February 20, 2024

Insights – Predict, Revise and Repeat

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

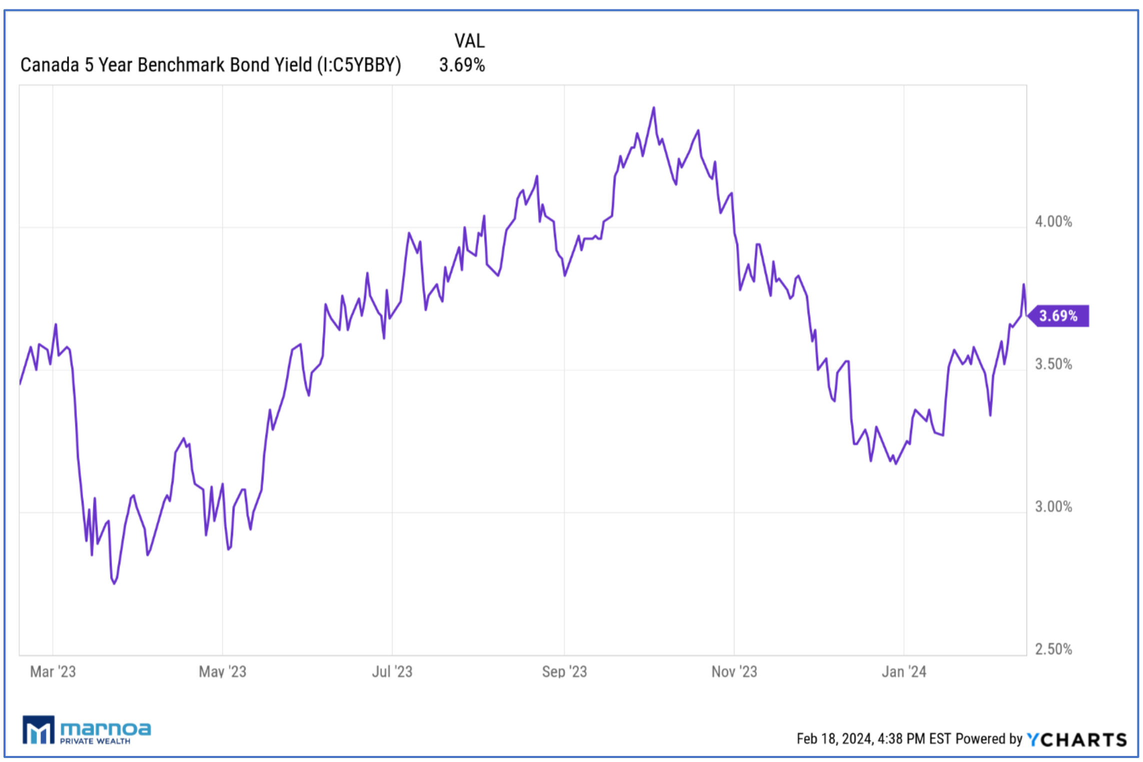
Predictions Are Worthless

Predictions related to the economy, interest rates or pretty much anything economic based from so called professionals seem to be as accurate as the 7-day weather forecast on my phone's weather app.

Towards the end of 2023 and going into 2024, the consensus was that central banks would start cutting interest rates as early as March of this year. Well, we are more than halfway through February and those predictions are now being pushed out into July.

My opinion (for whatever it is worth) is that neither the Bank of Canada or the Federal Reserve, will start to cut rates until it is crystal clear that inflation is under control, or the economy hits a wall. And, when it comes to the Bank of Canda, I believe hitting a wall or rolling over a cliff is what it will take.

