BARRANTAGH
Investment Management

BIM REVIEW

2Q22 | SENTIMENT SOURS ON GLOBAL GROWTH

INVESTMENT ENVIRONMENT

- A mid-cycle growth slowdown is upon us. The evolution of inflation, geopolitics, and consumer sentiment will influence the path forward from here.

EQUITY MARKETS

- Pullbacks are painful but precede rebounds. Sentiment is fickle and we see opportunity in businesses that can adapt to a dynamic environment.

FIXED INCOME MARKETS

- Bond markets have priced in aggressive interest rate hikes. Central bank policy is highly data dependent driving greater than normal volatility.

INVESTMENT ENVIRONMENT | IN THE MIDST OF A MID-CYCLE GROWTH SLOWDOWN

An absence of positive developments during the quarter concerning the conflict in Eastern Europe, elevated inflation readings, and aggressive central bank policy have placed the markets on recession watch.

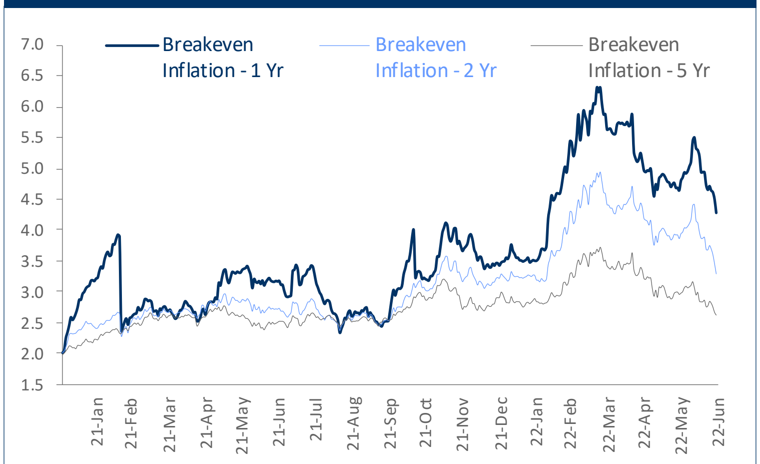
The start of a central bank rate hiking cycle was well appreciated as the year began, though expectations for the pace of activity continued to accelerate in response to economic data and official communications from the U.S. Federal Reserve (The Fed). Persistently high inflation readings in tandem with consumer survey data pushed The Fed to raise rates by 75 bps in June and signal future large hikes with an aim to keep long-term inflation expectations anchored at comfortable levels. **While the potential for peak near-term inflation may have been pushed out by a number of months, bond markets are pricing in much more palatable future levels of inflation in the two and five year time frames following spikes in March and most recently in early June (Figure 1).** Markets appear satisfied of the The Fed's commitment to control inflation, though the degree to which their actions will impact growth remains a key source of uncertainty.

Commodity markets continue to be influenced by the war in Ukraine, though the impacts outside of energy seem to be subsiding to a degree. Efforts to restart grain exports from the region involve several parties and could include a partial resumption of transit through the Black Sea, alternate marine routes, or direct rail shipments. Each potential remedy has its challenges and normalized shipment levels are not likely in the near-term, though dialogue on potential solutions is a positive first step. Natural gas remains an acute energy issue, with Europe expediting plans for increased floating and permanent import infrastructure while eagerly absorbing LNG (liquefied natural gas) cargoes from the U.S. Gulf Coast. Canada is in active discussions with Germany for potential LNG exports via the East Coast, though project timelines would not provide any relief to Europe's most pressing concern of this winter's inventories given a continued reliance on Russian pipeline imports. The general rollover of the commodity complex in sympathy with growth concerns may provide central banks with additional flexibility to engineer a soft landing, though years of chronic underinvestment in new supply could limit pricing downside.

China's Covid Zero protocol necessitated stringent lockdowns in a number of major population centres during the quarter leading to temporary production halts and further supply chain disruption. **China's Covid impacts were most notable in April with strong sequential improvement through May and June (Figure 2). Updated policy guidelines imply a more codified and nimble framework with some loosening of restrictions that would likely reduce the impact of any future lockdowns.** This would be a welcome development given China's standing as the world's second largest economy and integral role in global manufacturing and logistics networks.

