PALISADE
CAPITAL

Our Market View in Summary

October 2023

The financial landscape has recently produced some atypical datapoints in respect to historical relationships that are now very stretched compared to normal standards. Typically, when you see stretched relationships or aberrations, it would point to a potential reversal in the near-term towards more normalized levels. US bond yields are high relative to those of emerging markets and spreads in the mortgage market remain near historical highs. The fear that built up over the last three months regarding interest rates being "higher for longer" has manifested in these datapoints, which are very much outside the norm. Such stretched relationships don't typically last long as they tend to revert to the norm as investors recognize value in one side of the relationship. There is value and opportunity in buying some of the most beaten-up, but high quality names at current levels.

Recent Market Aberrations:

- The bull market in certain US indices has seen an unprecedented lack of support from small-cap stocks, diverging from historical market recoveries where small caps have outperformed in the early stages.
- A second aberration is that sectors traditionally deemed to be "widows and orphans stocks", such as utilities and banks, have underperformed significantly in Canada during the recent market correction. Unusually, these lower risk stocks have underperformed higher risk stocks in a "risk off" market environment.
- A temporary inversion occurred where yields on US Treasury bonds exceeded those of emerging markets bonds - a scenario suggesting that US yields are too high and have room to move lower. We would never want to purchase emerging markets bonds that are yielding less than US Treasury bonds. This is not sustainable and points to opportunity.

Near-Term Outlook:

- The US Federal Reserve's recent communications were interpreted by investors as pointing to a potential pause in interest rate hikes, a sentiment that appears to have been confirmed by the market with its swift upward move following the US Fed's November 1st meeting.
- The Canadian market's volatility and rangebound trend could potentially be replaced by a more sustainable upside move if expectations are set towards no further rate hikes. Typically the US will lead and Canada will follow, but in this case we think that the Bank of Canada will cut rates before the US does.
- The recent downturn, particularly in interest-sensitive sectors such as utilities and banks, represents a highly attractive buying opportunity, in our view.

In summary, the market has declined in the past few months due to fears regarding the impact of higher interest rates for a longer period of time than investors are comfortable with, and the risk that central bankers will be too dependent on short-term data points, rather than looking further out and assessing the potential impact of their rate hikes. With interest-sensitive stocks, among others, at multi-year lows notwithstanding stable underlying business models, we feel that the recent fearful move lower has priced in a lot of that potential risk. The market environment changed notably between October 31st and the most recent US Federal Reserve meeting on November 1st, and we think that the positive response to that meeting will set the tone for the rest of the year.

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October 2023

Fellow Palisade Investor,

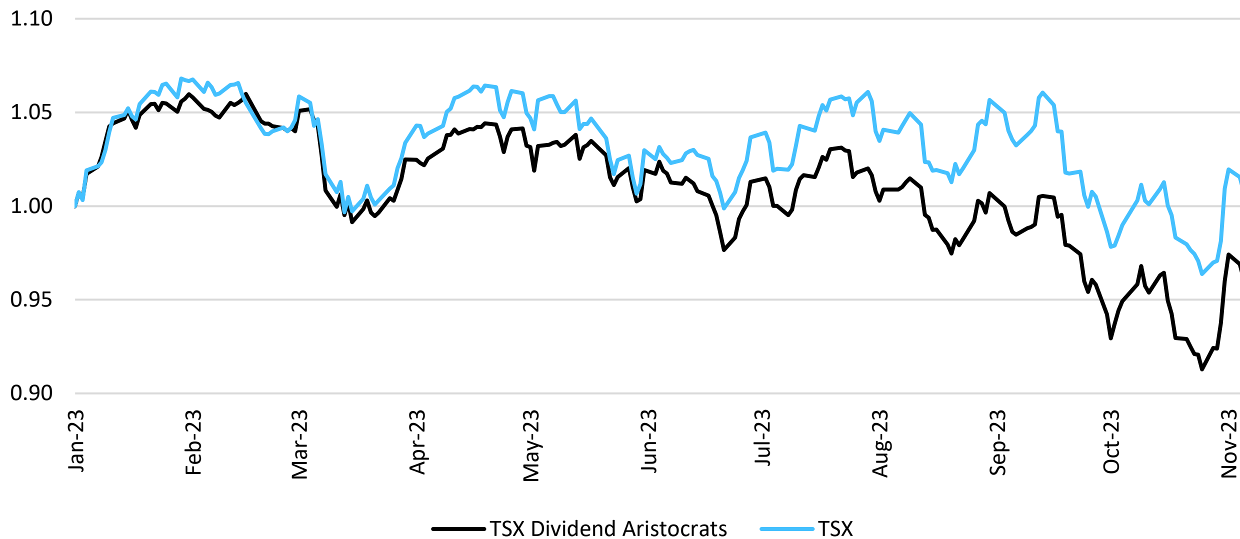
Please find attached the October 2023 Monthly Update and Fund Fact Sheets for the Palisade Funds. **This month's client conference call is scheduled for Thursday, November 16th at 11am MT.** We will use Zoom for this call which will allow participants to connect either through their computers or by calling a phone number. The Zoom meeting details will be provided the morning of the call. In conjunction with this call, we will be emailing out a presentation that contains data and charts to further detail our thought process and outlook. We look forward to speaking with you then and answering any questions you may have.

