AGILITH CAPITAL INC.

North American Diversified Fund

Quarterly Newsletter

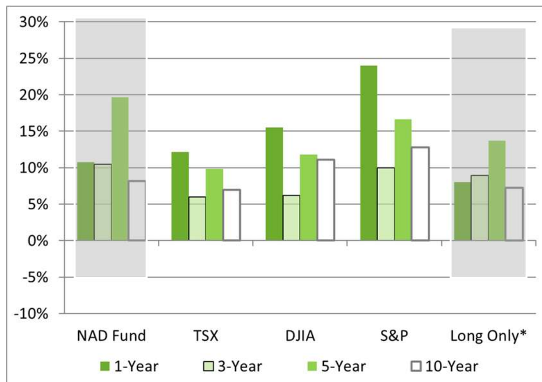
July 2024

"Over the next several years alone, we're going to spend over a trillion dollars developing AI...the issue is, what trillion-dollar problem is AI going to solve?" — Jim Covello, Goldman Sachs

Market Recap

As economic growth held up, markets were mixed in Q1/24. For the quarter, the S&P500 rose by 4.4%, supported by the ongoing momentum of the "Magnificent Seven". Meanwhile the Dow fell by 1.3% and the TSX declined by 0.7%. During the quarter, the Agilith North American Diversified Fund rose by 1.9% and the Agilith Long Only Fund was up by 1.4%, (Figure 1).

Figure 1: Agilith Performance (06/30/2024)



Economic Backdrop

The key economic development over the past quarter has been the ongoing moderation of inflationary trends across many of the developed economies. This has shifted many Central Banks to an easing bias. In fact, we believe we are in the early stages of a synchronous decline in global short term interest rates. The charge has been led by Sweden, the EU and more recently, Canada. Although the easing bias has not been led by the Federal Reserve, we expect the Fed to participate in 2024 with at least one cut in short term rates, if not two. The market is currently pricing in the first cut by the Fed in September.

Within Canada, economic growth has been weaker of late, hurt by poor productivity measures. Employment data has pointed to a weaker job market, as well. With slowing growth in prices in Canada, we have seen the latest core inflation data tucking just under the Bank of Canada's 2% target. The BoC was among one of the first Central Banks to begin a loosening cycle by lowering short term rates by 25 basis points in June and a matched drop in July of another 25 basis points. We believe that the BoC likely has two more cuts to go this year and potentially more if the Federal Reserve joins in and cuts rates in September.

The easing bias from Central Banks comes at a critical juncture. Although inflation currently appears to be settling close to Central Bank targets, economic growth has generally remained resilient, especially in the US. US GDP has slowed over the past year but remains firmly in positive territory and the most recent quarterly data showed an impressive jump in growth from 1.4% in Q1 to 2.8% in Q2. Labour markets have eased slightly but unemployment remains low, new claims are steady and job openings remain elevated. Notably, amidst a co-ordinated effort by global Central Banks to lower inflation and generally resilient economies, governments have continued with inflationary deficit spending, which could ultimately limit the ability of global Central Banks to maintain an easing bias. In addition, inflationary spending will have the impact of putting upward pressure on long term rates.

The US election is attracting considerable attention and while it is too early to call the outcome, we believe both parties will begin a new mandate with inflationary spending policies

(with Trump likely being slightly more inflationary given the intended increases in tariffs). We believe that this will put downward pressure on the USD, upward pressure on long term rates and potentially normalize the yield curve (so that long term rates are above short-term rates, reversing a historically long period of interest rate inversion).

On a global basis, we are seeing manufacturing begin to pick up speed, contributing to a rise in commodity prices. We have also seen better growth and tamer inflation measures out of Europe, with Spain emerging as one of the stronger economies, while Germany continues to feel the pressure of its reliance on exports to China, which continues to report anemic growth amidst troubled real estate and banking sectors.

Market Outlook

Underlying market dynamics remain relatively positive, overall. Importantly, over a one-to-two-year forecast period, earnings growth rates for non-US markets are re-accelerating and beginning to surpass forecast growth for US companies. In our view, market performance is likely to follow these earnings growth trends leading us to favour markets outside of the US.

