Q2 2022 Cidel Global Equity Strategy Commentary

Cidel Asset Management

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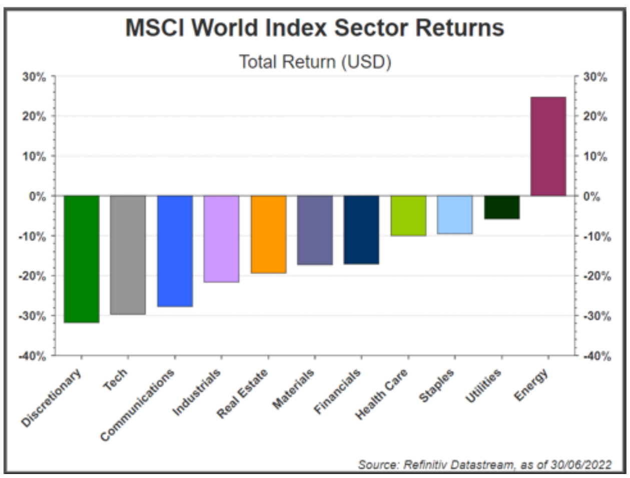
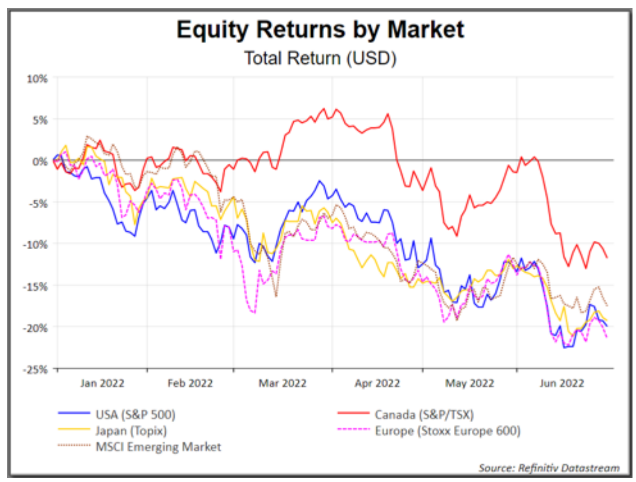
By Charles Lannon, CFA, Senior Vice President and Head of Equities

The dominant narrative in the market this quarter was, unsurprisingly, a debate surrounding whether or not the global economy would fall into recession, when that might be, and how severe? The weakness in Global Equities persisted into the second quarter of 2022 and made that question ever more important. Year to date the MSCI World Index declined by -20.5% (or by -18.8% in Canadian Dollar terms). terms. Apprehension that robust inflation will cause interest rates to continue to rise – thus slowing economic growth and raising the discount rate at which risk assets are valued – sapped investor confidence. Worsening geopolitical conditions and the persistence of lockdowns in Mainland China further contributed to the decline in investor sentiment. Economic fundamentals – in the form of economic growth expectations for 2022 and 2023 – have started to decline.

The charts below detail geographic and MSCI Industry Sector returns year to date. As was the case at the end of the first quarter, Energy – typically amongst the worst performing sectors during times of deteriorating growth expectations – remained the only sector with positive returns year to date. However, some early signs of commodity price weakness, which started in copper and agricultural prices eventually spread into Energy at the very end of the quarter. Canadian equities, owing to their modest geopolitical risk, abnormally strong banks, and outsized Energy exposure continued to outperform other geographic cohorts.





Portfolio Changes

As to be expected during bouts of market volatility, we continued to be active and make new investments this quarter. In fact, we have added three new positions funded by exiting two names. Individually we obviously like these three new investments over our anticipated holding period of two to five years (and ideally much longer), and collectively they will increase the organic revenue growth and profitability characteristics of the Global Equity Strategy.

