BARRANTAGH
Investment Management

BIM REVIEW

1Q23 | RESILIENT MARKETS DESPITE RATE HIKING STRESS

INVESTMENT ENVIRONMENT

- Select U.S. regional bank issues initially spooked the market. Quick action by The Fed and lack of systemic problems provided calm.

EQUITY MARKETS

- Shifting Fed expectations provide boost for secular growth stocks, including large-cap technology.

FIXED INCOME MARKETS

- Bonds exhibit volatility as markets were quick to embrace each data release and central bank communication.

INVESTMENT ENVIRONMENT | RISK MISMANAGEMENT AT SELECT REGIONAL BANKS PROVOKES FED RESPONSE

While the U.S. Federal Reserve's (The Fed) tightening campaign is designed to rein in inflation, the market remained mindful of any unintended consequences of the hiking program that began in earnest in early 2022. As it turned out, the near overnight failure of a once revered Silicon Valley focussed regional bank (SVB Financial Group (SVB)) in mid-March would serve as a flashpoint for scrutiny of both the banking system and the future path of Fed policy.

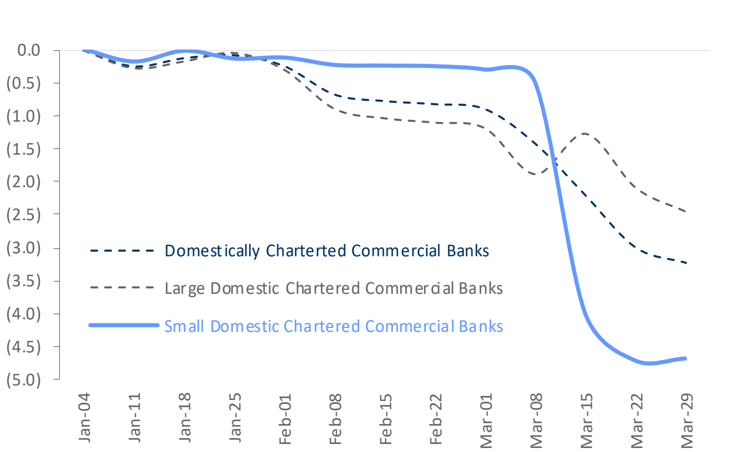
SVB was the preferred bank for Silicon Valley startups and served to stockpile their cash deposits built up over many years during a generous funding environment for technology. SVB sought to benefit from their deposit base by investing in long-dated government treasury bonds that racked up material unrealized losses following the rapid rise of interest rates in the last year. SVB's classification as a regional bank meant that their capital ratio would only be impacted once a loss was realized and seemingly provided time to alleviate the issue. However, SVB was forced to crystallize some of the previously unrealized losses to cover deposit withdrawals as the funding environment for technology companies became more difficult. These trends accelerated as the year progressed, exposing a growing asset-liability mismatch that prompted a failed equity raise by SVB which further spooked their predominantly uninsured deposit base. A bank run ensued with $42 BB of withdrawals occurring in a single day and resulted in SVB being placed into receivership.

Thankfully, The Fed quickly deployed a number of measures to restore confidence in the banking system and reduce the potential for contagion. Deposits were guaranteed at both SVB and Signature Bank (another troubled regional financial) as The Fed invoked a systemic risk exception in partnership with other government institutions. A temporary bank funding program was also created to provide loans for up to one year against the par value of eligible securities including treasuries. Other positive updates in the following weeks included a deceleration in the decline of the deposit bases of commercial banks (Figure 1) and the successful sale of large pieces of SVB to First Citizens Bancshares Inc.

The market quickly came to view the issues at both SVB and Signature as idiosyncratic events and therefore not indicative of systemic problems with the banking sector. Each bank was ultimately undone by overexposure to a particular industry and asset-liability mismatches on their balance sheets. Regulatory reform in the aftermath of the failure of two prominent U.S. regional banks is a likely outcome, but will take time to be enacted.

