BARRANTAGH
Investment Management

BIM REVIEW

3Q24 | ARE WE WITNESSING A GOLDILOCKS ECONOMY?

INVESTMENT ENVIRONMENT

- The chances of achieving a soft landing can only be helped by the supportive actions of the two largest global economies.

EQUITY MARKETS

- The initiation of rate cuts by "The Fed" in tandem with Chinese stimulus announcements helped to broaden equity market returns.

FIXED INCOME MARKETS

- Canada started easing monetary policy a quarter earlier than the U.S., though "The Fed" made up for lost time with a 50 bps cut.

INVESTMENT ENVIRONMENT | MONETARY EASING TICKS SOME BOXES ON THE SOFT LANDING CHECKLIST

Market expectations for the timing and pace of interest rate cuts by the U.S. Federal Reserve "The Fed" wavered throughout the past year with the ebb and flow of economic data. Ultimately, a string of moderating inflation readings provided cover for The Fed to move forward with a cut at the September meeting in order to prevent any further cooling of what is arguably a still healthy job market (Figure 1). With that said, debate quickly pivoted to whether The Fed made a policy error by waiting too long to act fueled in part by the triggering of the Sahm rule which monitors inflections in the rate of change of unemployment and in the past has coincided with recessions. However, some post-pandemic workforce related caveats endorsed even by the economist for which the rule is named should temper cause for concern. This time around, the dynamics at play appear to be driven more by an increase in new entrants to the labour market rather than weakness in demand given a yet to be seen increase in involuntary job losses. **Though the just announced rate actions will take some time to influence the underlying economy, the initial 50 bps cut is a meaningful move towards more normalized policy and shows The Fed is intent on preventing any unnecessary cooling of the job market.**

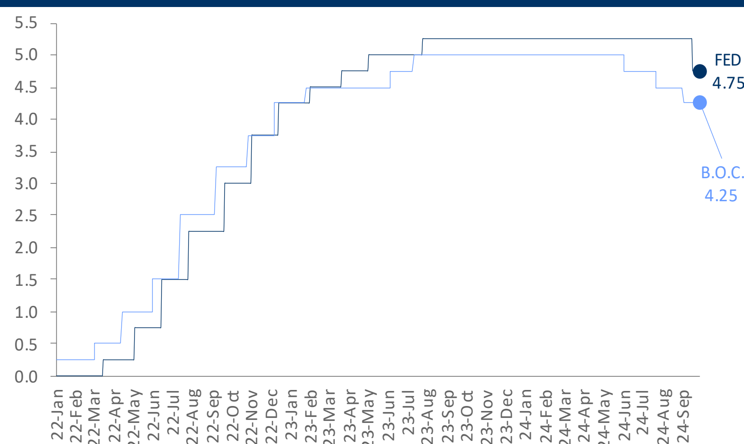
Stated growth targets in China have been difficult to achieve in recent years given an extended property sector slump that has weighed on the economy. Recent stimulus efforts have had mixed success, and an urgency to improve demand was evident with the announcement of numerous monetary and fiscal easing measures aimed at supporting the housing market and boosting consumer spending. The bold set of initiatives included interest rate cuts, unlocking cash for banks via lower reserve requirements, introducing liquidity support for equities, and relaxing rules for homebuyers. Follow through on the proposed stimulus will be important with government agencies pledging to expedite the implementation of the just announced plans as well as indicating an openness to study incremental efforts to support the economy. **The Chinese and related stock markets have surged higher in response to the easing measures and messaging that more help could be on the way if required (Figure 2).**

At the time of writing, developments in the Middle East increase the risk of a wider regional conflict. Despite the recent escalation, the main actors seem mindful of not crossing redlines that would constitute a point of no return. While we don't foresee an immediate reduction in tensions, we assume for now that hostilities will not spill over to the wider gulf region though events certainly warrant close attention.

