BARRANTAGH
Investment Management

BIM REVIEW

1Q22 | EASTERN EUROPE AND THE FED TAKE CENTRE STAGE

INVESTMENT ENVIRONMENT

- Fed is behind the curve, but the hiking cycle is now underway and future policy must navigate both high inflation and growth risks.

EQUITY MARKETS

- A geopolitical curveball boosts commodities but cools growth expectations. Resource heavy indices grab the spotlight.

FIXED INCOME MARKETS

- Hawkish rhetoric implies that policy normalization will proceed at a rapid pace. A large uptick in interest rates hurt bonds in the quarter.

INVESTMENT ENVIRONMENT | A TIME OF RISK AND OPPORTUNITY

The first quarter was a tumultuous period for financial markets. Coming into the year we had postulated that the initiation of a rate hiking cycle could introduce volatility, though unforeseen geopolitical developments amplified the expected impact.

The Russian invasion of Ukraine is a tragic situation with humanitarian and economic impacts well beyond their respective borders. While the combined GDP of the countries is relatively minor in a global context, their impact on several commodity markets is much more material and is contributing to already elevated inflation. Energy has attracted the most attention as Europe remains overly reliant on Russian imports and the security of this supply has quickly been called into question. This situation catalyzed the REPowerEU initiative which intends to ramp-up renewable energy at an accelerated pace and to expedite the transition towards alternative sources of natural gas (principally liquified natural gas [LNG] imports).

There are limitations to projecting conventional negotiating wisdom onto an autocratic leader, though we continue to assume that a mutually acceptable offramp for Russia and Ukraine will be achieved. Timing is an unknown, though a lack of military progress, hard hitting sanctions, and a more unified Europe and NATO argue against a protracted conflict. An extended timeline to resolution represents the largest risk to our outlook and would increase the potential for a recession with Europe being the most vulnerable region.

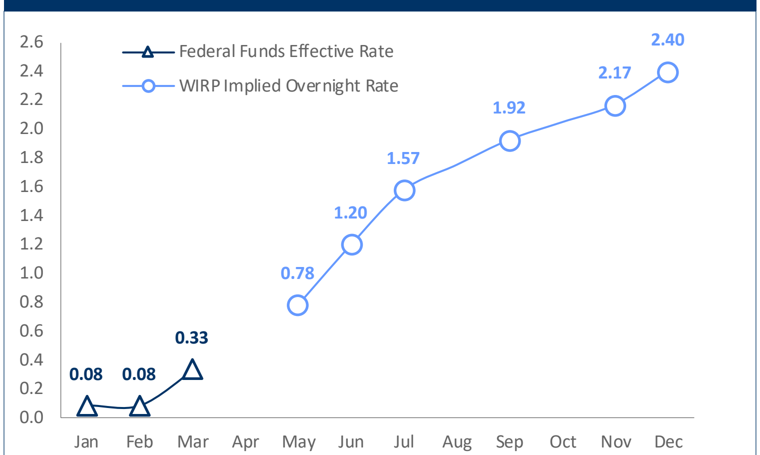
The U.S. Federal Reserve (The Fed) was expected to begin a rate hiking process this year with liftoff achieved at the March meeting. **A more pronounced commitment by Fed officials to tame a string of elevated inflation prints has the market pricing in eight additional hikes for the year as of quarter-end (Figure 1).** Future inflation readings and potential growth concerns emanating from the war in Ukraine will be key areas of focus that will influence policy, though additional hikes through early summer meetings are inevitable.

The most severe impacts from the Omicron variant appear behind us in much of the Americas and Europe, although parts of Asia continue to struggle. China in particular has maintained a zero Covid policy which has resulted in some severe yet localized lockdowns that may impact supply chains if they were to become more wide spread.

With current challenges dominating headlines, factors supporting global expansion including generally diminishing Covid impacts, government policy support, and strong consumer balance sheets are somewhat flying under the radar. **Despite inflation weighing on sentiment, the consumer remains a bright spot with households well placed to navigate higher prices given excess savings generated during the pandemic and favourable labour markets (Figure 2).** We expect the service sector to be the greatest beneficiary of pent-up demand given a still nascent recovery versus spending on consumer goods which received a boost from the pandemic.

