FAIRCOURT
Asset Management Inc.

3rd Quarter North American Market Commentary – 2023

Key Take-aways:

- We have a Federal Reserve with a complacent view on the U.S. economic outlook and an obsession with its 2% inflation target. The next two inflation reports are critical in determining whether the Fed hikes rates on Nov 1st and Dec 13th.
- Despite strength in lagging labor market data, the U.S. Treasury Yield Curves, bank lending standards, and leading economic indicators have only served to reinforce the recession forecast.
- The probability of a soft landing (raising rates to counter elevated inflation into an economic slowdown without triggering a recession) appears to be nearing zero.
- The risks weighted towards maximum allocation to equities and ignoring downside risk is not supported by fundamentals. Breadth remains unremarkable and any relief rallies are built on weak fundamentals and continued multiple expansion.
- The rate of change of the US economy continues to slow at a faster pace. Risks include geopolitical uncertainty, government shutdowns, student loan payments, unionism, higher interest rates, credit tightening effects, higher oil prices and waning stimulus.

Positioning:

- Monetary policy is still very restrictive and damage to the economy is still rolling through at a considerable lag. The way forward is risk managing a recession.
- Positioning for stagflation (rising inflation, falling growth) and weaker corporate earnings supports allocations to cash, energy and select growth focusing on investible volatility and reducing net market exposure.
- Canadian equities remain attractive destinations of capital in comparison to US equities.
- Money market and/or Treasuries are offering 5%+ returns. Gone are the days where participants do not allocate capital to this asset class in favor of 100% allocation to equities.
- Execute on selective shorts on vulnerable sectors/indexes such as financials, industrials, cyclical growth, US consumer, and high yield bonds.
- Current market consensus is as polarized as ever. The return of elevated equity volatility is probable.

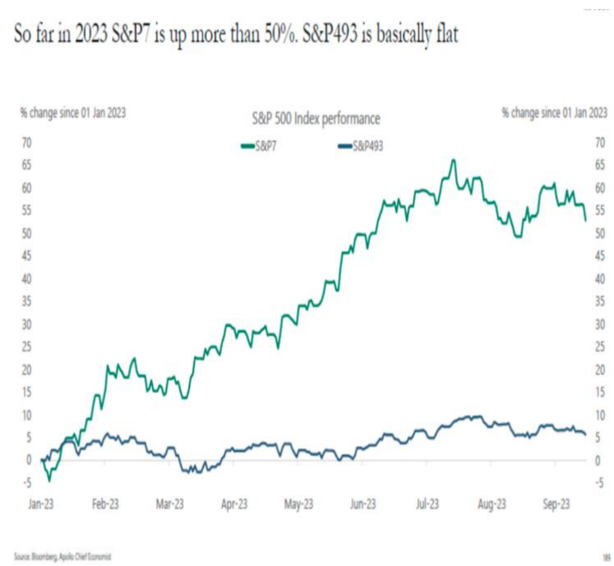
Federal Reserve ("FED") forecasting has been a disappointment since 2020 and market participants should take note that while the the FED may have paused on September 20th 2023 and may pause again on November 1st 2023 the bond market has raised the cost of capital for them. The 2 year yield is approaching 5.2% and the 10 year yield is approaching 5.0%. Basically, the bond market is in disagreement with the FED and Wall Street's complacent view as it continues to see US inflation accelerating. The FED has in our opinion been very slow to identify this economic cycle. They were slow to identify inflation and then slow to raise rates. And on the other side they have been notorious to rush in and raise rates. Upcoming monthly CPI report accelerations increases the risk of another rate hike(s).

In the USA, September Headline CPI accelerated to +3.7% year over year to the highest level in four months; and September Headline Producer Price Index ("PPI") accelerated to +2.2% year over year, which was the highest PPI report since April 2023. The bulls and bears are claiming victory using the same argument to justify their positioning. The bulls are celebrating this measure suggesting stability. All the while, and with a bit of tongue and cheek, the bears are noting if it weren't for our consumption of food, housing and energy we would be experiencing controllable inflation. Certainly, inflation has come down meaningfully from the peak of June 2022 but nonetheless, it remains high by recent standards. This persistent inflationary environment is going to keep on going and is the reality that market participants must come to accept. The FED cannot cut rates as elevated inflation sticks around. And if they do, the economy is suffering more than market participants want to believe. Simply put, we remain in a new inflation volatility regime, skewed to the upside of what was previously considered normal. Our position has been and remains that rates will remain at elevated levels for an extended period of time.

