PICTON MAHONEY
Asset Management

Q1 2024

Investment Review & Outlook

Can the market have its cake and eat it too?

- The market has embraced a soft landing for the U.S. economy
- BUT, has the market taken things too far already?
- We believe short-term rates will stay higher than the market expects
- Has the Fed abandoned its inflation resolve too soon?
- Other risks to the current soft landing narrative

Overview

Equity markets seemed to be in the throes of maximum exuberance as 2023 drew to a close. Investors have embraced an immaculate soft landing (in the U.S. at least) where inflation has been tamed, the economy is slowing but remains in growth mode, unemployment rates are expected to stay muted at under four percent, the Fed has pivoted policy just in time and is prepared to add significant support in March just when the economy needs it, the U.S. dollar has weakened, taking accident risk off the table (especially in emerging markets) and S&P 500 earnings have bottomed and will likely grow considerably in 2024. Wow! It's amazing how a market narrative can change so quickly over the course of one quarter.

However, investor positioning is now stretched on the long side, sentiment is exuberant and valuations seem to have already priced in this perfectly immaculate scenario. We believe a lot has to go right in 2024 to justify any meaningful upside in both stock and bond prices from current levels. Meanwhile, there are also some inconsistencies in current market expectations that will likely be increasingly difficult to reconcile as the year progresses. One such inconsistency: aggressive Fed easing already baked into forward rate markets, which suggests significant economic weakness may be just around the corner, set against forecasts for bullish earnings growth. A scenario where earnings accelerate is not one where the Fed will likely be cutting interest rates rapidly – or perhaps even cutting rates at all.

It appears that market bulls want to have their cake and eat it too. We think the near-term setup for risk assets isn't overly compelling, and that 2024 will bring back its share of volatility as the current soft landing narrative is challenged. We are also concerned about an emboldened Fed Chair who suddenly seems to be embracing forward thinking (instead of just trend following) in his policy decisions for the first time in his tenure and seems convinced that the inflation battle is now over, even while supply-side constraints continue in key areas of the economy.

Picton Mahoney House View January 2024

	PMAM vs. Consensus
Risk	
Macro risk spiked in October but then fell again to very low levels into year-end as the U.S. Federal Reserve (Fed) indicated that they may cut rates soon. However, we expect macro risk to rise into 2024 as the market comes to terms with the fact that rate cuts will likely come with economic weakness, whereas continued economic resilience will postpone those cuts further into the future.	Higher +
Macroeconomic	
Global real GDP The U.S. economy may not hold the rest of the world up for much longer, as more countries and regions slip into recession or are treading water. China in particular faces deflationary pressures as its population shrinks and its housing market continues to implode.	Lower –
U.S. real GDP Leading indicators are weakening and U.S. economic resilience may be coming to the finish line, although renewed fiscal stimulus and a dovish Fed could push it along further into 2024.	Same
Canadian real GDP The Bank of Canada has warned that the first half of 2024 will be difficult, as unemployment is rising, business optimism is very low and the housing market is in a deep freeze.	Lower –
U.S. inflation We expect that "the last mile" to get to the 2% target will be hard to achieve without significantly higher unemployment. The recent Fed pivot may push this from occurring further out in time.	Same
Equity returns	
U.S. equities The market is hoping for Fed cuts and a return to low rates, but there is little room for upside with sentiment and positioning already at extreme highs, while high real rates offer no valuation support.	Lower –
European equities Parts of Europe are in recession by some measures and yet the European Central Bank remains hawkish, which will likely not end well for European equities.	Lower –
Canadian equities The Canadian economy is facing a tough first half of 2024 and domestically focused equities such as financials will likely bear the brunt of equity weakness.	Lower –
Bond yields	
Treasuries (U.S. 10-yr) As the global tightening cycle comes to an end, we expect treasury yields to fall, although the ultimate bottom may be constrained by supply-demand imbalances in the treasury market.	Lower –
Investment-grade corporate bonds Falling government rates will likely offset widening spreads for Investment Grade yields to remain about even.	Same
High-yield corporate bonds Bankruptcies are creeping higher, while very tight spreads give little room for error.	Higher +
Other	
WTI crude oil Reluctant OPEC (Organization of the Petroleum Exporting Countries) cuts have not been enough to offset U.S. shale production, which is once again at new all-time highs and expected to keep growing.	Lower –
EPS growth (S&P 500) Leading indicators point to negative earnings growth.	Lower –
P/E (S&P 500) High real rates remain a headwind to equity valuations over time.	Lower –

PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at December 2023.

The market has embraced a soft landing for the U.S. economy

History shows that when the Fed pauses its tightening process, it is generally bullish for stocks and bonds. The table shows that equities typically rally considerably in the first three months following a Fed pause, regardless of whether the economy is headed for a soft landing or a recession.

Figure 1: Equities typically rally after a Fed pause

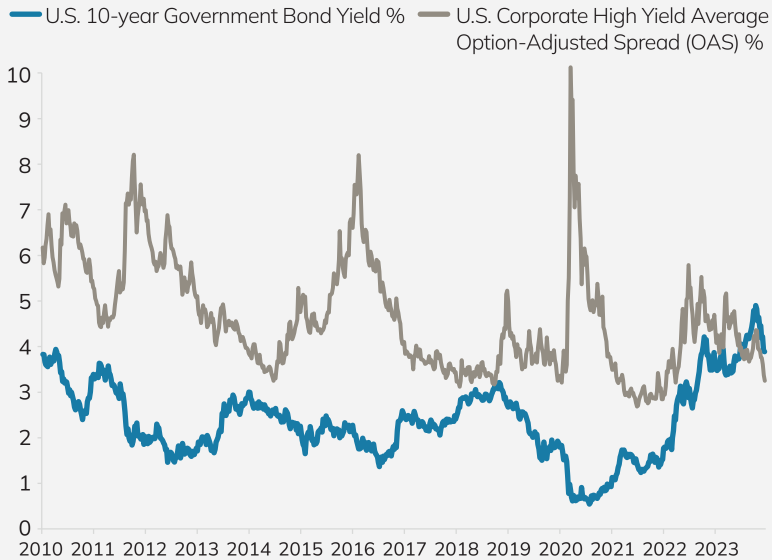
	S&P 500 Index	S&P / TSX Composite Index	MSCI World Index	U.S. 10 Year Bond Yield	U.S. 2 Year Bond Yield	10/2 Year Yield Curve	High Yield Credit Spread	U.S. Unemployment Rate
Fed Pause (pre-recession)								
Prior 3 months	3.1%	2.2%	1.0%	0.13%	0.39%	-0.26%	0.65%	-0.1
First 3 months	8.3%	9.2%	2.4%	-0.58%	-0.55%	-0.03%	0.06%	0.0
Following 6 months	-0.2%	-2.7%	1.4%	0.13%	0.39%	-0.26%	0.65%	**0.2**
Fed Pause (re-acceleration)								
Prior 3 months	7.9%	1.9%	4.2%	-0.24%	-0.10%	-0.14%	0.06%	0.0
First 3 months	6.9%	5.0%	4.8%	-0.78%	-0.92%	0.14%	-0.04%	0.0
Following 6 months	**12.5%**	**9.1%**	**8.2%**	-0.71%	-0.66%	-0.05%	-0.32%	-0.1

Source: Bloomberg, L.P., PMAM research. June 1982 to Dec 2023. Fed pause is defined as the last hike of a continuous hiking cycle. Fed pause (pre-recession) is a Fed pause that eventually led to recession and Fed pause (re-acceleration) is a Fed pause where the economy then avoided recession and accelerated.

We expected a rally once it became clear the Fed was likely done its tightening process. However, the market has moved upward further and faster than we thought it would, fully embracing a soft landing (in line with the "re-acceleration" scenario in the table above as opposed to the "pre-recession" one).

At this point, there is significant evidence to justify investors' faith that a soft economic landing is in store. Long bond yields have been falling on expectations of the end of the inflation battle and an ensuing flurry of Fed rate cuts. Yet credit spreads are very tight, suggesting that the economy will likely remain buoyant enough for corporate bond investors to rest easy at night believing they will avoid any undue credit events.

Figure 2: **Long-term yields are falling, yet credit spreads show little sign of recession fear**

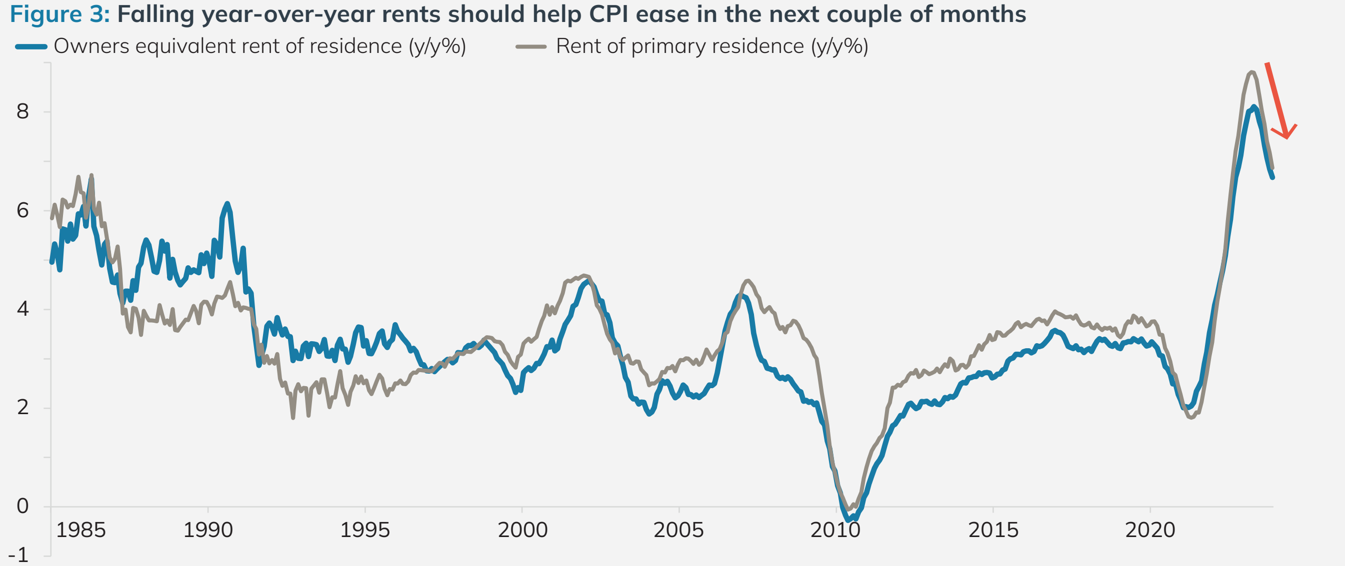


Source: Bloomberg, L.P., PMAM research. Jan 2010 to Dec 2023.

