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Canadian Equity Strategy

Key Takeaways

- ▶ Canadian equities suffered losses for the quarter, weighed down by weakness across interest-rate-sensitive sectors and a lack of AI-related catalysts that proved too much for strength in cyclicals and consumer staples to overcome.
- ▶ The Strategy performed in line with the benchmark, supported by solid contributions in materials and staples that offset headwinds in IT and industrials.
- ▶ Trading activity was robust with five new holdings and additions to attractively priced defensive/interest-rate-sensitive positions as well as out-of-favor cyclical and growth names. With myriad risks to the economic outlook, overall positioning remained more defensive than usual.

Market Overview

Following a strong first quarter and new all-time highs reached in the middle of the second, the S&P/TSX Composite Total Return Index (TRI) slipped in June to finish the period down 0.5%. Canadian equity performance continues to pale in comparison to the U.S., underperforming the S&P 500 TRI's advance of 4.3% (5.3% in Canadian dollars). For context, the U.S. equity juggernaut, driven by mega cap information technology (IT) and related growth stocks, has now outpaced the S&P/TSX Composite TRI in the past six consecutive quarters.

Benchmark 10-year interest rates in Canada and the U.S. ended the second quarter roughly flat at 3.50% and 4.40%, respectively, remaining at highs not seen since the Global Financial Crisis. Consensus expectations for Fed rate cuts in 2024 tempered further in the second quarter — with futures now pushing out most cuts to late 2024/2025, as opposed to the six cuts expected at the beginning of this year. In contrast, the Bank of Canada (BoC) cut rates at its June 5 meeting for the first time this cycle, lowering the headline overnight rate to 4.75% from 5.00%. For the BoC, a less robust economy in Canada relative to the U.S. and a more highly indebted homeowner facing pending mortgage rate renewals over the next couple years contributed to its more dovish policy stance.

Second-quarter returns in Canadian equities were divergent across sectors, but generally weak with seven of 11 sectors in negative territory. The health care sector, lacking in relevance due to its sub-1% weighting in the benchmark, was the worst performer. Interest-

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rate-sensitives remained under pressure, contributing to the material weakness in real estate and communication services. Meanwhile, the Canadian IT sector returns were anemic, absent meaningful generative artificial intelligence (Gen AI) enablers seen in the U.S. equity market — and therefore any leverage to the panic corporate spending on cutting-edge semiconductor chips. In addition, Canadian sector heavyweight Shopify, introduced to the Strategy during the quarter, came under considerable pressure following underwhelming first-quarter results and a disappointing outlook.

In contrast, with rising gold and copper prices, the materials sector was strong. Gold bullion advanced 5.5% for the quarter to US\$2,340/oz (COMEX) and hit a new all-time high of US\$2,439/oz in late May, and copper advanced 9.6% to finish at US\$4.39/lb (COMEX). Meanwhile, the resilient consumer staples sector also contained some of the strongest contributors in a softer market environment, including sector heavyweights and Strategy holdings Alimentation Couche-Tard and Loblaw. In energy, crude oil prices recovered from a steep decline mid-quarter to end down 2.0% at US\$81.54/bbl (West Texas Intermediate). There was significant bifurcation in North American natural gas prices with NYMEX natural gas prices increasing 47.5% to US\$2.60/mmbtu (NYMEX) while local Alberta (AECO) prices languished. Noteworthy for the Canadian energy sector, the long-awaited Trans Mountain Pipeline expansion is now online, and with LNG Canada expected to start exporting liquefied natural gas in 2025, prospects have improved for regional crude oil and natural gas prices in Western Canada.

Performance Overview

The ClearBridge Canadian Equity Strategy performed in line with the S&P/TSX Composite TRI benchmark in the second quarter, with slightly negative absolute returns. The most significant positive relative contributors to performance included our underweight position in the underperforming Shopify, as well as meaningful weights in the outperforming Agnico Eagle Mines and Saputo.

