PICTON MAHONEY Asset Management

Q2 2024

Investment Review & Outlook

Is the Fed Feeding a Bubble?

- Expectations of a Soft-Landing Have Sent Markets Higher
- The Fed Has Contributed to Easing Financial Conditions
- Significant Risks Remain That Could Upset the Goldilocks Narrative
- We Still Don't Think the Market Can Have Its Cake and Eat It Too
- Has Inflation Really Been Beaten for Good?

Overview

As we turn the page on the first quarter, stock markets feel euphoric. It appears that for the all-important U.S. economy, investors believe that a soft landing is in the cards: inflation has been tamed, but a recession has been avoided. And there is strong evidence indeed, at least at present, for a Goldilocks-like, soft-landing outcome. Inflation has come down substantially from its pandemic peak, while U.S. Gross Domestic Product (GDP) estimates have stabilized in the 2% range.

The U.S. Federal Reserve ("Fed") is now acting as though the fight against inflation has been won and that it is only a matter of a short time before it will be cutting interest rates. The Fed has jawboned financial conditions into easing, by clearly signalling its intent to enact multiple rate cuts as soon as falling inflation data provide the necessary justification to do so.

Our view is that a soft landing is very possible. That said, equity investors have likely priced that in already and we worry that there is much that could still go wrong. We think there is some probability that a recession could still happen; some economic indicators are deteriorating just as they did prior to past recessions. There is also some probability that the Fed may be making another policy mistake by easing financial conditions, and then monetary policy, before the inflation battle is truly won. We worry that if the Fed cuts rates too soon, it risks renewing inflationary pressures sooner than expected, given various supply-side issues that have not had time to resolve themselves.

There are times when markets present a compelling set-up for buyers of stocks. Unfortunately, we do not believe this is one of those times. A lot has to go right for economic data to continue to support the soft-landing narrative; however, stock market valuations are rich, positioning is nearing extremes, and bearish sentiment has evaporated.

Given this backdrop, even if an immaculate soft landing occurs, we think there is a good chance that markets will pull back enough to warrant being cautious in the short term, while waiting for a better entry point. Longer-term, we see a significant risk that inflation will return sooner than expected, forcing the Fed to embark on another tightening cycle, right on the heels of completing the anticipated easing process. That could shorten the next cycle considerably, while also causing a much more significant decline in risk assets.

Picton Mahoney House Views April 2024

	PMAM vs. Consensus
Risk	
Macro risk spent the first quarter of 2024 at low levels, as investors expected a Goldilocks environment of lower inflation, resilient GDP growth and lower rates down the line. We expect that all three won't be found at the same time as the year unfolds, and thus macro risk will increase.	Higher +
Macroeconomic	
Global Real GDP New Zealand slipped into a recession in the fourth quarter, while Canada and Germany have been treading water for the past year and are not in an official recession only by virtue of technicalities. China's population growth ended the year even more negative. The U.S. economy remains a bright spot, but even there some employment indicators are showing signs of fraying.	Lower –
U.S. Real GDP U.S. economic resilience may be coming to the finish line, as "stealth QE" (quantitative easing) runs dry while a growing number of states are experiencing rising unemployment. However, during an election year, there may be still enough levers to pull to keep the party going a little longer.	Same
Canadian Real GDP The Canadian economy was flat in 2023, and as long as the Bank of Canada remains hawkish, there is little hope for a recovery in 2024.	Lower –
U.S. Inflation U.S. Services inflation is keeping core CPI (Consumer Price Index) above target and progress seems to have stalled in the last two months. Looking forward, rising house prices and resilient wage growth may result in upward pressure on inflation as the year progresses.	Same
Equity Returns	
U.S. Equities As U.S. Federal Reserve cut expectations get pushed off with inflation progress stalling, 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 The European Central Bank seems much closer to cutting rates than the rest of its G7 counterparts, and thus might be the first to show an improved outlook for equities.	Same
Canadian Equities A weak Canadian economy and hawkish Bank of Canada does not bode well for Canadian equities.	Lower –
Bond Yields	
Treasuries (U.S. 10-yr) Rates cuts are more of a "when" than an "if", though rising issuance and demand imbalances in the treasury market may ultimately put a floor on treasury rates.	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 OPEC (Organization of the Petroleum Exporting Countries) cuts continue to battle to try to offset U.S. shale production, while the demand outlook remains uncertain.	Lower –
EPS Growth (S&P 500) Earnings growth has been anemic outside of large cap tech.	Lower –
P/E (S&P 500) We expect extreme equity valuations to normalize over time.	Lower –

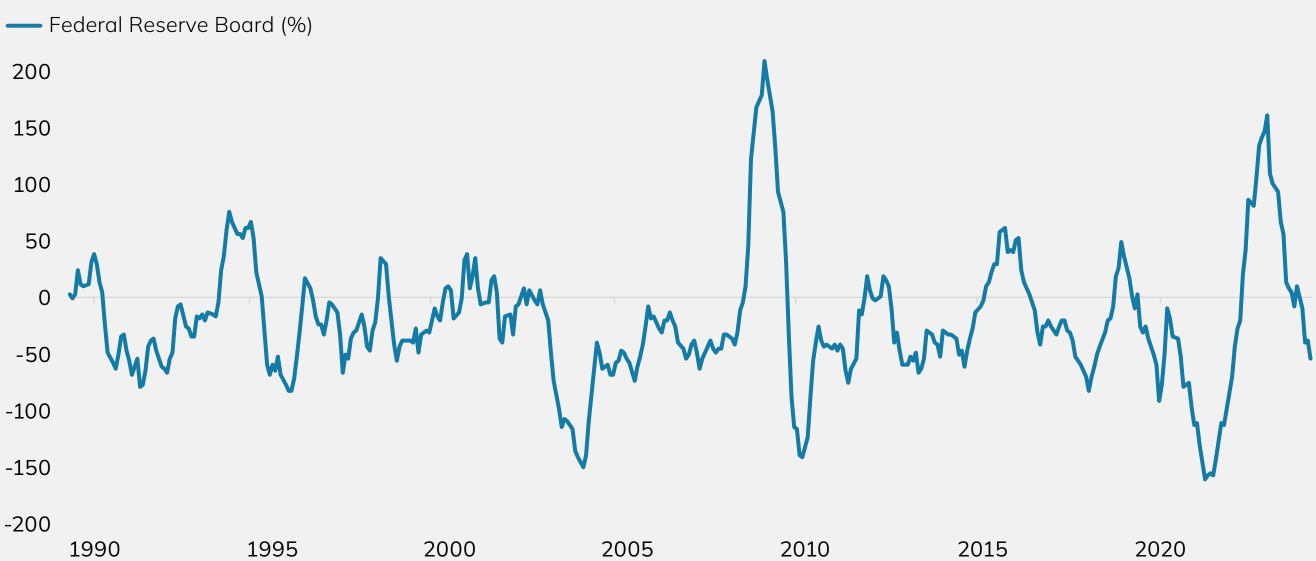
PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at March 2024.

Expectations of a Soft-Landing Have Sent Markets Higher

The emergence of a so-called Goldilocks economic environment (one that is not too hot and not too cold) has driven many markets higher, including benchmark U.S. equity indices, which reached all-time highs this quarter. A few factors have reinforced the soft-landing narrative and contributed to investor optimism. First, previous monetary tightening has led to a modest softening in demand, while helping to alleviate tight labour market pressures. Inflation levels are down substantially from their peak. Meanwhile, ongoing pronouncements about the end of Fed tightening and soon-to-occur interest rate cuts have eased financial conditions significantly, driving asset prices higher and creating a massive wealth effect to support consumer spending. Ongoing excess fiscal stimulus has also helped buoy the U.S. economy. As a result, investors are generally confident that a near-term recession is off the table.

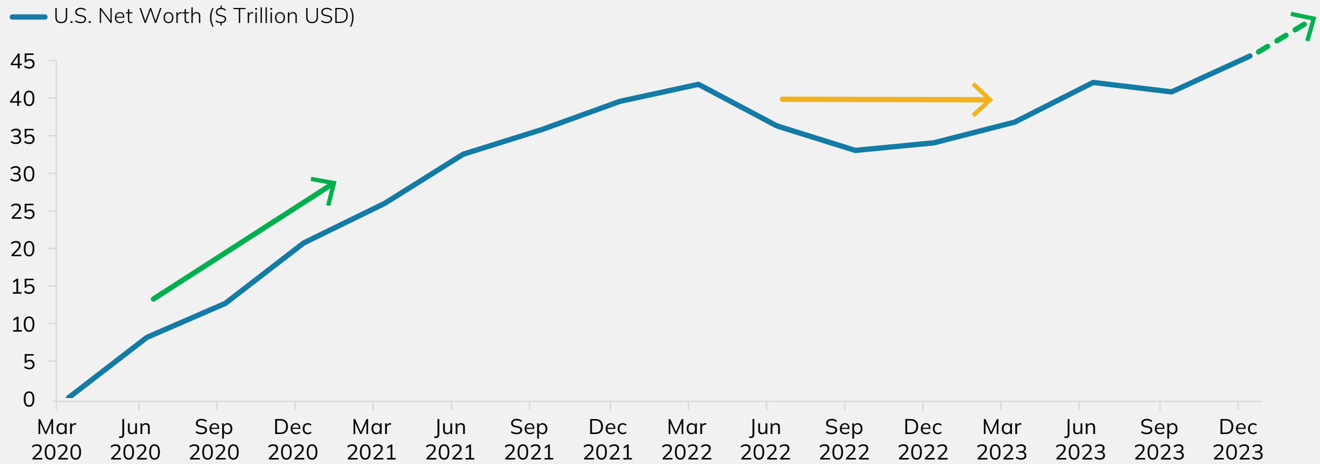
Figure 1: Financial conditions have eased materially since the second half of 2023

Financial Conditions Index



Source: Federal Reserve Board, Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1990 to Mar 2024.

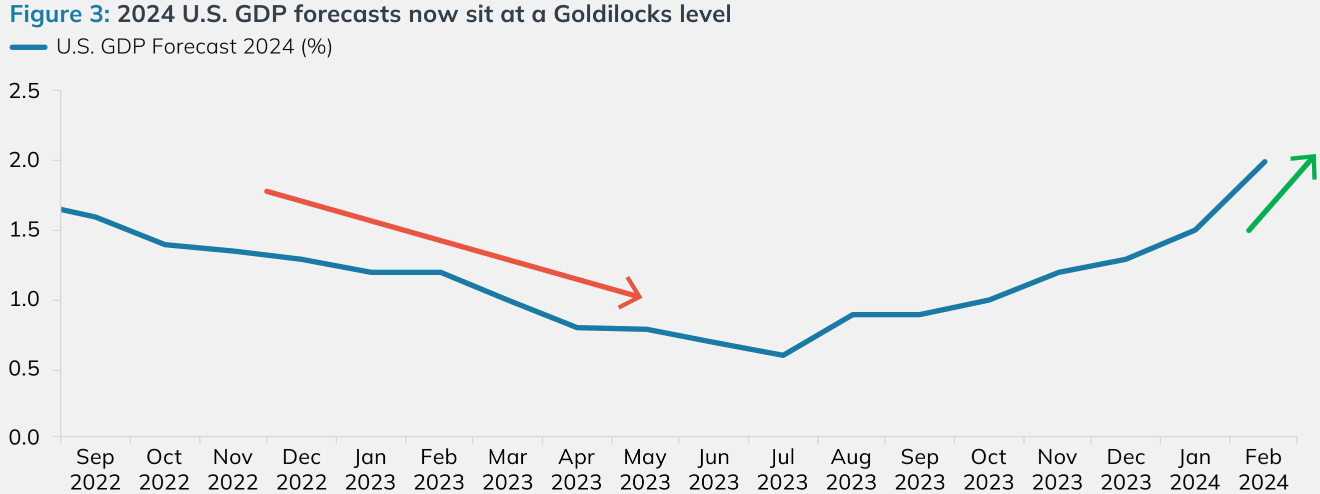
Figure 2: U.S. household net worth is soaring as financial conditions ease



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Mar 2020 to Dec 2023. (Dotted line is PMAM projection).

The Goldilocks adherents have, at least for the time being, some compelling data on their side. By the middle of last year, U.S. GDP stabilized and started to rise, and are now at a perfect "not too hot, not too cold" level of around 2%.

