LAM LESTER ASSET MANAGEMENT

RESPONSIBLE GROWTH

2nd QUARTER LETTER 2024

July 18, 2024

The 2nd quarter of 2024 saw much volatility in both equity and fixed income markets globally as economic and inflation data were mixed, creating uncertainty as to when central banks would start cutting interest rates. LAM generated strong returns in all of its asset classes, catching up to the TSX Composite in Canadian Equity and widening its significant outperformance in Canadian Fixed Income. Also, LAM's new Global Equity strategy, launched in February and a first of its kind in Canada, is off to a strong start. Initial returns for our ***Lynx Global Biodiversity Fund*** have faired well versus those of the MSCI World Index despite not owning any of the "Magnificent 7" and given that cash in the new fund was only partially invested.

We continue to expect inflation to subside and soon reach central bank targets which will trigger a long awaited first interest rate cut in the U.S. and more rate cuts in Canada, which in turn will fuel another rally in bonds. While U.S. and global equity returns have been strong, these have been driven by a handful of stocks, with the broader market being weak. This has been the case for several years now, with only four stocks contributing 50% of the entire return for the MSCI All Country World Index over the past 3 years. Never have equity markets been so narrow. In Canada, returns have mainly been driven by energy and gold stocks. However, we expect market breadth to widen as equities should also be buoyed by lower interest rates, though some industry sectors will be affected by the slowing economy. Overall, we remain very bullish on both equity and fixed income markets, and on our investment strategies, as evidenced by our strong returns in July so far.

CANADIAN EQUITY

For the 2nd quarter of 2024, the **LAM Canadian Equity Fund** rose by +**0.2%** versus a decline of -0.5% for the TSX Composite Total Return including dividends. Year-to-date, we are up +6%, similar to the TSX despite having little or no exposure to the Energy and Materials sectors which were largely responsible for the TSX return. Our outperformance during the quarter was mainly due to strong returns by some of our smaller cap holdings.

Our main contributor during the quarter was funeral services provider **Park Lawn**, which rose nearly 60% on the announcement that it would be acquired by a private equity fund and an insurance company, illustrating once again the extent to which some publicly traded smaller companies are undervalued. Other positive contributions came from renewable energy producer **Boralex** and discount retailer **Dollarama**, which both reported strong results, and rare earth processor **Neo Performance Materials**, which announced a strategic review to maximize shareholder value. **Element Fleet**, **Savaria**, **EQB**, and **Jamieson Wellness** also performed well. Detractors included **Pollard Banknote**, **Pet Valu**, **AG Growth**, **BMO**, and **Canadian Pacific Kansas City**.

During the quarter we exited **Park Lawn** after the takeover announcement, as well as home renovation supplies distributor **Richelieu Hardware** and plastics packaging company **Winpak**. With the sale proceeds, we increased our weightings in **MDA Space**, **Element Fleet**, **EQB**, and several of our other high conviction holdings. We also added **Canadian Western Bank** on the announcement that it would be acquired by **National Bank**, the rationale being that since the transaction is a share exchange that was trading at a large discount and that National Bank's shares were down over 10% on the announcement, it was a cheap way for us to invest in National Bank. Most companies in our portfolio continue to report solid results and are trading at reasonable valuations which bodes well for strong returns going forward.

U.S. EQUITY

During the 2nd quarter, our U.S. strategy rose **+0.9%**, compared to +4.3% for the S&P 500 Total Return (including dividends). It should be noted that the performance of the S&P 500 was entirely driven by a handful of tech-related stocks representing approximately 30% of the index which were up on average over 16%. In fact, the S&P 500 Equal-Weighted Index, which assigns equal importance to all stocks in the index, actually declined by -2.6% during the quarter. This illustrates how concentrated and narrow the breadth of the U.S. market is, and that most stocks were down in the quarter. Year-to-date, we are up +10.6% versus +15.3% for the S&P500, with the same few stocks driving most of the index's performance.

