North American Diversified Fund

AGILITH CAPITAL INC.

Quarterly Newsletter

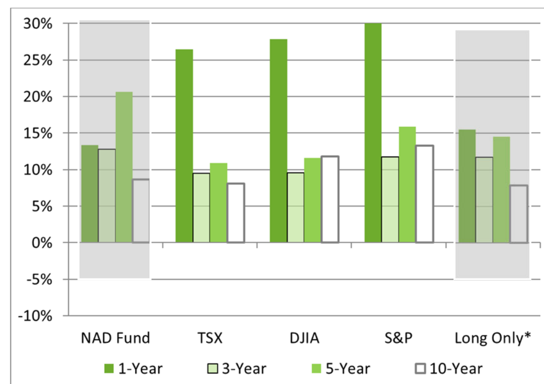
October 2024

"Americans are getting stronger. Twenty years ago, it took two people to carry ten dollars' worth of groceries. Today, a five-year-old can do it." Henny Youngman

Market Recap

Equity markets were strong in the third quarter as equity investors benefited from the US Federal Reserve joining in on the global easing bias. For the quarter, the S&P500 rose by 5.9%, while the Dow rose by 8.7%. The TSX led the group, rising by 10.5%, driven by strong gains in the gold sector. During the quarter, the Agilith North American Diversified Fund rose by 0.8% and the Agilith Long Only Fund was up by 3.6%. Year to date, the funds are up by 11.3% and 10.6% respectively (Figure 1).

Figure 1: Agilith Performance (09/30/2024)



Economic Backdrop

As inflationary forces have settled close to target, Central Banks across developed economies are synchronously adopting an easing bias. Moreover, with varying degrees of success, developed economies appear to have managed to navigate a soft landing in terms of tempering inflation without triggering a sharp contraction in growth. In the US, although the Federal Reserve took decisive action in September, lowering short term rates by 50 basis points, the economy has demonstrated real resiliency in the face of high interest rates. Labour markets remain healthy, and the economy has also been supported by improving productivity and healthy levels of capital spending. Trends that have been supporting ongoing economic growth include continued onshoring of manufacturing, as well as increased spending on technology.

With respect to US election next week, the ultimate winner is not critically important to markets. Based on current announced plans, both candidates will continue to run deficits. We believe the tax cuts and implementation of tariffs under a Trump presidency will be slightly more inflationary than the Democratic spending proposals. We also see more potential for tariffs to be disruptive to international trade, although the corollary impact is likely a renewed emphasis on onshoring of manufacturing activity and continued spending on technology to replace higher cost domestic labour. These trends would both be positive for the Agilith portfolios. That said, if implemented, we believe tariffs as a whole will be a significant mistake for the US economy in the long term and will prove to be inflationary and highly disruptive to international trade

The Canadian economy has proven to be somewhat less resilient than the US and, as a result, the Bank of Canada has had to cut short term rates more aggressively than the US and likely has more cuts still to go. On a positive note, CPI is now trending below target, giving the Bank room to lower rates further without a serious risk of re-igniting inflation. We believe Canadian economic growth will remain in positive territory through this period, partly as a result of the swift action taken by the Central Bank. Specifically, with short term rates now well below peak, the

risk associated with the leverage individuals hold relative to their homes has been mitigated. However, Canada also suffers from low productivity as much of the employment strength over the past few years has been driven by government hiring. We believe tighter cost controls, potentially under a new government would improve productivity and allow for non-inflationary growth.

European growth has also slowed to an anemic level and will also likely provoke more aggressive Central Bank easing over the coming quarters. The region's growth has been helped by a stronger services sector supported by reasonably healthy domestic spending. Manufacturing activity continues to be negatively impacted by ongoing softness in China, a key export partner.

Market Outlook

Earnings growth this quarter has been reasonably strong with a little more than three quarters of reporting companies beating their earnings estimates. While this beat rate is slightly lower than recent averages, it is largely explained by weakness in the energy sector as oil prices have come off of their highs. Outside of energy, the source of companies beating estimates has been increasingly broad based.

However, this broadening has not yet been reflected in market returns. Over the past year and a half, market performance has been heavily skewed towards a few mega cap names. In fact, the performance of the cap-weighted S&P has more than doubled the returns of the equal weighted index in this period. This has led to an expensive looking index as measured by price/earnings ratio but has left many excellent companies trading at attractive valuations. We note that the outperformance of the cap weighted index has moderated since July and the equal-weighted index has started to outperform. Statistical studies show that when the equal-weighted index starts to outperform after a period of underperformance, the trend tends to stay in place for a long time.

