Market Perspectives

PRIVATE CLIENT SOLUTIONS

Robert Mark, CFA

March 25, 2020

Canadian Dividend Investments in a COVID-19 World

The impact from COVID-19 has plunged the entire world into highly volatile and uncertain times. Canada and the US are currently in the eye of the storm and we expect the health impacts from the virus to continue to get worse before they get better. The good news is we have seen a model of what works in earlier impacted economies, in particular China and South Korea, where infection rates have been falling thanks to quarantines, strict travel restrictions and social distancing. As we see it, there is a three-step process that needs to be enacted to bring us and our economy through to the other side of this crisis:

1. **Mitigate the COVID-19 threat and create a firewall for further spread** –social distancing, travel bans, stay-at-home orders and quarantines.
2. **Alleviate the economic stress caused from fighting the virus** – direct fiscal aid to individuals and industry to float the economy while it is in hibernation-mode.
3. **Assist in the economic recovery after the worst of the outbreak is abated** – continued fiscal and monetary stimulus to support economic revival.

Central banks are doing their part by slashing rates, providing liquidity to the financial system and, in the case of the Federal Reserve, recently offering an open-ended commitment to back-stopping asset prices, through direct purchases in the capital markets. These actions won't do much to fight the immediate battle of defeating the spread of COVID-19 (Step 1) but they do help buttress the financial system that needs to be intact when we come out the other side and provide for an economic recovery (Steps 2 & 3).

North American politicians are addressing Step 1 in a piece-meal fashion (particularly in the US) and without a proper nationwide lock-down and/or a fuller acceptance and compliance with the concept of social distancing, we believe that we are still far away from seeing peak infection rates in North America. Politicians are in the process of addressing Step 2 to enact fiscal stimulus (putting money directly in the hands of people and businesses) to stave off impact from the actions needed to combat the virus spread. Although we are concerned about the initial feet-dragging in the US, it appears the immediacy of the crisis should bring a compromise soon. We expect the Canadian Parliament will approve emergency funding measures to proceed in a more orderly manner both at a federal and provincial level.

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With these facts in mind, it is clear that we have yet to see the worst of this crisis from both a health and economic viewpoint. The same is true from an equity market perspective, despite North American indices already off more than a third from the highs made in February. Even with the strong relief rally on Tuesday, March 24, we do not think it is the time to be taking on risk in portfolios and investors should be looking at their investments much as they should their health, by hunkering down and concentrating on safety.

Portfolio safety comes in many forms. Like in all crises, "cash is king" and holding a larger than normal amount is advisable. Gold and precious metals provide some safety as a store of value and high quality government and corporate bonds are another haven, albeit at very meagre current yields. High quality equities also play a major part and with ultra-low interest rates here for the foreseeable future, will be a major portion of the income component of most portfolios in the weeks and months ahead. High quality equities in Canada typically means large-cap, dividend-paying names but we are not living in typical times. As a result we thought we would go through the S&P/TSX, by industry sector, and give our thoughts as to where we think are the safest dividend stocks to ride out the current equity market upheaval.

Seeking Shelter in Dividend-Paying Stocks

In times of maximum distress and crisis, the areas of the economy that will receive the most attention and be the least negatively affected are those that provide the necessities of life, what we loosely describe as "food and shelter". The following discussion contrasts different sectors and sub-sectors of the S&P/TSX in relation with this theme and how we can use these and other characteristics to show a rough framework of the safety of the companies' businesses and dividends. We are using a series of five qualitative metrics to give a basic overview of how safe we feel the groups' respective dividend payouts are and our top stock picks within each group:

1. **Revenue & Earnings (EPS) Stability** – how likely the sector will be able to maintain its past income and profit profile through the crisis.
2. **Government & Regulatory** – how likely that government measures to fight COVID-19 and support key parts of the economy will benefit the sector.
3. **Weak Commodity Prices** – whether low energy and metals prices will help or hinder the sector.
4. **Low Interest Rates** - whether protracted low interest rates will help or hinder the sector and/or impact the value of the shares.
5. **Debt & Liquidity** – Whether the sector has strong balance sheets and ample capital liquidity to ride out the downturn.

We rate each factor with a positive, neutral or negative mark. As such, these are generalizations to give investors a basic view of each segment. More in-

depth comments are available on most of the individual names from Raymond James Ltd.'s investment strategists and research analysts.

