

**2<sup>nd</sup> QUARTER 2023 LETTER**

July 25, 2023

The 2nd quarter of 2023 was again marked by volatility in both global stock and bond markets as investors tried to digest hawkish comments and renewed rate hikes by central banks in the face of declining but persistent inflation and a slowing global economy. After an April relief rally following the U.S. regional bank debacle and the rescue of Credit Suisse by UBS, world equity markets plunged in May only to rebound strongly in June. Investor sentiment and momentum trading continues to be subject to wild swings, recently turning more bullish on the prospects of a soft landing, lower inflation data, and a possible end to the rate hiking cycle. No matter what, we are well positioned in both equities and fixed income securities to weather any eventual scenario. Finally, we are pleased to announce that our new website has now gone live at [www.lesterasset.com](http://www.lesterasset.com).

**CANADIAN EQUITY**

For the 2nd quarter of 2023, the **LAM Canadian Equity Fund** produced a gross return of **+0.1%** versus +1.1% for the TSX Composite Total Return including dividends. Our underperformance was almost entirely due to the TSX return being buoyed by a +32% rise in Shopify which contributed +0.9% or 80% of the +1.1% increase in the TSX. Year-to-date, we are up **+6.9%** versus +5.7% for the TSX. Strong positive returns by a few of our small and mid-cap holdings were offset by declines in others. Our main positive contribution was from marine cargo and environmental services provider **Logistec** which rose +45% from the announcement that the company might be sold. We have owned Logistec for 17 years and despite its share price having risen more than 8-fold over this period, we still consider its two businesses to be significantly undervalued. The market reaction to the news once again illustrates how inefficient the stock market can be and that patience is a virtue when investing. Other contributors during the quarter included **Stella Jones**, **Dollarama**, **Richelieu Hardware**, and **CGI**. Detractors included retailers **Neighbourly Pharmacy** and **Pet Valu**, renewal energy producers **Northland Power** and **Boralex**, real estate services provider **Altus Group**, as well as agricultural equipment manufacturer **AG Growth** and funeral services provider **Park Lawn**, all of which nevertheless announced positive news during the quarter.

Most of our holdings once again reported record or near-record results during the quarter and are trading at reasonable valuations. Nevertheless, shares of small and mid-cap companies underperformed those of large cap companies due to lingering uncertainties in the economy and higher interest rates. As a result, we see numerous attractive opportunities and continue to use volatility to invest in high quality companies at attractive prices which is a key element of our strategy aimed at generating strong long-term risk-adjusted returns.

**U.S. EQUITY**

During the 2nd quarter, the U.S. portfolio returned **+7.1%** versus +8.7% for the S&P 500 index Total Return. The market returns were driven by prominent tech-related stocks such as Apple, Microsoft, Nvidia, Amazon, Meta and Tesla, collectively contributing nearly 60% of the S&P 500's return. The rally in tech-related stocks was due to the hype surrounding artificial intelligence (AI), moderating inflation which supports a favorable soft-landing scenario, and the Federal Reserve's (Fed) rate hike pause in June. Year-to-date we are up **+10%** versus +16.9% for the S&P 500 due to our lower weighting in the Technology sector and more conservative stance.

Our top performers during the quarter were **Eli Lilly, Amazon** and **Microsoft**. Eli Lilly reached new highs as strong initial sales of the type-2 diabetes drug Mounjaro (Tirzepatide) far surpassed expectations and, pending regulatory approval, could be used as a weight-loss solution. **Amazon** and **Microsoft** reported solid earnings and rallied with other tech-related stocks. Our top detractors were **Crown Castle, CVS Health** and **Paypal**. Telecommunication infrastructure owner **Crown Castle** continues to generate strong free cash flow yet will underperform markets during a strong rally and a rising rate environment. **CVS Health** is working through several headwinds such as client losses and regulatory pressures, though results were encouraging supported by the company reaffirming guidance. **Paypal** missed the rally as the company requires more time to improve margins as post-pandemic activity moderates.

During the quarter, we added to our existing position in **Fifth Third Bank** as the banking crisis presented a buying opportunity and we reduced our position in Eli Lilly as the price rose above our target. In our view, a soft-landing scenario continues to be likely, supported by lower inflation and a resilient economy. As we navigate through a period of slower growth, we plan to add to companies that are trading at depressed prices that will benefit from the inevitable re-acceleration of the economy. We plan to achieve this by taking profits on expensive stocks with lower upside while adding companies with attractive growth profiles and short-term catalysts.

