BARRANTAGH
Investment Management

BIM REVIEW

2Q23 | CONTINUED MODERATION OF INFLATION IS KEY TO A SOFT LANDING SCENARIO

INVESTMENT ENVIRONMENT

- A soft landing remains in play given a resilient consumer and moderating inflation. Resolution of the U.S. debt ceiling was a key de-risking event.

EQUITY MARKETS

- Information Technology and A.I. exuberance leads the markets higher, though many attractive opportunities exist outside of the momentum plays.

FIXED INCOME MARKETS

- Interest rates in North America are likely to plateau soon as the focus of central banks will turn towards the terminal rate.

INVESTMENT ENVIRONMENT | UNCERTAINTIES REMAIN, BUT COMPONENTS ARE IN PLACE FOR A SOFT LANDING

As we entered the second quarter, two items being closely watched were the progress of U.S. debt ceiling negotiations, and the general health of the U.S. banking sector in the wake of the regional banking crisis. A bipartisan agreement to raise the U.S. debt ceiling for two years including spending provisions acceptable to both sides removed a potentially large market distraction, and was received well given expectations of a somewhat contentious debate. Also, while not giving an all-clear to the system at large, it was encouraging to see that all of the largest U.S. participant banks passed the Federal Reserve's (The Fed's) annual stress test. This outcome provides greater confidence that at a minimum the bellwethers could withstand economic challenges in what is still a sensitive time for the sector.

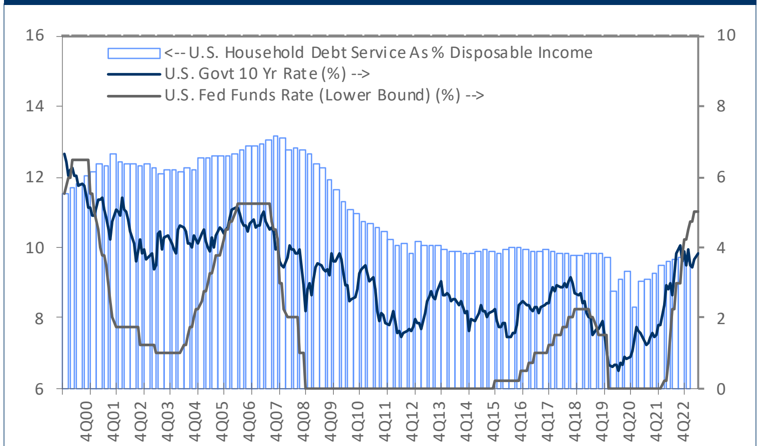
While there are always lags between policy change and its transmission to the broader economy, the continued strength of the consumer has been surprising given the magnitude and pace of rate hikes enacted to date. **A combination of tight labour markets, pandemic financial assistance, and potentially shrewd refinancing of U.S. mortgages at favourable rates appears to have buoyed personal finances. In fact, by the measure of household debt service to disposable income, the U.S. consumer is actually less pressured now than they were pre-pandemic (Figure 1).**

While currently elevated interest rates are sure to impact consumer spending levels given enough time, the hope is that there will be a gradual transition rather than an abrupt drop-off. **Notably, the rate of change for spending on goods began to decelerate in the second half of 2022, while outlays on services have maintained a steady pace of year-over-year growth for an extended period (Figure 2).** It would appear that consumers continue to chase experiences after having limited opportunities to do so over the last number of years.

Recent labour market related data has generally surprised to the upside, though manufacturing focused updates have been lacklustre as the goods sector absorbs some destocking and realigns with current consumer preferences. It is therefore not surprising that export oriented economies such as China have experienced fading growth momentum versus forecasts at the turn of the calendar year. China has also experienced some internal challenges which when paired with the current export climate have prompted the central bank to cut rates and for leadership to contemplate further stimulus. Policymakers have messaged that numerous measures are being considered ranging from additional property market reform to manufacturing incentives with further details expected following the upcoming Politburo meeting in July.