1. We have built a position in German online real estate advertiser Scout24 SE. ImmoScout24, Scout 24 SE's online real estate portal, has a German market share approaching 75% and as such benefits from a powerful network effect to sell an ever-increasing array of services to homeowners, landlords and real estate agents. The high margins, net cash balance sheet, and consistent free cash flow generation will enable the company to manage any economic slowdown with relative ease. We believe that the current share price represents a very attractive valuation. The company has been subject to bids from private equity firms in the past, and while not central to our investment thesis, it would by no means shock us if that interest were to rekindle.

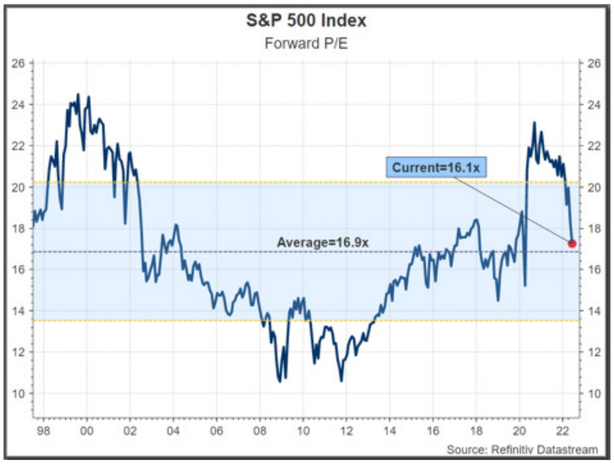
2. We have started building a position in Australian health care firm CSL Ltd. CSL has two business lines, flu vaccines (about 15% of the business) and the manufacture of proteins from plasma (the remaining 85%). The plasma business (CSL Behring) is different than conventional (i.e. chemical) pharmaceuticals in that it is very much a “manufacturing” type business with significant advantages accruing to scale and thus sizeable barriers to entry. However, it is highly dependent on blood donors, and thus has been somewhat weak during the recent COVID 19 pandemic as many donors have, unsurprisingly, been reluctant to visit donation clinics. We view this weakness as transitory, but it has opened up a rare opportunity to acquire shares in this very high-quality firm (return on invested capital is typically in the low 20’s) at a reasonable price.

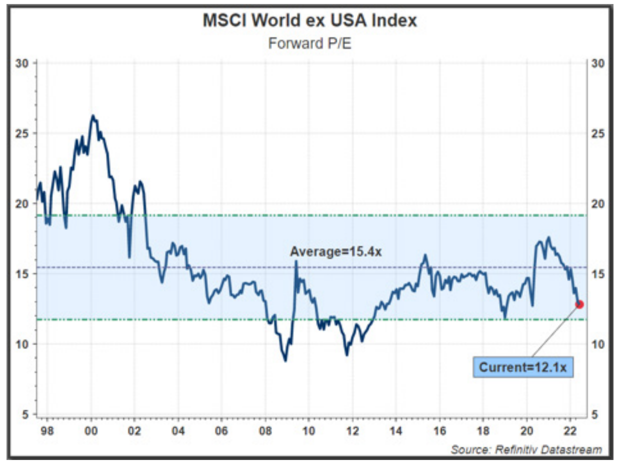
3. We have built a modest position in Australian energy firm Santos Ltd. With the strength in energy prices, existing holding ConocoPhillips (easily our top performing stock year to date) was on the cusp of being an outsized position within the strategy and as such we opted to diversify our exposure within the sector. While Santos does have conventional production, what separates it from most other energy producers is its outsized exposure to liquified natural gas (LNG) production, which is produced in Australia and neighbouring Papua New Guinea. Natural gas’ position as a transition fuel is significant, and LNG assets in countries not named Russia are strategically and increasingly financially attractive.

