LAM LESTER ASSET MANAGEMENT

RESPONSIBLE GROWTH

1st QUARTER 2024 LETTER

April 22, 2024

The 1st quarter of 2024 saw a continuation of the rebound in global equity markets that began in the last two months of 2023, however North American bond markets reversed course ending the quarter in negative territory due to stickier inflation and a delay in central bank interest rate cuts. LAM generated strong returns in all of its asset classes, including fixed income, for which its short duration high yield strategy continues to outperform the Canadian bond index. We continue to be bullish on both equity and fixed income markets going forward, although equities likely got ahead of themselves since the start of the year with April witnessing a pull-back thus far. With our expectation that inflation will continue to decline and reach central bank targets later this year which will finally trigger rate cuts, we anticipate another powerful leg up in fixed income securities. Equities should continue to be buoyed by the expectation of lower interest rates, although we remain cognisant of a slowing economy while rates are still elevated and geopolitical risks are heightened.

LAM also successfully launched its new global equity strategy, a first of its kind in Canada, focused on powerful underlying themes driven by aggressive UN targets to halt and reverse biodiversity loss. These include diverse sectors such as environmental consulting, pollution control and waste management, sustainable products and processes, and agricultural science and technology. The **Lynx Global Biodiversity Fund** is off to a strong start having generated solid returns since mid-February with only a small part of its cash invested. We would also like to welcome Rala Chen to our team as Research Analyst to assist Matthew Kaszel in managing this new fund.

CANADIAN EQUITY

For the 1st quarter of 2024, the **LAM Canadian Equity Fund** rose by +**5.8%** versus +6.6% for the TSX Composite Total Return including dividends. Our underperformance during the quarter was largely due our low weighting in the Energy sector which rose +13.1% and contributed +2.2% to the TSX return, and our high cash weighting. The quarter also saw the sale of our longest held stock, **Logistec**, which was acquired by private equity funds. While we are happy that we made nearly 8 times our money since we first purchased shares 18 years ago, we are still sad to see this Quebec-based gem go. While the company's main business is marine cargo handling, its fast growing environmental segment is what we wanted to maintain exposure to, and is one of the reasons we launched the Lynx Global Biodiversity Fund in which we invested a portion of the sale proceeds for our clients.

Our main contributor during the quarter was e-procurement provider **MDF Commerce**, which rose 40% due to the announcement that it would be acquired by private equity giant KKR, once again proving how undervalued publicly traded smaller companies can be. Other strong contributions came from supply chain management software supplier **Tecsys**, engineering consulting firm **WSP Global**, agricultural equipment manufacturer **AG Growth International**, and P&C insurance company **Definity Financial**. Detractors included automation systems integrator **ATS** whose battery manufacturing orders have been delayed due to a slowdown in electric vehicle sales, renewable power producer **Boralex** which nevertheless reported excellent results, and vitamin manufacturer **Jamieson Wellness** which continues to experience strong growth in international markets.

During the quarter we added **MDA Space**, a world leader in providing technology and robotics to satellite systems and space infrastructure. With the cost of launching satellites having decreased dramatically, the "space economy" is now booming and MDA's record backlog should continue to grow by double digits for years to come. Most of our companies continue to report record or near-record results and are trading at reasonable valuations which bodes well for solid long-term risk-adjusted returns.

U.S. EQUITY

During the 1st quarter, our U.S. portfolio rose by **+9.6%** versus +10.6% for the S&P 500 total return including dividends. We are satisfied with this result despite a slight underperformance due to being underweight in the technology and tech-related sectors. Notably, the "Magnificent Seven", which make up about 27% of the S&P 500, were up +16.7% accounting for +4.5% of the U.S. index's return. In any given quarter that experiences a strong tech-led rally, our strategy will participate on the upside but to a lesser degree.

Our top performers included **Eli Lilly** due to the continued success of the diabetes and weight loss drug Mounjaro, **Arch Capital** driven by strong execution in reinsurance and mortgage insurance underwriting, **Amazon,** and one of our newest positions, engineering firm **Jacobs Solutions** which announced strong results and an increased backlog driven in-part due by its market leading environmental consulting business. Defensive sectors underperformed during the quarter, with our main detractors being **Crown Castle**, **UnitedHealthcare** and **Mondelez**. These companies continue to report solid numbers while managing short-term headwinds.

During the quarter, we added environmental services provider **Clean Harbors** and HVAC supplier **Carrier Global** using some of the proceeds from taking profits on **Fifth Third Bancorp** which experienced a strong rally since the start of the year. Looking ahead, we will continue to invest in opportunities that have clear short-term catalysts and predictable, visible earnings, trading at attractive prices, while managing risk by taking profits on companies that are trading at higher valuations with limited potential for further upside.

