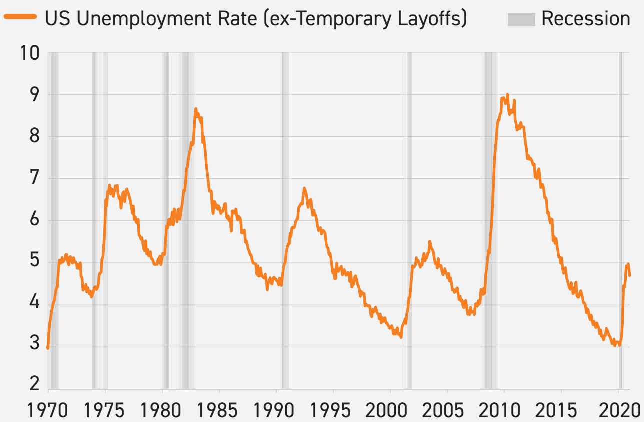
We believe CPI reports over 4% and 5% are concerning, in that they haven't been that high since the beginning of the nineties, but the structural factors that have helped keep inflation in check for decades didn't suddenly disappear when the pandemic arrived. Given the unusual circumstances of the rapid global pandemic shutdown and the rapid reopening, it is difficult to refute Fed Chair Powell's assertion that today's excess inflation pressures are likely transitory. As vaccine efforts increase around the world and more developing economies fully reopen, it is highly unlikely that supply chain issues will worsen or that the related pricing pressures won't start to abate. And while energy prices have soared, prices for certain commodities, such as lumber and, more recently, iron ore, have pulled forward considerably, which should contribute to deflating pricing pressures.

[8]https://www.reuters.com/business/global-supply-disruptions-could-still-get-worse-central-bankers-warn-2021-09-29/

[9]BCA Research Inc., Discussing Inflation, Growth And Market Implications, September 6, 2021

In the short term, bond yields are likely to remain more sensitive to jobs data than CPI and PPI inflation prints themselves. The Fed has signalled that it will tolerate inflation well above the 2.0% target, as long as it still believes forward pricing expectations are not climbing meaningfully. Fed Chair Powell's guidance points to easy monetary policy until the pandemic-related employment wounds are fully healed. As Figure 10 illustrates, if we exclude the distortion to the unemployment rate made by the huge spike of temporary layoffs that came and went, permanent unemployment in the U.S. is just starting to improve, and remains well above pre-COVID levels.

FIGURE 10: PERMANENT UNEMPLOYMENT TRENDS ARE JUST STARTING TO REVERSE (%)



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

However, this means that as employment recovers and wages increase through 2022, the inflation debate will likely intensify. If soaring vaccine immunization rates and easing supply chain constraints do not lead to a significant decline in inflation rates, then higher inflation expectations will become more rooted. Investors will then be faced with the very uncomfortable proposition that QE tapering will likely be followed almost immediately by actual interest rate increases by the Fed, along with other central banks around the world.

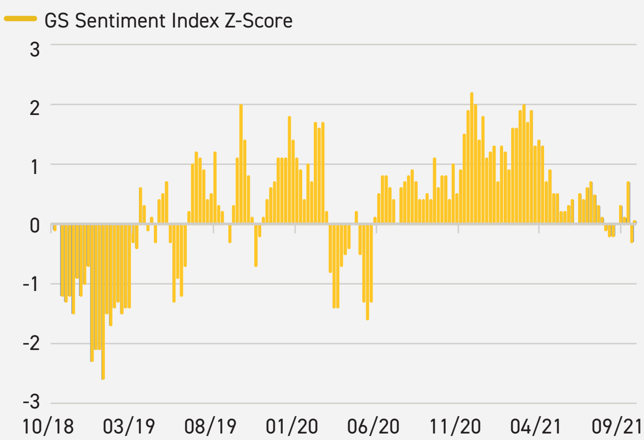
It has been decades since investors were confronted with real inflation and its negative effects on security prices. Those who are confident that inflation is temporary point to how the loose monetary policy of the past decade didn't lead to any meaningful uptick in longer-term inflation expectations. However, that stimulus occurred against a backdrop of balance sheets in need of repair at both the consumer and banking level. It also occurred during a period of excess capacity being ramped up in many commodities, such as copper and oil. This time, neither of these factors will offset inflationary forces, and could contribute to higher inflation pressures instead of lower. Globalization has also been a significant driving force for disinflation in the last two decades, but this trend will abate somewhat given growing geopolitical tensions, especially between the U.S. and China. Other countries are also bringing back domestic manufacturing for some industries, as a security measure, or to improve supply chains after having been caught off guard during the pandemic.

