QV UPDATE

Weekly Commentary | July 13, 2018

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Easing trade anxiety in your portfolio

The Bank of Canada raised its policy rate another 25 basis points (0.25%) on Wednesday. The hike was expected by the investment community given the solid pace of economic growth thus far in Canada and in its largest trading partner, the US. The Bank's growth projection for Canada's economy remained at around 2% per year through 2020. However, it acknowledged in its news release that while recent tariff measures between the US and Canada are expected to be modest on growth and inflation, "trade tensions are weighing on investment in some sectors."

According to consulting company McKinsey's June survey of executives' sentiment on economic conditions, "changes in trade policy remain the most cited risk to domestic and global growth." This concern moved ahead of geopolitical instability in March 2018. Furthermore, "the share of respondents that predict global conditions will worsen now exceeds the share predicting improvements, for the first time since December 2016," the month after the most recent US presidential election. Interestingly enough, at the company level respondents "expect no meaningful hits to their business in the near term…Overall expectations for profits and demand remain high."

As with any survey, we try not to draw too many conclusions. It's natural for executives to feel optimistic about the prospects for their own businesses, and less so when it comes to areas they may have little control (like the economy). All we can really say is that operating costs should rise if further tariffs are endorsed, and some businesses will fair better than others in this environment.

It is difficult to quantify the impact of a potential trade war on the QV Canadian Equity Strategy, primarily because there are still too many unknowns. However, it would be reasonable to assume that most sectors could feel a pinch. A few hypotheticals could be higher cost of goods in the consumer space, lower demand that reduces volumes and backlog in industrials, and uncertainty that slows mid-market lending for banks. Rather than estimate the sensitivity of the portfolio to a trade war, a very imprecise task, we feel it is more effective to seek out companies with enough flexibility to endure an economic shock. Typically, these types of companies have been around long enough and have diverse assets to make adjustments to their operations over time. Ideally, they would also be in a position to keep returning cash to patient investors.

Since it is Stampede week in Calgary, let's use an example from Canadian energy. The energy sector was the largest contributor to TSX returns in the second quarter of 2018. While oil prices returned roughly 14% in the period, issues remain that could slow growth in the sector. These include: the US-China trade spat curbing demand, the lack of near-term takeaway capacity, and sector spending that sits at 60% of 2014 highs.

In light of these worries, we are happy to be invested in a business like Canadian Natural Resources (CNRL), a major Alberta-based oil and gas producer established in the 1970s. The company is well-known for efficient (low cost) operations and strong capital discipline through the current cycle. Since 2009, the company has spent more than $52 billion to scale up its energy operations, the bulk of which was funded by internally generated cash flows. CNRL has also returned significant capital to its shareholders through share buybacks and a dividend that has increased for 18 consecutive years. In 2017, it completed the expansion of its Horizon Oil Sands project and is now expected to generate roughly $7.4 billion in free cash (i.e. funds from operations less maintenance capital). If the price of WTI falls 20%, CNRL should still be able to deliver around $5.1 billion in free cash flow; enough to fund growth, pay its dividend, and still retire more than 10% of its outstanding debt. Even more astonishing is the company's valuation, which currently trades at a free cash yield of 12.5% versus the TSX at 6%!

The QV strategy aims to hold in favourably against the TSX in periods of heightened concerns. We can achieve this by investing in companies where management not only expects the business will endure, but can also point to a history that exhibits resilience. Of course, it helps when we can buy them at a CNRL type of valuation too.