

Canadian Strategy Snapshot

Our Materials Weight Remains Focused on Gold

Bottom Line:

We remain slightly overweight the Materials sector, with a focus on gold and companies with strong operating efficiency and cash flow generation. Yes, industries within the Materials sector, particularly the base metals, are typically considered “late cycle” (meaning they traditionally underperform as the market begins to elevate from trough levels and slower economic growth). As such, the sector will likely continue to face near-term headwinds given the economic risks that are likely to persist in the 1H of 2023. However, according to our work, the Canadian Materials sector’s strong exposure to gold stocks adds a level of tactical defense against periods of heightened volatility as gold equities tend to meaningfully outperform during these periods and during recessionary years. Furthermore, fundamentally the Canadian Materials sector continues to check all of our boxes – namely, valuations are below historical averages, operating metrics are firmly above historical averages, cash generation is near record levels, cash is being returned to shareholders at near record pace, debt to equity is well below historical average, and capital spending remains moderate. Therefore, we believe the broad sector, including base metals, remains well positioned from an operating leverage and valuation position to outperform when commodity prices and growth headwinds subside. In the meantime, we remain slightly overweight the sector and tactically positioned within gold stocks and companies with strong operating metrics.

Overview:

- **Materials Sector: Strong Value and Operating Efficiency; Expectations Need to Adjust to Slowing Growth**
 - ✓ While commodity price movements are essential to price performance of the materials sector, fundamentals also matter, and the Materials sector continues to check all our boxes fundamentally. Ultimately, we believe the largest headwind for the sector near term is an adjustment to growth expectations as analyst mark-to-market estimates for lower commodity prices.
- **Emerging Markets Critical for Broad Sector, but Correlation Declining**
 - ✓ Yes, emerging markets are key to commodity prices. However, our work shows the sector’s correlation has declined in recent years, as the correlation of S&P/TSX Materials sector price performance versus Emerging Markets price performance declined to just 27% over the last five years from over 60% since 1990.
- **TSX Gold Weight Can Offer Tactical Defense**
 - ✓ According to our work the Canadian Materials sector’s strong exposure to gold stocks adds a level of tactical defense against periods of heightened volatility as gold equities tend to meaningfully outperform during broad periods of equity weakness and during recessionary years.

Investment Strategy

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CDN Strategy – S&P/TSX Targets

S&P/TSX Price Target	
2023 Calendar Year End	22,500
S&P/TSX EPS Target	
2023 Calendar Year End	\$1500

Source: BMO Capital Markets Investment Strategy.

CDN Strategy – Recommended S&P/TSX Sector Weightings

Sector	Opinion	Tgt. Wgt.
Communication Services	OW	5.5%
Consumer Discretionary	MW	3.5%
Consumer Staples	MW	4.0%
Energy	MW	18.0%
Financials	OW	32.5%
Health Care	UW	0.0%
Industrials	MW	13.0%
Information Technology	MW	6.0%
Materials	OW	12.5%
Real Estate	MW	2.5%
Utilities	UW	2.5%

Source: BMO Capital Markets Investment Strategy.

