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EP 191 | Energy, Gold, and Growth: Current Insights on Canadian Markets

Andrew Johnson: Hi, everyone. In this episode, I talk with Mark Rutherford, co-manager on the Canadian large cap strategy here at Mawer. We dive into some of the biggest topics affecting the Canadian markets lately, from commodities to banks to elections. Mark helps me understand what's happening out there and how it may affect the portfolio. We also talk about how the team is integrating AI into their work and some of the early benefits that are visible there. And we cover a lot of ground, so let's get right into it.

[0:31] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed are based on information available at the time and are subject to change.

[0.48] Andrew Johnson: Hey, Mark. How are you?

Mark Rutherford: Good. How are you, Andrew?

Andrew Johnson: I'm doing great. Welcome back to the podcast. There's been no shortage of news and headlines, and even the occasional existential threat to the Canadian economy and markets. We thought it would be great to have you on to talk through a few things. Are you up for that?

Mark Rutherford: Happy to dive in.

[1:08] Andrew Johnson: I wanted to start with oil because oil markets have been anything but quiet this year. And that's likely a reflection of both the general uncertainty around the global economic picture but also matters that are probably a little bit more specific to oil supply and demand. And in a lot of ways, it highlights just how difficult it is to analyze companies within this industry. What have been the key takeaways for you and the team as you're discussing oil markets this year?

[1:36] Mark Rutherford: Oil certainly had a number of big changes and volatility more recently. Number of factors impacting the oil market. Really, it's important to think about oil, but oil fits into really energy systems more broadly. While we can't go fill our vehicles with coal, these energy systems and energy sources are interdependent over the long term. And so there's a few big core, really incumbent systems that are cheap and abundant globally. So that would be crude oil, natural gas, coal, and then there's newer sources or more marginal sources as well.

Nuclear certainly in certain countries has a very big place as well as renewables. If we zoom out more broadly, there's lots of talk about an energy transition over time, but these incumbent systems are very hard to displace just because how cheap and abundant they are. In addition to the infrastructure that the globe really has in terms of getting these sources quickly and efficiently from their supply, where they are found in the earth, across the world, and into the hands of the users, whether that's pipeline infrastructure, shipping, storage facilities globally.

And so that's a very well established, smooth network. And it's very efficient and hard to displace. So if we look at crude oil, for example, the IEA estimates, there's roughly 104 million barrels per day of demand currently. And that's up from roughly 100 million barrels in 2019. So we continue to see oil demand growth steadily. And that's even with COVID having a material effect with increasing work from home or remote work capabilities.

And if going forward, most estimates call for growth. The IEA, for example, calls for roughly 3 million barrels of incremental demand growth going out to 2030. So still a huge need for energy globally. Those energy needs continue to go up. When we studied historical demand sources for oil, one of the big factors that drives that is really income levels. Income levels, whether it's China, India, Canada, even, they continue to go up globally. If you look at the amount of oil the average person consumes, really per capita demand for crude oil is roughly 23 barrels a year in the US. You can compare that to India. It's just at one and a half barrels per year.

There's a lot of structural reasons why countries can have different consumption levels, whether it be income, transportation systems that are established in that country, what that country produces from an industrial standpoint. But we do see a clear relationship just between how much energy someone consumes and their income level. Another simple example would just be if you took a cross-country flight across the US or Canada and compared that to the amount of energy that someone consumes on an annual basis, that could be maybe 3% to 5% of an individual's annual energy consumption. Just taking one flight is a huge impact on an individual's energy demand. And again, as the world gets wealthier, more people can afford to do things like travel. And that's a long-term trend that will likely continue.

Looking at the supply side, there's certainly a number of geopolitical factors that are always very important to watch, OPEC being one of them. And OPEC has certainly changed course this year, announcing more production that was announced really in tandem with the tariff announcements that came out of the US. Some would say that may be no coincidence that we saw that. There's geotechnical improvements. And then another big one would be cost of capital longer term. In recent years, really over the last probably 5 to 10 years, with ESG considerations becoming a bigger factor and the reluctance of certain parts and certain investors in the world to invest in energy space, that's maybe increased the cost of capital for some of the companies.

