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Cidel Asset Management Inc.

Cidel Global Equity Strategy Update - March 2020

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Global equities, after having reached all-time highs in mid-February, were hit later in the quarter by two "black swan" events. The first of these was the spread of the COVID-19 virus throughout the world. The second event was the onset of a Saudi Arabia-induced oil price war, which sent the price of oil down from over 50 USD to around 20 USD in a matter of a few weeks. Investors quickly envisioned that the simultaneity of these events may lead to a recession in 2020, and those who employed leverage in their investments were forced into panicked, indiscriminate selling to meet margin calls or otherwise generate liquidity. For the quarter, the MSCI World Index ultimately fell by 13.6% (in CAD terms).

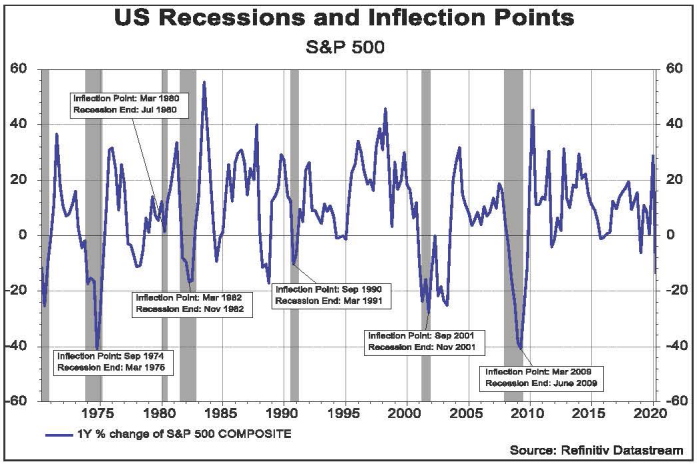
While the ultimate magnitude of this downturn will only be known in the fullness of time, investors can confidently know that gross domestic product in the second quarter, at least, will fall materially in all countries. Estimates for the decline in U.S. GDP are well into the double digits. Corporate profitability will be down sharply, but estimates today have barely started its downward move. As of March 31, bottom up estimates for calendar 2020 S&P 500 EPS were still an unrealistic $157.90, virtually identical to 2019's $157.12.

Inflation, already very low, will face further downward pressure over the short term as capacity utilization plummets. Saudi Arabia has financial reserves to survive low oil prices for at least three years, and thus oil and gas prices could well be under pressure for some time. Debt defaults and bankruptcies will rise, not just in the energy sector but in a host of industries, and perhaps even nation states.

"Buy low, sell high." Easy to say, but very difficult to actually do. Buying at lower prices inevitably requires an investor to summon the faith that conditions will improve and to have the fortitude to seize the opportunity, all the while knowing that they may be a month or two (heck, probably a quarter or two) too early. Regardless, the broad sell off in equities has presented an array of opportunities. In our estimation, the environment to make new public equity investments is the best it has been in the last eight years or so.

The following presents rationale as to why investors with time horizons longer than 24 months may consider phasing in (further) allocations to equities over the next several months.

1. Equities are a leading indicator of future economic conditions, so we typically see them move higher before the economy improves. While an investor who waits for the economy to recover may be gratified by a (false) sense of greater confidence, one needs to recognize that they will likely be investing at materially higher prices. In fact, a very significant part of the upside in return will have been sacrificed for coinciding this incremental investment with more reassuring statistics and news headlines. The tradeoff is not optimal. The chart below shows how equities bottom out anywhere between a couple of months to quarters before the economy ceases to contract.



