PICTON MAHONEY
Asset Management

Q4 2023

Investment Review & Outlook

On accident watch:

Unsustainable U.S. growth = global economic pain

- The U.S. economy continues to perform better than expected
- Leading indicators continue to suggest a coming recession
- Why the U.S. economy remains resilient
- But the rest of the world is more rate-sensitive—and other central banks are mirroring the Fed
- China's recovery is tepid at best
- Accident watch in effect

Overview

History, it's been said, may not repeat, but it often rhymes, making it a worthwhile if imperfect guide for understanding the economic cycle and its impact on risk assets. And the historic playbook has strongly implied, for much of 2023, that a U.S. recession is likely just around the corner. The U.S. Federal Reserve (the Fed) has tightened monetary policy significantly over the last 18 months, the yield curve is deeply inverted, and leading indicators continue to flash warning signs. Historically, this has been a toxic combination.

But so far, in the face of historical precedents and ominous signals, the U.S. economy remains surprisingly strong. The consumer is exhibiting tremendous resilience, corporate bankruptcies are low, and fiscal policy is aiding Gross Domestic Product (GDP) growth. The historic economic playbook for a recession may not ultimately be denied, but it certainly has been delayed.

Unfortunately, this surprising U.S. economic strength is a problem for the rest of the world. Global central banks have been mirroring Fed policy, yet their countries are generally far more rate sensitive than the U.S. And whether it's China, Europe or Canada, economic weakness is becoming pronounced. Add a Fed that's committed to staying tighter for longer, and that's a potential recipe for an even stronger U.S. dollar—the last thing a weakening global economy needs.

As far as equities are concerned, we believe stock markets are grinding their way through a longer-term trading range, at the very least, which will likely continue as the market adjusts to higher interest rates. At current levels, we would wait for better opportunities to emerge. But at the worst, there is the potential for an accident if the Fed stays tight for too long, especially if the U.S. dollar breaks out. History is replete with examples of a surging greenback acting as a wrecking ball, and we fear this time may be no exception, especially given the current setup for equities.