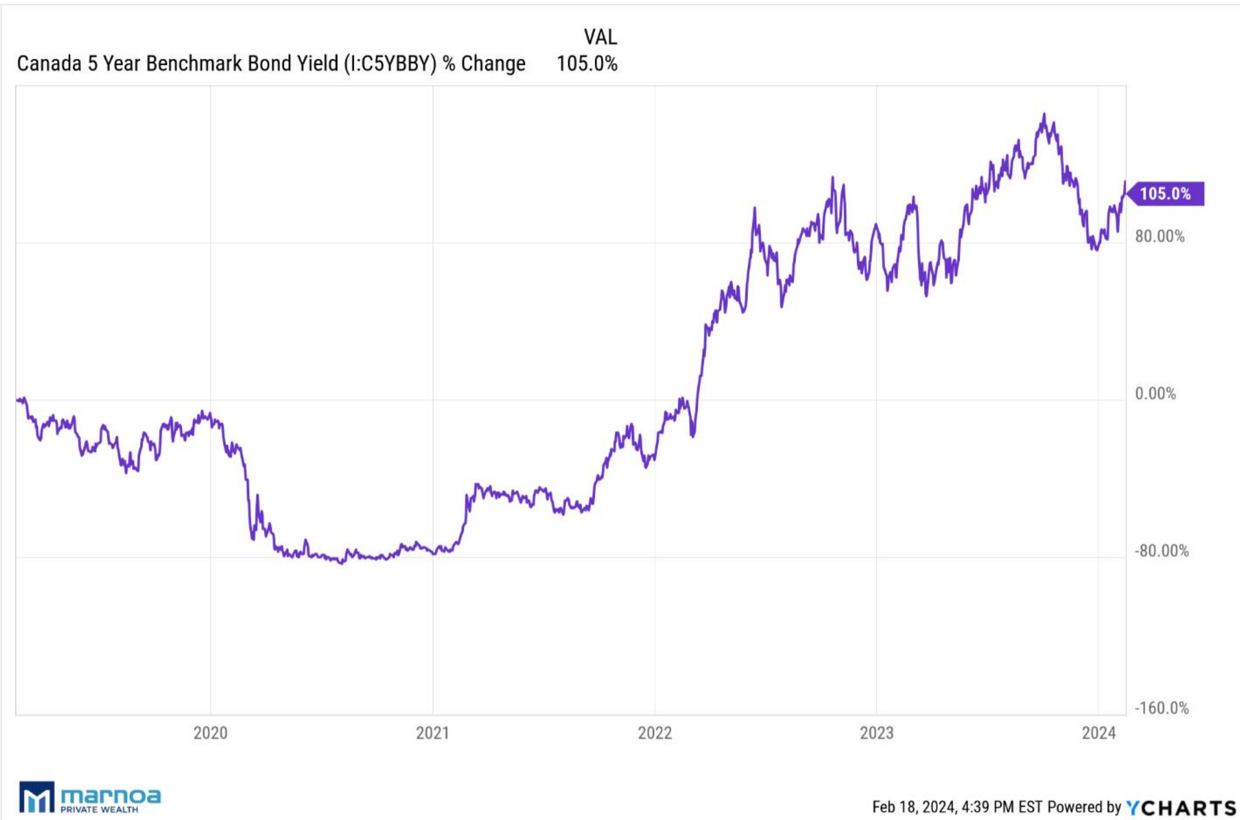
The latest CPI numbers in the United States made it clear the economy is doing just fine, which reinforces my view that the Federal Reserve will be in no hurry to lower rates. As a result, U.S. bond yields have been trending higher recently. Canadian bonds are reacting in a similar fashion.



The chart above illustrates the 5-year benchmark bond yield over the last twelve months. I illustrate this as it has a direct impact on 5-year mortgage rates, which is the most common term for Canadian mortgage holders. We can see yields peaked in October 2023 and started declining towards the end of the year. This was based on the view that rates would be cut in early 2024.

However, the chart clearly illustrates how rates have reversed and are in a short-term uptrend as of January 2024.

Below, I illustrate the percentage change in the 5-year benchmark bond yield over the last five years. This is important due to the shear number of mortgages renewing this year and next. Mortgage holders with 5-year terms renewing today are facing a renewal rate 105% higher than the current rate they are in.



Based on a recent conversation with a mortgage specialist, I was floored to learn that some Canadian lenders offered "static payments" on variable rate mortgages. To keep things simple, this means as the variable interest rate increased, the mortgage payment stayed the same. The result is the payment has not even covered the interest cost of the mortgage. This means interest has been added to the original principal and some amortizations are now as long as 99 years. Does anyone see the wall coming?

Not All Walls Are Created Equally

If inflation forecasts were based strictly around increasing mortgage payments and the impact they may have on real estate values, I could see why consensus calls for lower rates sooner rather than later. However, not all Canadians and Americans may be heading towards the same wall (nothing immigration related).

Historically, higher rates would directly impact the labour market. However—and I believe this is being overlooked—both the Canadian and American labour market is much different today than it was in the 1980's and 1990's when we went through the previous rate rise cycle.

