marnoa PRIVATE WEALTH

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Insights – AI The Revolution is Real

By Pedro Ribeiro, CIM®, FCSI® – Portfolio Manager and Cross-border Advisor

Nothing New on the Macro Front

Not much has changed from a macro-economic perspective. Investors and consumers continue to wait for rate cuts from central banks, but inflation remains stubborn delaying any short-term rate reduction. In fact, bond yields have risen since the beginning of the year making it more challenging for those renewing or applying for a mortgage.

My view is that we will only see rate cuts when inflation falls to the target rate and central bankers are confident it will remain there has not changed—or the economy hits a wall. In Canada, this scenario is more likely than in the United States, in my opinion.

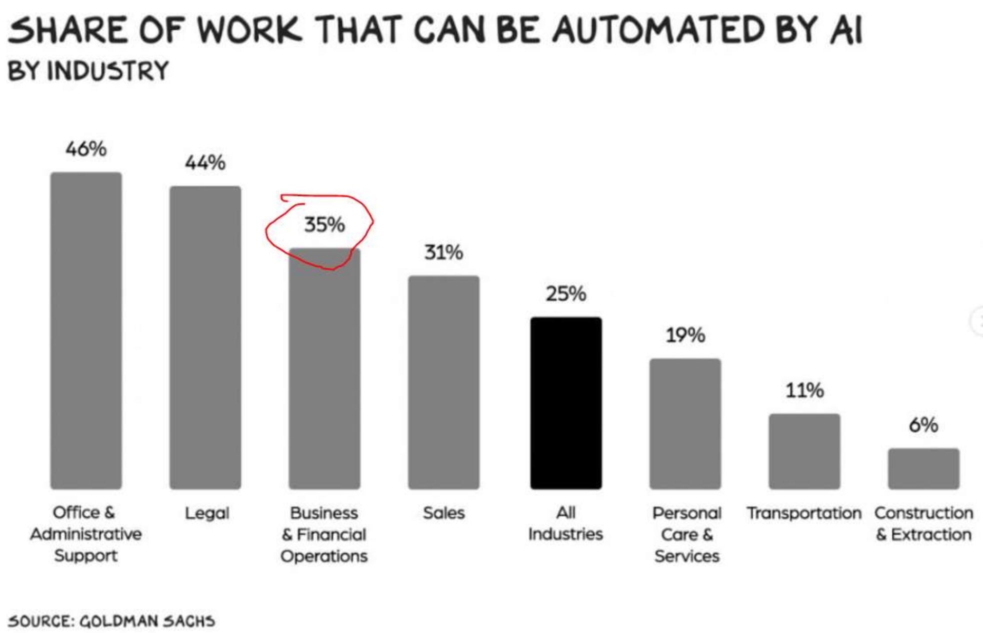
From a corporate earnings perspective, our businesses continue to do well. Later in this letter, Christopher summarizes some of our widely held positions.

The Revolution is Real

The artificial intelligence (AI) revolution is real and may be bigger than the internet. Based on the chart below from Goldman Sachs, the industry to be the least impacted is also one facing some of the largest labor shortages. This stat caused me to recently post on LinkedIn that parents should encourage their kids to learn a trade. However, the trades remain one of the least popular career choices. It's unfortunate in my opinion, but perhaps a huge opportunity for tech savvy entrepreneurs willing to focus on this field.

At this time, most of the population does not work with or give much thought to artificial intelligence. However, that will drastically change over the next 10 years or even sooner if AI continues to advance as fast as it has.

The employment fields to be most impacted are "white collar" jobs. Even the field I have chosen has seen and will continue to experience drastic changes. Unseen to our clients is how AI has already been implemented in our day-to-day processes. And projects underway when launched will assist in improving our service level and workflow.



The impact of artificial intelligence (AI) on the average person over the next 10 years is expected to be profound and multifaceted. AI is poised to revolutionize various aspects of daily life, shaping how individuals work, learn, communicate, and interact with technology.

Love it or hate it, AI is here. Our role is to determine how it may impact our client's portfolio's and how we can benefit from it. When looking over your statements you may not immediately recognize any AI names, but some of the holdings in our portfolios are leading the AI revolution.

Portfolio Changes

In February, the following portfolio changes were made:

- We purchased iShares Core S&P 500 Index ETF (XSP) and iShares S&P/TSX 60 Index ETF (XIU) in the Conservative portfolio model.
- We purchased Nvidia (NVDA) in the Growth portfolio model.