## **FIXED INCOME**

After a positive 1st quarter in terms of performance, the 2<sup>nd</sup> quarter of 2023 was volatile for fixed income securities. With the U.S. regional banking crisis seemingly behind us, central bankers' speeches and economic data took center stage. The tone of the market was generally positive during the quarter, resulting in tighter credit spreads for Canadian investment grade and high-yield corporate bonds. On the macroeconomic front, central banker rhetoric seemed to point to further interest rate hikes for 2023. Even if the U.S. and Canada showed a slowdown in inflation, the service sector remains sticky. Also, GDP growth and employment were strong. As a result, bond yields rose across the curve. At the end of the first quarter, the market was anticipating rate cuts between now and early 2024. Today, the market is anticipating initial rate cuts in the first quarter of 2024. The **LAM Canadian Fixed Income Fund** ended the quarter with a slight negative return of **-0.1%** on a gross basis versus a larger decline of **-0.7%** for the FTSE Canada Universe Bond Index. Year-to-date, the Fund is up **+1.7%** versus **+2.5%** for the index, while we are now ahead of the index as of the date of this letter.

During the quarter, our high-yield corporate bonds contributed positively to our performance. This was the case for **Air Canada 4.625% August 2029** and **Cascade 5.125% January 2025**. Also, some of our high dividend stocks such as **Altagas** rose following results that exceeded expectations. Our main detractors unsurprisingly included bonds with maturities in the 7 to 10-year range due to yields rising in that part of the curve.

Economic data seems to be driving market movements and central bank actions, with the economy continuing to show resilience in the face of the many rapid rate hikes since 2022. However, if central banks persist in raising rates, the negative effects will certainly be felt and even magnified for consumers and sectors where financial or operational leverage is high. In Canada, we seem to have gone back to a more restrictive monetary policy despite encouraging inflation data, however this has allowed our currency to appreciate against the U.S. dollar and the Euro, which also helps us to import less inflation (imported goods cost less). Luckily, corporate profit margins in general are higher than in the past, and leverage for high-yield companies as a whole is at its lowest level in 10 years, allowing most companies to better navigate the current high rate environment. This is also keeping credit spreads relatively tight, as investors are confident that most companies can cope with higher rates. We continue to find that corporate bonds currently offer extremely compelling yields in the 6% to 8% range, equivalent to what equities have provided over the long term. Note that the **LAM Canadian Fixed Income Fund** currently offers a very attractive average annualized yield to maturity of **6.9%** (versus **4.5%** for the index) with a duration of only around **3.5 years** (versus **7.3 years** for the index).

## MACROECONOMIC OUTLOOK

Monetary policy in both Canada and the U.S. remains very focused on the still too high but falling headline measures of price inflation and the tight labor market. The good news is that the Canadian CPI is now down to 2.8% annualized, while core CPI adjusted for the spike in mortgage rates is below 2% (the mid-point of our central bank's inflation target), down sharply from the peaks recorded in 2022. Also, as we have frequently stated, these are lagging indicators and do not reflect the good progress made by the more sensitive and leading measures. For example, in Canada, the Producer Price Index (PPI) is down over 5% from a year ago. Even more significant is the sharp decline in market-based measures of inflation expectations. These are showing that on 5, 10 and 20-year horizons, inflation expectations are all below 2% and falling as the time horizon lengthens.

The tightness of monetary policy can be seen in many ways. For example, the Bank of Canada (BOC) policy rate is well above the current and falling rate of price inflation. The yield curve (the 10-year minus two-year Government of Canada bond yields)—a reliable measure of policy tightness—is the most negative in 20 years. The BOC has been rapidly reducing its balance sheet (quantitative tightening) and money supply growth is negative after adjusting for inflation. In short, monetary policy, which always works with a long and variable time lag, will continue to push inflation down. The determination of both the BOC and the Fed to restore confidence in the value of money is a key factor in the growing expectation that future inflation will be well anchored within central bank targets. This dynamic will have a positive impact on interest rates and lead to strong returns in bond portfolios over the coming years.

Restrictive monetary policy is having the effect of not only bringing inflation down but cooling the overheated North American economy resulting in a softening of some indicators of the job market. This, together with the lower inflation numbers, are what the central banks need to see to begin a policy reversal and bring down short-term interest rates, which will take the pressure off long-term yields as bond prices rise. This could take a few more months as both the BOC and the Fed are still worried that inflation may prove sticky. Over the past few months, the 10-year Government of Canada bond yield has been range bound between 3% and 3.5%, despite the sharp rise in short-term rates. Technically, this is a very bullish sign when assessed against the declining rate of price inflation, both actual and expected, setting the stage for a major bond rally.

It should also be noted that Canada's fiscal deficit as a percent of GDP is much smaller than the U.S. deficit. This could be an important factor in the Canadian bond market outperforming the U.S. market. The North American economy, in the face of a major tightening in monetary policy and sharp rise in interest rates over the past year, has shown surprising resilience. It is slowing but there remain good prospects for a soft landing, which is what rallying equity markets appear to be anticipating. The bond market could well outperform stocks from this point on as falling interest rates and lower inflation more than offset the negative effects of a weakening economy. Canadian stocks and the Canadian dollar continue to be cheaply valued relative to the U.S. and other developed markets, making Canadian equities and fixed income securities attractive asset classes.

**Stephen Takacsy**

**Matthew Kaszel**

**Olivier Tardif-Loiselle**

**Tony Boeckh**

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