Putting the Pieces Together

A Roller Coaster Ride for Rates

We are hopeful that you and your close ones are safe and healthy! Our team is well, healthy, and fortunate enough to be fully operational. We have heard encouraging news from our Head Office that we could have the option to regain our office this fall, if the public health situation permits it… We will keep you posted, and we look forward to seeing all of you in person very soon.

As per the markets, they are feeling upbeat due to the vaccination rates and a continued positive economic outlook. Publicly listed companies will start announcing there Q2 results shortly, and we will be getting a glimpse of their expectations for the second half of the year. Our analysts' outlook for the more cyclical areas of the markets (Financials, Industrials, Consumer Discretionary, Energy and Materials) are still very positive, with good upside in sight. Our BMO strategists still see the Canadian index performing better in the short term, compared to the US indices. The bottom line is that consensus remains positive for North American markets for the second half of the year.

As always, there are still some causes of concern. After largely putting the pandemic in the rear-view mirror for much of this year, markets flashed a flicker of concern to start the second half. A variety of unsettling upticks were reported in new virus cases across many jurisdictions, including Korea, Japan, some southern U.S. states, Spain, and Britain. While the upswing is not shocking, given some of the aggressive reopening schedules and the prevalence of the Delta variant, the U.K. surge was particularly notable given its high vaccination rates. Furthermore, we saw modestly disappointing global economic data, including sluggish Chinese PMIs, soft Euro Area factory production results, and a slight slip in the U.S. services ISM. The frequently talked about supply shortage of materials and labour is slowing somewhat the growth trajectory, in all parts of the world. For instance, the lack of microchips in all industries is a prime example. Just recently, we got news that China is contemplating lowering their interest rates again to prevent a potential slow down. The recent mounting geopolitical confrontation between China and the USA, especially in the technology sector is not helping either. Because we are in an era of data driven economy, the latest China big tech crackdown (the DIDI story) is a clear attempt to keep Chinese IPO's closer to home and under their control.

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Not surprisingly, tension has resurfaced in the latest OPEC meetings. Disagreements on production levels could have WTI Oil prices spike to $100 a barrel. Good for the oil industry, not for the rest of the economy. Some of you may have noticed as well, that the 10-year US treasuries have been declining from 1.74% at the high for the quarter to now below 1.3%. Positive for the inflation debate, but questionable for the growth outlook.

Fundamentally, we believe the risks are reasonably manageable, and present only moderate downsides to our calls. On the restrictions, Canada offers a real-world example of an economy that has managed to claw out some growth even in the face of successive waves of partial shutdowns. And on the supply challenges, global evidence suggests they are a weight on growth, but not an anchor. On balance, we believe that the core view on the solid global recovery has not been altered by the emergence of the Delta variant or by the panoply of supply issues. Perhaps the biggest takeaway from the recent deep dive in long-term bond yields, including the persistence of deeply negative real yields, is that markets are certainly not pricing in a sustained economic boom.

All the above could have their effects on the economy and the markets in the next few weeks. Even if we do see the possibility for short term volatility and selective industry pullbacks, we do expect the markets to move forward for all of us.

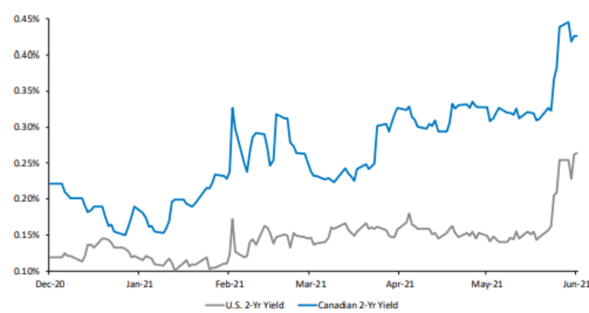
The performance of our portfolios in the Q2 has been encouraging. As mentioned in our last newsletter, Q1 results were somewhat lower than general indices. We realize that following a methodology that focuses on quality companies with a strong balance sheet, good long-term growth visibility, and proven management stewardship, does not outperform in the short-term when the focus is on momentum towards lesser quality companies catching up. This last quarter, fundamentally sound equities made their way back, and the longer-term outlook is positive for such a strategy. We will be talking about examples of these in this quarter's newsletter.