Inflation data have improved considerably over the past year, especially more recently. Most of the disinflationary gains this year have come from the energy component not only decreasing but becoming an outright negative drag on headline Consumer Price Index (CPI). This was most prominent in the June 2023 CPI report where energy detracted a full -1.5% from total CPI. More importantly, the supply chain disruptions and bottlenecks that plagued global manufacturing finally abated in 2023, and thus goods prices normalized (except for automobiles, which are now showing signs of peaking). While Core Services have peaked, the decline has been slow and they still represent the bulk of outlying contributions to both core and total CPI.

While still above the Fed's two percent target, further improvements in inflation data are expected in the near term. The cost of shelter (Owners Equivalent Rent) is still quite elevated within CPI, but is expected to decline in the near future on the back of falling rents.

Figure 3: **Falling year-over-year rents should help CPI ease in the next couple of months**

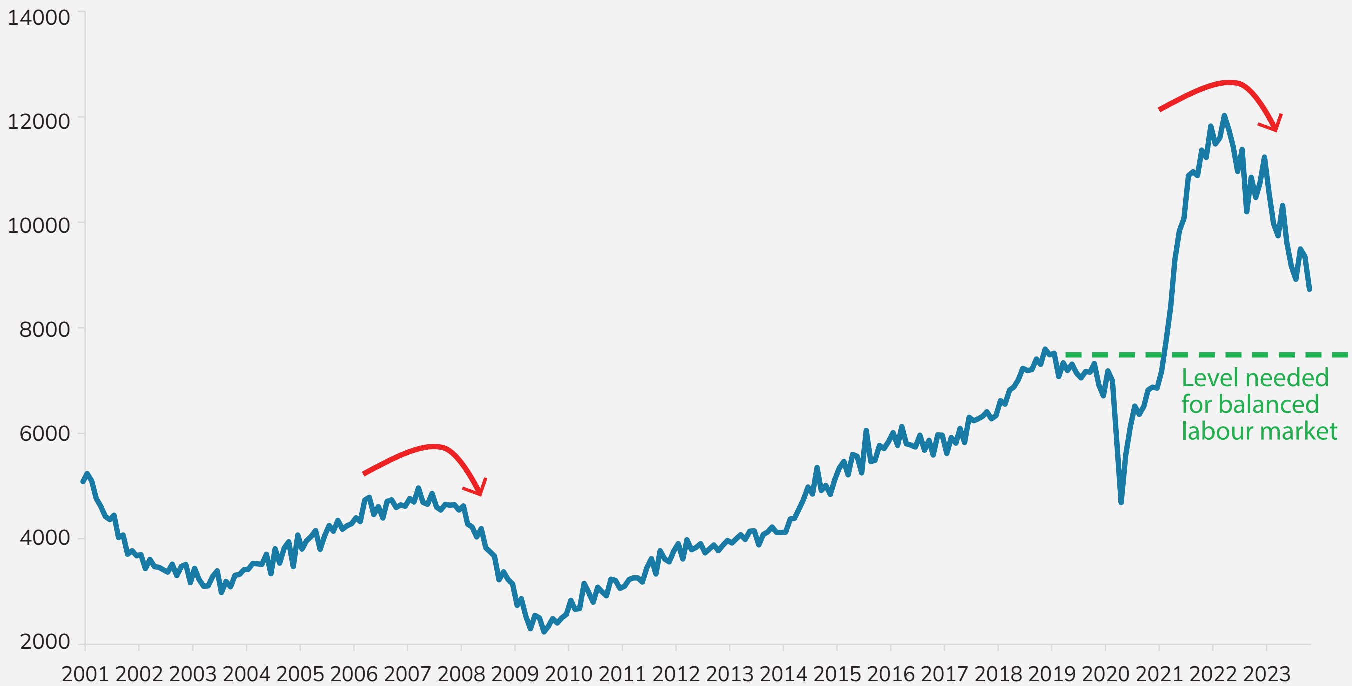


Source: Bloomberg, L.P., PMAM research. Jan 1985 to Nov 2023.

Recent economic trends also point to the lagged effects of restrictive monetary policy finally starting to work their way through the U.S. economy. Progress is being made with regards to Job Openings and Labor Turnover Survey (JOLTS) job openings, which are falling convincingly. This is reducing demand for workers, which is helping to soften up the labour market. Wage gains are still running higher than desired at four percent (average hourly earnings) but falling inflation expectations are expected to help moderate them.

Figure 4: U.S. job openings have fallen

U.S. job openings (in 1000's)



Source: Bloomberg, L.P., PMAM research. Jan 2001 to Oct 2023.

These recent developments contributed to Fed Chair Powell's recent pivot in December, which helped trigger the recent surge in markets (especially in lagging areas of the stock market). The Fed pivot was likely driven by a feeling that it is close enough to its inflation goal to start thinking about the next phase. But it was also likely motivated by a fear that it may be going too far amid signs that economic resilience is running out. For example, its most recent "Beige Book," which surveys companies about their outlook and general business conditions, included less-than-upbeat comments.

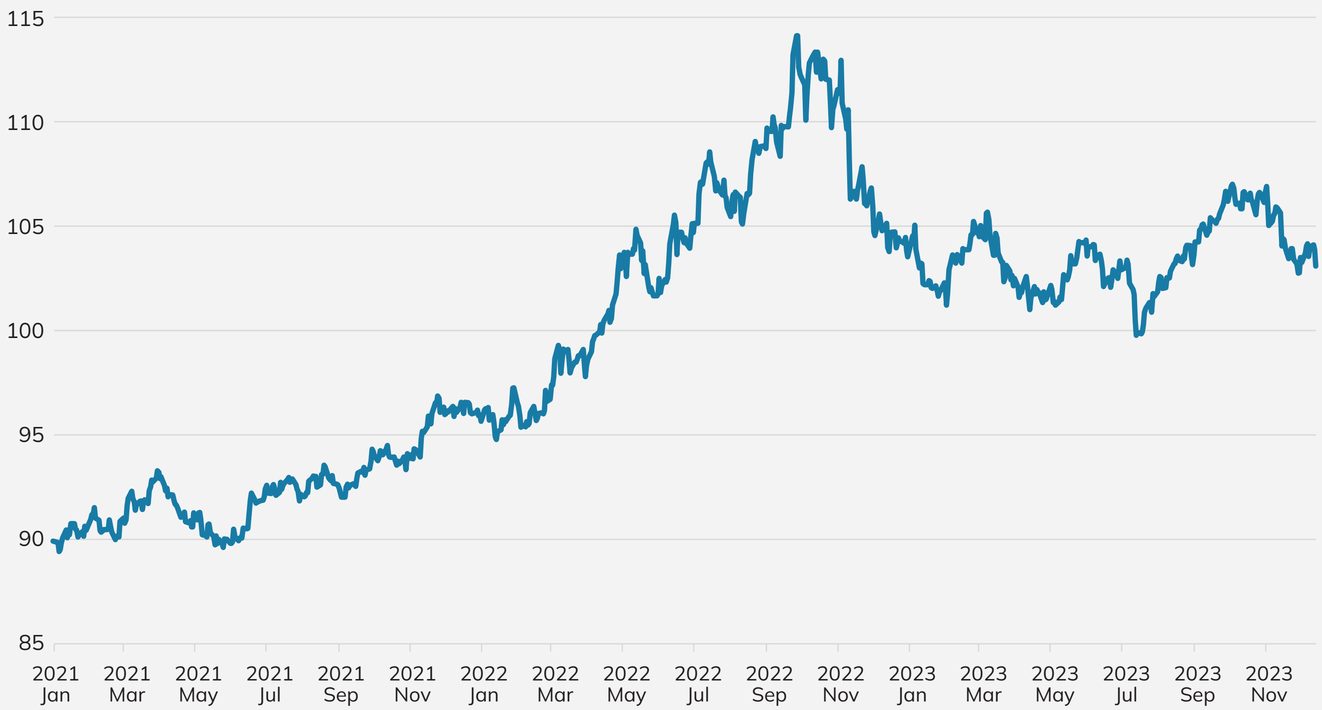
We learned from Powell's press conference, on December 13, 2023, that the Fed won't wait until core inflation is exactly 2.0%, because monetary policy has long lags and if it waits too long it may undershoot its inflation goals. The Fed expects core inflation to fall beneath three percent in 2024, and so it believes it is time to consider when to take its foot off the brake.

The U.S. dollar has weakened

The U.S. dollar, which rallied in the third quarter of 2023, pulled back in the fourth quarter as expectations for 2024 Fed cuts strengthened. As a result, countries whose economies are sensitive to changes in the greenback aren't showing much stress at present. The market has understandably been encouraged by this development, as it takes pressure off the rest of the world, reducing the probability of a significant funding accident occurring in an underperforming company or country that has significant U.S. dollar denominated debt.

