Sector Outlooks

THE 2025 PICTON REPORT

Industrials

Recently, we've seen industrials stocks waver as the market looks ahead to 2025. Erring on the side of conservatism, we have maintained a short exposure to relatively expensive multi-industrial/third-party logistics names, while also hedging cyclical long positions in broader secular themes. We are confident that the businesses we like – including those with cyclical exposure – will continue to meet our long-term return thresholds.

We continue to look for out-of-favour companies with a history of outsized growth, catalyst-driven idiosyncratic rerating angles and/or opportunities to improve structural returns on invested capital. Lately, we have been refocusing on Canadian airlines, given the valuation gap with their American counterparts, despite similar (if not better) fundamentals.

We've also spent more time on hazardous waste names exposed to growing infrastructure spending and onshoring. We remain bullish on the industrial leasing complex over the long term. We have hedged the cyclicality of rentals with less attractive names that have similar exposures.

More recently, we've also gained conviction regarding a couple of lumber-based product manufacturers and distributors. Finally, the merger and acquisition environment for serial acquirers continues to be quite favourable. Accordingly, we have shored up weightings in companies with a strong track record of acquisition and ample cash on hand.

Materials

Gold Market Dynamics

Gold continued its strong performance in October, rising to a peak of 2,790 USD per ounce due to continued geopolitical uncertainty coupled with dovish commentary from the U.S. Federal Reserve. This price momentum subsequently reversed following President-elect Donald Trump's larger-than-expected election victory, and a Republican sweep, which revived inflation concerns.

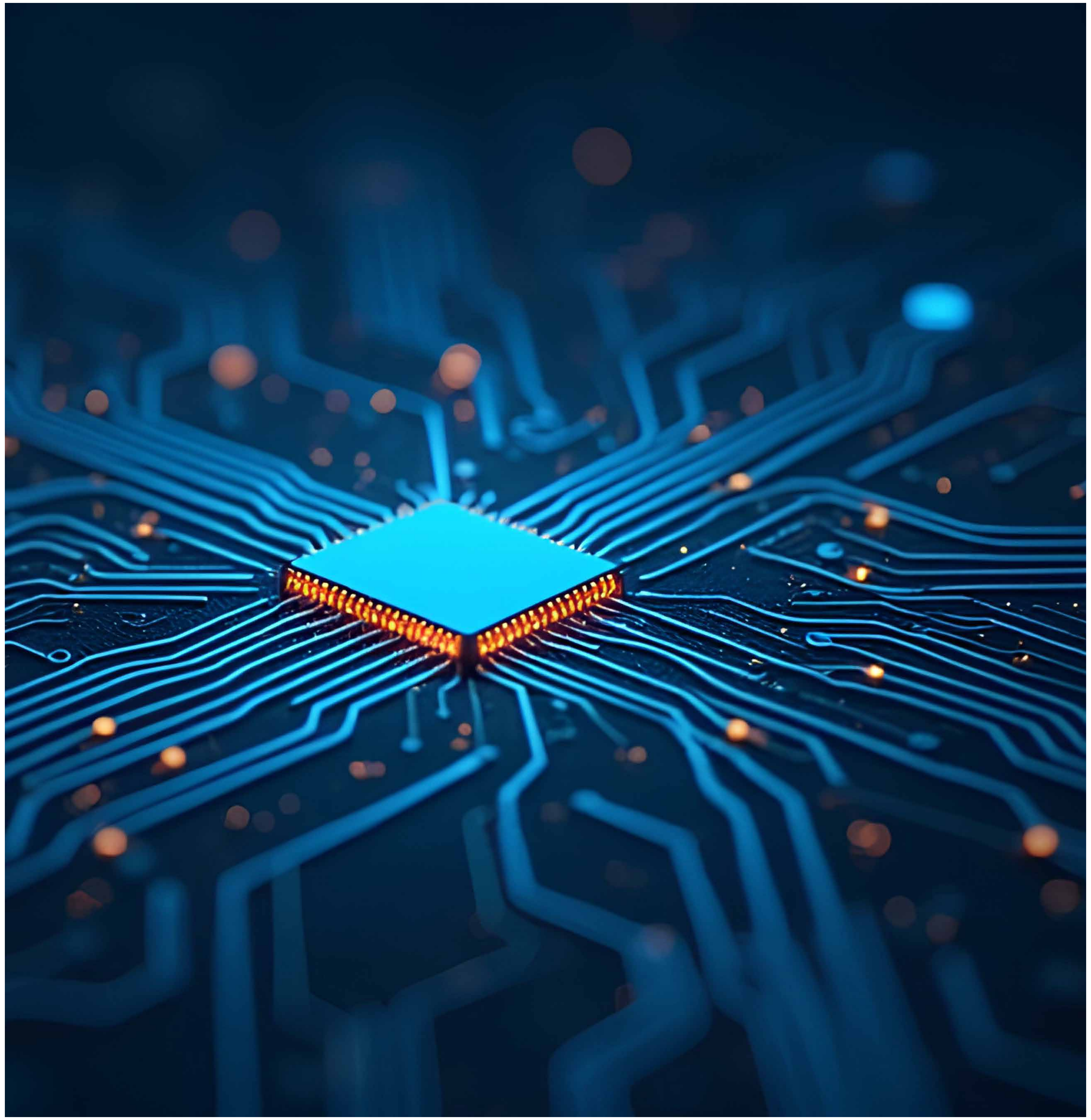
Looking to the first quarter of 2025, we expect a period of volatility, with negative pressure from inflation concerns being met with higher seasonal demand during the Chinese Lunar New Year. Given this expected volatility, we favour gold equities with a robust organic growth pipeline that have industry-leading track records of cost control to offset inflation, such as Agnico Eagle Mines Limited (XTSE: AEM) and Osisko Gold Royalties Ltd. (XTSE: OR).