Picton Mahoney House View September 2023

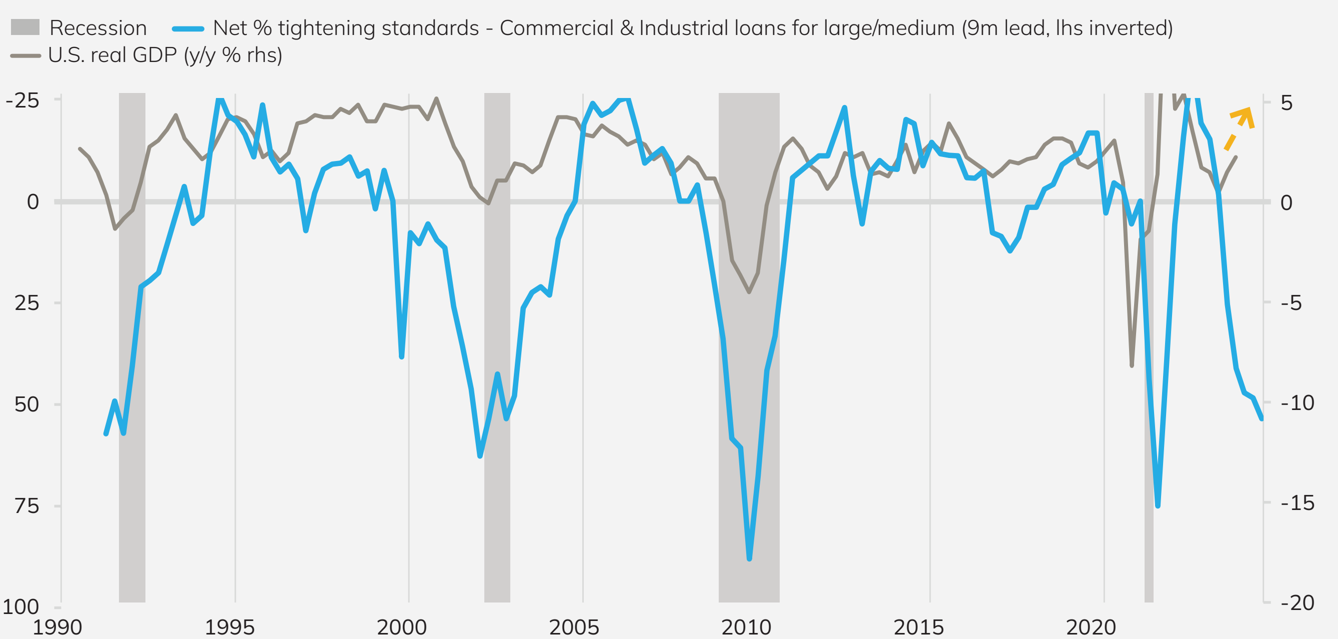
	PMAM vs. Consensus
Risk	
Macro risk is on the rise from last quarter's low levels, and we expect this upward trend to continue as the impact of high rates and tight credit conditions continue to be felt in the economy.	Higher +
Macroeconomic	
Global real GDP U.S. economic resilience should not be extrapolated to the rest of the world, where the bite of higher interest rates is quicker to hit economic growth due to shorter mortgage terms and reduced access to corporate credit financing.	Lower –
U.S. real GDP The U.S. economy has remained surprisingly resilient due to the extreme level of pandemic era stimulus and pent-up demand, coupled with new fiscal stimulus and lower interest rate sensitivity in both the consumer and corporate sectors. While this likely won't last forever, it has pushed out expectations of a weaker economy by potentially another quarter or two.	Same
Canadian real GDP The Bank of Canada (BoC) remains hawkish despite the precarious state of the real estate market which could soon spill into the banking sector.	Lower –
U.S. inflation Much of the gains in tackling high inflation are in the rear-view mirror, as suggested by the recent uptick. We expect that "the last mile" to get to the 2% target will be hard to achieve without an outright economic contraction and higher unemployment.	Same
Equity returns	
U.S. equities Extreme sentiment and positioning are falling from their highs, while we believe surging real rates no longer support current valuations.	Lower –
European equities Many countries in Europe are in recession, and with continued European Central Bank (ECB) hawkishness and falling leading indicators, there remains more downside for European equities.	Lower –
Canadian equities The Canadian economy is treading water as the real estate market slips and the banking sector racks up loan losses.	Lower –
Bond yields	
Treasuries (U.S. 10-yr) Surging treasury issuance together with continued U.S. Fed selling is being balanced by a high level of household buying, but rates will need to stay at these levels for the trend to continue.	Same
Investment-grade corporate bonds Investment Grade spreads offer a stable middle ground between deteriorating corporate credit and government rate volatility.	Same
High-yield corporate bonds Bankruptcies are on the rise, and already very tight spreads give little room for high yield corp to perform well.	Higher +
Other	
WTI crude oil Weaker global growth has kept a lid on oil demand, but the Organization of the Petroleum Exporting Countries (OPEC) cuts and supply disruptions have put upward pressure on oil prices.	Same
EPS growth (S&P 500) Earnings growth will likely be challenged into year-end, as leading indicators point to negative growth.	Lower –
P/E (S&P 500) Surging real rates will likely be 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 September 2023.

The U.S. economy continues to perform better than expected

Despite persistent deterioration in many leading indicators, the U.S. economy continues to perform better than expected. GDP reaccelerated in the second quarter on a year-over-year basis—quite the feat given the massive weight of soaring interest rates and tightening lending standards.