Utilities

Revenue & EPS Stability	✔	**Low Interest Rates**	✔
Government & Regulatory	✔	**Debt & Liquidity**	-
Weak Commodity Prices	✔		

At the top of the list of dividend safety are the power producers and electric utilities. These businesses provide the life-blood for the rest of the economy and are indispensable. Thus, the sector will have relatively steady revenue and profitability. There will be some revenue lost from shuttered businesses and industry but the sector will see an uptick in demand from residential consumers and much of the economy should bounce back quickly after the worst of the health crisis is over. The utilities sector will be strongly supported by governments, with low risk of negative regulatory impacts. Commodity price exposure is a positive as these are input costs and lower natural gas, oil and coal prices will be beneficial (although mostly passed on to customers). Regulated utilities will also pass on the positive effects from lower interest rates but will receive a boost from low rates in share price valuations due to the scarcity value of safe, predictable high dividend yields. Finally, debt levels for utilities tend to be higher than the market average but not unusual for businesses with predictable, low volatility revenue streams. Picks:

1. **Fortis Inc. (FTS-T)**
2. **Algonquin Power (AQN-T)**
3. **Emera Inc. (EMA-T)**
4. **Brookfield Infrastructure (BIP.UN-T)**

Consumer Staples

Revenue & EPS Stability	✔	**Low Interest Rates**	-
Government & Regulatory	✔	**Debt & Liquidity**	-
Weak Commodity Prices	✔		

Another group at the top of our dividend safety list are businesses selling consumer staples and everyday items (i.e. food, medicine, toilet paper!), like grocers/pharmacies, dollar stores and convenience stores. This group tends to pay out a lower percentage of profits in dividends due to skinnier profit margins but they remain dependable yield plays due to the essential nature of their services. This group sees the biggest potential for near term revenue growth due to consumers' stockpiling supplies and prioritizing staples over discretionary items. We have seen concrete proof of this from Canadian chains increasing temporary wages (Loblaw's (L-T), Metro (MRU-T)) and increased hiring (Dollarama (DOL-T)). Government and regulations will be supportive for most categories but particularly for grocers/pharmacies. Commodity price

sensitivity mostly comes from transportation cost (fuel and gasoline) which will be a net benefit. Lower interest rates and reasonable debt levels will have a negligible impact on the businesses and dividend safety. Our top two picks own both national grocery chains and pharmacies – Loblaw's/Shoppers Drug Mart, Metro/Jean Coutu:

1. **Loblaw (L-T)**
2. **Metro (MRU-T)**
3. **Dollarama (DOL-T)**
4. **Alimentation Couche Tard (ATD.B-T)**
5. **Northwest Company (NWC-T)**

Telecom

Revenue & EPS Stability	✔	**Low Interest Rates**	✔
Government & Regulatory	✔	**Debt & Liquidity**	-
Weak Commodity Prices	-		

Canada's big three national carriers (TELUS (T-T), BCE (BCE-T), Rogers Communications (RCI.B-T)) plus the largest regional (Quebecor (QBR.B-T)) are also near the top of our dividend payers list as they provide the telecommunications networks (telephony, mobile and internet) that tie people and businesses together across Canada. These services, as well as their television offerings, will become even more important to Canadians during and after the crisis, as we spend more time at home for both leisure and work. Government and regulatory actions should be supportive/non-invasive. Commodity prices have little impact, while lower interest rates will be beneficial for similar reasons as the utilities sector. Debt levels are higher than average but also manageable thanks to their stable, low volatility businesses. Picks:

1. **TELUS (T-T)**
2. **BCE (BCE-T)**
3. **Quebecor (QBR.B-T)**
4. **Rogers Communications (RCI.B-T)**

Gold and Precious Metals

Revenue & EPS Stability	✔	**Low Interest Rates**	✔
Government & Regulatory	-	**Debt & Liquidity**	✔
Weak Commodity Prices	✔		

Gold and precious metals companies are not typically held as dividend investments and few pay much of a yield. However, where investors can get a decent payout, we think the dividends will be safe and likely growing. We use two royalty streaming companies, Franco Nevada (FNV-T) and Wheaton Precious Metals (WPM-T), to play the space as they give us exposure to gold and silver, respectively, without the operating risks of owning a producer. We expect revenues to grow in coming months as gold and silver will likely increase in value as a hedge against the massive capital spending coming from

governments and prolonged low interest rates from central banks. Lower oil prices will benefit mine profitability and regulatory issues should be immaterial. Both names have strong liquidity and balance sheets. Picks:

1. **Franco Nevada (FNV-T)**
2. **Wheaton Precious Metals (WPM-T)**

Banks

Revenue & EPS Stability	-	**Low Interest Rates**	✖
Government & Regulatory	✔	**Debt & Liquidity**	✔
Weak Commodity Prices	-		

Canadian banks are seen by many, if not most, Canadian retail investors as a source of safe stable dividends and thus, a core position of any portfolio. While we agree with much of the sentiment and history shows that their dividends are amongst the safest in the S&P/TSX, we do caution investors that the banks are not "defensive" stocks. They are business cyclicals and their profitability prospects rise and fall with the economy. It just so happens that because of their near monopolistic position in the Canadian market, that they can often overcome soft spots in the economy and preserve earnings and dividends through creative cost controls and revenue sources (e.g. the dreaded fee increases). In the fallout of the Great Recession of 2008 none of the "Big 6" banks cut dividends despite the worst Canadian economy in decades. Our base case is that this time will be no different and the banks' strong capital positions and conservative business practices will preserve their dividends. However, adding to the banks would not be our first stop for dividend investors during this downturn, as the Canadian banks will face numerous challenges including Canadian consumers with record debt levels, a domestic energy industry in a worse crisis than 2008 and 2016 and the prospect of near-zero interest rates sapping profits from net interest margins. Add in lower probability risks to the Canadian housing market and a major increase in bankruptcies and this current crisis, if extended, could prove to be a similar or greater test than 2008. On the positive side, government should largely be supportive (even if the banks are called on to make short term sacrifices to save jobs and businesses), loan books to oil and commodity producers are relatively low and balance sheets and liquidity levels are very strong. We are keeping our list of picks short as we are not comfortable adding to the banks (yet) and want to stay with the top two quality names:

