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EP 177 | Canadian Equity: 2024 Overview and Looking Ahead to 2025

[00:00:00] Andrew Johnson: Hi, everyone. In this episode, I talk with Mark Rutherford, co-manager on our Canadian equity strategy. We dive into what fueled the strong growth in the Canadian market this year, including the strength of technology, financials, as well as energy. Looking toward 2025, we talked through some of the risks on the horizon. I hope you enjoy it.

[00:00:23] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:00:41] Andrew Johnson: Hey, Mark, how's it going?

[00:00:43] **Mark Rutherford:** Good. How are you, Andrew?

[00:00:44] Andrew Johnson: I'm doing very well. It's great to have you back on the podcast. As I was thinking about what we were going to talk about today, I thought we would start at the end. Let's take a look back at 2024 in Canadian markets, and let's start at the positives. As of this recording, which is mid-December, the TSX is up somewhere on the order of 25% year to date—quite a sizable move for the Canadian stock market. What have been the key drivers of that strength so far?

[00:01:11] Mark Rutherford: Yeah, it's been a really strong year. There's a number of broad categories in Canada that have performed really well. If we were to bucket it by sectors, really some of the strongest performances we've seen are from some of the technology stocks within Canada. Companies that we own in particular, Constellation Software, Topicus, which is a spinoff of Constellation Software, they're continuing to execute on their strategy and grow organically, as well as acquire vertical market software companies that attract good rates of return. Shopify is a company we added back to the portfolio this year and has performed very well more recently, where they're continuing to grow GMV or really the market value of transactions on their platform in the 20+% range. In addition to that, they're seeing margins improve, so that stock has performed very well. Then, if we look at other sectors, really within Canada, financials, which comprises almost a third of the index in Canada, has performed very well and that's driven really across the board. So banks have had strong results, insurance companies, as well as asset managers like Brookfield Financial.

In addition to that, outside of financials, we've had energy companies do well. In particular there, it's the midstream companies that have performed very well, where we've seen higher growth rates due to new expansion opportunities in the U.S., as well as interest rates coming down have really improved the outlook in some of those midstream companies. So, within Canadian equity strategy, AltaGas would be one that's benefited from that. And then lastly, gold companies within Canada in the material sector with gold prices going substantially higher have rallied significantly. So, across the board, really great strength, and now it's our job to compound that and continue to carry on that growth into next year and not give it back as we're seeing elevated valuations in a few areas of the market. We're working on those next opportunities where we're seeing better payoff profiles, given some of the movements that we've seen.

[00:03:24] Andrew Johnson: Sounds like a lot going on, Mark. In particular, I'm curious about the strength and

what's causing that within banks, as well as Brookfield, as you mentioned.

[00:03:32] Mark Rutherford: Within the banks, there's been a number of dynamics playing out. Overall, looking at the revenue side, loan growth, it's moderated somewhat from the last few years. We may be looking at more like mid-single digit earning asset growth on the balance sheet. That's been positive. Also, within the banks, margins as interest rates and shorter-term rates have been cut. We're seeing a little bit of margin expansion that spread between their funding costs, between deposits and other debt on the balance sheet and the rate that they're lending money out at, that's improved slightly. And then some of the banks did restructuring, took restructuring charges last year, and we're seeing a little bit better cost control at the banks. So overall, if we look at, a key metric would be pre-tax, pre-provision earnings. As the earnings provision from loan losses can sway the earnings per share number quite a bit in any given year, we're seeing pretty strong growth in pre-tax, pre-provision earnings. And then loan losses, they are normalizing from very low levels. They're still within a reasonable control band, and then with interest rates coming down and easing monetary policy, that should help some of the stress that some businesses and consumers are facing from higher rates. Looking into next year, that may be positive.

The other factor that's a big proportion of the bank earnings mix today is wealth management and capital markets. With easy monetary policy, stock market returns have been very high, particularly in the U.S. and Canada. Those wealth management businesses are earning a lot more money than they did a year or two ago, so that's been a big benefit and boost to the banks. What we're thinking about going forward really is two things that could really be risks to the banks. They are trading that roughly 12 times earnings, which is at the higher end of the range where they've traded historically in Canada, and a lot of the recent earnings growth has come from capital markets strength, and wealth management strength, which are a little bit more cyclical and tied to capital markets asset prices. So if you add a pullback or a big sell-off in equity markets, banks are always susceptible to that. Banks really go the way of the economy. Those are a few risks on the horizon that we're watching and managing just the exposure a little bit so that we don't get two overweight banks at really top of the cycle.