All Fund performance figures are shown net of fees and expenses and include changes in security values and distributions paid. They do not assume the reinvestment of distributions. The Palisade Vantage Fund currently pays a regular quarterly distribution of $0.11 per unit, or $0.44 per unit per year. The Palisade Select Fund and Palisade Absolute Fund pay irregular annual distributions for years in which taxable net income is positive.

MARKET COMMENTARY

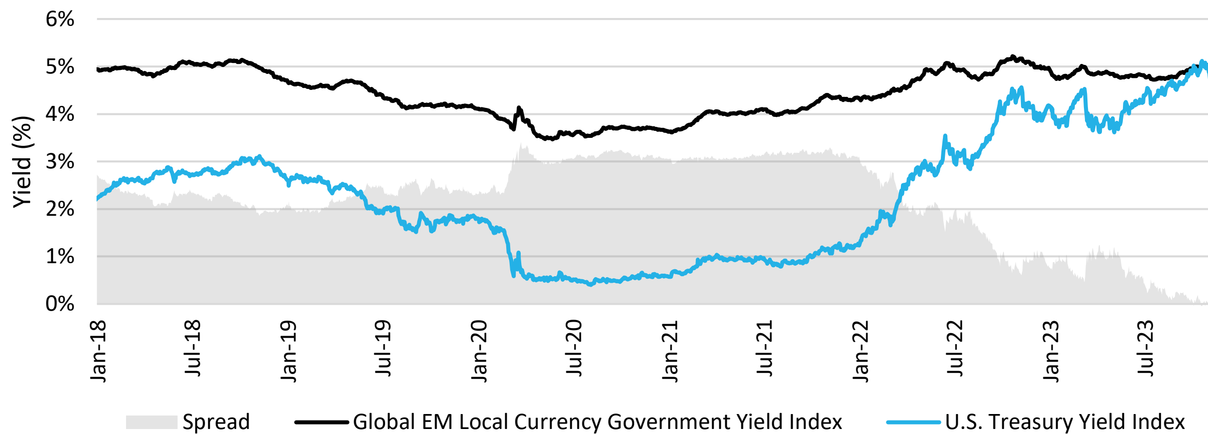
The last few weeks have produced some "weird" market dynamics. When long-standing relationships suddenly start to break down or get stretched beyond their usual ranges it's worth taking note. These situations are typically indicative of an imminent reversal in trend in the direction of something that is more "normal". With an expectation of interest rates being at elevated levels for some time and the general elimination of free money for the foreseeable future, it has caused havoc with many long-standing relationships in the stock market. For example, the bull market in some US market indices this year has seen basically zero contribution from small cap stocks, whereas in the past you would typically see small caps perform very well, especially in the early stage of the cycle. Another example would be the poor performance of what historically were called "widows and orphans stocks" for their low risk nature – sectors such as utilities and banks. With the contemplation of higher interest rates, utilities have been some of the worst performing stocks in Canada in the past few months with no day-to-day change in their businesses.