The announcement of a tentative agreement to avoid a prolonged port strike across the eastern U.S. seaboard was a welcome event. Companies increased shipments in recent months to minimize any potential impacts, though a growing queue of ships after only 3 days of disruption highlights the difficulties a lengthy stoppage might have caused. Also within the U.S., the presidential election is around the corner with polling implying a very tight race that is too close to call.

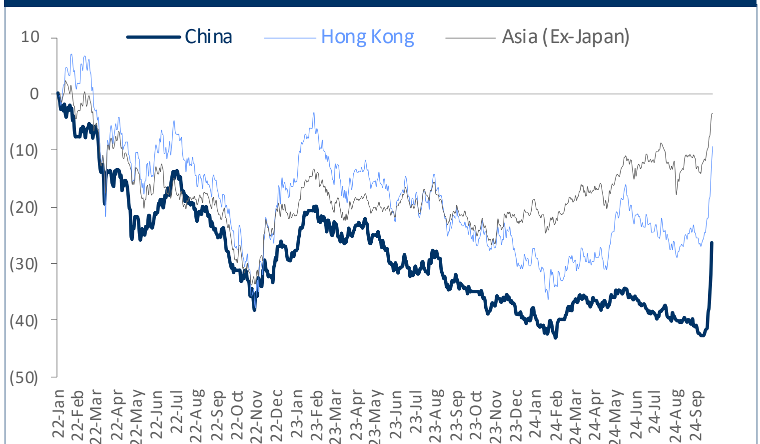
Notwithstanding a few flashpoints to be monitored, the prospects for a soft landing remain firmly in play. The likelihood of this coming to pass is only increased by the supportive actions of the central banks of the two largest global economies.

FIGURE 1: U.S. FED CUTS RATES FOLLOWING LONG PLATEAU



Source: Bloomberg | FED = U.S. Federal Reserve Funds Rate, B.O.C. = Bank Of Canada Overnight Lending Rate

FIGURE 2: CHINA STIMULUS BOOSTS ASIAN STOCK MARKETS



Source: Bloomberg | Equity Index Return Percentages Benchmarked To Dec.31 2021 in USD Terms

EQUITY MARKETS | SOMETHING FOR EVERYONE AS RETURNS BEGIN TO BROADEN OUT

Equity Index Returns	3Q24 (CAD)	3Q24 (USD)	YTD24(CAD)	YTD24(USD)
Global (Net)	5.0%	6.4%	21.8%	18.9%
Canadian	10.5%		17.2%	
CDN Small Cap	8.4%		18.0%	

Global equity markets continued their upward climb, though the sources of contribution differed from past quarters both in terms of geography and sector. The decline in rates benefitted Real Estate and Utilities, while Information Technology and Communications trailed. Not surprisingly, Asia Ex-Japan was the strongest region in response to Chinese stimulus. Canadian equity markets had a great quarter with Financials joining Real Estate and Utilities in the rate trade with Industrials and Energy lagging.

BIM EQUITY FRAMEWORK

Inflection points in markets can occur as specific headwinds turn into tailwinds or some other change in fundamentals occurs. The most direct Artificial Intelligence beneficiaries have for some time continually attracted more investors with successive reports of strong growth and solid outlooks while other sectors struggled to do so. **Could the initiation of rate cuts by the U.S. Federal Reserve "The Fed" in tandem with Chinese stimulus signify the beginning of a market rotation?** Some consumer focused and emerging markets facing businesses have been facing multi-year headwinds and now have a potentially rosier future ahead. The same can be said for rate sensitive businesses, and it is worthwhile to note that after an initial move lower post the first rate cut, it is not uncommon for yields to partially rebound before further declining as the monetary easing cycle continues. In examining opportunities at a potential inflection point, we make sure to apply our quality lens especially when the timing and trajectory of the potential recovery remains uncertain.

