Portfolio Strategy

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Here's Why You Want to Own Canada

OUR TAKE: [Positive]. Let's face it, despite some recent outperformance, Canadian equities have performed poorly relative to their US peers over the last decade. However, the last time we hit such levels of sustained underperformance, the 2000-2010 TSX outperformance cycle was about to start.

As often advertised in the investment industry: past performance is no guarantee of future results – which is obviously good news for Canada. With world/US economic activity expected to expand at a pace not seen in years, we believe Canadian equities are well positioned to outperform US stocks going forward. We highlight five reasons why you should OW Canada and flag our Top-30 large cap quant list.

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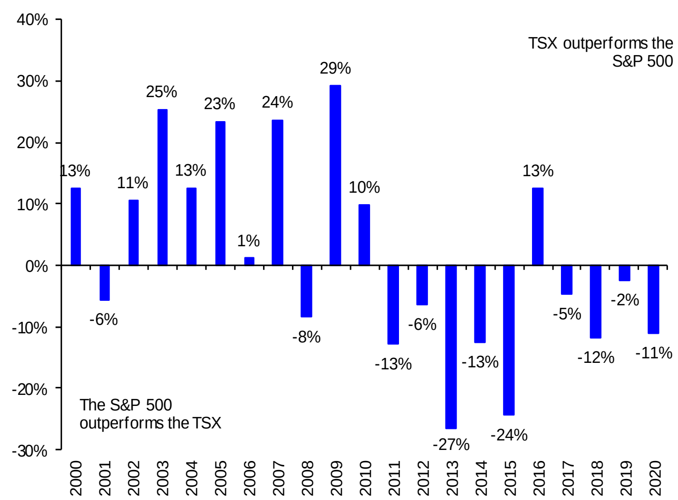
Here's Why You Want to Own Canada

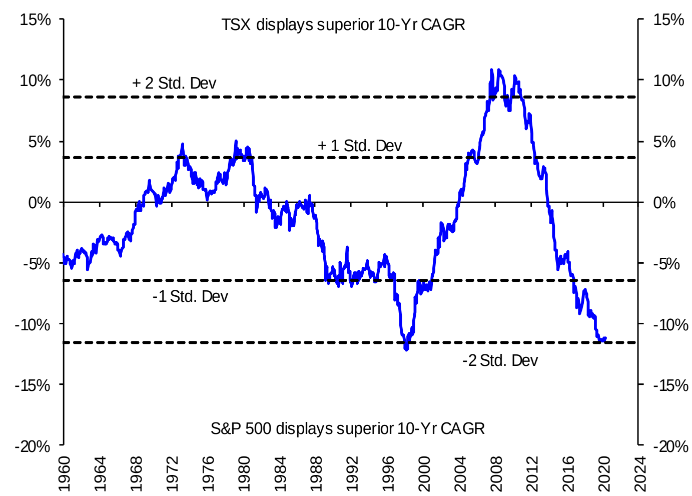
Let's face it, despite some recent outperformance, Canadian equities have performed poorly relative to their US peers over the last decade. As illustrated in Exhibit 1, the TSX index underperformed the S&P 500 in nine of the last 10 years (currency adjusted). In fact, its most recent outperformance on a calendar year (CY) basis was in 2016, when oil prices (and global growth) rebounded sharply. After such a bad stretch, the TSX 10-yr CAGR (+3.0% in CAD; +0.4% in USD) is trailing that of the S&P 500 (+11.5%) by more than 1,100bp, which is two-standard deviation below the mean as illustrated in Exhibit 2. **The last time we hit such levels of sustained underperformance, the 2000-2010 TSX outperformance cycle was about to start**.

