BARRANTAGH
Investment Management

BIM REVIEW

3Q23 | EQUITY AND BOND MARKETS DECLINE AS LONG END OF THE YIELD CURVE RISES

INVESTMENT ENVIRONMENT

- A higher-for-longer yield mindset dominated market psyche as the quarter drew to a close, despite inflation indicators stabilizing.

EQUITY MARKETS

- Rising rates take a toll on growth stocks and companies with high debt levels. Quality of business is key for yield stocks to perform in current backdrop.

FIXED INCOME MARKETS

- Markets quickly adjust to central banks' message that future hikes remain a distinct possibility if supported by upcoming data.

INVESTMENT ENVIRONMENT | LENGTHENING EXPECTATIONS FOR RESTRICTIVE POLICY AFFECT MARKETS

The rise of long-dated interest rates to levels not seen in over a decade led to a challenging quarter for capital markets with both fixed income and equity indices trading down. **The higher-for-longer interest rates mantra taking hold in the market is underpinned by changing expectations regarding how long monetary policy will stay restrictive to achieve target inflation levels. As such, the relationship between long-term rates and inflation has broken down for the time being despite the significant yet decelerating progress made in taming the latter (Figure 1).**

One of the unique attributes of the current economic cycle has been the stimulus measures that resulted in the accumulation of excess savings by consumers during the pandemic years. These 'nest eggs' have provided support for discretionary spending, yet the expected duration of such benefits has remained unclear. While there is no consensus among economists, the San Francisco Federal Reserve recently opined that the drawdown of excess savings among U.S. households is near complete. Although there is a fair degree of uncertainty in this regard, commentary from a number of companies with exposure to the lower-income consumer seem to provide some support to their findings.

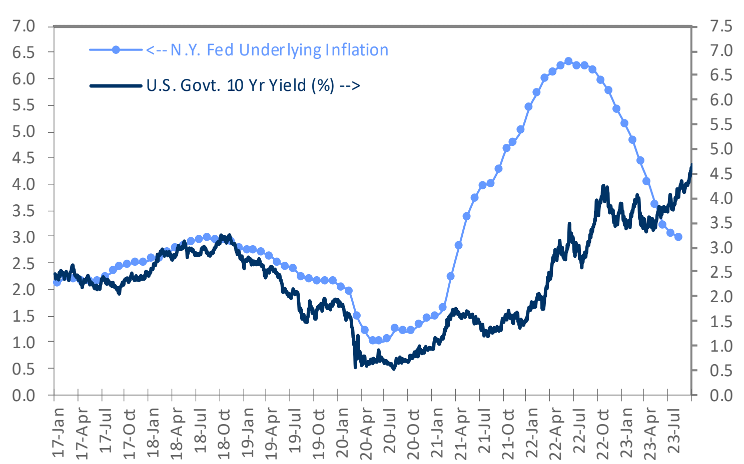
It appears that the delayed impact of rate hikes may be starting to influence behaviour in certain segments of the economy, and the resumption of U.S. student loan payments (paused since the onset of Covid) will be an incremental burden to those affected. Consumer sentiment has softened somewhat in recent months and although this metric can be volatile, it still bears monitoring as the year progresses (Figure 2). With that mentioned, it should be noted that a still robust job market with real wage growth continues to provide crucial support to consumer spending.

On the corporate front, a recent survey of U.S. CFOs revealed improving expectations for the economy notwithstanding some reservations about the path forward for monetary policy. Up until now, businesses have not significantly scaled back their capital expenditure plans, though higher interest rates could introduce some headwinds on this front. A potential offset to this concern is the pent-up demand from the easing of previously challenged supply chain conditions, and that government spending on infrastructure projects is still in its early stages and is expected to significantly boost economic activity over the next few years.

At a time of anxious markets, an ongoing united auto workers (UAW) strike, and a data dependent U.S. Federal Reserve (The Fed), it was encouraging to see the U.S. congress pass a last minute temporary funding measure to avoid a government shutdown. The continuing resolution funds federal departments through the middle of November and provides time for opposing sides to reach a compromise. Importantly, agencies responsible for the collection and release of economic data will continue to function during the interim and provide updates that The Fed relies upon in setting monetary policy.