Continued elevated inflation rates a year from now will most likely be met with much higher bond yields, a weaker U.S. dollar (until the Fed demonstrates it was back in control of inflationary pressures) and downward pressure on high-valuation stocks (such as technology growth leaders) and on stock markets in general. We do not view this as a near-term risk for equity markets, since the current elevated inflation data are mostly discounted in market expectations. However, over the coming year, as base effects normalize, pent-up demand is more satiated, and supply chains operate more smoothly, continued hot inflation data would not be well received by investors.

POSITIONING IS SUPPORTIVE FOR STOCKS

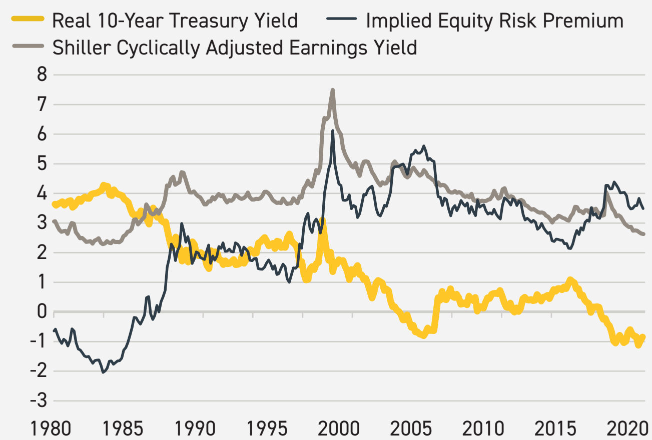
The quarter's volatility had the positive effect of tamping down investor euphoria. The Goldman Sachs Sentiment Indicator (SI) comprises nine variables that measure positioning and fund flows, including mutual fund cash positions, Commodities Futures Trading Commission (CFTC) positioning, hedge fund net exposure, foreign investor demand for U.S. equities, changes in retail margin debt and various measures of U.S. equity active and passive fund flows. Figure 11 shows that this sentiment gauge most recently peaked in March 2021, at two standard deviations above neutral, but has deflated considerably over the past six months, suggesting that equity investors are not aggressively positioned at this time. While equities are expensive on an absolute basis, they still remain inexpensive relative to real yields (Fig. 12).

FIGURE 11: EXTREME SENTIMENT HAS NEUTRALIZED IN RECENT MONTHS



Source: Goldman Sachs Research

FIGURE 12: VALUATIONS STILL HIGH, BUT MORE REASONABLE WHEN ADJUSTED FOR LOW RATES (%)



Source: Robert Shiller, Bloomberg, PMAM Research

IN CONCLUSION
OPPORTUNITY AHEAD

The pandemic was a once-in-a-century event, but the market cycle is proceeding as it typically does.

The third quarter likely marked the peak in monetary support for asset prices, but central banks remain extremely accommodative relative to history. The winding down of quantitative easing will likely begin shortly, but short-term interest rates are likely to remain low and unchanged for some time. Markets are already beginning to display the usual behaviour around the transition to a mid-cycle environment – more volatility and consolidation – which should be followed by more upside. In the near term, we believe more economically sensitive stocks are oversold and should bounce back, but longer-term, we expect investors to show a general preference for companies with stable and more reliable profit growth.

However, we will be increasingly focused on inflation data as we progress into 2022. Should current inflation rates sustain themselves at these high levels through 2022, we expect that bond yields will rise considerably, forcing us to revise our constructive outlook along the way.

SECTOR OUTLOOKS

INDUSTRIALS

The demand for freight, construction and machinery is expected to continue to remain strong well into next year. We are poised to reap the benefits of both the shored-up weightings in our high-conviction compounders and 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. Toromont Industries Ltd. (TSX:TIH), Waste Connections Inc. (TSX:WCN) and WSP Global Inc. (TSX:WSP) 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 TFI International Inc. (TSX:TFII) following an opportune pullback. TFII is a fast-growing trucking, logistics and parcel company and an astute acquirer with a long runway for M&A-based growth. Our stake in modular office solution provider Willscot Corp. (NASDAQ:WSC) has significantly outperformed the market since we initiated the 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 the industrial leasing complex. We believe the companies we own that are exposed to rentals, such as Triton International Ltd. (NYSE: TRTN) and United Rentals Inc. (NSYE:URI), are currently underestimated and will outgrow their competitors in the coming years.

