LAM LESTER ASSET MANAGEMENT

RESPONSIBLE GROWTH

3rd QUARTER 2023 LETTER

October 25, 2023

The 3rd quarter of 2023 was another volatile one for both global stocks and bonds. After a brief summer rally, world equity markets declined once again in August and September on higher than expected inflation data, and "higher for longer" interest rates, while bond yields surged higher pushing down bond prices. While global growth is slowing, the North American economy remains strong with high consumer spending and employment levels, causing the Federal Reserve and the Bank of Canada to maintain their hawkish stance. Shifting investor sentiment and momentum trading continue to create volatility in capital markets, which we expect to become more muted on the prospects of a softening economy, lower inflation data, and an end to the rate hiking cycle.

CANADIAN EQUITY

For the 3rd quarter of 2023, the **LAM Canadian Equity Fund** was down **-5.1%** versus a decline of -2.2% for the TSX Composite Total Return including dividends. Year-to-date, we are up **+1.5%** versus +3.4% for the TSX. Our underperformance during the quarter was largely due our low weighting in the Energy sector which rose +10.2%, without which the TSX would have been down around -4%. In fact, when excluding Energy and a few mining companies, over 80% of the stocks in the TSX were down during the quarter. Also, despite strong quarterly results released in August, several of our small and mid-cap stocks sold off more than the market.

Our main positive contributors included e-procurement technology provider **MDF Commerce**, natural gas distributor **Altagas**, engineering consultants **WSP Global**, and P&C insurance company **Definity Financial**. Detractors included retailer **Pet Valu**, funeral services provider **Park Lawn**, home accessibility products manufacturer **Savaria**, and vitamin and nutritional supplement supplier **Jamieson Wellness.** Ironically, one of our worst performers during the quarter, **Neighbourly Pharmacy**, is one of the top performing stocks on the TSX in October having received an offer to be privatized at a price 63% higher than its closing price on September 30, proving once again the stock market's inefficiency and that if a company stays too cheap, it will eventually get acquired. Of note is that the most defensive sectors such as Telecommunications and Utilities were amongst the worse performers on the TSX during the quarter, which included some of our holdings such as **Telus**, **BCE**, and **Boralex.** With dividend yields in these sectors near historic highs, we would expect this trend to reverse in the coming quarters as fears of further interest rate hikes subside.

Many companies have once again reported record or near-record results during the quarter, yet are trading near historically low valuations. This has created very attractive investment opportunities which has not gone unnoticed by private equity firms which have announced no less than 4 acquisitions of publicly listed companies on the TSX in early October, including two of our holdings, **Neighbourly Pharmacy** and **Logistec**. We believe that the stock market currently offers some of the best valuations we have seen since 2008 - 2009, and continue to use volatility to invest in good businesses at attractive prices, which is a key element of our investment strategy aimed at generating strong long-term risk-adjusted returns.

U.S. EQUITY

During the 3rd quarter, the US portfolio declined by **-1.3%,** versus -3.3% for the S&P 500 index. Year-to-date, we are up +8.6% on a gross basis versus +13.1% for the S&P 500. Stock markets remain challenged as inflation and job data continue to support a higher for longer rate environment. The uncertainty of when a rate-cutting cycle will begin weighed on markets throughout the quarter. Our top performers during the quarter were **Eli Lilly**, **Bookings** and **Activision**. Eli Lilly's (pharmaceuticals) performance continued to reach new highs as the company reported another exceptionally strong quarter, leading the company to raise its outlook. **Bookings** (online travel) saw resilient leisure travel demand throughout the summer that is expected to persist throughout the year. **Activision** (video games) saw positive regulatory developments as a U.S. judge denied the FTC's injunction request to stop Microsoft from acquiring the company, and after nearly 2 years, the acquisition was finally completed in October.

Top detractors included **NextEra** (renewable energy) which announced the surprise sale of Florida City Gas and a reduction in the growth rate of distributions, citing a higher cost of capital and high interest rates. Also, **Graco** (spray/powder equipment), which had been an outperformer this year, recently reported a weaker than expected quarter caused by customer destocking, giving back a large portion of this year's gains. **Microsoft,** which continues to execute well, declined in-line with most other large tech companies.

During the quarter, we increased our position in **Charles Rivers** (laboratory products & services) at an attractive valuation considering their growth profile and likely short-term catalysts. Despite its strong performance, we again trimmed a portion of our holdings in **Eli Lilly** as we must remain disciplined in taking profits, particularly on stocks trading at high valuations. In our view, a soft-landing scenario continues to be likely, supported by slowing inflation and a resilient U.S. economy. As we navigate through a period of slower growth, we plan to take profits on companies that are trading at high valuations and have low upside and add to companies with attractive growth profiles and short-term catalysts that are trading at depressed prices.

FIXED INCOME

Bond yields rose sharply across the curve during the 3rd quarter, which had a negative impact on bond prices. Strong economic data and central bank hawkishness once again set the tone for the market. The upward movement in bond yields (and corresponding decline in bond prices) was gradual throughout the quarter but became more pronounced towards September. Rigid inflation data in both Canada and the United States (mainly due to rising energy prices and housing costs from rising mortgage rates) was negatively perceived by the market, as it reduces the chances of a potential cut in key rates in the short term. Financial market pessimism intensified in September with a speech by the President of the U.S. central bank, who stated that interest rates would have to remain high for some time to calm the economy. The **LAM Canadian Fixed Income Fund** ended the quarter with a gross negative return of only **-0.6%**, compared with a larger decline of -3.9% for the FTSE Canada Universe Bond Index. Year-to-date, the Fund is up **+1.2%** versus a -1.5% decline for the index.