In materials, Agnico Eagle shares benefited from strong operational execution and robust gold prices. The company recently hosted a site visit at its long-life Detour property in Northeastern Ontario. Detour is the largest gold-producing mine in Canada with production expected to increase to one million ounces annually by 2030 from a current run rate of approximately 700k ounces. Across all its operations in Canada, Australia, Finland and Mexico, with solid production guidance, project and reserve updates, and better than expected cost control, the company has performed well.

In consumer staples, dairy products provider Saputo rebounded following its well-received fiscal fourth-quarter results (fiscal year ending March) and outlook for fiscal 2025. Following years of struggles, management is confident in the pending benefits from its

recent network optimization initiatives and reduction in capital expenditures. Furthermore, U.S. supply-demand dynamics are better balanced in a region that has been challenged by unfavorable commodity price trends. While its international business remains more of a wildcard, Saputo remains focused on improved free cash flow generation and balance sheet management to put the business back on a better track.

Meaningful detractors in the second quarter included OpenText in IT, and Telus International in industrials. Open Text shares declined following its fiscal third-quarter results, largely due to increased investments in AI capabilities within its software solutions, further marketing spend to grow the cloud business, as well as a change in acquisition strategy. Alongside recent divestitures, near-term margin and operating leverage improvements have been pushed out. That said, the base business is still showing areas of fundamental improvement, with continued increases in cloud bookings, ongoing deleveraging, stabilization of its recent Micro Focus acquisition and overall organic growth.

In the case of Telus International, demand weakness within the broader IT services ecosystem continues to plague its core digital customer experience business, with majority shareholder Telus, as well as Google, the only growing segments. Management's guidance incorporates a back-half recovery in 2024. However, with limited visibility and multiple missteps in the company's short public history, credibility is an issue. While AI remains a potential eventual tailwind for the business, macro headwinds are stiff in the near term, with tech and telecom clients reining in IT budgets. Telus will remain a "show me" story until management can prove out consistent revenue growth and profitability.

Portfolio Positioning

Trading activity in the quarter included an uncharacteristically high five new holdings: Parex Resources in energy, Franco-Nevada and Wheaton Precious Metals in materials, Shopify in IT and Brookfield Infrastructure Corporation in utilities. We also broadly added to more attractively priced defensive/interest-rate-sensitives as well as out-of-favor cyclical and growth names, while selectively taking profit in several defensive/less interest-rate-sensitive holdings.

Interest-rate-sensitive holdings in communication services and utilities continued to grow in prominence in the portfolio, with the higher interest rate environment weighing on sentiment to the point that we believe the risk/reward is excellent — hence the second quarter additions to BCE, Brookfield Renewable, Canadian Utilities.

Shopify was added to the Strategy on weakness for the first time since its IPO in 2015. While typically a volatile security, an 18.7% decline following the company's recent quarterly report represented its worst single trading day since the IPO. Shopify is undoubtedly a

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great Canadian success story and we've been consistent in this view over time. However, the success of a business and the attractiveness of an investment can be two completely different things, with calibration of price and value often a sticking point. The company has posted incredible historical growth, and we believe it can continue on an expanding trajectory — and profitably so. Market share gains are ongoing, and Shopify has successfully tested the price elasticity of its subscription business while abandoning its disastrous past fulfillment ambitions, providing a sign of improved capital allocation priorities and a level of maturity where we now have better visibility into the business model and prioritization of sustainable profitability.

In materials, we trimmed our position in Agnico Eagle and initiated positions in two royalty/streaming businesses, Wheaton Precious Metals and Franco-Nevada. In the precious metals subsector, we have tended to favor the royalty/streaming business model when valuations align. Once a novel business model, over past decades they have become a conventional source of financing for miners, complementing the traditional capital structure. Wheaton has demonstrated constructive portfolio growth over the past couple of years, while challenges at Franco-Nevada and related share price weakness present an attractive opportunity.