Copper Market Trends

The correction in the copper market continued in the fourth quarter, with copper prices falling by 11%, largely driven by fears of the impacts of potential tariffs on the global economy. However, with prices approaching 4.00 USD per pound – broadly considered the current incentive price for constructing new projects – we believe the market is nearing a floor.

We therefore view the current market as an attractive entry point for copper equities, which are poised to benefit from a structural deficit, due to historical underinvestment in the sector, coupled with strong long-term demand fundamentals from the energy transition movement.

While we believe it is prudent to own a portfolio of copper equities to capitalize on higher long-term copper prices, we also believe companies benefiting from positive rates of change and strong cash-flow profiles in 2025 will outperform and we therefore view names such as Hudbay Minerals Inc (XTSE: HBM) as well positioned.



Information Technology

The MSCI World Information Technology Index increased by 4.5% for the fourth quarter of 2024, while the Information Technology sector in the S&P/TSX Composite Index increased by 22.1%. Sector performance rebounded after a choppier third quarter.

The best-performing subsector was software, with iShares Expanded Tech-Software Sector ETF up 12%, with excitement about AI monetization boosting names such as Salesforce Inc and Atlassian Corporation.

Internet stocks performed well, with the Invesco Nasdaq Internet ETF up 7.5%, amid healthy e-commerce and advertising demand during the holiday shopping period.

The semiconductor sector was weaker in the fourth quarter of 2024, although generative AI names still outperformed. The VanEck Semiconductor ETF was down 1.3%, weighed on by election-related tariff fears, a rotation into software and a lack of catalysts.

In hardware and networking, results mirrored semiconductors, but with more idiosyncratic winners and losers as debates continue regarding the long-term beneficiaries of generative AI and its overall economic impact.

Our outlook for Information Technology in 2025 remains cautiously optimistic. In the first quarter specifically, we expect some choppiness as the post-election ramp-up in tech stocks is assessed according to January's earning announcements.

We are optimistic on the software space, where early readings of IT budgets suggest a better spending environment with a focus on AI.

In internet stocks, we think market share gainers continue to outperform in a stable consumer spending environment, although valuations appear to be slowing the pace of gains compared with 2024.

We are looking for clues from the rate market as a prediction of consumer wallet shift potential. In semiconductors and tech hardware, we remain cautious on diversified suppliers and bullish on names with high generative AI exposure.

While our positioning here has been consistent for several quarters, we see it as warranted, given that high capital expenditure spending could persist to support more advanced generative AI models and more useful software applications.

Health Care

The fourth quarter was a challenging one for Health Care overall. Material underperformance relative to the S&P 500 Index accelerated following the U.S. election, when investors rotated out of the sector due to a confluence of stumbling fundamentals and a rising tide of headline risk and policy overhangs.

Trump's unconventional nominations for key healthcare government positions, such as Robert F. Kennedy Jr., along with the Republicans' new hold on Congress, have created uncertainty about numerous issues including Medicaid, Affordable Care Act extended subsidies, National Institutes of Health funding, the use of pharmaceuticals, and the future of vaccines.

These concerns have wide-ranging implications across multiple subsectors, especially managed care and hospital providers. Elsewhere, broadly owned names in large cap biopharmaceutical stumbled in the quarter, given concerns about disruption from the new administration.

