BARRANTAGH
Investment Management

BIM REVIEW

4Q23 | 2023 ENDS ON AN OPTIMISTIC NOTE

INVESTMENT ENVIRONMENT

- Easing inflation and lower rates offer relief to economic challenges that were building. Uncertainty remains, though a soft landing is now easier to envision.

EQUITY MARKETS

- A broad based market rally as stock indices surge into year-end. More dovish central bank policy was particularly welcome for rate sensitive sectors.

FIXED INCOME MARKETS

- The peak in overnight rates appears to be in the rear view mirror. The market's perception of a policy pivot led to a significant repricing along the curve.

INVESTMENT ENVIRONMENT | DECLINING RATE ENVIRONMENT INCREASES THE CHANCES FOR A SOFT LANDING

The higher-for-longer mantra that gathered steam throughout the year reached a crescendo in early autumn as U.S. 10 year government yields surged towards 5%. Yet as we turned the calendar to 2024, rates had retreated back below 4% and performed a round trip to levels prevailing one year ago (Figure 1).

Markets interpreted higher-for-longer as meaning a sustained period of tight (but not oppressive) monetary policy designed to keep rates at a stable level in an effort to engineer a soft landing. The unknown however was the required duration of the strategy with any lengthening of expectations increasing the chances of an adverse outcome. In just a few months, the combination of some supportive economic data and a change in tone from the U.S. Federal Reserve (The Fed) dramatically altered perceptions of future policy actions.

The initial relief valve was a softening of the Consumer Price Index (CPI) data which hinted that Fed actions were having their intended impact and that a glide path towards target inflation levels was underway. This encouraged markets to increasingly factor in the likelihood that interest rates had peaked and that The Fed would begin to cut rates in the coming year. A look at Personal Consumption Expenditures (PCE) which is an alternative measure of inflation to CPI shows a continued downward trajectory in year-over-year percentage changes, and 3-month annualized numbers that imply further moderation may be ahead (Figure 2).

The follow on to the economic data was a notable softening in commentary from The Fed inclusive of median Federal Open Market Committee (FOMC) projections calling for several rate cuts in 2024.

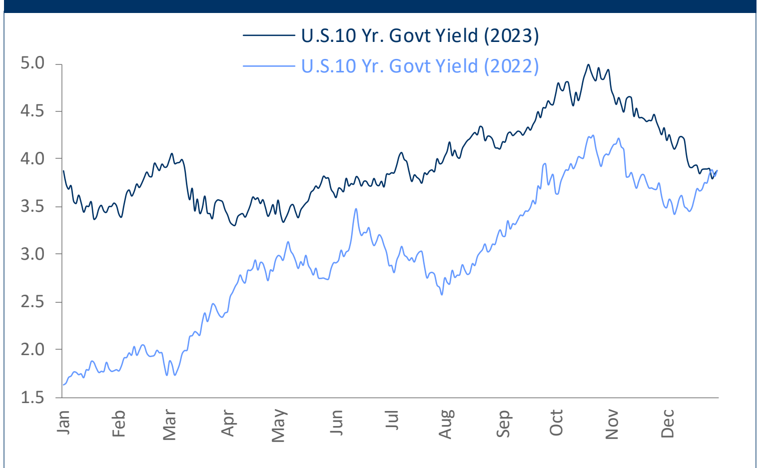
Precisely when rate cuts will begin is likely secondary in importance to the rate of change with markets currently pricing in much more aggressive policy easing than messaged by The Fed.

A more dovish Fed and better behaved inflation are very welcome occurrences though do not guarantee a soft landing. In fact, easing financial conditions, while great for the consumer and businesses, potentially muddy some of the future progress on inflation which could then imperil the pace of policy easing. This is all to say that there are a number of variables in play and progress will not always occur in a straight line.

Not all news has been rosy into year-end and developments in China bear monitoring. 2023 was a lacklustre year for a Chinese economy expected to rebound from a lockdown affected 2022 though troubles in the property sector had numerous impacts including consumer confidence. Stimulus is expected though is currently telegraphed as measured versus aggressive reducing the potential for a meaningful acceleration of activity.

