Cidel
Asset Management

Q4 2021 Cidel Global Equity Strategy Commentary

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2021 was another year of double digit returns in global equities, with the MSCI World Index returning 22.3% in U.S. dollar terms (or 21.2% in Canadian dollar terms). This strong annual return is consistent with a sharp rebound in both economic growth and earnings. It is projected that global GDP growth in 2021 will come in around 5.9% the best result in well over a decade. This is after having contracted 3.1% in 2020. 2021 S&P 500 Earnings per Share should come in between $205 and $210, representing around 15% annualized growth vs. 2019's $157. This level of profit growth is remarkable, given the challenges brought about by the COVID-19 pandemic. This growth is, in large part, a result of a margin rebound as companies were quick to cut costs in 2020 and have been slow to increase them to prior levels in 2021.

Underneath the surface, the year marked a notable transition within the equity market.Resource and other highly cyclical stocks that rose quickly after the COVID-19 vaccine announcements in November 2020 started to moderate in relative performance as 2021 progressed. Halfway through the year, other less volatile sectors assumed leadership. Geographically, U.S. equities beat out Canadian equities as the top performing market (30.6% vs. 25.5% in U.S. dollar terms). Emerging Markets were the worst performing major cohort (-2.5% in U.S. dollar terms), perhaps reflecting the pandemic's disproportionate impact on those nations (as well as a concerning trend of deteriorating political stability in many Emerging Market countries).

The fourth quarter was an active one for Cidel's Global Equity Fund as we initiated positions in four new investments:

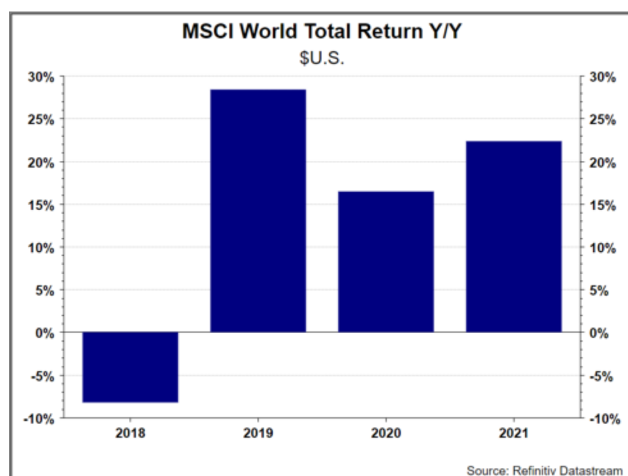
- We have built a position in Sony Group Corporation. Sony is a well-known Japanese conglomerate historically known for its consumer electronics products, though this is a smaller part of its business now (just 13% of operating profit). Today, the key drivers of the company are its gaming and imaging chips businesses, where Sony is the Global leader in both. Most readers will be familiar with the Playstation gaming business, but what might not be appreciated is that every iPhone camera contains a significant amount of Sony imaging technology. The economics (as well as the valuation) of its music business have improved with the rise of streaming, and its film business – which enjoyed a nice bump over the holidays with the strong box office performance of Spiderman: No Way Home – will recover as the COVID-19 pandemic recedes in the coming years.

- We have built a position in European exchange and financial data provider Deutsche Boerse AG. The company has done a good job of diversifying away from its traditional trading and clearing businesses by acquiring and building out less volatile financial data businesses, particularly in high growth areas such as aiding asset managers with environmental, social and governance analytics. The company is style consistent as demonstrated by its good organic growth opportunities, its free cash flow generation and shareholder returns, its strong balance sheet and profitability through the cycle. While not central to the thesis, Deutsche Boerse's derivatives business would be a prime beneficiary should European central bankers ever reduce their level of bond purchases, thus allowing market forces to generate a higher, but more normal level of interest rate volatility. The shares are somewhat emblematic of the broader European equity market in that they trade much cheaper than direct American peers.

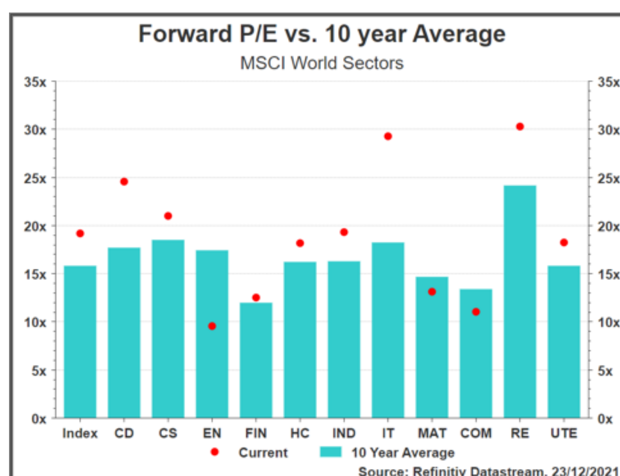
- We have built a position in U.S. industrial stock Emerson Electric Company. Emerson has strong capabilities in industrial automation and HVAC, and we see good long term demand in both end markets. After a tough decade, we believe global spending on capital equipment will pick up for a host of reasons including an ageing workforce, decarbonisation efforts and the need to strengthen supply chains. The company's shares have recently underperformed and are trading at a significant discount to peers, despite broadly similar organic growth prospects and profitability. The company has a strong 'A' credit rating and a multi decade track record of dividend increases.

