Manager's Commentary

Aman Budhwar, CFA

Market Overview: Inflation Remains in Focus

Headline rates of inflation across most of the world's developed economies have fallen back sharply since the autumn, but core rates — which exclude volatile categories such as energy and food — remain at, or close to, multi-decade highs. These elevated rates, seen as a better gauge of underlying price pressures, have sparked concern that central banks will struggle to hit their inflation targets without wiping out growth.

The Canadian Consumer Price Index rose 3.4% year-on-year in May, the lowest inflation rate in two years and down from 4.4% in April, benefitting from favourable comparisons to last year when commodity prices spiked after Russia's invasion of Ukraine in early 2022. However, measures of core inflation are tracking just below 4% expressed at annualized rates. Similarly in the US, the Fed's favoured measure of core inflation, the personal consumption expenditures index, rose 3.8% from a year earlier.

The Bank of Canada (BoC), concerned that inflation could stabilize materially above its 2% target, raised its policy rate to 4.75% in June, ending a pause in its hiking cycle that saw the BoC hike eight times between March 2022 and Jan 2023. While the Fed last month held its benchmark federal funds rate steady in a range of 5% and 5.25%, its first pause after 10 consecutive increases since March 2022, almost all officials participating in the meeting felt that additional increases in interest rates would be appropriate. According to Federal Reserve estimates published earlier, policymakers estimate the US economy to grow 1% this year and 1.1% next year as the unemployment rate peaks at 4.5%, up from 3.6% in June.

So far, consumer spending in Canada has held up better than expected in the face of heightened inflation, in part due to a buildup of savings over the COVID-19 pandemic as well as population growth (2.7% annualized rate), but a slowing trend is evident. Consumer spending, reported quarterly, grew 5.7% in the first quarter of 2023, but retail sales rose only 1.1% YoY in April, down from 2.4% in March, and the advance estimate for May suggests a gain of 0.5%.

Companies we talk to have started noticing a shift in consumer spending as inflation continues to bite into disposable incomes. In groceries, where prices rose by 9% in May on an annual basis, consumers are reportedly trading down from high value items such as red meats in favour of white meats. Even the pet foods business that was growing at 7 to 8% earlier is not immune from this slowdown.

Given the uncertainty, small caps underperformed the large cap index with the S&P/TSX Composite Index posting total returns of 1.1% in the quarter, whereas the S&P TSX Small Cap Index returned -3.8%. In particular, performance of the materials sector (which holds a heavier weight in the small-cap index) negatively impacted the small-cap index during the quarter. Similarly, in the US, total returns for the Russell 2000 index at 5.2% underperformed the Russell 1000 return at 8.6%. Gains in the large cap index have been driven by a handful of big technology stocks, thanks in large part to the excitement around artificial intelligence. Amongst the biggest winners in the quarter were Facebook parent Meta Platforms (+35.4%) and Nvidia (52.3%), while index heavyweights Microsoft (18.3%) and Apple (17.8%) also performed well on a total return basis. On the other hand, the small-cap index has been pressured in part by big declines in regional bank stocks, which were down 8.2% during the quarter.

As a result of the relative underperformance, small caps are less expensive than other corners of the market. The Russell 2000 is trading at 11.1x price to cash earnings & 2.0x price to book vs 13.9x & 4.1x, respectively for the Russell 1000.

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Portfolio Performance

The Pender Small/Mid Cap Dividend Fund (PSMDF) ended the quarter with total returns of 2.1%[1], outperforming the S&P TSX Composite Index total return of 1.1% and the S&P TSX Small Cap Index total return of -3.8%.

We made several changes to the portfolio in the quarter, opportunistically adding to high quality compounders at attractive valuations. Amongst the new additions was EQB Inc. (TSX: EQB), the "Challenger bank of Canada", whose stock was unduly punished in sympathy with US regional banks. Its focus on the attractive Canadian personal and commercial banking market has allowed it to consistently earn returns on common equity in the mid-teens and compound book value at 15% over the last ten years, making it the leader in total shareholder returns amongst Canadian banks over that period.

We initiated a position in Stella-Jones Inc. (TSX: SJ) during the quarter. It is the leading manufacturer of pressure-treated wood products, which supplies major electrical utilities and telecom companies across North America (40% of sales). Stella Jones also produces railway ties to meet the needs of Class 1, shortline railroads and commercial operators (24% of sales) and premium grade residential treated lumber, composite decking products, and accessories to North American retailers (24% of sales) with industrial products and trading in logs and lumber making up the rest 12% of sales. Stella-Jones stands to benefit as utilities companies are planning their biggest spending increase in decades to replace aging equipment, prepare for a surge in power demand driven by electric vehicle adoption and strengthen their systems to withstand severe weather patterns linked to climate change. Edison Electric Institute, an industry trade group, expects that utilities will invest roughly $159 billion in 2023 and $155 billion in 2024, more than any year since 2000 when the group began tracking spending. Telecom companies are also increasing their capital budgets to account for growth of 5G networks, "fibre-to-home" and other broadband network upgrades.

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[1] All Pender performance data points are for Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.

Another addition, Premium Brands Holdings Corp. (TSX: PBH), manufactures and distributes food products primarily in North America. It prides itself in selling differentiated products where customer choice is driven by factors other than price, such as quality, convenience, health and or lifestyle in the Speciality Food business segment (62% of sales) as well as specialized and or unique logistical solutions in the Premium Food Distribution business segment (38% of sales). Over the last 10 years, Premium Brands has grown free cash flow per share at a CAGR of 11% and management sees an improvement in organic growth over the next five years as new production capacity is commissioned to fulfill strong demand, particularly for its sandwich products.

We also used the opportunity provided by NFI Group Incs (TSX: NFI) recent capital raise to add to our position in the stock. NFI is a global bus and motor coach manufacturer leading the evolution to zero-emission mobility. After struggling for several years due to supply chain challenges, we believe NFI's performance is on the mend as demand for its products remains strong while its supply chain is gradually returning to normal. With its financing package expected to be finalized soon, we believe NFI should be able to return to its pre-2020 performance with low double-digit returns on capital employed. The recent decision by one of its key competitors to exit the US market adds to its competitive advantage and should help it gain market share.

Outlook

While our investment process is bottom-up with a focus on great businesses to own for the long term, we are cognizant of macro factors that could influence the performance of our companies. We expect economic growth to take a leg down as central banks in developed economies continue with their interest rate hiking cycle to combat inflation and higher rates to impact economic activity with a lag. Consumer spending is expected to soften as accumulated savings from the COVID-19 pandemic are depleted and consumer sentiment weakens due to rising unemployment.

We are finding attractive investment opportunities in Canada exposed to the energy transition and reshoring theme. Towards this end, federal funding in the US continues to flow from the CHIPS and Science Act and the Inflation Reduction Act passed last year that provide hundreds of billions of dollars in incentives to boost renewable energy production and semiconductor manufacturing. As per Commerce Department data, spending on construction of manufacturing facilities in May was up 76% year-on-year and in Q1 2023 made up nearly 0.5% of GDP, the most since 1991.

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