Importantly, while the S&P500 has been a leader in global market performance so far this year, not all the participants in the index have enjoyed equal upside. In fact, in the first half of 2024, it is notable that ten stocks represented 70% of the return of the S&P500, mostly related to the investment cycle in Artificial Intelligence (AI). It is our view that we are in the midst of a very large overinvestment cycle in AI that is leading to a number of excesses in the market. The promise of AI over the long term may well be transformational, but the near-term expense is likely to far exceed the benefit. One source we follow believes that it is likely to take 40 to 100 times more computing power to train the biggest AI models two years from now as compared to last year. Resources to train AI models have been quadrupling annually, far exceeding the pace at which chips can improve efficiency (roughly doubling every two years, according to Moore's Law). When money is cheap, budgets allow for this unconstrained spending. However, if funding becomes more expensive or cash flows are scarce, spending with a low or uncertain payback comes to an abrupt halt. We believe that there will likely be a correction that could be sharp in nature which will impact technology stocks, especially in semiconductors.

We do not think that the tech outperformance occurring during a prolonged period of an inverted yield curve is a co-incidence. In fact, the period of time that the yield curve has been inverted is one of the longest we have seen over the past century. An inverted yield curve is typically good for growth stocks and challenging for small cap cyclicals. This largely reflects the fact that small caps tend to use prime and short-term rates as their benchmarks for borrowing, while growth (and big cap tech, in particular) are typically funded through equity and have long dated cash flows that are more attractive when long term rates are supressed.

Over the past few weeks, we have seen the re-emergence of outperformance within the small cap sector amidst a technical correction of some of the S&P mega caps. The poster child for this rotation is the Russell 2000, an index of small cap US stocks that has rallied 11% over the past few weeks, with more than half of the constituents of the small cap index at the highs of the month. The Russell 2000 is largely comprised of economically sensitive stocks, many of which are commodity linked. The rally in economically sensitive stocks has been driven by a belief that relief in short term rates will likely continue to bolster stable economic growth.

Given this backdrop, we could see a scenario in which Canadian markets, small caps, emerging markets and value stocks all do well, and the US dramatically underperforms because of the excesses in large cap stocks.

Portfolio Positioning

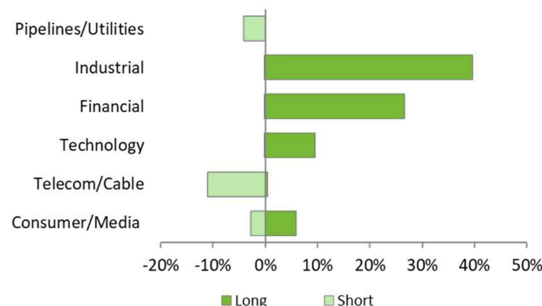
The top performing stock for the Funds in the quarter was Canadian Western Bank, which received a takeout offer from National Bank on June 11, representing a significant premium to

the prior close. The takeout is in the form of a share exchange (0.45 shares of NA for every CWB share) and at current prices, CWM still trades at roughly a 10% discount to the offer, which is expected to close in 2025. At this stage, Agilith has not sold any CWB shares. Strong share price performance from Computer Modelling as well as continued momentum from other investments in the Financial Sector contributed to the quarterly performance of both funds, while weakness in the telecom sector was a net positive for the Agilith NAD Fund, due to the short position in Rogers, BCE and Telus.

The largest change to the portfolio in the Agilith North American Diversified Fund over the quarter was the elimination of the short positions in the utilities, Emera, Fortis and Hydro One. Overall, the trade was roughly neutral to performance, but all of the transactions were done at prices more favorable than today. In our view, these stocks remain expensive; however, with the market focus on the additional energy generation capacity needed for AI, we believed the near-term price momentum was likely to be upwards. The transaction took us from an 8% cash position to roughly neutral. The North American Diversified Fund also increased its short exposure to Cineplex. In our view, markets are overly optimistic about the outlook for cinema, given the increasing focus of consumers and studios on the streaming market. Cineplex's heavy debt load will create pressure on the company's finances in the absence of a significant rebound in theatrical attendance.

During the quarter, both funds added to their positions in Transcontinental, which we believe has turned the corner with respect to revenue growth and is beginning to demonstrate positive margin leverage. The company generates a healthy stream of cash and trades at 6.5x forward earnings. We also increased our positions in Russell Metals and IGM, as both had come back to more attractive price points. These trades were funded with a sale of some of our position in Computer Modelling, although this stock continues to have a significant weight in the portfolio as a result of strong price appreciation, particularly over the past year. As mentioned in the last quarterly, we also closed out our position in ATS Automation in both Funds in April, after an excellent price run.

Figure 2: Agilith NAD Fund Portfolio Positioning (06/30/2024)



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