Portfolios RE: Constructed with Durable Growth

Event Summary

Our goal is to keep you connected to the people, products and ideas that are important to your business and help you make better more informed investment decisions.

The Mackenzie Bluewater Team recently shared their insights into the markets and how they are positioning their portfolios for long-term growth potential.

The elephant in the room

Inflation has caused market chaos across asset classes. Due to high inflation, central banks continue to raise interest rates, which is rippling through asset prices. There are two elements contributing to the inflation problem: goods inflation and service inflation.

- Price problems were caused by Covid due to government stimulus programs and supply disruptions with lockdowns and shortages. In early 2022, goods inflation was going up solid double digits, but now it is down to 6% and we anticipate it will continue to slow.
- Service inflation is a bigger problem, as it is driven by housing and wages, and takes longer to get back under control. If the Fed keeps raising interest rates to get the job market to loosen up and to slow down the price of rent and housing, we believe we are likely to face recession.

It takes a long time to feel the full impact of rate hikes, so the decisions central banks are taking today could continue to slow the economy into 2024.

Positioning for weaker economic outlook

The Mackenzie Bluewater team is positioning their portfolio with a more defensive tilt in Canada. The four-pronged plan of the team is outlined below:

1. Focus on companies that are resilient in a slowdown and have been adjusting internally to lead to an upward inflection in their free cash flows. Telus, as an example, has resilient topline, improving margins, capital intensities, resulting in a step function change in its free cash flow profile.
2. Ensure companies are financially strong to withstand any downturn. The team sold CP Rail and TD as they are both making large acquisitions that look expensive, affecting their financial flexibility.
3. Continue to trim overvalued businesses, such as Dollarama and Intact Financial.
4. Invest in businesses with long-term secular tailwinds that drive above market growth over the long term, such as businesses that will continue to benefit from the energy transition in the next 10 years.

Is energy the next theme?

Typically, each decade has an underlying secular theme that has driven outsized individual stock performance. From the "nifty-fifty” (franchise growth stocks) in the 1960s, to IT/software, cloud and the FAANGs in the 2010s. We believe energy will be the next theme which is why the team has started to invest in businesses that will benefit from the energy transition.

- Auto companies like Ford and GM are on track to grow their EV production and sales 50-100x over a few years. China, as the world's largest auto market, is leading the world in this transition and its market share is rising, hitting close to 25% in 2022.
- Economics is a driving force, not climate change. Projections suggest that EV prices have fallen enough for the products to become mainstream and batteries are improving faster than internal combustion on performance.
- From an investment standpoint, any industries attached to EVs, and electrification more broadly, should see outsized growth this decade. The team seeks to find those areas which are going to capture the growth in a profitable manner. For them, that includes investments like ON Semiconductor (a key provider of silicon carbide chips), Amphenol (provider of specialized electrical connectors that is used in electrical systems), as well as Schneider Electric (the number one company for low and medium voltage equipment and grid control software).

Traditional energy

Mackenzie Bluewater funds have zero exposure to the sector. They believe demand for oil is in a long-term structural decline, and are short energy. They are looking in the growth area of energy: wind, solar, electrification, etc.

- In Canada, there are no businesses in the renewable space that interest the team. Most of the Canadian businesses they have looked at are very capital intensive, are more commodity oriented with limited pricing power and are not generating sufficient free cash flow to fund their growth.
- However, they do own engineering firm Stantec and it's a core holding.
- They don't own "energy" but look for companies that will benefit from the "energy transition" — businesses that will see better growth than the last decade, have pricing power and are not commodity businesses.

Q&A:

1. If we do have a recession, can you tell us how you see things unfolding in the stock market?

The market tends to follow a pattern around recessions. In the first stage, the economy is still growing and companies continue to report good earnings. This happened during much of this year, particularly in the growthier end of the market.

This stage also happens in a market correction. The key difference between a correction and a recession is what happens next.

When corrections happened, the economy and corporate earnings continue to grow, and once the market realizes there isn't anything wrong, the market goes straight up (like 2018, early 2019). But in a recession, something major is happening, so corporate earnings fall (often 20%-30%), and the market will take another leg down.

The team believes we are leaning towards recession which they expect will be seen in the next 6-9 months. In the third stage, economy and earnings start to fall at a slower pace, and the market starts going up sharply, heading into a new bull market.

2. With negative press around the housing market, rising rates and inflation, what are your views on the Canadian banks?

We are getting both an interest rate shock and an inflation shock, and if there is a recession, it will be a consumer-led downturn. Canadian banks have many different revenue streams, but two-thirds of the banks' business is tied to the consumer.

Higher interest rates help banks expand their margins, but it impacts the demand for credit, particularly for interest-rate sensitive assets like mortgages and commercial loans. In the downturn, there will be pressure on loan growth and credit, so we should expect top line growth to slow and more provisioning for loan losses. We think this outweighs the benefit of better margins.

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