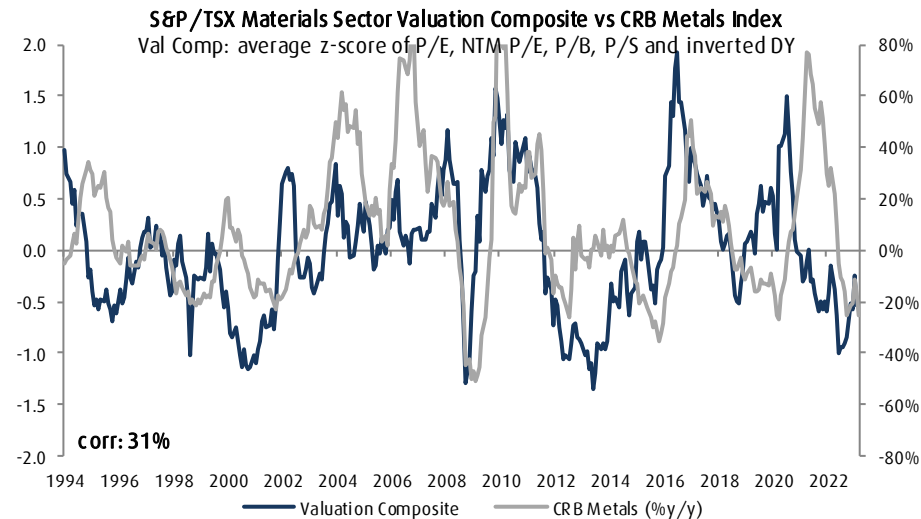
OW: Overweight

MW: Market Weight

UW: Underweight

Materials Sector: Strong Value and Operating Efficiency; Expectations Need to Adjust to Slowing Growth

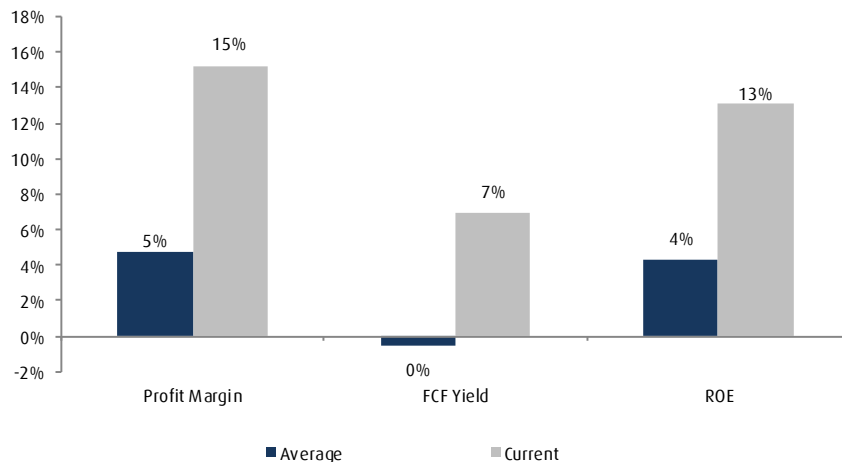
Materials Remains a Value Sector



Source: BMO Capital Markets Investment Strategy Group, Factset, Compustat, IBES.

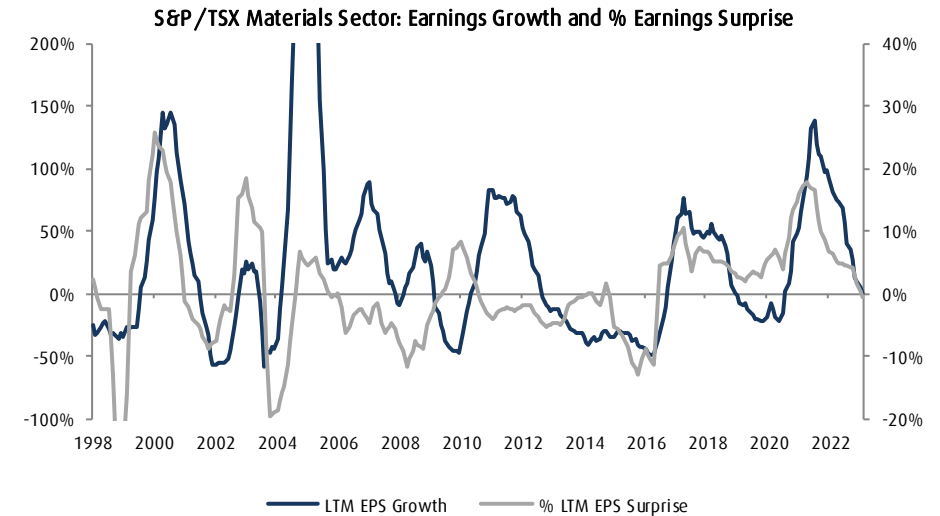
Operating Efficiency Remains Well Above Historical Averages

Operating Metrics: S&P/TSX Materials



Source: BMO Capital Markets Investment Strategy Group, Factset, Compustat, IBES.