FIXED INCOME

Bond yields rose sharply across the curve during the 1st quarter, which had a negative impact on bond prices. After a decline in bond yields towards the end of 2023 which fueled a sharp bond rally, this positive trend has come to a halt so far in 2024. However, thanks to our shorter duration and higher yielding securities including preferred shares, we generated strong returns for our clients, as the **LAM Canadian Fixed Income Fund** produced a positive gross return of **+2.8%** during the quarter compared to a negative return of -1.2% for the FTSE Canada Universe Bond Index.

During the quarter, central banks reaffirmed an end to the rate hiking cycle, but also mentioned that anticipated rate cuts would not be imminent, which threw cold water on the bond market. Other factors that contributed to higher yields included strong economic data and higher than expected inflation data in the U.S. Indeed, the Fed reiterated its forecast of a 75 basis points (bps) rate cut by the end of the year, but given the factors mentioned above, the market is now anticipating only a 40bps cut. In Canada, however, inflation data seems to be showing a more encouraging downward trend, with retail sales data also pointing to a slowdown in consumer spending. This suggests that the Bank of Canada (BOC) may be closer to a rate cut than the U.S., but there are other factors to be considered to understand diverging monetary policies.

During the quarter, the main contributors to our positive performance were our preferred shares, fueled by redemption and buy-back announcements of several issuers and the attractively high yield of the asset class. Contributors included **Altagas 4.242%** and **Brookfield renewable 5.5%**. Other contributors included hybrid bonds such as **Enbridge 6.625% 2078/2028** and high-yield bonds such as **Corus 5% 2028**, which published better-than-expected results and cut their common share dividend which is positive for debt holders. Unsurprisingly in the current environment, our detractors were bonds with longer maturities.

Looking ahead, we remain very positive on the fixed income asset class. We still see plenty of value in corporate bonds and preferred shares, where current yields are still very high, in the 6% to 8% range. The divergence in future monetary policy between the U.S. and Canada seems justified when you look at the economic data for each country. But, in reality, a widely divergent monetary policy would devalue the Canadian dollar and could fuel "import inflation" here. The Canadian federal budget appears to have expansionary elements, which may work against the BOC's inflation objectives. Over the coming quarters we will be keeping a close eye on economic data and geopolitical events that could trigger a re-acceleration of inflation, however, for the time being inflation in Canada seems to be heading in the right direction which is supportive of bond prices.

MACROECONOMIC OUTLOOK

Inflation continues to be the key to anticipating central bank policy, which in turn, affects the economic and financial environment. Through 2023, falling inflation created the expectation of large interest rate cuts and easier financial conditions in 2024. The bond market, which sold off sharply for a good part of last year, reversed course with the 10-year Government bond yield dropping sharply by over 100 bps. The first quarter of 2024 saw about 50% of this decline retrace due to inflation numbers coming in above expectations and the economy, particularly the U.S., showing signs of being stronger than expected. As a result, central bank policy easing has been put on hold for now and investors are left with uncertainty over whether or when the fall in inflation and interest rates will resume. Our view is that the North American economy will continue to do well, which is positive for equity markets, and that this should not reverse the longer-term trend of subsiding inflation.

Wage inflation, which is the dominant factor in service sector inflation, has continued to soften due to a growing labour supply from immigration and higher labour force participation. Significantly, core goods inflation in the U.S. is already negative, supported by falling Chinese import prices. A new capital goods spending cycle is now apparent which promises to increase overall production capacity. This will increase the supply of goods and hence support moderating inflation. Productivity growth, which is key to reducing unit labor costs, is rebounding significantly in the U.S., due in part to AI. While Canadian productivity has lagged, it should eventually catch this upward trend due to spillover from the U.S.

In Canada, core CPI, a key policy focus of the BOC, is running at around 2%, which is in the middle of its 1% to 3% target range. Canadian inflationary pressures are much weaker than in the U.S. because the Canadian economy has been softer. The BOC was not as reckless as the FED during the pandemic, while post-pandemic the U.S. has been running large budget deficits, averaging about 8% of GDP recently. On the other hand, Canada has been running a deficit of about 1.6% of GDP and this is projected to fall below 1%. Finally, Canadian housing has been very weak with average prices falling some 10%, while U.S. prices are still rising. The much-improved inflation outlook in Canada, both in absolute terms and relative to the U.S., bodes well for BOC policy easing.

In short, it is likely that the concern over “sticky inflation” is a short-term issue. Inflation should, in due course, resume its softening trend and, in turn, bring interest rates down again. Due to prospects for stronger productivity growth, it is likely that the economy can grow well alongside lower inflation. Because central banks erred on the side of excessive easing during the pandemic and underestimated subsequent inflationary pressures, they will move slowly towards easing. Hence, investors will need to be patient for a bit longer.

While Canada’s economy and stock market have lagged the U.S. for several years, some catch up is likely. The upswing in the global capital goods cycle, together with better growth in China, will support what looks like a new commodity cycle developing. This is good news for Canada’s growth and equity markets which continue to be very cheap by global standards. That, and the cheap Canadian dollar, make Canada’s capital markets look attractive to foreign investors.

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