Within Brookfield, the dynamics there are a little bit different. They're seeing strengths in two big pockets of the business. One is credit, and that has really been facilitated by the Oaktree acquisition a few years ago. They continue to see really strong inflows within their credit business. The core private equity infrastructure and renewables business has chugged along and continues to perform well. Reinsurance is a business that they entered a few years ago, with the acquisition of American Equity Life and Argo. They've built what is now one of the leading annuity players in the U.S. They're selling traditionally annuities and really improving the investment returns as they collect the premiums on that and earning a spread, aiming for roughly 2% spread on those assets. With their existing funds across real estate, infrastructure, renewables, but also importantly, Oaktree and the credit strategies that they have, they're able to deploy those funds much more efficiently and earn better returns than some of the traditional insurance businesses that own those businesses, didn't have the capabilities that they have on the private side. So, we're just seeing a lot of strength, and those results are starting to come through. Insurance or wealth solutions within Brookfield is becoming a much bigger proportion of the total earnings, and it has a lot of growth ahead of it. That's really driven it. Then the last thing that I'd mentioned on Brookfield is really with interest rates coming down, monetary policy easing, it's been a very attractive environment to sell assets that are more mature, that they've owned for a number of years. They've put work in to grow them or restructure the businesses, and now they're ready to sell and recycle that capital into new other opportunities. Those factors combined have resulted in just a much-improved outlook for the company, and we're seeing that in the stock price performance.

Outside of the banks and Brookfield that I noted, insurance companies have also had strong results recently. In

the Canadian equity strategy, that would be iA Financial, Manulife, as well as Intact. Within life insurance companies, we're seeing strength in the business as it's really transitioned over 15 years in Canada, where in the great financial crisis they were very interest rate-sensitive businesses. They were selling products, long-term care, variable annuity products that got them into trouble, and it created a lot of volatility in their earnings profile over time. As those products that were sold 10+ years ago have gradually become a smaller portion of the business, and with higher rates in recent years, Manulife has been able to sell off some of that business to reinsurance companies that are willing to take it on and recycle the proceeds and return that capital to shareholders in many places. With that shift into a more attractive product mix and earnings stream, we've seen earnings volatility come down at the life insurance companies.

Then with IAG, just a lot of really good execution and strength within the niches that they play in. It's smaller than Manulife, Sun Life, and Great West, but they're really focused within Quebec and the mass market segments, and they've executed very well to grow at high rates of return and be a really good partner for the representatives selling their products and provide a range of products across areas where they find they can allocate capital at reasonable rates of return. A broader element of it in Canada is just rational competition. The players are all looking to seek attractive returns. They're not really trying to gain market share over one another and drive returns down. So that is combined to produce some very good results.

Intact continues to chug along. This was a more challenging year from a natural catastrophe perspective. We had Jasper, there was hail in Calgary, floods out east. But they continue to weather that storm, and they're well-capitalized. They can absorb the losses, and that will likely result in a hard market going forward that will drive premiums higher. They've done well growing the investment portfolio, so earnings on the investment portfolio are growing. They also have a distribution income business where they own brokers themselves, and that continues to produce attractive double-digit growth and contribute to the bottom line. So Intact is rounded out and provided for a very broad-based strength within financials.

[00:10:55] Andrew Johnson: It certainly sounds like quite a few positives out there and not surprising given the stock market performance that we've seen in 2024. Let's go to the flip side. Where have we seen some challenges or weaknesses?

[00:11:07] Mark Rutherford: A couple of areas, Andrew, that we've seen more weakness in Canada that have been an area of weakness for a couple of years now is really telecommunications and real estate. Within telecom, the industry dynamics have really changed. Given two factors, the regulator has been more aggressive on pricing in the industry and trying to increase the amount of competition. That's led to pricing coming down, particularly in wireless. With the Rogers Shaw acquisition a few years ago, that's also changed the dynamic in Western Canada, where Rogers can now compete with a national wireless offering as well as a cable offering, and internet offering. So Telus has more competition out West. In addition, those businesses had some high payout ratios historically, and they were aided by interest rates coming down over a decade. As we've seen higher interest rates in the last couple of years here, they're refinancing their debt into higher interest rates. That has been a challenge.

That's also a challenge that we're seeing on the real estate side, where many companies term out their debt and they're very prudent as to staggering the debt maturity profile over a number of years. However, over the last few years, they're refinancing very cheap debt for debt that's more expensive. If companies have a significant amount of debt in the capital structure to finance buying assets or developing assets, then that's been a headwind to earnings growth. Lastly, within real estate, particularly industrial real estate and apartment multifamily real estate, rent growth has been slower and we're seeing a higher level of occupancy on the industrial side. So, until that supply starts to normalize, particularly in industrial, and we can have more attractive supply, demand

fundamentals, that needs to happen for occupancy to improve. We're seeing positive signs that it is improving for industrial real estate, but it does take some time. Real estate businesses have had a similar experience where the debt that they're refinancing today is at much higher rates than some of the debt that they were issuing four or five years ago. That is starting to factor in and limit rent growth. On top of that, in certain areas like industrial, you had quite a bit of supply growth through COVID and all the transportation shortages and supply chain issues. We had a big push from companies, as well as real estate companies, to develop a lot of supply. That's coming to market now at a time when demand has softened a little bit. We've seen occupancy that's been a little bit weaker in industrial real estate. However, it is slowing on the supply side, so we are seeing fundamentals improve a little bit there.