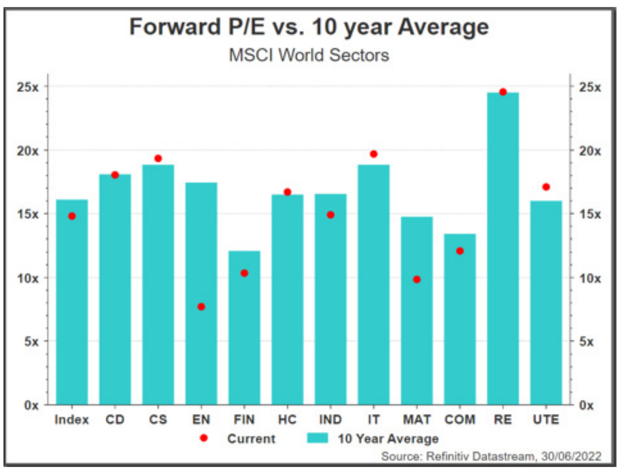
We funded these new investments by exiting two positions during the quarter. We exited our position in French product lifecycle management software firm Dassault Systemes SE; Dassault shares had had a great run from 2020- 21, but we fear their medium-term outlook is challenged by a full valuation, particularly in light of deteriorating market conditions in a couple of their key business verticals. We also exited our position in Panasonic Holdings Corp. While Panasonic’s shares are inexpensive, the most likely catalyst to bridge that valuation disconnect is an accelerating global economy which sadly is not the current situation. Many of Panasonic’s segments will also face margin pressure stemming from higher cost commodity inputs.

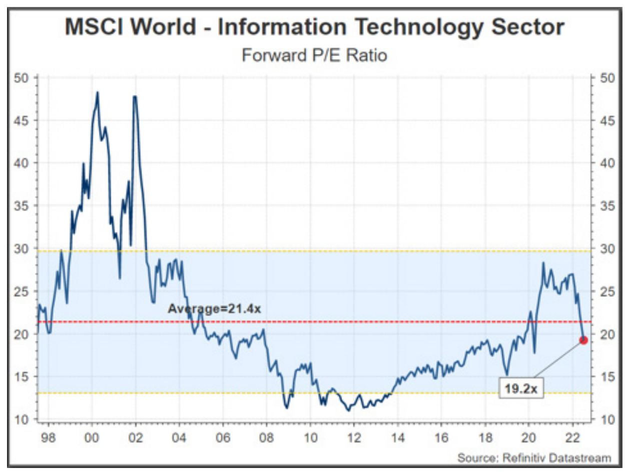
Outlook

After one of the all-time weakest starts to the year, equity investors will naturally wonder how long this Bear Market will last, and what sort of return prospects lie ahead. Since the end of World War Two there have been thirteen U.S. Equity Bear Markets (previous to the current one), and they have had a median longevity of sixteen months and a median decline of 31%. Relative to those medians we have thus far experienced roughly 2/3rd’s of the price decline, but just 1/3rd of the duration. While trying to precisely predict the medium-term course of the equity market cycle is a bit of a fool’s errand, investors do have plenty of tools to assess the extent to which nasty assumptions regarding growth and profitability are embedded into share prices. On this front, the good news is that the valuation backdrop is much improved across both geographies and sectors. While stocks as an asset class aren’t dirt cheap, the frothy assumptions that had been embedded into share prices over the course of 2021 have largely been removed. Non- U.S. equities had been inexpensive even prior to the outset of the decline and from a bottom-up perspective many of them, especially in more cyclical parts of the market such as Consumer Discretionary and Industrials are now largely pricing in an economic downturn. The charts below highlight how U.S. and non- U.S. stocks have deteriorated, how many sectors are trading below their 10-year averages, and thus how valuations have become more reasonable across the world. Technology remains the largest single sector in the MSCI World Index at 21% of total market value. And, unusually after a period of persistent outperformance it is the second worst performing sector this year. A futher reduction in tech valuations may be a pre-condition for the broader equity market to put in a bottom and the chart on the next page notes that Tech stocks are now trading in line with their 25-year average valuation, but still about 10% higher than the valuation level pre-pandemic.









