BARRANTAGH
Investment Management

BIM REVIEW

3Q21 | STRONG DEMAND ENVIRONMENT HELD BACK BY PRODUCTION CONSTRAINTS

INVESTMENT ENVIRONMENT

- Economic growth prospects remain strong, though transitory factors reduced some of the near-term momentum.

EQUITY MARKETS

- Supply chain constraints and more persistent inflation are weighing on earnings, but quality companies will be able to offset these with time.

FIXED INCOME MARKETS

- Central banks are reducing the financial stimulus enacted during the height of the pandemic as the economy continues its recovery.

INVESTMENT ENVIRONMENT | SOLID DEMAND AND CONSTRAINED SUPPLY CAUSING SOME FRICTION

Headlines related to supply chain bottlenecks, inflation, and potential regional energy shocks have tempered financial market expectations related to the pace of global re-opening. **We posit that the COVID delta variant contributed to several of the friction points, and that a rapid decline in caseloads portends improvement in the months ahead. Vaccination and other public health measures seem to have proven effective in managing contagion (Figure 1).**

Supply chain disruptions were a common point of discussion during recent industry conferences, and manufacturers with globally sourced inputs have been amongst the most impacted. While not likely to persist for the medium-term, forecasts for the resolution of supply-side issues have been pushed out into the new year. Rising energy costs represent another issue to be navigated, though at this time is of meaningful concern to a smaller subset of industries in Europe and Asia and has opened up opportunities for those companies at the front end of the value chain.

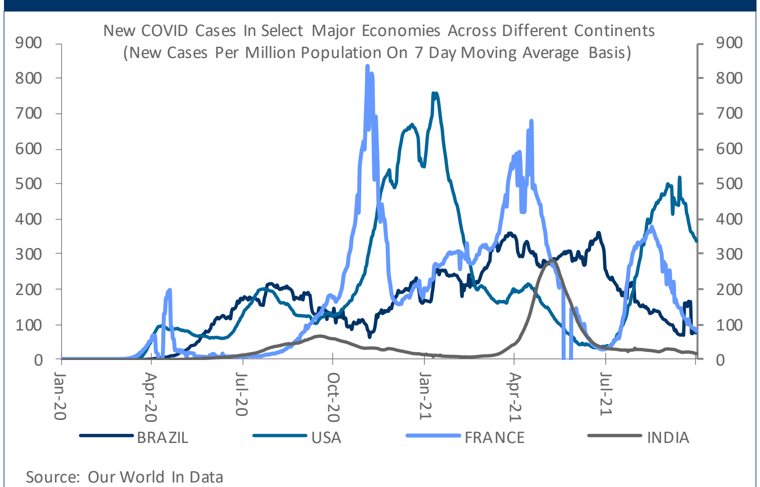
It is both surprising and encouraging to observe that job openings in the U.S. currently outpace the "officially" unemployed so soon after the onset of the pandemic (Figure 2). Job-seekers have been apt to stay at home for a number of reasons ranging from a fear of contracting COVID, to employment subsidies, or due to a lack of childcare. Arguably each of these unique circumstances are being addressed with improving vaccination rates, the expiry of government benefits, and the start of the school year. It will be interesting to see how the dataset evolves in the coming months, though employers are currently being forced to contend with a tighter than expected labour environment.

A strong demand backdrop is enabling companies to pass on rising input costs to consumers, yet not all pricing mechanisms are instantaneous which can result in timing mismatches and has led to a number of earnings pre-announcements. These developments are inflationary in nature and bear monitoring, though are not expected to derail the current economic recovery. The upcoming reporting season will provide greater insight into how companies are managing this dynamic.

In contrast to the strength in developed regions, emerging markets demand has been less robust and in part hampered by lower vaccination rates. Government policy has also had an influence with China targeting several industries viewed as a driver of inequality including real estate, education, and social media. China's actions to cool down these sectors has resulted in slower GDP growth recently. When combined with COVID related disruptions in the summer and liquidity concerns for one of their largest property developers, this has softened near-term growth prospects. We expect China to pull through this rough patch by stimulating other parts of the economy and providing support for the restructuring of the China Evergrande Group.