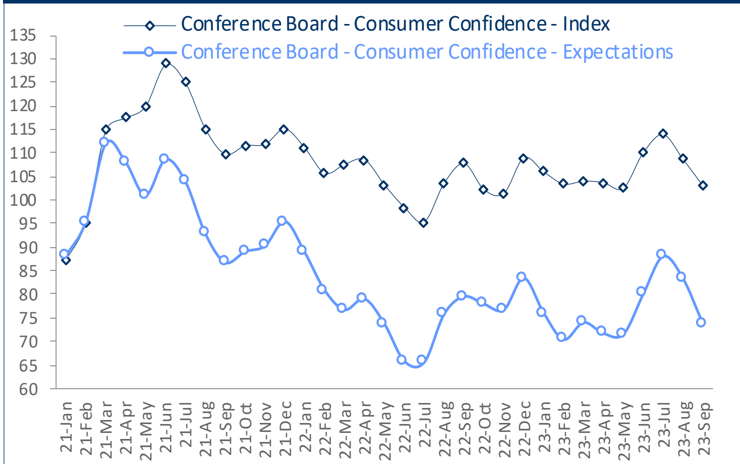
Markets had been relatively orderly up until mid-September at which time volatility increased to levels not seen for the better part of six months or more. Interest rate stabilization may be required for fundamentals to reassert themselves in the financial markets as we move towards year-end.

FIGURE 1: INFLATION AND INTEREST RATE LINKAGE TESTED



Source: Bloomberg

FIGURE 2: MODERATING CONSUMER EXPECTATIONS



Source: Bloomberg

EQUITY MARKETS | EQUITIES DECLINE AFTER AN EARLY SUMMER RALLY

Equity Index Returns	3Q23 (CAD)	3Q23 (USD)	YTD23(CAD)	YTD23(USD)
Global (Net)	-1.4%	-3.5%	10.9%	11.1%
Canadian	-2.2%		3.4%	
CDN Small Cap	-0.8%		-1.1%	

Equities began the quarter on a positive note in July with optimism fading in August and turning downbeat in September due to the rapid rise in interest rates as a higher-for-longer scenario became priced into markets. Energy was the positive outlier for the quarter as stocks responded to strengthening crude oil prices in part aided by OPEC production management. Due to the higher rate environment, non-energy cyclicals, growth technology, and companies with higher than average debt struggled from a return perspective.

BIM EQUITY FRAMEWORK

At a time when earnings yield and bond yields are converging (Figure 3), sectors perceived as 'yield' plays containing companies with resilient cash flows and dividends have come under pressure. Sometimes stale narratives can cloud perceptions, and it is important to remember that dividend payers can be much more than 'bond proxies' when offering growing cash flows. Ideally a dividend will grow over time as a function of increasing earnings as a business executes its strategy and distributes excess cash to shareholders to offer a more compelling total return. However, a high dividend may potentially indicate underlying issues regarding the sustainability of the payout, underscoring the importance of prioritizing the quality of the company in advance of examining yield.

Notwithstanding the current softness in traditional income sectors, it is important to note that dividends have represented a substantial portion of total return for indices over time (~40% of total return for the Canadian market since the turn of the century to year-end 2022 as shown in Figure 4). Toromont Industries is an example of a dividend grower that does not currently offer a high yield, but has steadily raised its distributions over time alongside increasing cash flows. Long-term holders of the name would be collecting an attractive yield versus their cost base while also sitting on substantial capital gains.

GLOBAL MARKETS

Both consumers and companies have generally been able to manage well in the recent period of rising inflation and interest rates. Consumers have benefited from a robust job market and increased wages to help absorb price hikes utilized by companies to counteract inflationary pressures. While consumers have been seeking out more affordable products in certain categories, the transition in spending from goods to services is primarily a function of elevated purchases of goods during the pandemic and subsequent pent-up demand for services that followed.

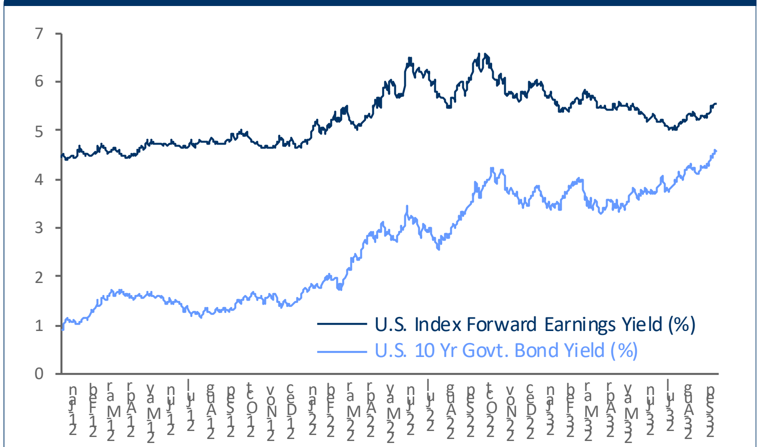
The current environment of higher inflation and rates will prompt companies to place a greater emphasis on enhancing their productivity and efficiency to boost their profit margins. Consequently, businesses that provide their customers with efficiency savings will see an increase in their market share. While technology businesses are first to come to mind in this regard, there are companies across various sectors including industrials, consumer goods, healthcare, and materials that also play a significant role in enhancing their clients productivity. This is a key factor we evaluate when identifying high-quality businesses with fair valuations. A prime illustration of this can be seen in our investments in Schneider Electric and CRH.