That would be really a positive in terms of supply side, in terms of less global supply and driving up prices. From a geotechnical perspective, while many are familiar with the advent of horizontal drilling, and that led to robust increases in productivity for the oil sector, particularly saw that in the growth in Texas oil production. But those improvements do continue at a pretty rapid pace. So if we look at the last five years, on a per rig basis, production in the Permian Basin has increased about 17%. So we're still seeing quite a bit of productivity improvements that continue to offset the demand side forces and help the current reserve base really meet that growing demand every year. So, when we talk to a number of sources in the industry, those experts really tend to think 60 to 80 is really a reasonable range longer term for crude oil, as if you get below that point, supply starts to maybe come off more quickly, especially in some of the shale oil.

But zooming out, like I said at the start, this is really, our oil fits into energy more broadly. And there's lots of talk of an energy transition. But another way to really reframe that might be just an energy addition, because we need way more energy. It needs to come from all different sources. We're likely seeing continued demand growth for

oil, that's going to get met by supply globally. But yeah, it needs to come from all sources. And the exposure that we do have in the Canadian equity strategy can benefit from that growing demand long term and their relatively low cost assets.

[7:29] Andrew Johnson: That's really good context. Thanks for that. And plenty of varying dynamics on the supply side. But what I'm hearing really overall, lots of tailwinds on the demand side as well.

Let's move from one commodity to the next. We've had gold hitting all time highs, obviously, investor interest has surged. But not all gold companies are created equal, as we know. And I do want to explore that maybe a little bit later. But before we do that, you and I had a conversation recently that I thought was worth revisiting. And I just wanted you to talk the listeners through how you frame gold's role over the last decade, maybe in the broader commodity cycle.

[8:06] Mark Rutherford: Gold is a little bit of a unique animal relative to other commodities. A big proportion of gold demand is really investor demand, whether it be central banks, other individual or institutional investors. A decent portion is still jewelry demand. However, it's slightly different relative to other commodities. It doesn't get used up, it stays in the world, and it gets traded around. But it is finite in nature. There's only a limited amount of it. The stuff and the gold that is there, a lot of the easy deposits around the world, they've been identified. So now they've been drilled and extracted, and now companies are going to the next best source and the next easiest source.

But over time, as these mines get older and go deeper into the ground over time, it typically gets harder and more expensive to drill them, and they get more complex. Gold companies themselves end up going into riskier areas of the world. So whether it's the Arctic could be going into South America, Africa, different parts of Asia, and some of these countries that companies are going into just have less certainty in terms of rural law, tax policy. Those are a few of the factors that people are dealing with when they're looking to extract it. Other factors we may have discussed in the past, but it's really an alternative to fiat currency. It's a store of value, or many people think of it as a store of value, and that's ultimately what matters.

It's been a store of value for thousands of years. So the odds of that changing are probably pretty low, certainly in the next five to 10 years, especially when you add on top of that just the pressure that we're seeing with rising deficits and fiscal pressures on major countries around the world, especially in the US more recently, it's getting a lot more attention now. On the demand side, as I mentioned, a big proportion of that is investment demand. Central banks, if you look back historically, were actually more net sellers of gold in the 1990s and the early 2000s. Really, since 2011 onward, central banks have been essentially net buyers of gold on an annual basis. And so that's been a pretty big demand tailwind as it's a very small market in absolute terms relative to other markets globally, whether you measure it against the bond market, against the equity market, even other commodity markets.

So that's been a big factor influencing just demand. And then the other factor on the supply side to mention, I think that's important to note is just increasing costs. So I mentioned companies are going to farther places in the world that are harder to get to, minds are getting deeper, more complex. We're seeing that result in just an increase in all in sustaining costs that's approaching almost $2,000 an ounce. Mining companies have not been immune to just inflation broadly, whether that's labor, machinery that they have to use, the technology they have to use, all those factors are some of the things that we're looking at when we're assessing what's driving the gold prices.

