Our Thoughts…

2024 April Commentary

> *At Kingwest, we are attracted to 'unrecognized value'. That is a business that we are confident will be worth significantly more in 5 years than today, not related to the movement in stock prices in general, but related to some development in its own affairs.*
>
> *We look to sell when the asset is still appreciating but the additional gains will be small.*

Both North American markets have been very strong since the beginning of the year. From the end of December to the end of March, the Canadian market rose 6.2%; the US market jumped 10.6%. Our equities underperformed in Canada but outperformed in the US.

Our Canadian Equity performance has lagged over the past couple of years. We have been in this position in the past, always rebounding sharply. On March 31, 2000, the Canadian Equity portfolio was 15.9% behind the TSX TR Index for one year. Over the course of the next three years, we outperformed the index by 36.5%. In the first six months of 2008 we were 13.0% behind the index.

Over the next three years we were 22.9% ahead of the TSX TR. While downturns in the market, and more importantly in your portfolio, does not bring us joy, it does provide us with longer-term opportunities. To go three steps forward sometimes you have to take one step back. The portfolio today is one of the best we have seen in terms of price and quality over the last three decades.

Underperformance has always been followed by outperformance and this is what has allowed the Kingwest Canadian Equity Portfolio to outperform the market by 3.9% per year since 1992. Your patience will be rewarded.

Interest rate cuts and the inflation outlook dominate the expectations about financial market movements.

It is the market's expectations of future performance, not just the actual performance that drives financial market prices. As markets reflect more optimism, investors' expectations extend farther out. As pessimism sets in, the horizon shrinks. As a result, expectations cause stock prices to be much more volatile than company values. In normal times, market prices reflect company values.

At the start of 2024, markets were expecting six interest rate cuts this year, driving the market up. That belief has changed dramatically over the past two months.

The economy in the US has shown amazing resilience. It continues to grow above trend and job growth is stronger than expected. Neither of the two are inflationary on their own, nor do they indicate an economy that is in need of lower interest rates. The annualized six-month change in CPI excluding food and energy prices — considered a reliable guide to underlying inflation — has risen from 3.1% last November to 3.8% in March.

This has pushed at least four of the twelve Fed officials who vote on monetary policy to be more hesitant about cutting rates.

While the timing of the cuts has become more uncertain, the expectation that there will be substantial interest rate cuts over the next few years is not. That is a reasonable conclusion. North American Central Banks have on average cut rates fourteen times once a change in policy occurred. That is why even though the near-term expectations have become more somber, longer term the optimism remains undiminished.

While policymakers generally agree that rates can fall later this year, Fed chairman Jerome Powell said that this will happen only when they "have greater confidence that inflation is moving sustainably down" to the 2% target. Atlanta Fed President Raphael Bostic said rates should likely not be reduced until the fourth quarter of this year. He anticipates only one quarter-percentage-point cut will be appropriate in 2024.

Mark Carney, former Governor of the Bank of Canada, and the Bank of England, said on April 9th that he expects interest rate cuts to be "slower and shallower," and that rates are unlikely to return to pre-pandemic lows. He also suggests "What's more relevant for most companies and individuals and households is that, in the medium-term, rates are going to be higher, and are going to be higher because of structural things."

Without explicitly criticizing the current government, Carney said the changing economic environment would "demand fiscal discipline and a relentless focus on delivery, rather than a spending reflex that only treats the symptoms but does not cure the disease."

"When we're debating the competing priorities here at home, we should first acknowledge that we have less to spend because we've become less productive,"

When asked about the likely trajectory of rate cuts after the bank's last rate decision, in March, Tiff Macklem, current Governor said, "it's very safe to say we're not going to be lowering rates at the pace we raised them." On April 10th the Bank of Canada held its target for the overnight rate at 5% for the sixth consecutive month.

While the timing of rate cuts is seriously in question, the fact that they will occur is not. We have seen the peak of interest rates in this cycle. In the short term, both bond markets and the stock market may be volatile, but over the longer term, inflation will come down and interest rate cuts will power the market. In the meantime, the market may be subject to volatility until the path of cuts becomes clearer.

The shift in expectations in the US could make it harder for the Bank of Canada to deliver multiple rate cuts this year without weakening the Loonie even more.

We have positioned the portfolios for the rate cuts. We may continue to see more volatility than we would like but inflation will come under control and interest rates will come down. The exact timing is cloudy but be sure the cuts will come.

Portfolio update

Canadian Pacific Kansas City (CPKC)

Canadian Pacific Kansas City is a high quality, inflation protected, unique North American railroad operating in an oligopolistic industry with significant barriers to entry.

In 2023 Canadian Pacific bought the Kansas City Southern railroad creating the only railroad with a direct route connecting Canada, the US and Mexico. They renamed the combined company Canadian Pacific Kansas City. The benefits of this transformative acquisition are not reflected in the current stock price.

This combination will generate a substantial increase in the value of the business through cost synergies and by improving revenue levers. It will create competitive options for shippers and reduce greenhouse gases by converting truck to rail transport.

In the year since the acquisition, CPKC has already realized US $350 million of run-rate revenue synergies. CPKC is also ahead of plan on realizing cost synergies as management successfully integrates the two rail networks . In summary, the substantial revenue and cost synergies realized from the merger should lead to accelerated earnings growth for the foreseeable future. We believe that CPKC is well on its way to achieving its goal of more than double the earnings per share within five years while capital expenditures will remain at the current level.

Despite CPKC’s attractive long-term earnings outlook, the stock continues to trade at a discount to our view of its value and its closest peer, Canadian National. We believe the magnitude of synergies is larger and the path for realization is longer than investors originally anticipated, providing CPKC with profitable long-term growth and driving share price appreciation in the years to come.

Citigroup (C)

Citigroup's stock is very cheap, but will it get better? The stock trades at 0.57 x book value, a measure of performance well short of JPMorgan Chase at 1.73x or even Bank of America at 1.1x. If the company can achieve its target of 11-12% return on tangible equity over the next three years, it would fuel a big jump in the stock. Citi’s stock could rise 110% just to trade at book value! Citigroup is at an inflection point that will increase its profitability. It is focusing on its competitive strengths and divesting businesses where it is a second-tier player.

The company is strong in corporate and investment banking worldwide, and weak in retail. Citi has completed the sale of nine retail businesses in Asia and is expected to be out of balance by the end of next year. Citi will leverage its relationships with the world's largest corporations to boost revenue in investment banking and wealth management.

We are living in highly uncertain geopolitical, and economic times. Despite the challenging environment, a long-term investment strategy has historically been proven to be the most beneficial approach for investors. We are confident that this time is no exception. As we often say, the best is yet to come.