At the same time, R&D and capital spending austerity in this industry had negative follow-on impacts on clinical research organizations and life sciences tools companies.

On the other hand, medical utilization and procedure growth have remained robust, supporting medical technology and provider fundamentals.

Looking forward, we anticipate continued sluggishness in the sector in the near term as Trump and his new team enter office and as concrete policy proposals materialize. With the spectre of uncertainty hanging over large swathes of the sector, Health Care is likely to remain a major source of funds.

As usual, the J.P. Morgan Healthcare Conference in early January will be important to watch for any meaningful shifts in trends and will set the tone for sentiment at the start of the year.

Longer-term, we continue to favour names with quality growth and positive estimate revisions through innovative product cycles and strong base businesses with defensible moats and opportunity for margin expansion.

We remain opportunistic in catalyst-driven names where risk/reward is favourable.

Consumer Discretionary

The year 2025 is setting itself up to be a "good but not great" year for consumer spending, although the U.S. in particular is likely to show continued resilience. Household balance sheets are clean, with debt as a percentage of disposable personal income now below pre-COVID levels, while household wealth climbs ever higher.

Consumer credit growth has slowed, and debt service costs – both mortgage debt and consumer credit – remain manageable, despite having risen back to pre-pandemic levels over the past three to four years. Housing affordability will likely be a challenge for the foreseeable future, but green shoots of improvement are emerging that could flow through into 2025 as rates move lower and housing inventories build up from their current low levels.

The risk to U.S. consumer spending comes largely in the form of creeping inflation, particularly if new tariffs are imposed and more stringent immigration policies are implemented. The outlook for the consumer and household spending in Canada is generally more subdued: household leverage is higher, the cost of living continues to rise, and a significant number of homeowners could face mortgage resets at materially higher rates in 2025.

Against this uneven backdrop, we expect to see a wide dispersion between winners and losers, and we are focusing on idiosyncratic growth stories, companies that are taking share of wallet and names that can outperform their peers in a stable spending environment.

We are leaning into consumer verticals with less tariff risk – such as leisure stocks – while reducing exposure to the industries that may feel the most impact from a tighter labour market, including homebuilders.

In retail, we expect to see structural share gainers such as The TJX Companies, Inc. (NYSE: TJX) and Walmart Inc. (NYSE: WMT) maintain their premium multiples, supported by strong outperformance in 2024.

Consumer Staples

In the fourth quarter of 2024, U.S. Consumer Staples saw notable underperformance relative to the broad market, while the Canadian sector performed in line.

Canadian staples continue to be led by the grocers, with Loblaw Companies Ltd. (TSE: L) and Metro Inc. (TSE: MRU) continuing to post solid performance. Investors are generally looking for certainty in a time of a slowing Canadian economy.

Grocers can likely provide that certainty and could benefit from a continued flight to safety; there is little debate as to their ability to grow earnings.

There remains a significant amount of uncertainty about an offer by Alimentation Couche-Tard Inc. (TSE: ATD) to purchase Seven & i Holdings Co., Ltd. (JT: 3382). However, this would widely be viewed as a positive acquisition, if the offer were to be accepted.

In the U.S., staples continued to languish. Walmart Inc. (NYSE: WMT) continues to outperform, consistently gaining share while it remains insulated from consumer weakness and pivots to higher-growth, higher-margin verticals such as advertising.

The rest of the sector, however, is underperforming, especially packaged food, which is battling sluggish volumes as consumers push back on high prices, and is also facing risks from GLP-1 drugs and from political headwinds related to increased regulation of processed foods.

BellRing Brands Inc. (NYSE: BRBR), Freshpet Inc. (NYSE: FRPT) and Performance Food Group Co (NYSE: PFGC) remain winners in this sector; we believe they are insulated from the headwinds, and they have shown impressive resilience despite the well-documented slowdown of the U.S. consumer. We still see a long runway for growth ahead for these companies.

Financials

For the second quarter in a row, Financials outperformed the broader market, after a Republican sweep in the U.S. election reinvigorated a growth acceleration agenda, including tax cuts and de-regulation. More defensive financial stocks, including property and casualty insurance companies and the exchanges, have begun to lag, and underperformed in the fourth quarter.

We remain somewhat cautious on banks in the near term, especially given their recent strength, but are becoming increasingly more positive on the group, because headwinds due to volumes, margins, credit and capital all appear to be abating. Also, market-sensitive businesses such as wealth and asset management are starting to build momentum.

We remain bullish on life insurance: we believe a structural re-rating opportunity could be provided by a higher-rate regime, compared with the zero-interest-rate policy that followed the global financial crisis.

