Manitou
Investment Management Ltd.

Quarterly Commentary
March 31, 2020

"We have nothing to fear but fear itself."

Franklin Delano Roosevelt 1932

A quick review of our own and countless other year end reviews, all forecast a gradually slowing world growth rate in 2020, with the sheer length of the economic expansion being the major concern expressed by economists and market strategists. As everyone now knows, three months later a zoonosis in the form of the novel coronavirus, has swept across the globe causing a deadly pandemic, the likes of which have not been seen in a century. Unfortunately the delayed response to the viral outbreak due to a lack of preparedness by most western countries has resulted in a more profound shut down of the global economy and sharper market sell-off than would have otherwise been the case. The drop in demand for oil caused by Covid-19 was exacerbated by a dispute between the OPEC+ members Russia and Saudi Arabia on how to manage production levels.

Not being epidemiologists, we have no firm predictions on the extent or duration of the pandemic. The outlook is rapidly changing, as additional testing is becoming more readily available, which will eventually lead to managing the contagion. Physical distancing in most countries is proving to be effective in flattening the upward curve in both cases and fatalities. A return to more normal patterns of daily life will eventually occur as the spread of the virus is gradually managed downward. This will likely be the result of the global pharmaceutical industry improving therapeutics and developing a vaccine. A timeline is impossible to accurately predict, but it is certain that the FDA drug approval process will be fast tracked.

While political leadership is open to criticism for its slow social response to the coronavirus, it was exceptionally well prepared and responded quickly from a fiscal and monetary perspective. Central banks in all major markets have been aggressive in providing liquidity to their banking systems through asset purchase programs, and loosening commercial bank reserve requirements. Unlike the Great Financial Crisis (GFC), we are currently experiencing a medically induced downturn, not a financial one.

North American banks are in excellent shape. This is a result of working closely with regulators and the world's leading financial institutions to bolster their financial positions over the last decade. Fiscal policy has been direct, aiming to sustain both large and small businesses via payroll reimbursement, interest free loans/grants, and expanding unemployment insurance benefits. Prior to the pandemic, these policy initiatives would have been characterized as 'stimulative'. Today, the hope is to save important parts of the global economy while waiting for the virus to wane.

Policy makers at the federal level in the United States, Canada and Europe have explicitly stated they will "do whatever it takes" to normalize the situation, while it is not entirely clear what normal will look like. What is certain is that in the wake of Covid-19 we must better prepare ourselves for future shocks of all types as a means of protecting the orderly functioning of our economic, physical and emotional well-being.

The most difficult variable to gauge is the collective market reaction to new information and how it will be acted upon by either human or computerized decision makers. History may be a guide and to that end we looked at every 10-year holding period for the S&P 500 index from 1930 to the present and found that 87% of these time periods produced positive returns inclusive of dividends. Moreover, the annualized return of approximately 9.3% is consistent with well documented research. Hopefully this empirical evidence, which includes many bear markets, supports our often stated conviction that equities will provide risk-adjusted returns well in excess of what can be obtained from fixed income instruments.

In these commentaries we often include graphs to capture large data sets that inform our outlook. In today's environment no pictures are required. Suffice to say that economic growth, employment, company revenues and earnings will be down substantially in the current and following quarters. Provided that physical distancing is effective in greatly slowing the spread of the coronavirus, an economic recovery could begin in earnest by the final quarter of 2020.

The correction in stock prices is beginning to better align individual companies more closely with their long-term earnings potential. Consumer behavior will no doubt change and the importance of securing local supply chains, even in the face of globalization, may lead to more on-shoring.

Q1 Quarterly Mandate Commentary

As mentioned in our recent letters, as well as in the above commentary, Q1 2020 was an extremely difficult period for all market participants. Our results were mixed with underperformance against the benchmark in the Global and US Equity Composites, and outperformance in the North American, Canadian, International and Focus 5+ Composites. Not surprisingly, none of these mandates produced positive nominal returns during the first quarter.

The weaker performing mandates were particularly impacted by their exposure to the energy sector. Specifically the holdings in Canadian Natural Resources (CNQ) in Canada and Apache in the US, were significant detractors in the mandates where held. These companies are both significant oil producers; the first involved in the oil sands in Western Canada while the latter, although more diversified geographically, is 50% exposed to the Permian Basin in the US.

Oil demand declined in January 2020 as Covid-19 appeared in China. In response, the Chinese government closed factories and imposed a drastic lockdown to contain the spread of the virus. As one of the largest global manufacturing hubs and a vital contributor to virtually every industry's supply chain, China is a significant driver of global oil demand. By shuttering many production facilities and thereby depriving companies of workers, the demand for oil plummeted. An impactful example of the effects of the Chinese government's decision was the rapid decline in pollution levels with citizens stating that the sky above had noticeably cleared. Tragically, the contagion subsequently spread across the globe. This impacted both the supply and demand of most goods, save a few including food, medical instruments and consumables.