[11:16] Andrew Johnson: Like I mentioned, investor interest is high. And I think that obviously coincides with all time highs in gold prices. This is an area that we are historically underweight relative to the broader Canadian stock market. But we do invest in gold companies. And we often do that through differentiated business models. How do you analyze the gold sector, generally speaking?

[11:37] Mark Rutherford: That's definitely a fair assessment. Like every other sector or industry, we have the opportunity to deploy capital into. We look at first principles basis, is this wealth creating business? Does it have aspects that we think give it the ability to continue to be a wealth creating business over a very long term? So in a commodity business, that's typically really if it's a gold mining company or an oil mining company, it would be typically very high quality, low cost assets with a very long reserve life. On top of that, we would typically want management to be excellent.

There's a lot of reinvestment risk in a commodity business where to maintain current levels of production and even grow production over time, whether that's organically through expanding a mine base or through M&A, it's really important to have great people that will reallocate the capital efficiently. One challenge we've seen historically is just very high degree of uncertainty on what management teams will do with that capital. There are some exceptions and there's some very good executives within the industry that understand and are very returns focused rather than just production growth focused.

And we think that is great. And then we'll also look at various business models. So while there are gold mining companies, there are also streaming and royalty companies. And we think that is also a very attractive business model. We have exposure to a gold streaming business model and a streaming business model in the portfolio. And that really provides a few different things. And there's a few benefits to that model. The first is you get paid on the revenue from the gold streams and the royalties, as opposed to the net profit. And so your incentives are a little bit different.

You get to benefit from higher prices over time as all in sustaining costs for gold prices go higher. And if that scenario is happening, that gold stream that you have on a property is often a circle over a very large area. The operator of that mine is very incentivized to increase production. While you might purchase a stream on a mine where it's producing maybe 100 ounces of gold in a year, over time that stream might grow significantly. So you get that perpetual optionality, which we really like in the gold and streaming business model. You also don't get caught on the cost side. So that's another really important factor. And then you have no really ongoing obligations. So oftentimes mines come to the end of a 10 or 15 year life and companies look forced to do reassessment to understand how can they expand it, go deeper, and continue to operate it economically over time.

That often results in very high capex that's very uncertain to forecast because it's very hard to understand what your costs are going to be five or 10 years down the road, especially for a major capital project. There are certain royalty business models that benefit from the fact that they don't have to finance that cost and they get to benefit from the incentive that the gold mining company has to keep that mine in operation. There's also just the optionality that some of these streaming companies have in terms of they can look all over the world.

They don't have to be tied to a very specific reason, and they can be counter cyclical. They can be opportunistic in nature, especially if a mining company really needs capital. They can provide a go-to source and they can do that and build a portfolio of streams that's highly diversified across high-quality assets. Those are a few different attributes of that business model that we like, and we currently have some exposure in the Canadian equity strategy.

[15:26] Andrew Johnson: Obviously, with so much going on in the world and with our own biggest trading and economic partner, the economy is on a lot of the minds of Canadians these days. I've always viewed Canadian banks as a lens in which you can look through to both the global macroeconomic picture and, of course, the domestic economic landscape. I'm curious to hear what has stood out for you and the team in the most recent Canadian bank earnings. Has that given you any readthrough to broader economic themes here or abroad?

[15:58] Mark Rutherford: Sure. Stepping back, the banks entered the year with a fairly strong outlook in terms of interest rates were expected to come down, Donald Trump being elected in the U.S., there's the idea that you could likely see deregulation across a number of sectors in the U.S., and there may be a follow-on impact with Canada, where the Canadian industry was really forced to look at regulations internally here as well.

Since then, what we've seen is really elevated interest rates, and that's interrelated to some of the policy changes that we've seen from the U.S., particularly on trade. That's appeared to cause a lot of companies, maybe even individuals, to just hit the pause button on a number of things until there's a little bit more clarity to what the plan is going to be going forward. The banks are talking about it, but then they're also seeing it in the results. At a high level, what we've seen is just very tepid, slow loan growth, which is understandable. Consumers or businesses are more likely to wait rather than take out a loan to go expand or acquire maybe a new business. We have seen some positives in terms of net interest margin expansion.

