iA Clarington 2022 Mid-Year Review

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iA Investment Management Inc.

IA Clarington Canadian Dividend Fund
IA Clarington Dividend Growth Class
IA Clarington Dividend Growth GIF
IA Clarington U.S. Dividend Growth Fund
IA Clarington U.S. Dividend Growth GIF

What was your outlook in January?

Our outlook at the beginning of the year could be described as cautiously optimistic, as we slowly reopened from Covid but were still feeling the effects of lingering supply chain issues, rising inflation, Covid variants and lockdowns in China. As corporate earnings soared in 2021, we expected a significant moderation in earnings growth in 2022, though we still anticipated a healthy increase. We reiterated our focus on investing in companies with durable competitive advantages and pricing power, which will help when dealing with inflation and supply chain issues.

In terms of positioning, we highlighted our increased interest in the energy sector as fundamentals improved and companies prioritized strong execution and shareholder returns over production growth. We saw a decent outlook for financials as economic growth, rising interest rates and the removal of capital restrictions could benefit the sector. Finally, we highlighted our preference for Canada over the U.S. as we believed the sector distribution of the Canadian market was an advantage in this environment, while the valuation differential between the two markets had moved to multi-decade highs.

What has transpired so far this year?

The investment landscape has changed dramatically since the beginning of the year. To start, energy and food prices have risen materially, mainly as a result of the Russia-Ukraine conflict, as the region is a major source of oil, gas, fertilizer and wheat. As the price of these commodities rose it had an outsized impact on inflation, as higher energy prices find their way into so many things, including manufacturing and the cost of transportation and shipping.

Consumers are very sensitive to energy and food prices, as these are staple items that are purchased on a regular basis, meaning that sharp increases are immediately noticed. One of the few tools available to central banks for fighting inflation is raising interest rates to cool the economy, which in theory should eventually cool inflation as well. This process is already well underway, but inflation continued to rise through the spring to levels not seen in over 40 years.

We are currently in a very challenging situation: interest rates will need to continue to rise over the next several months, but a sharp increase in rates will increase the chances of the economy falling into a recession. This will be an incredibly difficult balancing act as history has shown that there are very few instances where central banks were able to hike rates to an ideal level – high enough to cool the economy and inflation but not so high that recession results. The more common pattern is to see rate increases go too far.

We made numerous changes in our dividend mandates as this situation has played out. First, as recession fears began to increase, we tilted our portfolio to be slightly more defensive and removed our overweight in banks. While we believe a minor recession would not affect bank earnings materially, we do assume multiples would contract, and we have already begun to see this happen.

Within energy, we continue to be overweight peers due to positive industry fundamentals, including higher energy prices and improved cash returns to shareholders, but have trimmed our exposure to reduce risk. We have used the proceeds from our bank and energy sales to add to existing names across the portfolio that have had substantial corrections. We believe the current selloff creates opportunity as many individual stocks are pricing in a serious recession. Some of our names – all high quality – have dropped 15–30%, though their business fundamentals have barely changed.

Compared to six months ago, we are currently finding many interesting opportunities in multiple sectors and will continue to look for opportunities to add value in our mandates amid the volatility in the markets.

What is your outlook for the remainder of the year?

Given the challenges described above, we believe the second half of 2022 will remain volatile. Relief from high inflation will be critical to avoid a substantial recession, and it may not have peaked yet in North America. To see meaningful improvement on inflation, we believe we will need to see significant de-escalation in the Russia-Ukraine conflict and an absence of Covid-related lockdowns in China, as its zero-Covid policy has hampered global supply chains.

In terms of energy and food prices, we have recently noticed some green shoots of optimism as the associated commodities and stocks are starting to correct lower from recent highs. If this continues, it will help with inflation and put less pressure on central banks to keep hiking rates to the same degree. On China, the lockdowns are easing but in our opinion the government is not backing away from its zero-Covid strategy, and without mRNA vaccine approvals in that country we could see further lockdowns in the fall and winter.

We remain cautiously optimistic on the energy space as valuations on a cash flow basis remain at historical lows, given that the sector's equities are only pricing oil in the $65–70 range. We have reduced some exposure in energy, as our investment process involves trimming stocks when they move substantially above our target weighting. As mentioned, we have also reduced our financials exposure and have used the proceeds from these two sectors to add to existing holdings that have corrected.

IA Clarington Dividend Growth Class and IA Clarington Canadian Dividend Fund have been tilted defensively since the start of the year, so we are overweight names we think will hold up well during a downturn. This gives us the confidence to add exposure to these names as the markets correct. Positions we have added to include Rogers, WSP, Colliers and Thomson Reuters. We believe these companies are undervalued and are already pricing in a severe recession.

We also believe health care will do well in this environment, as it is a defensive sector and has already seen a significant correction. The sector has been under some pressure due to the threat of increased regulation, but we feel the worries are overblown and that this could provide some future upside in valuations if it becomes the consensus view. In addition, valuations are at interesting levels versus the S&P 500 and it is a sector where we can find a lot of dividend growth stocks that fit our investment criteria.

We still prefer Canada over the U.S. given the advantage in valuations and sector weightings; however, the correction in the U.S. has been substantial and we are already starting to add to existing names we feel have been oversold. With the range of interesting opportunities we are seeing for both our Canadian and U.S. mandates, we believe it is a great time to be an active manager.

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