This change in trend would fit with our view that we are in the early stages of a reflationary era, which we believe will be an important driver of equity outperformance. There are large swaths of the market that have not participated in the search for earnings growth and we believe many of these companies are now well positioned to outperform. If long term rates were to exceed 6%, we would be cautious but at current levels, equities continue to be the best vehicle to achieve the balance between real growth and an active inflation hedge.

With respect to the small number of stocks that were dominating market performance, we remain sceptical of the economic benefit of AI within much of this group. The developers of AI will bear a significant portion of the costs, but we believe they will not be able to earn a reasonable return on their investment. Instead, the spending that they are being forced to do is primarily to maintain market share and relevance, while the ultimate benefit will accrue to the suppliers (chip manufacturers, power generators) and the ultimate end users.

As another small side note, we believe we are seeing a lot more volatility in individual names following earnings reports. Moreover, the direction of the initial stock move is not necessarily indicative of the strength of the financial report. Post the quarter, we have seen many instances of stocks significantly declining and then fully recovering over the balance of the quarter. It is our firm belief that reacting to negative price momentum is a poor strategy to generate long term returns.

Portfolio Positioning

There were very few changes to the portfolios of the Agilith NAD Fund and Long Only Fund during the third quarter, other than increasing the exposure to Transcontinental to a full weighting. In fact, Transcontinental and Gildan were among the strongest performers in the quarter. Our exposure to banks and other financials was also a big positive contributor to the quarter as financials benefited from a steeper yield curve

and increased investor confidence that a recession could be avoided.

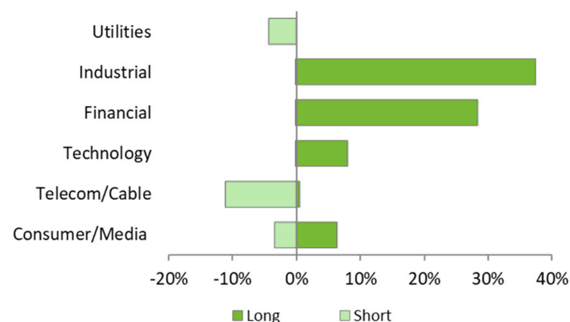
The biggest negative impact on the portfolio was Mattr, which had been one of the strongest performers of 2023 and 2022. The company has suffered from negative sentiment around the energy sector, despite having significantly diversified its operations. Also, the deferral of a large order has hurt 2024 earnings growth. We were conscious of the risks to Mattr coming into 2024; however, with a cost base below $3 per share, we were mindful of the impact of crystallizing a significant capital gain in a company that has an excellent long-term outlook. While the setbacks are unfortunate, we continue to believe that Mattr has a culture of innovation and trades at attractive multiples relative to future growth potential.

On balance, the short positions, which had helped the NAD Fund in the first half of the year, were a drag in Q3. The telecom companies benefited from the decline in short term rates as investors gained hope that the cash flow damage from the overleveraged balance sheets would be mitigated by lower interest rates. It is worth noting though that the leverage on these balance sheets is tied to long term rates and since Central Banks have cut short term rates, long term rates have actually risen by more than half a percent. Moreover, these companies continue to be plagued by a highly competitive market characterized by constant discounts to gain share. We do not expect significant capital spending relief in the near future and believe that, for the most part, it will be difficult for these companies to support their current dividend payouts. BCE’s recent sale of MLSE to Rogers adds some near-term relief to Bell but does nothing to help the company grow into its dividend, which currently exceeds the company’s cash flow. Meanwhile, Rogers has entered into an opaque, below-the-line sale/leaseback agreement providing no details on what has been sold or the approximate impact is on cash flow.

Our short on Cineplex also dragged on portfolio performance as Q3 box office outperformed expectations. In our view, increased consumer preference for streaming, combined with a bloated balance sheet have made Cineplex into a risky business model.

Over the past month, we have seen a reacceleration in many of our names and evidence of a broadening market rally. Financials continue to perform well, and the short book has started to add value to returns, as the yield curve has steepened. We are also seeing the re-shoring theme as having a positive impact on our portfolio. Renewed interest in nuclear has driven Atkins Realis higher. We have a number of stocks that we continue to monitor for potential investment ideas. For the most part these names have been lacklustre performers in an otherwise strong market. We think potential catalyst for improved stock price performance would be a further broadening of market momentum, but we are still too early in this trend to trigger further action at this time.

Figure 2: Agilith NAD Fund Portfolio Positioning (09/30/2024)



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