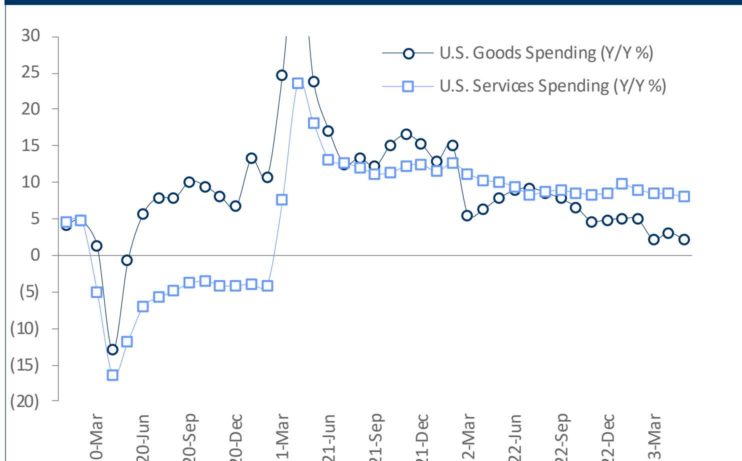
Commentary from The Fed is conditioning markets for a further rate hike in July and contributing to a deeply inverted yield curve that has been a reliable predictor of past recessions. Yet, the severity of a potential downturn in economic activity is uncertain with a number of factors arguing for a mild impact or soft landing. Headline inflation seems well past peak in many developed markets with core inflation proving stickier though also showing signs of moderation even if currently above targeted levels. Other de-risking events include the aforementioned U.S. debt ceiling agreement and improving news flow around the banking sector which could help support an orderly deceleration that markets could more easily digest.

FIGURE 1: CONSUMER FINANCES HOLDING IN WELL SO FAR



Source: Bloomberg | Most recent data for Household Debt Service is 1Q23, all others 2Q23

FIGURE 2: SERVICES ATTRACTING CONSUMERS' WALLETS



Source: Bloomberg | Last Data Point 23-May

EQUITY MARKETS | LOOKING FOR WINNERS OUTSIDE OF THE MOMENTUM PLAYS

Equity Index Returns	2Q23 (CAD)	2Q23 (USD)	YTD23(CAD)	YTD23(USD)
Global (Net)	4.5%	6.8%	12.4%	15.1%
Canadian	1.1%		5.7%	
CDN Small Cap	-4.6%		-0.3%	

Technology related stocks stole the show once again in the quarter as expectations of a peaking rate cycle and extensive coverage of the growth potential of artificial intelligence attracted evermore interest. Within global markets, the top seven technology related contributors represented greater than half of the total index return both for the second quarter and year-to-date. This narrow market leadership was made possible by each of these seven constituents having both a large (or more accurately mega) capitalization combined with significant outperformance versus the median stock in the index. The year-to-date impact of information technology has also been notable in the Canadian market though to a lesser extent than in the global context. Time will tell if the hype lives up to actual results, and in the interim, looking to names either in other sectors or within different areas of the market capitalization spectrum offers fertile ground for bargain hunting (Figure 3).

BIM EQUITY FRAMEWORK

Financial markets can be short-sighted at times when extrapolating temporary phenomenon well into the future. This dynamic can provide opportunities to the extent that high quality companies may be mispriced should transitory challenges be accepted as the new normal and become embedded in forecasts for the coming years. Cost pressures and supply chain disruptions have been longer lasting than many anticipated, though there is now growing evidence of moderating inflation which bodes well for near term relief in industries that are still managing through lingering impacts (Figure 4).

A recipe for potentially outsized returns can arise at the intersection of a depressed valuation and an inflection in operating results. Patience is a necessary discipline for such an opportunity, as timing a turn to a specific quarter relies more on luck than skill. However, understanding the dynamics of a particular industry, company, and management team can provide the confidence to deploy capital into a particular name with a view that positive change is a "when" and not an "if" event. We would characterize Premium Brands in such a mold and expand on our premise in the "BIM Equity Thesis Spotlight" section that follows.

GLOBAL MARKETS

Strength in technology remained a dominant theme in the quarter, though companies that can execute well operationally and drive sales growth and margin expansion should also attract investor attention regardless of their sector classification. Positive secular themes are not exclusive to the technology space, and compelling opportunities can be found in a number of different industries that may not trade at the lofty valuations of the names that are currently dominating the headlines.

