BARRANTAGH Investment Management

BIM REVIEW

2Q24 | ARTFICIAL INTELLIGENCE REMAINS THE DOMINANT GROWTH THEME

INVESTMENT ENVIRONMENT

- Markets continue to track economic data for additional signs of an orderly deceleration. The Fed remains focused on the labour market and inflation.

EQUITY MARKETS

- Artificial Intelligence (AI) remains a dominant growth theme. Mega-cap AI winners have surged higher leading to narrow markets.

FIXED INCOME MARKETS

- The Bank of Canada proceeded with the first interest rate cut of this cycle and remained open to further action pending supportive data.

INVESTMENT ENVIRONMENT | AN ORDERLY DECELERATION WOULD KEEP A SOFT LANDING IN PLAY

Markets remain on the lookout for continued signs of an orderly deceleration of economic activity that would restore the supply/demand balance in support of a soft landing. Consensus forecasts generally align with this narrative, and economic releases that deviate from this script can cause volatility. Data coming in cooler than expectations has been better absorbed in recent months than upside surprises, as it potentially provides cover for the U.S. Federal Reserve (The Fed) to move more quickly on rates.

Fed communications consistently highlight the labour market and inflation as two of the key areas it is monitoring in advance of changes to monetary policy. Some individual components of labour data can be erratic and prone to revision, however a broader index can smooth out some of these deviations. The Kansas City Fed Labour Market Conditions Indicators (LMCI) provides measures of both activity and momentum levels based on 24 variables (Figure 1). Positive values indicate conditions are above the long-run average and the activity level remains well above zero though continues to normalize from the elevated readings of a few years ago. Labour markets cannot be characterized as loose based on the LCMI, though they certainly seem to be less tightly wound than in the recent past.

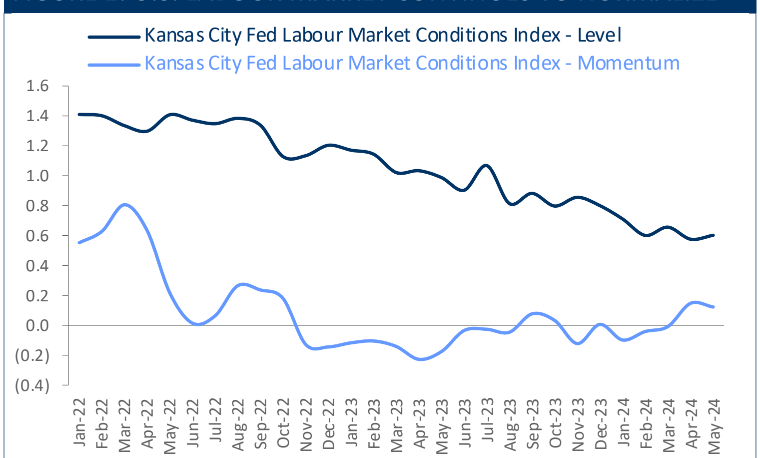
While markets pay keen attention to the more promptly released Consumer Price Index (CPI), The Fed's most keenly watched inflation measure is the Personal Consumption Expenditures (PCE) Price Index. Some of the rapid progress on disinflation achieved in the back-half of last year seemed to be stalling out in recent months, though the May reading was another move in the right direction towards target levels (Figure 2). Qualitatively, the prevalence of contributing items still at elevated levels of inflation is narrower than in the past yet further progress on some stickier variables such as shelter and service prices would be a welcome development.

As we go to print, election season is either in full swing or around the corner in a number of G7 nations and has injected some uncertainty into markets as challengers can bring different priorities and agendas to incumbent policies if successful at the ballot box. Factors such as which leader is successful in their election bid and the strength of the victory offered by the electorate will affect the potential for future change to be enacted. While the U.S. election is still months away, movement in betting odds for the candidates is having some impact on the bond markets given differing outlooks for fiscal policy and potential impacts for public finances.

While a number of indicators point to some moderation in economic growth, one area that remains white hot is the Artificial Intelligence (AI) and related ecosystem. Companies with deep pockets and strong ambitions continue to invest in research & development and seek to tie up the necessary computational capacity and physical infrastructure to enable their future business plans. A more in depth discussion of the AI landscape including pockets where we have been able to find opportunities is detailed in the 'Equity Markets' section that follows.