Our top performers during the quarter were **Alphabet,** due to a strong performance in its search, cloud, and YouTube businesses, **Eli Lilly,** whose diabetes and weight loss drug Mounjaro continues exceeding expectations, and **Analog Devices**, which seems to have passed a cyclical trough with continued bookings momentum. Our detractors were **Charles Rivers Laboratories,** which, despite reporting solid results and an improved outlook, remains cautious on large pharma company spending, **CVS Health**, which continues to manage higher medical costs and reduced their outlook for the remainder of the year, and **Graco,** which reported weakness in the industrial and construction markets which have yet to recover from higher interest rates.

Recent economic data in the U.S. is pointing towards eventual interest rate cuts and we remain confident in how our portfolio is positioned. We also believe that the market leading tech-related stocks are overbought, and that market breadth will widen. We remain focused on opportunities that have clear short-term catalysts, predictable earnings, and are trading at attractive valuations, while managing risk by taking profits on shares of companies that are trading at high valuations with limited potential for further upside.

GLOBAL EQUITY

We are delighted to present our inaugural quarterly commentary on the **Lynx Global Biodiversity Fund**, which was launched on February 12, 2024. In the 2nd quarter, the Fund rose **+2.3%**, compared to the +4% for the MSCI World Index Total Return, inclusive of dividends in Canadian dollars. This is a strong start given that the Fund was, on average, only 65% invested as we gradually deployed inflows from subscriptions, and that the Fund owns none of the handful of tech-related stocks that were responsible for an astounding 80% of the returns for the MSCI World Index. In fact, the MSCI World Equal Weighted Index was down -0.8% in CAD dollars during the quarter, underscoring the stock market's reliance on the "Magnificent Seven". Since its inception, the Fund has generated a gross return of **+5.1%**, compared with +10% for the MSCI World Index, however this was again achieved with only around 65% of the cash in the Fund invested during the period.

Our top contributors during the quarter included **CECO Environmental** (industrial air and water solutions), **Valmont Industries** (irrigation systems), and **Clean Harbors** (hazardous waste management and environmental services), all of which announced strong quarterly results. Our top detractors were **Eurofins** (laboratory testing), which was affected by recent geopolitical events in France and a short seller's report that the company thoroughly refuted, **CNH Industrial** (agricultural equipment), and **Agilent Technologies** (instrumentation).

Nature-based themed investing is in the early stages of multi-decade tailwinds driven by aggressive UN targets to halt and reverse biodiversity loss and restore degraded ecosystems, increased financial disclosure by corporations regarding nature-related impacts, dependencies, and risks, and heightened regulatory compliance regarding "greenwashing."

FIXED INCOME

Once again, we are very pleased with the performance of the **LAM Canadian Fixed Income Fund**, which, during the 2nd quarter, rose **+2%** on a gross basis versus +0.9% for the FTSE Canada Universe Bond Index. Year-to-date, we continue to significantly outperform our benchmark with a gross return of **+4.9%** versus -0.4% for the Canadian bond index. During the quarter, the tone of fixed income markets was generally positive, however bond yields still treaded water. Nevertheless, and as mentioned several times in our monthly commentaries, the high yielding securities in our portfolio resulted in a favorable performance. During the quarter, economic data indicated a slowdown in growth, consumption, and employment, while inflation data was generally down as well. Central bank rhetoric was also encouraging, and on June 5th, the Bank of Canada (BoC) finally announced its first rate cut in over 4 years (25 basis points), the first G7 country to do so.

Although credit spreads didn't move much either, the high current yield of our portfolio benefited us. Contributors included most of our preferred shares such as those issued by **Altagas** and **Brookfield Renewable** which continue to perform well due to the attractively high yields of this asset class, and redemptions and buy-backs announced by several issuers. Our contributors also included high-yield bonds of **Videotron** whose credit rating was upgraded to investment grade (BBB) status during the quarter. As a result, the credit spreads on Videotron bonds narrowed versus government bonds, causing the price of its bonds to rise.

