Canada's Time to Shine?

By Doug Cooper, Senior Portfolio Manager, Canadian Equities
March 25, 2021

Since November 2020, there has been a material rotation away from growth/momentum stocks into value/dividend stocks in Canada and globally.[1] There are a number of reasons behind this rotation all of which point to a very favourable outlook for Canadian equities and in particular Empire Life's Canadian mandates which focuses on high quality businesses trading at sensible valuations.

Underpinning this rotation is the expectation for a material acceleration in global economic growth. According to Bloomberg, the consensus view for global GDP growth in 2021 and 2022 is 5.6% and 4.1% respectively, levels not seen in decades. This abnormally high level of economic growth is based on a few important assumptions. First, a successful global COVID-19 vaccine rollout (i.e. herd immunity for the global population); second, that consumers exit lockdowns with pent up demand and a high propensity to spend as a result of unprecedented levels of monetary and fiscal stimulus to combat the economic damage caused by COVID-19. As an example, the US consumer's net worth rose to a record level of $130.2 trillion at the end of the fourth quarter of 2020, up 23.3% versus the same period last year (source: Barron's).

In the aforementioned scenario inflation and higher interest rates would be a likely outcome – we have already seen rates double from depressed levels over the past few weeks.[2] Rising interest rates, as a result of a sharp acceleration in global economic growth, is an extremely favourable environment for Canadian equities because of the cyclical nature of Canada's economy (energy, financials, materials) and because a significant part of Canada's equity market (financials in particular) benefit from rising rates.

There are a couple of reasons why growth/momentum stocks have materially underperformed value/dividend stocks since November 2020.[1] First, higher interest rates discount future cash flows to a greater degree which lowers the price investors are willing to pay for high growth companies. Second, the valuation discount between growth/momentum stocks and value/dividend stocks widened to record levels in 2020 making the latter stocks very attractive especially in the context of the current economic growth outlook.

Empire Life's Canadian mandates strive to invest in high quality companies with attractive growth prospects but only if their share prices are trading at an appropriate discount to fair value. Because of this value-based approach, our Canadian mandates have generated strong absolute and relative returns since value stocks began to outperform growth stocks in November 2020. These strong returns are already reflected in the one year numbers of our Canadian mandates which still include roughly seven months of value/dividend stocks underperforming growth/momentum stocks. As an example, over the past year as of March 25, 2021, Class A shares of Empire Life's Asset Allocation Fund was up 34.4% beating 92% of peers; Empire Life's Dividend Growth Fund was up 41.5% beating 87% of peers; Empire Life's Canadian Small Cap Equity Fund was up 85.2% beating 92% of peers; and Class G shares of Empire Life's Dividend Balanced Fund was up 32.9% beating 84% of peers; and Empire Life's Elite Balanced Fund was up 33.4% beating 85% of peers (Source: Morningstar).

[1] From October 30, 2020 to March 25, 2021 the MSCI World Value Index was up 29.6% versus the MSCI World Growth Index up 14.5%; over the same time period the MSCI Canada Value Index was up 35.1% versus the MSCI Canada Growth Index up 7.9% (Source: Bloomberg).
[2] From October 30, 2020 to March 25, 2021 the 10 year US government bond yield increased to 1.63% from 0.77% (Source: Bloomberg).

If consensus estimates for economic growth prove correct, this will likely continue to be a material tailwind for attractively valued high quality companies which populate Empire Life's Canadian mandates. There have been multiple brief periods over the past decade where value/dividend stocks outperformed the broader equity markets. It's possible that the current period of outperformance is much longer in duration. The modern world has never endured a global pandemic and considering the unprecedented level of monetary and fiscal support coupled with material pent up consumer demand higher than normal economic growth could persist for longer than expected.

Also, despite what could be one of the best environments for Canadian equities in years, the S&P/TSX Composite Index's valuation is at a ten year low versus the MSCI World Index and the S&P500 Index.[3] Moreover, consensus earnings for Canadian equities, in particular financials, are likely in the early stages of a positive earnings revision cycle which means that the forward looking valuation of the S&P/TSX could prove even more attractive than consensus suggests.

In summary, we have seen a sharp rally in Canadian equities over the past few months and more importantly strong absolute and relative performance of our value-based Canadian mandates as reflected in the one year numbers. There are a number of factors which continue to bode well for Canadian equities and in particular Empire Life's Canadian mandates including the prospects of further increases in interest rates underpinned by strong global economic growth. Lastly, valuation remains very attractive for Canadian equities and in particular for high quality value and dividend stocks which we believe position Empire Life's Canadian mandates well for continued outperformance.

As always, thank you for your continued support.

[3] As of March 25, 2020 16.6x 2021 consensus earnings for the S&P/TSX versus 20.9x for the MSCI World Index and 22.7x for the S&P500 (Source: Bloomberg).