Below are brief summaries on a few of the holdings in our portfolios.

Written by Christopher De Sousa, CIM® | Associate Portfolio Manager | www.marnoa.ca

Canadian Natural Resources

Canadian Natural Resources (CNQ) is a crude oil and natural gas exploration, development, and production company, with operations in Western Canada, the U.K. portion of the North Sea and Offshore Africa.

CNQ achieved record quarterly oil and natural gas production in Q4 and record production in 2023. Annual production in 2024 is now estimated to range between 1.33-1.38 million barrels of oil equivalent per day, an increase of ~2% from 2023 levels. Operating costs continue to moderate across the business resulting in a high degree of operating leveraging. CNQ is executing very well from a cash flow point of view. In 2023, free cash flow was $6.9 billion after dividend payments and capital spending.

CNQ achieved its $10 billion net debt level and will now target to allocate 100% of free cash flow (after growth capital and M&A) to shareholders through dividends and share buybacks. This capital program is expected to build momentum in the second half of this year as the Trans Mountain Expansion (TMX) project is targeting to be in service in the second quarter of 2024. CNQ has committed to shipping 94,000 barrels per day for 20 years on Trans Mountain—an additional stream of revenue and cash flow.

CNQ has a significant reserves base underpinned by a low-cost structure. Total proved plus probable reserves have a life index of 43 years. What this means is CNQ has enough oil reserves that can last over 40 years if the company maintains its current production rate and if there were no additions to reserves. Furthermore, CNQ has one of the lowest WTI breakeven prices among industry peers in the mid-30s per barrel (vs. industry average >$50 per barrel). The combination of a significant reserve base and a low operating cost structure has helped CNQ deliver superior returns over the years.

Subsequent to quarter-end, CNQ announced a 5% increase to its dividend and plans to split the company's shares on a two to one basis.

Microsoft

Microsoft continues to outperform and deliver outstanding results. Revenue and earnings were up 18% and 33%, respectively, for the quarter ending Dec 31. Microsoft's revenue from its Azure cloud platform rose 30% as the company integrates AI technologies across every layer of the company's tech stack.

Azure is rapidly gaining market share in the cloud services market. This is evidenced by the growing number of customers migrating workloads to the Azure platform. Microsoft is securing more substantial and strategic contracts for Azure, with a growing number of new and existing customers making Azure commitments exceeding a billion dollars. Azure AI currently serves 53,000 customers, with one-third of them having joined Azure for the first time in the past year.

Microsoft is in the very early days of monetizing AI across its Azure and Office platforms. The early adoption and monetization of Microsoft 365 Copilot, in particular in the commercial market, has been promising to Azure's growth and conversions from Office 365. There is strong enterprise demand for AI-related workloads and services. We expect demand to remain elevated and drive better-than-expected growth in long-term Azure contracts.

AI represents a new technology category that holds significant earnings potential for Microsoft, but it will require time for enterprise customers to fully utilize this technology on a large scale as many are still in the process of modernizing their tech stacks with new cloud computing infrastructures.

In our view, Microsoft is well-positioned to deliver double-digit sales and earnings growth through the next five years as it gains market share and benefits from a multi-year AI investment cycle.

Apple

Apple reported revenue and earnings growth of 2% and 16%, respectively, for the quarter ending Dec 31. Sales were driven by strength across iPhones (+6%) and services (+11%). The higher margin services business set record sales in advertising, cloud services, and payments. Paid subscriptions (e.g., Apple TV+, iCloud+, Apple Music, etc.) exceeded 1 billion and continues to grow in the double digits. Apple's installed base of active devices is over 2.2 billion, which establishes a strong foundation for the future expansion of the services business.

The subject of generative AI has been gaining considerable attention lately. Interestingly, Apple is rarely brought up in these conversations. We think Apple is an underappreciated AI beneficiary that could benefit from integrating large language models (i.e., deep learning algorithms and large data sets used to understand and generate new content) into their technologies. Apple expects to reveal and discuss their generative AI products later this year. Like Microsoft, we believe Apple could integrate AI around their ecosystem to add more functionality and use-cases to their products, especially the iPhone.