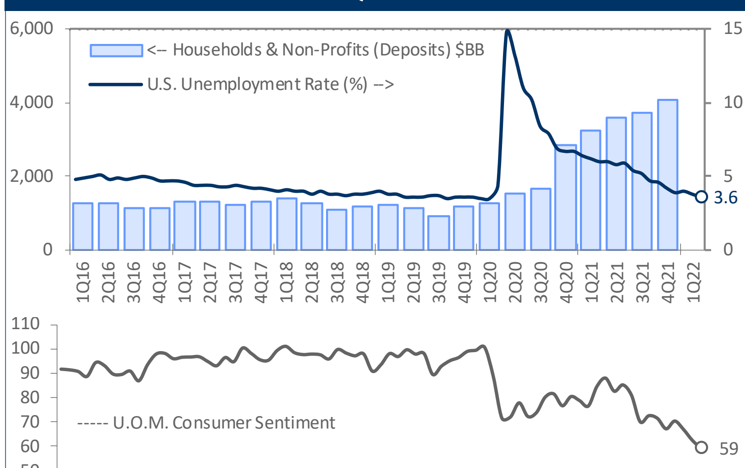
Conflict in Ukraine, inflationary pressures, and aggressive central bank policy has dampened growth expectations, yet a robust job market and high savings rates should allow consumers to skate past these short term headwinds. Furthermore, corporations continue to generate high levels of free cash flow and possess very healthy balance sheets, leaving them well positioned for these challenges.

FIGURE 1: FED HIKING CYCLE ACHEIVES LIFTOFF



Source: Bloomberg | Pricing As Of Mar.31 2022

FIGURE 2: U.S. CONSUMER EQUIPPED TO HANDLE INFLATION



Source: Bloomberg | Most recent data for Deposits is Dec/21, all others Mar/22

EQUITY MARKETS | GROWTH SCARE BROUGHT ON BY GEOPOLITICAL STRIFE

Equity Index Returns		
	1Q22 (CAD)	1Q22 (USD)
Global (Net)	-6.2%	-5.2%
Canadian	+3.8%	
CDN Small Cap	+8.8%	

Performance of equity markets this quarter was impacted by greater macroeconomic uncertainty resulting in heighted volatility, which was even more pronounced at the sector and country levels. Elevated inflation and more hawkish commentary from The U.S. Fed led to rising interest rate expectations, and the breakout of war in Ukraine disrupted commodity markets and softened growth projections. This environment was positive for commodity and defensive sectors and caused a rotation away from growth stocks and companies exposed to inflationary headwinds.

BIM EQUITY FRAMEWORK

Rising interest rate concerns in tandem with Russia's invasion of Ukraine resulted in an intra-quarter correction in equity markets. As with past instances of growth scares, stocks initially selloff during the peak of uncertainty and recover as greater clarity surrounding the situation at hand is revealed (Figure 3). As detailed in the 'Investment Environment' section of this report, we believe a resolution to the conflict will be achieved albeit with little visibility as to the timing of when this will occur. As at quarter-end, markets had moved past pricing in some of the more dire scenarios though will remain sensitive to headline developments in Eastern Europe.

Geopolitical developments have dampened global growth forecasts, though it is noteworthy that recent economic releases have topped moderated expectations while inflation continues to surprise to the upside (Figure 4). Given the environment, we seek to achieve a balance within portfolios of inflation beneficiaries as well as companies that are well placed to outperform as conditions normalize. Within consumer sectors, we are more focussed on finding ideas within the service economy aligned with our view that spending will continue to migrate towards reopening themes.

GLOBAL MARKETS

The surge in energy prices combined with Russia's invasion of Ukraine has created an energy crisis in Europe. In response to this event, the EU has announced a proposal called REPowerEU to dramatically shift towards renewables and electrification, and many other countries have become more interested in making a similar shift. This would require a significant amount of capital investment over the next 10+ years in order to achieve these goals. Our holdings in Schneider Electric and Quanta Services are well positioned for these trends. Their customers will look for more ways to conserve electricity consumption and move towards solar, wind and natural gas power generation requiring significant upgrades to their electric grids.