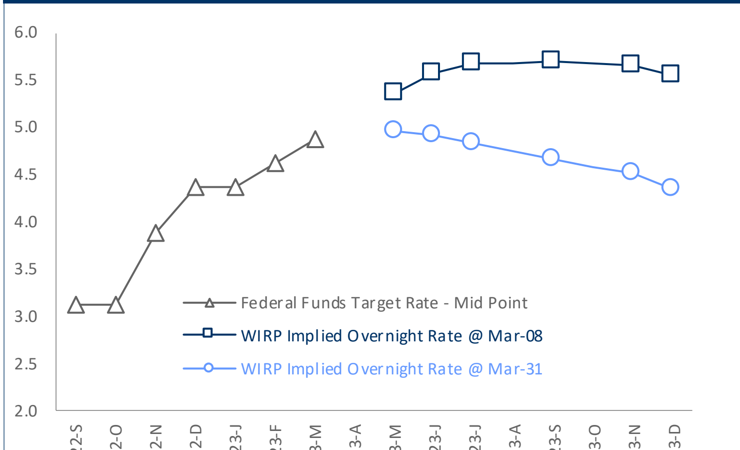
In the near-term we expect a reduced risk appetite of banks to lead to tightening lending standards and slower than previously expected loan creation, which likely impacts growth projections. That being said, expectations of a much more accommodative Fed (Figure 2) in combination with potentially moderating inflation suggests that interest rates may have peaked. The job market also remains resilient, which, when coupled with high savings, enables the average consumer to withstand some incremental challenges to the economy. From a global perspective, the European economy is better positioned having averted an energy crisis over the winter, and China remains in the early stages of reopening their economy following extreme Covid lockdowns that remained in place as recently as last autumn.

FIGURE 1: FED MEASURES DECELERATE DEPOSIT FLIGHT



Source: Bloomberg - Deposit Levels Indexed To Beginning Of 2023

FIGURE 2: MARKETS ONCE AGAIN EXPECT THE FED TO PIVOT



Source: Bloomberg

EQUITY MARKETS | FALLING RATES MORE THAN COMPENSATE FOR GROWTH UNCERTAINTY

Equity Index Returns

	1Q23 (CAD)	1Q23 (USD)	YTD23(CAD)	YTD23(USD)
Global (Net)	7.6%	7.7%		
Canadian	4.6%			
CDN Small Cap	4.5%			

Despite conflicting macro indicators, equity markets showcased resilience by returning strong gains albeit with a fair amount of volatility. Anticipation of Fed policy drove sentiment early on with a perception of peaking inflation (Figure 3) and a potential end to the tightening cycle driving solid gains in January. However, less supportive macro data and hawkish Fed rhetoric led to a partial reversal of performance in February. March was shaped by stress within the banking sector with the forced sale of Credit Suisse and the sudden failure of two regional banks in the U.S. that prompted quick action by central banks to provide liquidity, stabilize deposit outflows, and significantly reduce the risk of contagion. These developments prompted a shift towards less cyclical names, with large-cap technology stocks being a particular beneficiary.

Looking forward, the potential for more conservatism in banks' lending practices could dampen growth prospects. Nonetheless, corporate confidence appears reasonably strong and the job market remains healthy. Other supportive factors include China's continued reopening and Europe's avoidance of a natural gas crisis.

BIM EQUITY FRAMEWORK

Given the recent issues in the banking industry, it is timely to review our quality value framework on the financials sector. Typically, the banks best positioned to outperform over time are those with strong capital ratios, resilient deposit bases, and diversified loan books and revenue streams. While regulation can sometimes be viewed as constraining profitability, it also serves to safeguard against periodic episodes of stress. Incidentally, Canadian banks are subject to some of the strictest regulations in terms of capital ratios and other measures that have likely played a part in their relative year-to-date outperformance versus U.S. peers (Figure 4). TD Bank is in the interesting position of pursuing approval for the acquisition of First Horizon which is a regional bank active in the Southeastern U.S., and may be able to renegotiate more favourable deal terms in light of recent events. TD's existing U.S. operations, and favourable deposit and capital dynamics position them well to absorb First Horizon, notwithstanding some current weakness in their Charles Schwab investment.

GLOBAL MARKETS

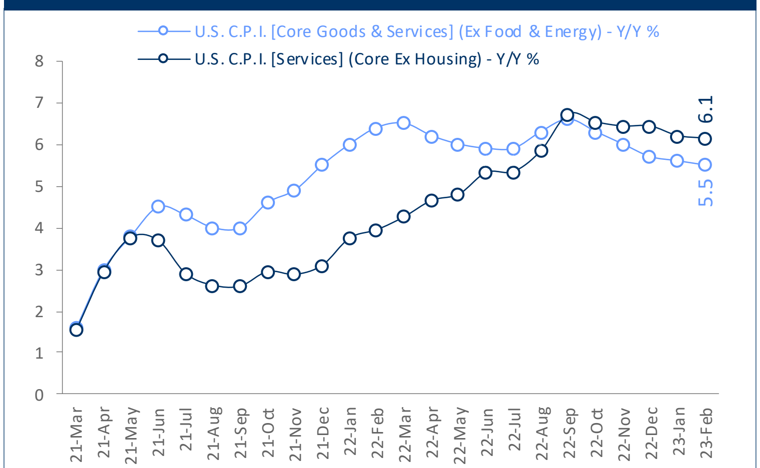
The stock market is currently uncertain about whether inflation and interest rates will soon reach their peak (which would result in a "soft landing" for stocks), or if rates have already risen too quickly (which would lead to a "hard landing" scenario). The failure of two regional banks has added to concerns about a potential economic slowdown if lending becomes more restrictive. However, valuations of safe haven or structural growth stocks that have healthy balance sheets and less exposure to economic cycles, have widened considerably relative to the rest of the market, suggesting that a lot of pessimism is already reflected in market prices.