CANADIAN ALL-CAP MARKET

Market access has long been a concern for Canadian energy producers given geographic positioning at 'the opposite end of the pipe' to most of their customers in the U.S. gulf coast. The Trans Mountain Expansion Project (TMX) will nearly triple capacity of the existing Edmonton to Burnaby pipeline to 890,000 barrels of oil per day (bpd) and represents a key source of egress for the Canadian basin. The project has been plagued by large cost overruns and lengthy delays and faced additional challenges as recently as late summer upon encountering engineering difficulties that necessitated an application to deviate the pipeline routing. Release of this news caused heavy oil differentials (the variance between the heavy oil price and the WTI benchmark) to increase on fears of further construction delays.

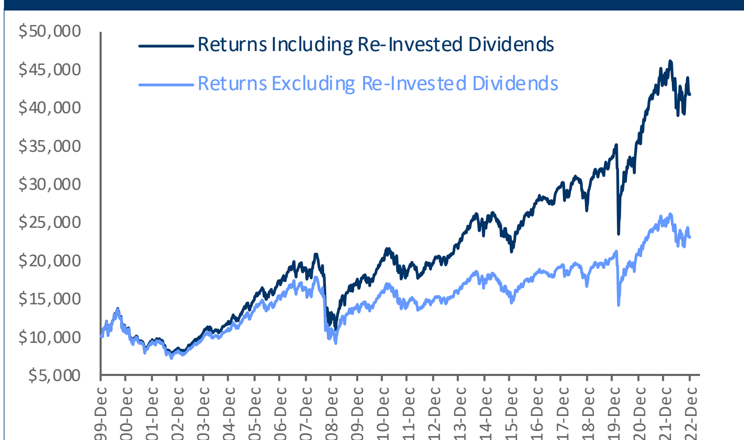
A positive ruling from the Energy Regulator in late September approving the route deviation was therefore a welcome development for oil sands players who are eagerly awaiting mechanical completion and the onset of line fill activities in the coming year. The opportunity to transport additional volumes in a strong oil price environment would benefit many producers including Canadian Natural Resources and supplement an already impressive shareholder cash return framework.

FIGURE 3: EARNINGS YIELD AND BOND YIELD CONVERGING



Source: Bloomberg - Earnings Yield = 1/(Consensus Fwd 12 Month P/E [Unadjusted])

FIGURE 4: DIVIDENDS ARE A KEY COMPONENT OF RETURNS



Growth in $10,000 invested in Canadian Equity Market

CANADIAN SMALL-CAP MARKET

Canadian equity markets turned red during the third quarter, with negative momentum accelerating in September. Overall performance was buoyed by the energy sector, while under the surface pain was inflicted on anything with rate-sensitivity including utilities and REITs as the higher-for-longer market narrative solidified.

Much has been written this year about the poor breadth in this market ‘rally’ with the U.S. index up ~13% year-to-date and the equal weight equivalent up just ~1%. This poor breadth has also been a factor for Canadian small caps. Excluding the top 10 performing stocks (~3% of the index), the aggregate return for the Canadian small cap benchmark is –5% in 2023. Returns fall to –8% and –11% if expanding the exclusion to the top 10% and 25% of the index respectively. 2023 has been challenging if missing out on pockets of resource and cyclical sectors.

As noted above, energy has been strong. Years of underinvestment and a more disciplined supply dynamic has supported commodity pricing while companies have embraced shareholder-friendly return strategies and low debt. We added Logan Energy (LGN) during the period, a high-growth Montney producer led by the highly regarded team behind prior Spartan entities where a track record of accretive production growth rewarded past shareholders. We like LGN’s assets and leadership team and see the company as set to benefit from west coast LNG development in the years ahead.

