GUARDIAN CANADIAN SECTOR CONTROLLED EQUTIY FUND
Q1 2023
MANAGER COMMENTARY

Market Review

Despite the liquidity crisis in pockets of the US regional banking space, most equity markets moved higher during the quarter. Economies remained relatively strong as inflation continued to fall. Meanwhile, recent market action seems to imply that tightening financial conditions may limit the US Federal Reserve (Fed)'s ability to continue raising interest rates. For example, the Fed only raised rates by 25bps in the Federal Open Market Committee's recent March meeting due to caution surrounding the recent US bank failures. The Bank of Canada held their interest rates unchanged during their March meeting and continues to monitor the lagged impact of recent tightening.

In February, the Canadian Consumer Price Index (CPI) came in at 5.2% year-over-year, down from 5.9% year-over-year in January 2023 and below market expectations of 5.4%. The lower inflation rate was driven by lower transportation costs, as a slowing economy lowered energy costs, and costs for shelter also slowed. Food inflation continues to remain elevated. The US CPI reading was in-line with expectations at 6% year-over-year for February, continuing to slow down but still well above the Fed's 2% target.

The S&P/TSX Composite Index (the Index) advanced 4.6% during the first quarter of 2023. Information Technology, Materials, Consumer Staples, Utilities, Industrials, Communication Services, and Real Estate each outperformed the overall Index during the quarter. Information Technology rose 26.0% during the quarter, helped by falling interest rates, a softer US dollar and the outperformance of quality factors. Underperforming sectors included Energy, and Financials, which faced cyclical headwinds during the quarter.

Performance Attribution

The Guardian Canadian Sector Controlled Equity Fund (the Fund) outperformed the S&P/TSX Composite Index during the quarter. The outperformance was due to both sector allocation and stock selection.

Positives

- Overweight Information Technology (+26.0%) and underweight Energy (-2.3%) contributed positively to sector allocation.
- Positive stock selection was driven by Industrials (SNC-Lavalin, CN Rail, and Stantec) and Utilities (Brookfield Renewable).

- Top stock contributors during the quarter:

  - Open Text – Open Text recovered from an oversold position at the start of the year as the company articulated the merits of the Micro Focus acquisition. We believe OTEX is in a good position to grow earnings substantially in the face of challenging economic conditions.
  - Gildan Activewear – Gildan has performed well vs. low expectations, and we believe the company is poised to grow market share driven by new low-cost capacity additions.
  - SNC-Lavalin - SNC Lavalin performed well as the company continued to exit the loss-making LSTK projects business. Investors are becoming more focused on the value of the high-quality engineering business that will form the core of SNC when the LSTK projects are completed.

Negatives

- Underweight Materials (+8.1%), was a material headwind in sector allocation during the quarter.
- Stock selection was negative primarily in Information Technology (CGI, no exposure to Shopify), Financials (Fairfax Financial, Element Fleet), and Consumer Staples (Metro, no exposure to Alimentation Couche-Tard).
- Bottom stock detractors during the quarter:

  - TD Bank – Banks, including TD, underperformed the market amidst stiffening economic headwinds, exacerbated by the recent bank runs in some regional US banks. In addition, there is increased uncertainty related to closing the First Horizon deal.
  - Aritzia Inc. – While Aritzia posted strong results, investors appear worried about a weakening outlook for the consumer. We believe that the company's strong growth, led by its US expansion plans, will be able to outrun a softening consumer outlook.
  - Magna International - Magna posted disappointing earnings and gave a soft outlook when reporting Q4 2022 earnings.

Fund Transactions

We outline position changes during the quarter below:

Cameco Corp: We re-initiated our position in Cameco after deepening our conviction in the upcoming nuclear cycle. The company also enjoys an enhanced competitive position, assuming a successful partial acquisition of Westinghouse.

Fairfax Financial Holdings: We added Fairfax to the Fund during the quarter. After a period of under-earning, due to a conservative positioning within its investment portfolio, Fairfax has been deploying cash into higher-yielding fixed income opportunities, which we expect to boost the company's run-rate earnings power. Also, the company continues to benefit from strong growth in the current strong insurance pricing environment. Despite these twin drivers of a higher ROE, the company still trades below book value, providing a compelling entry point.

Fund Outlook & Positioning

As has been the case for some time, global policymakers continue to “talk tough”, even as the impacts of their aggressive tightening moves are felt with a lag. While near-term inflation appears to have peaked in Canada and the US, it is still unclear how far inflation will fall and how fast. As the US dollar and bond yields decline alongside inflation, financial conditions should ease at the margin, but recent turbulence in the US regional banking sector will likely offset this, as US banks react to tightening liquidity conditions. Whether or not the US and Canadian economies fall into recession has yet to become clear. Still, caution is warranted as policymakers seem determined to bring down inflation, even if it means intentionally leading the economy into recession.

At the company level, falling inflation and slowing growth are introducing crosscurrents. Falling inflation is simultaneously a headwind for revenue growth and a welcome relief from escalating input costs. Meanwhile, slowing growth and easing supply chain pressure are generally leading to higher inventories, which may lead to further price declines. While companies held in the Fund, we believe, exhibit strong market positions and pricing power, the short-term impacts from the crosscurrents mentioned above are uncertain, which has led to valuation compression in many areas of the market. Over time, we expect higher-quality companies to overcome these headwinds, making current valuations attractive for long-term investors.

The Fund maintains a strong quality bias and remains diversified across cyclical and defensive companies. Economic headwinds are expected to affect all Fund holdings to various degrees, however, we believe that, as labour markets and supply chains continue to normalize, multiple companies in the Fund should benefit, irrespective of the economic outlook.

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Date Published: April 12, 2023