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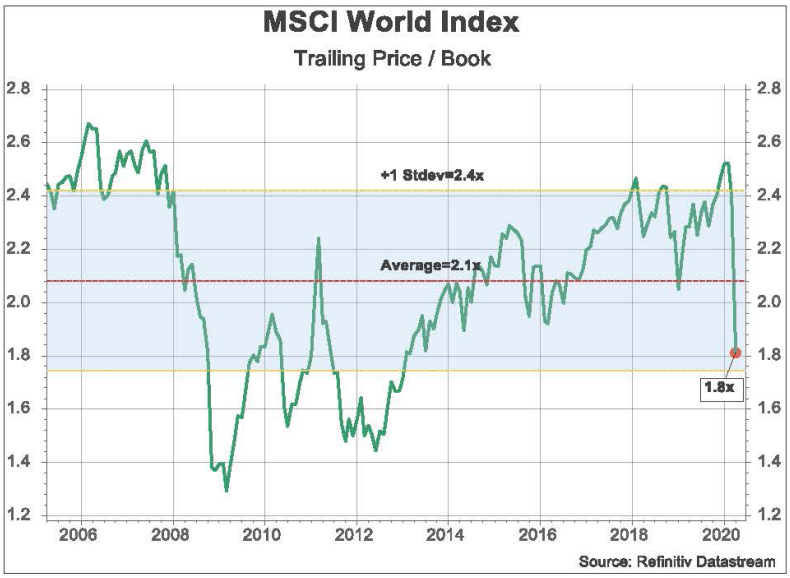
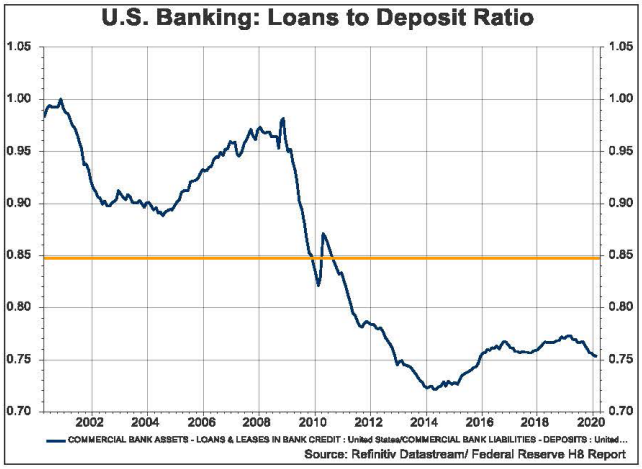
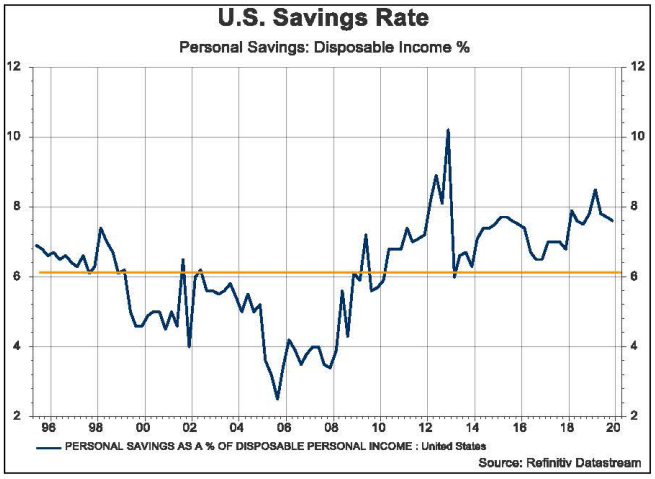
2. For equity investing, price matters. It is simply the best predictor of long-term returns and the best guarantor of satisfactory long-term returns. The chart below shows how, after being elevated for a couple of years, valuations have returned to more normal levels (albeit not at the rock bottom valuations immediately following the 2007-09 Global Financial Crisis).



3. The 2007-09 Global Financial Crisis was centred around the U.S. consumer who had overextended in housing, and the global banking system which served as the enabler. The charts below illustrate how the balance sheets for both the U.S. consumer and banking sector have improved. This displays that the eventual economic recovery could be faster and more broadly based.





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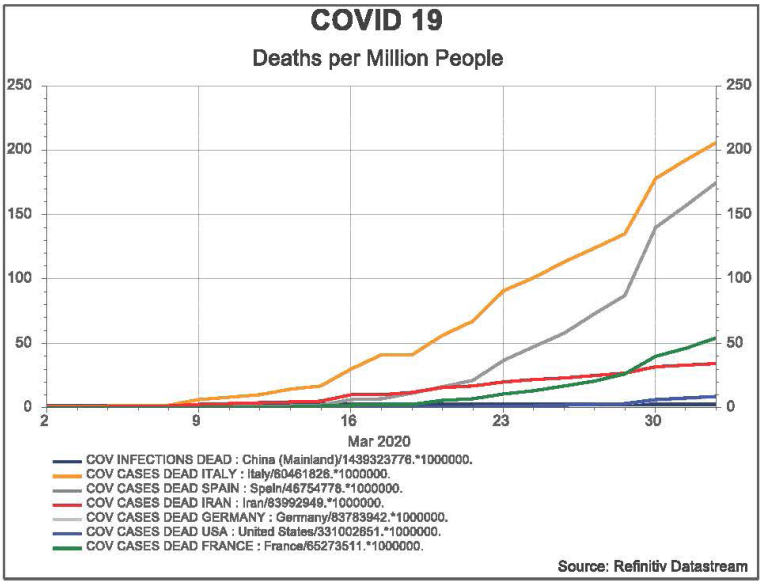
4. The government response from both central banks and public stimulus has been swift. While government payroll supplements will not be wholly sufficient and will undoubtedly arrive too late for many affected workers, they nonetheless equate to a sizeable proportion of global GDP. In mid-March, liquidity was absent throughout much of the fixed income universe. Since then, central bank purchases (also referred to as "quantitative easing") have quickly restored some stability to money markets and credit spreads. Both of these are pre-conditions for the economy to return to growth. The chart below shows how the VIX measure of implied stock market volatility peaked on March 16th but has declined somewhat since. A sustained decline in volatility is an important pre-requisite to the market bottoming out, as it enables confidence to build.