Earnings Momentum Has Clearly Slowed and Estimates Need to Adjust



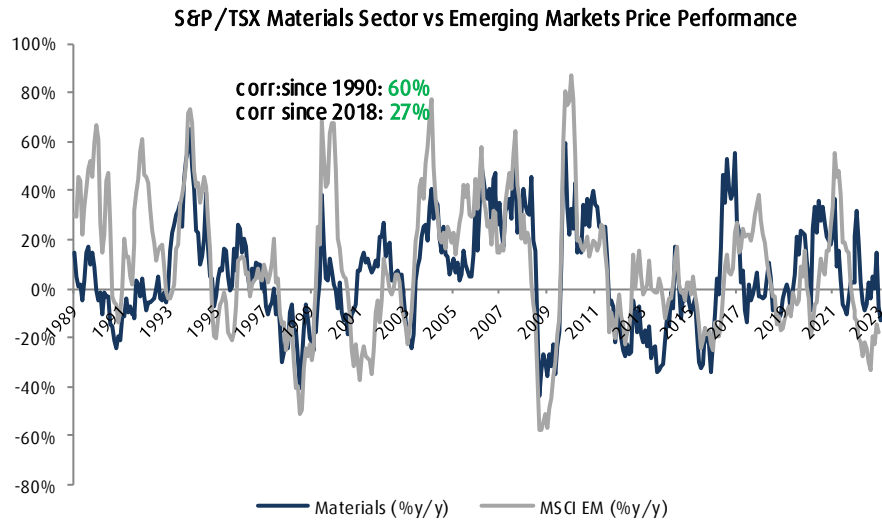
Source: BMO Capital Markets Investment Strategy Group, Factset, Compustat, IBES.

Yes, commodity price movements are essential to price performance of the materials sector. However, fundamentals do matter and the Materials sector continues to check all our boxes – valuations are below historical averages, operating metrics are firmly above historical averages, cash generation is near record levels, cash is being returned to shareholders at near record levels, debt to equity is well below historical average, and capital spending remains moderate. With that said, earnings momentum has clearly slowed and likely to turn negative in the quarters ahead. As such, we believe the largest headwind for the sector near term is an adjustment to growth expectations as analyst mark-to-market estimates for lower commodity prices.

- Materials sector valuations remain well below historical averages and generally in line with the slower commodity price environment. Yes, soft commodities are largely priced in, in our opinion.
- Operating metrics remain strong, highlighting the sectors significant operating leverage when commodities rebound.
- Earnings Momentum is the clear headwind for the sector and expectations likely need to adjust, in our opinion. Indeed, 4Q22 earnings season saw significant negative surprises for the sector as analyst have been slow to adjust expectations.

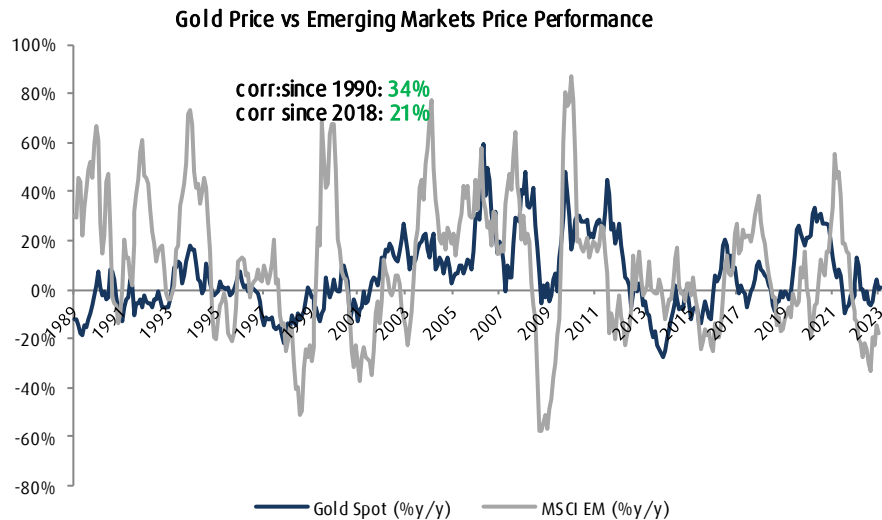
Emerging Markets Critical for Broad Sector, but Correlation Declining