In energy, we initiated a position in Parex, a Canadian company with oil and gas assets in Colombia and a key partner of the Colombian state oil company Ecopetrol, holding a number of production sharing agreements. It has an established track record of generating excess free cash flow, from which it has pursued a multiyear share buyback program as well as, more recently, instituted an attractive dividend. Reporting first production at the company's Arauca exploration well should provide more confidence around its ability to add to its reserve base, as well as re-ignite production growth.

In utilities, the seemingly higher-for-longer interest rate environment has weighed on interest-rate-sensitive equities, with names such as Brookfield Infrastructure (BIPC) coming under considerable pressure. The company owns and operates a globally diversified portfolio of high-quality, long-life infrastructure assets spanning utilities, transport, energy and data infrastructure, which are poised to prosper from secular tailwinds of decarbonization, deglobalization and digitization. The scarcity and strategic positioning of these assets provides valuable protective moats. BIPC operates under a Master Service Agreement with Brookfield Asset Management (BAM), which allows the company to leverage BAM's global reach, deep expertise and strong capabilities across key areas of operation and allows BIPC to co-invest in compelling, high-quality assets of significant size and scale alongside BAM and its institutional partners.

At quarter end, the Strategy's largest sector exposures were financials, industrials, energy and consumer staples. Relative to the benchmark, the Strategy is overweight consumer staples, utilities and industrials, and is most underweight financials, energy and materials.

Outlook

While corporate earnings have largely delivered to date in 2024, equity market valuations mostly remain heightened. This is particularly true in the higher-growth and less interest-rate-sensitive portions of the equity market. With meaningful risks to the economic outlook remaining, including the lagged potential impacts of tightened monetary policy, residual inflationary concerns, geopolitical risks and uncertainty surrounding upcoming U.S. elections, and something close to an ideal scenario already priced in for those favored equities, the Strategy continued to drive toward more defensive positioning than has been the case in many years. Despite the BoC's divergent rate cut in the second quarter, with tempered U.S. rate cut expectations in the short run and the overall gravity of a structurally higher interest rate environment in North America, we remain mindful of the inherent risks in equities as investors continue to re-acclimatize to a non-ZIRP (zero interest rate policy) and non-TINA (there is no alternative) environment.

While the differences in the Canadian and U.S. equity markets have undoubtedly led to significant divergence in performance in recent years, the resulting fear of missing out (FOMO), capital flows and market concentration can often lead to overlooked opportunities elsewhere. Our bottom-up approach is designed to seek out such opportunities, with a particular focus on visibility to high full-cycle profitability, secular growth, effective capital allocation and a discerning approach to valuation.

With superior predictability and downside protection available at a reasonable price, we continue to appreciate and emphasize the more defensive posturing of the Strategy. We believe our positioning can provide ballast in more challenging equity market environments, which will allow the Strategy to power ahead with predictable growth, and serve as dry powder when better risk/reward opportunities arise. We will continue to target a trailing beta of 0.8 to 0.9 for the Strategy, limiting the systematic risk and volatility relative to the benchmark.

Portfolio Highlights

During the second quarter, the ClearBridge Canadian Equity Strategy performed in line with its S&P/TSX benchmark. On an absolute basis, the Strategy generated gains in five of the 10 sectors in which it was invested (out of 11 total). The primary contributors were the consumer staples, materials, consumer discretionary and utilities sectors, while the main detractors were the industrials and IT sectors.

Relative to the benchmark, negative security selection offset positive sector allocation. In particular, a sector overweight in the strongly performing consumer staples sector, as well as an underweight to the underperforming IT sector, as well as stock selection in consumer discretionary and utilities contributed to performance. Stock

selection in industrials and IT as well as an underweight to materials detracted from relative performance.

On an individual stock basis, leading absolute contributors included Royal Bank of Canada, Dollarama, Agnico Eagle Mines, Saputo and Brookfield Renewable. Top absolute detractors included Open Text, Canadian Pacific Kansas City, Canadian National Railway, Toronto-Dominion Bank and Bank of Nova Scotia.

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