Figure 3: 2024 U.S. GDP forecasts now sit at a Goldilocks level



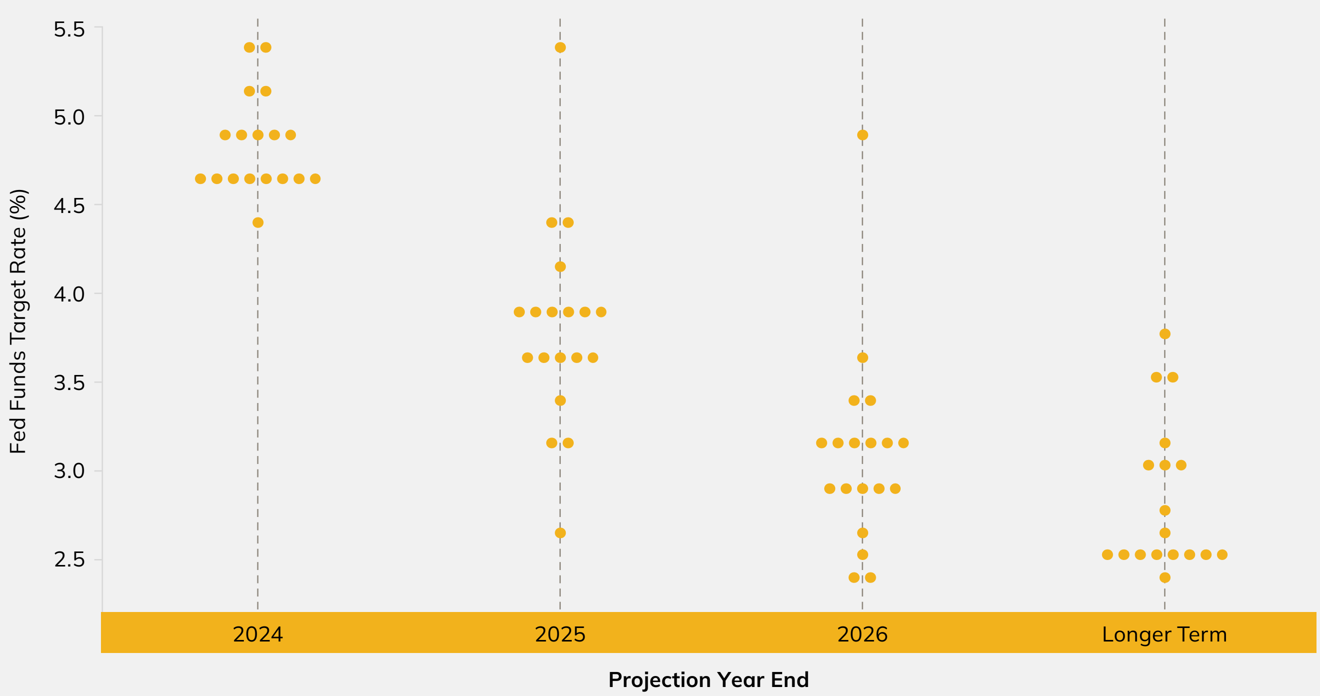
Source: Bloomberg, Picton Mahoney Asset Management Research. Sept 2022 to Feb 2024.

Market-based expectations for inflation one year out also stabilized by mid-2023 in the 1.5%–2.0% range that existed before the pandemic. (A recent increase in January & February Consumer Price Index prints challenges these expectations – something discussed below). Expectations for Fed cuts have also changed dramatically in the last quarter. At the end of 2023, Fed fund futures showed that the market expected the first rate cut to occur in March (odds of 85%), with a total of six or seven cuts in the year to follow. With the economy and earnings data remaining surprisingly resilient through the first quarter of 2024, there are now only two or three cuts expected this year, with the first cut expected by June or July.

The Fed Has Contributed to Easing Financial Conditions

While expectations for the number of rate cuts have been scaled back, the market strongly believes that the next move by the Fed will be to lower rates, and that this will likely take place soon. Much of this conviction is rooted in what investors have been told by the central bank committee members themselves in regular public forums over the past six months. Even when recent inflation data might have given the Fed reason to dial back its rhetoric, Fed members have maintained their resolve to begin rate cuts soon. The most recent "dot plot" released after the March Federal Open Market Committee meeting continues to offer guidance indicating a less restrictive monetary policy.

Figure 4: The March dot plot suggested three rate cuts in 2024



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. All data is projected.

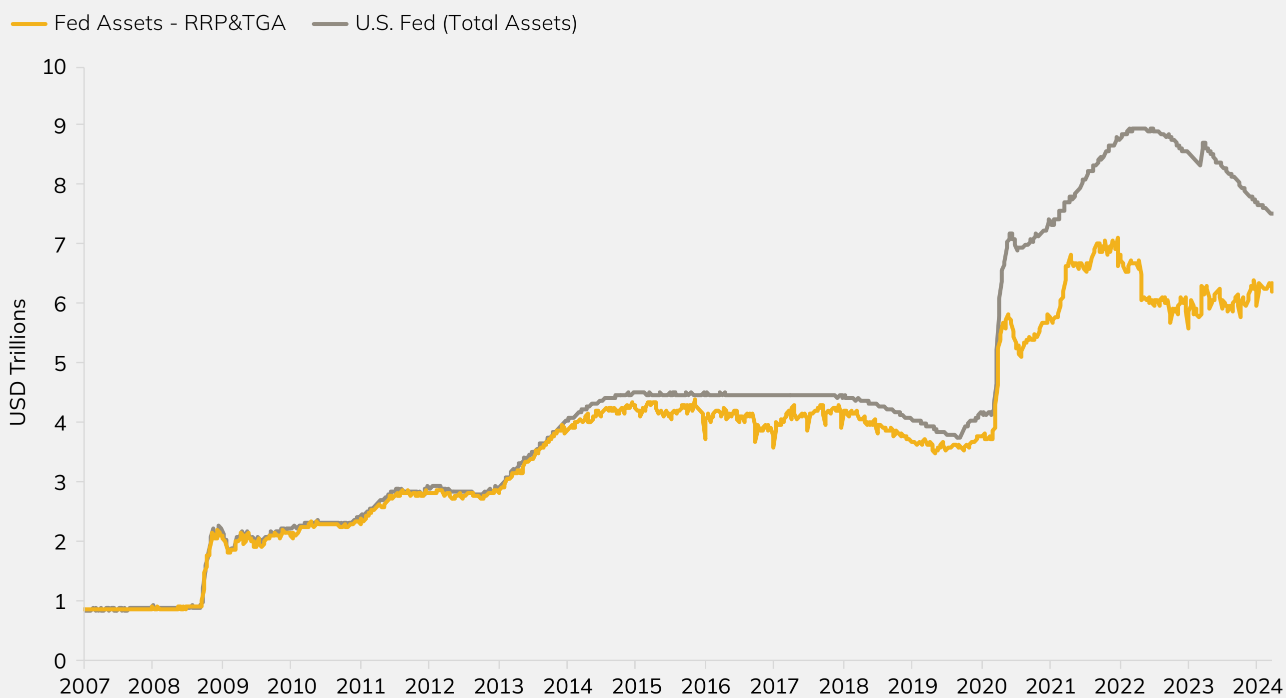
Liquidity in the U.S. Economy Has Increased

While Fed Chair Powell's and the other Fed members' jawboning has helped ease financial conditions, overall liquidity in the U.S. economy has also been boosted.

The process of quantitative tightening (QT), in which the Fed shrinks its balance sheet, should have caused liquidity to contract over time. However, several factors that are somewhat out of the Fed's control have helped drive liquidity higher rather than lower and injected more cash into the U.S. economy. These include changes to both the U.S. Treasury's General Account (TGA) balance and the reverse repo facility (RRP). Increased liquidity from these two programs has resulted in what has been dubbed "stealth quantitative easing" (QE): they have maintained and even added to total market liquidity during a time when it was supposed to drop as part of the Fed's tightening process.

To get a better sense of the size and impact of this "stealth QE", we can adjust the size of the Fed's balance sheet to net out the impact of the TGA and RRP. The graph below shows the positive impact on liquidity that changes to RRP and TGA have had in offsetting the Fed's shrinking balance sheet.

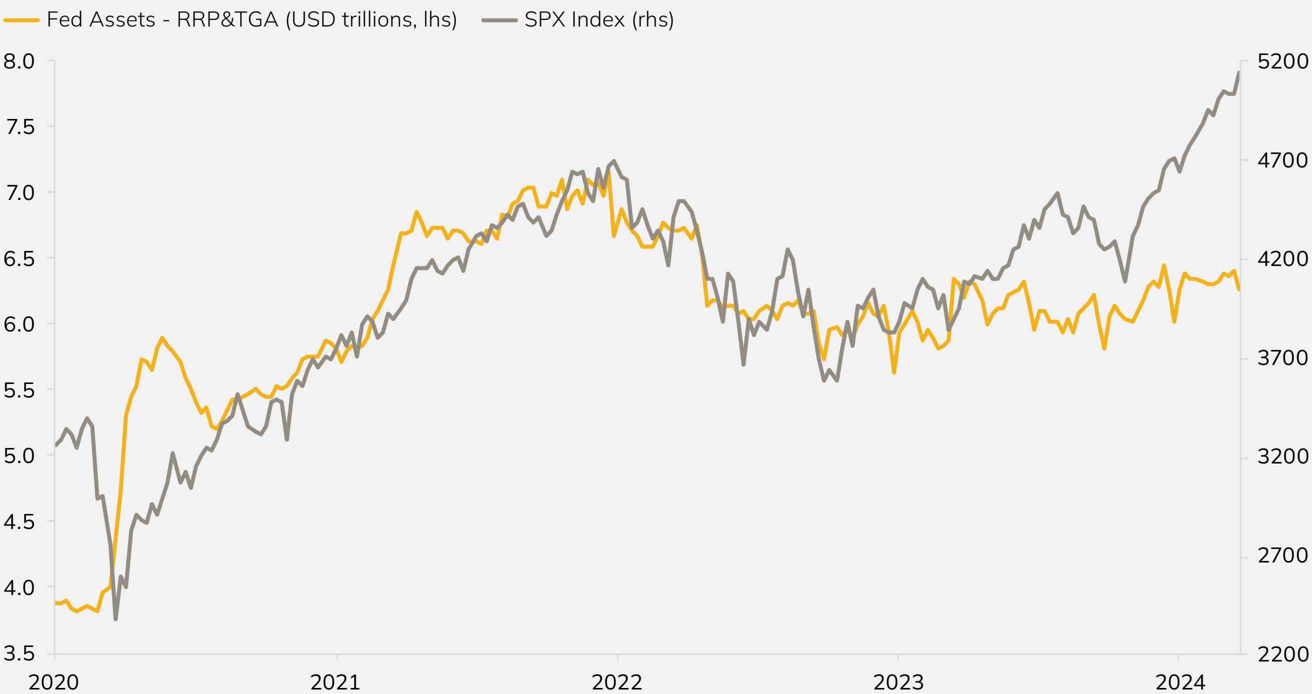
Figure 5: Changes in the RRP and TGA have offset quantitative tightening



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2007 to Mar 2024.

We can see that rather than uniformly falling once QT started, net liquidity started to stabilize and then to rise by the middle of 2022. It's worth noting that this adjusted measure of liquidity peaked on December 22, 2021, almost at the same time as the S&P 500 Index, which peaked on December 29, 2021. This adjusted liquidity measure then bottomed in late 2022, which again coincides with the bottoming of the S&P 500 Index in late 2022.

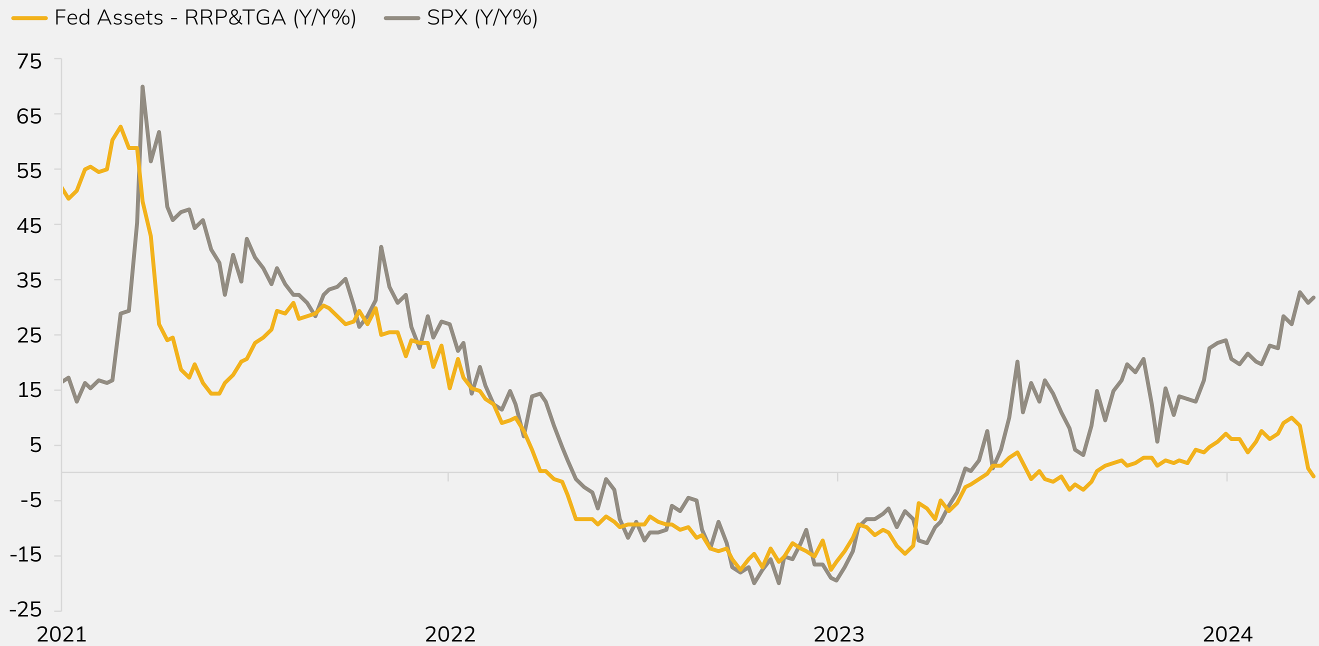
Figure 6: Equities topped out when net liquidity peaked – and bottomed when it reversed



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2020 to Mar 2024.