Despite these macro concerns, we believe that there are attractive investment opportunities within our quality value matrix. Many companies in a variety of sectors and regions have been discounted too heavily due to near-term growth concerns. We see two areas that offer particularly good risk/reward opportunities: quality small caps and turnaround stories with significant self-help potential beyond the short-term. As an example of a quality global small cap, we hold Wabtec, a railroad equipment provider that is well-positioned to benefit from both a short-term recovery in freight locomotives and other longer-term secular trends that we describe in greater detail in the "BIM Equity Thesis Spotlight". We also maintain a well-balanced portfolio that diversifies against some of the macroeconomic risks that exist and compliments our disciplined stock selection process.

CANADIAN ALL-CAP MARKET

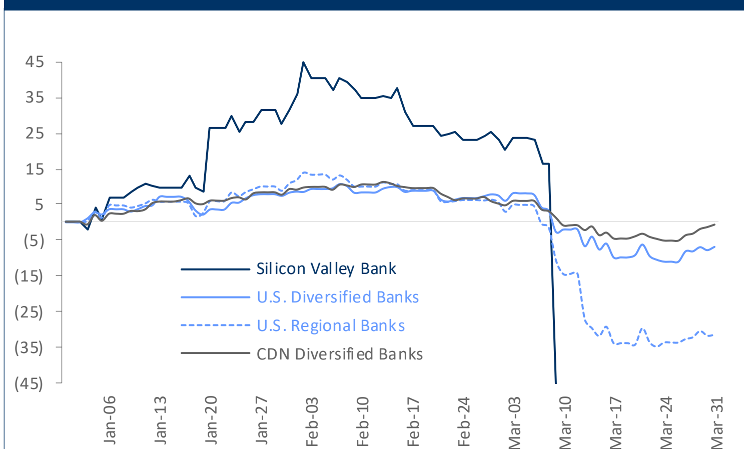
Following a few twists and turns during two year review processes, CP Rail's merger with Kansas City Southern, and Rogers' acquisition of Shaw obtained final approvals from their respective governing bodies (with close expected mid-April for CP and already achieved for Rogers). At a high level, the industrial logic underpinning each transaction is enhanced infrastructure to facilitate the provision of an improved service offering to existing and prospective customers. CP Rail's tri-coastal network will allow direct and more fluid access to a wider range of destinations including Mexico, and Rogers can leverage a stronger western Canadian footprint to offer improved bundling and 5G related services while also being better placed to compete for national corporate accounts. Debt levels will be elevated at closing for each company, and we believe that the respective leadership teams will demonstrate strong execution to both prove the strategic merits of the deals and generate free cash flow to right size their balance sheets.

FIGURE 3: CORE INFLATION STILL HIGH BUT MODERATING



Source: Bloomberg

FIGURE 4: REGIONAL BANK STOCKS HURT MOST BY SVB WOES



Source: Bloomberg - Simple % Returns Indexed To 2022-Dec-31 in USD currency

CANADIAN SMALL-CAP MARKET

Amid much volatility, equity markets delivered further gains during Q1. Sentiment shifted risk-on to start the year, risk-off in February, and towards both defense (size, liquidity, stability) and growth (on bets that interest rate hikes had peaked) in March. Small caps lagged during the period outside of precious metals, where a weaker USD, falling rate expectations, and flight to “safety” all aligned to lift gold prices. This environment was not favourably disposed towards our focus on small cap, cash flow compounding businesses trading at attractive valuations.

With sentiment shifting strongly one way, some high-quality small caps have fallen out of favour, providing attractive valuation opportunities. One example, long-term holding Cargojet (CJT). This previous high-flyer (pun intended) has been trimmed over the years (most recently Feb/21 and Jun/20 at much higher prices) to manage position size given the accelerated pace CJT grew intrinsic value. Fast forward to today, the market has myopic focus on the slowing freight environment, growing international competition, and deferral of the fleet expansion plans. We don’t discount these challenges, but an overly short-term and pessimistic outlook loses sight of (1) the strength of the franchise (near-monopoly in overnight air-freight, long-term contracts, e-commerce tailwinds, etc.) and (2) the high likelihood that the current grey skies will pass. We can’t control when or how deep the pendulum will swing from euphoria to despair, but we can seek to take advantage when it does.