- Finally, we have built a position in Lloyds Banking Group PLC. Lloyds is the top consumer oriented bank in the UK, with a market share in excess of 20% in mortgages and most consumer and Small/Medium business lending categories. The bank has a very good cost structure, with a cost to income ratio of 50% (whereas the number is closer to 70% for most British and continental peers). As provisioning and client demand continues to normalize, we see a straightforward path for the bank to generate a return on equity above its cost of equity, which will put upwards pressure on the valuation (at year end, the shares were trading at about 0.75x book value). Capitalisation and liquidity are excellent and we expect strong dividend growth and a buyback plan in 2022/23.

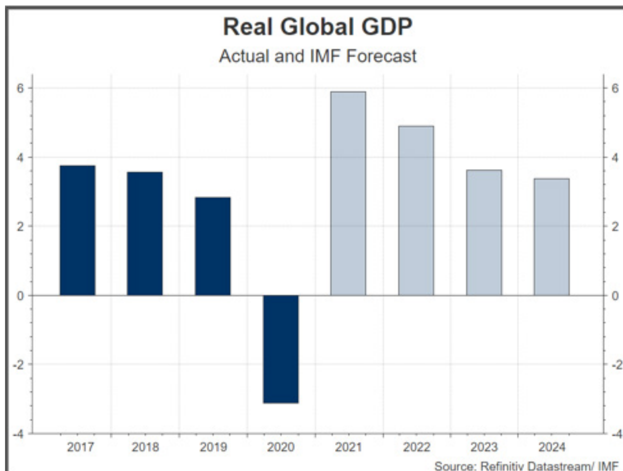
These investments were funded by exiting two stocks, Cleanaway Waste Management Limited and Adidas AG. We also trimmed position sizes in AstraZeneca plc, Johnson and Johnson, Chubb Limited and CRH plc.

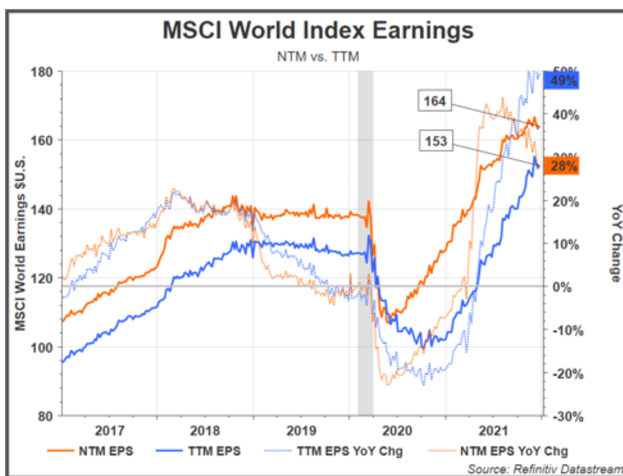


The above chart illustrates how unusually strong global equities have been over the past three calendar years; each of 2019, 2020 and 2021 offered up returns well above the high single digit rate of return that stocks offer up over long periods of time. In all three years, U.S. stocks materially outperformed other geographies, primarily due to the outsized performance of a small handful of very large technology stocks. The below chart illustrates how much these technology stocks ("IT" on the X Axis) have seen their price: earnings multiples expand; most other sectors' P/E ratios are largely inline with the 10 year average. This chart is indicative of what we are seeing from the "bottom up" trenches; there are a host of good opportunities across most sectors and value for money is generally most challenged in technology shares.