On a year-over-year basis, the correlation between net liquidity and the S&P 500 Index appears to be even clearer.

Figure 7: Year-over-year changes in liquidity and equities appear correlated



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2021 to Mar 2024.

If there is a relationship between liquidity and stronger economies or markets, why would the Fed also want to contribute to easing financial conditions while inflation is still above target? We believe one possible answer is that the central bank is responding to fiscal pressures emanating from the U.S. Treasury. The U.S. government is facing significant challenges from the current pace of funding that is required when budget deficits are running at about 8% of GDP. The Fed's formal responsibility to promote financial system stability likely has the central bank reacting to the impact of Treasury funding on the bond market. With this in mind, earlier in March this year, Federal Reserve Governor Christopher Waller advocated for a shift in the central bank's balance sheet toward an increased weighting of shorter maturities, potentially to facilitate a longer-term Treasury issuance tilt toward bills and shorter-dated notes instead of longer-term bonds[1].

And we believe even more liquidity could be on the way. The International Swaps and Derivatives Association (ISDA), a trade organization representing financial firms active in derivatives, has submitted a proposal to the central bank (and other regulators) that U.S. Treasuries held on bank balance sheets be excluded from leverage calculations for the purpose of maintaining minimum levels of capital. If adopted, this change could likely turbocharge bank demand for Treasuries and give a significant boost to system-wide liquidity.

[1] Reuters, Fed's Waller: Upcoming balance sheet decisions have no bearing on monetary policy, March 1, 2024.

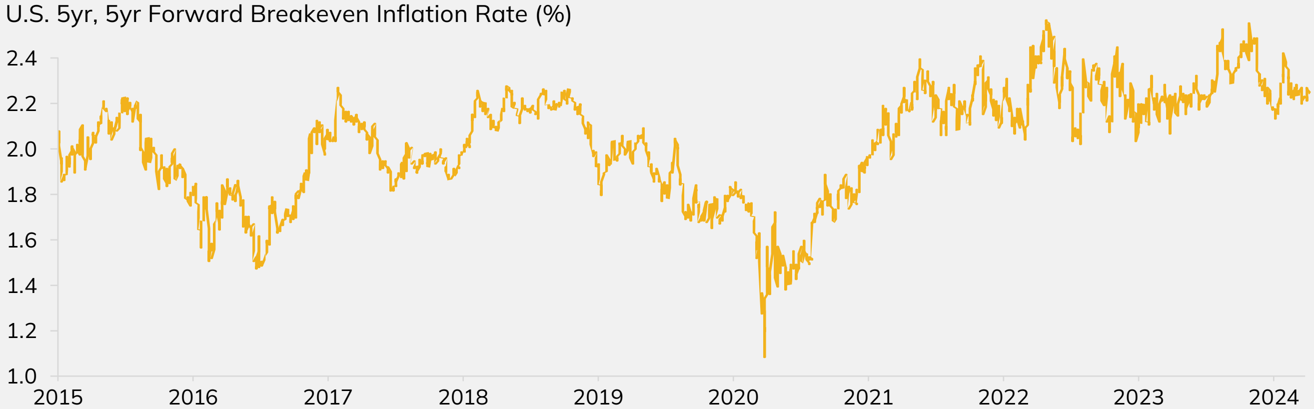
Is This the *Real* Reason Equities Have Surged?

Perhaps part of the recent optimism in equities is due to the declines in real interest rates that have occurred over the past six months. After spiking to a high of 2.5% in October 2023, the ten-year Treasury Inflation-Protected Securities (TIPS) yield fell nearly a full percentage point moving into 2024, before settling back up at 2.0% in March. This movement also appears to correlate with a higher spike in the stock market valuations.

It is worth noting that while shorter-term inflation measures have increased, longer-term forward expectations for inflation remain benign.

Figure 8: Despite elevated short-term inflation, longer-term expectations remain subdued

U.S. 5yr, 5yr Forward Breakeven Inflation Rate (%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2015 to Mar 2024.

Jefferies strategist David Zervos suggests that this scenario – one in which short-run inflation is elevated but long-run expectations remain well-anchored – is a significant net positive for most consumer, business and government balance sheets:

> *...there are clearly benefits to "transitory" periods of higher inflation that many folks may be missing. Sticky inflation that coincides with no meaningful change in long-run inflation expectations creates a huge benefit for leveraged balance sheets. Anchored inflation expectations keep the peace on long-run growth expectations, while the short-run inflation spike devalues debt and revalues assets. Inflation is a natural deleverager, which in a highly indebted society like the U.S. creates huge benefits.*
>
> *So as long as stats like 5y5y breakevens don't budge (as they haven't during this entire three-year-long supply-side-driven inflation shock), there are some incredible net benefits to sticky inflation. Leveraged corporate, individual, municipal, and federal balance sheets all strengthen. And all the while, central bank credibility ensures that any costs associated with a potential long-term expectational de-anchoring of inflation are de minimus."*[2]

[2] Jefferies, David Zervos Market Commentary, March 13, 2024.

Significant Risks Remain That Could Upset the Goldilocks Narrative

Despite widespread belief that a U.S. soft landing is in the cards, we believe there are a number of things that could soon disrupt this rosy narrative.

While stock markets have marched higher, government bond markets have not kept pace.

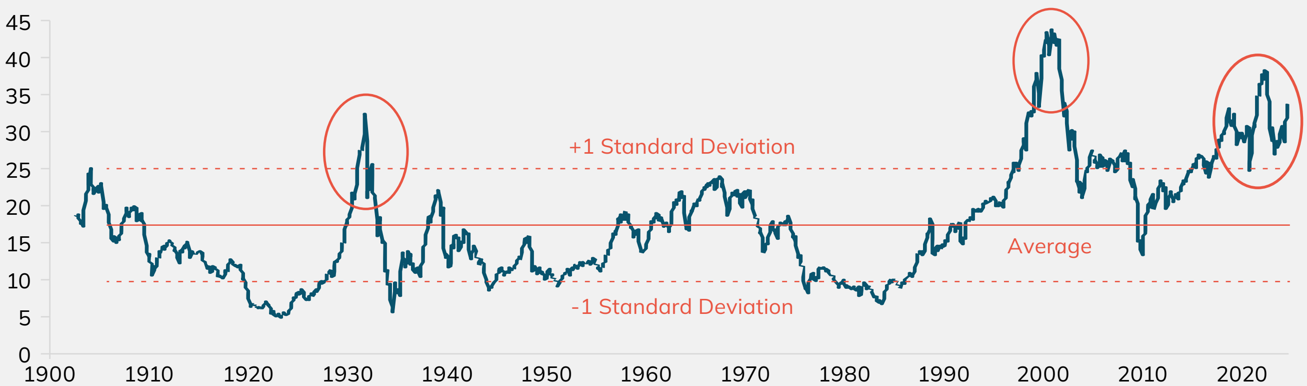
Consider the following:

- Long-term Treasury rates are higher than they were on December 31, 2023.
- Rate cut expectations (economic fuel) have been meaningfully trimmed for 2024.
- The yield curve remains inverted (although it has been steepening).

Risk Assets Are Ignoring the Bond Market's Weakness – For Now

Yet in the face of these lukewarm signs from the bond market, equity valuations have surged to levels only seen in the late 1920s and late 1990s – two bubble eras that notoriously ended quite badly for investors.

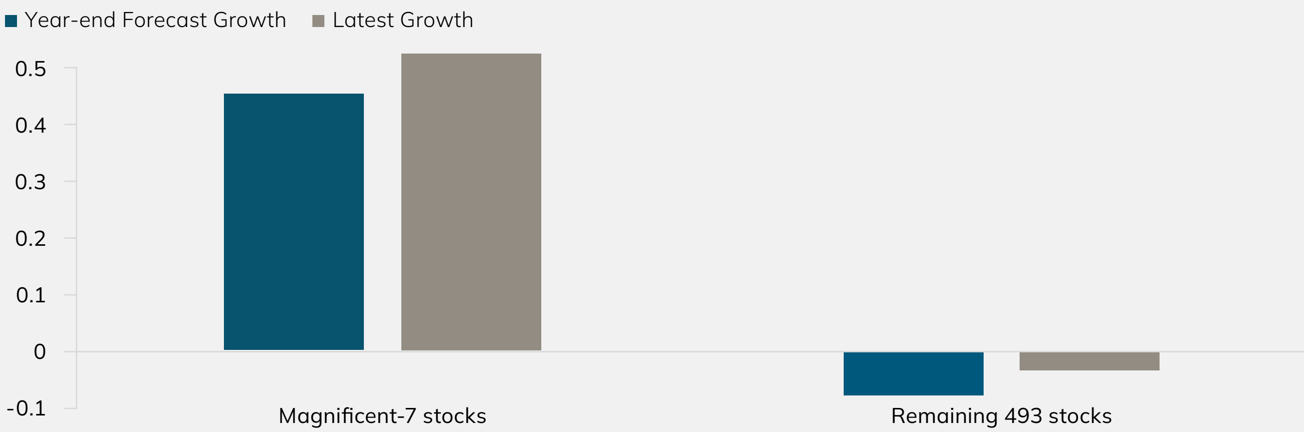
Figure 9: Equity valuations are lofty by historical standards
Shiller Cyclically Adjusted Price/Earnings



Source: Robert Shiller, Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1900 to Mar 2024.

Some of this elevated valuation can be attributed to the narrow group of the "Magnificent Seven" tech stocks, which have become very crowded trades. However, these companies also drove the bulk of the overall earnings growth in the entire S&P 500 Index in the fourth quarter of 2023 so the optimism about them is certainly justified.

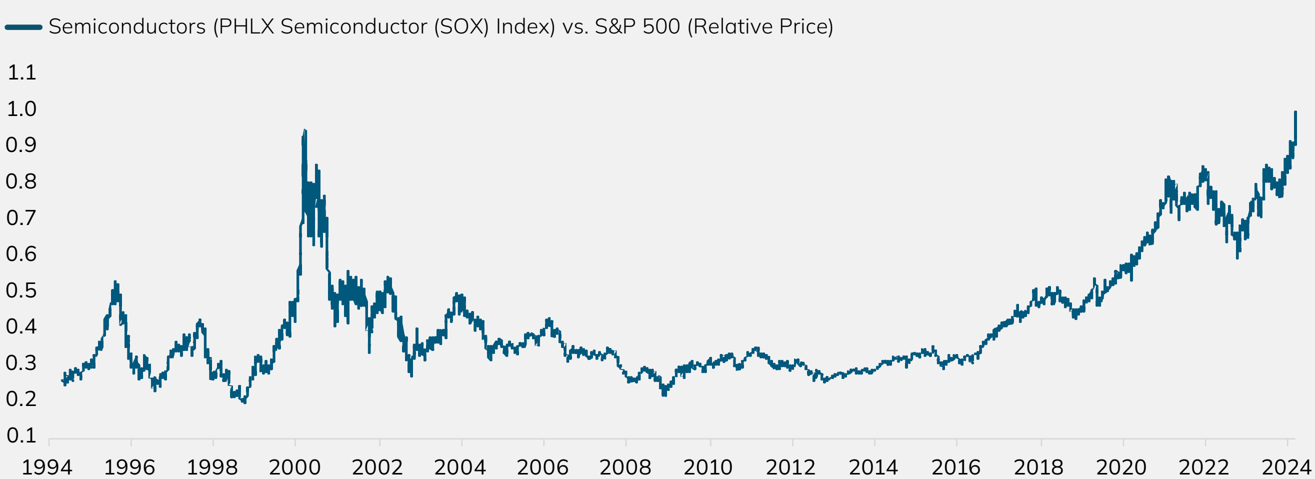
Figure 10: Magnificent Seven stocks carried the market's earnings in the fourth quarter of 2023
2023 Q4 Forecast and Latest Y/Y% Growth



Source: Absolute Strategy Research. Q4 2023.