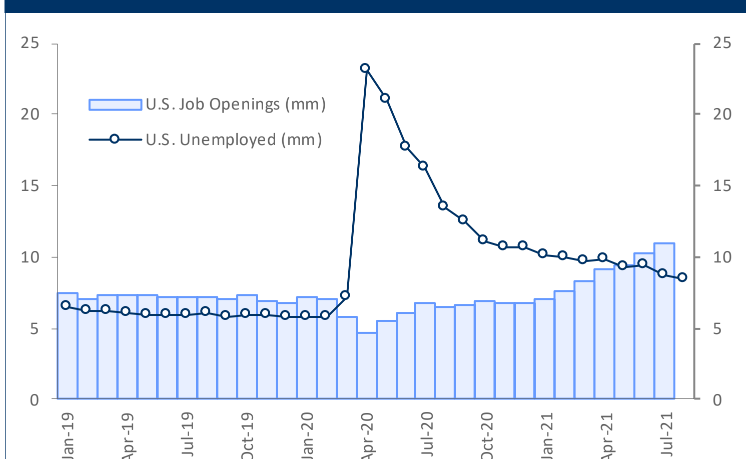
With the worst of the delta wave likely in the past, governments and corporations will be better able to focus on relieving bottlenecks in order to fulfil a healthy demand environment supported by a strong consumer. Importantly, the world has only recently begun to emerge from the pandemic and a solid economic expansion should continue.

FIGURE 1: DELTA WAVE APPEARS TO HAVE PEAKED



Source: Our World In Data

FIGURE 2: JOB MARKET ARTIFICIALLY TIGHT



Source: Bloomberg

EQUITY MARKETS | PENT-UP DEMAND NOT FULLY SATISFIED DUE TO SUPPLY BOTTLENECKS

Equity Index Returns	3Q21 (CAD)	3Q21 (USD)	YTD21(CAD)	YTD21(USD)
Global (Net)	+2.3%	+0.0%	+12.4%	+13.0%
Canadian	+0.2%		+17.5%	
CDN Small Cap	-2.5%		+16.8%	

Index returns were more modest than in prior quarters, though some themes echoed the earlier part of the year with the return of reflationary developments contributing to a value rotation to close out the period. Sector level returns were relatively evenly distributed for the quarter, though Financials and Energy were the standouts in September. Financials benefited from rising rates as the strong economic recovery enabled central banks to discuss scaling back stimulus, and Energy performance was driven by rising oil and gas prices underpinned by still recovering demand and supply-side discipline. Supply chain and logistical pressures intensified in the quarter leading to some pre-announcements as affected companies seek to quickly adjust to the changing conditions by passing through inflation and optimizing their operations. Declining COVID cases should provide relief and help corporations capitalize on a still strong environment with unmet demand pushed slightly into the future.

BIM EQUITY FRAMEWORK

The correlation between interest rates and performance of growth and value stocks has been strong year-to-date (Figure 3). Trading multiples of growth stocks benefit from low or declining rates as the discounting of cash flows potentially many years into the future is less impactful. Many value stocks profit from rising rates which can expand margins for traditional financials and may also be a broad indication of economic growth in support of cyclical companies. The value leadership that peaked in May might reassert itself with the delta variant on the wane and reflation winners capitalizing on some of the numerous supply constraints at present. While the outcome of our quality value investment philosophy avoids both hyper-growth and distressed value, we do maintain exposure to the financials, energy, and materials sectors which should benefit from these trends.

GLOBAL MARKETS

Earnings growth has moderated as short-term headwinds have become more prominent in recent months. This has resulted in slower revenue growth and pressures on profit margins for a growing number of companies. With time, manufacturing bottlenecks should ease and strong companies will be able to adjust their business model for any cost pressures that may persist. Higher vaccination rates should also help alleviate bottlenecks and support growth. Companies best positioned to navigate these challenges have demonstrated an ability to deliver meaningful productivity improvement over time and implement price increases. Furthermore, these companies should emerge from the pandemic stronger and are more likely to grow their market share.

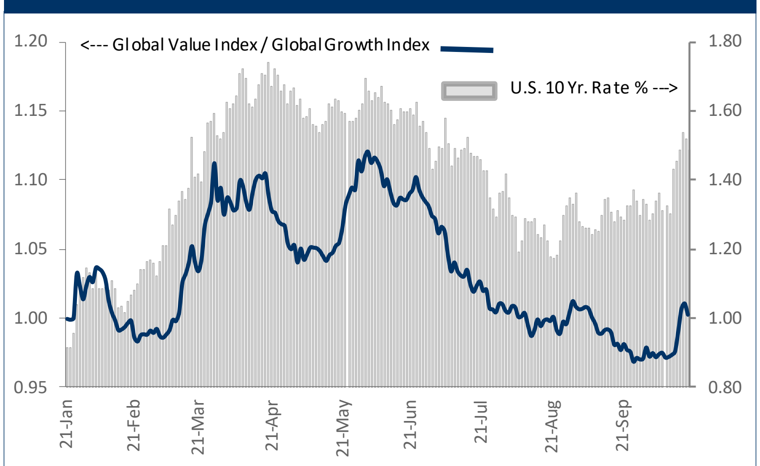
A good example of this is in the North American railroad industry where congestion at the ports and bad weather has resulted in elevated costs and lower revenue growth near-term. With a lag, railroad companies should be able to adjust their resource allocation to improve productivity and make use of pricing strategies that compensate for the growing value they provide, particularly in such a tight environment for logistics. In addition, market share gains versus trucks will continue to be a long-term opportunity for the industry.