We will also be looking at the latest initiative from BMO Capital Markets in the Ethical Social and Governance (ESG) space: on how BMO CM is leading the field, in the integration ESG criteria, customized industry by industry, in its research assessment.

Shouldn't Interest Rates Be Moving Higher?

If markets believed mainstream media, interest rates would be higher. Strong commodity markets, high producer and consumer price indices, strong economic recovery, elevated inflation expectations, record fiscal and monetary stimulus, and record supply of government and corporate debt should, intuitively, lead interest rates higher. Instead, the U.S. 10-year Treasury yield has gradually trended lower since hitting 1.74% at the end of Q1. A similar trend was observed in the Canadian rates market, with the 10-year Canadian yield falling by more than 25 basis points over the quarter. Not even the U.S. Federal Reserve's (Fed) more hawkish tone in June could pressure long term rates higher. However, the Fed did impact short-term rates. Tapering talks (Fed reducing their asset purchases) and concerns that inflation could be a bit more persistent than initially thought led short-term rates significantly higher. In addition, an indication that some Fed members had pulled forward their expectations for the start of the rate lift-off, pushed the 2-year U.S. Treasury yield to almost double, trading at over 0.25% for the first time since March 2020 and leading the 2-10 year yield curve to flatten significantly.

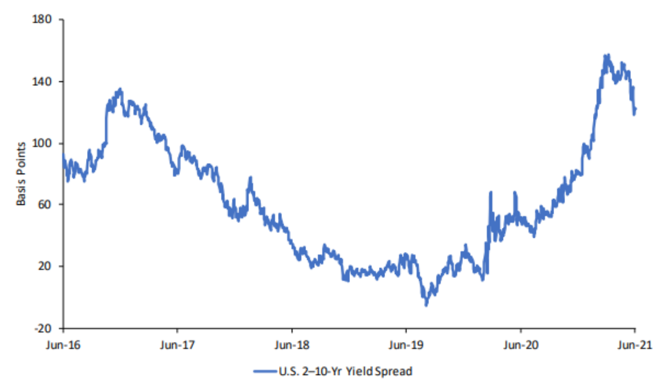
The Fed's Negative Impact on Short-Term Rates



Source: Bloomberg, BMO Private Wealth

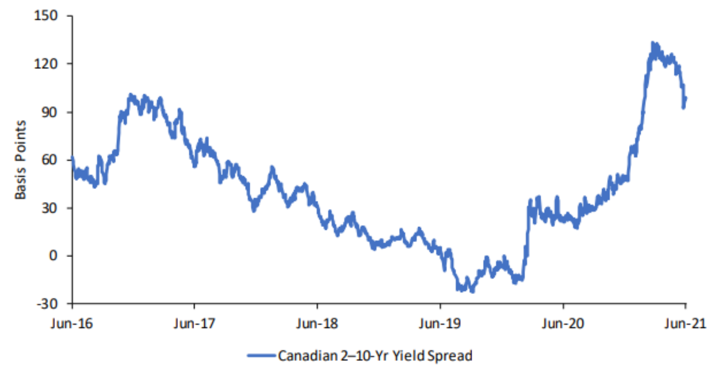
It is interesting how perception can change quickly in only a quarter. From rising long-term rates over fear of strong inflation, to now resuming their downtrend on signs of inflation expectations may have peaked. The flattening of the yield curve seems to indicate that the market is ready to buy into the Fed's transitory message, but also that an earlier rate liftoff may reign in inflation risk. Perhaps the most interesting development is the fact that the market seems to be targeting a lower policy terminal rate than initially anticipated – that is, the rate at the end of the tightening cycle is being priced in lower than it had been. This helps explain why long term rates have fallen over the period and indicates that the market sees a risk of a potential policy mistake in the near future, i.e. raising rates too early and/or too fast that would force the Fed to reverse course. When combining the earlier start of the hike cycle with the extended drop in the breakeven rates of inflation lately, the market's perception is that the Fed's tightening may either come too soon or be too strong and negatively impact the economy.