They're seeing some benefit, it appears, just with interest rates staying high on floating rate loans, even maybe loan renewals or refinancing of existing loans coming in at higher interest rates. If you had a mortgage renew, that's probably coming in at a higher rate than it was issued at. On the other side, they are also seeing strong activity in the trading books that they have.

Trade and activity has been a tailwind in terms of revenue for the banks, just with the volatility. Lots of investors and individuals and institutions are looking to trade and take advantage maybe of some of the volatility that we've seen in the markets and reposition portfolios. On the other side, on the loan book, banks are taking higher provisions to account for the fact that economic growth may be lower than they originally expected going into the year.

The good news is that most of the provisions that we're seeing, and these are really estimates of future loan losses by the bank, most of those provisions are what we call performing provisions. Those customers are often still current and still paying their loans back to the bank, but for some reason, whether it be the sector that they're in or maybe the credit score of the borrower could be the geographic location, there's something that makes the bank think that credit, for some reason, is a higher risk of defaulting in the future. They're recording higher provisions, but they could release those provisions if future subsequent periods show that, hey, the economic outlook is better.

We think we don't need to provision for a loss on these certain credits. That's really what we're seeing, not the really robust gangbusters year that the banks maybe were hoping for at the start of the year, but they're well capitalized. They're still seeing some but limited loan growth. They're well positioned for a scenario where maybe interest rates come down moderately and they continue to grow, cross-sell customers, expand their business over the long term. Very strong institutions generating really attractive returns on equity and able to pay healthy, attractive dividends to shareholders in the meantime.

[19:17] Andrew Johnson: That's a pretty good segue into the next question on my mind. Let's just stick with the broader Canadian market and the economy for a moment. We do have a newish federal government or at least a new leader, which could signal a shift in the political tone or the direction. When you think about that change at the federal level, what's been on your mind? I guess, what challenges and opportunities do you see ahead for the government that might impact your investible universe?

[19:43] Mark Rutherford: A big change from our perspective on really essentially new management in Canada. Government ultimately is allocating all of our capital in the form of tax revenues and the scarce resource we have across the country and how they see best fit from our observations. What we've seen so far appears to be just more center-right, pro-growth focused after really a decade of lagging productivity growth on a per capita basis.

The big shift at the end of the day is really just more focus on wealth creation rather than really wealth redistribution. I think that will largely be positive. Just seeing more pragmatic people at the table. Example, one would be Tim Hodgson, former CEO of Goldman Canada. He's also the chair of Hydro One, which is an holding of the Canadian equity strategy. Overall, that's very good. They'll look to implement their plans, but I think overall just that shift to being more focused on growth and wealth creation is one that has us very optimistic just on what could get done really over the next five to 10 years. We're starting to see some positive signs in terms of provincial premiers even come out with either legislation or discussing the idea of how to break down the inter-provincial trade barriers. That's been a big topic.

Build Canada theme is another one that the federal government is touting. There's a number of ways that we have exposure to that theme, and then we've also added exposure to that theme more recently. Caterpillar distributors would be one with Finning and Tormont in the portfolio that we've discussed in the past, utility businesses, even the banks that we were discussing earlier. Those companies that want to build and expand in Canada, they're going to need to be financed. They're going to have employees that need wealth management services, advice, and the banks are well positioned to provide it to them in a number of ways. We continue to look at new opportunities as well, turnover stones.

Overall, we're finding great opportunities within Canada. I think overall, it's a positive shift that people were looking for. Now, we really need to see just the follow up and see the action out of it. That's one thing we're definitely monitoring very closely, but we're excited about it. I think there's a big opportunity that the country has.

[22:05] Andrew Johnson: More to come, I guess, is how we can leave that. This topic in particular strikes me as an area where you can have really deep discussions with other research team members that may not be working directly with you on this portfolio, but they do have a vested interest in the area. I'm thinking, for example, the Canadian small cap, obviously, but perhaps even the broader global teams that also look to invest in Canada.