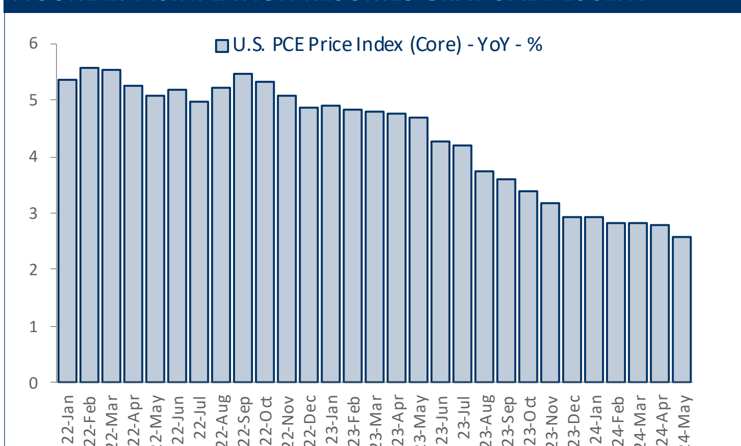
With a number of crosscurrents at play including slowing growth, uncertainty over forward central bank actions, and weak breadth in certain stock markets we foresee potential for volatility ahead though view a soft landing as the most likely path forward.

FIGURE 1: U.S. LABOUR MARKET CONTINUES TO NORMALIZE



Source: Bloomberg

FIGURE 2: DISINFLATION RESUMES GRADUAL DESCENT



Source: Bloomberg: Last Data Point = 2.6, at May-24

EQUITY MARKETS | NARROW MARKET DRIVEN BY ARTIFICIAL INTELLIGENCE WINNERS

Equity Index Returns	2Q24 (CAD)	2Q24 (USD)	YTD24(CAD)	YTD24(USD)
Global (Net)	3.8%	2.6%	16.0%	11.7%
Canadian	-0.5%		6.1%	
CDN Small Cap	0.8%		8.8%	

Global markets continued to climb higher on the back of strength in Information Technology and Communications with the majority of other sectors pulling back slightly. Names levered to Artificial Intelligence (AI) performed particularly well. The Canadian market gave back a bit of gains from earlier in the year with mining stocks being the bright spot in the quarter.

BIM EQUITY FRAMEWORK

AI was a dominant theme in the second quarter as the blue sky scenario for future market potential continued to expand and the share prices of companies with the most direct exposure surged higher. Many of these first order beneficiaries reside in the technology sector which has led to greater concentration in certain markets. At quarter-end, the five largest U.S. stocks accounted for just shy of 30% of the weight of their home market which is a greater percentage than the ten largest stocks contributed just a few short years ago (Figure 3). Along similar lines, the divergence in performance between the U.S. market cap weighted index versus the average share price return for each individual stock was very noticeable in the quarter (Figure 4). AI will provide opportunities to a multitude of companies across a variety of sectors and we outline some of our exposure uncovered using our quality value lens in the following paragraphs.

GLOBAL MARKETS

Economic growth remains quite resilient in the face of several macro and geopolitical uncertainties, but it has moderated somewhat over the past quarter. Similarly, we have seen inflation ease somewhat during this same period, but it remains higher than desired. This is pushing companies to put more effort into productivity initiatives to expand margins, particularly because customers are having a more difficult time accepting price increases.

While AI is a dominant force, we continue to identify attractive opportunities outside this sector. For instance, companies that can deliver productivity savings to their customers will grow at above average in this environment. This trend is benefiting Wabtec, which is one of our holdings. They are a leader in manufacturing fuel efficient locomotives for the rail industry who are constantly looking to find a way to reduce their fuel consumption. This is an example of how we apply our quality value framework and find companies with strong cash flow growth potential that also trade at reasonable valuations. We believe these companies offer a compelling risk-reward profile, as specially when the market broadens, and these companies receive wider recognition.

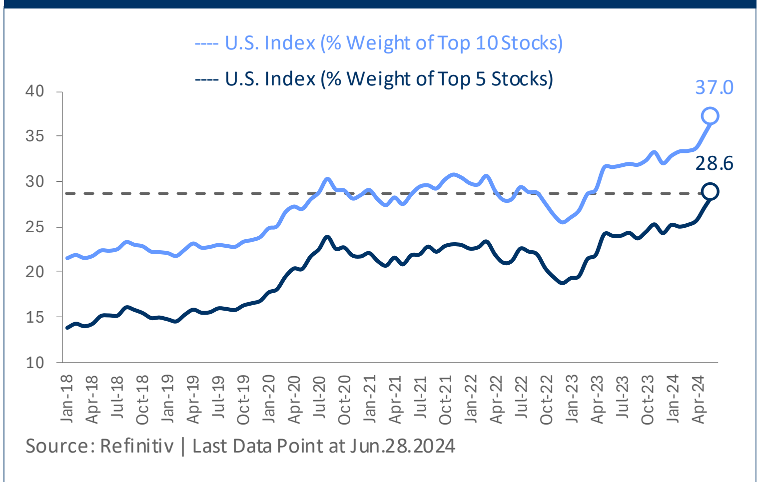
In addition, our global equity portfolio includes companies positioned to capitalize on the AI boom, while their share prices trade at more reasonable valuations. For instance, Schneider Electric, a leader in manufacturing and servicing of electrical products used in all types of buildings (including for data centers), and helps customers optimize their energy use. Additionally, Quanta Services, a North American grid construction leader, benefits from the growing demand for data centers and the increasing integration of renewable energy sources into the grid. We remain on the lookout for companies that will capitalize from this trend over time, yet still trade at reasonable valuations.