The emergence of generative AI and its requirements for computing power have certainly made for a boom for Microsoft Corporation and Nvidia Corporation, and are expected to benefit the margins of many more companies in the long term. No one really knows the extent to which AI might change the future earnings landscape, but it is fair to say that at least some of the hype is already reflected in share prices. For instance, the current outperformance of semiconductors is at the technology bubble peaks from back in 2000, when internet-related hype was at its maximum.

Figure 11: Semiconductors so frothy they will knock your SOX off



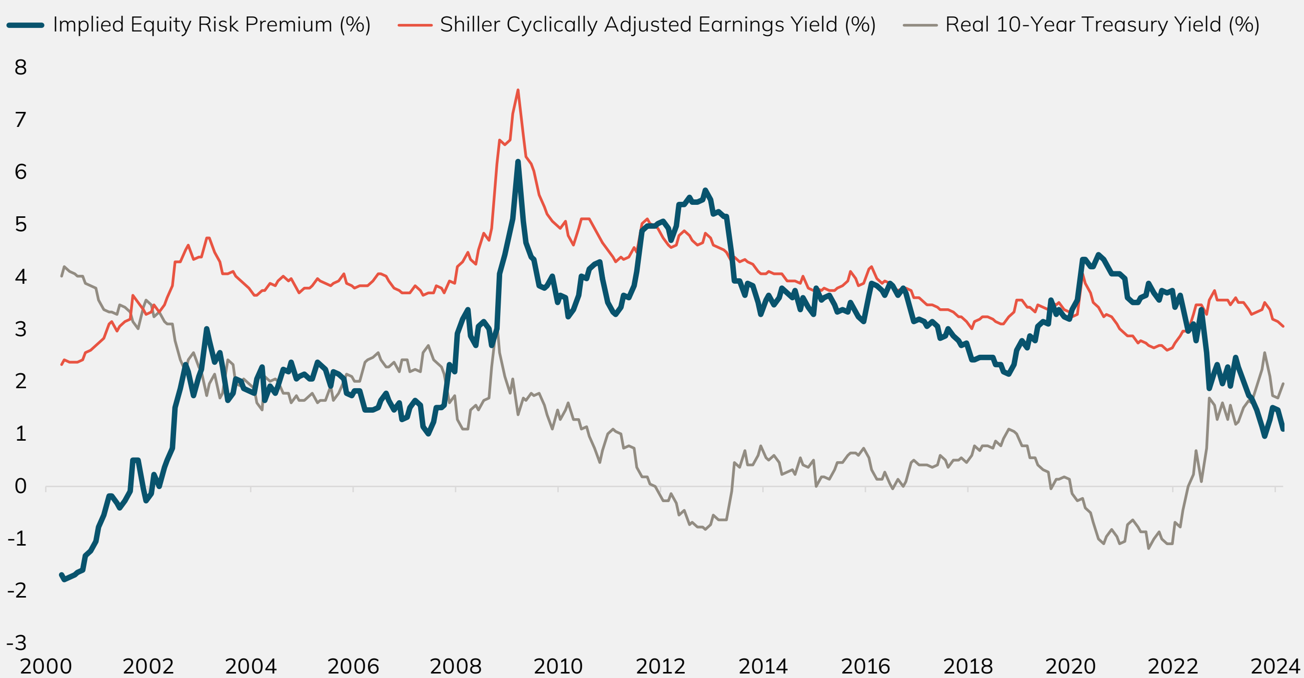
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1994 to Mar 2024.

It’s Not Just Tech: The Broader Market is Also Pricey

It’s tempting to believe the current frothiness is confined to large-cap tech stocks. But data show that the rest of market is also expensive compared with history. According to Ned Davis Research, “*The biggest stocks are more overvalued, but to call the market outside the top 10 cheap is being generous.*”[3] Their analysis shows that the median P/E multiple of the top ten S&P 500 Index stocks is 2.6 standard deviations above the long-term mean, while the bottom 490 stocks are not that much lower, at 1.8 standard deviations above the long-term mean.

One way to look at the extent of the present euphoria is to consider the equity risk premium. There, we see that the spread between earnings yields and bond yields has tightened even more than last quarter (i.e., the risk premium has fallen further). Another way of saying this? Investors are demanding very little compensation for buying equities rather than Treasuries.

Figure 12: The implied equity risk premium remains low



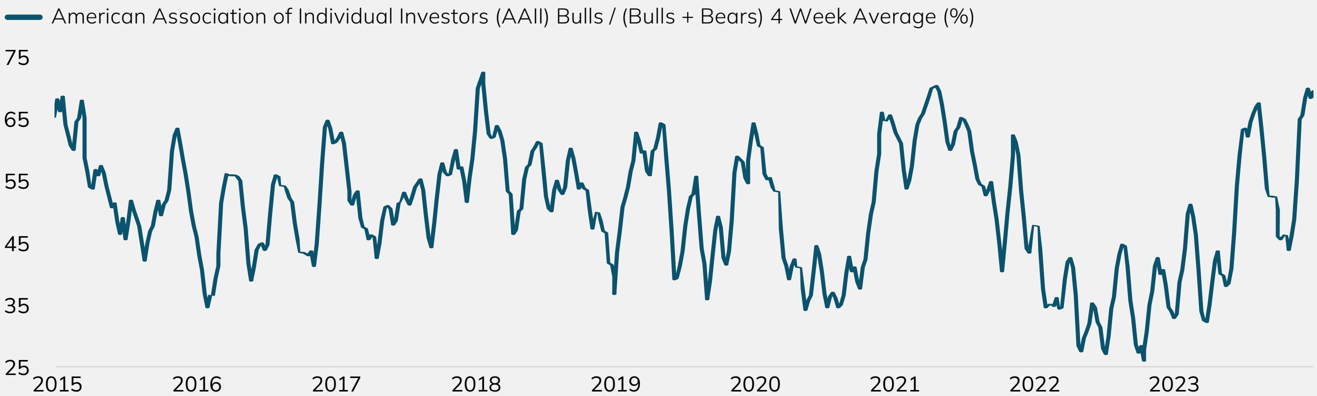
Source: Robert Shiller, Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to Mar 2024.

[3] Business Insider, The biggest threat to high-flying stocks may be the bond market, research firm says, March 14, 2024.

Other Evidence Points to a Very Overbought Market

Positioning, flows, and market action data also suggest that equities are very extended at their current levels. Institutional Asset Managers in S&P 500 futures are still hovering near their 100th percentile exposures, while the Bank of America/Merrill Lynch Fund Manager Survey reveals that clients have reallocated assets from bonds back into equities this year.[4] Other sentiment measures have also spiked upwards to perhaps overly bullish levels.

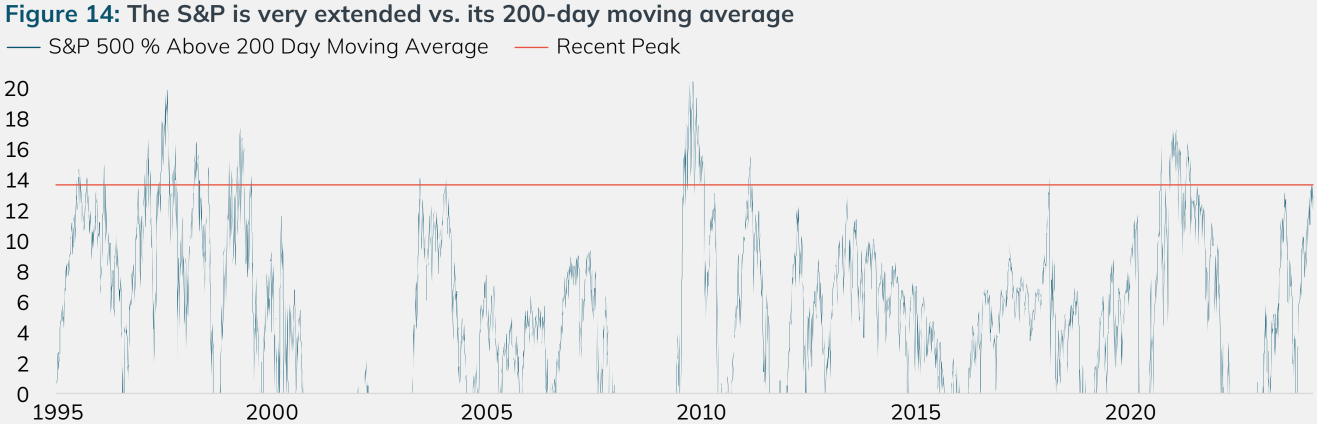
Figure 13: U.S. Investor Sentiment has spiked upward



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2015 to Mar 2024.

The stock market's surge has driven equities to very overbought levels. On March 1, 2024, the S&P 500 Index hit a multi-year high of 13.5% above its 200-day moving average. As technical analyst Andrew Thrasher recently noted, outside of recoveries from bear markets, the S&P 500 rarely gets much further from this trend measure. Indeed, in 2011 and 2018, the market peaked around 14% and 15%, respectively, above the 200-day average.[5]

Figure 14: The S&P is very extended vs. its 200-day moving average



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1995 to Mar 2024.

[4] BofA Global Research, Global Fund Manager Survey, February 13, 2024.
[5] Bloomberg L.P., Stock Momentum Slams Into a Wall in S&P 500's Worst CPI Day In Years, February 13, 2024.

From a Firehose to a Vacuum: Is Liquidity About to Contract Sharply?

As discussed earlier, system-wide liquidity has been abundant in the U.S., providing a powerful tailwind for equities. But the firehose may be on the verge of turning into a vacuum, which could have negative implications for risk assets.

A number of factors have contributed to the boost in liquidity over the past year. Under Janet Yellen, the Treasury's General Account has been drawn down significantly. In addition, Treasury actions caused the Fed's reverse repo facility to fall by over $2 trillion USD since the second half of last year. As these have fallen, they have pushed liquidity out into the general economy.

The problem is that this beneficial tide of liquidity looks about ready to recede, starting with the upcoming tax season. April is tax month in the U.S., which means the TGA is set to be replenished as Americans and U.S. corporations pay the Internal Revenue Service (taking money out of the economy). Strategas estimates a possible drain of $250 billion USD from the banking system if we see a strong tax season.[6]

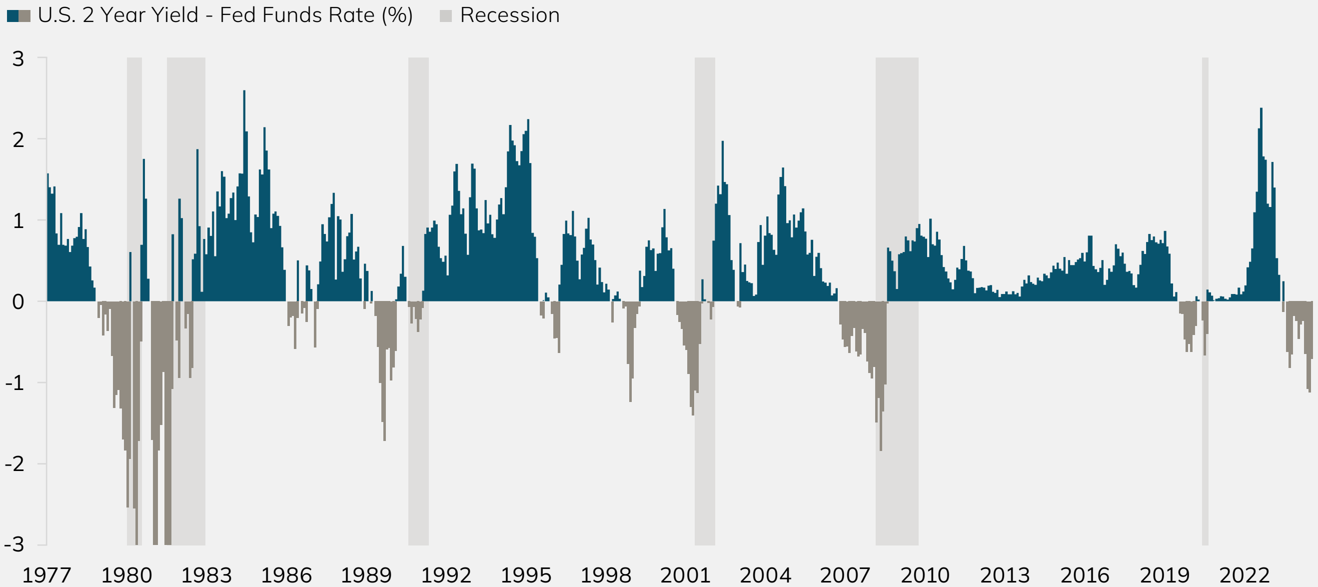
Meanwhile, financial institutions are beginning to repay Federal Reserve loans related to the Bank Term Funding Program (BTFP) initiated during last year's banking crisis. These repayments will boost the RRP. Finally, overall bank lending (which is another source of liquidity for the economy) is weak. All these effects, combined with continued QT by the Fed, likely suggest that overall liquidity is just at the point of shifting from an economic and market tailwind to a headwind in fairly short order. If risk assets and/or the economy did indeed benefit from improved liquidity this past year, then they may soon feel the associated pinch from reduced liquidity.