Looking ahead, we remain very positive on the Fixed Income asset class. We still see plenty of value in preferred shares and corporate bonds, where current yields are still very high, in the 6% to 8% range, which is well ahead of inflation. Our Fund still offers a very attractive current yield of around 6% with a duration of only 3.5 years. Canada's rate-cutting cycle is just beginning, and based on slowing economic data, bodes well for the Canadian fixed income market in the short-to-medium term. Nevertheless, we need to keep an eye on the U.S. Federal Reserve (Fed), which seems to be more patient, and the upcoming U.S. elections. Recent economic data in the U.S. also points to a slowdown, which should make the Fed more comfortable with rate cuts.

MACROECONOMIC OUTLOOK

Our view remains that the North American economy is slowing but will continue to do relatively well. However, this doesn’t mean that the trend towards lower inflation will reverse or even stall. Recent evidence points to a developing soft spot in the economy, although the risk of an outright recession appears low. Financial stress indicators are not ringing alarm bells, and falling inflation allows the Fed and BoC plenty of room to ease liquidity. While a softer economy could put a damper on the broader equity markets, it also puts downward pressure on inflation, which bodes well for a strong bond market as bond prices rise when interest rates fall. This would ensure that any weakness in the stock market would be short-lived. Falling interest rates are a more important positive driver for equities than temporarily weaker earnings are as a negative influence.

Economic data in the U.S. continues to cool. The Purchasing Managers Index (PMI) shows that the service sector, the biggest component of GDP, has moved into mild contraction. The unemployment rate has picked up and most measures of the labor market are showing weakness. Non-farm unit labor costs are under 1% as wage inflation is down sharply. The PMI services sector is now showing a sharp easing of both input and output prices. Inflation expectations are now within the Fed target, yet the policy rate is far above inflation (ex-housing). The housing market remains tight and rent inflation is still high. However, evidence points to eventual lower rental inflation, which will further bring down broader inflation measures.

At least two Fed cuts are anticipated this year, but we could easily see more, which would push longer-term rates down further than markets are expecting. The Canadian economy is relatively weaker than in the U.S.. This is due in part to the huge reduction in housing affordability in Canada despite a 20% drop in housing prices since the peak. Canadians, on average, pay about 50% of their income on housing, which means they have less to spend on other things. There has been a big policy failure at all three levels of government as implications of the surge in immigration have been ignored. Policy in Canada has been more focused on redistribution of wealth than on growth. Also, the global economy ex-U.S. has been weak which has affected Canada’s export potential.

Like the Fed, the BoC's policy rate is still about 300 basis points above the rate of inflation (ex-housing) which is now well under control and far below the upper end of the BoC's target range. With unemployment rising faster in Canada, this policy stance is too tight given the economic weakness, and a significant easing is overdue.

Longer-term interest rates, while volatile, are on a falling trend. Barring some negative surprises, this trend should continue and be positive for bonds. Equity markets appear to have discounted much of the easing of economic activity. Some sectors are overbought where speculation has been rampant such as AI. However, most of the MAG7 outperformers have experienced excellent profit growth and their stellar performance has disguised the weak returns of the rest of the market. A major catch-up seems inevitable in the smaller and more value-oriented indices, with Canadian equities appearing particularly cheap. The Canadian dollar continues to trade in a range against the US dollar, near the lows of recent years. Rate cuts ahead of the U.S. weaken the Canadian dollar, but the U.S. will be easing soon as well, so the real effective Canadian exchange rate is very cheap. As a result, Canada's trade surplus with the U.S. has soared from $7.5B a month to $19B. One risk that lies ahead is a potential Trump victory which would almost certainly bring into play his 17th and 18th-century mercantilist rhetoric again as he did in his previous administration. Fortunately, nothing much actually materialized then, but we cannot be so sure this time around.

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