CANADIAN ALL-CAP MARKET

While semiconductor companies have been among the largest beneficiaries of the AI boom to date, the concurrent increase in demand for data centers is also transforming the electricity generation market with a multitude of consultants forecasting increasing power demand for years to come. Given the net zero commitments of the hyperscalers supporting much of the data center growth, renewable power is expected to make up a disproportionate amount of the new power generation required. The renewable power sector at large is set to benefit from these developments, though some unique aspects of Brookfield Renewable Partners differentiate its opportunity set which is discussed in greater detail in the BIM Equity Thesis Spotlight that follows.

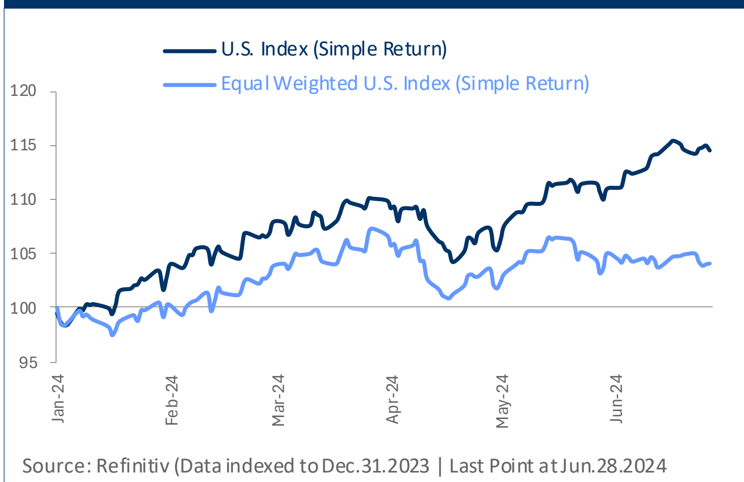
Much optimism also exists around the potential for a nuclear renaissance in a world seeking a greater amount of emissions-free baseload power. Atkins Realis is well placed to capitalize on such a trend with a strong nuclear franchise providing comprehensive engineering expertise across the full industry life cycle from design to decommissioning. Company targets from the June investor day imply strong growth from this segment for a number of years to come.

FIGURE 3: U.S. INDEX CONCENTRATION AT ALL-TIME HIGH



Source: Refinitiv | Last Data Point at Jun.28.2024

FIGURE 4: WEAK BREADTH RETURNS IN SECOND QUARTER



Source: Refinitiv (Data indexed to Dec.31.2023 | Last Point at Jun.28.2024

CANADIAN SMALL-CAP MARKET

The second quarter provided choppier performance for equities in increasingly narrow led markets. Globally, AI-enthusiasm drove larger-cap tech winners to all time highs and small caps lagged top-heavy large-cap benchmarks.

The current “peak rate” environment has been supportive for Canadian small cap returns, up meaningfully since markets bottomed last October. Our commodity-light approach has been a relative headwind (materials has contributed 40% of the benchmark return) but we have made sizeable gains elsewhere (Financials, Industrials, Technology, Staples). In the long run we believe focusing on quality value names with less cyclical exposure provides stronger risk-adjusted returns over the economic cycle.

We believe there are multiple levers for small caps to outperform. In a steadying/declining interest rate environment earnings and cash flows rise (lower debt service) and valuations lift (time-value of money). Sentiment can shift to the very large valuation differentials between large caps and small caps. Outside of mining/energy all nine sectors in the small cap benchmark are trading at double-digit discounts to 5-yr average multiples (-17% avg). This compares to Canadian large caps, where just two sectors trade at large discounts (Telcos, REITs), and the remaining sectors trade at a 1% discount to 5yr average multiples. Markets move in cycles and the current set-up looks quite attractive for smaller cap names.