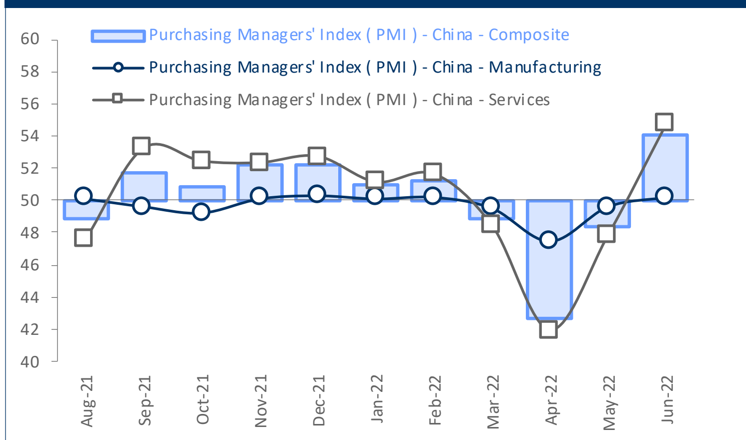
Amid a mid-cycle growth slowdown, we do not envision a hard landing as a foregone conclusion and maintain a degree of cautious optimism. Notably, we believe that central banks will remain sensitive to growth concerns once inflation begins to cool from current highs. A pullback in commodities along with China's evolving Covid Zero policy and a further correction in ocean freight rates could each contribute to moderating price pressures in the months ahead.

FIGURE 1: FUTURE INFLATION EXPECTATIONS MODERATING



Source: Bloomberg

FIGURE 2: CHINA EMERGING FROM LOCKDOWN



PMI > 50 indicates sequential monthly activity increase
Source: Bloomberg

EQUITY MARKETS | REBOUNDS OFTEN FOLLOW DRAWDOWNS

Equity Index Returns	2Q22 (CAD)	2Q22 (USD)	YTD22(CAD)	YTD22(USD)
Global (Net)	-13.4%	-16.2%	-18.8%	-20.5%
Canadian	-13.2%		-9.8%	
CDN Small Cap	-20.8%		-13.9%	

Themes present as the calendar turned to March echoed ever louder in the second quarter and equity markets came under further pressure. The now prolonged war in Ukraine fostered continued uncertainty and contributed to existing supply-side pressures affecting global inflation. This persistently high inflation and hints that it could be impacting long-term consumer psyche resulted in hawkish U.S. Fed actions and rhetoric that spooked the equity markets and further dampened growth expectations.

BIM EQUITY FRAMEWORK

The quarterly drawdown was of a magnitude rarely seen since the turn of the century and was a product of recent negative developments and fragile investor sentiment (Figure 3). Historically, this same time period shows that for major North American equity indices, each quarterly correction in excess of 10% was followed on average by one year annualized returns in excess of 20%. While empirical observations have their limitations, what is clear is that a lot of bad news has been priced into markets at present. A hard landing scenario may not be discounted at this time, but a growth scare has been reflected which helps to de-risk expectations and improves the potential for future returns.

Share prices of equities perceived as having the greatest sensitivity to the current environment have been most impacted year-to-date, with high growth technology and businesses exposed to discretionary consumer spending particularly affected. This market bifurcation also exists along market capitalization lines where the share prices of smaller companies have seen greater pressure than larger peers independent in several cases of strong underlying business fundamentals. This current bias can yield interesting opportunities for investment particularly where valuation dislocations have taken place in businesses with strong mid-term prospects. When available, the most attractive ideas are those that do not require an explicit call on the economy, but more so a market recognition of company specific fundamentals. Across all industry sectors, we are also placing emphasis on companies able to adapt to a dynamic environment to best navigate any uncertainty ahead.

GLOBAL MARKETS

As businesses navigate a difficult environment, consumers must also deal with inflation crimping their budgets. This has led to concerns regarding discretionary goods demand amid rising interest rates and a greater share of spending shifting towards services. **Inventory management has been a challenge for the U.S. retail sector as memories of prior logistical constraints and a normalization of demand for big ticket items and electronics from pandemic highs complicated order patterns. Poor spring weather impacting the sale of seasonal products added to the complexity, and certain retailers reduced earnings guidance with a view to clear excess inventory with Target being the most prominent example (Figure 4).**

Dollar stores are in a much better position to navigate the current environment due to their exposure to consumables and small ticket items and closer proximity to a consumer that may be increasingly sensitive to higher fuel prices. Our long-term holding in Dollar General has a strong business model that can quickly adapt to changing demand environments and proactively offset inflationary headwinds by modifying package sizes and adjusting merchandising plans. Heading into the back-to-school season, all retailers will have to remain nimble to react to quickly changing consumer needs.