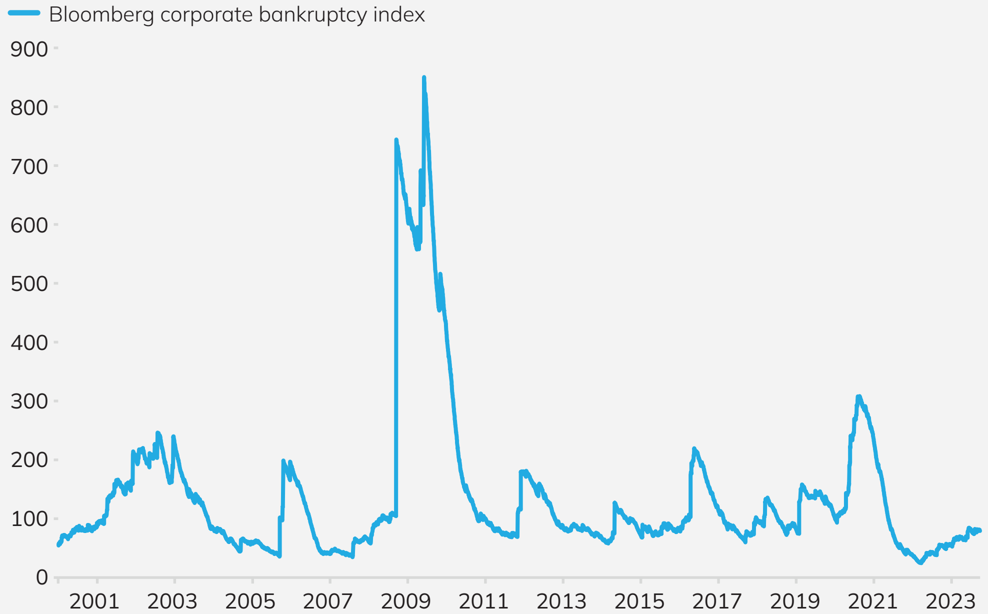
Figure 1: U.S. real GDP accelerated even in the face of tighter lending standards



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

Despite tight credit markets and high rates, there seem to be few signs of stress so far in the U.S. economy. Bank lending standards for businesses are about as tight as they ever get, yet corporate bonds spreads are well contained. And while bankruptcies are on the rise, the absolute level of corporate bankruptcies is still low.

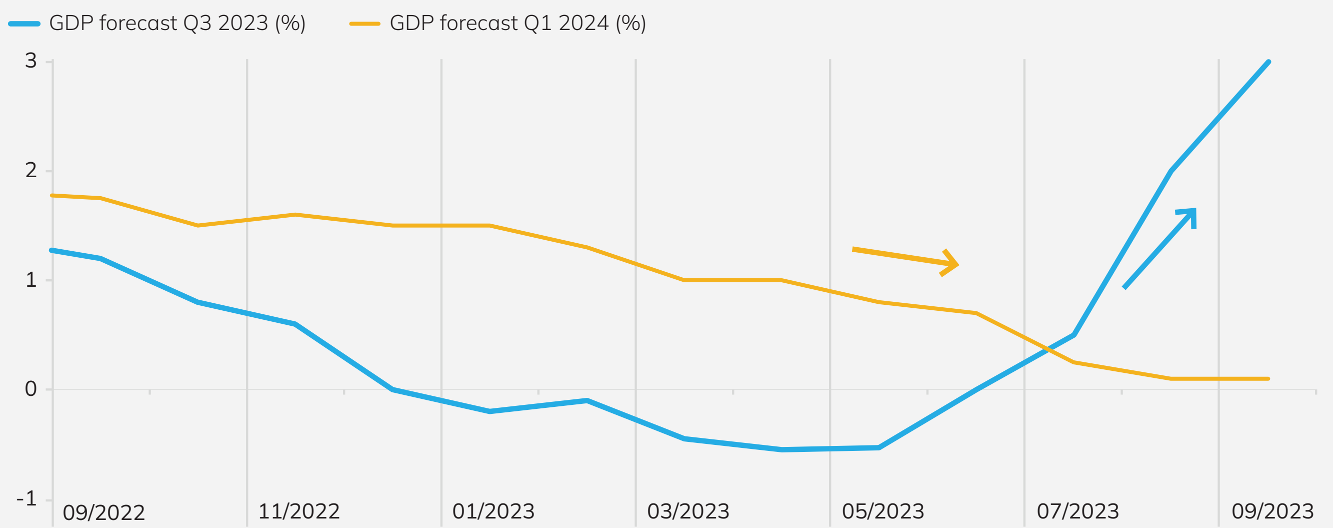
Figure 2: Corporate bankruptcies remain low despite high rates and tight lending



