THORNMARK ASSET MANAGEMENT INC.
PERSPECTIVE
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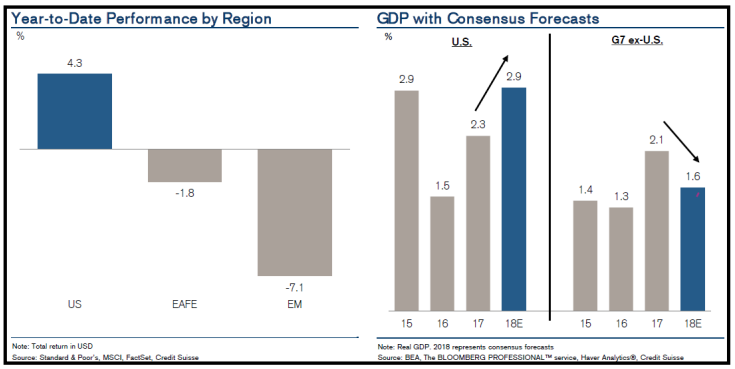
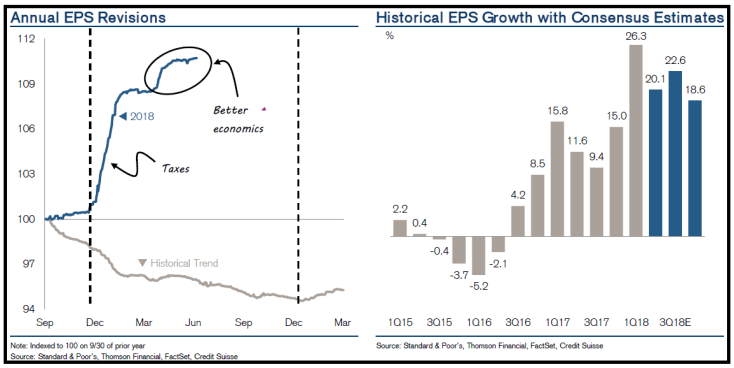
SYNCHRONIZATION YIELDS TO REGIONAL DIVERGENCE & U.S. ACCELERATION

Daniel L. Bain
Chief Investment Officer

The Goldilocks economic environment was fun while it lasted. It provided a strong boost, lifting global equity markets in virtually all regions over the past year. While the global expansion remains generally synchronized, with most economic regions expanding, a divergence is emerging between high and low growth regions. North America is leading both EAFE (Europe, Australasia and the Far East) and EM (emerging market) in 2018. As shown in the upper chart on this page, courtesy of Credit Suisse, regional market performance is reflective of underlying economic trends. Excluding the U.S., G7 GDP is forecast to remain positive in 2018 but will decline from 2.1% to 1.6%. Conversely, U.S. GDP is expanding from 2.3% to 2.9% (with room for final results to exceed consensus). As a result, our analysis this quarter focuses on North America.





MARKET DYNAMICS

The first six months of the year saw a strong opening rally, followed by a swift and meaningful correction, only to see the market gradually rebound again. In Canada, the S&P/TSX Composite Index was up 6.7% in the second quarter. Performance was dominated by energy (benchmark oil WTI was up 14% in Q2 – see our security note below on Husky Energy), healthcare (cannabis stocks rallied into the receipt of Royal Assent for Bill C-45, the Cannabis Act), technology (broad performance across all but one securities) and industrials. In the U.S., the S&P 500 was up 3.4% (U.S. dollars), similarly led by energy, consumer discretionary (led by mega-cap retailer Amazon – see our security note below) and technology (including our investments in Adobe, Alphabet, Apple and Facebook). As we discuss below, accelerating growth supports further stock market gains in the second half of the year.

ECONOMIC FUNDAMENTALS

The stock market rebound was well justified as economic momentum accelerated in North America. In the face of low but rising interest rates and rising oil prices, employment, wages, ISM Manufacturing PMI, retail sales and corporate earnings are all trending positively. At the same time inflation remains tame, for now. We don't expect CPI to increase materially before the New Year. Therefore, the pace of central bank rate increases remains measured (as opposed to reactionary).