The ability to run AI-enabled prompts on new AI-enhanced iPhones could potentially shorten the replacement cycle (currently ~40 months) as users upgrade to the new device. The last two iPhone "super cycles" occurred in 2014 when Apple first introduced the iPhone with a larger screen, and in 2020 when Apple introduced the first iPhone with 5G connectivity. The next cycle could be driven by AI in our view.

Apple has traditionally been a consumer-focused company, but now with the company's latest innovation, the Vision Pro, we see the company making inroads into the enterprise market. Vision Pro is Apple's first new product category since it launched the Apple Watch in 2015. We see a substantial opportunity for Vision Pro, and spatial computing as a whole, in various industries such as manufacturing, health care, and entertainment. While still in its infancy, immersive technologies like Vision Pro could revolutionize our entertainment experiences (e.g., sitting courtside at a basketball game) and the way we communicate and collaborate at work.

There are a number of interesting developments at Apple that could unlock upside to sales and earnings which we will be monitoring closely.

Amazon

In the latest quarter, Amazon reported strong revenue acceleration across retail, AWS, and advertising and record-high operating profits (and the second highest operating margins). All in all, Amazon had a great year, with net sales rising 12% to $574.8 billion and operating profits growing 3x to $36.9 billion in 2023.

Retail: Amazon is delivering orders to customers much quicker and at a lower cost. In 2023, Amazon reduced its cost to serve on a per-unit basis globally for the first time since 2018. Amazon has been overhauling its logistics network to regionalize its fulfillment to reduce delivery costs while maintaining fast shipping speeds. As a result, operating profit margins for Amazon's North American retail business rose to 6.1%, just shy of its pre-pandemic record high of 6.4% in Q1 2019.

Ads: Amazon's ad business is re-accelerating, growing 26% in Q4 (vs. 22% in Q2 and 25% in Q3). The growth was primarily driven by the launch of Prime Video sponsored ads, which is a new stream of high-margin incremental revenue. The advertising business is on the cusp of reaching a $50 billion annual revenue run-rate (growing at a rate of mid-20%). In 2024, we expect Amazon's Prime Video ad inventory to attractive global advertisers, especially as AI tools enhance targeting and audience segmentation.

AWS: Amazon's AWS cloud division has seen a quarter-to-quarter acceleration, with a growth rate of 13% compared to 12% in Q3, and an operating profit margin of approximately 30%. AWS is nearing an annualized revenue run rate of $100 billion. Current customers are renewing their AWS cloud contracts with increased commitments over longer periods. Similar to Microsoft, the backlog at AWS indicates a growing trend of customers transitioning and introducing new workloads to the cloud. Amazon projects that the annual recurring revenue related to generative AI will escalate to "tens of billions of dollars" in the coming years.

We expect the accelerating trends across Amazon's major segments to continue through 2024.

As always, please do not hesitate to reach out, should you have any questions or wish to discuss any matter in further detail.

Yours truly,

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Performance as of February 29, 2024

Gross performance results as of February 29, 2024 for our discretionary model portfolios are as follows:

	Performance Summary (%) as of February 29, 2024								
Portfolio Mandate	3 months	6 months	9 months	Year-to-date	2023	2022	2021	2020	2019
Marnoa Strategic Allocation	5.91	7.15	10.84	3.07	10.54	-12.70	12.38	18.01	15.78
Marnoa Conservative	2.42	3.72	3.85	1.31	5.69	-12.05	10.86	9.90	19.86
Marnoa Moderate	5.86	8.25	11.53	3.97	12.35	-13.55	12.92	20.79	25.52
Marnoa Growth	10.09	12.82	18.28	7.66	19.28	-17.26	15.00	29.74	28.70

The returns above are gross of fees. Individual performance may vary based on cash flows and fees. Performance figures for periods greater than 1-year are annualized. The performance data quoted represents past performance. Past performance is no guarantee of future results.

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The returns presented are gross of fees. Individual performance may vary based on cash flows and fees. Performance figures for periods greater than 1-year are annualized. The performance data quoted represents past performance. Past performance is no guarantee of future results. The above performance data is current as of February 29, 2024.

Inception date is January 1, 2019 for Marnoa Strategic Allocation, Marnoa Conservative, Marnoa Moderate, and Marnoa Growth.

Generally, mandates with higher returns entail higher levels of risk. Investors should consult with their advisor prior to making an investment decision to help ensure their investments are suitable for their particular situation.

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