Exhibit 1: TSX Total Return Performance Relative to S&P 500 (USD)



Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 2: TSX vs. S&P 500: 10-Year CAGR Spread (USD)



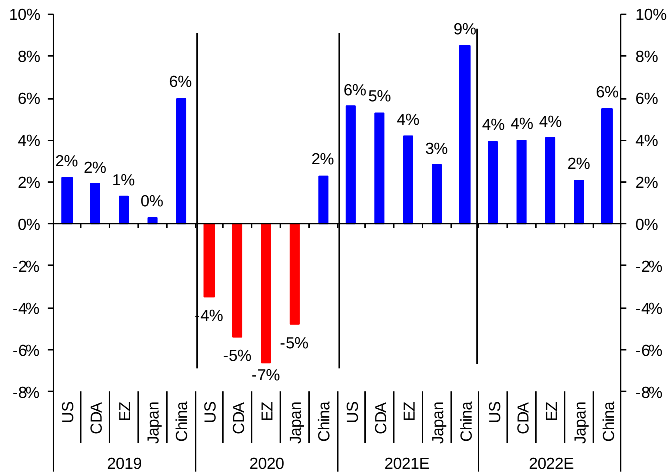
Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

As often advertised in the investment industry: past performance is no guarantee of future results – which is obviously good news for Canada. With world/US economic activity expected to expand at a pace not seen in years, we believe Canadian equities are well positioned to outperform US stocks going forward. Here are five reasons why you should OW Canada.

#1) High Exposure to Global Growth

After a painful 2020, GDP growth is set to accelerate strongly around the world this year. Pillars of growth are well-known: excess liquidity, huge monetary and fiscal support, lockdowns abating, and vaccinations accelerating. As illustrated in Exhibits 3 and 4, GDP growth and revisions to forecasts are both extremely strong. In fact, the U.S. economy is poised to grow at a 5.6% clip in 2021 according to consensus forecasts, which would mark its strongest expansion since 1984. Moreover, above-trend growth (+4.0%) is also forecasted for 2022. By means of comparison, the rebound post financial crisis occurred in smaller amplitude (+2.6%) in 2010 and was followed by a scant 1.6% the year after. Canada is also expected to rebound strongly, with consensus calling for GDP growth of 5.3% this year and 4.0% next year. That bodes well for the TSX, which generated just shy of 60% of its sales outside Canada between 2017 and 2019 (i.e. pre-pandemic years). To provide some perspective, foreign sales account for just over 40% of the S&P 500 total revenues, making the TSX more of a play on global growth.

Exhibit 3: Global GDP – From Contraction to Expansion (consensus estimates)



Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 4: Revisions to Consensus GDP Forecasts (bp)

	Last 1M		Last 3M	
As at Mar. 19, 2021	2021 GDP	2022 GDP	2021 GDP	2022 GDP
World	+20	-5	+40	+40
US	+70	+30	+170	+85
Canada	+60	-10	+90	+55
Eurozone	+0	+5	-40	+40
UK	+10	+20	-60	+120
Japan	+10	+0	+10	+15
Australia	+20	+0	+50	+15
Emerging Markets	+7	+3	+22	+11

Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 5: TSX Foreign Revenues as a % of Total Revenues (Pre-pandemic)

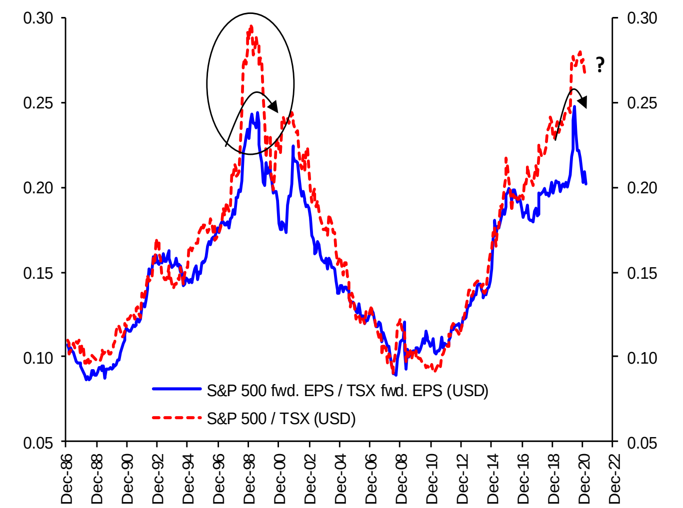
	FY 2016	FY 2017	FY 2018	FY 2019
Energy	60%	59%	59%	59%
Materials	86%	83%	85%	65%
Industrials	58%	61%	62%	65%
Discretionary	68%	69%	72%	72%
Staples	35%	39%	46%	43%
Healthcare	83%	80%	78%	77%
Financials	56%	60%	59%	58%
Technology	90%	92%	88%	96%
Telecoms	0%	0%	1%	1%
Utilities	51%	57%	67%	73%
Real Estate	39%	42%	42%	28%
Total	**56%**	**58%**	**59%**	**56%**

Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

2) Relative EPS Momentum Shifting in Canada's Favor

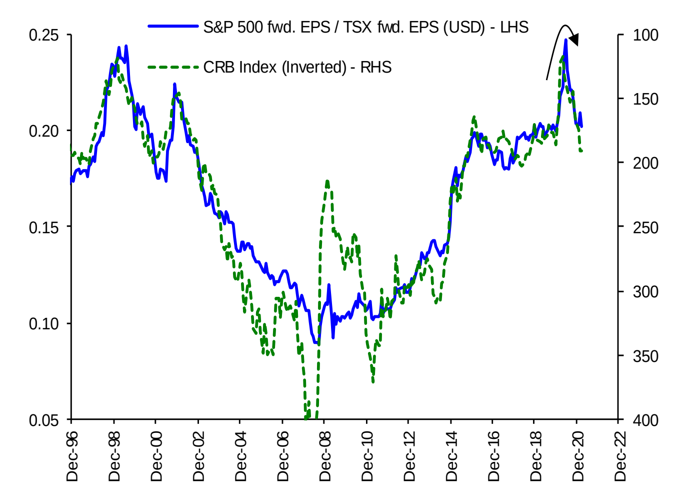
In the past 10 years, the outperformance of US equities relative to Canada was supported by superior earnings momentum (see Exhibit 6). More specifically, the ratio between S&P 500 12-M forward EPS and TSX 12-M forward EPS (USD) was rising at a steady clip (blue line on the chart), which provided more support to US stocks (red line). More recently, however, we note a sharp reversal in the relative earnings momentum, where Canadian forward earnings are now rising faster than their US peers (i.e. the blue line is now falling). As shown in Exhibit 7, the reversal appears mainly driven by the acceleration in commodity prices. Hence, if commodity prices continue to trend higher as we expect, the TSX should maintain its nascent earnings leadership over the S&P 500, giving strong support to price leadership as well.

Exhibit 6: S&P 500 vs TSX: Fwd. EPS Ratio and Relative Performance



Source: Scotiabank GBM Portfolio Strategy, Refinitiv, Bloomberg.

Exhibit 7: CRB Index vs. S&P 500 to TSX Fwd EPS Ratio

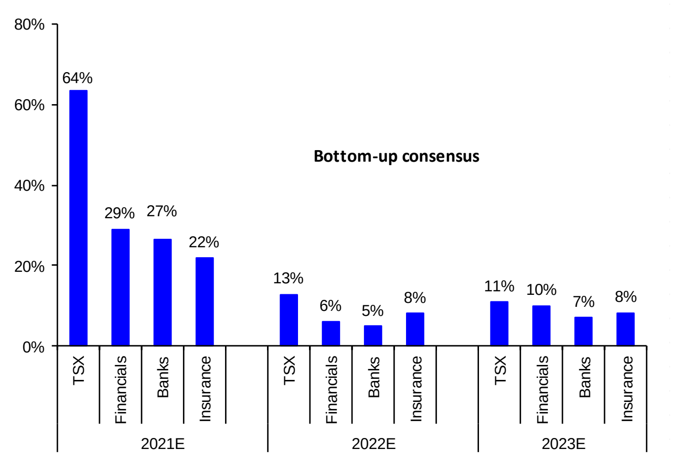


Source: Scotiabank GBM Portfolio Strategy, Refinitiv, Bloomberg.