U.S. 2–10-Year Yield Spread Curve, in Basis Points



Source: Bloomberg, BMO Private Wealth

Canadian 2–10-Year Yield Spread Curve, in Basis Points



Source: Bloomberg, BMO Private Wealth

In the meantime, we remain of the opinion that the combination of strong economics and stickier inflation in the months ahead may lead rates higher. This supports our recommendation to keep a slight defensive bias for fixed income portfolios. Our technical analyst, Russ Visch, notes that he sees the potential for the U.S. 10-year yield to challenge a previous peak near 3.25% at some point in the next year or two. While we agree with the trajectory, we aren't convinced that the fundamental economic backdrop will be strong enough to thrust rates much higher in a short period of time. A Fed announcement of its dialing back of asset purchases could still lift longer-term yields higher but considering the initial tapering discussion yielded limited market reaction, the odds of a 2013 style taper tantrum have significantly dropped. Labor market, economic growth, and inflation surprises could still help lift long term rates.

However, looking beyond this year's strong recovery, all indications are that growth and inflation will likely decelerate from 2021 highs. The New York Federal Reserve meaningfully lowered in June its U.S. real GDP forecast for 2022 and 2023 from 4.9% & 3.5% to 2.6% & 1.7% respectively. Assuming their forecast for core inflation is expected to settle around the 2% target and a path to tapering starting later this year or 2022, it is not difficult to see that the runway for rising rates may be shorter than initially expected.

With inflation expectations, CPI, economic growth, and now the yield curve steepness close to or having peaked already, the more muted reaction of long-term rates begins to make sense. In line with the pricing of lower terminal policy rates, we suspect that the market is also starting to price in a lower long-term rate target for this cycle. As always, the uncertainty around the evolution of the pandemic, the reopening of economies and the inherent risks with forecasting could still lead interest rates on a different path. One thing for sure though is that despite the fact that tapering and rate hikes are now closer, monetary policy remains very accommodative and will continue to be supportive for interest rates and credit spreads.

ESG (Environmental Social Governance)

We believe that ESG integration – the process of incorporating environmental, social, and governance (ESG) information into an investor's investment process – is a secular trend that is only going to become more important over time. In our view, ESG integration is a permanent step-change in investment decision-making, and in the long run we think financially material ESG factors will be fully reflected in security prices across asset classes.

However, we are not there yet. Although remarkable progress has been made in recent years, ESG disclosures continue to be characterized by a lack of comparability and standardization. We do not expect the ESG disclosure demands on issuers to abate anytime soon. On the contrary, they are likely to intensify as a result of upcoming regulations. Plus, the emergence of new but difficult to measure themes such as biodiversity, are taking on increased prominence in the ESG investing community. We will touch on these two major themes; transparency and biodiversity.

Firstly, we think a confluence of factors is pushing the capital markets into an age of transparency characterized by a significant increase in the supply of ESG disclosures from issuers. One of the key drivers of this transition is a pronounced rise in regulatory attention to ESG reporting.

Many regulatory bodies have long been advocating for corporate ESG disclosures, and we have seen a dramatic uptick in regulatory engagement over the past few months:

- ✓ On March 10, the European Parliament approved a resolution calling for mandatory human rights, environmental and governance due diligence standards covering the supply chains of companies based in the European Union.
- ✓ On April 21, the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD) that would set ESG disclosure requirements for all listed companies (except microenterprises) and all large private companies in the European Union (~50,000 firms) beginning in 2023.
- ✓ On June 16, the United States House of Representatives passed the ESG Disclosure Simplification Act which, if passed into law, will require the Securities and Exchange Commission (SEC) to define ESG metrics to guide corporate disclosures.
- ✓ Additionally, the SEC has launched a climate and ESG enforcement task force and signaled that it is considering mandatory climate change disclosures for corporates in the United States for the first time.
- ✓ In the United Kingdom, where climate risk assessments will become mandatory for all listed companies by 2025, the Financial Conduct Authority (FCA) submitted a plan on June 22 to extend climate reporting to domestic money managers, life insurers and pension providers.