Materials Sector Historically Correlated with EM, But Correlation Has Declined



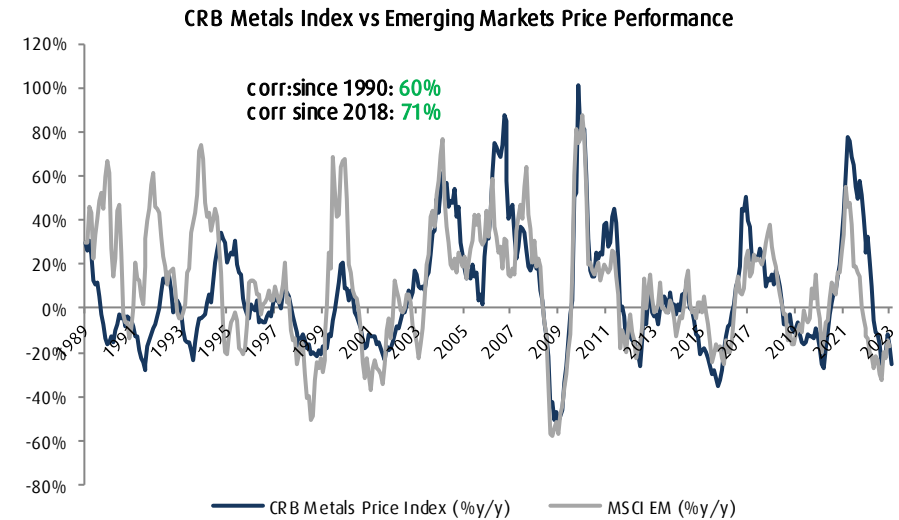
Source: BMO Capital Markets Investment Strategy Group, Factset, Compustat, IBES.

EM Correlation versus Precious Metals Declining



Source: BMO Capital Markets Investment Strategy Group, Factset, Compustat, IBES.

Yes, Emerging Markets Is Key for Broad Metal Prices



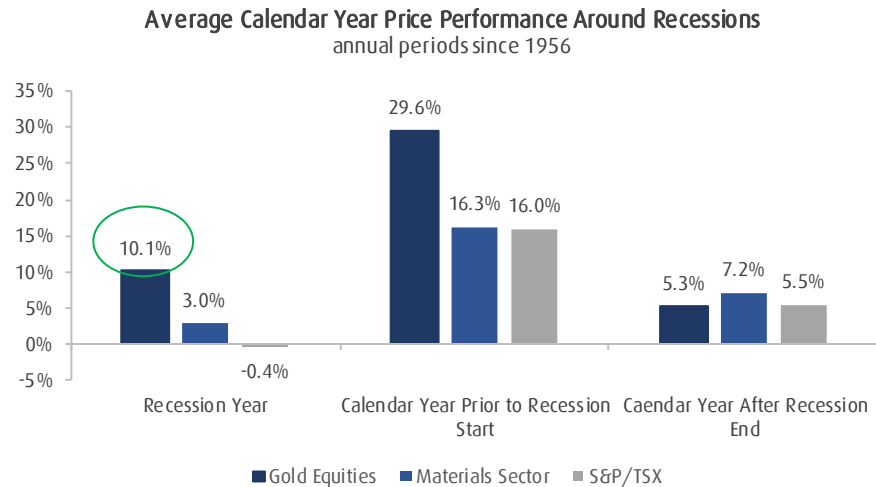
Source: BMO Capital Markets Investment Strategy Group, Factset, Compustat, IBES.