#3) Canada Has the Sectors You Want to Own

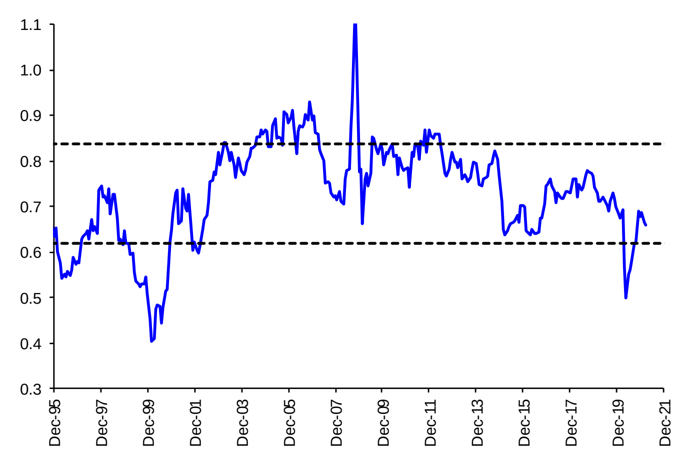
Financials/banks: Stars are aligning. The sector accounts for 32% of the TSX index. As we have indicated in the past few months, we believe the outlook for Canadian Financials/banks stocks is improving. The sector should benefit from a strong bounce in GDP growth over the next several years, intense real estate/mortgage activity, a steepening curve, and strong capital market activity (surging volumes of equity transaction, bouncing M&A, IPOs and secondary issues). Moreover, Canadian banks increased their provisions for credit losses massively last year as they anticipated high loan losses. Yet, consumer bankruptcies, instead of rising due to the pandemic, dropped 30% last year. The Q1/21 earnings season already saw some tentative signs that banks might release some previously booked PCL charges back into earnings. In our view, this increases odds that authorities (OSFI) will give banks the greenlight to raise their juicy dividend over the summer (already yielding 3.5% to 4.5%). On top of attractive valuation levels (banks at 10.8x forward P/E vs 16.3x for the market), outperformance potential remains high.

Exhibit 8: TSX Financials EPS Growth: Banks vs Insurance



Source: Scotiabank GBM Portfolio Strategy, Refinitiv

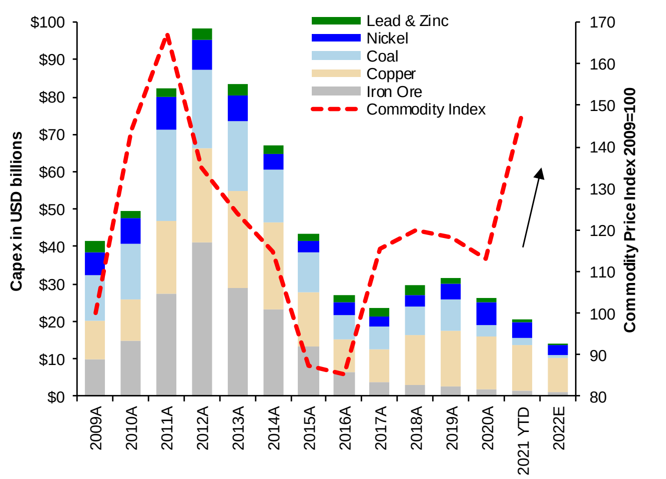
Exhibit 9: Canadian Banks Relative Fwd P/E Ratio



Source: Scotiabank GBM Portfolio Strategy, Refinitiv, Bloomberg.