CANADIAN ALL-CAP MARKET

Commodity sectors have contributed positively to year-to-date returns and offer exposure to attractive supply-side dynamics in certain cases, yet we also maintain interest in industrial names on the cusp of overcoming cost inflation and logistical challenges. Manufacturers have endured a host of pandemic related issues in recent years that in several cases have necessitated a recalibration of operations.

Our holding in Savaria (a maker of accessibility products) is one such company that is in the process of reshoring certain production lines. We recently toured the Brampton plant that is assuming the manufacture of curved stairlifts destined for North America from a European facility. This change will reduce both order lead times and freight charges while affecting technology transfer from last year's Handicare acquisition. Additionally, a recently leased site in Mexico will soon absorb some sub-assembly responsibilities from China and expand capacity close to the company's largest market. Liberated space at the European and Chinese operations will be repurposed to serve local markets, further optimizing the company's footprint and highlights an efficient use of available resources.

FIGURE 3: 2Q QUARTERLY DRAWDOWN WAS AN OUTLIER

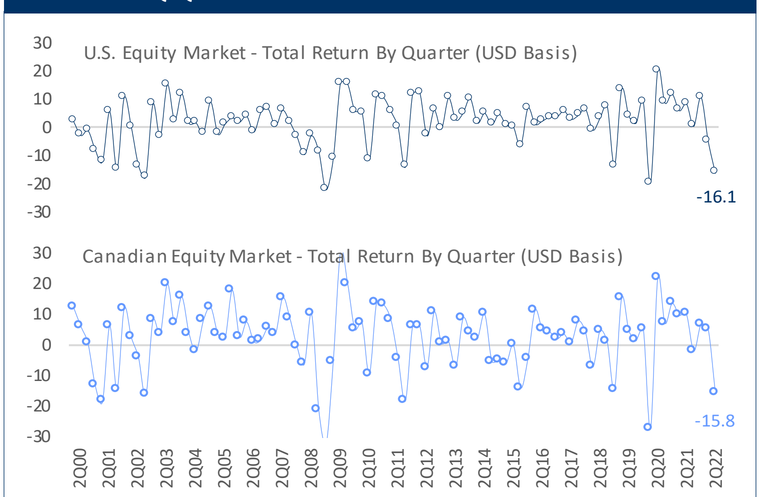
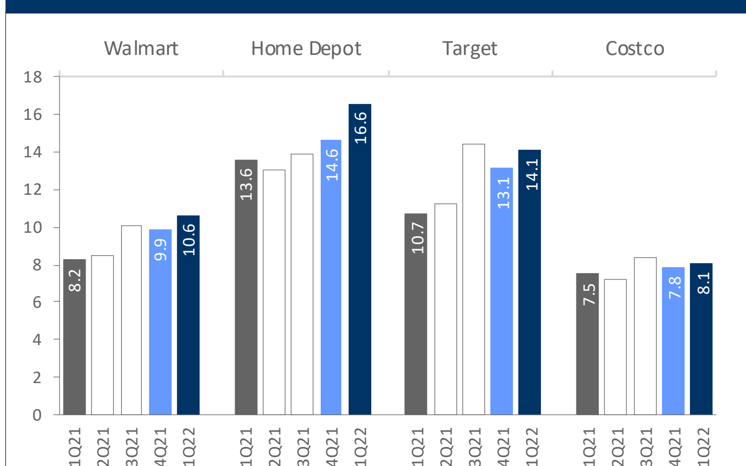


FIGURE 4: RETAILER INVENTORY TO SALES IN FOCUS



Source: Refinitiv | Calendar Period Ending Inventory Divided By Prior 12 Month Sales (%)

CANADIAN SMALL-CAP MARKET

Small-cap stocks typically bear outsized selling pressure during market corrections as traders move up-cap with the notion of de-risking portfolios. Though unpleasant, it is during these time periods that we have historically delivered the most alpha for our clients. Since strategy inception in 2008 there have been over 40 rolling three-month periods where the Canadian small-cap index traded off by more than 5%. We have outperformed in every instance and by an average of 9%. A comparison to the bellwether large-cap Canadian index is also favourable as our strategy has outperformed against the same criteria three quarters of the time across 24 occurrences. These historical outcomes highlight the importance of capital preservation which is a key tenet of our investment philosophy.

Our focus on both quality and value seeks to "overexpose" the portfolio to superior businesses unburdened by investor exuberance. These entities tend to weather the business disruptions from economic pullbacks better than cyclical peers without carrying the valuation risk of pure growth names. Application of this lens to small-cap equities provides asymmetric opportunity by offering upside to small entities with long growth runways and downside protection from our quality value framework. Every market pullback follows its own unique path and like everyone else we do not have a crystal ball. What we can control is our investment process and we will continue to strive to preserve capital in market drawdowns, while staying exposed to the inevitable rally off the bottom.