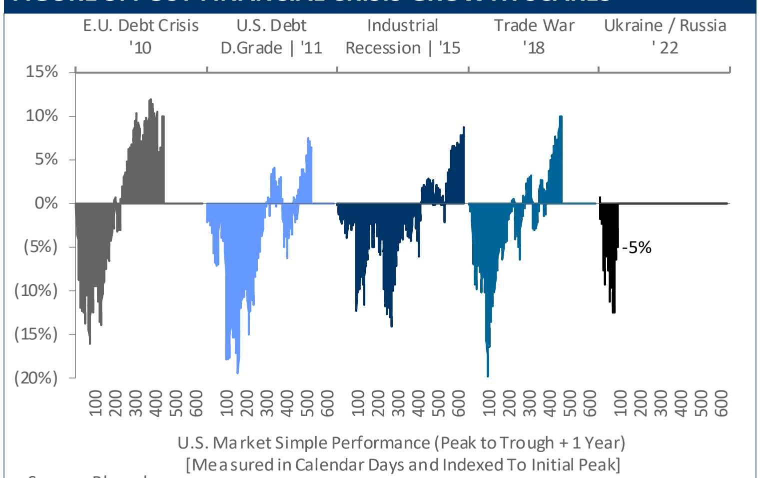
Outside of this mega trend we continue to opportunistically look for companies with strong business models that may suffer from margin pressure in the short term due to the heightened inflationary environment yet have the ability through pricing and efficiency actions for margins to recover, albeit with a lag.

CANADIAN ALL-CAP MARKET

In our prior publication we had noted that the Canadian market historically performed well during periods of elevated inflation given a healthy representation of commodity linked equities. This relationship held true during the quarter with Canadian indices easily outpacing the vast majority of their developed market peers. While several commodities are incorporating a component of geopolitical premium at present and could be prone to a partial correction with a resolution of the war in Ukraine, supply-side impacts would take time to resolve and still be supportive of higher than pre-conflict pricing in many instances. We expect fertilizers and energy to be two such cases given the region's outsized agricultural influence and Europe's push to wean itself off Russian sourced natural gas.

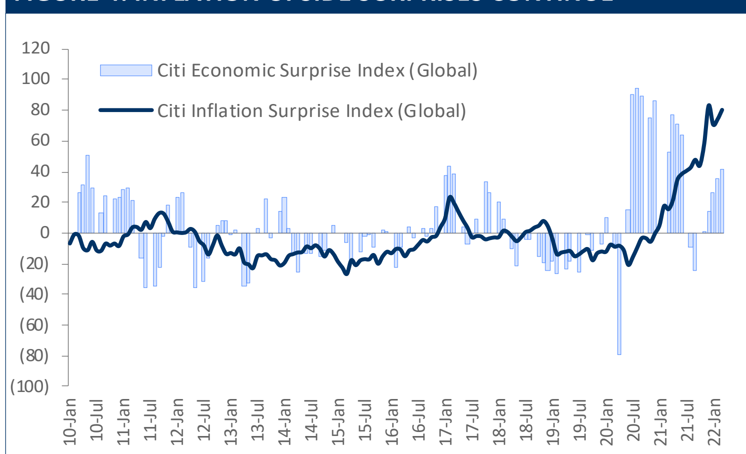
The market rotation into natural resource sectors has opened up some interesting opportunities in businesses that are well placed to navigate the current environment and potentially thrive as conditions reach a new equilibrium. Premium Brands is a specialty food processor and distributor that can produce artisanal quality offerings at scale, has a strong track record of growth, and is exposed to both food-at-home and food-away-from-home markets. Escalating input costs do create some challenges though the majority of operations have efficient pass through mechanisms to minimize the impact. State of the art automated sandwich facilities offer labour savings to quick service restaurant clients and represent but one example of value add that the company provides. A more fulsome reopening would provide a tailwind to demand and better showcase the investments and product initiatives undertaken in recent years.

FIGURE 3: POST FINANCIAL CRISIS GROWTH SCARES



Source: Bloomberg

FIGURE 4: INFLATION UPSIDE SURPRISES CONTINUE



Source: Bloomberg

CANADIAN SMALL-CAP MARKET

The heightened volatility ending last year accelerated in the quarter with geopolitical risk, supply chain disruptions and ramping inflation all top of mind. The strongest performers have been a barbell of commodities and defensives with weakness in other areas of the market. The commodity-laden small cap benchmark posted very strong returns in this environment which proved more challenging for certain quality-value cash flow growers that offered attractive opportunities to add to certain favoured long-term holdings.

Boralex is a renewable power producer with assets in Europe and North America. Shares of the company sold off in 2021 to a level that far undervalued its long-term contracted infrastructure assets prompting us to add to our position. This proved prescient as the company was able to monetize a minority stake in its French portfolio at multiples higher than the public market valuation, leading to a strong re-rate in the stock during the quarter.

Similarly, Calian Group, a services provider across communications, defence, health care and technology verticals, had meaningfully lagged despite strong execution during the pandemic. We believed the market had mischaracterized the company simply as a "Covid winner" pressuring the stock last year in favour of cyclical exposure. We added to the position seeing fundamental value and the shares recovered strongly in the quarter as growth continued to outperform and sentiment brightened around defence-related spending.