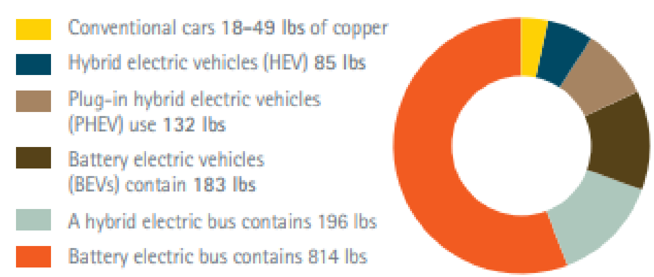
Resources stocks: Back to life. Energy and Materials have a combined weighting of 24%. As the US Congress recently approved the US$1.9T stimulus bill, the Biden's administration could now turn its focus on to another campaign promises: a multi-trillion-dollar infrastructure package. President Biden promised during the Presidential election to invest US$2T over 10 years in infrastructure and clean energy. The US is far from alone investing in green energy and infrastructure: multiple countries are taking cues from the same playbook, which we believe will boost demand for all types of commodities. After almost a decade of diminishing capex in the global mining industry, the supply response could be somewhat slow to materialize as shown in Exhibit 10. We believe this could be extremely supportive for commodity prices. In the energy market, we note that while WTI is back near its 2018 high, TSX Energy stocks are still hovering near their 2016 lows, when oil was trading around US$25/bbl. We think a sustained US$60/bbl environment is likely. As illustrated in Exhibit 13, sell-side consensus forecasts remain in catch-up mode, with 2021 forecasts still around US$57/bbl. Industrials stocks (12% weighting) should also benefit from accelerating North American growth.

Exhibit 10: Expansion Capex by Commodity vs. Equal-Weighted Commodity Price Index



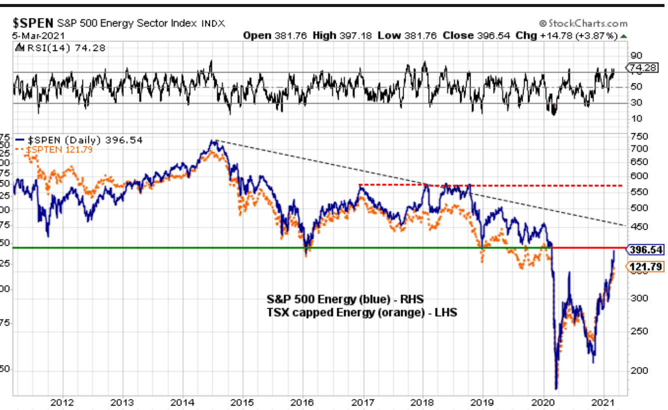
Source: Scotiabank GBM estimates, Wood Mackenzie, Bloomberg.

Exhibit 11: Copper Content per Vehicle



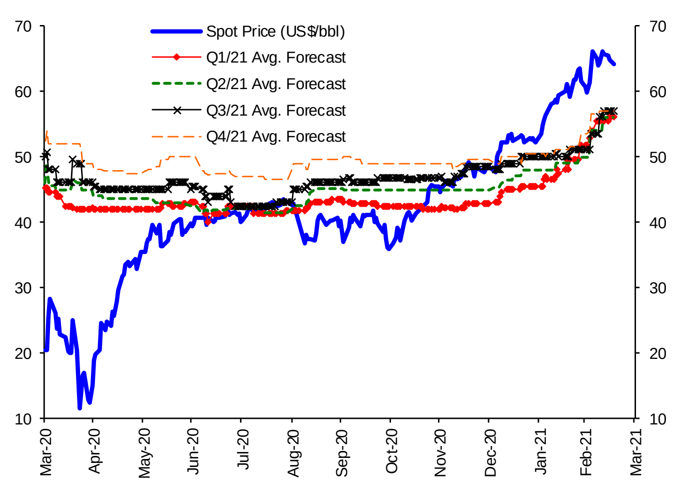
Source: Copper Development Association Inc.

Exhibit 12: WTI Above $60, But EN Stocks Still Near 2016 Lows



Source: Scotiabank GBM Portfolio Strategy, chart courtesy of StockCharts.com.

Exhibit 13: Spot WTI Price vs. Sell-Side Consensus (US$/bbl)

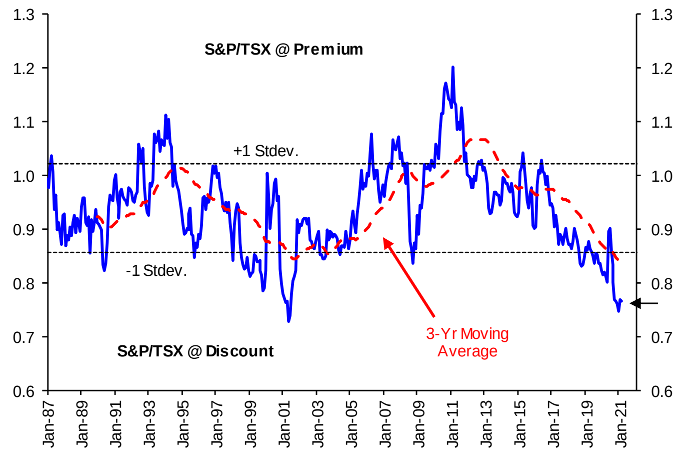


Source: Scotiabank GBM Portfolio Strategy, FactSet.