Ultimately, Emerging Markets remains key to the sector and commodity price performance. As such, the reopening of China should be a net positive for commodity prices in our opinion and ultimately the sector. However, our works shows the sectors correlation has declined in recent years, as the correlation of S&P/TSX Materials sector price performance versus Emerging Markets price performance declined to just 27% over the last five years. From our perspective, while this is largely due to the decline in correlation with gold prices, it also reflects the strong underlying fundamentals of the sector, which we believe can insulate the sector from periods of commodity price weakness.

- The Materials sector price performance correlation with Emerging Markets price performance declined from 60% since 1990 to just 27% since 2018.
- However, commodity prices remain highly correlated with Emerging Markets. The correlation between CRB Metals index and Emerging Markets price performance increased to 71% since 2018 versus 60% since 1990.
- A significant reason for the decline in the TSX Materials sector correlation with Emerging Markets has been the declining correlation of Gold versus EM, which remains a significant weight in the TSX (Gold = ~50% of the Materials Sector).

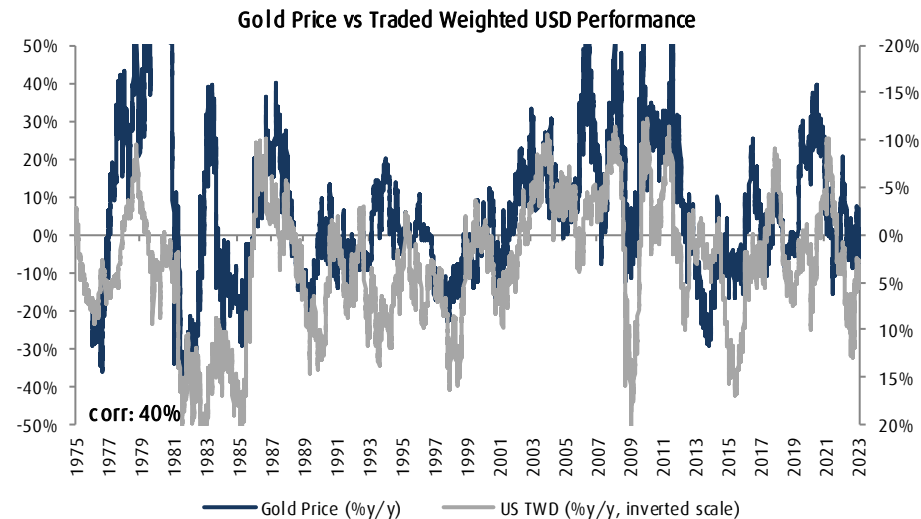
TSX Gold Weight Can Offer Tactical Defense

Gold Equities Drive Materials Sector Outperformance in Recession Years



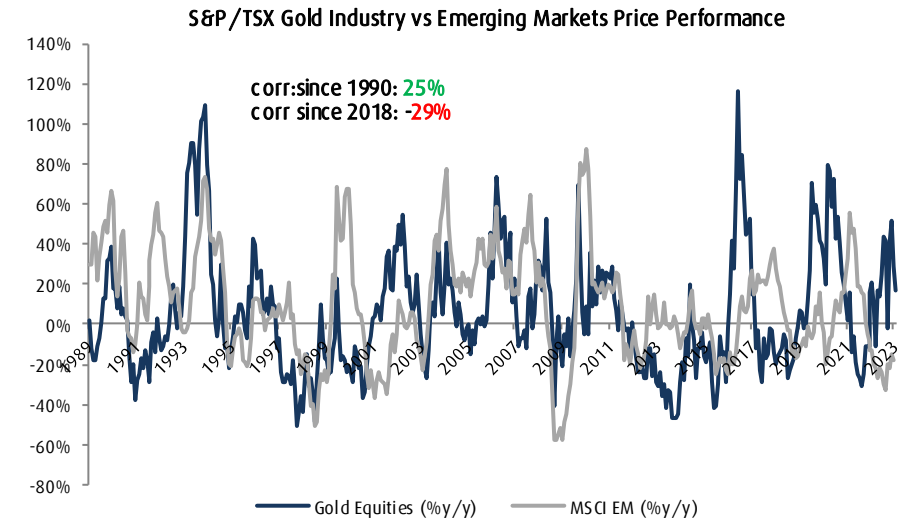
Source: BMO Capital Markets Investment Strategy Group, Factset, Compustat, IBES.