Here at home, Canadian CPI once again ramped up 70bps to 4% to the unaware's surprise. While the reacceleration was driven by energy, rent and utilities powered up the shelter inflation. The impact of immigration coming into Canada will continue to press supply and may help keep inflation elevated and the Canadian consumer squeezed. The Bank of Canada noted in its recent Monetary Policy Report, that, although inflation had declined from its peak, inflation in Canada remains too high. To combat inflation, the Bank of Canada increased the benchmark interest rate by 500 basis points since the start of 2022, to 5.0%. The Bank of Canada held rates steady at its October 25th 2023 policy decision date. The Bank of Canada signaled that it intends to assesses the impact of the policy actions already taken but as we have learned there remains, however, the potential for additional rate increases in the near term.

On the surface, this has been a positive year thus far for select equities. The top 10 stocks in the S&P500 now account for 33% of the index, the highest level since during the

1973-74 bear market, and are carrying the entire equity market. Approximately 90% of S&P 500's year-to-date return is in 7 stocks. The magnificent 7 stocks, as they have come to be known, (MSFT / AAPL / AMZN / META / GOOGL / NFLX / NVDA) price to earning's ("P/E") ratios has expanded from 29x at the beginning of 2023 to 46x more than double the S&P remaining 493 stocks. The view that this positive performance can be sustained suggests these ratios are reasonable. Meanwhile, the broadest definition of US equity market is the iShares Russell 2000 ETF, is down -14% since August 1st 2023 and down -30% from its cycle peak November 2022. The S&P500 correction since the July 31st 2023 peak is now -10%. This market action lacks market breadth. Breadth remains unremarkable and any relief rallies are built on weak fundamentals and continued multiple expansion. Trading volumes continue to accelerate on down days and decelerate on up days. These results are very narrow and not indicative of a healthy market. Also of importance, on October 19th 2023, the VIX closed above 20 for the first time in 101 trading sessions, ending the longest such stretch since 2018. If you buy the S&P500 today, you are basically buying a handful of companies that make up 33% of the index and have an average P/E ratio around 46. The point is, either interest rates must decline drastically from current levels or the magnificent 7 stocks are primed for a meaningful drawdown.



Equity markets are ignoring geopolitical risks (Ukraine / Russia; Israel / Hammas; China / Taiwan), slowing consumer, elevated yields, PE expansion instead of profit expansion; alternatives available such as money markets paying north of 5pct. Toss in the notion the US government may be headed toward a shutdown in mid November due to Congress's inability to pass permanent federal appropriations bill for the upcoming fiscal year, which expired on October 1st. Let us not forget, Moody's, the only major rating agency to still have a AAA credit rating on the US, warned that a government shutdown would likely have negative repercussions to its rating. Rating agencies are concerned about the US's weakening fiscal policymaking procedures amidst rising debt costs associated with rising interest rates. Market participants find themselves in a conundrum. Other than flow and keeping up with benchmarks, certain equities are melting up with no fundamental rationale behind the multiples, forcing investors to take on higher levels of risks that would have been considered unacceptable years ago. The uncomfortable truth is S&P500 valuations are distorted with an environment where the cost of capital remains on the rise to be followed by an increasing risk of an economic drawdown that looks to surprise most market participants. The risks associated with a full allocation to equities and ignoring downside risk is not supported by fundamentals.

The fixed income market is materially larger than the equity market. The recent bond market selloff is both alarming and threatening hopes for a soft landing for the U.S. economy, as traders prepare for borrowing costs to remain higher for longer, while fears over the widening federal deficit continue to mount. As we have discussed at length, the Federal Reserve may not ease up on quantitative tightening anytime soon continuing to put pressure on duration. Long duration bonds have endured their worst drawdown in history and such drawdowns has typically foreshadowed events such as the October 1987 crash, the Dotcom Bubble, and the Nasdaq surge (Oct 2022). Ultimately, there needs to be a significant and sustainable drop in U.S. Treasury, mortgage, and corporate bond yields for a more durable rally to take hold. In our view, such a dramatic change in the bond market tone is only likely to come from either a financial market event or extreme weakness in the economic data, and more specifically the employment indicators.

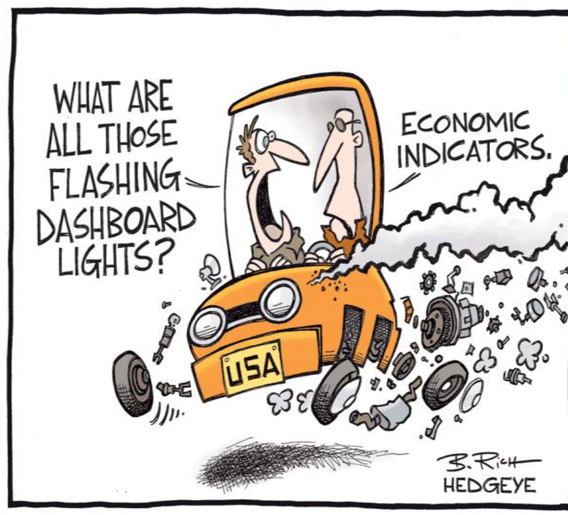
On the labour market, the unemployment rate is sitting at 3.6% down from 3.7% the previous month. The issue is the labour market is a lagging indicator. Looking past lagging labour indicator headlines and focusing on leading indicators (overtime hours, temporary staffing, average hourly work week, job openings) these are moving lower and trending in negative territory. This is in fact what you begin to see when economic growth is slowing. Going back over 70 years this is the classic transition from economic expansion to economic contraction and this is generally what takes place ahead of job cuts as companies realize a recession is unavoidable. The trend is clear, the labour market is deteriorating with the early leading indicators suggesting this strongly. This has all historically coincided with recessionary conditions.