#4) Relative Valuation Stands at Rock Bottom Levels

Exhibit 14 speaks for itself. On a 12-M forward P/E basis, the TSX (16.3x) has rarely been cheaper versus the S&P 500 (21.3x), trading at a 23% discount. The valuation gap is extremely wide, with ample room to mean-revert in coming years.

Exhibit 14: S&P/TSX vs. S&P 500 - 12-M Forward Relative P/E

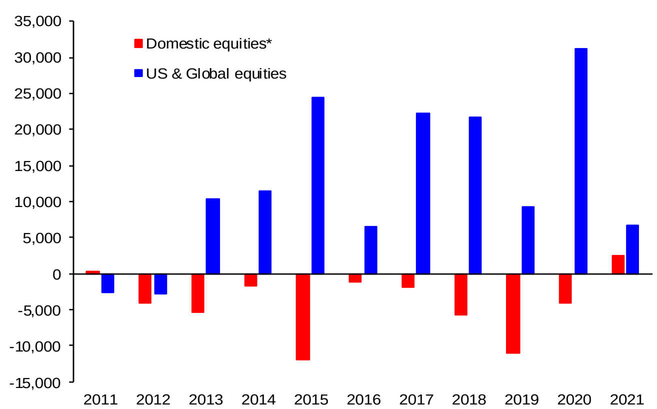


Source: Scotiabank GBM Portfolio Strategy, Refinitiv.

#5) Flows Coming Back

Canadian investors have fled the Canadian equity market in the past few years in search of better opportunities. From a Canadian standpoint, local investors boosted their foreign equity content, buying equity funds/ETFs investing in US and International stocks, while domestic funds/ETFs suffered huge outflows. See Exhibit 15. Global investors did the exact same in the last few years. Outside of 2016/2017, inflows have been relatively anemic with 2019 and 2020 being outright negative (outflows). However, the nascent rotation towards Value could clearly play in favor of Canada going forward. In fact, we have started to notice some flows into Canadian branded equity funds funds/ETFs this year. The bleeding of the past few years could be over if the macro landscape improves as we expect.

Exhibit 15: Canadian Investors Fleeing Canada: Outflows in Domestic Equities, Inflows in International Equities (C$M)

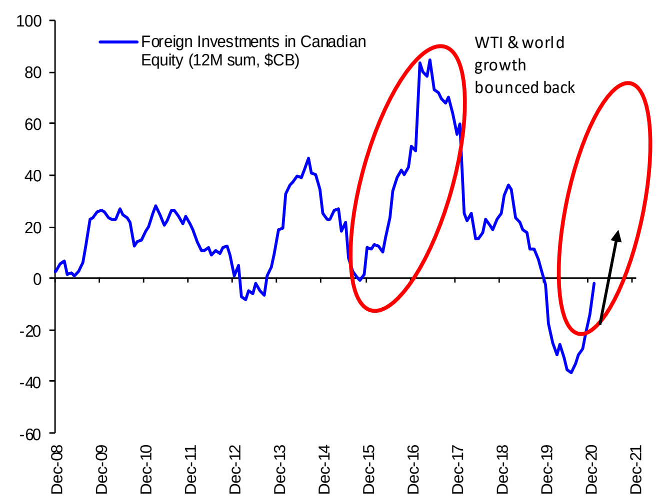


As at March 9, 2021.

*Include Canadian mutual funds, Canadian ETFs, and foreign ETFs focused on Canadian equities

Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 16: Foreign Investors Also Selling Canada



Source: Scotiabank GBM Portfolio Strategy, Bloomberg, Statistics Canada.