BIM EQUITY THESIS SPOTLIGHT

Wabtec is a leading locomotive, component, and technology supplier to the freight train and passenger transit industry worldwide. With a significant share in the North American locomotive market, the company has a long runway of recurring service revenue opportunities due to their large installed base and quality service offering. Moreover, the increasing adoption of public transit worldwide is partly driven by governments who look to leverage the environmental benefits of rail.

The company is poised to benefit from the shift towards fuel efficiency and decarbonization as railroads aim to meet their environmental goals. They achieve this by upgrading their existing diesel fleet, adopting hybrid battery locomotives, and ultimately transitioning to hydrogen power. Furthermore, Wabtec’s onboard products and software enable railroads to optimize their train operations. In particular, their signalling systems allow trains to be controlled using algorithms with built-in safety and accelerate/breaking features that are customized to each stretch of track.

The company’s leadership has a proven track record of strong execution, which underpins our confidence in the achievement of above-average growth and margin expansion opportunities over time. There is also potential for a recovery in locomotive deliveries from currently depressed levels to that of replacement demand which would provide a short-term boost.

FIXED INCOME MARKETS | CONFLICTING NARRATIVES LEAD TO FLIP-FLOPPING MARKET EXPECTATIONS

Fixed Income Index Returns		
	1Q23	YTD23
Canadian	3.2%	

Market expectations at the beginning of the year forecasted 100 bps of hikes from The Fed, but as the quarter evolved, these assumptions flipped to projections of 100 bps of cuts. In that context, it is not overly surprising to learn that volatility in the bond market has reached levels not seen in many years. This measure has increased due to the dichotomy between central bank communications and the data contained in economic releases. With both narratives finding support in the markets, we find ourselves in the midst of a tug of war between the two.

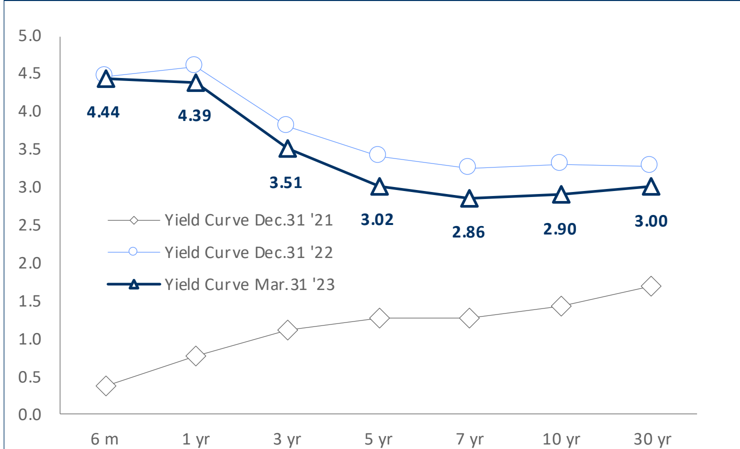
Economic data began to soften as the quarter came to a close and the rate of growth in inflation began to moderate while still remaining elevated. Going forward, the market is implying that a potential slowdown in the economy stemming from stresses in the regional banking sector due to the failures of SVB and Signature Bank will lower inflation and eliminate the need for further rate hikes. The bond market is currently pricing in rate cuts beginning in the second half of 2023, though expectations will be quick to react to future developments in the regional banking sector and its related dealings with commercial real estate in addition to other macroeconomic headlines.

The narrative from The Bank of Canada has remained consistent with inflation remaining top of mind including their resolve to bring it back down to targeted levels. In addition to managing inflation, central banks are also engaged in maintaining the stability of the financial system with targeted measures such as the Bank Term Funding Program providing liquidity support to the regional banking sector and minimizing the risk of contagion.

BIM FIXED INCOME FRAMEWORK

The liquidity support provided by The Fed in support of regional banks triggered lower yields in government bonds (Figure 5) and wider spreads on corporate bonds. In reference to the earlier mentioned volatility, outsized changes in yields occurred in the quarter with government bonds exhibiting a peak to trough move of over 70 basis points in the 2-, 5- and 10-year part of the curve. Corporate credit spreads widened 25 basis points in the short end and 15 basis point in the middle of the curve across all ratings. This combination of yield and credit spread dynamics led to outperformance in the middle part of the curve. We will look to recycle some of our overweight corporate exposure in the short-end as opportunities present themselves and maintain our holdings in the long-end which is weighted towards government product.

FIGURE 5: CANADIAN YIELD CURVE (%)



Source: Bloomberg

BARRANTAGH
Investment Management

100 Yonge Street, Suite 1700
Toronto, Ontario M5C 2W1
(416) 868-6295
www.barrantagh.com

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.

For more information contact: Barrantagh Investment Management Inc. (416) 868-6295