3rd QUARTER LETTER 2022

October 25, 2022

The 3rd quarter of 2022 was again marked by extreme volatility with both global equity and fixed income markets rebounding sharply in July only to collapse further in August and September. While the aftereffects of the pandemic and supply chain disruptions are waning, labor shortages and some rising costs are still causing inflation rates to stay uncomfortably high, forcing central banks to continue aggressively hiking interest rates in the hopes of suppressing demand. As a result, investors fear that central banks will cause a sharp slowdown in the economy. The S&P 500 and NASDAQ stock indices declined -4.9% and -3.9% respectively during the quarter, finishing down -23.9% and -32% year-to-date. Europe, the Far East, and Emerging Markets were down -4.2%, -2.4% and -5.4% respectively during the quarter, and were down -22.1%, -26.1%, and -20.5% year-to-date, in Canadian dollar terms. Bonds continue to post their worst performance in history with the Canadian Universe Bond Index down -11.8% year-to-date and the U.S. bond benchmark down -14.6%.

While rising interest rates are putting tremendous pressure on both equity valuations and bond prices, it is also creating some very attractive opportunities. Investors have not seen such high yields in a long time and can take advantage of these through our diversified fixed income strategy for which we intentionally kept maturities short allowing us to reinvest our clients' money at higher rates. Also, the North American economy remains strong with near full employment, so any slowdown should be relatively mild (which cannot be said of Europe, Asia, and Emerging Markets). Equity markets are already discounting a recession and investor sentiment is at an all time low, which has historically been a great time to invest in stocks. As we know from past experience, it is important to stay invested as markets can turn on a dime, and the slightest evidence that inflation is coming under control, which would signal an end to the rate hikes, would cause both stocks and bonds to rally strongly.

CANADIAN EQUITY

During the 3rd quarter, the **LAM Canadian Equity Fund** was down **-3.1%** before fees versus a decline of -1.4% for the TSX Composite Total Return. Our underperformance was mainly due our exposure to small and mid-cap stocks which sold-off more than the market and to high yielding dividend stocks such as in the Utilities and Telecommunications sectors which had held up well until then but suddenly felt the brunt of sharply rising interest rates. Given our high exposure to the Industrial sector which was up +3.9% during the quarter and our low exposure to the Energy sector which was down -6%, we should have performed better and are disappointed with these results. While Utilities and Telecommunications are among the safest sectors to invest in during an economic slowdown, they were nevertheless caught up in the sharp sell-off of high yielding securities such as REITs which are more interest rate sensitive. Year-to date, we are down **-15.2%** versus -11.1% for the TSX, almost entirely as a result of our low weighting to oil & gas stocks in the Energy sector which is up over +31.5%.

Our top contributors during the quarter included railway tie and utility pole manufacturer **Stella Jones**, property & casualty insurance company **Definity Financial**, pet supply retailer **Pet Valu**, agricultural equipment manufacturer **Ag Growth International**, discount retailer **Dollarama**, and label maker **CCL Industries**, which all released strong financial results**.** Our biggest detractors included funeral services provider **Park Lawn** which saw a slight slowdown following the pandemic, air freight operator **Cargojet** which announced record results and strong future growth but was caught up in the sell-off of overseas carriers, and high dividend yielding energy infrastructure companies such as **TC Energy** and **Enbridge** and telecommunication services providers such as **BCE** and **Shaw Communications**. Communication services was the worst performing sector down -9.7% during the quarter, despite its highly defensive characteristics.

While some sectors remain vulnerable to rising rates such as real estate and consumer discretionary spending, most of our companies continue to grow their profits, increase dividends, and are trading at cheap valuations. Given the volatility and economic uncertainty going forward, we remain highly diversified in non-cyclical and non-economically sensitive sectors that are recession resistant and have pricing power. We see Canada as one of the safest and most attractive markets to invest in and continue to take advantage of market weakness to add high quality companies at attractive prices which should help generate strong long term returns.

U.S. EQUITY

During the 3rd quarter, our U.S. portfolio declined **-4.7%** versus -4.9% for the S&P 500 Total Return. Year-to-date, we are down **-20%** versus -23.9% for the S&P 500. Our outperformance during the quarter was due to select Consumer Discretionary and Technology positions and high cash balances. Positive contributions were generated by **Paypal, Lowe's, Keysight Technologies** and **Amazon.** Detractors included **Fedex,** Technology stocks such as **Microsoft** and **Alphabet**, and Consumer Staples like **Colgate-Palmolive** and **Mondelez**.

During the quarter, we reduced our overweight position in **Arch Capital** as it approached our target price. We believe Arch Capital's P & C insurance business will perform well during firmer market conditions and continue to hold this company but with a lower weighting. We added to our existing positions in **Cisco** and **Fedex**. Cisco presented an attractive opportunity as it reported an encouraging quarter supported by improved guidance, product supply, and end demand. We continued to build a position in Fedex, as the company reported improvements in June and better-than-expected guidance. In September, the company took the market by surprise by withdrawing 2023 guidance resulting in significant selling pressure. While disappointing, the company plans to quickly cut costs, and support their stock price with a $1.5 billion share buy-back.