Figure 5: Rising rate cut expectations have weighed on the greenback

U.S. Dollar Index

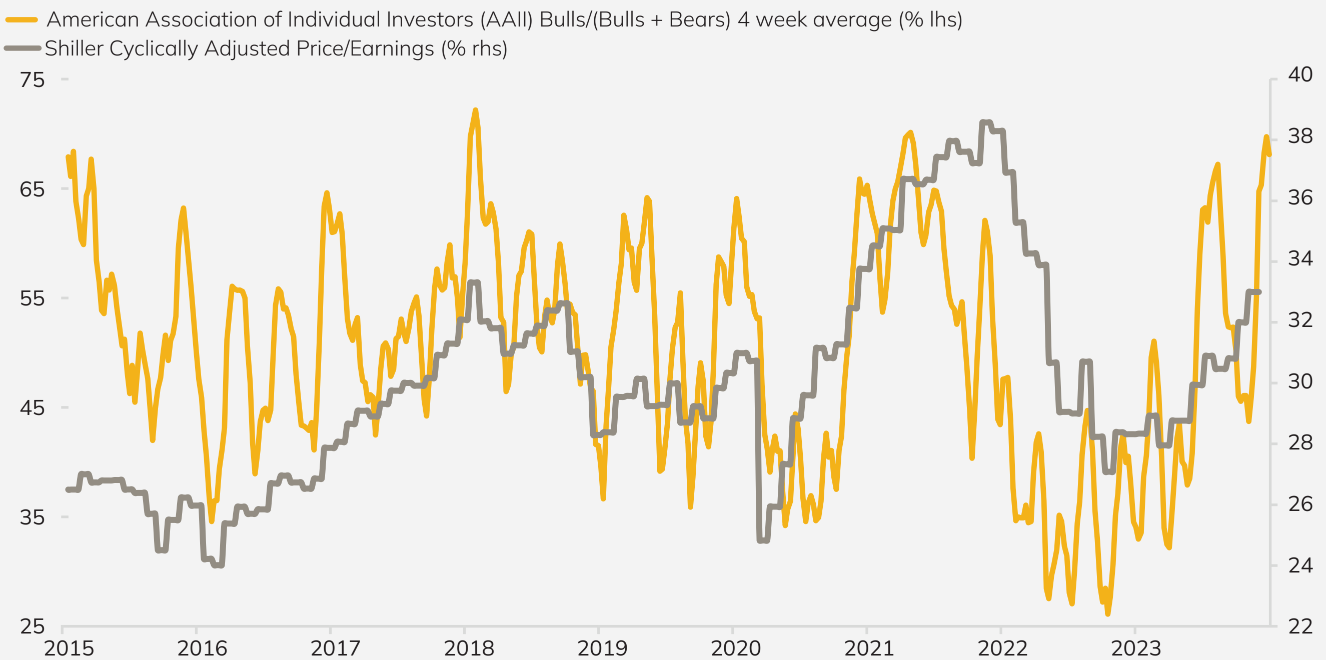


Source: Bloomberg, L.P., PMAM research. Jan 2021 to Dec 2023.

BUT, has the market taken things too far already?

Markets are discounting mechanisms, with investors pricing in the future as they anticipate it. In the case of the current soft landing narrative, however, we are concerned that the market has already taken things too far. As Cantor Fitzgerald recently noted, the bull-bear ratio at 2.65 among individual investors is one of the highest readings going back 16 years.[1] The latest Bank of America/ Merrill Lynch Fund Manager Survey shows there is a strong conviction that the Fed is done, and that bond yields are heading lower in 2024.[2] These expectations come alongside a solid consensus for either a soft economic landing or no landing at all. Sentiment is clearly exuberant.

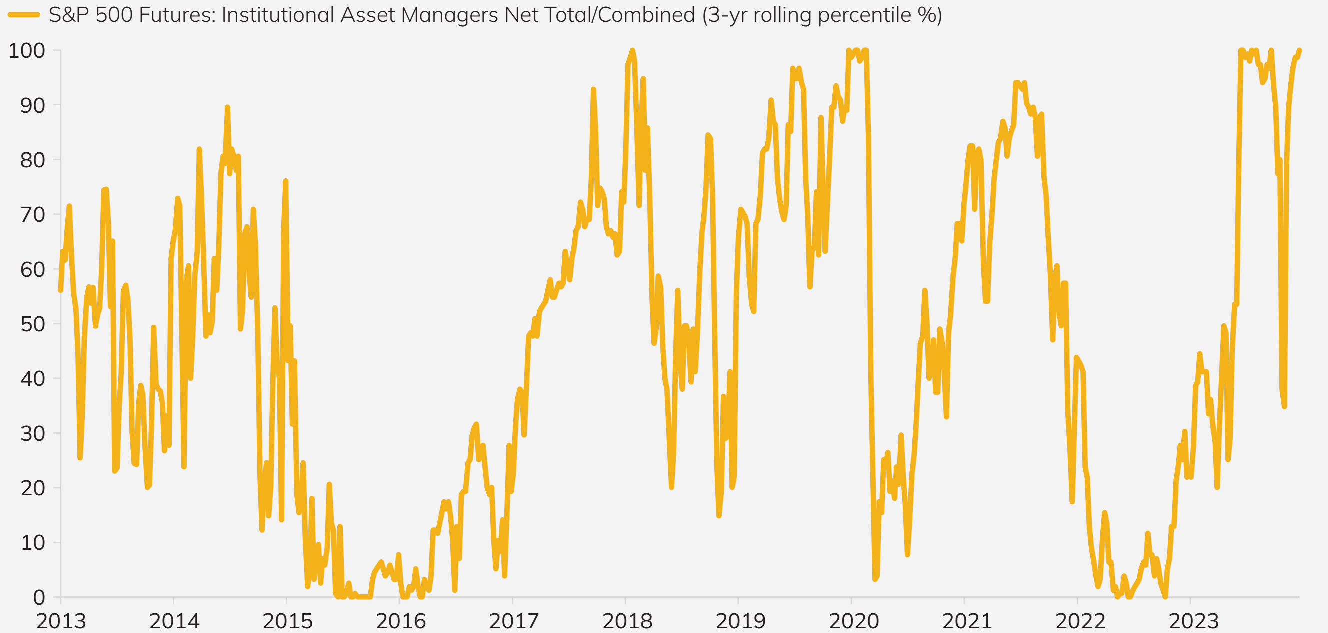
Figure 6: Individual investors are very bullish ...



Source: Bloomberg, L.P., PMAM research. Jan 2015 to Dec 2023.

[1] Cantor Fitzgerald, Cantor Bi-Weekly Equity and Macro Trading Presentation, December 18, 2023.
[2] Bank of American Securities, Global Fund Manager Survey, December 19, 2023

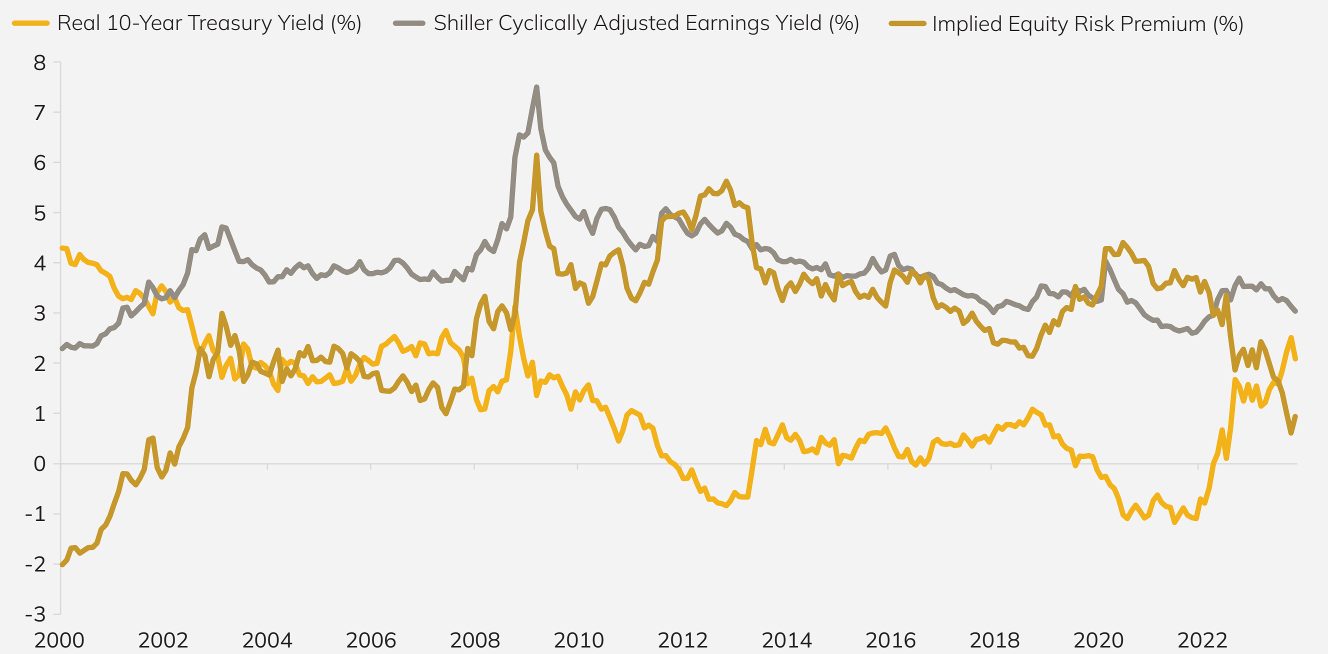
Figure 7: … while institutional asset managers are nearly max-long again



Source: Bloomberg, L.P., PMAM research. Jan 2013 to Dec 2023.

While the consensus is clearly coalescing around a soft landing, it also appears that equity valuations are extended and baking in a rosy outcome for inflation and the economy. With the equity risk premium at lows of 20-plus years, it's difficult to expect further multiple expansion.