GLOBAL MARKETS

The recent softening of input cost inflation in the last twelve months has been beneficial for margins in the manufacturing industry, which has helped to offset some of the sales weakness during this period. Moving forward, a declining rate backdrop provides optimism for better consumer demand and improved volume, which should drive higher profit margins for manufacturers in the year ahead.

In contrast, the service industry has seen wage inflation moderate at a slower pace which has been a bigger drag on their profit margins. These pressures were compounded for companies that have a portion of revenues under long-term fixed price contracts, which means that there is a time lag for pricing to adjust to the prevailing cost environment. However, as these contracts expire and are renegotiated at higher prices, combined with moderating wage inflation (see figure 3), service industry margins should improve.

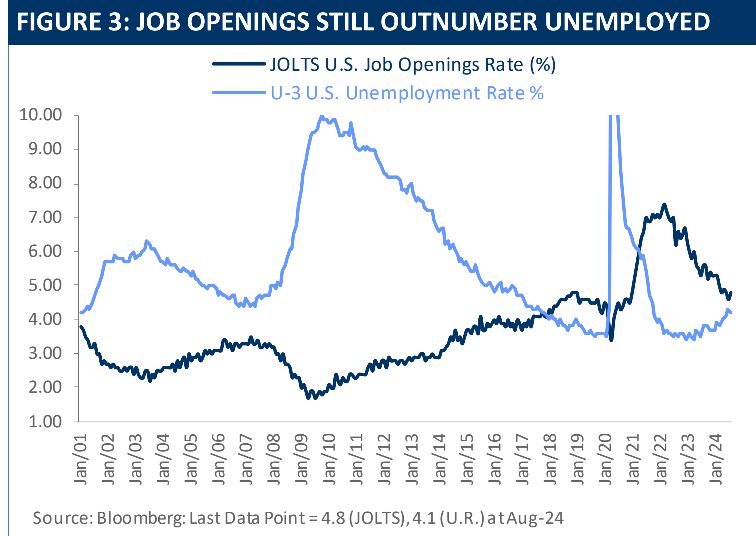
One example of a company we own that is benefiting from these factors is Compass Group PLC, a leading food caterer. Over the past two years they have benefited from strong growth due to market share gains and a growing trend of outsourcing catering services, and they are now well positioned to see meaningful margin improvement going forward. Our approach to security selection is based on a Quality-Value framework, and helps us construct a well-balanced portfolio that can effectively adapt to changes in market conditions.

CANADIAN ALL-CAP MARKET

As interest rates moved higher though 2022 and 2023 the attractiveness of fixed interest term deposits increased and captured investor inflows. With central banks now entering an easing cycle, the path of least resistance for short-term rates is lower, and high yielding equities are a likely destination for at least a portion of expiring term deposits. Within the Canadian market, equity sectors that could benefit from such a trend include Telecom, Real Estate, Utilities, and Financials as each continue to maintain a relative yield advantage versus the central bank policy sensitive 2Y government bond (Figure 4).