1. **Royal Bank (RY-T)**
2. **TD Bank (TD-T)**

Railroads

Revenue & EPS Stability	-	**Low Interest Rates**	✔
Government & Regulatory	✔	**Debt & Liquidity**	✔
Weak Commodity Prices	-		

Canada has two world-class railroads in Canadian National (CNR-T) and Canadian Pacific (CP-T). These companies provide another essential service to the North American economy moving goods and commodities across the continent and by extension, supporting trans-global trade. Both names will definitely take a revenue hit in the coming weeks as manufacturing and trade will slow during the shutdown. However, there will still be traffic moving for many essential parts of the economy, the most significant being agriculture products. Government and regulatory should be supportive as much of their business is essential to the economy and unlike much of the services and manufacturing sectors, does not require a lot of people working together in close proximity. Lower commodity prices are a double-edged sword as the company will lose revenue from oil and some mining shipments (coal should be steady) but lower fuel prices will support profitability. Lower interest rates are a benefit and debt and liquidity levels are strong. Unless the economic pause is extended well beyond current forecasts, we would consider current railroad dividends as safe. Picks:

1. **Canadian Pacific (CP-T)**
2. **Canadian National (CNR-T)**

Pipelines

Revenue & EPS Stability	-	**Low Interest Rates**	✔
Government & Regulatory	✔	**Debt & Liquidity**	✔
Weak Commodity Prices	✖		

In the past, pipeline companies were often mentioned in the same breath as power producers and utilities but in 2020 it is important to differentiate them, as pipelines are tied closely to the oil and gas industry. The larger companies, which our list focuses on, have very little direct commodity price exposure (i.e. their revenues don't benefit/suffer from higher/lower commodity prices) and their businesses are backstopped by long term contracts. However, their customers are directly levered to oil and natural gas prices, which are both heavily impaired right now. Canadian spot oil prices in particular are at multi-decade lows and trading below production costs due to the demand shock caused by COVID-19 and exacerbated by a price war playing out between Saudi Arabia and Russia. We do not expect this disconnect to sustain for a prolonged period (not even the Saudis can make money at current levels) but it could result in short term curtailments in Western Canada. We expect the provincial and federal government to provide a relief package for the energy industry in the coming days and protect the pipeline companies as their infrastructure is just as important to the North American economy as power producers. The point is that this group's dividend profile has higher risk than the previously

discussed sectors. On the positive side of the ledger, lower interest rates are a benefit and the group has been reducing debt levels in recent years. We are not calling for dividend cuts from the pipeline group at this time but there are more questions about the future for this sector than some of the others in this report. Picks:

1. **TC Energy (TRP-T)**
2. **Enbridge Inc. (ENB-T)**
3. **Pembina Pipelines (PPL-T)**

Life Insurance

Revenue & EPS Stability	-	**Low Interest Rates**	✖
Government & Regulatory	-	**Debt & Liquidity**	✔
Weak Commodity Prices	-		

Life Insurance (lifecos) stocks took a big hit in 2008 and have taken another big one in 2020. Profits from their key businesses of insurance underwriting and wealth management will be impacted by ultra-low interest rates and weak capital markets, respectively. We don't see government/regulatory burdens being material at this stage nor commodity price impacts. Debt levels and liquidity are generally strong and many of the long-term annuity products that caused significant pain in 2008 are much less material in 2020. Overall financial strength was solid going into the current downturn and as a result, dividend sensitivity is likely to be more correlated to the length of the economic downturn, rather than the immediate severity. Nonetheless, of all the sectors discussed in this report, the lifecos insurance businesses may face some of the largest headwinds coming out of the downturn due to the prospect of a protracted period of ultra-low interest rates. Picks:

1. **Sun Life Financial (SLF-T)**
2. **Manulife Financial (MFC-T)**

Conclusion

This report covers the areas of the Canadian markets where investors typically go for dividend yield and safety. All of the names that we have listed here are very high quality companies that will survive the current economic downturn and most will likely thrive on the other side of it. However, because we still can't properly forecast how long and how severe the downturn will be, the thrust of this report is to give investors some context as to how safe we feel the dividends from different high quality parts of the market are at this point in time, with a strong conservative bias. As the crisis progresses and we get closer to the lifting of the extraordinary social/economic restrictions, our confidence in dividend safety will increase and our willingness to take on more risk will rise.

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