Figure 8: The implied equity risk premium is very low by historical standards

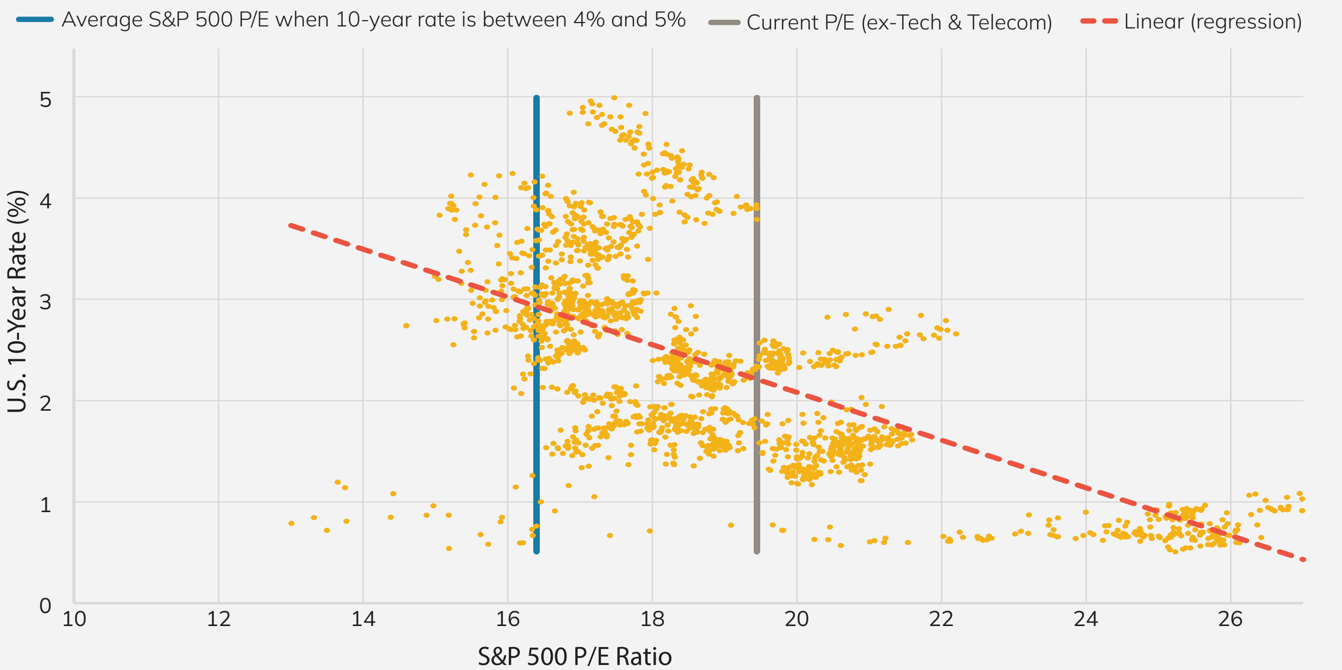


Source: Bloomberg, L.P., PMAM research. Jan 2000 to Nov 2023.

Crucially, the market's stretched valuation isn't just being driven by the mega-cap technology stocks. Valuations are also stretched in other sectors such as Industrials and Consumer Staples. For example, if you remove the Technology sector from the S&P 500 Index, the market's valuation is still higher than normal given the current level of interest rates. Positioning has also flipped from underinvested to much longer equities (and bonds).

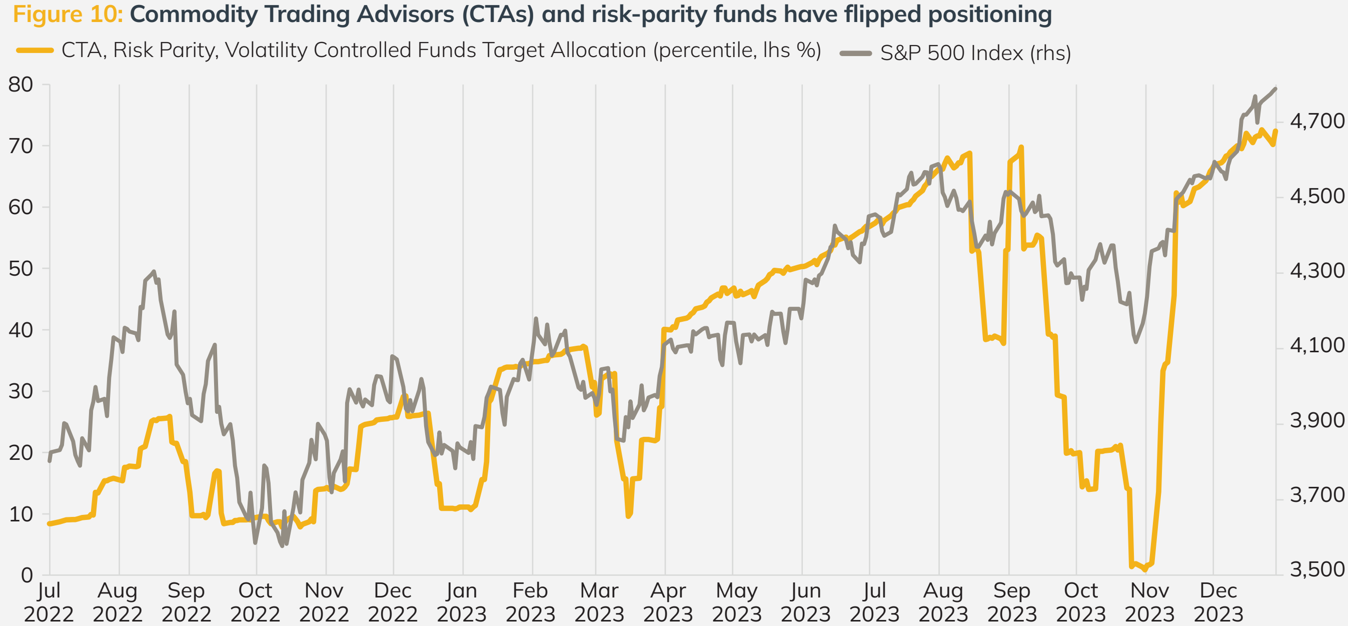
Figure 9: Excluding Technology, the market still seems overvalued based on current interest rates

S&P 500 ex-Tech & Telecom Forward P/E Ratio vs. U.S. 10-year rate (2016-2023)



Source: Bloomberg, L.P., PMAM research. Jan 2016 to Dec 2023.

Figure 10: Commodity Trading Advisors (CTAs) and risk-parity funds have flipped positioning



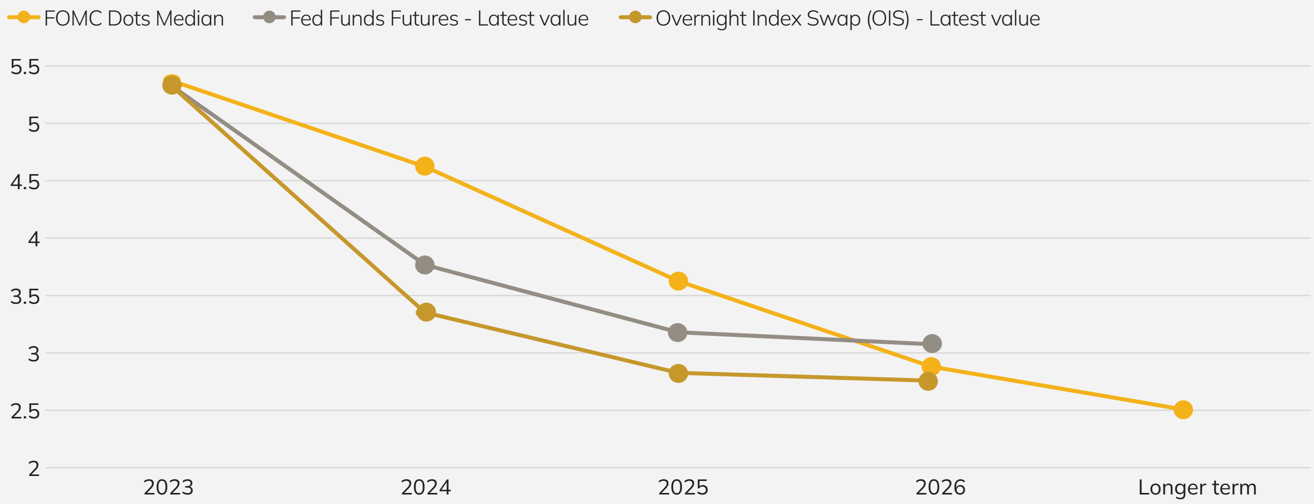
Source: Bloomberg, L.P., PMAM research. July 2022 to Dec 2023.

Rate expectations: The market seems to be bullying the Fed

After the December Fed pivot, market expectations for interest rate cuts have surged ahead of the Fed's outlook, with five interest rate cuts priced into 2024, starting as early as March. By contrast, the central bank's "dot plot" (the median estimate of Federal Open Market Committee members) sees only three cuts this year.

Figure 11: Fed fund futures are pricing in a much more dovish Fed than the Central Bank itself

Implied Fed Funds Target Rate (%)



Source: Bloomberg, L.P., PMAM research. Dec 2023. OIS Latest Value is as on December 13, 2023. Longer Term projection is the Fed approximation of 10 years out.

We fear the market might be setting up for disappointment on the extent and pace of Fed loosening of monetary policy. For one thing, it's hard to reconcile the market's expected path of rate cuts with current S&P 500 earnings growth forecasts. Current earnings estimates are suggesting high single digit earnings growth in 2024, as opposed to baking in a stalling economy as interest rate futures are implying.

We believe short-term rates will stay higher than the market expects

Our belief is that short-term rates will remain higher for longer than the market currently expects. There are a number of drivers that could not only sustain economic growth but perhaps even lead to an uptick in inflation expectations in 2024.

Firstly, fiscal stimulus continues at unsustainably high levels and is unlikely to abate meaningfully in an election year. As we discussed last quarter, increased spending by the U.S. Federal government via various pandemic and infrastructure building programs has sent the U.S. Federal deficit to levels seen back in the depths of the Global Financial Crisis in 2009, which at the time seemed extreme (until the off-the-charts COVID-related deficits began in 2020, of course). On a 12-month rolling cash basis, it's approaching US$2.1 trillion.