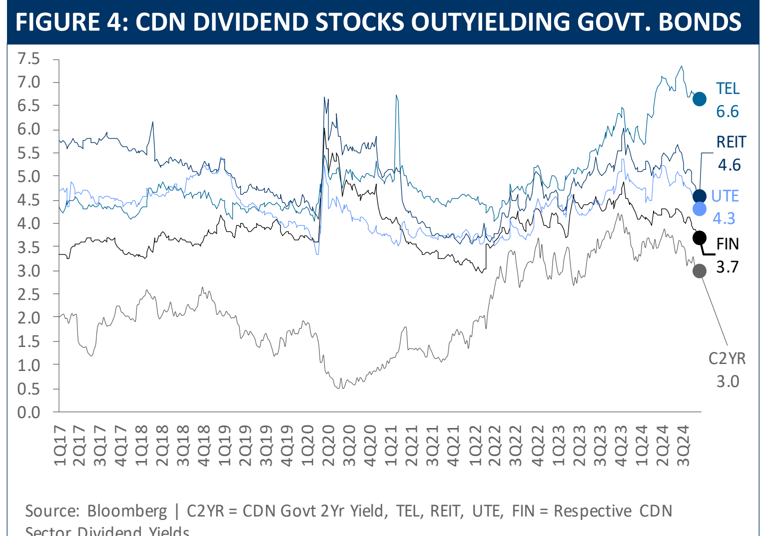
In addition to easing mortgage rates that would help prospective homebuyers, the Canadian government announced some measures of their own intended to improve housing affordability. Effective mid-December, the limit for mortgage insurance increased to $1.5 mm from $1.0 mm and first-time homebuyers and purchasers of newly built homes can choose a maximum amortization of 30 years as compared to the prior 25. The insurance increase will serve to reduce downpayments for those that make use of it, and the extended amortization period will benefit either purchasing power or monthly payments to the order of 9-10%. The Canadian housing market may remain topical throughout the "mortgage renewal wall" of 2025 and 2026 named for those that financed during the low rate Covid years. The Bank Of Canada will be well aware of this when setting policy and may partially explain why it was quicker to initiate cuts than its U.S. counterpart.

FIGURE 3: JOB OPENINGS STILL OUTNUMBER UNEMPLOYED



Source: Bloomberg: Last Data Point = 4.8 (JOLTS), 4.1 (U.R.) at Aug-24

FIGURE 4: CDN DIVIDEND STOCKS OUTYIELDING GOVT. BONDS



Source: Bloomberg | C2YR = CDN Govt 2Yr Yield, TEL, REIT, UTE, FIN = Respective CDN Sector Dividend Yields

CANADIAN SMALL-CAP MARKET

The third quarter was a positive one for Canadian equities across the market cap spectrum with most sectors seeing positive returns. The big driver for the small cap benchmark continues to be the materials sector, specifically the mining sub-sector. It is so large (~30% of benchmark) that sustained rallies (or sell-offs) can substantially drive market returns. Given the recent run up in gold prices (as the market gained confidence on the US Fed easing interest rates) and supportive copper price (longer-term demand from electrification, China stimulus in September) junior Canadian mining stocks have led the market accounting for ~55% of the benchmark returns for the quarter, year-to-date, and trailing 12 months. This has been a sizable headwind for us given our "resource-light" approach but will come back to benefit us as the cycle retreats.

One welcome trend for Canadian small caps and equity markets in general has been the return of M&A in 2024. Part of the headwinds for smaller company valuations last year in a rising rate environment was uncertainty around cost of capital, which significantly decreased large buyers (private equity, pension plans, strategics) from taking out discounted small cap equities. With rates plateauing and then coming down this year, deal activity has picked up. Based on the data we track there has been ~$26 bln in market cap value subject to completed or pending take overs though the first nine months of the year. This is up over 4x the ~$6 bln in all of 2023. One holding subject to this trend was Sleep Country Canada.

BIM EQUITY THESIS SPOTLIGHT

Sleep Country (ZZZ) is a specialty retailer of mattresses and related sleep accessories with a dominant market position in Canada.

The last two years had been a challenging period for the company after consumers shifted spending away from goods/home-related (which spiked during the pandemic) and towards services, with one large U.S. peer noting "a historic nadir" for the mattress industry.

Despite the challenges, we liked ZZZ's strong market share (~40%), longer-term history of healthy organic growth, high returns on capital, and outstanding management team. Case and point, their ability to skillfully navigate both the pandemic boom and following retrenchment a testament to their strong industry experience. Now having come through these challenges (7 straight quarters of negative same-store sales) relatively unscathed, and with a healthy balance sheet and attractive valuation on cyclically depressed earnings, we were quite interested in the set up for strong returns ahead. Others shared our view and a few months after entering into the position, Fairfax Financial made an all-cash offer at a ~33% lift to our cost base.

