North American Diversified Fund

Quarterly Newsletter

AGILITH CAPITAL INC.

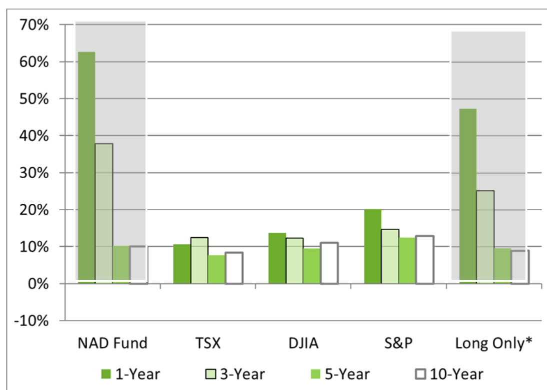
April 2024

""The individual investor should act consistently as an investor and not as a speculator." — Ben Graham

Market Recap

As economic growth held up, markets responded positively in Q1/24. For the quarter, the Dow and S&P rose by 5.9% and 10.3%, while the TSX rose by 6.4%. The TSX performance was boosted by strong commodity price moves, particularly in gold and energy. During the quarter the Agilith North American Diversified Fund rose by 8.3% and the Agilith Long Only Fund was up by 5.4%, with the difference between the funds largely explained by the performance of the short book (Figure 1).

Figure 1: Agilith Performance (03/31/2024)



Economic Backdrop

Economic conditions in the United States, continued to defy projections of a slowdown, even as inflation gradually tapered. U.S. employment data has been generally stronger than anticipated, while the economy has also enjoyed improving productivity. Meanwhile, CPI, while declining, has been running just a little hotter than expected, with some sectors of the economy, such as auto insurance and medical services remaining stubbornly inflationary.

Going into the year, the Federal Reserve had indicated that they were fully prepared to lower short-term rates and the market prepared for an easing cycle to begin in March 2024. However, data did not co-operate as economic growth and inflation data continued to come in a little hotter than expected. The impact on the yield curve was pronounced as expectations of six rate cuts in 2024 was reduced to forecasts of only two cuts by the end of March.

We believe the US economy has been supported by ongoing government deficit spending, willingness by the consumer to reverse the savings trend over the past several years and reshoring of manufacturing activity. We expect these trends to largely continue for the foreseeable future. Specifically, as Trump and Biden have emerged as the contenders in the US presidential contest, we believe both will continue a strategy of maintaining high budget deficits, either through spending or tax cuts, with neither candidate seriously contemplating deficit reductions. As a result, we do not believe the results of the election are likely to materially alter the path of the economy. Increased tensions with China, combined with a recognition of the importance of reliable supply chains has prompted manufacturing to bring operations closer to home. Lastly, COVID marked a dramatic change in consumer behavior from net savings to net spending, a change that we think will persist for many years.

From a geo-political perspective, the Russian-Ukrainian and Israel-Gaza conflicts have only pressured energy markets as scarcity concerns have collided with years of underinvestment in the sector.

Despite help from stronger commodity prices and decent global growth, the Canadian economy has proven less resilient than the US.

We have been hampered by lower productivity growth, although inflation has been slowly approaching the Bank of Canada's target. The slightly cooler economic growth has led to expectations of the Canadian rate cuts happening sooner than in the US, putting pressure on our dollar.

Perhaps one of the other notable outliers in the quarter was the strength in many of the international markets such as Germany, France, and India that all have produced better growth and modestly higher inflation numbers than had been expected. China, in contrast, remains in a conundrum. After years, if not decades of excess spending on domestic infrastructure, China is having to now work through these excesses. The government has committed significant resources to minimizing the economic fallout from poor credit and questionable asset values; however, progress is likely to be sluggish.

Market Outlook

Looking at asset returns for portfolios, equities handsomely outperformed other major asset classes with the exception of strong price increases across a few base metals, gold and oil. Bonds and bond proxies (low volatility, low growth, stable high dividend equities) lagged in performance as yields reached new near-term highs. Real estate has been another laggard with office vacancy rates at multi-year highs as the hybrid workforce continues to relieve demand for downtown square footage. We think this cycle could take time to unwind as companies that have leases coming up for renewal search for smaller footprints.