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

Meanwhile, consensus estimates for third-quarter GDP have swung from a nearly 1% drop year-over-year to a 3% gain. Many of the upward revisions to third-quarter estimates are attributable to strong retail sales data for July, which surprised on the upside, coming in at 0.7% month-over-month. At the same time, July housing starts in the U.S., although weaker than a year ago, did manage to stay above the 1.4 million level on an annualized basis.

Figure 3: Consensus estimates for third-quarter GDP growth have reversed sharply higher



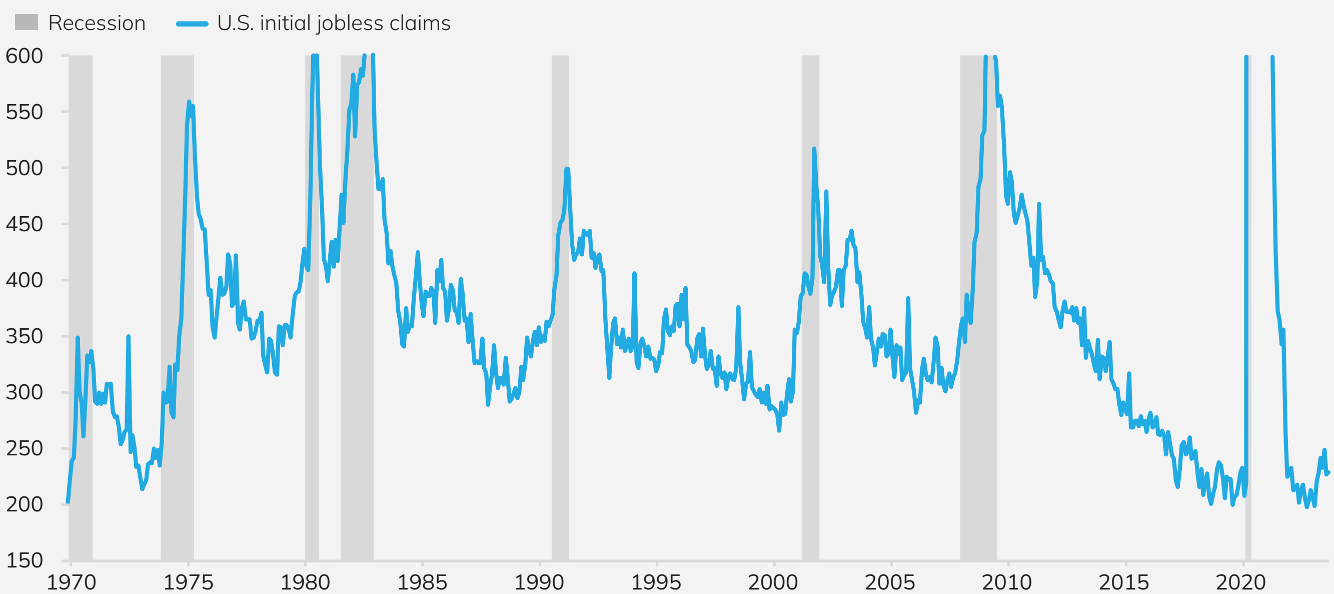
Source: Bloomberg, L.P., PMAM research. Sept 2022 to Sept 2023.

Some of this positive momentum has flowed into higher fourth-quarter GDP expectations, although the revisions have been more muted. Consensus estimates for the final quarter of 2023 have recently increased from nearly -0.5% year-over-year to 0.35%.

However, it seems that at least part of this optimism for fourth-quarter growth may be at the expense of next year's first quarter, which has seen consensus estimates fall to almost zero. In other words, expectations of economic weakness may have simply been pushed into the new year (at least for now), rather than abandoned entirely.