Between 2010 and 2022:

- the population of Canada grew from approximately 33.9 million to 39.3 million (an increase of 15.9%) and
- the number of federal public servants increased from 282,980 to 335,957 (an increase of 18.7%).[1]

Public sector employees are the fastest growing segment of the labour market. Based on data from the Government of Canada web site, federal public servants increased by 18.7% between 2010 and 2022 and the total public sector employees increased another 4.1% from January 2023 to January 2024.

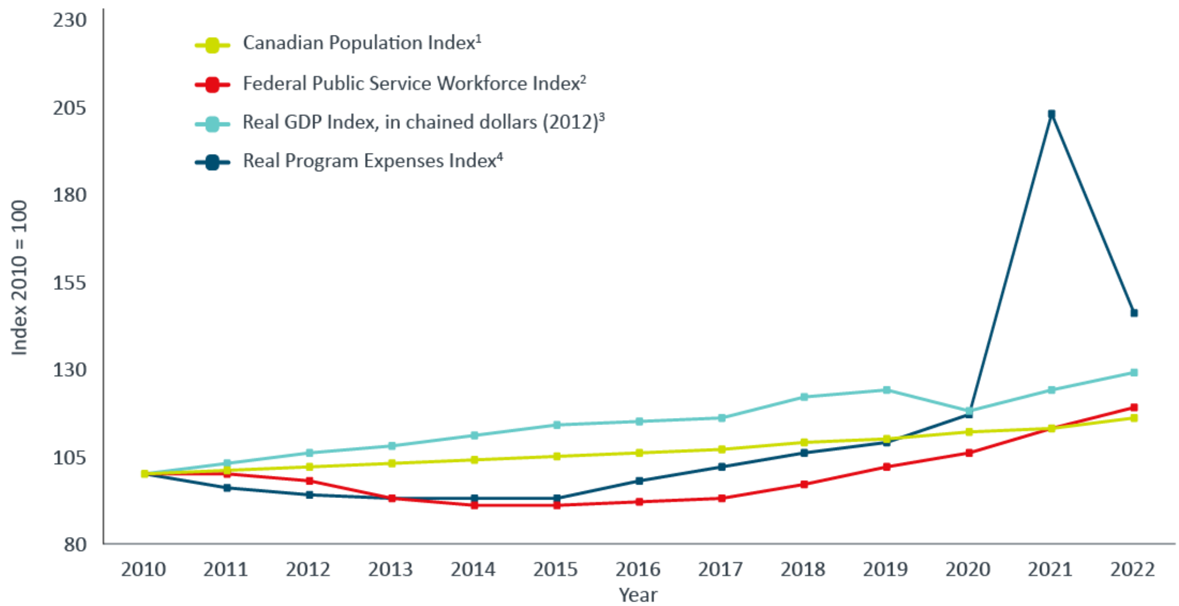
	December 2023	January 2024	Standard error 1	December 2023 to January 2024	January 2023 to January 2024	December 2023 to January 2024	January 2023 to January 2024
	thousands	thousands	thousands	change in thousands	change in thousands	% change	% change
Class of worker							
Employees	17,680.9	17,735.9	36.7	55.0	384.0	0.3	2.2
Public sector employees	4,330.4	4,378.0	19.8	47.6	174.4	1.1	4.1
Private sector employees	13,350.5	13,357.9	35.7	7.4	209.6	0.1	1.6
Self-employed	2,644.0	2,626.3	23.5	-17.7	-38.7	-0.7	-1.5
Total employed, all industries	**20,324.9**	**20,362.2**	32.1	**37.3**	**345.2**	**0.2**	**1.7**

Source: StatCan [LINK]

As a result, we now have a much larger percentage of the population with potentially much greater job security. This makes it difficult for the Bank of Canada to increase unemployment which in turn would put downward pressure on inflation.

[1] Government of Canada [LINK]

In fact, the Federal Public Service workforce is now growing faster than the Canadian population.



Source : Government of Canada [LINK]

Portfolio Changes
There were no new additions to our portfolios during January.

Below are brief summaries on a few of the most recent additions to our portfolio.

By Christopher De Sousa, CIM® – Associate Portfolio Manager

DANAHER

Danaher indicated that some of their biopharma customers have returned to normal ordering patterns for instruments and consumables. This is supported by the 20% quarter-to-quarter uptick in customer orders in Q4. Nevertheless, Danaher has not yet seen a widespread inflection in demand.

Inventory destocking remains to be a drag on the bioprocessing business. Customers are still working though inventories accumulated during the pandemic. Concurrently, emerging biotech firms continue to conserve capital. But the recent downward trajectory in interest rates suggests an impending improvement in biotech spending and VC funding. This bodes favorably for tool suppliers such as Danaher.