These improving valuations represented by price/earnings ratios won't be sufficient to protect against further downside in the equity market if the global economy does in fact slip into a recession. The earnings expectations will be too optimistic (probably by at least 20%) and investors' willingness to pay for stocks will likely be challenged even further. Key to ultimately determining whether or not the economy slips into the recession will be discovering if inflation has indeed peaked already. If it has, then perhaps expectations of future interest rate levels need not move up much further. Equity Bulls would argue, that is what is playing out right now.

Stabilization in inflation and interest rate expectations would absolutely help firm up investor confidence. While it is far too soon to decisively conclude that the worst of the inflation spike is behind us, the decline in copper, oil and agricultural commodity prices at the end of June is welcome news. The left chart below shows that while the May level of inflation (the measure used here being U.S. Core PCE) decelerated slightly, it is still at uncomfortably high levels. The chart on the right shows that expectations of future short term interest rates have for the time being peaked, and in fact are now pricing in interest rate cuts in 2023. It is too soon to say that inflation fear is subsiding, but the recent improvement in these charts is an unambiguous positive for equities.

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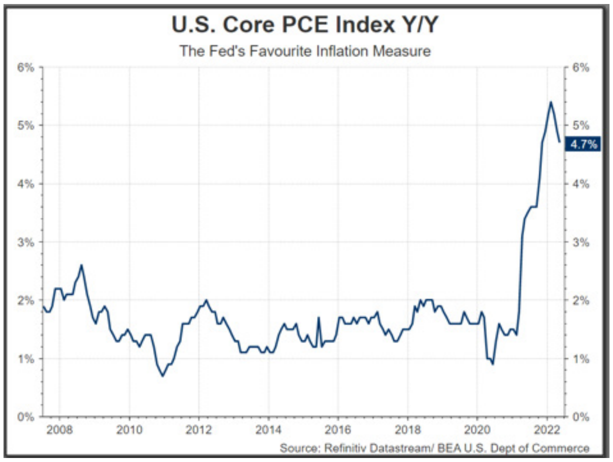

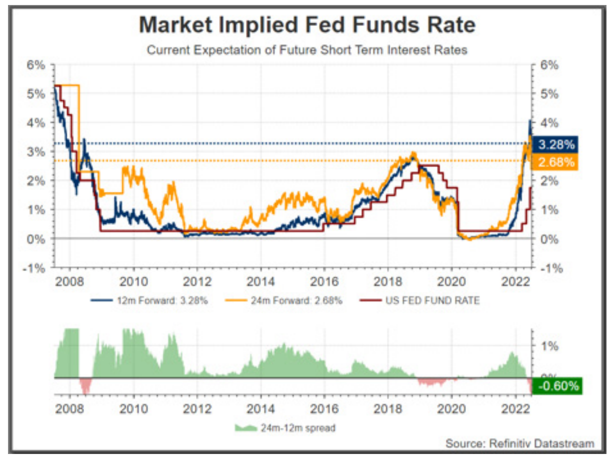

Regardless of the ebb and flow of the business cycle, our philosophy on building and managing equity portfolios remains unchanged: we invest our client's capital into businesses that prove their quality via strong cash flow generation and high levels of profitability. We insist on strong balance sheets so that we are only investing in companies that can not only survive a downturn but can thrive by winning share from their weaker competitors. We look to invest in as many distinct businesses as possible within the confines of our concentrated strategy so as to reap the benefits of true diversification. Finally, we rigorously value our current and potential investments to ensure we aren't overpaying, and thus maximizing the odds of achieving our return objective on the stock over a two-to-five-year time horizon.

A question we are frequently hearing from clients is whether or not it is the "right" time to invest more money into stocks. There is no clear answer to this, as a) perfectly timing the market is impossible, and b) investor client circumstances and risk tolerance vary widely. Our crystal ball is no better than anyone else's! What is clear is that stock prices are on average 20% lower than they were at the start of the year and that we feel our portfolio is well-positioned for the coming months.

July 2022