Cracks Are Starting to Appear in the Economy

While many economic data points currently support the soft-landing narrative, some do not. The New York Fed's probability of recession model, which is based on the longer-term yield curve (the ten-year yield minus the two-year yield), is still at elevated levels. Meanwhile, inversion in the short end of the curve (the two-year yield minus the Fed funds rate) is worsening. This has been a more timely measure of recession than the longer-term yield curve, as it is usually the last segment to invert before a recession.

[6] Source: Strategas, Policy Outlook-Liquidity and Fiscal Squeeze Has Arrived, March 25, 2024.

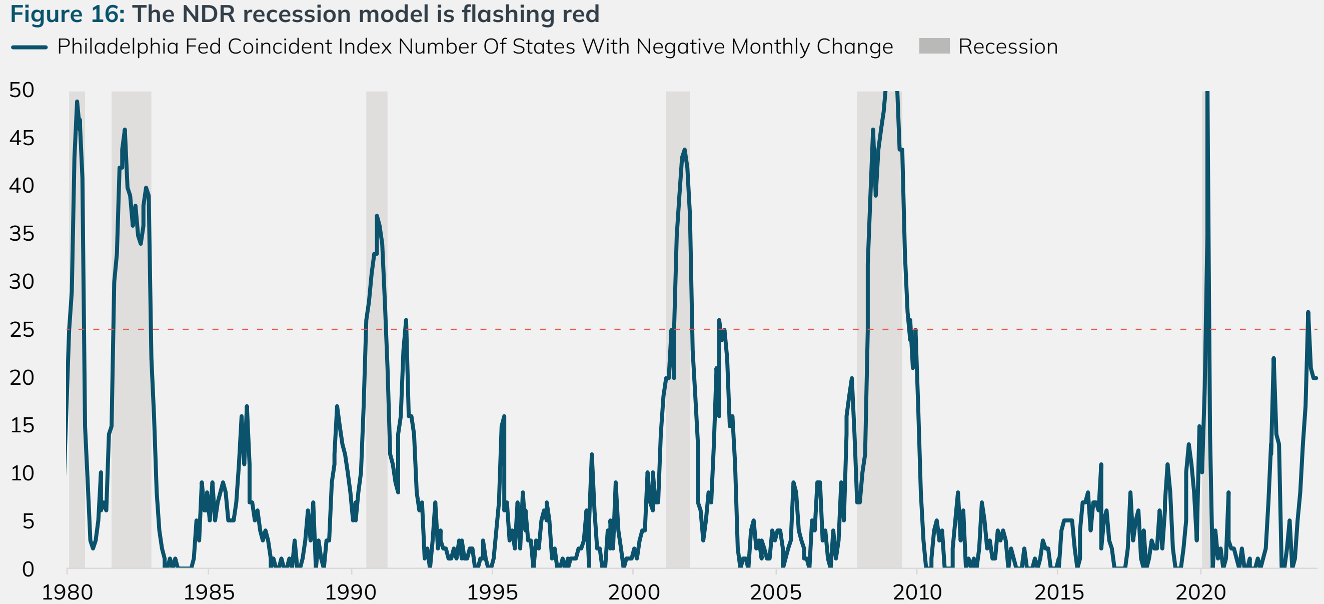
Figure 15: The short end of the yield curve is deeply inverted



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1977 to Mar 2024.

Several other recession indicators are flashing red once again, including the Ned Davis Research (NDR) recession model, which is based on the Philadelphia Fed's state-by-state survey of economic conditions. The NDR recession model shows that when over half of the U.S. states are in a contraction, a national recession is not far behind. This signal just crossed the 50% mark. This indicator has been good at predicting overall recessions, with the exception of two post-recession echoes just after the 1990 and 2000 economic contractions.

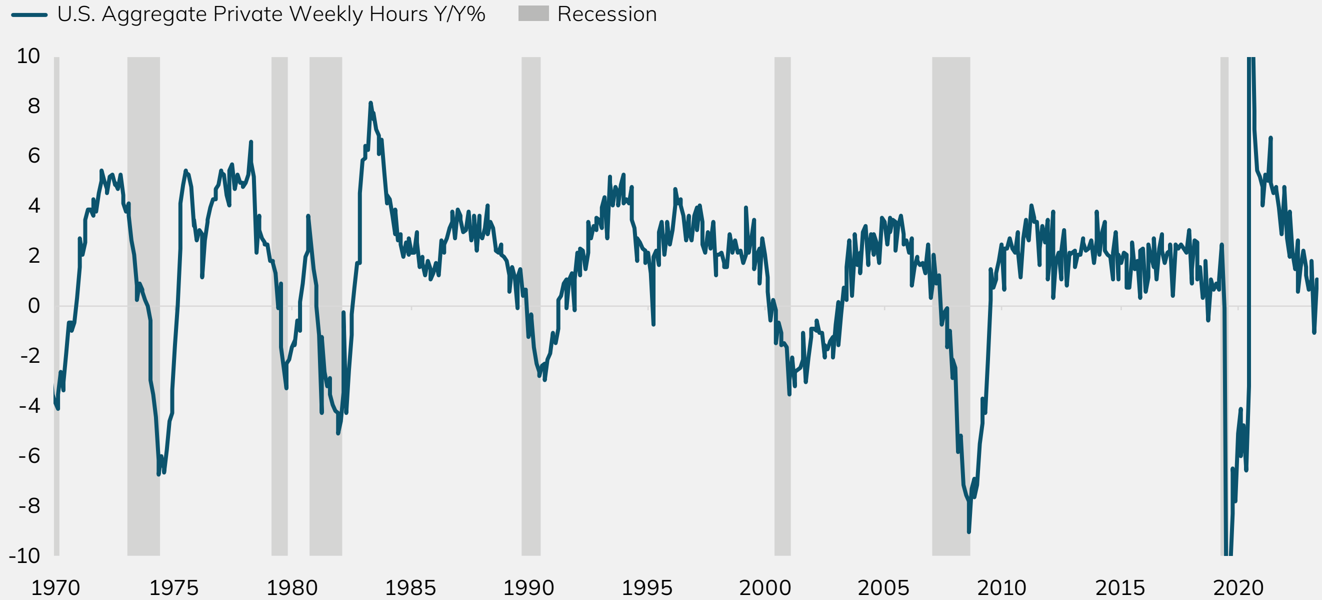
Figure 16: The NDR recession model is flashing red



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1980 to Feb 2024.

Indications of labour market weakness are increasing. While the most-watched indicator, the non-farm payrolls report, remains robust, there are indications that the labour market is weakening. Aggregate private weekly hours, for instance, just dipped into negative territory.

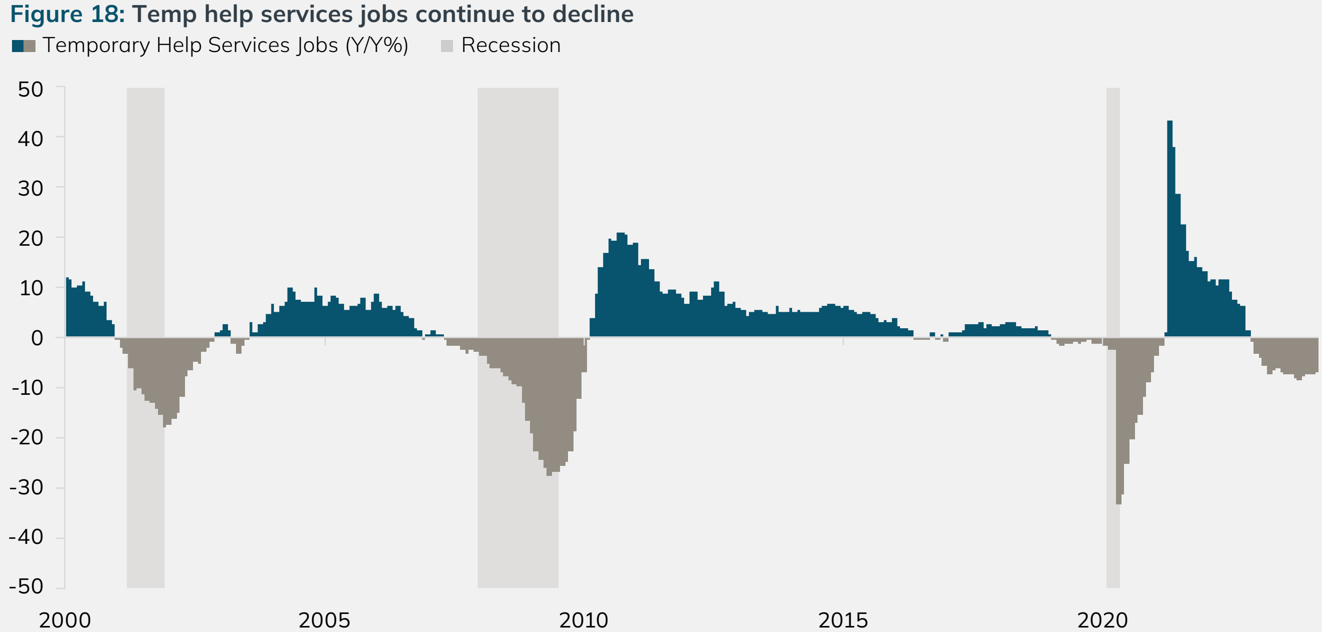
Figure 17: Aggregate private weekly hours have gone negative



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1970 to Feb 2024.

Temp help services jobs are typically the first to go in a weaker economic environment, and these have been trending lower for some time.

Figure 18: Temp help services jobs continue to decline



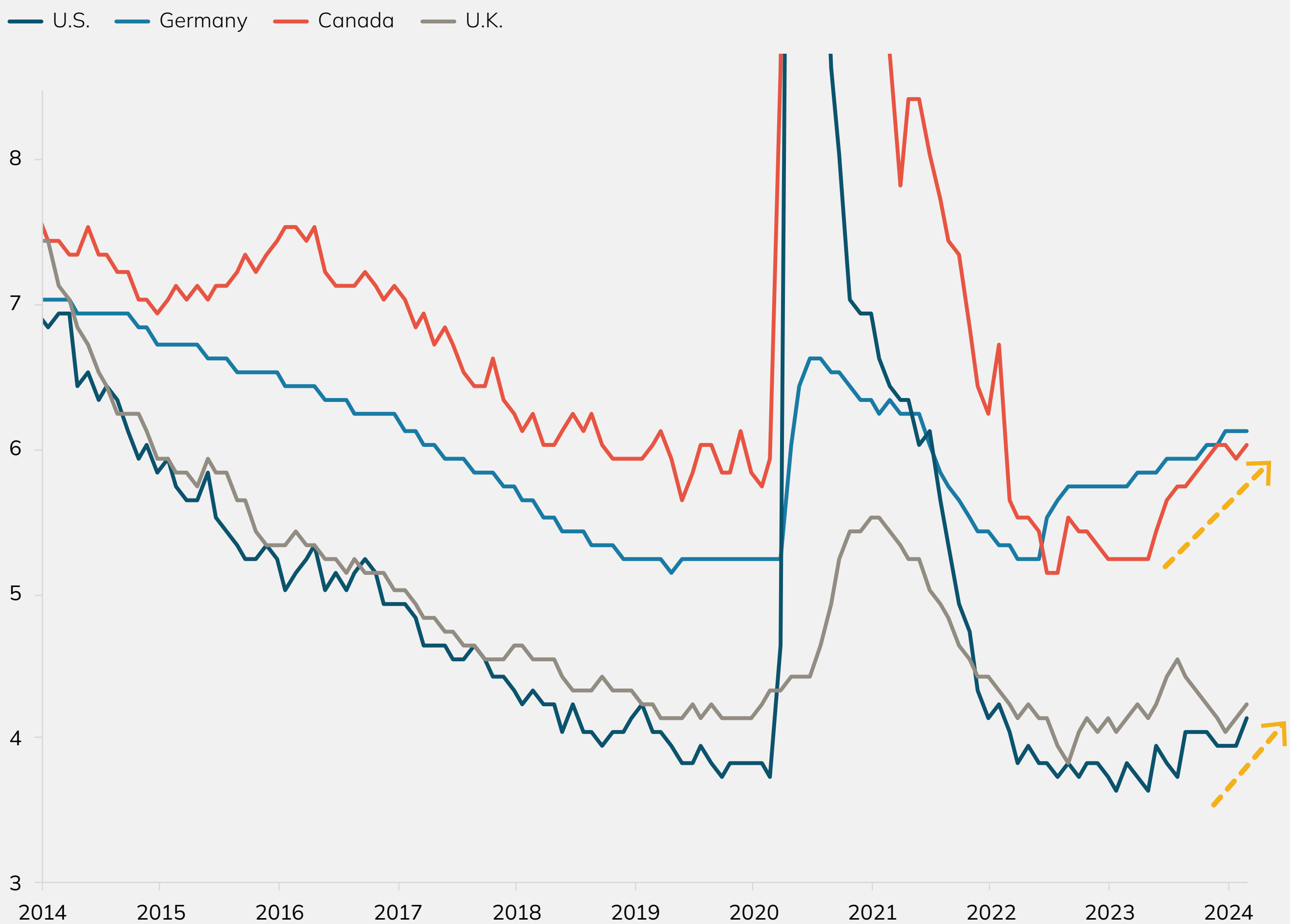
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to Feb 2024.