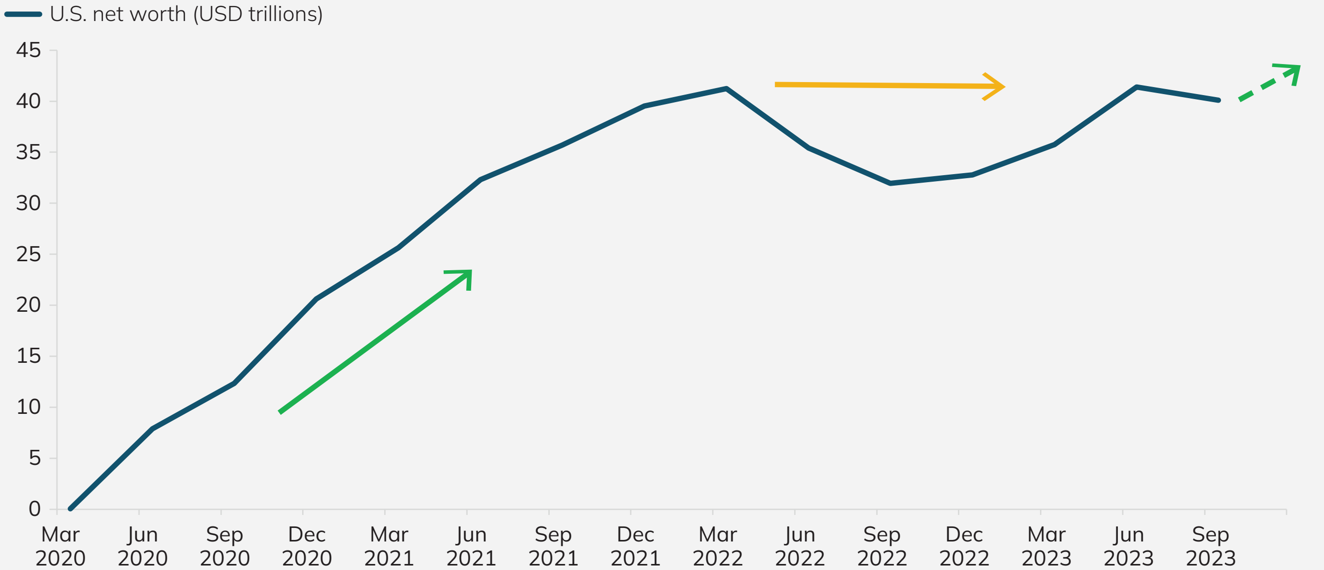
Though the deficit is unsustainable over the long term, President Joe Biden has a wide set of tools he can and will likely use to offset any economic weakness in 2024 ahead of the U.S. election. Two specific fiscal measures are currently in discussion and close to being passed:

- A resumption of the Employee Retention Tax Credit in 2024, which would be a boost to the U.S. economy, but also another driver of an increasing deficit.
- An expansion of the Child Tax Credit, and permission for companies to expense the Research and Development tax credit, which would amount to another US$100 billion of fiscal policy stimulus and an equal increase in the deficit.

Wealth effect ahead? U.S. net worth is booming

A wealth effect may also lead to higher-than-expected consumer spending. With equities and bonds soaring and real estate stable to higher, household balance sheets are in great shape. American net worth, which surged to US$40 trillion following the pandemic but then declined amid persistent Fed hawkishness, has reversed higher this past quarter as markets surged. This rebound, combined with strong wage growth, could support higher-than-expected consumer spending in the months to come, especially if the jobs market remains reasonably tight.

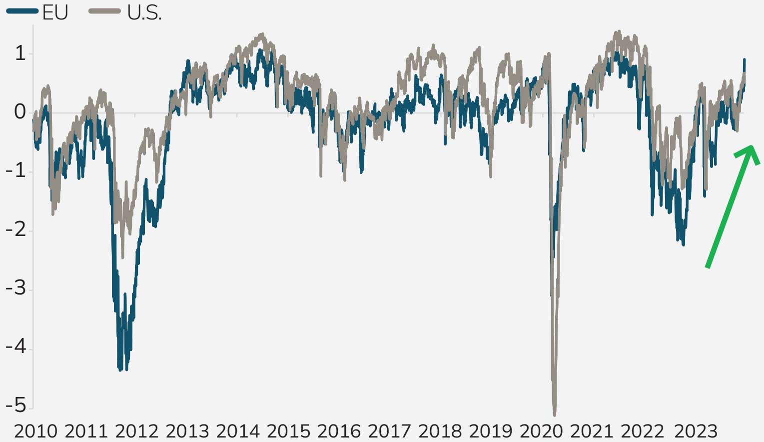
Figure 12: The net worth of the U.S. consumer is booming



Source: Bloomberg, L.P., PMAM research. Q1 2020 to Q3 2023. Data beyond Q3 2023 is estimated.

Looser financial conditions also have the potential to reverse disinflation and rekindle inflationary pressures. The Fed allowed conditions to improve materially by introducing its pivot on monetary policy. The U.S. Treasury, under Secretary Janet Yellen, also did its part to improve the situation by temporarily altering the supply of long bonds, choosing to fund the deficit with short-term debt instead. The combined result of these Fed-Treasury actions has been a falling 10-year yield, which is now over 100 basis points off its peak.

Figure 13: Financial conditions have improved



Source: Bloomberg, L.P., PMAM research. Jan 2010 to Dec 2023.

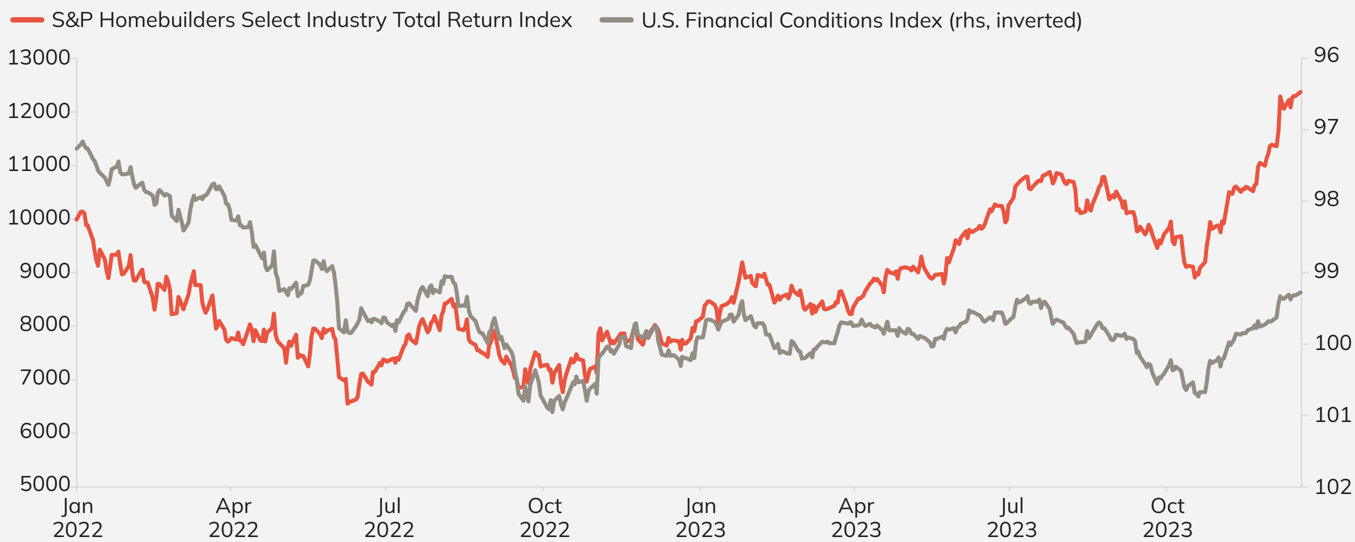
Has the Fed abandoned its inflation resolve too soon?

It's possible that U.S. Fed Chair Jerome Powell and his Federal Open Market Committee (FOMC) colleagues pivoted before it was too late, effectively averting a recession in the process. It's also possible that the Fed abandoned its inflation resolve before the job was truly done by fueling a premature improvement in financial conditions and surging wealth levels that, in turn, fuel stronger-than-expected growth and reignite the same inflationary pressures the Fed thought it had already conquered.

We remain of the belief that some of the key drivers of the post-pandemic surge in inflation will be with us for some time before they are vanquished. The Fed is less able to affect certain components responsible for this potentially more persistent inflation. For instance, there is nothing Chair Powell and his colleagues can do to produce more oil, copper or other commodities that are in balanced (or even short) supply now, but that can quickly become very scarce when the economy starts to improve.

A structural shortage of U.S. housing also poses challenges for the Fed. In spite of dramatically higher mortgage rates, U.S. home prices and rents remain very elevated. Existing homeowners have been virtually unscathed by rising rates if they took on 30-year fixed mortgages when rates were low. But household formation is on the uptrend, creating more prospective homebuyers at a time when there is a shortage of at least 1.5 million homes already. It is little wonder that as soon as financial conditions improve, there seems to be an immediate boost to housing demand. Figure 14 shows financial conditions versus the homebuilding stocks, which reinforces this point.

Figure 14: Looser financial conditions impact housing stocks

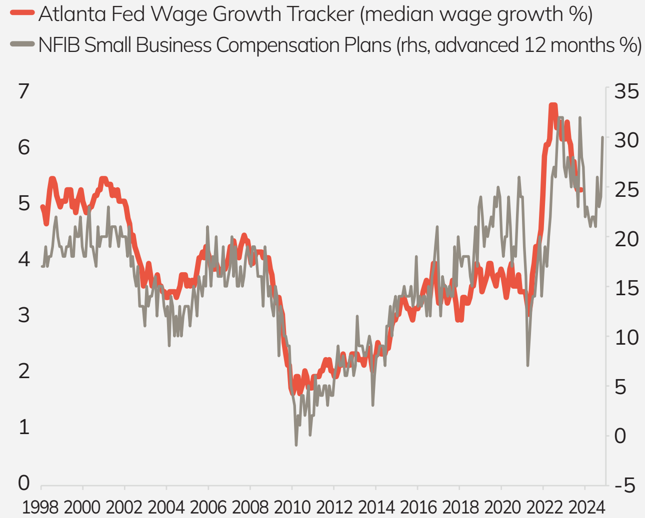


Source: Bloomberg, L.P., PMAM research. Jan 2022 to Dec 2023.

Could wage growth become a problem?

Workers have a greater ability to negotiate with prospective employers, given the low unemployment rate and still significant amount of unfilled job openings in the U.S. economy. Recent lucrative wage settlements for autoworkers are just one example of how strong this bargaining power has become, even as job openings are slipping across the U.S. The Fed, for its part, is assuming an unemployment rate of 4.1% in 2024 which it seems to expect will help further moderate wage pressures. However, this unemployment rate is still quite low by historical standards. Should the economy prove more robust than expected (possibly due to contributions from the recent improvements in financial conditions and household wealth), and job growth begins to re-accelerate in an already tight labour market, then the Fed may be caught off guard in its battle against inflation. Recent surveys already seem to suggest wage pressures may indeed be building in certain regions of the U.S. (see Figure 15).