CANADIAN ALL-CAP MARKET

Many regions are pursuing a journey towards decarbonization of their power generation and natural gas has an important part to play as a transition fuel in the decades to come. Renewable power investment will continue to grow, though the intermittent nature of wind and solar generation requires baseline support with natural gas amongst the cleanest burning alternatives. Calmer weather has reduced wind output in Europe this year, increasing the call on natural gas at the same time as deliveries of the fuel from Russia have been running below expectations. This has resulted in depleted inventories in advance of the heating season and has forced Europe to compete with Asia for liquefied natural gas (LNG) cargos (Figure 4).

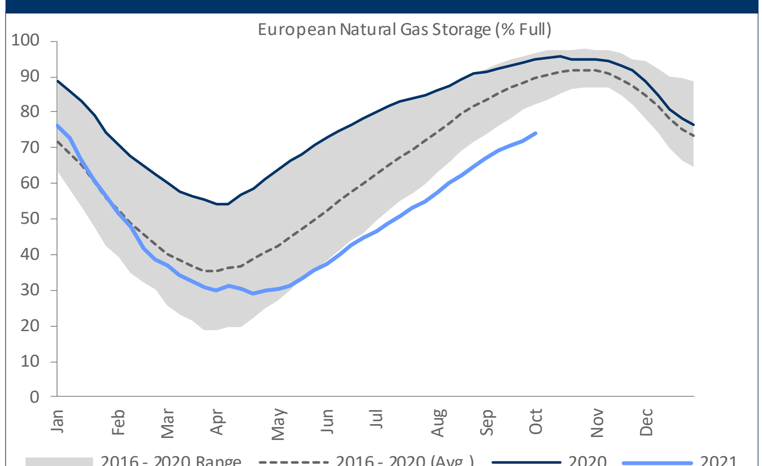
The U.S. has meaningfully expanded LNG export capabilities during the past five years and has emerged as a major player on the global scene with additional capacity expected to come online in the coming year. Brookfield Infrastructure L.P. has a direct stake in the Cheniere Sabine Pass export facility in the Gulf Coast, though Canadian natural gas producers are even larger beneficiaries of the current situation. The story of North American natural gas had been one of ever-increasing supply until the onset of the pandemic which resulted in a sharp pullback of capital expenditures. Investor demands of producers have since prioritized free cash flow generation over production growth which has resulted in supply largely holding flat at a time when LNG exports provide an outlet to draw down local inventories to the benefit of North American pricing.

FIGURE 3: VALUE AND GROWTH LINK WITH INTEREST RATES



Source: Bloomberg | Equity Returns (Simple Basis) Indexed To Jan.1 2021

FIGURE 4: EUROPE NATURAL GAS IN SHORT SUPPLY



Source: Bloomberg

CANADIAN SMALL-CAP MARKET

Despite the volatility in the benchmark, small cap names with strong business models underpinned by predictable cash flow generation continued to grind higher in the quarter. Under the hood, the risk-on environment of the summer shifted negative in September with the growing evidence of widespread supply chain constraints and more persistent inflation. This dynamic drove interest rates higher and de-risking across asset classes (including small cap) with the notable exception of the energy sector where a confluence of factors previously discussed has driven a very strong price environment for the related commodities.

The small cap index contains a large weight in energy including many names with either material balance sheet or operational leverage that exhibit much volatility and have greatly benefited from this year's circumstances. Our quality-value focus and preference for companies we can own through cycles that compound cashflow over many years limits our investable universe in small cap energy, however we continue to pick our spots with quality assets and attractive value propositions which has been additive to absolute performance.

Exiting the third quarter, we are optimistic some of the churn experienced by equity markets will shake out some interesting investment opportunities in strong businesses that now meet our stringent investment criteria.