Danaher expects destocking in North America and Western Europe will be mostly completed by the second half of 2024. Book-to-bill remains in the 0.8-0.85x range but is expected to modestly step-up to 0.9x or higher in the latter half of 2024. Bioprocessing sales in the first half of the year are projected to look similarly to the second half of 2023—down mid-to-high teens. And then reaccelerate to mid-to-high single digit growth in the second half of 2024—followed by high-single digit growth or better as they exit 2024 and head into 2025.

We believe the negative destocking trends are temporary setbacks. In our view, it does not impact the long-term growth profile of the company or the large secular growth opportunities (e.g., gene and cell therapy) in the biopharma market. Last year saw a record number of FDA approvals for biologic and genomic medicines and the drug development pipeline is significantly more robust than at any previous point in history, according to Danaher CEO Rainer Blair.

(You can read our latest research on Danaher on our website here.)

LVMH Moët Hennessy Louis Vuitton

LVMH, the owner of luxury brands Louis Vuitton and Christian Dior, reported organic sales and net profit growth of 13% and 8%, respectively, in 2023. We maintain the view that LVMH will continue to deliver industry leading sales and profit growth in 2024 against the backdrop of normalizing global luxury growth. Over the last 35 years, LVMH has delivered an average organic sales growth of 9.1%. LVMH chairman and CEO Bernard Arnault stated that LVMH intends to maintain that growth rate over the long-term.

We continue to see broad strength across the group's portfolio of brands. Louis Vuitton, Christian Dior, Celine, Fendi, Loro Piana, Loewe, and Marc Jacobs, all gained market share and achieved record levels of revenue and profits. LVMH reported double-digit organic sales growth in Europe (+13%), Japan (+28%) and the rest of Asia (+18%). While the U.S. saw organic sales growth (+4%), there was "softness" in luxury demand, and that particularly showed in sales in Q2 (down 1%) and Q3 (up 2%). What's promising is the reacceleration in Q4 (+8%) with Sephora being a key contributor (+76%).

LVMH addressed concerns around the "slowdown" in Christian Dior's growth rate. Christian Dior is still growing low double-digits after more than tripling in size over the past seven years. LVMH simply cannot keep up with the demand, and as a result, has restricted orders on certain items (e.g., Dior dresses). In our view, the slowdown is deliberate to focus on maintaining the brand's desirability for the long-term. LVMH and other luxury brands such as Hermès employ such strategies to preserve their brands. Too much of something in the marketplace can dilute the desirability and brand equity.

In a call with analysts, Bernard Arnault highlighted that "growth must not be a goal. The goal is desirability. People must desire the brand, whether it's for Dior or other brands in the Fashion & Leather division. It's good to generate growth… But we've reached a stage such that we no longer need to have such high growth, and between 8% and 10% is perfect. We do more at [Louis]Vuitton too, but the goal isn't to generate growth at all costs." We remain upbeat on LVMH and the luxury sector in 2024.

(You can read our latest research on LVMH on our website here.)

ELI LILLY

Did you know that about 74% of adults in the U.S. are overweight? According to the U.S. Centers for Disease Control and Prevention (CDC), that includes nearly 43% who are considered obese. In Canada, about 65% of adults are classified as overweight, with 30% of this group falling into the category of obesity. Obesity has become a global epidemic, leading to increased cardiovascular problems (e.g., heart disease, stroke, and heart attack), type-2 diabetes, some types of cancers, and reduced quality of life in general. Obesity costs the U.S. healthcare system about $173 billion annually.

Demand has been very robust for Eli Lilly's diabetes drug Mounjaro and obesity drug Zepbound—so much so that demand for these GLP-1 drugs continue to outstrip supply. In 2023, Mounjaro brought in sales of over $5 billion with solid sequential growth as more type-2 diabetes patients gain access to the drug. Following FDA approval in November, Zepbound launched in U.S. pharmacies in early December, generating fourth-quarter sales of $176 million. In 2024, Eli Lilly forecasts revenues to range from $40.4 billion to $41.6 billion, indicating an approximate 20% increase from the midpoint of this guidance. Mounjaro and Zepbound are expected to be meaningful contributors to long-term revenue and profit growth as they scale globally.