Can you speak to some of those discussions and how you work together on larger topics like this, whether it's looking for specific companies or just discussing those higher level macro topics like the Canadian election?

[22:39] Mark Rutherford: We try to come together as a team on a number of ways through simple things like weekly meetings, risk meetings. We have client meetings that we often share and discuss feedback with. We just had our entire research team out at an offsite working through a number of longer term strategic items. That was an opportunity just to connect on a number of things, not only portfolio wise, team wise, but themes as well, so in terms of what's going on globally. We also have just shared key systems internally in terms of our M42 research database. We're all on Microsoft Teams and there are a number of themes that come up in different channels there where we discuss things like AI, even oil and gas.

There's a lot of different strategies and more that are looking at oil and gas companies. There's lots of opportunities in the Canadian small cap universe, but then also more globally. That's the area that we continue to discuss on a regular basis. Banks as well. We've added some exposure more recently, I know, in international portfolios to certain banks in Europe. We can leverage the earnings that we've had in Canada as to what makes for good, profitable bank investments.

There's also other areas of the world where even the US, for example, would probably be a great example where we don't have as many examples of really great bank investments over the long term, just given we can compare and contrast the different characteristics of those markets and what truly determines whether these banks can be profitable and wealth creating over the long term, or will it just get eroded away? That profitability yields higher competition and then your ROEs come down.

I think banks definitely get oil and gas. There's really a number of sectors. AI has been another one where we continue to look at other areas of the world, ask our teammates what they're seeing, and then try to apply some of those learnings to the Canadian market.

[24:37] Andrew Johnson: One of the constant parts in the work that you and the team do, obviously aside from scouring the market for great opportunities and managing the portfolio, is to continuously be thinking about how to improve the investment process here at Mawer. Picking up on one of the words that you just mentioned, AI, maybe that's a direction that we go with this question, but just before we wrap up, I'm always curious to hear what's new on the process front within the team. Is there anything interesting or evolving that you can share with me and the listeners?

[25:06] Mark Rutherford: I want to give away competitive secrets here, but we're certainly looking at AI and how it can impact and improve what we do. At a higher level, how I'd summarize it for now is some of the tools are a huge advantage in terms of the ability to gather, collect, and synthesize some of the data that historically has been done manually, and there are a lot of different ways that we're coming up with to harness that power. Ultimately, you think it's great and it's leading to really an explosion of ideas.

We're working together. We have the lab team here with six dedicated people, some AI expertise internally as well, just to advance some of the tools and how we incorporate them. Then I think, importantly, once you have that data collected, put into context, you verified it, and you've assembled it in a way that you can assess the information. Importantly, for us, there's still a human in the loop that ultimately has to make a judgment based on that information that's presented.

The other big thing that we're finding is helpful is just all of the AI tools and models that have come out publicly. Those are all great, but those also need a lot of data to train the models on and to extract the insights. For us, it's great to have M42, this proprietary research database with tens of thousands of notes going back over 10 years. Now we can apply some of these large language models to our own existing data. We're working to do that and really help build a more robust decision-making process here and just turn over more stones, get more accurate information, and really pull that information out.

There's also lots of investment implications. The way we're utilizing it itself, it's resulting in new investment ideas coming up just because there's different learning. When you look to apply it yourself, what that means for the value of certain companies that might have data, for example. Very exciting time on the AI front. We're continually working to add that in just like a number of other things to improve the process over time.

[27:11] Andrew Johnson: Yeah, it certainly seems like we're just at the beginning of trying to understand what those second order and third order impacts are from an investment perspective, how these are going to be integrated at the individual and company level. What I'm hearing there also is just more to come on that as well. That's probably a great place to wrap it up. Thanks, Mark, for not only taking the time to sit down and chat today, but just for all the work that you're doing on behalf of our clients when managing the portfolio.

Mark Rutherford: Thanks, Andrew. It's great catching up.

[27:39] Andrew Johnson: Hey, everyone. Andrew here again. To subscribe to the Art of Boring podcast, go to mawer.com.

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