BIM EQUITY THESIS SPOTLIGHT

Brookfield Renewable Partners is among the best positioned renewable power producers to execute on the massive ongoing build-out of renewables owing to a global presence, strong corporate relationships, differentiated access to capital, and development expertise. Many of these qualities were epitomized in the recent announcement of a renewable energy framework agreement with Microsoft for 10.5 GW of clean power from 2026-2030. Aside from the obvious benefit of providing growth visibility, the agreement highlights the critical nature of data centres tor technology companies and the clean electricity that powers them. The arrangement also calls attention to the evolving nature of contracting within the renewable space whereby companies may choose to interface directly with end users versus governments.

Sentiment towards the clean energy sector had soured somewhat over 2023 due to a number of challenging industry updates related to offshore wind in addition to rising interest rates. It is therefore noteworthy that Brookfield Renewable is inflation indexed on greater than 70% of existing power purchase agreements that are of 13-year average length and has de minimis exposure to the offshore wind space.

An attractive historical funds flow per share growth rate of 10% is expected to continue and in fact may accelerate dependent on success with M&A and capital recycling initiatives.

FIXED INCOME MARKETS | BANK OF CANADA LEADS THE WAY WITH THE FIRST RATE CUT

Fixed Income Index Returns		
	2Q24	YTD24
Canadian	0.9%	-0.4%

Canadian economic data in the second quarter followed a similar path to earlier in the year with inflation remaining below 3%, GDP inching forward at a sub 1% pace, and unemployment rising slightly higher. **The Bank of Canada (BOC) proceeded with a 25 bps interest rate cut in the second quarter and messaged potential for further action ahead while cautioning that decisions will be made on a meeting by meeting basis.** With the BOC open to more cuts contingent on supportive data, volatility is likely to remain elevated around economic information releases. Canadian bond markets are currently pricing in two additional rate cuts by year-end across the four remaining meetings.

The U.S. Federal Reserve (The Fed) continues to be on hold with economic data seemingly a bit more resilient than north of the border. U.S. GDP and inflation persist above desired levels and unemployment remains quite subdued. Accordingly, The Fed continues to be patient, and awaits further movement of key variables towards target levels prior to enacting any cuts to interest rates. U.S. bond markets have priced in two rate cuts by year-end with four planned meetings interspersed with the added nuance of a presidential election.

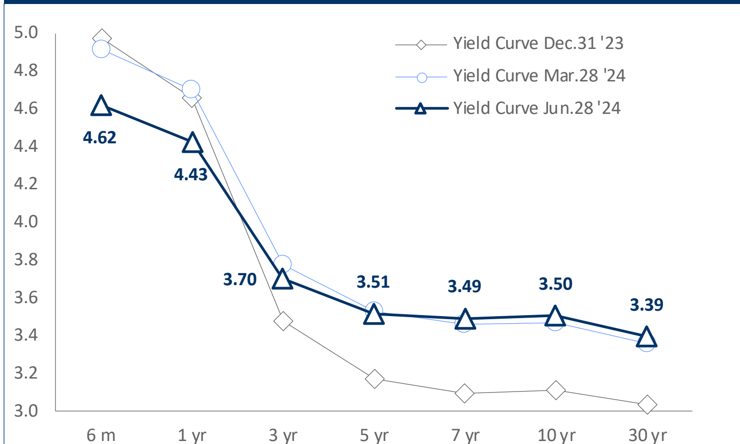
Volatility in the quarter was evident in peak to trough moves in government of Canada bond yield of 55 to 60 bps with the most movement occurring in the 5-10 yr range of the curve. 2 yr government of Canada bond yields moved tighter by 18 bps, 5 yr yields tightened by only 1 bps, and 10 yr and longer yields moved wider by 4 bps (Figure 5). There were also significant peak to trough moves in U.S. government yields at 40 to 50 bps however the curve pushed slightly higher with 2 yr yields up 13 bps, 5yr up 16 bps, and 10 yr and longer yields up around 20 bps.

BIM FIXED INCOME FRAMEWORK

Portfolios began the quarter slightly overweight both duration and corporate bond exposure. During the quarter we chose to add duration to portfolios though our relative positioning was unchanged as a significant number of short-dated bonds dropped out of the index. The introduction of three new names increased our weighting in corporate bonds accompanied with a reduction in governments mostly within the provincial space.

Upon gaining increased conviction in a soft landing, we would look to increase corporate exposure and unwind our duration barbell by adding weight to the middle of the curve. We continue to hold ample liquidity in the portfolio to take advantage of any dislocations that might occur in the market.

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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