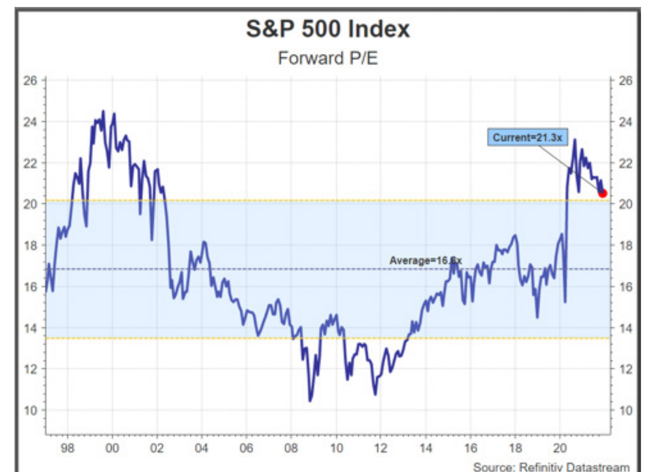


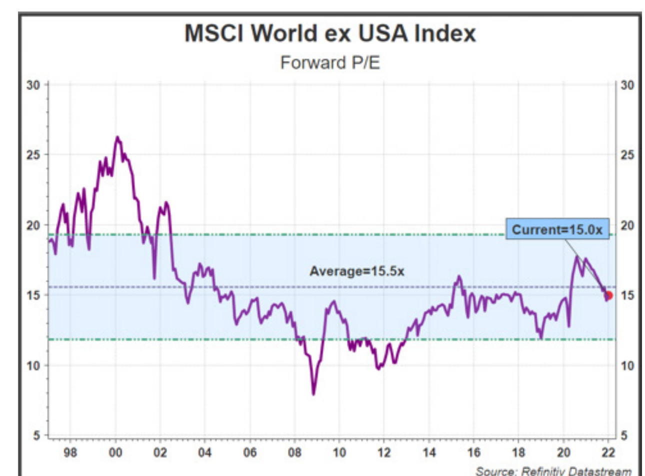
After three consecutive calendar years of returns well above long term averages, it is understandable for equity investors to ponder "What are the return prospects going forward, and where are the best opportunities"? We believe medium term global equity returns should be positive, but less impressive than those of the recent past as various puts and takes play out. On the positive side, 2022 Global GDP growth should be good (the IMF estimate is currently at 4.9%; we'd suggest anything above 4.0% qualifies as "good"). This forecast will be challenged by high near term inflation, which has negative consequences for consumer confidence and thus spending. In terms of profits, analysts expect strong, albeit decelerating, profit growth for global equities, which consensus currently estimates at 7%. That number looks quite reasonable.





However, offsetting this broadly attractive growth backdrop is a significant risk that valuation multiples compress; this compression actually started midway through 2021. The prospect of higher inflation begetting higher interest rates, or more specifically less radically negative after inflation "real" interest rates, is a threat to the P/E multiple on stocks generally but particularly high growth, but low or no profit companies. Such stocks have seen their valuation multiples expand tremendously as real interest rates declined (a trend that actually started in 2019). These high growth but low profit stocks – to which we have no exposure – could absolutely suffer a reversal if real rates normalize. By contrast, other sectors of the market – and other geographies beyond U.S. large capitalisation stocks – haven't seen a similar valuation bump and should be less vulnerable. From the perspective of geographic valuation, a strong rebound in earnings has meant that U.S. equities are no longer at their valuation peak, but are still well above the 25-year average. By contrast, non U.S. equities have a much more favourable valuation back drop. This doesn't mean that non U.S. equities are destined to outperform, but it does mean that they should be more receptive to any upside surprises.





Our mission over the coming months and years is to source and manage a portfolio of highly profitable, cash flow generative companies that pay dividends. Companies will also have understandable business drivers and strong balance sheets. Over the medium term, we remain optimistic for return prospects (although we'd re-emphasize that a repeat of the past three years' returns is too optimistic), and not just

because of the valuation backdrop for non U.S. equities highlighted above. We see attractive opportunities to source style consistent stocks that are well aligned with the following long term trends::

- Information technology spending should continue to grow faster than the economy overall. The pandemic has greatly accelerated hybrid and work from home environments, and this, in turn has meant that businesses, governments and individual employees are ramping up spending on a host of new hardware and software to accommodate this shift. Said differently, the pandemic has greatly accelerated the shift to cloud computing, and has likely increased cloud computing's already immense total addressable market. The pandemic will also have a lasting impact in lowering workforce participation and this too will necessitate technology and other capital spending to make up for the lost human productivity. Semiconductor demand, while cyclical, will remain very robust.

- The clean energy transition will continue to require immense levels of capital spending primarily by utility, industrial, technology and natural resource companies. Companies that can source profitable opportunities (especially opportunities that aren't reliant on government subsidies) to participate in this transition will be well placed for years to come. Relatedly, consumers will pay even more attention to the environmental and social implications of the goods and services they purchase.

- Consumers will continue to spend on their health, wellbeing and leisure. They will continue to pay a premium for high quality and brand name products where they can afford to do so. Consumer services such as travel and dining out will continue their post pandemic recovery (albeit at a moderate and not parabolic growth rate). Consumer companies with the capability to engage customers with a compelling online sales experience will continue to take market share.

- Finally, governments, employers and individuals will continue to pay ever increasing amounts in the hopes of obtaining more and better health care and quality of life. There are still unmet medical needs in a host of major chronic and acute illnesses. Pharmaceutical and medical device companies that can develop products that show legitimate improvements over prior generation products will enjoy robust demand.

We thank you for your continued confidence, support and interest and extend our best wishes for 2022!

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