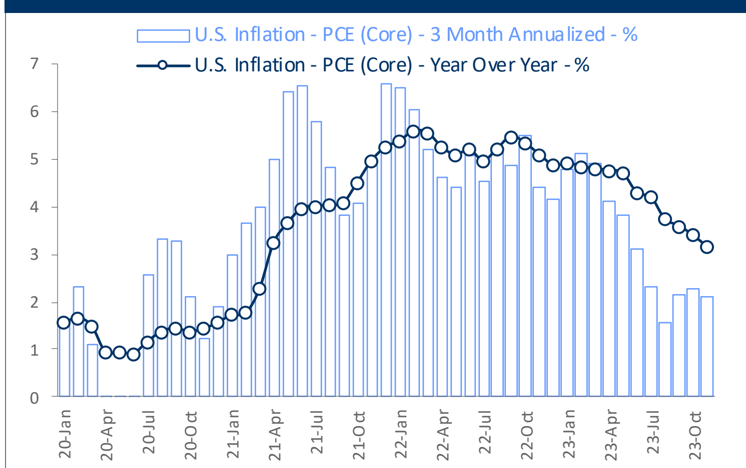
As we look ahead into 2024, it is important to balance positive economic developments with what is already priced into markets. While we continue to see upside ahead, we must note that a very strong finish to the year for financial markets embraces a healthy level of optimism. The run into year-end was also accompanied by very low volatility which we would not expect to continue uninterrupted. Still simmering global conflicts and election cycles in a number of major economies including the U.S. each have the potential to inject transitory uncertainty into the outlook.

FIGURE 1: U.S. 10-YR FINISHES THE YEAR WHERE IT STARTED



Source: Bloomberg

FIGURE 2: CORE INFLATION CONTINUES TO MODERATE



Source: Bloomberg

EQUITY MARKETS | MID-OCTOBER THE TURNING POINT FOR A BROAD BASED RALLY INTO YEAR-END

Equity Index Returns	4Q23 (CAD)	4Q23 (USD)	YTD23(CAD)	YTD23(USD)
Global (Net)	8.7%	11.4%	20.5%	23.8%
Canadian	8.1%		11.8%	
CDN Small Cap	6.0%		4.8%	

Equity markets moved sharply higher in mid-October as interest rates fell from their peaks (Figure 3). The momentum continued into year-end and also included a broadening of market gains beyond stocks such as the "Magnificent 7". The sentiment change was driven by reduced fears of unmanageable inflation and the resultant policy flexibility afforded to the U.S. Federal Reserve (The Fed) to avoid a potential hard landing. While the strength in the quarter was broad based, some of the best performing areas of the market were rate sensitive sectors, and indebted companies that had been under pressure for most of the year.

BIM EQUITY FRAMEWORK

While the pullback in rates and a more dovish Fed reduces the probability of a recession, doubt persists regarding the extent of growth in the coming year. Some "early-cycle" sectors such as consumer goods have already endured several quarters of deceleration or outright decline in demand, though an uptick in U.S. consumer confidence may signal some improvement ahead (Figure 4). In contrast, "late-cycle" backlog driven industries such as those involved in construction and resource development have only begun to experience a bit of a slowdown. With that said, a lower rate environment would be supportive of growth in industries across the business cycle continuum as well as relieve some pressure in Emerging Markets and other international regions. This would include China and Western Europe whose economies either underperformed or lost momentum in 2023. **Relative to a few short months ago, prospects for the economy are much improved though uncertainty in the path forward remains.**

GLOBAL MARKETS

Although a lower rate environment is expected to provide considerable support to sectors and regions that have experienced softness for several quarters, it remains challenging to precisely gauge the extent to which this will offset ongoing headwinds to demand that are expected to continue. In navigating these uncertainties, our investment framework emphasizes thorough stock selection and aims to balance exposures across various potential economic scenarios.

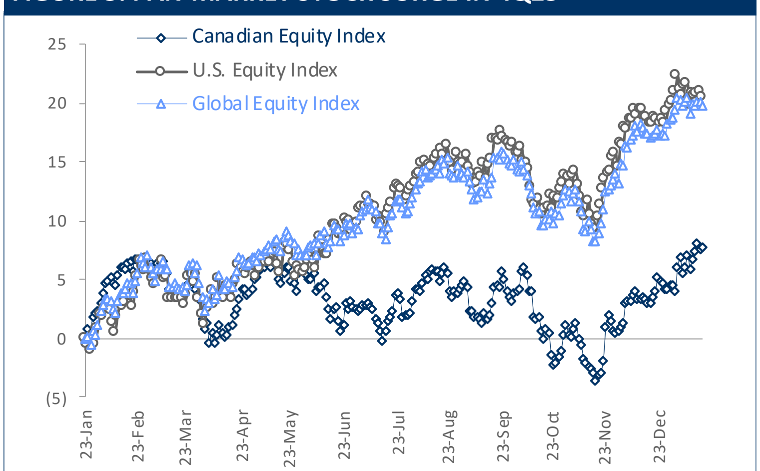
Our quality value approach has proven effective in identifying attractive businesses with reasonable valuations in a variety of industries and geographies. One example of a consumer services company with a lower volatility earnings stream is Compass Group. It is a global food catering business benefiting from secular drivers which when combined with a client base spanning a wide swath of industries reduces its sensitivity to underlying economic conditions. At the other end of the spectrum, we have identified companies that are well positioned to capitalize on a potential rebound in growth in key regions like China and Europe. Schneider Electric, focused on energy management and automation solutions and a beneficiary of the increasing demand for digital transformation, has over half of its business in these two regions. This balanced approach cultivates a well-rounded and adaptive portfolio that should be well placed to navigate diverse market conditions and deliver sustainable risk adjusted returns.