The U.S. economy has also been buoyed by a labour market that remains quite strong. A worrying jump in initial jobless claims earlier in the year has abated, allaying market fears that a prolonged wave of layoffs was in the cards. As Figure 4 shows, sharp rises in initial jobless claims have historically been associated with recessions, so the current breather is a welcome, though far from definitive, development.

Figure 4 : The worrying increase in jobless claims has taken a breather

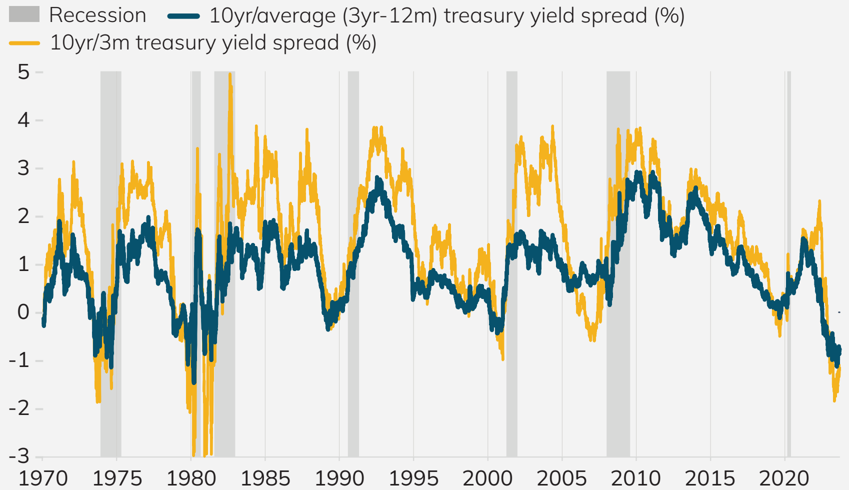


Source: Bloomberg, L.P., PMAM research. Jan 1970 to Sept 2023.

Leading indicators continue to suggest a coming recession

While current U.S. economic data are robust, leading indicators continue to point to recession risks on the horizon. The yield curve, for starters, is still flashing red. Historical precedent suggests that an inverted yield curve usually leads to an economic contraction, although lead times are long and variable.

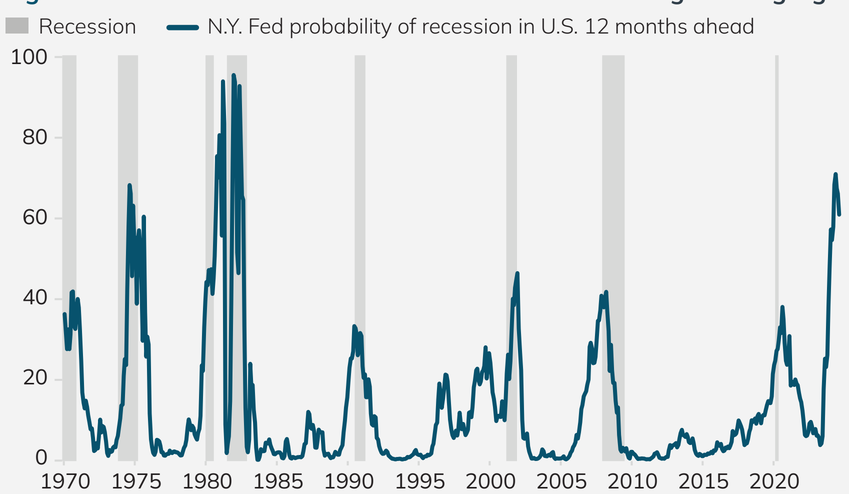
Figure 5: The yield curve persists with its ominous message



Source: Bloomberg, L.P., PMAM research. Jan 1970 to Sept 2023.

The New York Fed's recession probability model, which incorporates the yield curve as a key input, is, not surprisingly, warning of a coming recession in the next 12 months.