MATERIALS

The third quarter was challenging for the S&P/TSX Materials sector, which underperformed the broader index by 6%. The slowing momentum we saw in June developed into increasingly negative sentiment as investors questioned whether recent gains had outpaced fundamentals, and as concerns about peak growth increased. Both the precious metals and base metals subsectors were under pressure, while forest products rebounded after lumber prices had troughed, and fertilizers benefited from strong underlying fundamentals.

We remained tactical in our cyclical exposure in the sector as the market managed its way through economic deceleration and macro risks from China. We remain positive on copper for structural reasons, given secular demand tailwinds from global decarbonization trends and a more muted medium-term supply outlook that reflects both constrained capital spending over the past few years and limited development pipelines. First Quantum Materials Ltd. (TSX:FM) remains our preferred exposure for copper. While managing our core high-quality holdings in the gold space, we have focused on names that we believe have organic opportunities to add or unlock value without relying on higher prices.

INFORMATION TECHNOLOGY

The MSCI World Information Technology Index increased 1.3% for the third quarter of 2021, while the Information Technology sector in the S&P/TSX Composite Index declined 0.5%. Subsector performance was mixed, with strength in software and IT consulting offset by weakness in the internet and catalog retail and semiconductor subsectors. Internet and catalog retail stocks faced some moderating demand, relative to the elevated levels of 2020, while semiconductor stocks were weighed down by concerns about pricing and anticipated supply increases. Spending remains strong in the software subsector, but high-valuation stocks will continue to depend on the stability of real interest rates. We like Salesforce.com Inc (NYSE: CRM) as a relatively inexpensive software stock, with an enterprise value at 8.8 times calendar-year 2022 revenues. Growth in the company's core business will likely be consistently in the 20% range, with incremental contributions coming from the recent Slack Technologies Inc. acquisition. The company is also communicating a new commitment to operating margin improvement and to avoiding any additional large acquisitions in the near term. The valuation should be able to expand as the company meets its expected growth and margin targets.

HEALTH CARE

In the third quarter of 2021, the Health Care sector (up about 1.02%) marginally outperformed the S&P 500 Index (down about 0.29%). The poor performance of the sector was driven by macro variables such as the risk of interest and corporate tax rate hikes, style and sector rotation, supply chain constraints and commodity price increases (which affect the medical technology, medical supplies and hospitals segments), labour shortages, and policy and regulatory uncertainties, such as the impact of drug pricing on biopharma and distributors. These headwinds are expected to continue into year-end.

The rising rate of COVID delta variant infections slowed the post-COVID reopening dynamics late in the third quarter, and normalization is now expected in 2022, compared with earlier expectations of late 2021. Staffing pressures at all skill levels have been accelerating and are likely to post a new risk to the recovery theme for hospitals, facilities, medical technology, telemedicine and laboratories. The increased costs of hiring and retaining the necessary labour force could pressure company margins and earnings. The best subsector performers were hospitals (up about 10.8%) and life sciences tools (up about 5%). The resurgence of the delta variant stalled the utilization recovery (facilities, medical technology), but unlike in prior waves, hospitals in most of the country maintained an elective surgery schedule while treating COVID patients. The life science tools space is less leveraged to macro and health care policy-related headwinds, but it is sensitive to the unwinding of high-multiple growth names that happened toward the end of the third quarter. All other subsectors were marginally better than or underperformed the S&P 500 Index, the worst being facilities (down about 12%), followed by biotechnology (down about 8.5%) and managed care (down about 4.5%).