Figure 15: Small business surveys suggest wages will likely accelerate in 2024

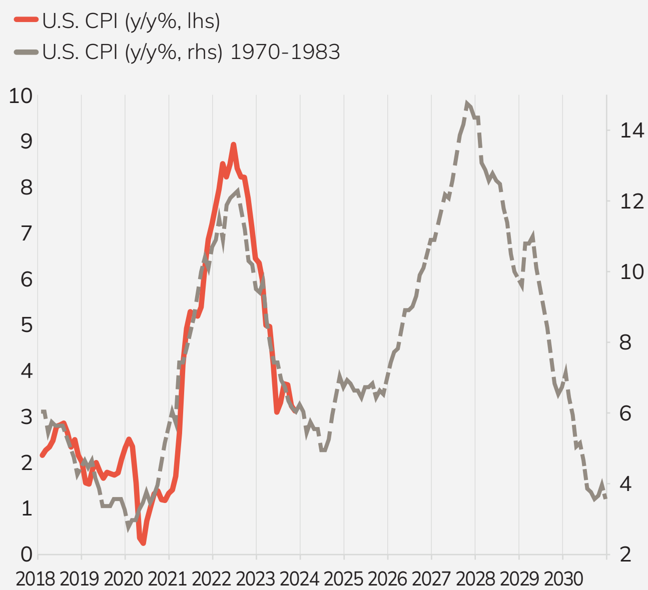


Source: Bloomberg, L.P., PMAM Research. Jan 1998 to Nov 2023.

We remain of the view that housing, commodity and even labour supply/demand imbalances need much more time to work themselves out to truly remove inflation pressures from the U.S. economy. We also continue to believe that there is a significant risk that inflation will pick up more quickly than expected when the Fed takes its foot off the brake and gives the economy some gas. A quicker than expected increase in inflation will likely be followed by a quicker resumption in the tightening cycle. If the Fed does not tread carefully, it risks putting the economy on a path of repeated shorter, sharper market cycles like those in the 1970s.

Of course, should inflation not only prove itself more difficult to flatten further, but instead tick upward unexpectedly over the next year or two, it will pose a significant challenge to the current bullish soft landing market narrative. It would be quite something if, having highlighted the policy mistakes of the 1970s, the current Fed leadership repeats the same error in 2024 by letting off the brake pedal too aggressively and too soon.

Figure 16: Are we in for a repeat of That '70s Show?



Source: Bloomberg, L.P., PMAM research. Jan 2018 to Nov 2023. The dotted line shows U.S. CPI from 1970 to 1983.

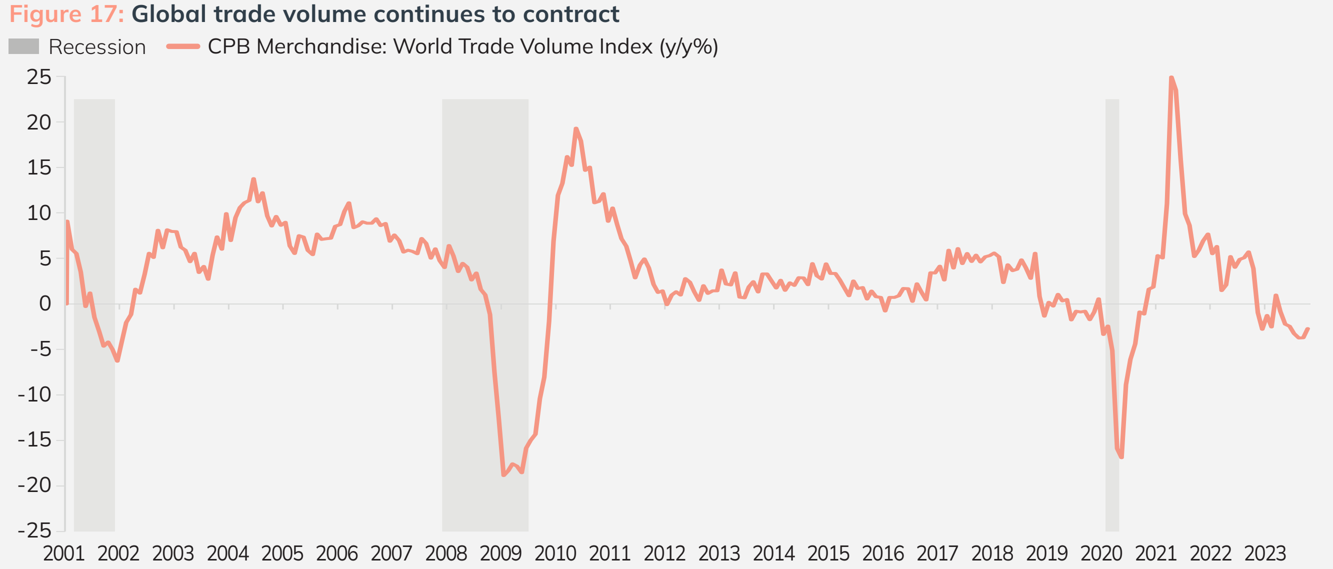
Other risks to the current soft landing narrative

For the U.S. economy to pull off a soft landing, it may need some help from the rest of the world. Perhaps other major economies will accelerate from here as foreign central banks cut interest rates, or governments enact large fiscal stimulus programs. Coupled with a weaker greenback, a stronger global economy would provide a tailwind to S&P 500 earnings that could help justify the high multiples at which U.S. stocks are currently trading.

Global trade volume continues to sink as the picture darkens beyond the U.S.

However, beyond the resilient U.S. economy, the rest of the world isn't faring as well with higher rates and tight monetary policy, although the impact varies greatly by region. The volume of global trade has been sinking deeper into negative territory, as Figure 17 illustrates.

Figure 17: Global trade volume continues to contract



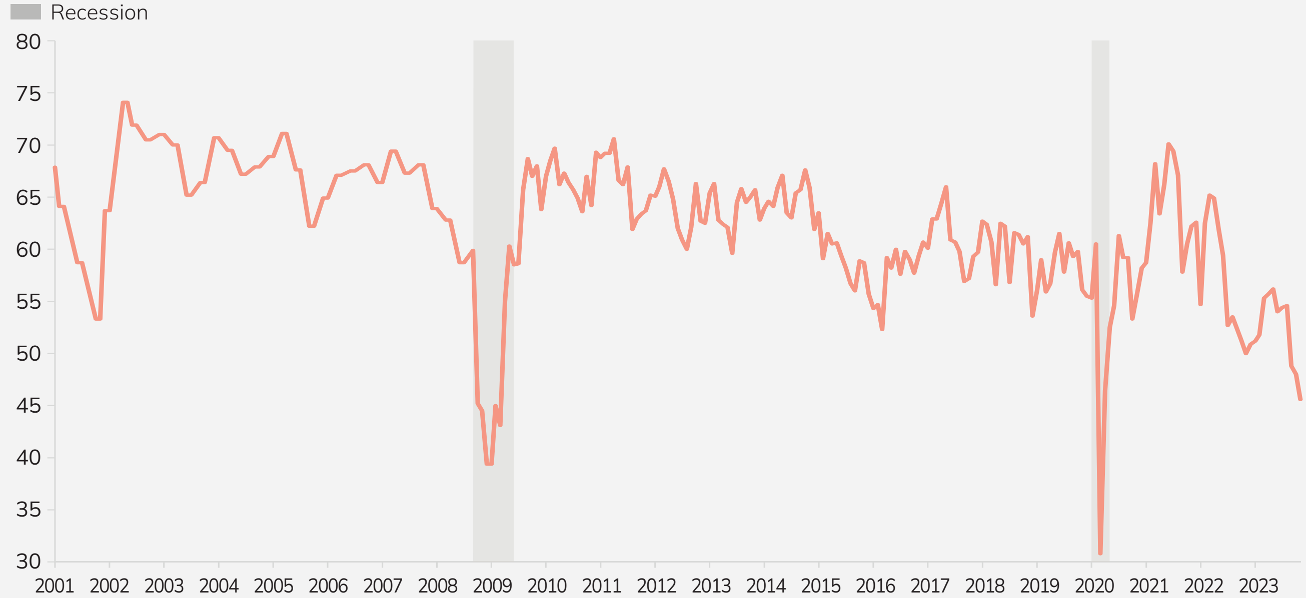
Source: Bloomberg, L.P., PMAM research. Jan 2001 to Oct 2023.

Powell's Fed has tightened monetary conditions considerably since 2022, and other central banks have followed suit, effectively mirroring U.S. policy. But while the U.S. has some built-in resilience to handle a rate shock, other countries aren't in such a favourable position. The rest of the world did not benefit from as extreme a fiscal and monetary stimulus as the U.S. enjoyed. Nor did many other countries enjoy the favourable refinancing cycle that allowed consumers and corporations to lock in historically low rates for long periods of time, as in the U.S.

Tighter monetary policy and less fiscal spending is now slowing the economy in the rest of the world and pushing more and more countries either into or toward recession. The Canadian economy, for example, posted negative third-quarter growth of -1.1% (annualized) amid deteriorating sentiment. The Canadian Federation of Independent Business (CFIB) Monthly Business Barometer index, a measure of small business confidence, continues to plummet, hitting 45.6 in November 2023. As Figure 18 shows, this has fallen to levels not seen since the darkest hours of the pandemic, in March 2020.

Figure 18: Canadian business confidence has breached pandemic lows

CFIB Business Barometer Index Canada



Source: Bloomberg, L.P., PMAM research. Jan 2001 to Nov 2023.

Both the Euro area and U.K. economies are weak

Euro area GDP also shrank to the tune of -0.2% in the third quarter of 2023. Economic growth is not receiving any assistance from central bank policy, with the European Central Bank (ECB) sounding more hawkish than the Fed. In the U.K., the economy contracted by -0.3% in October, and monthly GDP is estimated to have shown zero growth in the last three months ending October 31, compared with the three months ending July 2023. Unless the ECB and other central banks begin to ease monetary policy soon, it seems likely that the economic contraction will deepen outside the U.S.

China to the rescue?

China remains challenged, with its CPI hovering around zero and a housing contraction deepening. In early December, Moody's slashed its outlook for Chinese sovereign bonds, citing the property downturn and increased borrowing to support local governments. The nation is on track for record bond issuance this year, and its 2023 central government deficit will easily exceed three percent of GDP – a limit typically adhered to by policymakers.[3]

On the surface, China's headline government debt figures don't seem to be a cause for concern. However, China's non-financial corporate debt is very concerning. State Owned Enterprises (SOEs) account for a staggering three-quarters of the almost US$12 trillion of total non-financial corporate debt in China, despite comprising only one-third of China's corporate issuers. Compounding the problems is that most of these SOEs – especially the smaller ones – don't generate much in the way of profit. In fact, the bottom 90 percent of SOEs have a debt-to-EBITDA ratio of almost 20x.