Quant Large Caps List

Our usual TSX Top-30 quant list contains several small and mid cap names that could be hard to buy for large foreign institutional investors. Hence, earlier this month, we published a modified version, which picks its Top 30 names only from the 120 largest TSX Composite companies. In terms of selection universe, this makes it much more in line with the MSCI Canada benchmark.

Exhibit 17: SQoRE Canada Large Caps Top 30 List

As at Feb. 26, 2021 Selection Universe: 120 Largest TSX Companies			SQoRE Percentile (Higher = Better)			SQoRE Percentile by Factor			
Sector	**Ticker**	**Company Name**	**Now**	**1M Ago**	**3M Ago**	**Value**	**Growth**	**Momentum**	**Quality**
Energy									
	TOU	Tourmaline Oil	89	83	98	72	80	89	38
	CNQ	Canadian Natural Resourc	82	81	62	66	79	78	24
	IMO	Imperial Oil	81	80	43	90	77	76	6
Materials									
Chemicals									
	(None)								
Metals & Mining									
	FM	First Quantum Minerals	98	99	96	49	97	97	20
	LUN	Lundin Mining	94	90	77	47	82	93	62
	IVN	Ivanhoe Mines	90	91	78	20	41	96	46
	TECK/B	Teck Resources	87 ↑	66	70	98	72 ↑	91	12
	FR	First Majestic Silver	86	70	0	16	62	88	42
Lumber/Packaging									
	WFG	West Fraser Timber	99	99	99	56	99	96	66 ↑
	SJ	Stella-Jones	83	86	90	55	72	79	79
	CCL/B	CCL Industries	78	69	68	26	55	83	90
Industrials									
	FTT	Finning	85	67	53	51	31 ↑	90	77
	TFII	TFI	84	88	91	22	85	77	83
	CP	Canadian Pacific Railway	77	83	89	30	48	63	99
	TIH	Toromont Industries	70	72	82	27	39	69	99
	WSP	WSP Global	67	78	55	14	45	58 ↓	94
	STN	Stantec	64	60	79	30	44	73	96
Discretionary									
	MG	Magna	95	89	86	63	91	86	70
	DOO	BRP	94	94	75	25	89	94	51
	CTC/A	Canadian Tire	80	82	83	61	75	73	59
Staples									
	EMP/A	Empire	72	74	80	52	91	55	71
Health Care									
	(None)								
Financials									
Banks									
	BNS	Bank of Nova Scotia	79	72	54	84	62 ↑	67	85
	NA	National Bank of Canada	78	72	76	72	72	70	89
	CM	Canadian Imperial Bank o	75	64	65	87	49 ↑	72	76
Div. Financials									
	(None)								
Insurance									
	MFC	Manulife Financial	83	78	62	92	85	57	62
	IAG	iA Financial Corp	73	60	66	91	88	45	55
Technology									
	LSPD	Lightspeed POS	85	85	21	0	60	100	15
	SHOP	Shopify	68	63	67	6	35	88	80
Communication									
	(None)								
Utilities									
	H	Hydro One	60	67	79	61	40	29 ↓	91
Real Estate									
	FSV	FirstService	71	73	84	15	73	71 ↑	86

Note: Shaded names highlight new additions to the Top 30.

Source: Scotiabank GBM Portfolio Strategy.

Appendix A: Important Disclosures

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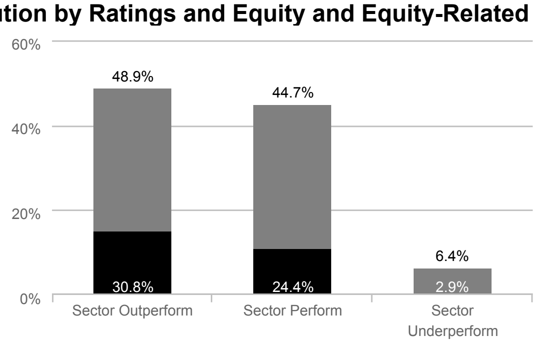

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