[00:14:02] Andrew Johnson: I'm also curious, Mark, just as we look ahead to 2025, what risks are top of mind for you and the team, especially in light of the current optimism that we have around markets, really globally.

[00:14:12] Mark Rutherford: There's always a number of risks that we're trying to watch and be mindful of within the portfolio or even outside the portfolio. Looking at Canada and what's happened over the last few years, is relatively reasonable economic growth, but that's largely been driven by inflation compared to growth in per capita incomes. We've seen a shift in policy from the federal government looking at slowing that, so that has a ripple effect across a number of companies from banks to insurance companies, telecom, even real estate. That's one concern.

We're also seeing weakness in Canada from an economic standpoint compared to the U.S. As we've seen that economic divergence happen, that's causing the central bank to cut interest rates more aggressively compared to the U.S. We're also seeing the Canadian dollar weaken along with that. That creates some knock-on effects. If you think of most of the food that we buy at grocery stores is imported from the U.S. or Mexico, a lot of other imported consumer goods will be impacted by a weaker Canadian dollar.

On the financing side, we are still watching. The performance has been relatively strong so far. But going back to the banks, people will be refinancing mortgages at higher interest rates in 2025 and 2026. And you are seeing unemployment within Canada tick up slightly. Unemployment is probably the number one driver for credit losses at a bank. If someone loses their income, it becomes very challenging to pay off any debt with savings alone or by selling assets. That's a risk that we're watching. We're looking at the portfolio, trying to understand if we need to reposition or reassess. One of the nice things with a lot of the well-managed Canadian companies is that we do have a pretty significant proportion of global companies within Canada. If we were to look at Royal Bank, they have a very strong U.S. capital markets retail franchise. Even companies that we own like Brookfield Asset Management, very strong international franchise, Couche-Tard, other companies. And a lot of the companies, if we do have higher levels of inflation in Canada again, or it's sustained at a higher rate, the strong business models allow a significant degree of pricing power that can manage that. That's one area.

Tariffs within energy have been another relatively new risk that we've been discussing as a team. If 25% tariffs were applied to oil and gas, for example, that could create, in our view, just a widening differential between Canadian crude oil prices and U.S. prices. The benefit for Canadian companies is they have very low break-even costs, but there's not a lot that those companies can do if the differential widens on them. The one benefit for those companies is a lot of the U.S. refiners that Canadian Natural Resources or Suncor would sell oil to, they are geared towards heavy oil that we produce in Western Canada. It may not be very easy for that refiner to buy that heavy crude from somewhere else, whether it's the Gulf of Mexico, Venezuela, other sources, find pipeline capacity for it, get it to the refinery, when you factor in different costs that may result from sourcing different crudes. There are risks there, and that's one area where we have lightened up exposure in the portfolio, just given

it performed very well. We're seeing some signs that there's weaker demand and significant excess supply on the oil side. If tariffs are implemented on energy, that would be likely a hit to these producers that don't have a great way to counteract it easily.

[00:18:05] Andrew Johnson: Certainly sounds like to me, Mark, regardless of stock market performance, risk is always looming out there. Let's wrap it all up, bring it all together. We've had this strength this past year. You just highlighted some of the risks, not only for you as a portfolio manager, but to the broader Canadian economy. How do you balance these factors when thinking about building and maintaining a resilient portfolio?

[00:18:29] Mark Rutherford: We're obviously grateful that the performance has been really strong within Canada. The job now is to maintain that and not give it back if the market goes through a big correction. So how do we do that? Really, it's important to have landing spots. We've done a lot of work on inventory ideas that we don't own, and we're looking to recycle capital into those companies that may not have performed as well, but we see better risk adjusted returns. That's been a big push on the team lately. I'm excited because there's a number of opportunities that are returning over, and I think we're still seeing enough pockets of opportunity within Canada across the board where we can recycle capital from areas that have performed really well in some cases into new opportunities or companies where we've deemphasized within the portfolio and now it's at a price that is much more attractive for us. So that's important. We're also just staying bottom-up. It's easy to get caught up in macro fluctuations and headlines, but we're looking at bottom-up fundamentals and companies with good management teams that are aligned that trade at reasonable prices. We know if we consistently repeat on that, we can compound on the great returns that we've had so far over the last year.

[00:19:41] Andrew Johnson: Great stuff, as always, Mark. I appreciate you making some time, bringing your insight into the markets. As always, I'm looking forward to the next one.

[00:19:48] Mark Rutherford: Thanks, Andrew. Appreciate it.

[00:19:50] Andrew Johnson: Hey everyone. Andrew here again. To subscribe to the Art of Boring podcast, go to mawer.com. That's M A W E R dot com forward slash podcast, or wherever you download your podcasts. If you enjoyed this episode, leave a review on iTunes, which will help more people discover the “be boring, make money” philosophy. Thanks for listening.