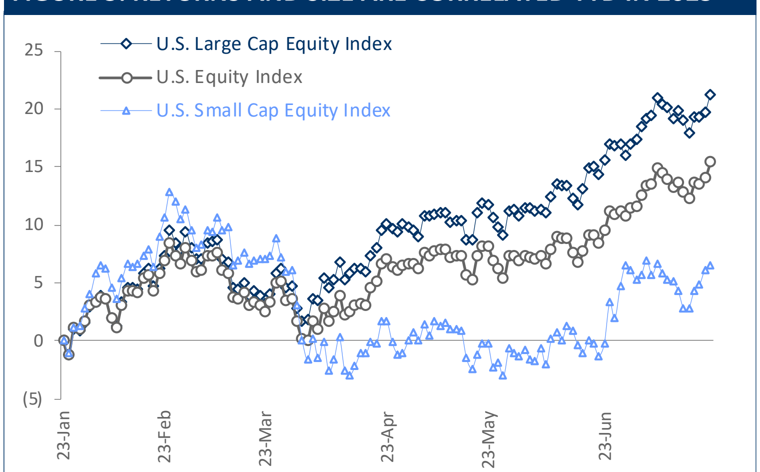
One such sector is the medical device space where companies have been impacted in recent years by supply disruptions and hospital staffing shortages, though relief on these fronts is occurring and pent-up demand for procedures that were deferred during the pandemic remains strong. Boston Scientific has a diversified range of offerings across numerous end markets, has a strong history of innovation supporting new product launches, and is focusing its portfolio mix in its fastest growing segments. The company is also well placed to benefit from the continued trend of procedures shifting to hospital outpatient departments and ambulatory surgical clinics. An aptitude for high quality tuck in acquisitions has been an important part of the capital allocation strategy over time, with the two most recent transactions being the purchases of Acotec Scientific Holdings (a majority stake), and Apollo Endosurgery.

CANADIAN ALL-CAP MARKET

In our 4Q22 publication we provided commentary on the banking regulator increasing the required capital ratios for the group via an adjustment to the Domestic Stability Buffer (raised 50 bps to 3.0% within an upwardly revised range of 0.0% - 4.0%). The month of June brought about the semi-annual review of this policy, and once again, out of an abundance of caution, the regulator decided to increase the buffer by 50 bps to 3.5% with an implementation deadline of November 1st (effectively prescribing a minimum CET1 capital ratio of 11.5%).

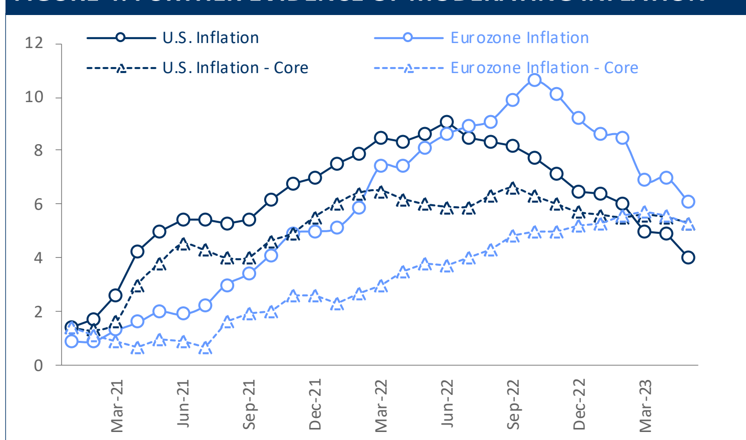
All the large banks are well placed to exceed the requirement (particularly TD post walking away from First Horizon), though holding more capital does impact the returns that can be earned on equity. With that said, the higher capital ratios also provide defence against any potential negative economic scenario or other unforeseen development and help to cement the Canadian banks as relative safe havens versus their global peers.

FIGURE 3: RETURNS AND SIZE ARE CORRELATED YTD IN 2023



Source: Bloomberg - % Change Indexed To Beginning Of 2023

FIGURE 4: FURTHER EVIDENCE OF MODERATING INFLATION



Y/Y Consumer Inflation | Last Datapoint Graphed Is 2023-May
Source: Bloomberg

CANADIAN SMALL-CAP MARKET

The second quarter was marked by continued volatility and Canadian equities lagging global benchmarks. Canadian large and small cap benchmarks are off 2% and 8% from their respective highs since the recovery bounce in January, and small caps have trailed their larger cap peers during the current AI-fueled mega-cap tech bull market. When splitting 400+ Canadian stocks into market-cap buckets of small (<$750 mm), mid ($750 mm - $4 bb) and large (>$4 bb) we note a marked performance difference based on size over both a year-to-date (ytd) and trailing-twelve-months (ttm) time frame (small: -2% ytd, -4% ttm | mid: +4% ytd +10% ttm | large: +10% ytd, +19% ttm). Strongest performers were found in the barbell positioning of high-multiple tech and deep cyclicals which are two pools in which we tend not to fish.

When sentiment temporarily moves away from a certain investment style or factor, the pull to "chase" performance can be strong. At Barrantagh, our "Quality Value" ethos permeates everything we do. Our goal is to dispassionately analyze the fundamentals and identify great businesses, at attractive prices, run by capable leaders that can grow and thrive over time. We can't control market multiples, prevailing narratives, or sentiment shifts. We can however take a longer-term view, control what we pay, and let compounding capital work in our favour. Like a rubber band being pulled back, medium-term fundamentals can only be ignored for so long before a snap back to "reality" occurs.

