Manitou

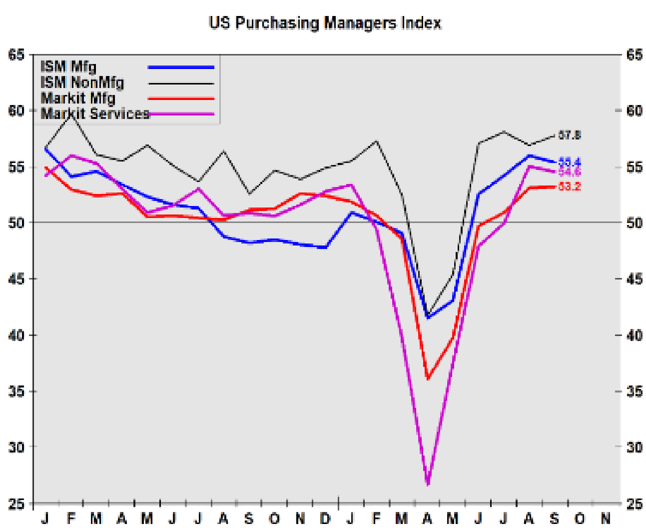
Investment Management Ltd.

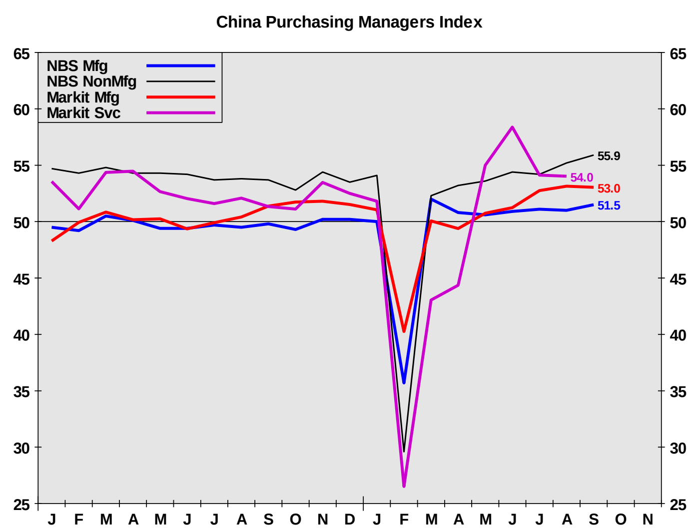
Quarterly Commentary
September 30, 2020

Slow and Uneven Recovery in the Pandemic

It is a certainty to conclude that the current global macro-economic outlook is uncertain. The future path of the economy is determined by factors such as the course of Covid-19, monetary and fiscal policy, not to mention the approaching US election. Furthermore, the news cycle is unfolding at such a rapid pace that it has contributed to considerable stock market volatility.

Last spring's global economic lockdown has been characterized as an "induced coma" that has made comparative statistics difficult to interpret. As an example, monthly Canadian and US employment data has shown steady improvement over the last couple of months, yet more than two million Canadians and ten million Americans remain jobless. In addition to the high unemployment rates, corporations have been guiding forward earnings estimates downwards. In spite of this backdrop, optimism regarding business sentiment continues as is illustrated by the charts below. The Purchasing Managers Indices in the US and China follow the same pattern. Both graphs underline a positive economic outlook as countries overcome the initial shock of shut downs and prove resilient in their efforts to contain the economic impact of the pandemic.





TD Securities – John Aitkens – September 2020

In response to the significant structural damage inflicted on parts of the US economy by the pandemic, and to ensure the continuous recovery, Federal Reserve Chairman Powell has stressed that monetary policy will remain accommodative. As a result, low interest rates will continue for the foreseeable future and the economy will be allowed to "run hot", meaning that the historic inflation target of 2% will no longer be upheld. In our opinion, such decisions have contributed to the tech rally where a handful of large cap stocks grew exponentially and now represent 27% of the S&P 500 index.

While fiscal policy has taken a backseat to monetary policy since the onslaught of Covid-19, additional fiscal stimulus is clearly needed to save main street jobs as well as many small and medium-sized businesses. Regardless of who occupies 1600 Pennsylvania Avenue or 24 Sussex Drive, we anticipate that economic stimulus will include significant investment in infrastructure via either direct investment or subsidies. Additionally, funds are likely to be channeled toward multi-year investments in renewable energy given the necessary global focus on lowering greenhouse gas emissions.

Managing the balance between inflation and deflation was a task that Powell's predecessors grappled with during the aftermath of the Great Financial Crisis. However, the massive doses of economic stimuli applied thus far, and the commensurate mountain of accumulated debt point to a political path of least resistance, that we believe favours inflation.