The chart below shows the S&P/TSX Composite Index and the S&P/TSX Canadian Dividend Aristocrats Index ("DAI") for the year-to-date in 2023, indexed to the start of the year. The DAI includes companies that have stable or increased dividends for the last five years. These companies are typically viewed as being safe, high quality and blue chip in nature. As you can see, these high quality stocks began to notably underperform the broader S&P/TSX Composite starting in August through late October. This underperformance occurred during a time when broad markets were selling off, which would usually be a period when higher quality stocks outperform the broader market. Lower risk stocks underperforming higher risk stocks in a time of market correction would also stick out as outside the norm.



Source: Bloomberg

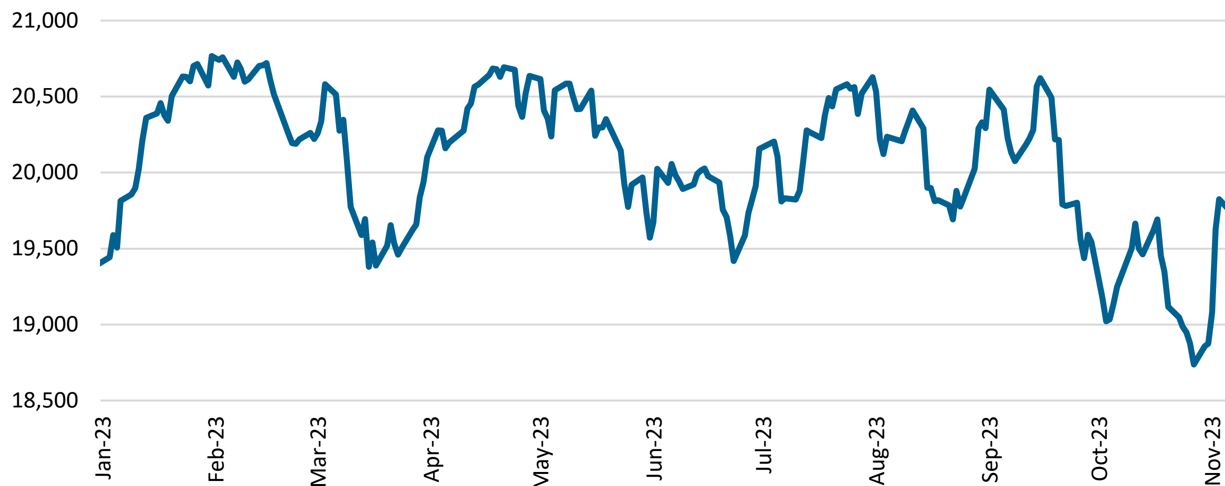
Another "weird" data point is detailed in the chart below. Last month, for a short period of time, the yield on US Treasury bonds exceeded the yield on emerging markets bonds. This is not sustainable and points to US yields being too high and other factors at play in the determination of short-term interest rates. At no point would we want to own emerging markets bonds for the same yield as US bonds. The spread in yields is also detailed in the chart and shows that 2% to 3% is a more normalized level. The other factors at play in the short term may be the selling of US Treasury bonds by China, Japan, the US Federal Reserve in its quantitative tightening program and the US Treasury itself in order to finance large budget deficits. All of these factors coming together at the same time may have led to the most recent spike in US interest rates. We think that this relationship should normalize in the coming months, which should come with lower interest rates and less fear about the economy.



Source: Bloomberg

On November 1st, the US Federal Reserve met and decided to keep its benchmark interest rate at the same level of 5.5%. What was more interesting was the interpretation of Fed Chairman Jerome Powell's comments in the associated press conference. Investors felt that the "read between the lines" view was that rates will most likely not go higher from here, which caused a very quick move higher in markets during the following week. It will be a long process, but the first step of properly recognizing that interest rates won't be going higher is a positive. It's

been a very choppy and volatile market for the last two years driven by a constant fear of what might be possible for higher interest rates and the economic impact of those rate hikes. Moving from a fear of rate hikes to an expectation of stable rates is a positive first step.



Source: Bloomberg

The last chart that we'll speak to is the most straightforward, simply being the S&P/TSX Composite Index. As you can see above, the Canadian equity markets have been on a volatile path to nothing through the year. The main question at this point needs to be "What changes the volatile and rangebound nature of the Canadian market?" The first criteria would be an elimination of fear of further rate hikes. We think we may have seen the first signs of that following the November 1st US Federal Reserve meeting. The market interpreted the Fed commentary to be dovish and increased the likelihood that it is finished raising rates. As you can see on the far right of the chart, the TSX Index responded very positively to that expectation, moving up approximately 5% in less than a week.