Vaccination rates against COVID infection remain spotty. In the U.S., resistance to being vaccinated appears to be entrenched in some regions of the country, despite federal government and large employer mandates. Recently, Merck (NYSE:MRK) and Ridgeback Biotherapeutics released positive interim results for a COVID-19 oral antiviral that showed a significant reduction in hospitalizations and deaths in infected patients. Merck and Ridgeback have applied for an Emergency Use Authorization. The positive news on the antiviral pressured a number of COVID-leveraged companies: vaccine manufacturers Moderna, Inc. (NYSE:MRNA), BioNTech SE-ADR (NYSE:BNTX), Pfizer inc. (NYSE:PFE) and Novavax, Inc. (NYSE:NVAX); antibody therapeutics companies Regeneron Pharmaceuticals, Inc. (NYSE:REGN) and Vir Biotechnology, Inc. (NYSE:VIR); vaccine manufacturing suppliers Maravai LifeSciences Holdings, Inc. (NYSE:MRVI), Danaher Corporation (NYSE:DHR) and Thermo Fisher Scientific Inc. (NYSE:TMO); and contract manufacturers such as Catalent, Inc. (NYSE:CTLT). The pullback was excessive for the contract manufacturers and suppliers, since the capacity and materials currently supporting vaccine manufacturing can be deployed elsewhere. It is too early to assess the implications for vaccine companies, because there is still a need for a large volume of vaccines for the rest of the world, for children under 12 years of age, and for boosters that will be required for the current pandemic and if the virus becomes endemic. The negative implication for the COVID antibody therapeutic companies is clearer, since an oral treatment would alleviate the need for a more complicated antibody treatment, such as hospitalization, to get an infusion or injection.

On the policy front, the issues of drug pricing and importation continue to be discussed, with no clear direction. The issue will likely remain an overhang if there is no clarity as to how far any drug pricing proposal will go. Subsectors that remain insulated from policy-related volatility, and that are positively leveraged to the reopening themes, include medical technology, tools and medical equipment.

CONSUMER DISCRETIONARY

The Consumer Discretionary sector again underperformed the S&P 500 and, to a greater extent, the S&P/TSX Composite Index in the third quarter. A combination of rising inflation concerns, along with fading government stimulus support and supply chain constraints, presented real risks to third- and fourth-quarter earnings. Although rising vaccination rates in many parts of the world are encouraging and continue to drive consumer spending, additional outbreaks in key sourcing and manufacturing regions severely curtailed the delivery of goods, from T-shirts to sneakers to semiconductors. Many consumer verticals also face higher costs for commodities (e.g., cotton), freight and labour.

We view most, if not all, of these exceptional headwinds as transitory, and expect a normalization in 2022. Longer-term, we remain positive on the sector and continue to view underlying conditions, including still record-low interest rates, depleted inventories and pent-up demand, as favourable. However, we acknowledge that second-half earnings will be noisy, and have reduced our exposure to the sector. We continue to prefer structural winners trading on reasonable multiples, where we believe earnings upside will be more durable. These include Magna International Inc. (TSX:MG), Spin Master Corp. (TSX:TOY) and BRP Inc. (TSX:DOO) in Canada, and TJX Companies Inc. (NYSE:TJX) and General Motors Company (NYSE:GM) in the U.S.

CONSUMER STAPLES

Consumer Staples outperformed the broad market by about 5% in Canada, but underperformed by about 1% in the U.S. for the third quarter of 2021. In Canada, the sector benefited from rotation into defensive food retailers from cyclicals as investors looked for an inflationary hedge. In the U.S., investors remain apathetic about the sector: many companies face uncertainty in the second half of the year as inflationary pressures – commodities, labour, freight – mount and pricing offsets lag. Meanwhile, there are some questions as to what "food at home" demand looks like as economies continue to open up and consumers return to school, work and travel.

In Canada, we are positive on Neighbourly Pharmacy Inc (TSX: NBLY), the third-largest pharmacy in Canada, which has significant opportunity to expand market share as it continues to roll up the highly fragmented Canadian pharmacy industry.

In the U.S., we have positioned ourselves in names that we believe can either weather the supply chain storm, given their strong supply chains, or that have robust demand. Walmart Inc. (NYSE: WMT) and Procter & Gamble Co. (NYSE: PG) are two names that continue to gain market share and seem to be able to ensure supply to meet heightened demand; many of their smaller competitors are unable to do so. Simply Good Foods Co. (NYSE: SMPL) provides exposure to U.S. mobility and health and wellness trends, which continue to improve as we emerge from the pandemic.

FINANCIALS

The Financials sector performed largely in line with the S&P/TSX Composite Index in the third quarter, led by strength in traditional asset managers and life insurance, which outperformed the banks. Heading into the fourth quarter, we are positive on the bank group, because we believe the Office of the Superintendent of Financial Institutions (OSFI) will be unlocking the COVID-induced capital constraints. Our favourite name for this theme is Home Capital Group (TSX:HCG). HCG has more than 20% of its market capitalization in excess capital, which we believe is readily available for a sizeable substantial issuer bid (SIB) once capital constraints are lifted. Additionally, we are expecting sizeable dividend increases (in the 5–10% range), with National Bank of Canada (TSX:NA) faring the best, because its payout ratio has declined into the mid-30s, compared with a 40–50% target range. We also favour banks with structurally higher ROEs, which tend to have more exposure to strong fee-based businesses; we see them compounding book value more quickly and, at this point in the cycle, benefiting from more structural growth in market-sensitive fee businesses such as wealth and M&A advisory.