For a brief review of the historical impact of past inflationary periods on fixed income and equities, we drew on some useful US research by Goldman Sachs that compiled returns for all ten-year holding periods from 1880 to the present. To summarize the study, ten-year holding period returns were measured against average inflation rates from minus 2% to over 5%. The highest annualized stock market return of 10.6% accrued when inflation was contained within a range of 0% to 1.5%. As might be expected, when inflation exceeded 4%, equity returns declined to low single digits and bond coupon rates offered a reasonable alternative. To quote a certain oracle from Omaha, in the context of today's interest rates, any meaningful increase in inflation would render bonds "certificates of confiscation".

We are encouraged by Goldman's work demonstrating that stock returns have exceeded inflation in 88% of the analyzed holding periods. History has shown that companies that have contained operating expenses and debt while maintaining pricing power, have outperformed during inflationary periods. We believe that one of the most important prerequisites to outperformance is a company's ability to continuously innovate. Innovation requires investment in research and development, and a corporate attitude that promotes curiosity and drive. A good example is Apple, which sells billions of dollars of products and services that in many cases did not exist a decade ago.

Manitou seeks out high quality and innovative companies that should perform well in 'all weather' conditions, and perhaps better than average in an inflationary environment. Portfolios are a collection of ideas and display diversification when all holdings do not move in unison. We will eventually emerge from this pandemic, however, as the title suggests, we are likely to experience a slow and uneven recovery.

Mandate Performance

Many trends we highlighted in the second Quarter of 2020 continued into the third Quarter. The Technology sector benefitted from remote working due to the ongoing Covid-19 pandemic. The Consumer Discretionary and Industrial sectors experienced increased demand when economies re-opened in most counties. The Energy and Financials sectors continued to struggle. Energy declined due to lower demand as business travel and vacations were cancelled in addition to factories resuming production at lower capacity utilization than pre-Covid. Financials, namely Banks, suffered from lower interest rates in addition to the threat of increasing non-performing loans associated with the end of stimulus packages.

As alluded to earlier, the significant investment flows into the Technology sector pushed multiples to increasingly higher levels during the last Quarter. Our returns were positively impacted by our holdings in Apple and Mastercard, with Microsoft also outperforming year-to-date. In spite of historically high valuations, we believe in the longer-term demand characteristics of these firms. As such, we continue to own all three of these companies, as well as other FAANGs, albeit at lower weights relative to the benchmark indices due to their historically lofty valuations.

Our economically sensitive holdings in the Industrial and Consumer Discretionary sectors including Home Depot and Whirlpool continued to benefit from Covid-related home improvement spending. Two of our international names in the global Building Materials industry, Sika and Kingspan, outperformed over the Quarter and Year-to-date. Their products' contribution toward lowering CO_2 emissions underpins their long-term growth prospects.

Our Energy holdings namely Canadian Natural Resources and Apache Energy, as well as our Banks, particularly Wells Fargo, continued to lag the broader indices in sympathy with lower global oil demand and economic uncertainty. Wells Fargo under the leadership of the new CEO Scharf is addressing legacy issues. We anticipate that regulatory constraints will be lifted soon, enabling the company to expand its balance sheet and return to previous levels of profitability. Our holdings in these sectors are leaders amongst their peers, which provides confidence that they will overcome current headwinds.

The impact of the Corona virus has undeniably accelerated the pace at which all businesses must respect Darwin's "adapt or die" philosophy. An example is Shopify, which was added back to all eligible portfolios during the quarter. Both revenue and gross merchant volume grew by 95% and 119% respectively during the period. While this magnitude of growth is unsustainable over the longer term, it provides analytical value now. The ability to achieve such outperformance reflects how quickly Shopify's merchant customers are adopting different methods of reaching customers whether it is by switching from bricks and mortar shopping to on-line or a blend of the two.

Another area that is experiencing rapid change is renewable energy. Just as with retail, Covid-19 has accelerated the global focus on the topic. We believe the combined impact of lower demand for oil and the reduction in exploration and production will push oil prices considerably higher as economies fully emerge from the pandemic. When this happens, we anticipate a positive re-rating of our energy holdings. Moreover, our commitment to the evaluation ESG[1] factors in our investment process has deepened further since becoming signatories to PRI[2] in 2019. As a result, any future incremental investment in the energy sector will be made with an even sharper eye than in the past.

Covid-19 has profoundly affected our daily and corporate lives. In spite of the disruption, the lessons gleaned from the pandemic have provided the opportunity to improve productivity and push forward on several continuous improvement projects within Manitou. We are confident that we will emerge from this period of uncertainty stronger than before.

We are pleased to introduce Joanna Wolff and Jeff Watson to the Client Service and Research teams. Their contributions are already creating a positive impact. We would also like to take the opportunity to thank our longstanding clients for their trust and welcome many new clients who have joined Manitou during the past year.

As always, we encourage inquiries into any and all aspects of our current thinking and outlook, which remains tilted towards the long term.

[1] Environmental, Social & Governance
[2] Principles for Responsible Investment