A stabilized Canadian economy would be a second key milestone. While the month-to-month data continues to hold in reasonably well, there is ongoing fear about what could be coming down the pike. This fear has been present for the better part of two years and won't go away slowly, but some consistent data points around consumer credit and housing would go a long way towards providing a more consistently positive trend for the TSX Index. We think that we'll see this data in the coming months and that the Bank of Canada is closer to rate cuts than a further rate hike. We think the most recent spike down in the Canadian market, which was led by high quality interest-sensitive sectors like utilities and banks, will turn out to be a good buying opportunity when we look back in six months' time.

PALISADE FUND COMMENTARY

The **Palisade Select Fund** ("PSF") was down 1.4% in October. The S&P/TSX Capped Energy Index ("Energy Index") was down 1.2% and the WilderHill Clean Energy Index (NYSE: ECO) was down 21.1% for the month.

We have further reduced our energy technology exposure, which currently sits at about 9% of total fund assets. The near-term challenges from higher interest rates and lower consumer demand in certain end markets has been longer lasting than we anticipated and even though many of the names are already down dramatically over the last two years, the stocks have continued to underperform. We will revisit these names in time, but for the near-term we prefer to focus on oil and gas-oriented stocks. The drag from even small exposure in this sector is not acceptable, so we will revisit in time. The ECO Index decline of 43% over the last three months has been quite astonishing, considering that this index was already down 70% from its highs before the recent weakness.

We have added incremental exposure to Kelt Exploration (TSX:KEL), Canadian Natural Resources (TSX:CNQ) and Peyto Exploration and Development (TSX:PEY), among others. We also have a small cash position that can be put to work in the coming weeks.

The **Palisade Absolute Fund** ("PAF") was up 0.3% in October. This month was positive in that the PAF was up while broad markets were down. The returns were generated from the Fund's short positions and the performance of select names generated by our growth screens. We continue to maintain net exposure of around 50% long and expect it to remain in that area through year-end given the market's positive response to recent decisions around interest rates.

The **Palisade Vantage Fund** ("PVF") was down 4.0% in October compared to a loss of 3.2% in the S&P/TSX Composite Total Return Index. Typical Vantage Fund holdings (blue chip dividend growth stocks) are at the heart of recent market weakness. We have always compared PVF returns to those of the S&P/TSX Composite Total Return Index, but that index includes many sectors in which the PVF will typically not invest. For frame of reference, looking at an index such as the S&P/TSX Dividend Aristocrats Index is a little more insightful. For the month, that index was down 3.5%, while year-to-date it was down 7.1%. Both of those values are in the ballpark of the PVF over the same time periods.

Nothing has changed in respect to the quality of the companies in the PVF - we just need to get past the fear of higher interest rates, which we believe has started following the November 1st US Federal Reserve meeting as we laid out above. It's important to note that most of the PVF's October losses have been regained in the first few days of November. Any positive running room from here should be additive through the balance of the year.

We continue to have confidence in our fundamental outlook and see meaningful value across many sectors of the Canadian market, which should manifest itself in higher stock prices in the coming months. If you have any questions, please feel free to reach out at any time.

Best wishes,

THE PALISADE CAPITAL MANAGEMENT TEAM

Please note that it is the responsibility of each investor to inform Palisade Capital of any changes to the information provided to us on the most recently completed Know Your Client ("KYC") information form or subscription agreement. Please contact Marni Friesen at (403) 531-2673 or marni@palisade.ca to provide any such updates. If you no longer wish to receive the Monthly Update, please send an email to info@palisade.ca.

All Palisade Fund performance figures are shown net of fees and expenses and include changes in security values and distributions paid. They do not assume the reinvestment of distributions. Income taxes would have reduced returns. The Funds are not guaranteed. Performance of the Funds will fluctuate and past performance may not be repeated. To establish relative performance yardsticks for the Palisade Funds, we provide comparative references to the S&P/TSX Composite Total Return Index ("TSXTR"), the S&P/TSX Capped Energy Index ("Energy Index") and the WilderHill Clean Energy Index ("ECO Index"). Those indices are relevant to our portfolio content however the TSXTR, Energy Index and ECO Index data is provided for general reference purposes and their content should not be construed as directly comparable to the content of the Palisade Funds.