BIM EQUITY THESIS SPOTLIGHT

Tourmaline is Canada's largest and lowest capital cost natural gas producer with dominant positions in prolific basins and operatorship of strategic midstream infrastructure. Insider ownership is the highest amongst senior producers and this alignment with shareholders is evident in a preference to declare special dividends during periods of elevated commodity prices.

The company has generated significant value through the consolidation of contiguous assets by leveraging existing infrastructure and economies of scale to drive cost efficiencies. The acquisitions have driven immediate financial accretion while enhancing an already enviable reserve base.

Gas marketing agreements to gain access to premium North American hubs have long been integral to the company's risk mitigation strategy. Tourmaline has recently elevated these efforts by signing a 15-year deal with Cheniere energy to supply one LNG cargo per month to gain direct exposure to Asian markets beginning in January 2023.

Environmental leadership is another hallmark of the company with numerous initiatives and targets for water recycling, methane capture, diesel displacement, and emissions reduction. Markets tend to lump commodity producers together, though Tourmaline is meaningfully differentiated across much of its business.

FIXED INCOME MARKETS | CENTRAL BANKS BEGIN TO TAPER AND POSITION FOR RATE HIKES

Fixed Income Index Returns	3Q21	YTD21
Canadian	-0.5%	-4.0%

As the economy continues its strong recovery central banks are reducing the financial stimulus enacted during the height of the pandemic. Most notably the U.S. Federal Reserve (Fed) has moved closer to the point of tapering its bond purchasing program (QE). **Provided employment data does not regress, the Fed is expected to announce in November that it will taper QE. Combined with further tapering from the Bank of Canada (BoC), as well as similar restrictive actions from other central banks, interest rates rebounded from lower levels intra-quarter to finish higher at period end (Figure 1).**

While global supply chain issues and constrained employment are significant headwinds to stronger economic growth, central banks are encouraged by rising long-term inflation expectations. Coming out of any recession the return of optimism can be elusive, but in this case the reappearance of demand and inflation has been robust. It is now at the point where central banks must be careful not to overstimulate the economy and allow longer-term interest rates to rise in order to keep both a healthy and sustainable trajectory for growth.

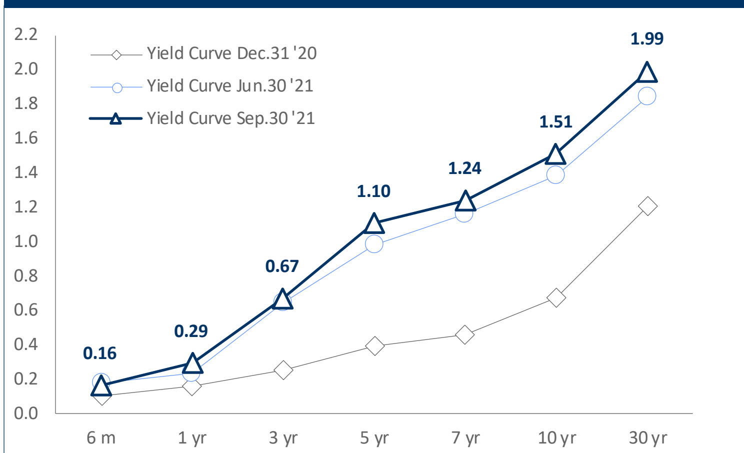
In the coming quarters central banks must thread the needle of cooling inflation without jeopardizing the recovery. High inflation has persisted longer than forecasts of just a few months ago, likely due to ongoing supply chain constraints, but is still expected to be temporary and subside once bottlenecks are able to normalize. The focus of central banks remains on the demand-side expecting that in time the supply-side will inevitably catchup and fill any excess demand.

BIM FIXED INCOME FRAMEWORK

The Canadian fixed income index returned -0.5% this quarter with interest rates 10 bps higher, partially offset by interest income. Short and mid term corporate BBB rated bonds performed the best due to credit spread tightening and higher interest income. Long government bonds underperformed due to a higher sensitivity to changes in interest rates and minimal credit spread exposure.

During the quarter we increased credit risk in the portfolio as we expect spreads to tighten further. The portfolio remains underweight exposure to changes in interest rates, overweight credit risk, and has higher interest income than the benchmark, all working together to provide a superior return.

FIGURE 5: CANADIAN YIELD CURVE (%)



Source: Bloomberg

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Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners. We are dedicated to preserving our clients' capital while generating growth through consistent application of our quality value-based fundamental investment philosophy. We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

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