CANADIAN ALL-CAP MARKET

Canadian bank stocks were strong performers in the fourth quarter with the partial alleviation of certain headwinds that the sector had been facing. Improved prospects for a soft landing helped to ease fears of a potential credit cycle whereby the banks would have to absorb outsized credit losses, and there was also a positive update on the regulatory front. The Domestic Stability Buffer (DSB) is designed to act as a cushion to cover losses during periods of financial uncertainty and is set twice a year in June and December. The announcement that the level would be maintained at 3.5% versus market expectations of a further increase was therefore a pleasant surprise. Banks were thus free of the obligation to further build capital reserves with potentially positive implications for earnings and dividend growth as well as returns on equity. While it is possible that required capital levels may rise in the future, the current 3.5% level remains significantly higher than the pre-COVID setting of 2.25%.

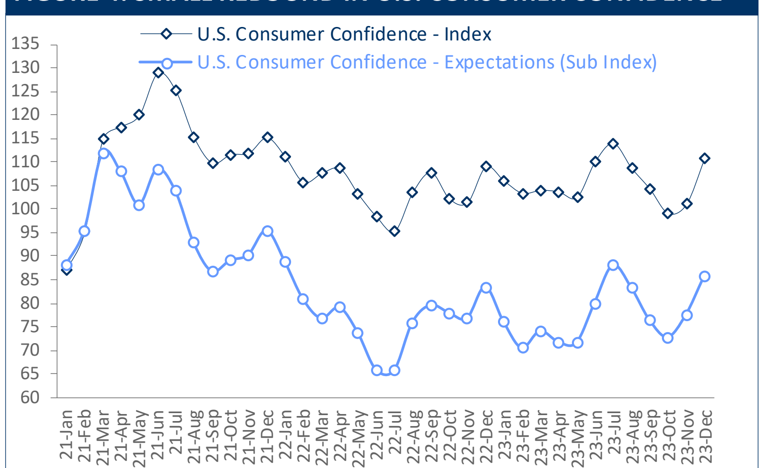
Also of note was Scotiabank's first investor day under new CEO Scott Thomson. The strategic refresh outlined client profitability over volume, operational efficiencies, and a targeted capital reallocation focus. Moving forward, 90% of incremental capital will be put towards priority areas (including USMCA regions and wealth management) versus 70% in the past. The strategy appears sound and execution towards targets would be beneficial for shareholders.

FIGURE 3: PAN-MARKET STOCK SURGE IN 4Q23



Source: Bloomberg - % Change (Simple Basis) Indexed To Start Of 2023 (In CAD)

FIGURE 4: SMALL REBOUND IN U.S. CONSUMER CONFIDENCE



Source: Bloomberg & Conference Board

CANADIAN SMALL-CAP MARKET

After starting the fourth quarter with negative momentum, risk markets bounded higher to close out the year. Supportive economic data of cooling inflation and signalling from central banks raised prospects for an end to the coordinated interest rate hikes that defined the last eighteen months. Interest rates fell, interest rate sensitive securities got bid higher and a relief rally ensued to end 2023.

Despite the welcome lift it was a challenging year for Canadian small caps. We have written previously about the poor breadth of this market and smaller companies being left behind. Though breadth improved during Q4/23, performance for the year was bifurcated by market cap size. Of the ~460 Canadian equities we track the median return of the top quartile (largest companies) was +12%, second quartile +3%, third quartile +2%, and bottom quartile (smallest companies) -13%. Over the last year, investors in smaller cap equities were battling strongly against the tide.

The flip side of this backward-looking analysis is the opportunity ahead. Looking at current valuations for this same grouping of Canadian stocks the largest group currently trades at a 5% discount to their five-year average, the next largest trades at a 17% discount, the third largest trades at a 20% discount, and the smallest group trades at a 32% discount. Simple mean reversion implies stronger future returns for smaller stocks. Further, as interest rates steady and eventually go lower, this previous headwind on valuation and deal activity will become a tailwind for smaller cap equities and free cash flow growth should reaccelerate.