Not only has manufacturing stalled, but people in general are unable and unwilling to shop for anything other than necessities. This unforeseen Black Swan has led to closures of many businesses, both large and small and social distancing of 70-80% of the populations in North America, Europe and parts of Asia.

As stated above, the second impact to hit oil stocks was the breakdown in OPEC+ negotiations. Saudi Arabia responded by flooding the global market with cheap oil at the precise time that demand evaporated, sending the price crashing to lows not seen in more than half a century. It is widely believed this act was meant to cripple US producers that have taken market share as a result of low-cost fracking in the Permian Basin.

There are no winners in this price war with predictions of bankruptcies, consolidation and perhaps a government bail-out within the next 12-24 months. Cash flow of all players will diminish and balance sheets will be strained the longer this price war persists. At these levels, no oil company is profitable and the industry as currently structured is unsustainable.

As mentioned in our letter last week, we are holding both CNQ and Apache, but are not presently adding to these positions despite their distressed prices. Both are led by excellent management teams and operate unique assets. CNQ has several long-term assets with the flexibility to cut expenditures and wait for oil prices to recover. Apache, which has been disappointed with the quality of oil extracted from its Alpine High deposit, is still participating in the production of oil from other Permian regions albeit at significantly lower rates. The company has invested in cryogenic plants through its investment in Altus Midstream to move liquefied natural gas through the Gulf of Mexico and continues to produce in profitable sites in the North Sea and Egypt. Most importantly, Apache has partnered with Total SA of France in developing a promising deposit in Suriname. In fact, Apache recently announced the second discovery of high quality oil in Suriname. Although the dividend and capex have been reduced to preserve cash, exploration and production in this region will continue with two additional wells expected later this year.

Another holding worth mentioning is Wells Fargo. Its share price has come under pressure during the quarter along with virtually all US banks due to deteriorating US macroeconomic concerns. What remains misunderstood in our opinion, is the strength of Wells Fargo’s franchise, its balance sheet composition and the improvements made at the Board and Executive Management levels. Management has seriously addressed regulatory issues previously raised and acknowledged. We foresee a reprieve for Wells Fargo at this time when government relief programs for struggling consumers and businesses are being administered through the commercial banking system. Given the quality of its assets and loan book, Wells Fargo has the capability to return to previous industry high levels of profitability and returns on equity.

We believe that companies in strong financial positions outperform in declining markets. Another example of a core holding is Constellation Software that has been comfortably in a net cash position since its public flotation in 2006. Acquisitive companies such as Constellation will experience declines in their share prices like most others during a market correction, but those with strong balance sheets tend to perform better and emerge sooner from the bottom than others that are more levered. In fact, balance sheet strength allows asset-light, acquisitive companies such as Constellation to deploy capital at attractive valuations during turbulent times.

Finally, a bright spot for fundamental stock picking investors such as Manitou is that cyclical downturns allow us to take positions in companies that had previously traded outside of our estimate of their intrinsic value. The act of "trading up", i.e. buying a higher quality company at a similar valuation to lower quality ones enabled us to recently initiate a position in Home Depot within the Global, North American and US equity mandates. This high quality DIY retailer has shown that it can withstand market corrections and maintain market share. Although exposed to the housing market, Home Depot also serves the home maintenance market, which tends to be more defensive during times of economic stress when people do not necessarily buy a new home, but rather improve their existing residence. Expansionary spending does fall off, but non-discretionary spending such as replacing lights or plumbing continues irrespective of economic swings. We have admired and followed the company for years, but until the last quarter were unable to buy the stock at an attractive valuation. We believe Home Depot to be an A+ company that will be held for the long term.

Although this commentary follows a regular frequency of 90/91 day intervals, it is the third we have written in the past 40 days. On top of reaching out to clients directly, this represents an unprecedented level of communication. To us this underscores the severity of the situation we have all recently experienced and are living through. Some of our clients have vivid memories of depressions and wars. Others remember deep recessions involving 18% interest rates. Others remember events such as the first Iraq War, 9/11, the second Iraq War and the GFC. And for some, Covid-19 is their first crisis. Each of these previous 'events' while different in many ways, all resulted in stock prices plummeting precipitously.

While Manitou itself has not been around to witness all of these events, a number of clients and members of our team have. What those of us who have been here before know is that owning a well reasoned and carefully chosen collection of high quality businesses run by skilled management teams has always stood the test of time.

As always, we ask that you contact us regarding any questions. In the meantime, we wish you and your family good health and safety.