Regulators in other jurisdictions are also pushing for expanded ESG disclosures, including those in India, Japan, Singapore, South Africa and South Korea.

Secondly, biodiversity loss, which refers to the reduction of plant and animal species both worldwide and in specific habitats, is surging to the top of the ESG agenda for companies, investors, and policymakers.

The launch of the Taskforce on Nature related Financial Disclosures (TNFD) and the final communiqué from the G7 calling for the integration of biodiversity loss considerations into economic and financial decision-making have sharpened investor attention to biodiversity issues. The TNFD aims to develop a framework for corporates and financial institutions to report on their nature related dependencies and impacts, with a rollout scheduled for 2023.

The central motivator of the ongoing biodiversity push has increased market awareness of the harmful effects of human behavior on biodiversity levels. Key drivers of biodiversity loss include climate change, resource overexploitation and environmental pollution. According to the Living Plant Index, monitored vertebrate species populations (>20,000) have declined by an average of 68% since 1970. It is estimated that the current rate of biodiversity loss is 100 to 1000 times higher than the naturally occurring background extinction rate. These are early days for biodiversity reporting: only one-third of the 100 largest companies in the US and Europe currently disclose biodiversity activities within their business. However, we think this number is likely to increase going forward, particularly in industries that can generate significant biodiversity impacts, including construction materials, food products, forestry, metals & mining, and oil & gas. Companies that are ahead of their peers in biodiversity risk management are likely to be better prepared to comply with future regulations and mounting disclosure demands and may provide a unique investment thematic for investors looking to get ahead of a key ESG trend.

Recent transactions:

Over the course of the quarter, we have been adding selectively to sectors which we believe will deliver good results in the current environment as described previously;

- ✓ Consumer Discretionary: the sector should benefit from an economic recovery
- ✓ Financials: like insurance companies, which should benefit from a steepening yield curve, improved economy and lack of ownership
- ✓ Industrials: because of the good international growth landscape. Further, President's Biden's Infrastructure Plan, even if it is slimed down, will be a bonus for this sector
- ✓ Materials: such as containers, paper, and chemicals will represent good inflation hedges

A brief overview on certain names

We will begin with an overview on the rails sector because it is a sector that we are overweight in our portfolios. That said, BMO Capital Markets (BMOCM) is restricted on the Canadian names because of the pending deal with Kansas City Southern but we believe a quick overview of the sector is warranted.

The railroads are poised to enjoy a strong demand and pricing improvement over the next two years. BMOCM believe that cost inflation will remain modest in the 2-3% range, while productivity is set to rise as volumes are boarded onto more efficient networks. Further, volume recovery is set to drive a significant improvement in operational revenue. The rail industry faces limited inflationary pressures, improved competitive positioning, and a very strong positive productivity outlook. On the heels of PSR (Precision Scheduled Railroading) implementation, the railroads are in a unique position to deliver strong incremental margins, ROIC (Return on Invested Capital) expansion, and improved free cash flow (FCF) conversion.

Pricing environment has continued to firm up into Q2/21 with the potential for sustained momentum well into 2022 as contracts are gradually repriced. And finally, low inventory levels support sustained, strong demand level.

1. Cargojet:

This is a name in which we have been accumulating in the recent months and has not yielded much of a return yet. However, Cargojet has a positive long-term outlook. Firstly, they have significant international expansion opportunities with the acquisition of five new 767 aircrafts. The latter will be entering into service later this year and into 2022 and will each contribute $10-12 million annually in incremental revenue at strong +70% incremental margins. The medium-term growth pipeline remains robust with two new 777 aircrafts expected to enter the fleet in late 2023/2024, each contributing $25 million in annualized revenues. BMOCM forecast for international air cargo capacity, is for it to remain constrained and lag demand until 2023 at the earliest. Further, on the domestic side, E-commerce is set to drive improved utilization. Cargojet's domestic network has significant capacity to grow into as demand continues to shift towards e-commerce which operates 24/7 versus the traditional Monday to Friday B2B segment. E-commerce penetration remains low in Canada which leaves significant opportunity to improve asset utilization and operating margin. Beginning in Q3/21, CJT will fly two dedicated aircrafts on behalf of AMZN with the option of increasing to four aircrafts in the coming years. We expect that any initial volume dilution on the domestic network would be minimal and would increase available capacity for higher margin in their international operations.

