Donny Moss, CFA

Portfolio Manager, North American Equities Industrial Alliance Investment Management Inc.

Donny: We believe that focusing on companies that grow dividends is especially important in times of higher inflation. What better way to keep up with inflation than by holding dividend stocks that will grow the income in your portfolio?

What are the key opportunities and risks?

Donny: We see two main risks with the economy right now, and they are related to interest rates, and inflation. There's a lot of concern in the market on when inflation will peak and at what level it will finally settle, and also concern on where interest rates will settle. And the discussion on these issues will probably continue for many months to come.

The main risk is that if inflation continues to remain high, rates will need to continue to rise. And that may move the economy into a recession. Currently we do see the economy slowing from previous levels, but at this point we believe that if we do enter a recession, we believe it will be mild, as employment levels remain very strong compared to other time periods where we saw a slowing economy.

As a result of this view, we believe the current sell-off creates opportunity as investors, as many individual stocks are pricing in a serious recession. In some cases, we have high quality companies we own that have dropped 15%-30%, where the business fundamentals have barely changed. We are currently finding many interesting investment opportunities in multiple sectors, and we also believe it's a great time to be an active manager.

Do you believe Canadian equities will outperform U.S. stocks?

Donny: We're of the view that the outperformance we've seen in Canada could continue for some time. Historically when we see rotation in the market such as we're experiencing right now, they tend to have some staying power. It's important to keep in mind that this current rotation is only two to three quarters old. So we think there is much more room to go for this trend to play out. Also, the composition of the Canadian market is set up nicely for a period of higher interest rates, and higher commodity prices.

Canada has a high weighting in financials, which, outside of large recessions, tend to do well in times of rising rates. In addition, we also have a high weighting in energy and materials, which is obviously benefitting from higher commodity prices. While energy prices have already outperformed materially, cash flow multiples 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.

The management teams of energy companies have also made very positive changes from prior cycles and are now prioritizing the shareholder over production growth. That means less debt, more dividends, and more buybacks, which as investors we are all in favour of. This also means that the sector is being de-risked as balance sheets are in better shape than ever. The Russia/Ukraine conflict is also benefitting commodities.

While Russia is only a small part of the world economy, it controls an outsized share of oil and gas, and food-related commodities. The finance and commodities sectors combined make up over 60% of the TSX. So, we feel that these weightings will help Canada to do well on a relative basis.

What about valuations?

Donny: The Canadian market is trading fairly inexpensively versus historical levels and is currently at a one standard deviation discount to the 30-year average. And when we compare Canadian valuations to the U.S., the valuation discount is even more stark, as Canada is trading at levels not seen in over 30 years. This is the reason why we have lowered the U.S. weighting in our Canadian mandate to only half its historical level.

So in conclusion we feel that this is a great time to be focusing on Canada with your investments.

How do dividend stocks perform during periods of rising inflation?

Donny: In times of higher interest rates and higher inflation, multiples usually compress as investors place a higher value on current earnings, and cash flow versus cash flow that will only come several years out. This environment favours lower multiple and higher dividend stocks. As returns are usually lower, and dividend yield makes up a greater percentage of total return. For example, when we look at the 15-year period in the 1970s and early 80s, it was a time period similar to what we see today, with high commodity prices, higher interest rates, and inflation.

During this period, dividends made up 60% of the total return for the S&P, and 80% of the total return for the TSX. So while we hope current conditions don't last as long this time around, we believe our mandate is well-positioned for this shift in the market as we solely focus on dividend paying stocks with growth potential.

Which sectors are you currently overweight in the Dividend Growth mandate?

Donny: We've been overweight energy for the past nine months, which has worked well. While higher energy prices have helped this sector, we are more excited about the changes in the way these companies are managed in this environment. In prior cycles when we saw high energy prices the focus was always on production growth. So the cash flow was always reinvested, which left companies in poor financial shape once the next downturn and commodity prices took hold.

After a near-death experience in 2020, companies are now focused on paying down debt, growing dividends, and even repurchasing their own shares. Even as oil and gas prices continue to rise, we are seeing no public companies break rank and materially grow production. We think the delevering that will take place will make the sector less risky than before and could afford the companies a higher multiple in the future.

We are overweight communication services. The companies were slow to recover over COVID, as travel remained low and wireless data usage fell significantly. This is now a tailwind for the sector as the economy reopens. It's also a sector with high dividends that have a long track record of growth. And we feel in this volatile market it's a good area to have additional exposure. Our overweight in the sector is the product of our positions in Rogers and Québecor, where we see greater upside relative to peers.

With Rogers, we feel the acquisition of Shaw will be very accretive. In our opinion, investors have not yet priced in the combined earnings power of both companies. And with Québecor, we feel the company has a great opportunity to outgrow its peers as they grow their share of wireless in Quebec, and also have the opportunity to grow its footprint across the country with the purchase of Shaw's wireless assets.

Why are dividend funds a good option for investors?

Donny: Historically dividends have made up almost one third of total returns in equities. So it's a very important source of returns that sometimes people overlook. Now if we think we're heading into a period of lower stock market returns, dividends become even more important to your overall return. When we look back to the 1970s in Canada, a time with high commodity prices and high inflation, dividends made up about 80% of total return in that time period. And finally, we believe that focusing on companies that grow dividends is especially important in times of higher inflation. What better way to keep up with inflation than by holding dividend stocks that will grow the income in your portfolio at rates that will match current inflation and will exceed inflation levels in most time periods.

For definitions of technical terms, please visit iaclarington.com/en/glossary or contact your Advisor.