Embedded within the SOE group are Local Government Financing Vehicles (LGFVs), which have been top-of-mind for many market watchers. In 1995, China passed a budget law that prohibited local governments from issuing bonds, borrowing or incurring deficits. However, in order to support the four trillion RMB stimulus package in 2008, many local governments set up LGFVs as a way to borrow money without violating the rules. Some of these funds came from banks, but many of them came via trust loans, or wealth management products.

There is no official data on the size of the LGFV market, but the Chinese government pegs it at around 35 trillion RMB, or US$4.75 trillion. Some experts believe, however, that the true figure could be three times the official estimate.[4] The upshot of all this: China's debt-to-GDP may be approaching 200 percent, if central government, local government, and SOE debt are all factored in. If loan defaults were to start mounting, the Chinese government would likely be faced with some hard choices – and it's unclear how it might proceed.

These debt issues are also coming at a time where foreign investors and corporations are re-evaluating their commitments to China. In the push for "common prosperity," Chinese government policies have increasingly become less friendly to wealth creators in China, as well as foreign investors. Many global companies are diversifying their supply chains away from China as a result.

The Chinese government has begun a campaign to try to assuage foreign investors and lure them back to China. However, according to recent U.S. media reports, President Xi Jinping told President Biden at their December summit that he would re-unify Taiwan with mainland China.[5] Xi also apparently disputed public assertions by U.S. officials that an invasion could happen in 2025 or 2027, telling Biden he had not set a timeframe. Obviously, an invasion of Taiwan would wreak havoc on global supply chains and could result in significant military confrontation between the U.S. and China. Disinflation would likely be halted in its tracks even as the global economy suffered. Whether it invades Taiwan or not, these kinds of threats do not help attract foreign investment to China at a time when the country increasingly needs it.

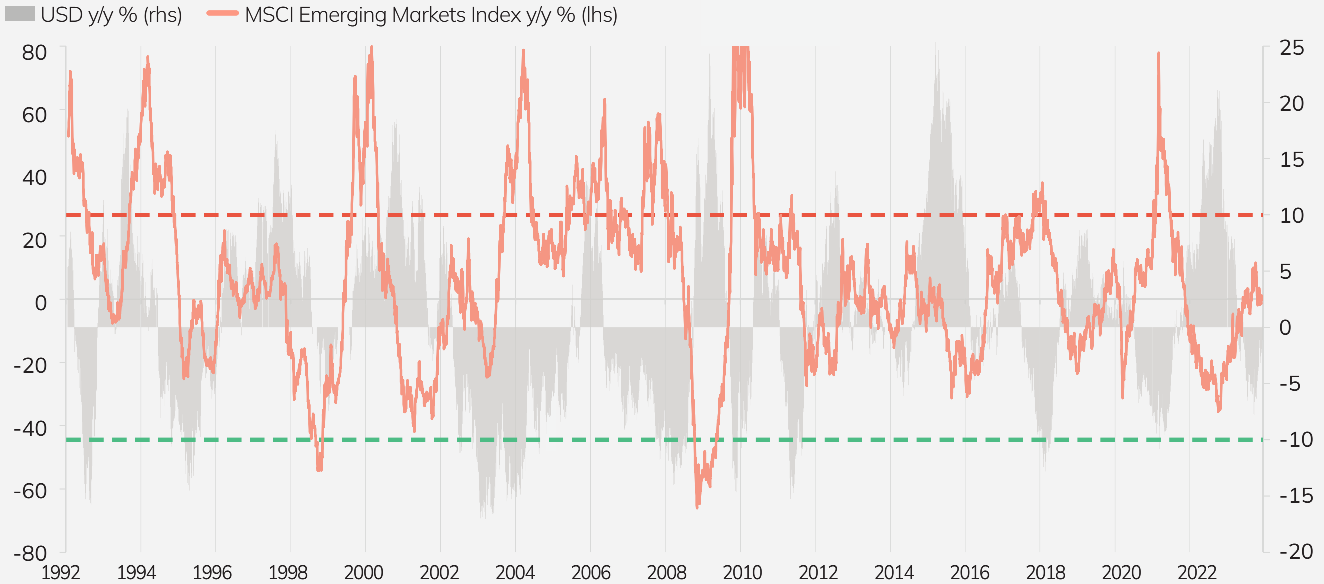
[3] Financial Post, Moody's cuts China credit outlook to negative on rising debt, December 5, 2023.
[4] Apollo Global Management, Outlook for China, September 2023.
[5] NBC News, Xi warned Biden during summit that Beijing will reunify Taiwan with China, December 20, 2023.

The greenback could also spoil the party

The U.S. dollar has sold off on the U.S. Fed pivot. However, we wonder how sustainable this is given our expectations of growing economic divergences between the U.S. and the rest of the world in the 2024 election year, which should result in higher relative interest rates in the U.S. Widening rate differentials could cause the greenback to resume its upward trend as the year progresses, especially if market expectations for five interest rate cuts prove to be too aggressive.

For nations that have borrowed heavily in U.S. dollar denominated debt, a renewed surge would be increasingly problematic. In fact, if you look back historically, it's evident that when the dollar surges, it typically corresponds to plunging returns in emerging market equities, especially those forced to borrow in U.S. dollars.

Figure 19: Historically, emerging market equities plunge when the U.S. dollar surges



Source: Bloomberg, L.P., PMAM research. Jan 1992 to Dec 2023.

Conclusion

Throughout 2023, many investors feared that a higher-for-longer Fed would cause a U.S. recession – one that would likely take a substantial toll on corporate profits. As we enter 2024, however, that fear has been replaced with excessive optimism. The market now believes an immaculate soft landing will occur in the U.S., given the Fed pivot combined with falling inflation readings and a still buoyant economy. The rest of the world now has cover to cut interest rates as well. Although the market is now expecting five rate cuts this year, S&P 500 earnings are also expected to re-accelerate to help justify the lofty equity valuations for U.S. stocks especially.

At some point this year, some of these beliefs – which seem at odds with each other – will have to reconcile somehow. If the market is right about both a soft landing and a re-acceleration of earnings, 2024 could turn out to be a good year, especially for cyclicals and other laggards. For the first couple of months, we expect the consensus to continue embracing this narrative.

As the year progresses, however, reality may begin to intrude on the bulls' newfound hope. If the economy slows enough for the Fed to validate current rate cut expectations, we believe bonds should do well, but equities will likely suffer. Alternatively, if earnings re-accelerate on the back of a strong economy, it's very difficult to see the Fed slashing rates nearly as much as the market expects at the outset of 2024. Our view is that a stronger economy should also re-ignite inflationary pressures, forcing the return of a hawkish Fed – a risk for both stocks and bonds.

Can the market have its cake and eat it too? We doubt it will be that easy, and we expect volatility to return at some point in the year as the immaculate soft landing narrative is challenged.

Sector outlooks

Industrials

More recently, we've seen lower quality industrial cyclical names rally, perhaps on the premise of future rate cuts. Erring on the side of conservatism, we've increased our short exposure to more expensive multi-industrial/ground transport names, while also hedging cyclical long positions in broader secular themes. We are confident that the businesses we like – including those with cyclical exposure – will likely continue to meet our long-term return thresholds.

We continue to favour companies with a history of compounding, catalyst-driven idiosyncratic growth angles and/or opportunities to improve structural returns on invested capital. Lately, we've been focusing on industrial auto companies in the salvage auction and collision repair spaces. Despite potential near-term demand weakness, we also remain bullish on the industrial leasing complex over the long term. We've hedged the cyclicality of rentals with less attractive names that have similar exposures. Lastly, we're still quite negative on airlines despite their cheap valuations.

Materials

The S&P/TSX Materials sector exhibited modest gains in Q4 2023, primarily driven by an upswing in gold equities. Gold equities experienced an upward trajectory throughout the quarter, propelled by a commodity that approached multi-year highs.

Despite the positive performance of gold equities, gold miners have faced challenges in recent years. The benefits of higher commodity prices have been overshadowed by margin pressure induced by cost inflation, creating hurdles for sustained profitability in the sector.

A significant development in the Materials sector unfolded in the copper market, significantly impacting future supply. The Panamanian government's unexpected announcement of a ban on all new mining concessions and the closure of the Cobre Panama mine owned by First Quantum Minerals Ltd. sent shockwaves through the industry. Civil unrest and public protests against the mine preceded the government's decision. The Cobre Panama mine, a substantial contributor to Panama's economy, accounting for 3-4% of GDP, 75% of exports, and 40,000 direct and indirect jobs, would have a profound impact on the country if closed.

From a copper perspective, the shutdown of the Cobre Panama mine represents a major hit to copper supply, resulting in the loss of 300,000 tons of copper. Another blow to copper supply came during the quarter when Anglo-American plc, a global copper miner, revised its 2024 production outlook downward by 195,000 tons due to changes in mine plans at two large mines. These events collectively position the copper market to enter deficits in 2024, with forecasts indicating a sustained deficit through the end of the decade.

Within our portfolio, we maintain a favourable view of copper given these supply dynamics. We believe Teck Resources Limited (Teck) is well-positioned to benefit from the evolving copper landscape. In a strategic move during the quarter, Teck announced the full sale of its coal business to a consortium of buyers for US$8.9 billion. The proceeds from this transaction are expected to significantly strengthen Teck's balance sheet, providing ample resources to fund future growth initiatives for its copper and base metals business. This strategic realignment underscores Teck's commitment to capitalizing on the positive momentum within the copper market.

Information Technology

The MSCI World Information Technology Index increased by 17.4% for the fourth quarter of 2023, while the Information Technology sector in the S&P/TSX Composite Index increased by 23.9%. Sector performance rebounded strongly after a decline in Q3. The best-performing subsector was semiconductors, up 21.1%, led by Advanced Micro Devices (NASDAQ:AMD), followed by software, up 18.7%, led by Fair Isaac Corp. (NYSE:FICO). The weakest subsectors in the fourth quarter were Communications Equipment, up 2.5%, and Interactive Media & Services, up 10.2%, led by weakness in Cisco Systems Inc. (NASDAQ:CSCO) and Match Group Inc. (NASDAQ:MTCH), respectively.