We continue to monitor the health of the U.S. and global economy and pay special attention to the Fed to give the market visibility on when the rate hike cycle will end. The narrative of higher rates for longer is dominating short-term investor sentiment causing significant volatility in stocks. We will deploy capital opportunistically as we continue to evaluate companies to add to the portfolio that either present catalysts supported by solid fundamentals, or are exposed to growing sectors, with strong management teams and attractive valuations.

FIXED INCOME

The 3rd quarter was again marked by extreme volatility in all asset classes including Fixed Income securities. The market tone was initially positive during the quarter until the Fed and BOC reiterated their aggressive stance on monetary policy to fight inflation. This disappointed investors who were hoping to see an end to interest rate hikes sooner. By maintaining a hard line, the market had no choice but to reconsider higher final policy rates for the current cycle. During the quarter, yields for most terms remained little changed, except for those of short maturities which rose again. Corporate credit spreads, for both investment grade and high yield, continued to be under some pressure, although the widening of spreads was much less pronounced than in the 2nd quarter. Due to our heavier weighting in corporate bonds and shorter maturities, the **LAM Canadian Fixed Income Fund** underperformed and ended the quarter with a gross negative return of **-0.9%** versus +0.5% for the FTSE Canada Universe Bond Index. Year-to-date, the Fund remains well ahead of the benchmark with a return of **-8.9%** versus -11.8% for the FTSE Canada Universe Bond Index.

Many of our corporate bonds nevertheless contributed positively, specifically, **Nuvista Energy 7.875% July 2026** due to higher oil prices, and **Rogers Communications 3.75% April 2029** which benefited from an incentive fee to extend the bonds which were issued in the context of the Shaw Communications acquisition. We purchased these bonds because we expected that the regulatory approval for the acquisition could take longer which would put Rogers in a position of having to either redeem the bonds at a premium price or pay bondholders to extend them. Among our detractors were most of our preferred shares which had been performing relatively well until recently. Although the preferred shares that we own are currently offering very attractive reset rates when they are extended beyond the redemption date, ETF sales by panicky retail investors has put downward pressure on the prices of preferred shares which are generally less liquid than bonds.

Economic data will continue to dictate how aggressively central banks will keep raising rates. Today's high yields along with widened interest rate spreads have now made Fixed Income an extremely appealing asset class. In fact, the **LAM Canadian Fixed Income Fund** currently offers a very attractive average yield to maturity of over **6.7%**, close to Canada's inflation rate which is sure to come down, and with a duration of only 4 years.

MACROECONOMIC OUTLOOK

Leading indicators of inflation and the global economy continue to soften, which is consistent with the lagged effect of monetary tightening that started earlier this year. While the year-over-year inflation rate in Canada ticked down to 6.9% in September, the core rate is still high at around 6%. Comparisons with the low numbers a year ago gives a misleading picture of how future inflation will play out. With time, comparisons with much higher levels of price inflation means "year over year" prices will show a sharp drop in published inflation. This will be positive for markets. Unfortunately, the Fed and BOC are still in panic mode because they blundered in letting inflation get out of control and are continuing to tighten policy to get it back down to their 2% target. Their actions and rhetoric are risky because they are targeting lagging indicators. Current CPI readings are still high primarily because of labor and rental costs but these tend to fall only well after a recession has started.

The markets do seem to be looking through this risky central bank behavior and focusing on what is likely to be a sharp fall in inflation in the next six months or so. If this pans out, it should cause central banks to stop raising short-term interest rates and eventually start cutting them if the economy simultaneously slows down too much. Stocks and bonds have become extremely cheap because of this short-term uncertainty. When there is some clarity that policy easing is imminent, both stock and bond prices should rebound sharply. Until then, investors will have to live with short-term volatility and uncertainty. As is well-known, markets are forward-looking so a better environment for financial markets is likely within the next few months.

Of particular relevance for Canada is the housing market, which has cooled off significantly. Prices are dropping in the most inflated markets—Toronto and Vancouver and their surroundings. They are still high relative to incomes and debt servicing, and further erosion is likely if unemployment starts to rise. This will help soften the overheated economy but will also bring down rents and related accommodation components of the CPI, which have been quite sticky. Commodity prices, while still high, have fallen and will also work their way through the economy to soften price inflation and shorten the time to when the BOC can ease off the brakes.

The Canadian dollar has been weak against the surging U.S. dollar which is now overvalued due to the Fed's aggressive rate hikes. This has given Canada a boost in its international trade surplus against the U.S., an important support for the economy. There are a variety of cross currents at play: the persistent strong decline in leading indicators, expectations of future inflation, and economic growth. Yet, central banks remain focused on coincident and lagging indicators which means they might be late in backing off their tight policy stance. The result will likely be a very sharp drop in inflation and interest rates when the turn comes. Stock and bond prices are at extremely undervalued levels, as is the Canadian dollar. Investor sentiment is overwhelmingly negative, an excellent contrarian indicator. As a result, Canadian equity and fixed income markets are very attractively priced, be it from the perspective of domestic investors or when viewed through the lens of foreign investors who face increased risks at home, be it in the U.K., Europe, Asia or Emerging Markets.

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