BIM EQUITY THESIS SPOTLIGHT

Premium Brands is a Canadian specialty food business that produces artisanal food products at scale. Acquiring entrepreneurial companies and providing their leaders with the resources needed to achieve their ambitions is a strength of management which has fostered strong innovation led organic volume growth over time.

Some of the company's greatest successes have been within their sandwich platform whereby high quality premade offerings enable their customers to offer their clients a great product while also saving on their own labour requirements. In effect, Premium Brands is providing not just a product, but also a solution. In this vein, it is notable that the company maintained excellent fill rates during the supply chain challenges of the last number of years to do best by their clients while absorbing some extra costs and carrying safety inventory. These decisions impacted margins, free cash flow, and return on capital numbers for a period of time, yet also provide strong reputational benefits and position the company to capture outsized growth opportunities with their partners in the future. In the parlance of their annual letter to shareholders from years past, Premium Brands is playing "the long game" to maximize the intrinsic value of their company.

The future appears bright as supply constraints ease, organic initiatives begin to bear fruit, and inventory normalization improves the cash conversion cycle.

FIXED INCOME MARKETS | ARE WE NEARING THE CONCLUSION OF THE RATE HIKING CYLCE IN NORTH AMERICA?

Fixed Income Index Returns		
	2Q23	YTD23
Canadian	-0.7%	2.5%

During the second quarter of 2023, we saw concerns about the regional banking crisis ease and a solution to the debt ceiling which refocused the markets attention towards the pace of progress in central banks' fight to return inflation towards targeted levels. **The Bank of Canada hiked in June after two consecutive pauses, and the Federal Reserve provided the market with what participants are calling a hawkish pause. Both central banks are focusing on the appropriate terminal rate now and no longer on the speed and size of the rate hikes intimating that we are likely in the closing stages of the tightening process barring unexpected results in upcoming economic data releases.**

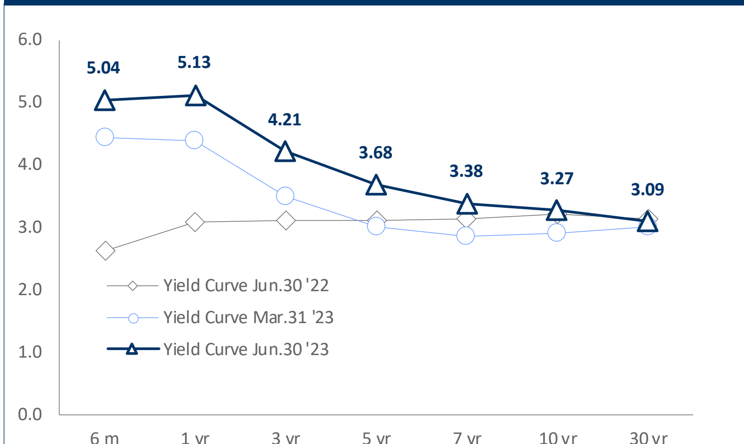
The Bank of Canada tracks three measures of inflation including Core, Median, and Trim (essentially core excluding any extreme results). All measures are trending lower and came in below 4% in the quarter yet remain elevated in absolute terms. As of quarter-end, markets have fully priced in one additional hike in both Canada and the U.S. with the possibility of one more prior to year end after which central bank messaging implies that rates will plateau for some time whereas the market foresees a cut as soon as the first quarter of 2024.

Volatility in the rates market continue to be a theme with peak to trough moves of over 100 basis points in the short-end (1-5yr), 75 basis points in the middle-part of the curve (5-10 yr), and 40 basis points in the long-end (10+ yr) (Figure 5). In the quarter we also saw credit spreads tighten 10-15 basis points across the curve. At the beginning of the quarter our portfolio was underweight the short and middle part of the curve, and overweight corporates, benefitting from the moves in rates and credit spreads.

BIM FIXED INCOME FRAMEWORK

Prior to quarter-end we made some changes in the portfolio to close our underweight in the short and middle-part of the curve and reduce our exposure to corporate bonds. Our model is currently neutral to our benchmark with regards to interest rate risk, and we remain overweight corporates though to a lesser degree than when the quarter began. Our exposure to corporate bonds continues to be in the short-end and primarily within well known and liquid issuers, with the goal of recycling those short-dated maturities into opportunities that may be created by any dislocations in the market. Our exposure to government bonds (both provincial and federal) remains primarily in the longer-end of the curve.

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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