Horizons Active Cdn Dividend ETF (HAL)

Market Overview

The S&P/TSX Composite Index advanced 6.6% during the first quarter (Q1) of 2024. Industrials, Health Care, Energy, and Information Technology each outperformed the overall index during the quarter. Underperforming sectors were Communication Services, Utilities, Materials, Real Estate, Consumer Discretionary, Consumer Staples, and Financials, which faced headwinds during the quarter.

Global central banks held rates steady, contrary to market expectations at the beginning of the year. The expectation was that the Bank of Canada (BoC) would be among the first of the major central banks to lower rates, but this is now forecasted for mid-year. Canadian inflation dropped to 2.8% in February, while economic growth slowed slightly due to diminished consumer spending. On the other hand, the U.S. showed promising growth, despite the jolt felt by high interest rates.

Oil prices increased during the quarter due to supply cuts from OPEC+, calming concerns of excess U.S. production, and intensifying tensions in the Middle East. As economic growth has continued to slow, investor hopes for a 'soft landing' in Canada rest on the timing and pace of the Bank of Canada's interest rate cuts.

Quarter in Review

On a sector level, Energy was the largest contributor to relative performance as oil prices recovered. An overweight stance in the sector led to a positive allocation effect and positions in ARC Resources, Crescent Point Energy, and PrairieSky Royalty added a positive stock selection effect. An overweight in Industrials led to a positive allocation effect. In the Materials sector, a rebound in Altius Minerals and CCL Industries led to a positive stock selection effect. The mandate's underweight in the Real Estate sector contributed to the positive allocation effect.

In the Communications Sector, Telus and BCE had a negative stock selection effect, slightly offset by a positive allocation effect from an underweight stance in the sector. Other than the negative allocation effect from underweight in Financials, the sector saw big intra-sector dispersion this quarter as some stocks recovered from last year's weak performance. As a result, a negative stock selection effect came from underperforming stocks in the portfolio such as Toronto Dominion, Royal Bank of Canada and Great-West Lifeco. Financials was the only sector that underperformed.

The mandate added goeasy Ltd., a company which provides non-prime leasing and lending services through its easyhome, easyfinancial and LendCare brands. The company was rated "Buy" in our model, based on strong earnings growth and dividend growth. The mandate also bought Toromont Industries based on model conviction. Toromont is a major Canadian dealer of Caterpillar and other heavy machinery, which serves the specialized equipment and lifetime product support needs of customers in diverse industries from roadbuilding to mining and telecommunications to food and beverage processing.

Following the tax loss capturing trades in the fourth quarter (Q4) of 2024, the mandate re-established positions in the Energy sector through the purchase of Parkland Corp, a retail distributor of gas and fuel, Crescent Point Energy and Whitecap Resources, two upstream oil and gas exploration and production companies. Both names offered good valuations and suitable points of entry.

The trades were funded by Ovintiv on high volatility and Gibson Energy on behind-its-peers dividend growth potential. Ovintiv is an oil and gas exploration and production company operating in both the U.S. and Canada, and Gibson Energy is a downstream oil and gas refining company.

Outlook and Positioning

The Sub-Advisor has a core belief that successful asset management should be focused on three core pillars: Growth, Payout and Sustainability. For outlook and positioning, the Sub-Advisor will address each of these core pillars.

Growth — In positioning the portfolio to secular drivers of dividend growth, the Sub-Advisor believes consistent earnings growth is critical for predictable and sustained dividend growth. According to our research, earnings growth in Canada had a positive trend since February for the majority of the sectors this quarter. The Energy sector has the strongest dividend growth outlook, followed by consumer staples. The Sub-Advisor also sees a healthy growth forecast in both earnings and dividends for the Financial sector. Overall, Canada has the most robust dividend growth forecast, with all sectors targeting a year-over-year growth forecast of 5% to 10%. However, the Sub-Advisor does see moderation in dividend growth potentials in Utilities, Real Estate, Materials and Communications.

Globally, the Sub-Advisor sees the strongest revenue and cash flow growth from secular companies that are thematically driven, especially in the area of technology and industrial automation. Artificial Intelligence (AI) demand is certainly a tailwind, as well as continued chip re-shoring, and the implementation of AI into software-as-a-service (SaaS) companies in multiple industries. The Sub-Advisor believes that companies' adoption of AI can be transformed into positive earnings momentum and sentiment, and the Sub-Advisor's Machine Learning earnings prediction framework will help it capture the winners in AI adoption and earnings growth.

Overall, the Sub-Advisor continues to position and focus on companies with positive earnings growth coupled with strong dividend growth.

Notwithstanding the speculative nature of the Bank of Canada's (BoC) interest rate cycles, the Sub-Advisor is more positioned for secular dividend growth versus timing the U.S. Federal Reserve's (Fed) decision. Over the past 12 months, 100% of the companies in the portfolio have increased their dividends. Overall, Canadian earnings look resilient.

Payout — Despite a relief rally in high-yielding asset classes on dovish statements from the BoC in Q4, the Sub-Advisor focuses on dividend growth as the Sub-Advisor believes a yield for yield's sake approach results in a minimal broad upside capture amidst hidden downside risks. This is especially apparent in a higher-rate environment where credit quality is much more important. The BoC opted to leave its policy unchanged in its first two meetings of 2024, which was anticipated. "Higher for longer" rates have continued to put a strain on cashflows and dividend sustainability.

The Sub-Advisor believes that we continue to be in a phase when profitability, stability and safety need to be embraced, and the Sub-Advisor continues to focus on earnings and cash flow growth supporting dividend growth versus extraneous events.

Sustainability (cashflows) — According to the Sub-Advisor's research, regionally the Canadian probability of dividend cuts continues to be lower than in Europe or Asia. The probability of dividend cuts for Canada is between the U.S. and Europe. The forecasted probability of dividend cuts decreased further for Energy in Canada and the Sub-Advisor continues to stay overweight. Materials and Real Estate has the most elevated level of probability of dividend cuts.

The mandate is to overweight the Energy and Industrial sectors and underweight Financials, Consumer Staples, Real Estate, and Communication Services.

The Sub-Advisor believes the Energy sector still represents an evolved industry that focuses on shareholder yield and a sustained payout of dividends, followed by Industrials. In Financials, the Sub-Advisor sees opportunities emerging from Insurance and non-bank companies. On the other hand, challenges are prolonged in the Communications and Real Estate sectors as the companies are forced to adapt to further digital transition, in addition to the headwind of a high-interest rate environment.

The Sub-Advisor believes its AI-powered Growth/Payout/Sustainability model (GPS) offers a total return approach and the best of many worlds through owning companies that can continue to reward shareholders through dividends, buybacks and debt reduction, combined with careful consideration of stock and sector allocations by actual portfolio managers.

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