Eli Lilly stated that in the future, oral drugs, like orforglipron, will be key to supplying obesity and diabetes treatments at scale to satisfy global demand. The reason being is that oral capsules are easier to manufacture because of the less complicated nature of small molecule drugs compared to large molecule drugs (like Mounjaro and Zepbound). Orforglipron is a once-daily oral GLP-1 that is undergoing Phase 3 trials for the treatment of obesity and type-2 diabetes.

Eli Lilly has a solid pipeline of drugs in Phase 3 clinical trials—the most in the company's history—with approximately 110,000 patients enrolled collectively. For example, some of the Phase 3 studies include the use of GLP-1s to treat sleep apnea and heart failure. Others include Phase 3 studies for donanemab, a monoclonal antibody for treating early Alzheimer's disease, and lebrikizumab, a monoclonal antibody for treating eczema.

We think the growth runway for Eli Lilly is wide and long.

CANADIAN PACIFIC KANSAS CITY

CPKC is the combination of two railways—Canadian Pacific and Kansas City Southern—creating the first and only single-line transnational rail network that connects Canada, the U.S., and Mexico with access to ports and energy hubs on the Atlantic, Pacific and Gulf of Mexico.

While CPKC still remains the smallest of six U.S. Class 1 railroads by revenue, the combined company is operating a larger and more competitive network spanning 20,000 miles of rail in North America. We believe CPKC has the most attractive growth of the Class 1 railroads, with long-term (2024-2028) guidance calling for revenue to grow high single-digits and earnings per share to grow double-digits over the same 5-year period. CPKC has identified ~$5 billion in new revenue opportunities to support this growth, including route conversions (single-line hauls vs.

connecting lines), truck-to-rail conversions (~1.8 million miles addressable truck market), and domestic near-shoring as businesses look to reduce their reliance on distant suppliers such as China.

It has been less than a year since CP and KCS combined on April 14, 2023. CPKC is still in the early stages of unlocking value from the revenue and cost synergies from KCS. CPKC is currently repricing a portion of CP and KCS contracts that were not renewed during the period of higher inflation in 2022 and 2023. These pricing actions, in addition to volume growth and KCS synergies, are expected to improve CPKC's operating ratio in 2024. In the railroad business, the operating ratio is a measure of profitability that compares operating expenses to net sales. The lower the ratio, the more efficient and profitable the railroad.

Securing direct access to Mexico—one of the world's major automotive hubs—represents a huge win for CPKC's automotive business. Prior to the merger, CP was responsible for transporting vehicles over a distance of 100 to 200 miles to Detroit. From there, the cargo was transferred to rival American railroads, who would then carry out the remainder of the journey to Mexico. CPKC now has the capability to connect auto assembly plants and distribution centers to major hubs such as Mexico, Detroit and Ontario. Single-line hauls are just one of the many benefits from the CPKC transnational rail network. Furthermore, CPKC expects intermodal transit times to be more competitive than long-haul trucking alternatives.

Overall, we think the merger will create significant value for CPKC—but more importantly—the primary beneficiary will be the customer, who stands to gain considerable value.

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,

Pedro Ribeiro, CIM®, FCSI®
Portfolio Manager
519.707.0049

OUR TEAM		
PORTFOLIO MANAGEMENT	WEALTH MANAGEMENT	CLIENT MANAGEMENT
Pedro Ribeiro, CIM®, FCSI® Portfolio Manager RIA – Raymond James USA 519-707-0049	**Tracy Andrade, CFP®** Associate Wealth Advisor 519-707-0050	**Marci Paquete** Client Care Specialist 519-707-0051
Christopher De Sousa, CIM® Associate Portfolio Manager 519-707-0053	**Paul Thomas, CFP®, FMA®, CIM®, FCSI®** Financial Planner 519-707-0055	**Suzanne Ribeiro** Client Service Coordinator 519-707-0054

Performance as of January 31, 2024

Gross performance results as of January 31, 2024 for our discretionary model portfolios are as follows:

	Performance Summary (%) as of January 31, 2024								
Portfolio Mandate	3 months	6 months	9 months	Year-to-date	2023	2022	2021	2020	2019
Marnoa Strategic Allocation	8.81	3.75	6.58	0.72	10.54	-12.70	12.38	18.01	15.78
Marnoa Conservative	3.85	2.19	1.96	0.58	5.69	-12.05	10.86	9.90	19.86
Marnoa Moderate	5.75	6.24	7.14	1.14	12.35	-13.55	12.92	20.79	25.52
Marnoa Growth	8.12	8.60	12.05	2.08	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 January 31, 2024.

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

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