Opportunities in North American Equities

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The following is a summary of a panel held on June 15, 2022.

The Canadian market has outperformed the U.S. mainly because of strong commodity prices. Do you think this is temporary or the beginning of a new trend?

Marc Gagnon:

- We think it will last for several months and potentially years, and for three reasons:
  - First, the war in Ukraine has resulted in sanctions on Russia, a key producer of energy and other commodities also produced in Canada. These sanctions are likely to last for at least a couple of years.
  - Second, there is currently a lot of underinvestment in Canadian resources, as producers are looking to keep volumes where they are to benefit from price increases.
  - Third, valuations are cheaper than average in Canada.

Ian Cooke:

- Commodities will certainly be a positive for Canada in the near team, but we see some structural and valuation tailwinds as we look ahead to the medium term.
- Despite recent outperformance, Canada has underperformed the U.S. for a very long time. Innovation at any price was in vogue for much of the past decade, and as the U.S. stock market was at the epicentre of this trend, the momentum there continued to build, with retail fund flows pouring into the U.S. market.
- From 2006 to 2016, we had very stable and consistent valuation ratios between the U.S. and Canada, but as momentum in the U.S. built, the differential between the two countries reached levels not seen since the tech bubble burst over 20 years ago.

- Our market does have more of an old economy tilt, and it didn't benefit from some of the extremes we witnessed in recent years in the U.S.
- We think Canada has tailwinds that will be supportive of mean reversion, and the valuation level will provide more support in challenging times.

Donny Moss:

- I also think the outperformance we've seen in Canada can continue for some time.
- Historically, market rotations like the one we're seeing now tend to have staying power. The current rotation is only two or three quarters old, so there is plenty of room for this trend to play out.
- The composition of the Canadian market is set up very well for a period of high interest rates and commodity prices.
- There is a large weighting to financials, which, outside of large recessions, tend to do fairly well in a rising rate environment.
- We also have a high weighting in energy and materials, which are benefitting from higher commodity prices.
- While energy prices have already outperformed materially, cash flow levels are still at very low levels, which tells us that investors haven't fully bought into the idea that commodities can stay at higher levels for an extended period of time.
  - Importantly, management teams of energy companies have made some positive changes from previous cycles, such as prioritizing the shareholder over production growth, which means less debt on the balance sheet, more dividends and more buybacks.
  - With balance sheets in better shape than ever, the sector as a whole has de-risked.
- With 60% of the Canadian stock market in financials and energy, we think it's poised to do very well on a relative basis.
- Also important is that the Canadian market is trading fairly inexpensively on an historical basis, currently at a one standard deviation discount to its 30-year average. Compared to the U.S. market that discount is even more stark. For this reason, we have lowered the U.S. weighting in our Canadian mandates to about half of its historical level.

Has the correction in technology gone too far, opening up opportunities to buy good companies at very attractive valuations?

Donny Moss:

- Within the sector we have to separate out the newer, smaller, high-growth names from the larger and more established players.
- Companies in the first group are in many cases still unprofitable or marginally profitable. Instead of trading on earnings or cash flow, they're trading on a multiple of sales. When we look back to last fall, those valuations became very stretched; rising rates and the prospect of an economic slowdown led to the correction, which we feel was justified. So when it comes to the first group, we think it's still too early to jump in.
- The other segment of the technology sector is the area we focus on. These are companies with lots of free cash flow; they also pay dividends and repurchase shares. Valuations have dropped about 30% on average. Since most of them are still growing at a pretty good rate, once we get some certainty on interest rates these names can start to outperform again. Within this group, the more value-oriented stocks are looking more interesting to us.
- One of these value-oriented names that could find its way into our portfolio at some point is OpenText.
  - It's a well-run company that historically has grown its earnings more than 10% per year.
  - Over 80% of the company's revenue is recurring.
  - It operates at very high margins, so inflation is less of a headwind than it is for companies in other sectors.
  - The stock dropped about 30% from its peak last fall and now trades at about 11× earnings. We think this type of valuation is close to a trough, and the company could even be a takeout target for a larger peer.

Ian Cooke:

- I think there are some opportunities, but I think we have to be very selective and patient, recognizing that when the tech bubble burst 20+ years ago, it took about four years for things to normalize.
- The excesses that have built up over recent years do not appear to have cleared completely at this point. The valuation risk is still somewhat apparent in the technology space overall, but the bigger risk to us is related to shifts in cost structure as well as the increased competition a lot of these businesses are facing.

Marc Gagnon:

- There is an inverse relationship between the 10-year rate and technology stocks, especially in Canada, because the sector is dominated by long-duration stocks. This refers to companies whose profits are expected further into the future, so when you discount them with a higher interest rate, they look much less appealing.
- We are inclined to add some exposure to some high-growth names because we think the valuation correction is mostly behind us. Finding the ones with strong business models is key, as it's very easy to lose money in this sector if you pick the wrong companies.

Is the correction in the small-cap space justified by the macroeconomic environment or is it a good opportunity for investors?

Ian Cooke:

- If you look at the cannabis industry in Canada over the last year as an example, we've seen a correction of greater than 70%. This reflects the fact that the bubble of speculative excess within the small-cap space has burst.
- Small-cap markets tend to be overweight speculative names and underweight companies with strong fundamental underpinnings.
- As fear has set in and people are walking away from small caps, the setup is very attractive for investors like us who focus on quality businesses with strong prospects for long-term growth.

Visit iaclarington.com to learn more about our actively managed North American equity mandates.

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