Our outlook for Information Technology in the first quarter of 2024 is cautiously optimistic, as an improved interest rate environment could lead to increased confidence and spending. Cost optimizations have begun stabilizing with some pockets of recovery among companies with consumption-based business models. Semiconductor stocks could continue to perform well as inventory corrections near an end. Networking companies remain mixed as order patterns have weakened following large drawdowns of backlog. PCs and servers could see some recovery following muted demand through 2023, with uplift driven by AI-enhanced offerings and a new refresh cycle as Windows 10 nears end of support.

Healthcare

Like many other sectors in Q4, Healthcare was marked by two very different halves, with the S&P 500 Health Care index down 3.1% from the beginning of the quarter to October 31, before rallying 7.2% to finish the quarter up 3.9%. However, Healthcare lagged the S&P 500 Index, which increased 9.9% over the same time period. Subsectors within Healthcare saw dramatic rotations as a result of easing inflation data and the perception of softening Fed commentary. Biotechnology and life science tools subsectors started the quarter as the biggest laggards, only to end the quarter leading the pack, up 20.0% and 10.4%, respectively. Defensive subsectors underperformed: managed care, the relative outperformer through October, ended the quarter as an underperformer, second only to pharmaceuticals, up 1.9% and down 1.0%, respectively.

To the extent this regime change continues, the outlook for the first quarter of 2024 is one of optimism for growth. As with every year, the January J. P. Morgan conference is a key event to watch, with potential merger and acquisition transactions likely to add more fuel to sentiment in small/mid cap names. In the near term, we expect life science tools names leveraged to bioprocessing to call out green shoots as inventory destocking runs its course while remaining cautious on the Chinese macroeconomic environment. Despite significant outperformance from the GLP-1 (glucagon-like peptide-1)/obesity theme this year, we anticipate continued strength given a steady stream of clinical and commercial catalysts in the year ahead. There is potential for further rotation out of managed care as it is also likely a source of funds during an election year, though the headline risks this cycle may be more muted than in the past given that the two leading candidates and their positions on healthcare are relatively known variables. While valuations in pockets of pharmaceuticals appear attractive, we remain downbeat on names that lack needle-moving catalysts and have lagging base businesses, unaddressed patent cliff overhangs, and meaningful Inflation Reduction Act exposure. In medical devices, we see a steadily improving backdrop as procedure trends remain robust amid abating hospital staffing headwinds; we prefer names with new product cycles driving growth and margin expansion, while avoiding those most exposed to obesity treatments.

Consumer Discretionary

The Consumer Discretionary sector experienced a significant lift in Q4 2023 as expectations of a U.S. soft landing overwhelmed more muted third quarter results. Corporate management teams took a notably cautious tone when speaking about consumer spending into the holiday period and early 2024, though profit margins do continue to benefit from lower freight and shipping costs. But with the U.S. Federal Reserve indicating that interest rates have peaked and may start to move lower, we saw discretionary stocks – particularly in early cycle sub-sectors like homebuilders, home renovation, cruise lines, autos, and mall-based retail – leg higher after underperforming in Q3 2023.

Although "Don't Fight The Fed" has become a popular mantra, it may still be too early to confirm definitively that the worst is behind us and that the U.S. economy is in the clear. We anticipate a volatile start to 2024 as equity markets attempt to reconcile a still-pressured U.S. and Canadian consumer with the possibility of rate cuts as we move through the year. Against this backdrop, we are starting to add opportunistically to certain high-quality cyclical stocks trading at attractive multiples, while continuing to focus on idiosyncratic growth stories with positive change dynamics that are less reliant on a tailwind from material improvements in consumer spending.

Consumer Staples

In Q4, Consumer Staples performed in line with the broad market in Canada, but continued their underperformance in the U.S, underperforming the broad market by a staggering 27% for calendar year 2023. This has been a very bad year for defensive sectors as the U.S. economy averted a recession through strong employment with a consumer who is more insulated from rising interest rates. The soft landing narrative has gained full steam leaving little appetite for Consumer Staples.

In addition to a stronger U.S. economy, Consumer Staples have been hit by disinflation and rising elasticities from the significant pricing taken by Consumer Packaged Goods companies over the past two years and negative sentiment from GLP-1 drugs. The soft landing will likely continue to weigh on Consumer Staples performance, however, if recession risks do rise, this would prove an attractive entry point for a lot of names in the sector.

We continue to favour Bellring Brands Inc. (NYSE: BRBR), a growth name in a low-growth sector. The company is gaining notable shelf space with its protein shake offering and remains on-trend and potentially a beneficiary from GLP-1 users who need more protein in their diets. We believe the company is an attractive takeout target.

We also continue to favour Alimentation Couche-Tard Inc. (TSX:ATD), a name that we expect will continue to perform well as Canada faces a potential economic slowdown. The company has benefited significantly from expanding industry fuel margins. Bottom quartile convenience store operators are getting squeezed as tobacco consumption has fallen dramatically. Tobacco is a major component of sales for smaller operators, who are forced to offset lower sales of tobacco-related products with higher gasoline prices. ATD does not generally face the same tobacco pressures as smaller operators and is able to benefit from higher gasoline prices along with its superior fuel procurement. Its clean balance sheet can act as a war chest in times of economic uncertainty.

Financials

2023 was a rollercoaster year for Financials, most notably bank stocks. Strength earlier on in the year quickly reversed (and then some) when the markets witnessed a regional banking liquidity crisis in the U.S. that resulted in a handful of banks being put into receivership by the Federal Deposit Insurance Corporation. Following the regional banking crisis in March, the banks remained relatively range-bound throughout the year as deposit headwinds remained front and centre and volume growth moderated with tightening lending standards. Following the Fed's recent dovish FOMC meeting, financial conditions were quick to ease aggressively and enabled bank stocks to break out of their ranges as sentiment continues to build for a soft landing.

Notwithstanding the recent rally, we lean a little cautious on the Canadian banks, as the revenue picture is slowing, and credit losses are trending higher. Additionally, we believe that we are set for a period of more rapid deleveraging which should hold back growth and profitability for the most Canadian-centric franchises.

We prefer less credit-sensitive companies with good idiosyncratic growth tailwinds, irrespective of the macroeconomic backdrop. Life insurance we find compelling, as we believe there is a structural re-rate opportunity provided by a different rate regime versus the post-Global Financial Crisis period of zero interest rate policy.

Communication Services

Thanks to dovish commentary from the U.S. Fed and a decline in Canadian (10-year) bond yields, an equal weighted portfolio of BCE Inc. (TSX:BCE), Rogers Communications Inc. (TSX: RCI.B), Telus Corp. (TSX:T), Quebecor Inc. (TSX:QBR.B) and Cogeco Communications Inc. (TSX:CCA) modestly outperformed the TSX Composite by 100 basis points, driven largely by 21% return delivered by Rogers. It was also a quarter of significant dispersion among the big three (Telus, BCE and Rogers) with Rogers delivering +21% versus just 2% for BCE.

We have said that we were looking for disciplined competition and were modeling flattish growth in average revenue per user (ARPU) for 2024. Promotions around Black Friday made us feel relatively comfortable with our current expectation. Results of the spectrum auction also highlighted prudence in capital allocation. Looking ahead, we are not making any material change to our sector view, which is healthy growth in service revenue driven for the most part by growth in net subscriber additions.

Utilities

Just as with the telecommunication sector, a favorable 10-year was not sufficient for the sector to outperform versus the S&P/TSX Composite as the sector return of 8% was approximately in line with the broader index. Notwithstanding the decline in bond yields, we continue to believe that focus should remain on stories that have strong balance sheets with the capability to fund their capital expenditures, operating in favourable regulatory jurisdictions and not requiring large rate cases, which can make it difficult to balance rate base growth and customer bill pressure.

Looking at independent power producers (IPPs), we lean toward those that have strong balance sheets, have costs locked in for the ongoing projects and are not reliant on one or two large projects to grow.

Real Estate

Within the real asset category (telecom, utilities, and real estate), real estate derived the most benefit from the relatively dovish commentary from the U.S. Fed with the sector modestly outperforming the S&P/TSX Composite. While we acknowledge and understand the rally in names that have more questions than answers on the fundamental side, we continue to refrain from reaching out to own such names. Our preference remains for those names that have the strongest fundamental set-up given that current financing rates versus in-place rates imply a financing (and earnings) headwind for most REITs and we don't feel comfortable with assuming balance sheet risk, notwithstanding dovish commentary.

Energy

The fourth quarter of 2023 brought significant developments in the energy sector, witnessing shifts in both oil and natural gas markets. Oil prices faced challenges due to concerns over product demand and a saturated physical market. OPEC demonstrated resilience by extending voluntary cuts, signaling its commitment to stabilizing the market. This decision to roll over cuts is anticipated to persist through the first quarter of 2024.

Natural gas prices experienced a notable pullback during the quarter. Factors such as warmer weather and delays in the startup timeline of a U.S. liquefied natural gas (LNG) facility contributed to a reduced demand forecast. However, amidst these challenges, the LNG Canada project is on track to start up in 2024. As of December, the project is 85% complete and represents the largest private sector investment in Canadian history. LNG Canada aims to export Canadian natural gas to Asian markets, marking a pivotal development for the country's energy landscape.

A flurry of merger and acquisition (M&A) activities continued in the quarter, particularly in regions such as the Permian Basin. While consolidation remained a prominent theme south of the border, Canadian exploration and production (E&P) producers exhibited a more restrained approach, prioritizing the return of capital over M&A. An illustrative example was a substantial issuer bid (SIB) announced during the quarter by Imperial Oil Ltd., amounting to CA$1.5 billion and repurchasing 3.5% of total shares outstanding. Looking ahead to 2024, Imperial Oil is positioned for strong performance, driven by its Kearl Oil Sands operation. Significant capital investments in recent years are expected to yield positive operational results.

Within the realm of Canadian natural equities, Advantage Energy Ltd. (TSX:AAV) garnered attention by securing a CA$200 million investment from the Canada Growth Fund (CGF) for its subsidiary, Entropy Inc. This investment, the inaugural one by CGF, is earmarked for Canadian carbon capture and storage projects. The capital infusion will empower Entropy Inc. to progress with additional carbon capture initiatives, benefiting AAV shareholders given its ownership stake in Entropy Inc.

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