2. Air Canada:

This is a name in which we don't hold for many investors especially for investors with a lower tolerance to volatility but that said, it is a name in which we field many questions, especially during this pandemic. BMOCM are positive on the name mainly because they state that Air Canada is poised to benefit from leaner cost structure and improved competitive position post-pandemic environment. The trends in bookings suggest confidence in travel is gradually returning. AC is seeing bookings continuing to improve for August and into the fall for transatlantic routes as well as sun/leisure destinations well into Q1/22. Moreover, since the onset of the pandemic, AC has cut costs by ~$1.7 billion. More fuel-efficient aircraft and improved technology (including a new reservation system and a touchless airport environment) should deliver long-term benefits. Not included in the $1.7 billion reduction are over $40 million/year of lowered costs associated with regional flying. As for business travel, we believe that it will lag leisure demand, but signs of pent-up demand are starting to show.

3. Deere & Co:

Deere has aggressively optimized its operations, and precision agricultural technologies have augmented its pricing power. Recently, the company highlighted an accelerated adoption of its precision agricultural solutions. Because of these, and other factors, Deere has shown better-than-expected performance despite volume that remains well below prior highs.

Farmers' sentiment in North America has greatly improved over the past year. This is mainly the result of robust demand from China to replenish its swine herds and a strong rebound in grain prices. Meanwhile, pent-up demand for agricultural machinery has been building since the last peak in 2013. And the average age of large machines is the oldest it has been in 20 years.

Deere's operational excellence and leading market shares should help to further propel earnings as demand kicks into a higher gear. Nonetheless, Deere's valuation multiples seem to capture much of these positives. BMOCM rates Deere shares Market Perform with a $425 target price, which is based on 17x their fiscal 2023 EPS estimate. Hence, if it pulls back even further it can be a better entry point in order to start accumulating the position.

4. Parker Hannifin:

The company has been concentrating on operational improvements and integrating recent acquisitions. These factors have enabled Parker to add more than 550 bps to its adjusted EBITDA margins since 2016 and have contributed to its recently solid quarterly results despite lingering weakness across several end markets.

Parker continues to work toward its fiscal 2023 goals. These include achieving adjusted segment profitability, excluding acquisition-related amortization, and adjusted EBITDA margins of 21%, which could be reached this year.

As Parker moves past the severe downturn over the past year, it has proven itself to be much less cyclical than before. This may help it garner a sustainably higher multiple. BMOCM has a $365 target price for Parker shares and is based on about 20x their fiscal 2023 EPS estimate. Once again, the same can be said for PH as we stated for DE, whereby a pullback represents a good entry point. PH is a cyclical name which is sensitive to economic cycles, however management has done a better job in earnings visibility. Henceforth we have avoided the name because of its cyclicality but going forward it can be an interesting option.

5. Texas Instrument:

This is a name in which we hold for growth-oriented investors in our quality growth portfolio and there's a lot to like! TXN rewards its shareholders by giving cash back with confidence. They aim to return 100% FCF to investors, with a new target of 40-80% of current FCF in the form of dividends with the balance going to share repurchases. They have solid operations with 300mm manufacturing for ~70% of analog revenues in 2020. With a focus only around analog and embedded processing (~90% of total), we see meaningfully higher free cash flow and earnings potential for TXN than past earnings cycles would suggest. For example, FCF-sales came in at 38.0% in 2020 vs. the five-year median of 31.2%. This compares with the group's current median at ~25%.

6. Broadcom:

This is a name in which we have been adding for our value-oriented investors and in our dividend growth portfolio. Bottom line, they consistently generate FCF and grow with organic growth from core businesses and via acquisitions.