Strong USD has Been a Headwind to Gold, But Could Become Tailwind



Source: BMO Capital Markets Investment Strategy Group, Factset, Compustat, IBES.

Gold Equities Negatively Correlated to EM Since 2018



Source: BMO Capital Markets Investment Strategy Group, Factset, Compustat, IBES.

We remain slightly overweight the Materials sector, with a focus on gold and companies with strong operating efficiency and cash flow generation. Resources, particularly the base metals, is typically a “late cycle” sector and as such will likely continue to face challenges given the economic growth risks in 2023. However, according to our work, the Canadian Materials sector’s strong exposure to gold stocks adds a level of tactical defense against periods of broad equity market weakness as gold equities tend to meaningfully outperform during broad periods of equity weakness and during recessionary years. Furthermore, the correlation of gold stocks and emerging markets has shifted sharply negative over the last five years, highlighting the more globally defensive nature of gold in our opinion.

- Gold can consistently outperform into and during recessionary years.
- The correlation of S&P/TSX gold industry price performance versus emerging markets price performance declined from +25% since 1990 to -29% since 2018.
- The strong USD has been a clear headwind to gold prices over the last year, this could become a tailwind as USD peaks sometime in 2023, in our opinion.

Recent Canadian Strategy Research Reports

Date	Title
Canadian Strategy Snapshots	
3/14/2023	Canadian Strategy Snapshot: Highlights From Fourth-Quarter Earnings Season
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8/10/2022	Canadian Strategy Snapshot: Thoughts on TSX Performance Reversals
7/27/2022	Canadian Strategy Snapshot: Cyclical Deviation in Canada vs. US
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6/23/2022	Canadian Strategy Snapshot: Our Market Weight Industrials
6/15/2022	Canadian Strategy Snapshot: TSX Positioning as US Enters Bear Market
6/9/2022	Canadian Strategy Snapshot: Fundamentals Dictate Increased Selectivity
5/30/2022	Canadian Strategy Snapshot: We Remain Overweight Canadian Materials
5/18/2022	Canadian Strategy Snapshot: Maintaining Our 2022 S&P/TSX Targets
4/20/2022	Canadian Strategy Snapshot: Remaining Overweight Canadian Financials
4/13/2022	Canadian Strategy Snapshot: Factor Style Preferences as Earnings Growth Slows
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Monthly Reports	
3/8/2023	Canadian Strategy: Canadian Chartbook - March 2023
3/8/2023	Canadian Strategy - Canadian Factor Profiles - March 2023
Investment Strategy Snapshots and Special Reports	
09/06/2022	Investment Strategy Comment: Hold the Line
11/30/2022	Investment Strategy: 2023 Market Outlook
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Buy	Outperform	47.9 %	18.3 %	51.9 %	53.3 %	58.3 %	57.7%
Hold	Market Perform	49.4 %	15.2 %	44.3 %	44.8 %	39.2 %	37.5%
Sell	Underperform	2.8 %	23.1 %	3.8 %	1.7 %	2.0 %	4.8%

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http://researchglobal.bmocapitalmarkets.com/documents/2013/rating_key_2013_to_2016.pdf

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