Credit is what drives economic growth and the data is clear, credit has been contracting for some time suggesting real economic growth slowdown is inevitable. Viewing US credit trends and credit quality, delinquencies continue to deteriorate on a rate of change basis. Same for business lending. Every category of business lending (CNI lending, commercial real estate, consumer, auto lending) continues to slow week on week, month on month, year on year. Bankruptcy filings of small businesses and corporate downgrades are both accelerating confirming broader slowdown. Corporates and small businesses continue to be vulnerable to rising rates, rising labor costs and rising input costs. The combination of higher yields, a higher US dollar and higher oil prices is a toxic brew for corporate earnings. Current bond markets yields are very restrictive. Slowdowns in credit growth cause slowdowns in economic growth. Improvement in the outlook for lending doesn't happen when the vast majority of U.S. Treasury Yield Curves remains inverted. And a bull market does not begin with Financials being a weak link.

On the US consumer, commentary coming out of the recent Tier 1 Bank conference calls looking forward was telling. A fair amount of caution was expressed over 2024 and rising concerns over interest rates and layoffs. Consumer deposits (excess savings) also continue to contract with saving rates down for 3 straight months. This is the steepest and most rapid savings decrease in US history. This is just further indications of the broader macroeconomic activity beginning to slow down. While inflation has indeed decreased significantly on a year-over-year basis, the reality remains that over the past three years, the Headline Consumer Price Index (CPI) has still risen by +20.4% in total. While this may not concern those fortunate enough to have discretionary income, it has significant implications for the average family. Median family income has only increased by 7.1% over the last three years. There is more strain at the low end, with prices continuing to rise and less assistance from food stamp programs this year. The American consumer is facing the dual challenges of compounding inflation and rapidly rising interest rates and this combination is making average consumers miserable. Consumer confidence is at levels consistent with the onset of past recessions, and trending lower. The point is consumers are not healthy and the narrative spoken by mainstream media and government is misleading.

This market has been trained into thinking drawdowns rarely take place justifying long only exposure. Currently, money market funds and/or Treasuries held to maturity are offering 5%+ returns. We are beginning to see outflows out of equities and into money markets. This could be leakage in the market of typical investor flow. The risk free rate is in fact an alternative. The idea that inflation rates and interest rates will move back down to pre 2020 levels seems optimistic and will be a struggle. We are 2 years post COVID and market participants must understand hoping for those low levels to return is not a strategy. If inflation rates settle in the 3.5% range this means rates will likely settle in the 5% range and equity and fixed income markets now have direct competition for capital from money markets. What this means is gone may be the days where participants do not allocate significant capital to risk free assets such as treasuries and money markets in favor of 100% allocation to equities. Heading into the final quarter of the year we are leaning towards cash under current conditions, consistent with our overriding goal of preserving capital while awaiting choice opportunities to compound at attractive rates.

The divergence of the market from economic fundamentals has been remarkable and sobering. It is important to recognize this divergence and come to terms with the data and discontinue pointing to the stock market as an economic indicator when in fact, at best, it's a momentum indicator. Current market consensus is as polarized as ever, and that is why volatility will return. Risk happens slowly and then all at once. On October 19th 2023, the volatility (VIX - fear index) closed above 20 for the first time in 101 trading sessions, ending the longest such stretch since 2018. This global industrial recession appears to be unavoidable. Macro is the principal risk to outlook, particularly around the Federal Reserve's delicate balancing act of controlling inflation and not harming the expected trajectory of real economic growth. Looking back thru history, since the 1954 there have been 10 recessions and all of them have been proceeded by a significant rise in short term yields. The point is this dynamic has been festering for some time. The US is a very expensive market when benchmarked against risk free rates and even the Canadian and some Emerging markets. We are basically back to peak multiples in the face of an earnings recession and the FED is still hiking. Core message here is rallies not backed by fundamentals are not sustainable and while they can be exciting to watch they are anxious to own. Patience remains our core allocation.



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Sincerely,

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The Portfolio Management Team