The Rest of the World Is Weakening

As we have discussed in the past, the U.S. economy is much less interest rate sensitive than other economies. That means restrictive monetary policy hasn't had the same impact in the U.S. as it has in other countries around the world, which are experiencing more recession-like conditions. For instance, the graph below shows a few countries with more interest rate-sensitive economies that are experiencing significantly more deterioration in their labour markets compared with the U.S.

Figure 19: Outside of the U.S., unemployment is on the rise

Unemployment Rate (%)



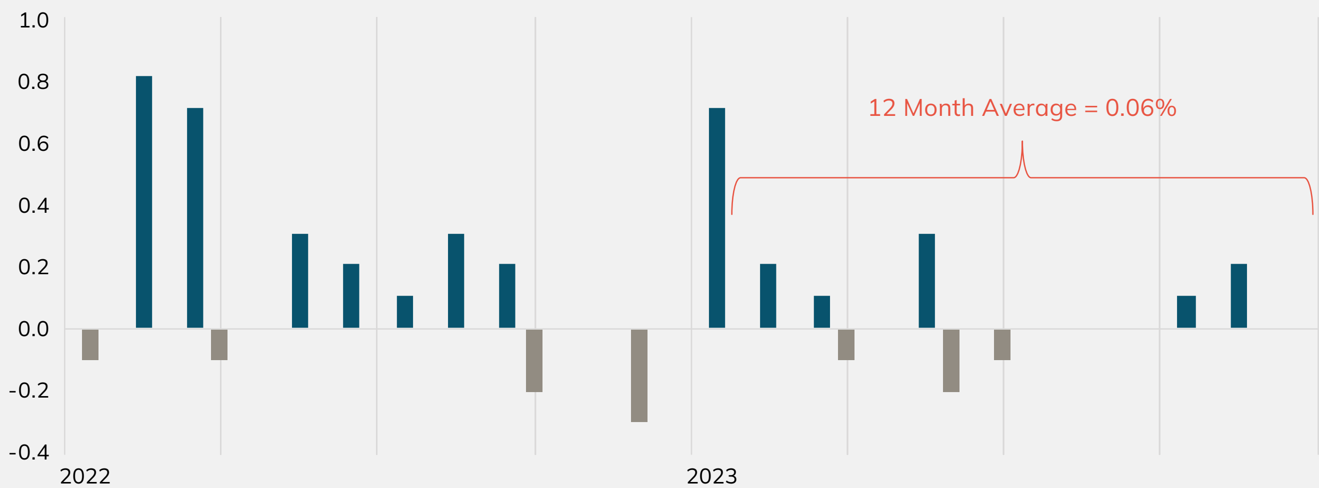
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to Feb 2024.

In past quarterly commentaries, we've expressed the view that Canada's economic position is weak, both in absolute terms and relative to the U.S. The latest data reaffirm our belief.

The Canadian economy continues to tread water and has only escaped an official recession thus far by virtue of technicalities. GDP growth over the last year has averaged 0.06% month-over-month, a tepid 0.7% on an annualized basis.

Figure 20: The Canadian economy is treading water

Canada GDP (1m%)

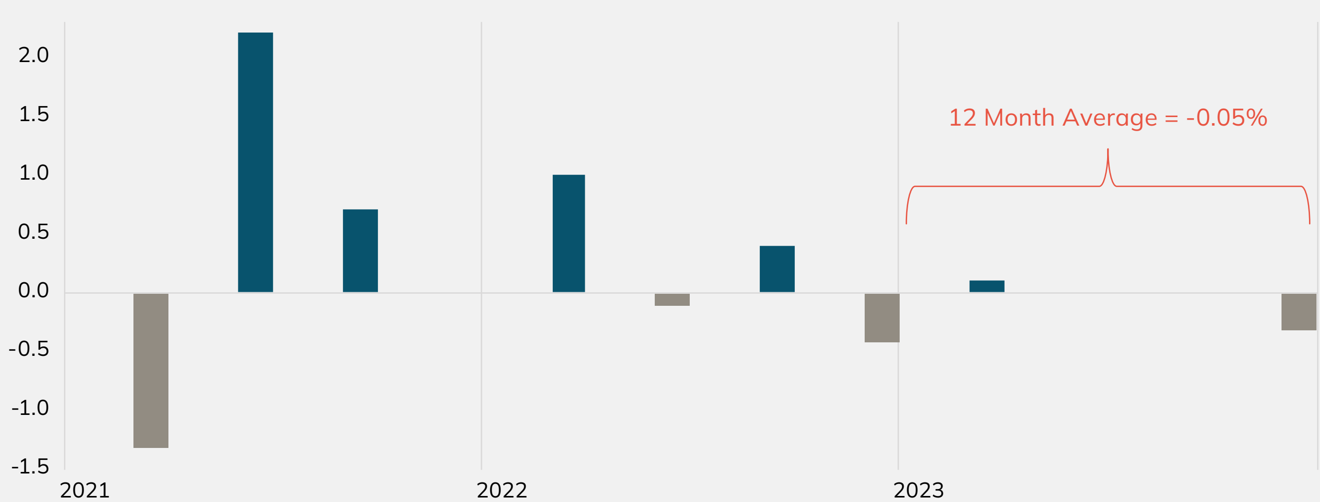


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2022 to Dec 2023.

It's the same story with Germany, where 12-month average GDP growth has been -0.05% month-over-month (-0.2% annualized).

Figure 21: German GDP growth is now slightly negative

Germany GDP (Q/Q%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 2021 to Q4 2023.

We Still Don't Think the Market Can Have Its Cake and Eat It Too

Last quarter, we suggested it was unlikely the market could have its cake and eat it too. In other words, we thought the probability was low that the Fed could cut interest rates six or seven times and perfectly stick an economic soft landing while S&P 500 earnings still grew by double digits. But market expectations for just this outcome were high. Now, while bond markets have backed off on some of their expectations for interest rate cuts, the soft-landing narrative in equity markets (and most credit markets) has become even stronger.

We think the Fed may have a problem getting through the "last mile" on inflation, which could have negative implications for the soft-landing narrative. The pandemic had an outsized impact on inflation due to supply chain disruptions, but that impact is now largely in the rearview mirror. Still there are underlying inflationary pressures that remain, in the form of longer-term supply-demand imbalances – principally in housing, commodities and labour – that we have discussed in the past. Our belief is that not enough time has passed with a restrictive monetary policy to allow the supply-demand imbalances in these areas to alleviate themselves. Therefore, we think a near-term easing cycle could lead to these inflationary pressures returning sooner than desired by central bankers, leading in turn to a new tightening cycle much sooner than in previous cycles over the past couple of decades.

Recent comments by Atlanta Fed President Raphael Bostic echo our concerns that the inflation dragon has not yet been slain. Having noted that "*January inflation readings came in surprisingly high,*" Bostic offered the following anecdote:

> *I asked one gathering of business leaders if they were ready to pounce at the first hint of an interest rate cut. The response was an overwhelming "yes."*
>
> *If that scenario were to unfold on a large scale, it holds the potential to unleash a burst of new demand that could reverse the progress toward rebalancing supply and demand. That would create upward pressure on prices.*
>
> *This threat of what I'll call* ***pent-up exuberance*** *[our emphasis] is a new upside risk that I think bears scrutiny in coming months."*[7]

For his part, former Treasury Secretary Lawrence Summers has questioned why the Fed seems so eager to cut rates:

> *My sense is still that the Fed has itchy fingers to start cutting rates and I don't fully get it,"*

Summers said during an interview with Bloomberg on Thursday, March 21, 2024, citing key economic indicators that seem at odds with the Fed's appearance of being "*in such a hurry*" to loosen policy:

> *We've got unemployment if anything below what they think is full capacity. We've got inflation, clearly even in their forecast for the next two years above target. We've got GDP growth rising if anything faster than potential. We have financial conditions, the holistic measure of monetary policy at a very loose level."*[8]

[7] Federal Reserve Bank of Atlanta, Three Economic Realities That Make Me Grateful Yet Vigilant, March 4, 2024.
[8] Bloomberg, L.P., Summers: Fed Still Has 'Itchy Fingers' to Start Cutting Rates, March 21, 2024.

Has Inflation Really Been Beaten for Good?

We didn't think resurgent inflation would be an issue in 2024, but rather in 2025 or 2026, after the Fed cut rates and the global economy began to recover. However, shorter-term inflation pressures are not abating, and might even be ticking up already.

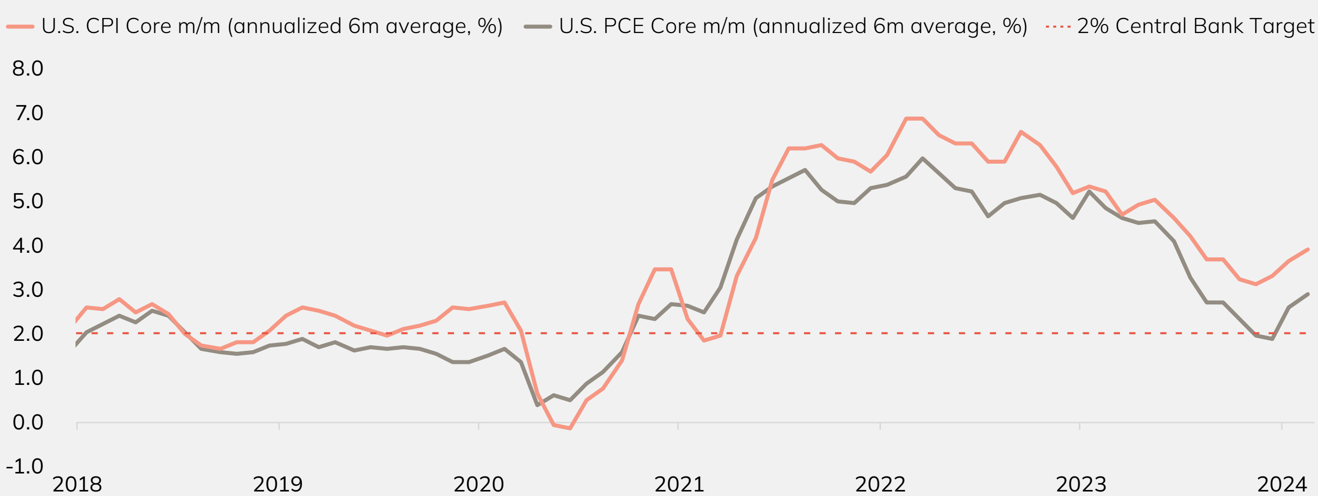
At the press conference following the January FOMC meeting, Fed Chair Powell said:

> *"We're looking for inflation to continue to come down, as it has been coming down for the last six months... What do we want to see? We want to see more good data. It's not that we're looking for better data. It's–we're looking at continuation of the good data that we've been seeing."*[9]

What additional data have come out since the January FOMC?

- Two Core Consumer Price Index (CPI) releases (January and February) that showed much higher monthly growth, taking the six-month average back up to 3.9%.
- Two Core Personal Consumption Expenditure (PCE) Price Index releases (January and February) that mirrored the uptrend in the CPI report.

Figure 22: Core inflation is moving in the wrong direction

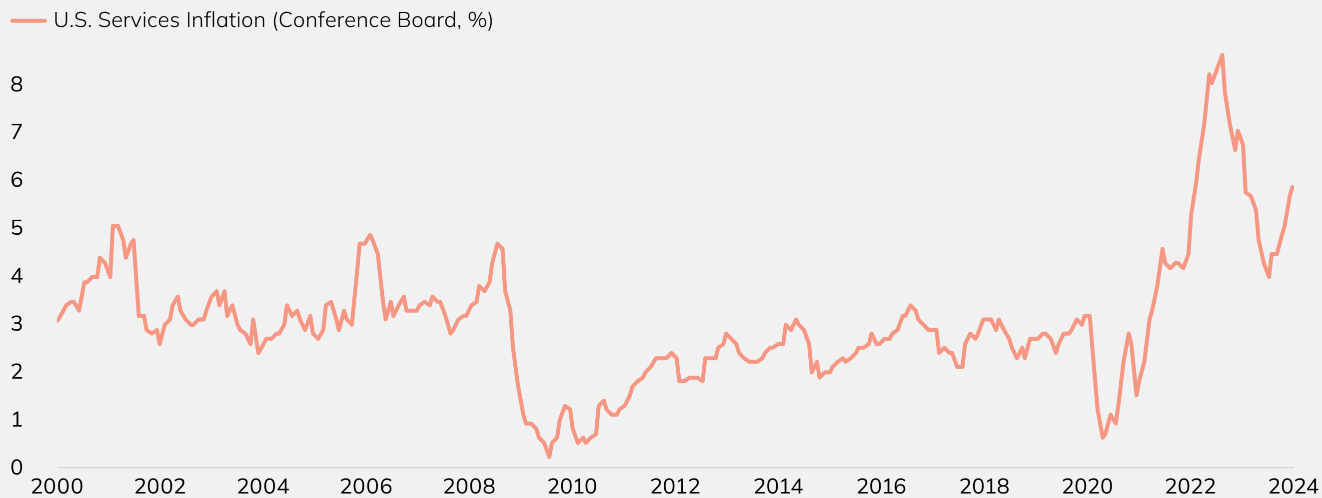


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2018 to Feb 2024.

