

Manager's Commentary

Greg Taylor, CFA

Market Insights

The month of May felt an awful lot like April, and it's not just the weather. April was a positive month that saw equity markets recover most, if not all, of the March losses stemming from the US-Iran war concerns. Turning the calendar over to May, many market observers were calling for more of a pause. The conditions that led to the March selloff (higher oil prices and bond yields) had not gone away and were accelerating higher. Yet, as is often the case, the equity market did what it does best – prove the majority incorrect – once again climbing the 'wall of worry,' to finish the month at all-time highs.

What did change was an acceleration of corporate earnings. Heading into the Q1 reporting season, there was a lot of uncertainty. The impact of AI on software companies and white-collar employment was a fear that hit markets earlier in the year. Add to that a surge in energy prices, combined with the breakdown of the global supply chain, and it seemed like the perfect backdrop for corporate executives to give cautious guidance. However, that wasn't the case. Aside from some retailers that commented on a slowdown at the lower end of the consumer, earnings were stronger than expected.

Of course, energy companies surprised to the upside given the surge in related commodity prices, but other sectors also showed surprising gains. Technology continued its leadership, as spending on AI related projects appears to remain elevated and given the record amount of capital raised in the high yield market, this trend does not appear likely to pause in the near term. Certain semiconductor companies have risen, up 70% in two months, but it's different names within the group that are moving higher. NVIDIA Corporation (NVDA) continues to put out record financial results, but other companies such as ARM Holdings PLC (ARM) and Micron Technology Inc. (MU) are seeing their share prices move higher.

It was also a positive to see software companies recover. At least for now, in our view, fears of the effects of AI appear to be overstated. Most companies reported little or no impact on demand during the quarter. The shares of many of these companies surged on these reports, potentially driven by short covering. Dramatic price moves like these are often associated with 'late cycle' behaviour. It's too soon to determine if that is the case once again, but it bears watching. Narrow markets such as we are witnessing can turn quickly.

One theme that does seem ready to take hold is an increase in corporate activity. Mergers and acquisitions were near a record last year and appear to be continuing the trend this year. Activist investors are aggressively targeting smaller companies that have seen their valuations fall. There is also a push to see deals announced and approved before there is a potential change to a less business friendly administration in Washington later this year.

We are also getting ready for what could be the largest IPO in history, SpaceX. This issue has the potential to set all sorts of records for hype and scale. It also appears to have been able to circumvent the inclusion rules of several index providers to be added sooner than it usually would, potentially increasing broader market volatility. Given the attention around this deal and what is at stake for many investment dealers, we believe there is likely a huge incentive to hold markets near record levels until it has closed. Once that is done, who knows what will happen?

One pattern that is increasingly pointed out is that during US mid-term election years there has been a tendency for a summer correction. Will this year be any different? Of course, the sitting

President has all the incentive in the world to try to show market gains heading into the vote, and Trump may not be any different. There is also the added push to have everyone happy for the 250th birthday celebrations on July 4th. But that isn't always completely in one person's hands.

With markets at all-time highs, the risk is always that we are missing something and might be pricing in all the good news while ignoring some risks? There remains an expectation there will be a deal shortly to end the conflict with Iran and with that a normalization of shipments from the Strait of Hormuz. The new Chair of the FOMC is also appearing to signal a more market-supportive tone, including some pushback on further rate hikes. Add to that the optimism around earnings strength and it's difficult to come up with what could be even better news?

Given that setup, in our view, the risk/reward for equity markets remains concerning. Warning lights are flashing but that alone isn't enough to say it's time to step away. There remains the potential for further gains, and seeing a broadening out of the rally to include other sectors would be a positive. Yet the setup for a volatile summer remains and must be watched. Hopefully during some warmer weather.

Fund Update

For the month of May the Pender Alternative Select Equity Fund was higher by 2.4%¹ which brings the year-to-date return to 22.7%. This compares to the S&P/TSX Composite return of 2.5% for May and 10.6% for the year-to-date. After being cautious on technology, we did add tactical exposure to the semiconductor space during the month as the momentum was, in our view, too strong to ignore. We took a position in memory stocks through exposure to the DRAM ETF early in the month but exited the position by the end after strong gains. We also took profits in names such as ARM Holdings PLC (ARM) and Lam Research Corp. (LRCX). To end the month our technology exposure is back near the lows we have had over the last year.

We continue to see parts of the equity market as risky at these levels. The narrow leadership of technology in the US and banks in Canada is concerning. As a result, we have cut our exposure to these groups and added put options to position for a drop. The amount of capital being raised in both the equity and credit markets to fund the AI boom is concerning and has the risk of overwhelming demand.

Summer markets can be very tricky to navigate. Volumes are usually below average as attention turns towards vacations. After a good start to the year, we don't see this as the time to add risk exposure and have been becoming more defensive. The gold sector that led last year has seen price declines for the last few months. We have been adding exposure on this pullback and believe the sector could expect a stronger second half.

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¹ All Pender performance data points are for Class F of the Fund unless otherwise stated. Other classes are available. Fees and performance may differ in those other classes. Standard Performance Information for Pender's Liquid Alternative Funds may be found here: <https://penderfund.com/fund/pender-alternative-select-equity-fund/>