BIM EQUITY THESIS SPOTLIGHT

One example of a small/mid-cap that has persevered against this sentiment headwind is Equitable Group (EQB), which has grown to be the seventh largest Schedule I bank in Canada. The self dubbed "Challenger Bank" outperformed strongly during the year (+57%) versus the bank sector (+9%) and has also significantly outperformed over three years (+22% CAGR versus +11% for bank stocks).

Driving these strong returns for shareholders has been outstanding growth in the business. In 2023, EQB delivered double-digit EPS growth and return on equity (ROE) of 17%, while larger banks fought to hold flat or mitigate declines. EQB navigated the rising rate environment well; their digital first strategy with no physical locations helped them be competitive on costs, while more diversified funding sources and keen underwriting did a solid job protecting net interest margins.

Despite the strong share price performance, EQB's valuation remains undemanding at ~7x forward P/E (in-line with its five year average), a 30% discount to the Big 6 banks. With its fiscal year-end now aligned with the large banks (easing comparability) and continued execution on mid-teens book value per share growth and ROE we expect this gap to narrow over the coming years ahead.

FIXED INCOME MARKETS | PERCEPTION OF POLICY PIVOT LED TO A SIGNIFICANT REPRICING ALONG THE CURVE

Fixed Income Index Returns		
	4Q23	YTD23
Canadian	8.3%	6.7%

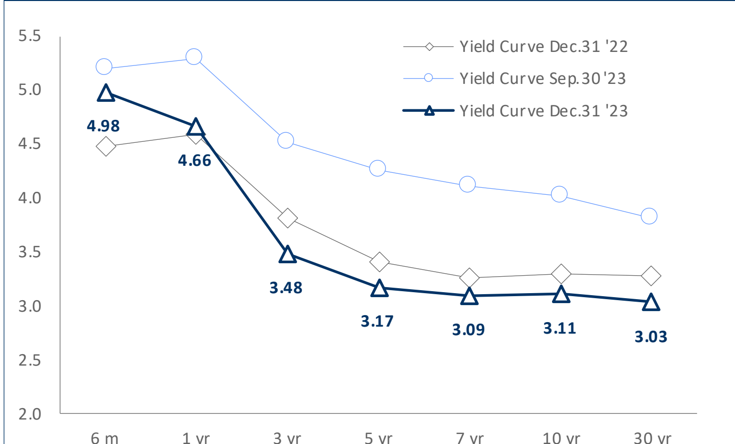
The U.S. Federal Reserve (The Fed) and the Bank of Canada (BoC) have indicated that they have reached (or are very close to reaching) a peak in overnight rates. **Minutes from the most recent Fed meeting indicate that of the 19 member committee, 17 foresee at least one interest rate cut in 2024, and 11 project at least three cuts with a caveat that their economic projects come with a high degree of uncertainty.** Other noteworthy commentary from the minutes included observations that supply/demand dynamics for products and labour are more in balance, and that the risks to the economy are skewed to the upside. Financial markets interpreted this disclosure as a pivot in policy and priced in rate cuts to begin as soon as the March meeting of 2024. During the quarter, yields on U.S. government bonds dropped anywhere from 25 to 60 basis points across the curve. The Fed has consistently emphasized that prevailing financial conditions can either support or undermine their progress towards inflation targets, and upcoming economic data releases will therefore bear scrutiny.

The BoC indicated that the Canadian economy is no longer dealing with excess demand, yet wage and core inflation measures remain above target levels. In fact, the BoC noted that it would be prepared to keep rates high, and even raise them should economic data warrant it, while keeping a keen eye focused on the inflation outlook held by consumers and businesses. Notwithstanding some cautious commentary, yields on Canadian government bonds in the quarter fell anywhere from 25 to 66 basis points across the curve with the largest drop occurring at the short end (Figure 5). Canadian corporate spreads also fell during the quarter compressing between 5 to 10 basis points across the curve.

BIM FIXED INCOME FRAMEWORK

The combination of falling rates and tightening corporate spreads resulted in a strong finish to the year for fixed income markets. Portfolios benefited from an overweight in spread product (provincial and corporates). The corporate holdings are concentrated in the 10 year and shorter part of the curve with a portion set to mature in the next 18 months. The short end of the curve (18 months and less) derived the least benefit from movements in the curve and the compression of corporate spreads but will also be less sensitive to any increase in volatility should it arise. Additionally, as these bonds mature, they will be reinvested opportunistically across 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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