[8] Transcript of Chair Powell's Press Conference, January 31, 2024.

Recent measures of U.S. Service inflation are also rising.

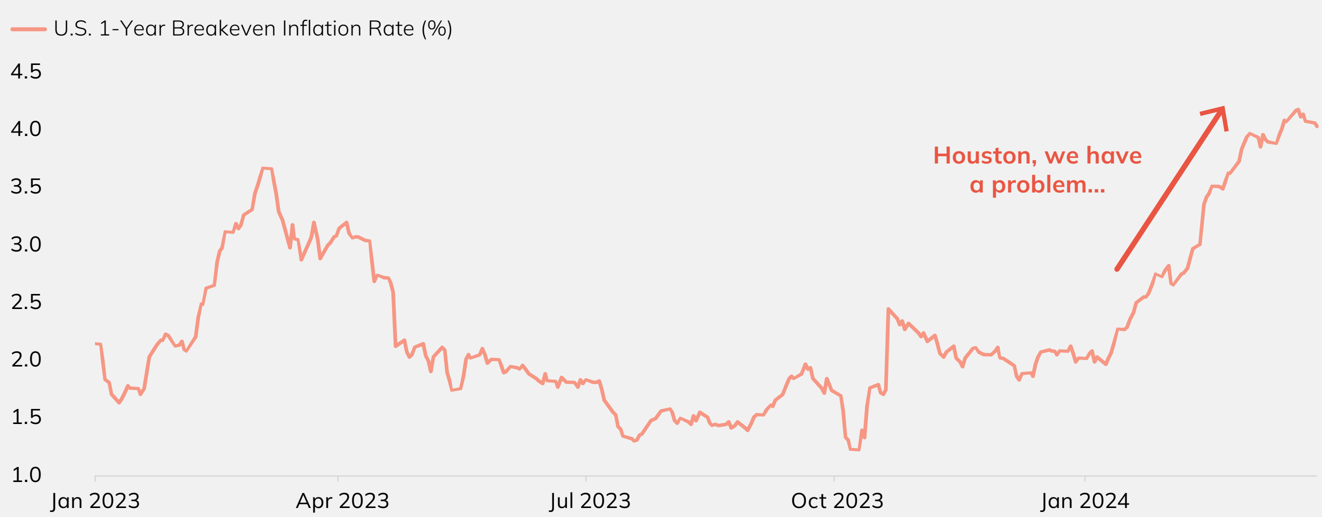
Figure 23: The Conference Board's measure of U.S. Services Inflation is back above 5%



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to Feb 2024.

In other words, the Fed has not lately seen the "*continuation of the good data*" that Powell suggested in January was necessary for rate cuts. Many market participants believe (or hope) that the recent uptick in inflation might be due to improper seasonal adjustments, and that the true inflation levels to start the year haven't properly been measured. This may prove to be correct. However, it also suggests that should the inflation trend continue upward over the next few readings, it will not be well received by markets. Incidentally, market-based inflation expectations, as reflected in the TIPS one-year breakeven rate, have risen from 2% to start the year to 4% as at March 31, 2024.

Figure 24: Market expectations for inflation one-year out have soared to 4%



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2023 to Mar 2024.

Commodities Are Rising – And Could Enjoy a Strong 2024

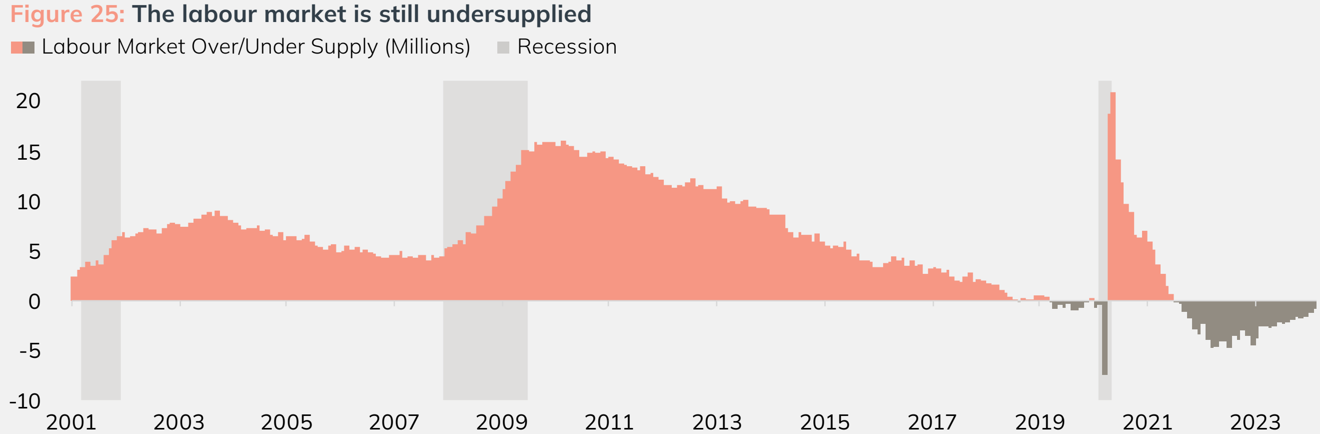
Complicating matters further for the Fed are the strong recent moves in key commodities. Crude oil prices are near their highs of the past eighteen months while copper recently broke out above $4.00 USD per pound. Meanwhile, the research team at Goldman Sachs is forecasting that a basket of commodities will rise by 15% this year in the event that the Fed cuts rates, absent a recession. Needless to say, if this happens, we believe it will pressure the inflation side of the central bank's mandate.

The Second Wave of Inflation

Based on history, inflation has tended to come in waves. Investment research firm Strategas recently published an interesting study showing that inflation spikes above 6% don't tend to resolve themselves in just one cycle. They show that 87% of inflationary episodes above 6% have multiple inflation waves before the pressures finally subside.[10] We believe that one contributor to these waves is consumers' built-in desire to "catch up" on wages to offset their lower standard of living due to the first inflation wave (when their real spending power generally declines). These wage increases then lead to subsequent inflation waves. The lag between a first and second inflation wave can likely be over a year. Given the large supply imbalances that exist this time around, we think the clock will start ticking on the next inflation wave as soon as the Fed starts to cut rates.

That brings us back to the longer-term supply-demand imbalances for labour, housing and commodities, where we don't think there has been nearly enough economic weakness for the issues to resolve themselves. While progress has been made, the jobs market is still undersupplied, and there are millions of workers seeking to make up for the purchasing power they have lost in the past couple of years.

Figure 25: The labour market is still undersupplied

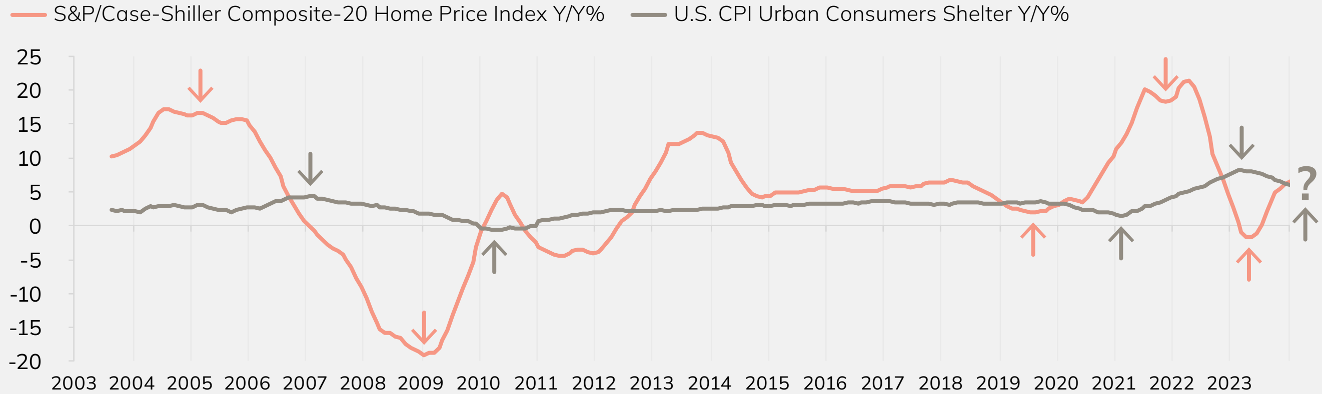


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2001 to Feb 2024.

[10] Strategas, Economics Report, August 9, 2023.

Meanwhile, housing shortages related to low building rates, combined with the demographics around higher household formations, still exist. This suggests that shelter inflation – after services, the next largest contributor to core CPI – is also likely to increase, especially if interest rate cuts lead to lower mortgage rates. There is generally a strong correlation between home prices and shelter inflation, with a variable lag that averages about 18 months. Housing prices bottomed last year and have since been on the rise.

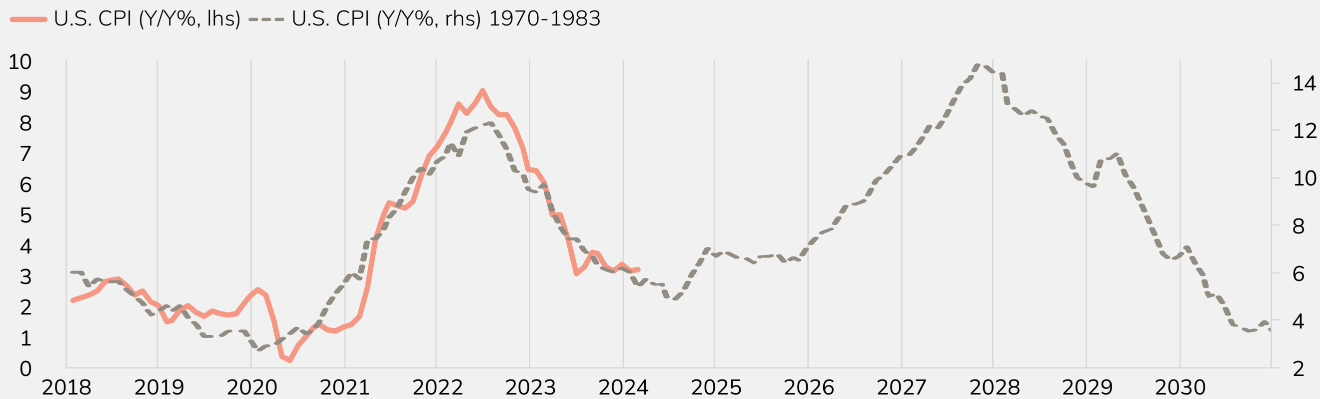
Figure 26: With a lag, rising home prices generally lead to higher shelter inflation



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2003 to Feb 2024.

Putting everything together, the analogy to the inflation waves of the 70s is still tracking quite closely!

Figure 27: Back to that 70s' show on inflation



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2018 to Feb 2024.

We fear that if the Fed loses some of its vigilance on inflation too early, stronger inflationary pressures will re-emerge more quickly than expected, forcing the Fed to make a hasty about-face and start hiking again. This would not be good for risk assets, especially if current levels of valuation and positioning sustain themselves into the next economic reacceleration.

Conclusion

There is strong evidence, at least for now, to support the market narrative that a Goldilocks-like soft landing is likely for the U.S. economy. We think a soft landing is indeed very possible – but that said, equity investors have likely priced in this outcome already, and we worry that there is much that could still go wrong. There is some probability that a recession could still happen, given that some economic indicators are deteriorating just as they have prior to past recessions. There is also some probability that the Fed may be making another policy mistake by easing financial conditions and preparing to cut interest rates before the inflation battle is truly won. We worry that if the Fed cuts rates too soon, it risks renewing inflationary pressures sooner than expected, given various supply-side issues that have not had time to resolve themselves.

We believe that there are risks to equities, even if the Fed is successful in sticking a soft landing. Tactically, we would prefer to “buy the dips”, so long as the U.S. maintains positive growth with generally subdued inflation. Longer-term, however, we worry that the soft landing could be upset, either by an economic contraction or re-accelerating inflation. It’s worth remembering, after all, that at the end of the Goldilocks fairytale, the bears do return.