Outside of the banks, we continue to have a favourable view on Trisura Group Ltd. (TSX:TSU). We believe there remain multiple growth levers for it to maintain 20%-plus EPS growth for the next couple of years. We also believe 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 mixed bag for the Big Three telcos, with significant dispersions in returns across the group. BCE Inc. (TSX: BCE) was the best performer, returning 5.2%, outperforming both Telus Corporation (TSX:T) at 1.2% and our preferred name, Rogers Communications Inc. (TSX: RCI/B), which fell by 9.5%. Although second-quarter results for Rogers were largely consistent with market expectations, weaker-than-expected commentary on margins and ARPU spooked the market, resulting in a move lower. We view the market reaction as extreme, given the tailwinds for Rogers provided by reopening (roaming and business travel) and the consummation of a transformative deal with Shaw Communications Inc. (TSX: SJR/B) – which we believe will go ahead, with remedies – that comes with significant synergies ($1 billion). Also, Rogers' valuation discount against BCE is at a level that has been rarely seen, suggesting that the negative sentiment is excessive.

UTILITIES

It was a largely quiet quarter for Utilities, which delivered a modest 0.8% for the quarter. However, looking under the hood, we saw notable differences for the third straight quarter, with renewables moving further into the red, driven by unfavourable weather, and regulated utilities outperforming the broader index, which was largely flat for the quarter. After outperforming considerably for two straight quarters, our preferred name, AltaGas' Ltd. (TSX: ALA), took a breather in the third quarter, falling by 3%. There is no change to our positive view on the company's management, which has done a terrific job thus far at both deleveraging and improving operations (both midstream and utilities), and on the prospects for AltaGas' midstream assets. Strong demand for propane should position AltaGas' midstream very well for the remainder of 2021 and the first quarter of 2022, and should also aid AltaGas at improving its mix of tolling (vs. merchant).

REAL ESTATE

REITs had a good third quarter, generating 2.3%, compared with 0.2% for the S&P/TSX Composite Index. It was a stellar quarter for our top pick Colliers International Group Inc. (TSX: CIGI), which handily outperformed, returning 16.8%. Our thesis continues to play out, with brokers continuing to gain market share in the transaction market and increasing the percentage of recurring revenue by expanding into areas such as asset management, outsourcing and project advisory. Notwithstanding the run-up, we believe there is room for further upside, given that Colliers' balance sheet still leaves open the potential for both tuck-ins and potentially transformative acquisitions. We also believe that given the healthy credit markets, transaction activity should remain robust, offering the potential for organic growth to surprise on the upside.

ENERGY

While oil prices ended the quarter essentially flat, compared with the second quarter, there was significant volatility during the period, with crude falling 15% intra-quarter as the COVID delta variant and China concerns weighed on global crude pricing. Meanwhile, natural gas strengthened over the period: seasonal demand increased during the summer, due to higher temperatures, and supply response remained limited due to the fall in associated gas and to capital discipline by producers. The Canadian energy sector continued to outperform the S&P/TSX Composite Index during the quarter and is the top-performing sector year-to-date, up 40%.

We have become more positive on energy producers Freehold Royalties (TSX: FRU) and Cenovus Energy (TSX: CVE). Over the past year, Freehold Royalties has completed a series of acquisitions that were financially accretive and diversified their portfolio, adding some of the most attractive energy basins in the U.S. These basins will likely be first to receive growth capital when energy producers increase capex, leading to growth for Freehold Royalties at no additional cost. Cenvous' acquisition of Husky was extremely well timed, with oil prices now materially higher. The integration has been successful, achieving operational synergies that were nearly one-third of Husky's market cap at the time of acquisition. We expect further operational synergies based on Husky's assets and the sale of non-core assets, with the proceeds going toward balance sheet deleveraging and share buybacks.

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All figures provided are sourced from Bloomberg L.P. unless otherwise specified, and are based on data as at the dates indicated.

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