During the quarter, our shorter maturity corporate bonds made a positive contribution to our performance. This was the case for **Air Canada 4.625% August 2029**, **Ford credit Canada 4.46% November 2024** and **Cascade 5.125% January 2025**. Likewise, some of our high dividend yielding stocks, such as **Altagas**, continued to perform on better-than-expected results. Our main detractors were, unsurprisingly, bonds with longer maturities (7 years or more), since as bond yields rise, longer dated bond prices are impacted more.

Going forward, we will again be paying close attention to economic data, as it seems to be the biggest influence impacting bond movements and central bank actions. The Federal Reserve seems to recognize that rate hikes appear to be working, albeit slowly, and that the continued strength of the economy means that it will have to adopt a "higher for longer" monetary policy. In Canada, the Bank of Canada is following a similar path. There are also technical factors causing volatility in 10-year government bonds such as fewer large buyers. Yields have also been pushed higher by the withdrawal of central bank purchases from the bond market, less advantageous cross currency swap yields for foreign holders of U.S. bonds such as Japan, and rising deficits.

Regarding whether bond yields have peaked, our strategy of buying more bonds whenever yields spike seems to be a good one, since current yields have become increasingly attractive and will benefit medium-to-long-term returns. In the short term, the current volatility in the bond market makes it difficult to anticipate any trend in bond prices. However, buying longer term bonds is beginning to look attractive due to the risk premium currently offered. Over the past 25 years, the risk premium on a 10-year U.S. government bond has averaged 80 basis points, so if one assumes that a 3% inflation target will soon be achieved, the theoretical fair value yield on such a bond would be around 3.8% versus the nearly 5% it is yielding today. This is a large discrepancy. The situation is the same in Canada. Also, bond yields are at levels not seen in over 20 years, and so are highly attractive on an absolute basis. We therefore persist in saying that investing in corporate bonds is highly attractive now, generating yields to maturity in the 7% to 9% range which is similar to the returns that equity markets have delivered over the past decades, however with much lower risk than equities.

MACROECONOMIC OUTLOOK

The North American economy has remained relatively strong despite the sharp increase in interest rates. Central bank policy has continued to tighten because the economy has remained resilient. However, there are mixed signals. Some sectors, notably housing, have weakened markedly. The world economy excluding North America has been soft. Along with the long and variable lags in the tightening of monetary policy, it is likely that economic activity will soften in Canada and in the U.S. in 2024, although there is no reason to anticipate a recession.

Inflation, and more importantly, the expectation of future inflation, have continued to soften through the year. In the U.S., core PCE (personal consumption expenditures) has dropped sharply despite the relatively robust economy. Forward looking models indicate it will be down to around 2.4% by year end or early 2024. This is very close to the Federal Reserve's target of 2%. Market-based measures of expected inflation are stabilizing at around 2% in the 2 to 3-year timeframe and only slightly higher in the 4 to 5-year timeframe. This is consistent with other market-based measures of expected inflation. Unit labor costs are running around 2.5% per annum; commodity prices are down 25% to 35% since the 2022 peak; natural gas prices are down 40%, all consistent with future declines in inflation. Oil and gasoline prices, however, are up but this is due primarily to geopolitical risks and OPEC production restraints. With financial conditions still tightening, time lags will continue to put downward pressure on inflation. This pressure is being reinforced by the strong U.S. dollar.

In Canada, inflation has also continued to fall persistently all year and has been coming in below surveys. Market-based measures of inflation expectations have fallen as sharply as in the U.S. and have stabilized in the 5-year range at about 2% and at between 1.5% and 2.0% in the 10 to 20-year range, which is at or below the mid-range of the Bank of Canada's policy target. There are additional positive forces for Canadian inflation. The economy is softer than in the U.S. and total government debt to GDP is well below all G7 countries, excluding Germany, and is far below the U.S. debt to GDP. Canadian house prices are also weaker than in the U.S.

There are also several factors supporting the Canadian economy. The rise in oil prices, while a negative for inflation, is a positive for Canada and for the Canadian dollar. Canada is running a huge trade surplus with the U.S. and the Canadian dollar is undervalued trading near the lower end of the historic range against the U.S. dollar. Canada and the Canadian dollar are also recognized as a "safe haven" in a turbulent geopolitical world. A stronger Canadian dollar would put downward pressure on inflation and attract foreign investment. The net effect of all these forces is positive for further inflation reduction and for Canadian capital markets.

The bond market has sold off recently because of its focus on the resilience of the North American economy and still high interest rates. However, it has been ignoring very encouraging signs from the leading indicators of inflation which are pointing to further declines. Bond yields have continued to rise to new highs, and this has created a great opportunity for investors. Soon enough, both the Bank of Canada and the Federal Reserve will stop their tightening policy and then, in due course, will start cutting interest rates. Investors will be able to lock in the currently attractive high yields and then benefit from capital gains as bond prices rise.

The equity market has been propped up mainly by a hand-full of tech stocks in the U.S. and oil stocks in Canada. The sharp rise in interest rates has dramatically compressed valuation multiples and caused most stocks to decline year-to-date. Nevertheless, most companies have been releasing strong financial results. This is a bullish development and reflects the expectation that recession will be avoided, assuming central banks avoid overkill. Falling inflation, which should soon reach central bank targets, and the expectation of an eventual shift to policy easing will provide a powerful tailwind for stock prices. Canadian equities, like their fixed income counterparts, are very cheap and undervalued. Canadian stocks are trading at a P/E ratio of only around 13 based on forward earnings, far below the rest of the developed world, and in U.S. dollar-terms, stock prices are at about the level of 15 years ago, down about 50%. We believe that Canada is poised for a strong rebound going forward.

Stephen Takacsy **Matthew Kaszel** **Olivier Tardif-Loiselle** **Tony Boeckh**

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