Many of the life insurance companies we like have built large capital-light wealth/ asset management businesses that will likely continue to benefit from numerous secular tailwinds and strong growth.

We are also positive on alternative asset managers, because we believe they can continue to raise significant third-party capital and will be able to deploy it into the next cycle; they also have long-term secular tailwinds for growth as they increase penetration in the retail channel.

Communication Services

In the fourth quarter, an equally weighted portfolio of BCE Inc. (TSX: BCE), Rogers Communications Inc. (TSX: RCI/B), Telus Corporation (TSX: T), Quebecor Inc. (TSX: QBR/B) and Cogeco Communications Inc. (TSX: CCA) delivered -14.4%, underperforming the S&P/TSX Composite Index by about 1800 basis points (bps), driven by concerns about a lack of improvement in pricing and, more importantly, slower population growth.

The year 2024 has been a year to remember for Canadian telecommunications – but not in a good way. We have seen the Canadian telecoms lose their higher growth, oligopoly premium, with companies leaning aggressively on pricing following Quebecor's entry as a fourth player in the market.

Looking ahead, we expect pricing to stabilize as companies realize that re-pricing the backbook punishes profitability, and that their balance sheet positions do not offer very much latitude to absorb a hit on the bottom line.

That said, we prefer to wait before becoming more aggressive, since the pricing aggression has already lasted longer than we originally expected. We are also waiting to see the impact of population growth on evolution of strategy for Canadian telecom companies.

Utilities

In the third quarter, we wondered whether the outperformance in utilities would continue, given the beginning of the rate-cutting cycle.

We got an answer: no. Following a strong quarter of outperformance, utilities stocks struggled to hold their gains in the fourth quarter, and the sector underperformed the S&P/TSX Composite by about 550 bps.

While the sector lagged in aggregate, there were significant intra-sector dispersions, with thermal Independent Power Producers (IPPs) outperforming, attributable to optimism about load growth, and renewable IPPs materially lagging, primarily due to the results of the U.S. election.

We might sound like a broken record, but we have repeatedly said that our preference is for IPPs that can fund growth and for regulated utilities with balance sheets that can fund growth.

Both have performed very well this year, and we don't see any reason why that should not continue in the future.

As for renewable IPPs, we believe the market sees all the names as being the same, notwithstanding geographical differences – a generalization that we believe should correct itself in due course.

Real Estate

The soft-landing optimism that had previously driven the sector's material outperformance of the S&P/TSX Composite Index was overshadowed by an announcement from the Canadian government to limit population growth.

Notwithstanding the rate-cutting cycle, REITs underperformed the S&P/TSX Composite Index by a whopping 1,850 bps: investors who had invested in REITs because of optimism about the superior population growth dynamics compared to other G7 countries likely pulled out their funds.

Looking forward, we expect multi-family, storage and, to some extent, industrial REITs will have to navigate a tricky environment, and will need to prove to investors that a year or so of slowing population growth will not materially alter the long-term attractiveness of these investments.

We believe that retail REITs, however, are somewhat better placed: retail has seen limited or even no supply, and population growth in the near term is more of a second-order factor for the group. Looking ahead, our preference will be to combine value with quality growth.

Energy

The fourth quarter has seen a more subdued North American oil and gas sector, with natural gas developments taking precedence.

Oil prices remained range-bound, influenced by uncertainties surrounding the U.S. presidential election. Following the election, prices continued to fluctuate, due to a combination of geopolitical risks in the Middle East and concerns about a potential surplus in 2025.

Market participants are closely watching OPEC's ability to balance supply and demand amid these uncertainties, which have created a cautious trading environment. In contrast, European natural gas prices have strengthened significantly. This tightening is attributed to robust demand and substantial storage withdrawals.

Currently, European gas storage is below the five-year average, indicating an increased reliance on liquefied natural gas imports. The looming possibility of reduced Russian gas flows, adds another layer of complexity to the supply outlook.

In North America, natural gas prices rallied during the period, driven by weather patterns and long-term demand growth from sectors such as data centres.

The oil and gas producers' segment has experienced widening performance dispersion in 2024. For instance, some Canadian integrated oil companies, such as Imperial Oil Limited, are up 40% year-to-date, while others, such as Cenovus Energy Inc, have seen no growth.

In our portfolio, we continue to favour oil sands producers over mid-cap exploration and production companies. Oil sands producers could offer several advantages, including lower decline rates, longer reserve lives, and higher free cash-flow generation.

We believe these factors could enable them to maintain strong financial performance without resorting to dilutive acquisitions to sustain inventory levels, in contrast to several mid-cap oil-weighted producers.

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