Sector Outlooks

Industrials

More recently, we've seen industrial names across the board rally on the premise of a soft landing. Erring on the side of conservatism, we've increased our short exposure to more expensive multi-industrial/staffing 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 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 niche aerospace parts suppliers indexed to commercial aerospace upcycle. We also remain bullish on the industrial leasing complex over the long term. We have hedged the cyclicality of rentals with less attractive names that have similar exposures. We have been looking into certain airlines but are not positive quite yet despite their cheap valuations.

Materials

Gold reached an all-time high during the quarter, marking a significant milestone in the commodity's performance. However, gold miners continued to face challenges, trailing behind the commodity itself due to persistent margin pressures induced by cost inflation. Despite these hurdles, gold equities rallied in the latter half of the quarter, with the gold-to-gold equities ratio reaching its lowest level since December 2015. Our preference within the gold sector remains tilted toward companies that demonstrate strong operational execution. One example is Agnico Eagle Mines Limited (TSX: AEM), which has showcased resilience and efficiency in navigating the volatile gold market.

Additionally, positive changes are seen in companies such as Osisko Gold Royalties Ltd (TSX: OR), which is returning to its roots as royalty company and offering exposure to attractive organic growth and concentration of its assets in low-risk mining jurisdictions.

As highlighted last quarter, the copper market has experienced significant supply disruptions, including the closure of the Cobre Panama mine and downward revisions in production outlook by major miners. These disruptions positioned the copper market to enter deficits in 2024, with forecasts indicating sustained deficits throughout the decade. Copper prices had been rangebound over the past year due to concerns about global economic growth that clouded the demand outlook. However, during the quarter, copper prices broke higher after resilient economic data in the U.S. suggested a potential soft landing. This supported a turnaround in copper demand and could potentially initiate the next bull cycle for the metal. The explosive growth in artificial intelligence (AI) and associated data centres also presents a promising avenue for copper demand, given copper's importance in power-intensive data infrastructure. Looking ahead, we believe the imbalance between supply and demand in the copper market suggests that significantly higher prices may be necessary to rebalance the market, especially considering the lengthy timeline for bringing new copper projects online. Maintaining a favourable view of copper, we have adopted a diversified approach in our portfolio, holding multiple copper names to capitalize on an anticipated upswing in copper prices.

Information Technology

The MSCI World Information Technology Index increased by 12% for the first quarter of 2024, while the Information Technology sector in the S&P/TSX Composite Index increased by 5%. Sector performance compounded on fourth quarter 2023 strength. The best-performing subsector was semiconductors, up 19%, led by Nvidia Corporation (NASDAQ: NVDA), followed by internet stocks, with the Nasdaq CTA Internet Index up 11%, led by Instacart (NASDAQ: CART). Software sector gains were weaker in first quarter of 2024, with the iShares Expanded Tech-Software Sector ETF up only 4.5%, while Snowflake Inc (NYSE: SNOW), Adobe Inc. (NASDAQ: ADBE), and Five9 Inc. (NASDAQ: FIVN) all had weak starts in a mixed demand environment.

Our outlook for Information Technology in the second quarter of 2024 is cautiously optimistic, as an improved interest rate environment could lead to increased confidence and spending as well as ongoing multiple expansion. In Software, enterprise budgets generally appeared more optimistic as we began 2024, and AI revenue is likely to begin scaling into 2025; therefore, this quarter's underperformance may be an opportunity to add to dislocated names. Semiconductor stocks exposed to AI remain winners, although we think there may be some near-term processing of the recent moves, while cyclicals may begin to perform better as inventory corrections near an end. In the Internet subsector, we favour high-quality names in each sub-grouping, with a slower growth environment for consumer end markets benefiting dominant market share players. In Networking, we saw continued softness in demand as firms deal with ongoing digestion of excess inventory in end markets. Hardware, while mixed overall, was better this quarter, with notable inflections in server OEMs, driven by ongoing AI buildouts at hyperscalers and enterprise companies.

Health Care

The optimism we had exiting 2023 has been sustained through the start of 2024. The S&P Health Care Index is up 8.3% in the first quarter of 2024, but has underperformed the S&P 500 Index, which increased 10.2% over the same period. Biotechnology capital markets funding and activity, a key proxy for end-market health, saw a resurgence in the first quarter, with strong follow-on, venture capital, PIPE (private investment in public equity) deals and M&A (merger and acquisition) transactions, driving strength in subsectors such as Biotechnology (up 6.3%) and Contract Research Organizations (CROs) (up 11.6%). Life Science and Tools wavered, up 2.5%, given ongoing debates about bioprocessing recovery, weakness in China's macro environment and high valuation multiples. Health care utilization and hospital procedure volumes remained robust, with labour improving, helping Hospitals (up 15.7%) and Medical Devices (up 8.2%), and driving weakness in pockets of Managed Care, especially among companies most leveraged to Medicare Advantage (up 2.8%). Large Biopharma was up 7.8%, again led by Eli Lilly and Company (NYSE: LLY, up 33.5%) as sentiment on the obesity drug theme has only strengthened.

Looking forward, we are cautiously optimistic that momentum will continue, especially in subsectors and individual names where outperformance during the first quarter has been supported by positive estimate revisions. Biotech funding may continue to recover, given the more stable interest rate environment and improving capital markets sentiment. In such an environment, we continue to prefer catalyst-driven stock selection in Biotechnology and remain broadly optimistic among CROs. In Pharmaceuticals, we continue to prefer quality growth stories, while avoiding names that lack needle-moving catalysts or have lagging base businesses, unaddressed patent cliff overhangs and meaningful exposure to the Inflation Reduction Act. In Medical Devices, against the current macro backdrop, we continue to prefer companies with new product cycles that are driving growth and margin expansion.

Consumer Discretionary

The Consumer Discretionary sector got off to a choppy start in 2024 with softer U.S. Census retail sales numbers in January and February, along with hotter inflation readings that acted to slow the cyclical rally toward the end of 2023. With that said, fourth-quarter results were mixed: holiday sales largely came through as expected, but many management teams were taking a cautious approach in their outlooks for 2024. Stock specifics really mattered this quarter, as did positioning: we can highlight, for instance, the diverging performance of Tesla Inc. (NASDAQ: TSLA) and General Motors Company (NYSE: GM) in the first quarter of 2024, reflecting the slower adoption of electric vehicles in the U.S., or the relative outperformance of Restaurant Brands International (TSX: QSR) compared with Canadian Tire Corporation, Limited (TSX: CTC/A), with discretionary spending in Canada still under considerable pressure.

We expect more of the same in the near term for the sector. Recent data from inflation prints over the past couple months suggest that it is still too early to confirm definitively that inflationary headwinds are behind us and that consumers are about to begin benefiting from meaningfully lower rates. With that said, we do expect to see some rate cuts as we move through the year and continue to monitor high-quality cyclical stocks trading at attractive multiples, such as BRP Inc. (TSX: DOO), General Motors Company (NYSE: GM) and D.R Horton, Inc. (NYSE: DHI). Our core holdings remain unchanged. We continue 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 the first quarter of 2024, we saw the sector perform generally in line with the broad market in both Canada and the U.S., with some slight outperformance in Canada and slight underperformance in the U.S. In Canada, we are seeing a flight to quality reflected in the notable outperformance of Alimentation Couche-Tard Inc. (TSX: ATD) and Loblaw Companies Ltd. (TSX: L).

In the U.S., after a horrendous year in 2023 that saw significant underperformance, the sector is finally starting to perform in line with the broad market. U.S. Staples, particularly packaged food, were hit hard last year as consumers started to react to price increases, just as the emergence of GLP-1 drugs began to worry investors about the future of calorie consumption. However, as we move into 2024, the U.S. Staples sector looks to fare better, with many companies seeking to drive volume growth after years of declines.

We try to look for companies that are growth names in a low growth sector like Consumer Staples. We believe Monster Beverage Corp (NYSE: MNST) is a good example – the company is one of the few operating in an expanding energy drink category. Its recent acquisition of Bang Energy can provide distribution upside, the emergence of “clean energy” drinks that are viewed as healthier is a new opportunity, and the company has promising international growth opportunities, specifically in China. Their balance sheet is pristine with over $3 billion USD in net cash. Another example is BellRing Brands Inc. (NYSE: BRBR). The company is gaining notable shelf space with its protein shake offering and remains on trend with, and may benefit from, GLP-1 users who need more protein in their diets. We believe the company is an attractive takeout target.

George Weston Ltd. (TSX: WN) is another example in the sector, which we believe can provide quality exposure to Loblaw Companies Ltd. (TSX: L) and which, through its REIT exposure, should also benefit if the Bank of Canada reduces interest rates.

Financials

Financials have lagged the broader market in Canada to start the year, while trading in line with the broader market in the U.S. In the sector, Insurance (both property & casualty and life) has led the gains, while the more credit-sensitive banks have lagged. We continue to be a little more cautious about banks, especially in Canada, as revenues are slowing and credit losses are trending higher. In Canada, we believe we are headed for a period of more rapid deleveraging that will hold back growth and profitability for the banks' domestic banking businesses. Among financials, we favour less credit-sensitive companies with good idiosyncratic growth tailwinds, irrespective of the macroeconomic backdrop. We remain very bullish on life insurance: we believe there is a structural re-rate opportunity provided by a higher rate regime than the zero-interest-rate policy that followed the Global Financial Crisis. Additionally, many of the life insurance companies we like have built large capital-light wealth/asset management businesses that will likely continue to benefit from numerous secular tailwinds and strong growth.

Communication Services

The macroeconomic environment did not co-operate for this defensive sector: yields climbed higher, resulting in significant underperformance compared to the broader index (the S&P/TSX Composite Index). 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) declined -5.8%, lagging the S&P/TSX Composite Index by about 1250 basis points (bps). Macro dominance was reflected in the lack of material dispersion among the big three (Rogers, BCE, and Telus).

We have previously laid out our expectation for flattish growth in average revenue per user (ARPU) for 2024 because of discipline in pricing. However, with Quebecor now maintaining its Black Friday promotions through March, we are modestly revising our 2024 ARPU projection from "flattish" to "flattish to down modestly".

We maintain our outlook for healthy growth in service revenue, driven largely by growth in subscribers. In summary, we have a lukewarm view of the sector, given the lack of pricing power (for now) and higher bond yields offset by reasonably healthy dividend yields.

Utilities

Higher bond yields led to material underperformance, and the utilities sector lagged the broader index (the S&P/TSX Composite) by about 800bps. Our view is unchanged: we prefer strong balance sheets that can self-fund growth, favourable regulatory jurisdictions, and no large rate cases.

With regard to independent power producers, we favour names that have no large project risk and are able to self-fund growth.

Real Estate

Higher bond yields supported by hopes of a soft landing helped REITs the most within this defensive sector. While REITs underperformed the S&P/TSX Composite, lagging it by about 700bps, it underperformed the least compared with other defensive sectors such as Utilities and Telecommunication Services, given the degree of benefit that REITs derive on the topline from a healthy economy. We remain positive on stories that have embedded growth that can more than offset refinancing issues – a headwind for the entire sector – and names that are de-leveraging through asset dispositions and/or stabilizing development deliveries. Notwithstanding the potential for a soft landing, we remain skeptical about the value of going down the quality curve with regard to balance sheets.

Energy

Oil prices exhibited a notable turnaround in the first quarter of 2024, rebounding from initial declines driven by concerns about global demand. Despite the uncertain start, crude oil prices strengthened over the quarter, positioning the sector as one of the strongest performers. Positive surprises in Chinese demand in February, coupled with resilient economic data in the U.S. that suggested a potential soft landing, provided support to the demand picture. Geopolitical tensions also increased, with new Ukrainian attacks on Russian oil refineries helping WTI crude oil prices break above $80 USD per barrel during the period.

In Canada, heavy crude oil prices tightened significantly ahead of the startup of the Trans Mountain Expansion (TMX) pipeline. The “heavy barrel” of oil has received varying discounts over the past years, ranging from 10% to 30% off the WTI price. Looking ahead to 2024, the differential is expected to narrow for structural reasons as the TMX pipeline expansion comes online and facilitates increased shipping of Canadian oil. Specifically, heavy oil differentials are anticipated to tighten, resulting in improved pricing for the Canadian heavy barrel.

In contrast to the oil market, natural gas prices experienced a collapse during the quarter, primarily due to a record warm winter across North America, leading to reduced demand and a storage overhang. Toward the end of the quarter, supply responded, with several large U.S. natural gas players reducing capex and production, providing a floor for the commodity. Gas equities rallied on supply cuts, but still lagged behind oil stocks during the period.

We maintain a positive outlook on Exploration and Production (E&P) companies poised to benefit from tighter heavy oil differentials and strong underlying operational momentum. Examples include Imperial Oil Limited (TSX: IMO) and MEG Energy Corp (TSX: MEG), which we believe are positioned to capitalize on narrowing differentials and favourable market conditions.

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