As shown in the lower chart on this page, positive economic trends are driving corporate earnings higher. Normally earnings estimates decline as the year unfolds. However, under the Trump Twitter administration, nothing is normal. However, not normal has been good for business. While there seems to be a serious imbalance between fiscal and social policy, deregulation, tax cuts, fiscal stimulus and the potential for better trade terms all bode well for earnings. Indeed, earnings are legitimately coming in better than expected and the earnings backdrop is very positive. With no recessionary indicators within our investment horizon, earnings will drive stock markets higher. Therefore, tactical investment strategy is to remain fully invested, with a strong skew away from fixed income and cash, in favour of equities.

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SECURITY COMMENTARY

Husky Energy, a high growth, diversified, large-cap Canadian oil and gas company with international operations, was added to portfolios during the quarter. Husky's attractive energy portfolio earns premium pricing compared to peers. While peers often struggle to get their oil to increasingly competitive international markets, Husky has strategic pipeline contracts in place in Western Canada to avoid transportation bottlenecks plaguing other companies and can cheaply transport oil from its China and East Coast Canada operations. It also owns five refineries that process oil into higher value products that are more easily transported and benefit when there is a wide gap between international Brent prices and Western Canada Select pricing. Investor reaction to a Husky refinery explosion in April was swift but misguided, creating a tactical opportunity to buy Husky. The resulting 9% stock price decline was worth more than the entire value of the damaged refinery. With business interruption insurance in place, the Husky sell-off was non-sensical and a good buying opportunity for the well-run company. Since the sell-off, Husky's stock price is up 17%. Regardless, it still trades at a meaningful valuation discount to its peers. This discount is expected to narrow, providing a further boost to the stock price. Husky has one of the industry's strongest balance sheets with room to add leverage. Future production growth is strong and is less dependent on large projects and more focused in its low-cost Lloyd operations. In the past they have overpromised on targets but that no longer seems the case with its growth out to 2022 based on very conservative assumptions (like $45 oil) and it has refined its drilling technique in Lloyd that is now easily replicable. Our price target of $22 assumes a 2018 FCF yield of 10%, narrowing from the current 14% FCF yield, which conservatively assumes a modest discount to its peers at 8%. Eventually Husky's valuation should trade to through the peer average but that remains the opportunity beyond our investment horizon.

Amazon, the e-commerce and cloud computing giant, once the world's biggest bookstore has grown into the world's biggest everything store. Amazon's retail business (55% of profits) offers over 600 million products at competitive prices, fast shipping, friendly customer service, and extra perks for its 64 million Prime members. With significant penetration, more Americans have Prime memberships than vote in U.S. elections or go to church. Amazon's cloud computing business, the most dominant in the industry, generates 45% of profits with a $350bn valuation, provides file storage on industrial servers. While Amazon's valuation may appear high at 140x P/E or 30x EV/EBITDA on this year's earnings, this ignores its growth potential and new business opportunities. Sales should increase by 20%+ per year for a while since all online sales in the world only represent 12.5% of all retail purchases compared to 16% in the US. Also, Amazon is underpenetrated outside the US with a 9% market share compared to 34% in North America which should improve as they expand beyond the 17 countries Prime is available in. It also has opportunities to expand sales in North America with new business segments (pharmacy, delivery), growth in its Alexa/Echo products which automate the home and focusing on its advertising business which only represent 3% of total revenue compared to 33% for Alibaba (and analysts expect to grow from $7bn to $22bn in five years). Its margins will improve with time as well from 3% today to closer to 10% given its operating leverage. For instance, R&D spend is currently 13% of sales or $24.6bn total which is probably more than its retail peers combined and will likely start approaching the ratio of mature tech companies at 5-10%. Our target is $2100 for a total potential return of 21% since revenue growth should outpace street estimates and over a medium time frame profit margins should beat as well. Our price target is 27x's EV/EBITDA on next year's earnings. We believe this is reasonable given Amazon's EBITDA growth is expected to exceed 30% for the foreseeable future, with free cash flow growing from $10 billion today to $80 billion over the next decade. Amazon is therefore forecast to generate a staggering $500 billion in cash during the next ten years, over half it's current market capitalization.

Phone: 416-204-6200 Toll: 877-204-6201 E-mail: info@thornmark.com