BIM EQUITY THESIS SPOTLIGHT

CRH is a leading building materials company with operations in North America and Europe. They are in the business of producing and distributing aggregates, cement, and asphalt in addition to a diverse range of architectural and infrastructure products.

Over time, the company has evolved from being simply a supplier of building materials into a fully integrated solutions provider. This transformation is especially visible in road construction where they manage every aspect of the supply chain, encompassing key raw materials and concrete products, to engineering and construction services. These processes have provided numerous benefits to their customers including an ability to execute projects in a more efficient manner and with a reduced environmental impact. At the industry level, CRH and their peers should benefit in the coming years from growth opportunities emanating from substantial government led infrastructure initiatives across the globe.

Management has a strong track record of effectively deploying capital as demonstrated through successful acquisitions and divestitures, and a fragmented market structure implies a long runway for future value creation. Shareholder return policies include an increased share buyback program in 2023 and a greater than 50 year history of dividend delivery. A recent listing on the NYSE should shine a light on the company’s attractive valuation and potentially narrow the multiple gap with U.S. industry peers.

FIXED INCOME MARKETS | HIGHER-FOR-LONGER NARRATIVE EVIDENT IN FLATTENING CURVE

Fixed Income Index Returns		
	2Q23	YTD23
Canadian	-3.9%	-1.5%

Central banks around the globe including The Federal Reserve (The Fed) and the Bank of Canada (BoC) continue to dominate headlines in their efforts to tame inflation, and each hiked rates at their July meetings. Both institutions stood pat at their September meetings, yet The Fed in particular strongly messaged the potential for future hikes should the upcoming economic data warrant a move.

The post-meeting notes released by the BoC highlighted continued strength in the U.S. economy and the potential positive knock-on effects for prospects north of the border. Weakened demand for interest rate sensitive products such as housing was identified as increasing financing costs impact both home builders and consumers. While the labour market remains tight, some indications of easing were noted as a function of reduced job vacancies as opposed to job losses. Wage growth remains elevated, though is forecasted to moderate going forward and will be important to monitor together with shelter costs which both have the potential to complicate BoC’s inflation goals.

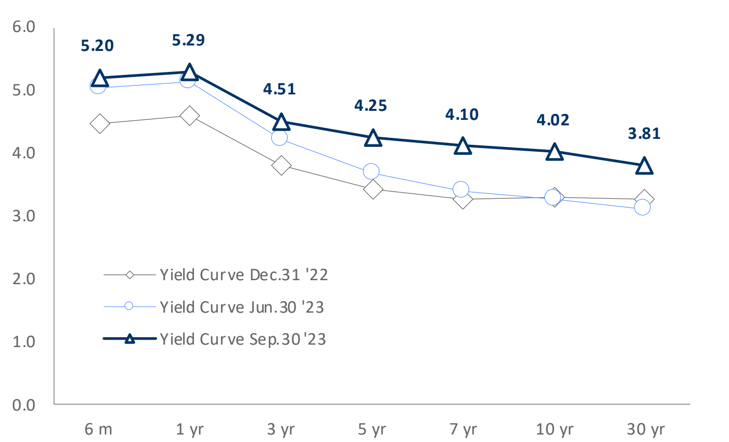
The net impact of the economic developments in the quarter was a reduced confidence in a timely return of inflation to target levels and therefore a period of higher-for-longer rates. Interest rates moved higher across the curve, though much more so in the long-end versus the short-end. In Canada 2-year yields increased 29 basis points in the quarter with 10 year and 30yr bonds moving over 70 basis points (Figure 5).

BIM FIXED INCOME FRAMEWORK

At quarter end our portfolio is positioned neutral to the benchmark with regards to duration risk, as the path for interest rates is uncertain. The BoC can either maintain rates at current levels and trust that policy is restrictive enough to moderate inflation in an acceptable time frame or be more aggressive and hike to accelerate the process while putting incrementally more stress on the economy.

Our neutral positioning with regards to duration risk will remain until the economic data warrants a change. Our overweight in corporate bonds remains, though slightly reduced from the prior quarter, and focused on the short end with primarily well-known and liquid issuers. We look to recycling some of the short-dated maturities into any opportunities that may arise from future dislocations in the market. Our exposure to government bonds (provincial and federal) remains primarily in the longer end of the curve.

FIGURE 5: CANADIAN YIELD CURVE (%)



Source: Bloomberg

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