BIM EQUITY THESIS SPOTLIGHT

Equity markets can fundamentally misprice securities when too many participants are myopically focused on transitory headwinds or a potential upcoming quarterly reporting miss. Intertape Polymer Group was such an example which in early March announced a sale to Clearlake Capital Group for a greater than 80% premium to the prior day's closing price.

Intertape is a leading specialty plastic and packaging provider in North America servicing a diversified set of end markets. A dominant position in water activated tape provides growing exposure to secular e-commerce trends while being additive to margins. We viewed the trading valuation as unrepresentative of exciting growth prospects and a differentiated ability to quickly pass-through rising input costs due to strong demand for its products. The short-term focus of equity markets meant they were unwilling to credit the company for operational enhancements implemented over several years and an improved capital structure and free cash flow profile.

In addition, recent acquisitions of automation and sustainable paper-packaging equipment capabilities advanced their strategy of moving upstream into customers' production processes entrenching them as critical suppliers for years to come. Predicting a takeout is often a fool's errand, though strong business models attached to long-tailed growth themes are likely to attract interest from private equity if mispriced for too long.

FIXED INCOME MARKETS | RAPID INCREASE IN RATES HURTS BONDS

Fixed Income Index Returns	
	1Q22
Canadian	-7.0%

Amid rapidly rising inflation, Canadian interest rates increased by a record 105 bps in the past three months. The Bank of Canada (BoC) raised its overnight rate by 25 bps to 0.50% in March with the market poised for an additional 50 bp increase in April and further hikes throughout the year.

The ascent of inflation globally has central banks eager to raise interest rates at a rapid pace to cool demand and inflation. The last reading of inflation in Canada was 5.7%, the highest since 1991, when interest rates were also much higher. In addition to interest rate hikes the BoC will soon begin Quantitative Tightening (QT), which reduces the money supply and the central bank's balance sheet. QT also places pressure on longer term interest rates to increase which helps to fight inflation.

Short-term interest rates have risen the most and the yield curve has flattened. Typically a flat, or even inverted, yield curve occurs when the market is concerned about the economy. In Canada the 5-year interest rate of 2.4% is the same as the 30-year rate, with the 2-year rate just 10 bps lower (Figure 5). With a BoC overnight rate of 0.5% the market has priced in a full and rapid rate hiking cycle, which the BoC has only just begun to execute.

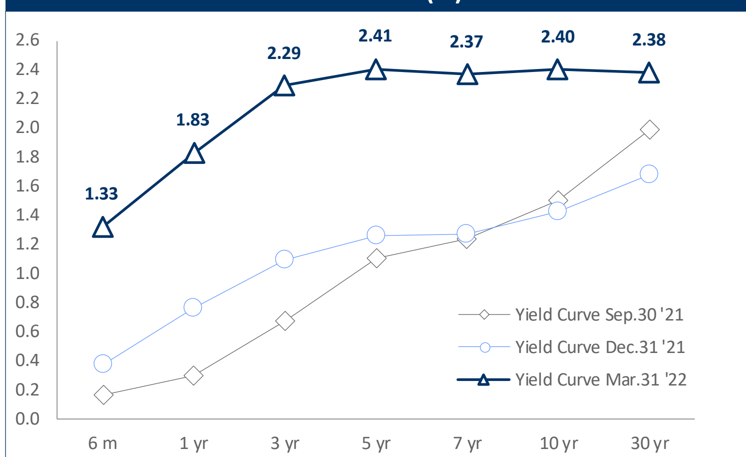
BIM FIXED INCOME FRAMEWORK

While higher interest rates are good for new fixed income investments, the value of existing holdings decline. Additionally, the extraordinary market volatility has a negative impact on the credit market and results in higher credit spreads and lower valuations for provincial and corporate bonds. With a 105 bp rise in interest rates and 10 bps widening of credit spreads, the fixed income index posted a negative return of -7% in the quarter.

Fixed income portfolios have a much lower sensitivity to changes in interest rates than the overall market, however, being overweight credit was a drag. We remain confident in the fundamentals of the companies we are invested in and the overall economy. No corporate bond, or Canadian government issue that we have invested in is at risk of being late on their payments, but the market has priced their bonds lower.

Short corporate bonds, with the least amount of market risk, were the best performers at -1.5%, and long government bonds underperformed at -17% in the past three months. During the quarter we made adjustments to reduce duration and credit risk. At the end of March the portfolio yield-to-maturity was 3.3%.

FIGURE 5: CANADIAN YIELD CURVE (%)



Source: Bloomberg

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