Within equities, we have been encouraged to see a gradual broadening of participation in the market rally, while the performance of old leadership becomes more differentiated. Small and mid caps have started to experience some positive momentum, although in Q1, the S&P performance was still dominated by 5 mega-cap stocks. We can see the impact when comparing the performance of the equal weighted S&P index against the traditional index, which is weighted by market capitalization. The cap weighted index outpaced the equal weighted by 285 basis points in the quarter. The 73% year to date rise in Nvidia with its $2.2 trillion market cap has had a significant impact on the cap weighted index, while it's influence on the equal weighted is not meaningful. We note that the impact of these few mega caps tapered over the latter half of the quarter and these stocks have underperformed, by and large, in April. We note also that the performance of the mega cap stocks has become much less correlated with one another, which we believe is characteristic of healthier market dynamics.

With continued expansion of international growth, we have also seen a broadening out of the equity markets to emerging markets.

We are in the early stages of the first quarter earnings season and the banks have dominated the reporting so far. The key trends we have seen within the financial sector include difficult comparisons with respect to loan growth and net interest margins as interest rates rise, offset by improving capital market activity.

We continue to believe that inflation will remain elevated above Central Bank targets and that this period will also be characterized by higher growth and productivity. This environment will benefit companies that are cyclically oriented, with strong cash flows and balance sheets, while putting pressure on business models that have relied on cheap debt to finance growth or sustain operations. Moreover, in an environment of healthy economic growth, we do not believe the market will continue to pay the same excess multiples for long-dated growth assets. While some pockets of the market appear to us to be highly overvalued, we continue to see excellent value within select sectors.

As we indicated in our last quarterly newsletter, we believe that some of the key drivers that excited enthusiasm within the technology sector, such as AI, cloud computing and 5G, will be the drivers of productivity growth within many of the companies outside of technology. We believe that this will be a catalyst to margin expansion and earnings growth in these sectors. This will ultimately ease some of the labour

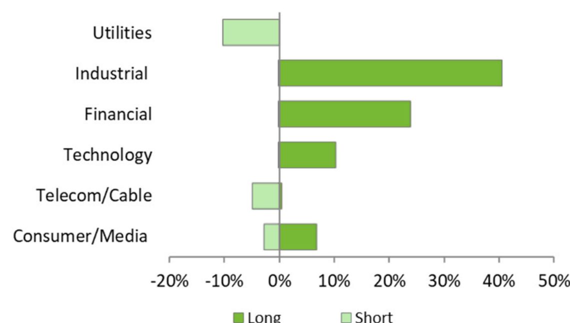
constraints that have hampered growth in these industries over the past few years.

Portfolio Positioning

Some of the top performing names for the funds in the quarter included Atkins Realis (formerly SNC Lavalin), as well as Enerflex and Precision Drilling, service providers to the Energy sector. Mattr (formerly Shawcor) also staged a sound recovery in the quarter, erasing much of the weakness the stock experienced in Q4/23.

There were a number of changes to the portfolio over the course of the first quarter. From a broad positioning perspective, the size of the short book in the NAD Fund rose from 28% of the net asset value to closer to 34%. While many of the names remained the same, we closed our position in Loblaws. Although the stock remains expensive, the immediate catalyst to a price correction is less clear. We re-initiated short positions in Telus, Rogers and Cineplex and increased our short exposure to Bell. We believe the highly competitive environment in Telecom will continue to challenge cash flows, threaten dividend yields and put added pressure on leveraged balance sheets. We expect continued migration of viewing patterns from theatres towards streaming services to make it difficult for Cineplex to get ahead of it's own over-levered balance sheet as well. We have and will continue to reduce our positions in some names which we believe have achieved close to full value. Following the end of the quarter, we closed out our position in ATS Automation, after an excellent price run. We have also initiated a long position in Transcontinental in the current quarter. This is a company we have invested in in the past, although it has been a number of years now. We believe the company has passed through the worst of its structural challenges, while generating strong cash flows and trading at a highly attractive price point.

Figure 2: Agilith NAD Fund Portfolio Positioning (03/31/2024)



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