5. While we can expect the COVID-19 news to likely get worse in the near term, it will start to improve as the year progresses. By the end of the first quarter, the number of new daily cases were starting to decelerate throughout much of Asia and Europe, however it is reasonable to expect that new cases will only accelerate in the U.S. and many developing countries (due to slower implementation of social distancing and testing). As we progress into the summer, more economic activity will likely resume and the news headlines around potential vaccines or respiratory treatments will only increase. Investor confidence, and thus equities, will likely react positively to the cresting of new daily cases in the developed world.



6. Finally, and most importantly, all of the companies in our portfolio are in sound financial shape. None of the companies have liquidity issues or weak balance sheets, and we expect they will remain profitable and generate substantial cash flow even in a recession. They will keep paying dividends - the critical ingredient to successfully compounding returns. Unlike stocks with weaker business models and stressed balance sheets, investors can rest assured that our companies will still be around to participate in the new bull market when it inevitably starts to pick up steam.

We have undertaken several portfolio changes prior to March as well as capitalized on the downturn in the markets to add a few more new investments towards the end of the quarter.

- We have built a position in U.S.-based food company Mondelez International Inc. Mondelez's key global brands include Cadbury, Toblerone, Oreo and Chips Ahoy. Snacks are amongst the most attractive product categories in consumer staples as they engender high levels of brand loyalty and thus provide firms with a good degree of pricing power. The new management team has successfully undertaken a strategic shift to re-emphasise strong local brands, which has resulted in one of the better organic growth profiles in the space. This purchase was financed primarily by selling our position in U.S. refiner Philips 66.

- The portfolio has a position in French passenger train and signals manufacturing and engineering firm Alstom SA. Subsequent to our purchase, Alstom announced a deal to buy the train assets from Montreal's Bombardier Inc. While the deal is dilutive over the short term, it is very attractive over the long term as Alstom has picked up Bombardier's fixed assets at a very reasonable price and has strong prospects of bringing the anemic margins at the legacy Bombardier operations closer to those of Alstom's. While the conspicuousness of ESG considerations continues to grow in the investment industry, there are few companies that legitimately move the needle on social and environmental issues that are also actually worthwhile investments. Alstom is one of those select few. Its backlog has grown steadily in recent years due to urbanization and governments looking to expand public transportation. This investment was financed primarily by exiting both German manufacturer Kion AG and Belgian bank KBC.

As markets started selling off in March, we began building two new positions as valuations in a few style-consistent, high-quality dividend payers became more attractive.

- While Starbucks Corporation's near term results will be bleak due to store closures brought on by the COVID-19 pandemic, fast food restaurants such as Starbucks have a surprisingly high degree of economic resiliency, and we expect their business to rebound quickly when consumer behaviour normalizes. Starbucks is also amongst the most sophisticated consumer companies in the world. Their app has 19 million active monthly users and fully 16% of transactions are now mobile, double the rate from just two years ago. We expect the company will continue to successfully employ analytics to grow and maximize the profitability of its client base.

- We have also started building a position in Visa Inc. Over $11 trillion of payments, just over 10% of global GDP, was processed through Visa's payment network in 2019. The company is a leading player in the growth of e-commerce. Visa enjoys a powerful network effect as the company provides a vital link between banks, merchants and consumers. Once the economy starts to recover, we expect that Visa can resume high levels of free cash flow and dividend growth.

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Bear markets are not fun. They are cruel and unforgiving to investors who sell either because of illiquidity or nerves. For such investors, "mark to market" or "paper" losses are crystalized and become permanent and unrecoverable. On the other hand, bear markets also present opportunities for good payoff. In order to capitalize, however, investors must adhere to their philosophy, process and playbook. We believe our emphasis on highly cash flow-generative, financially strong dividend growers has served our investors well for many years. Without wishing to minimize the very real human toll extracted by the COVID-19 pandemic, we encourage our investors to look past the near-term fear and uncertainty. This too shall pass.

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