Often our thesis can take longer to play out, but this dynamic allowed a more immediate realization of return to intrinsic value. In a broader sense, the return of M&A to the Canadian equity space is a strong positive for small cap equities.

FIXED INCOME MARKETS | THE FED IS SEEMINGLY CUTTING FROM A POSITION OF STRENGTH

Fixed Income Index Returns

	3Q24	YTD24
Canadian	4.7%	4.3%

Developments in the quarter continued to reinforce the soft landing narrative. **Most importantly, the U.S. Federal Reserve "The Fed" gained the confidence to initiate the rate cutting cycle and reduced the Fed Funds rate by 50 bps at the September meeting as key economic variables landed within target ranges.** In particular, U.S. inflation fell below 3% for the first time in over 3 years, the unemployment rate increased to 4.2% versus a 5 year pre-pandemic average of 4.4% and GDP remained in positive territory. Moderating inflation was a gatekeeping item to change policy and came at a good time as unemployment had started to move up in recent months. We expect further cuts at upcoming meetings and the path of least resistance is lower rates. The Bank of Canada (BoC) also cut rates by 50 bps in the quarter (25 bps each across two meetings). The figures supporting the move point to some relative weakness versus the U.S. economy with inflation making a 3 year low of 2%, the unemployment rate ticking up to 6.6% versus a 5 year pre-pandemic average of 6.4% and a positive GDP print.

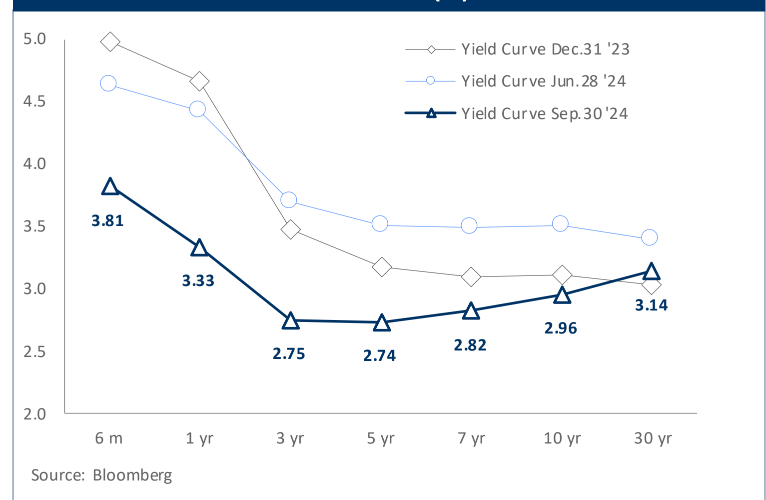
As the quarter began, just under 2 Fed Funds rate cuts were priced in for the remainder of the year, and by quarter-end, this had increased to nearly 3 cuts even after 50 bps of easing had already occurred. Put another way, market expectations for rate cuts by year-end increased by ~75bps as the quarter progressed. Chair Powell and Governor Macklem continue to communicate that no further action has been predetermined though without a large economic surprise it is difficult to envision a scenario without more cuts on the way.

The third quarter brought large moves in yields in both Canada and the U.S. In Canada we saw peak to trough moves of over 100 basis points in the 2 year, approximately 80 basis points in the 5 and 10 year space, and 45 basis points in the long end (Figure 5). In the U.S. the 2year moved over 120 basis points, 5 and 10 year bonds moved tighter by around 90 basis points and the long bond moved tighter by almost 70 basis points.

BIM FIXED INCOME FRAMEWORK

Over the third quarter we moved duration longer than the benchmark by reducing our holdings in the very short-end and moving out the curve. Provincial bonds were trimmed in favour of government of Canada and corporate holdings. Within corporate bonds, Financials and Utilities exposure was topped up and Telecoms were trimmed. Our focus continues to maintain liquidity in the model enabling us to take advantage of any dislocations in the market.

FIGURE 5: CANADIAN YIELD CURVE (%)



Source: Bloomberg

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