BIM EQUITY THESIS SPOTLIGHT

For the second consecutive quarter, we were happy to read a press release announcing a takeout proposal of one of our holdings at a substantial premium.

Lifeworks is a leading provider of digital and in-person services related to employee wellbeing. The share price traded lower in 2022 on growing concerns related to margins and competition that first emerged last year. Given the downdraft in the shares we performed a comprehensive review of our thesis and renewed our comfort in the holding. Our findings reminded us that the short-term margin squeeze was the product of strong secular demand for mental health services and that the company's multi-model approach (virtual and in-person offering) remained a key differentiator versus new virtual-only competitors. These conclusions were supported by Telus Health's mid-June acquisition proposal of Lifeworks at a premium of 80% to the previous closing price.

As we look back on past takeovers of portfolio companies, we note that strong business models attached to long-tailed growth themes often attract interest from strategic buyers or private equity if mispriced for too long. This optionality is amplified amongst small-cap names where niche leaders can be acquired by much larger entities at material premiums. Recollection of these observations is most important during periods of market dislocation when traders chase price momentum and patient capital focuses on value.

FIXED INCOME MARKETS | WILL CENTRAL BANKS STICK THE LANDING?

Fixed Income Index Returns	2Q22	YTD22
Canadian	-5.7%	-12.2%

Central banks around the world are acting in unison to battle inflation. Sources of pressure include supply chain bottlenecks, the war in Ukraine, and pent-up demand from a consumer itching to spend accumulated savings. Talking heads from the ECB, Federal Reserve and the Bank of Canada are focused on convincing the market that they will do whatever it takes to ensure that inflation expectations will not get out of control. With that in mind we are seeing the bond market price in some aggressive interest rate hikes from the U.S. and Canada for the next few meetings.

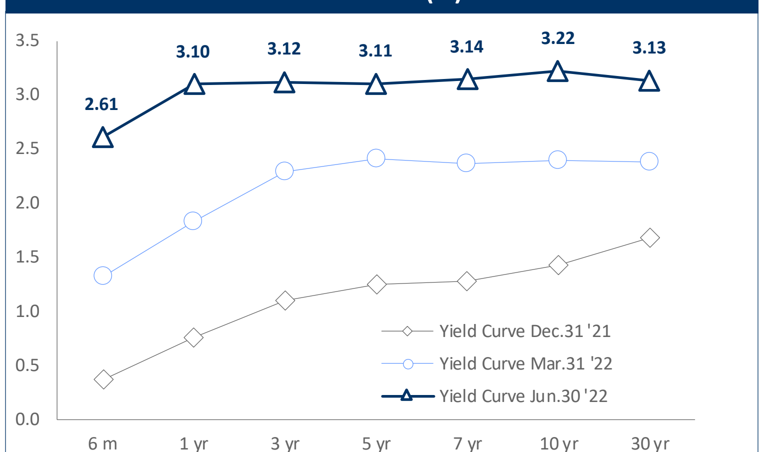
Rising rates are causing some concern about the strength of the economy. We are seeing yields in the long end of the curve increasing at a slower pace when compared to the shorter end implying the market is becoming concerned about the possibility of a recession. We saw that theme play out as yields turned down across the curve in the last couple of days of the quarter, providing some cover for The Fed to engineer the soft landing everyone desires.

Volatility was a dominant theme in the fixed income markets. Yields on government bonds peaked around 3.5% or approximately 115 basis points above the lows seen at the beginning of the quarter, while the final few days in June oversaw a drop of 25 to 30 basis points across the curve as concerns of a recessions started to increase. The end result of all of these up and down moves was an increase in yields of about 80 basis points versus the end of the prior quarter. The curve also flattened with only 3 basis points difference between 1 year and 30 year bonds (Figure 5). Credit spreads widened over the quarter with the 5 year bonds moving the most. The long end of the bond market was hit the hardest with Federal, Provincial and Corporate bonds underperforming 10 year bonds and the shorter part of the market.

BIM FIXED INCOME FRAMEWORK

Central banks have made it clear that they are closely watching each data release and will react accordingly. We look to the data in the same way, and over the quarter we brought duration closer to neutral and reduced the corporate overweight when compared to the benchmark. Going forward, we look to be opportunistic in the market with a close eye on duration, credit spreads, and relative value among the different sectors and aiming to take advantage of any dislocations available. At the end of the quarter the yield to maturity of the portfolio was 4.05%.

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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