Broadcom has an industry-leading gross margin, operating margin and FCF of 73.5%, 54.2% and 48.6% respectively (FY20 Actuals), which BMO believes is a sustainable operating model through the cycles, within a relatively narrow range.

Their target price of $550 is based on a P/E multiple of 18x their 2022 EPS estimate.

7. Walmart:

This is a name which we hold for many investors. We believe WMT is under earning today due to e-commerce losses which are poised to improve in coming years. The moat (competitive advantage) being created by the significant multi-year investments (people, technology, supply chain, higher margin businesses) required to build its multi-channel infrastructure, along with benefits from membership-based Walmart, will eventually command a premium multiple.

BMO believes WMT has aspirations for e-commerce to be nearly as profitable as in-store over time. Assuming a 1% EBIT margin improvement, that would imply the potential for multi-billion-dollar ($5Bn+) EBIT growth in the coming years. WMT is uniquely positioned among U.S. retailers for potential long-term e-commerce profitability given its significant investments in its e-commerce infrastructure and third-party marketplace.

WMT has serious ambitions to develop into a top 10 digital media platform within 5 years (Walmart Connect), which has potential to be an alternative profit stream in the future.

8. Linde PLC:

This is a name that we have been accumulating for fundamental reasons in which we will touch on below and because Linde PLC is among the industry leaders in ESG investments. In October 2018, Praxair and Linde came together to form Linde plc. becoming a leading industrial gas and engineering company. Linde employs ~80,000 people globally and serves customers in more than 100 countries worldwide.

The company designs, engineers, manufactures, and operates facilities that produce and distribute industrial gases globally.

Targeted approach towards Hydrogen opportunities: LIN will continue to remain selective and have more of a regional approach as it relates to capital deployment (as seen in its early-2021 Electrolyzer project in Germany). While we believe the industry is still a number of years away from maturing to a point that the economics make sense for large-scale use, with subsidies, investments in the technology and an eventual scale being achieved by many companies (and regions), we continue to see it as a solid long-term growth opportunity. We expect to hear more in this space from LIN in 2021.

A recovery in the macro will help to drive solid growth in the merchant and packaged gas businesses while also setting the stage for filling the backlog for longer-term tonnage projects. Management expects double-digit EPS growth in 2021 if volumes remain at 3Q20 levels. As pricing, new tonnage business coming on and buybacks help support earnings, the risk is to the upside as the macro recovery kicks in, which seems more evident with the hope of vaccines.

9. Tronox:

Tronox is a vertically integrated producer of titanium dioxide (TiO2), a premium pigment used to deliver whiteness, brightness, opacity, and protection in everyday applications such as coatings, plastics, paper, and other industrial uses. The company is also a global leader in the mining of mineral sands, which include titanium bearing ores, zircon, and pig iron. The company recently completed the acquisition of Cristal making it the second largest TiO2 produce.

Multiple drivers helping pricing: these include, solid demand in China as well as the Western markets, limited supply compounded by low inventories, China ore supply shortages and sulfur price escalation resulting in raw material inflation needing to be recouped by those producers and shipping/ freight costs. All of this has resulted in a turn in pricing that should continue to push higher over time.

10. Microsoft:

BMO rates MSFT shares Outperform. They believe that MSFT is inexpensive on an EV/FCF basis but less so on a P/E basis. However, for the stock to move higher, they believe estimates need to move higher, driven by improving revenue and operating income growth.

Azure, which is their cloud business, maintains a strong trajectory and can grow in the mid-30% range in FY22, driven by robust consumption, which we believe is a primary differentiator for the business (moat). Because of the latter, MSFT can maintain healthy, double-digit revenue growth with strong FCF margins through FY22. Azure will continue to deliver very strong growth rates with improving margins.

MSFT has both offensive and defensive attributes, including less downside risk to the company's multiple amid a backdrop of rising rates.

The fight against Covid-19 and the return to normalcy is not over, and so your team will remain alert to emerging trends and be active to keep your short and long term plans on track. Hope to talk to you soon.

Team Roux & Associates