Figure 6: The New York Fed recession model is also flashing warning signs



Source: Bloomberg, L.P., PMAM research. Jan 1970 to Aug 2023.

Why the U.S. economy remains resilient

U.S. lending is tight, interest rates have soared, and the yield curve has been inverted for quite some time now. According to the historical economic playbook, the U.S. economy should be weakening already—and even in recession. Yet so far, few signs of broad economic weakness have emerged.

What, then, explains the impressive resilience of the U.S. economy? One explanation is that the U.S. economy has become much less rate-sensitive, at least so far, than most other global economies. For example, in 2020 and 2021, many U.S. consumers were able to refinance their mortgages for 30 years at very low rates. Contrast this with the economies of Canada and Australia, for example, where the typical mortgage is much shorter-term, meaning that interest rate reset risk is always around the corner, and is probably already having a significant negative impact on consumer spending.

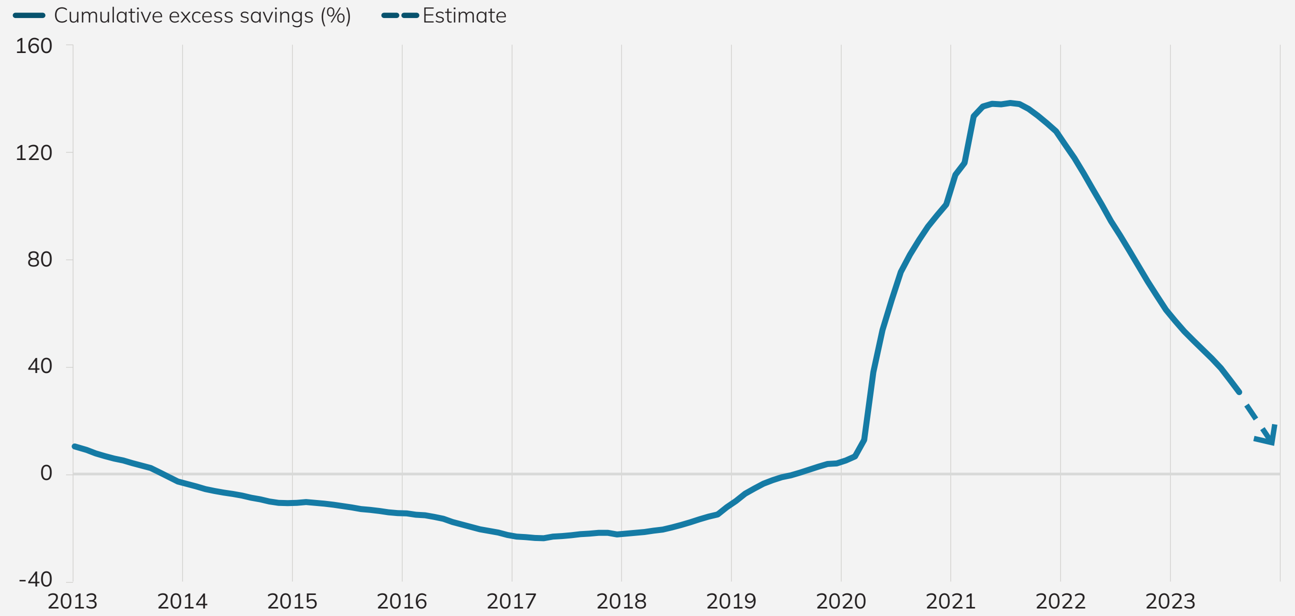
U.S. corporate credit has also remained unusually resilient. U.S. companies enjoy decades-low leverage levels and record-high interest coverage ratios. Compared with the last pre-recession period, an index of U.S. corporate loans is in better shape today, with approximately 50% of loans rated BB and about 10% rated CCC, compared to about 35% and 20%, respectively, heading into the Great Financial Crisis of 2007-08.

Some of this current business strength may be due to the wave of pandemic-era bankruptcies in 2020 that claimed the weakest or most COVID-sensitive companies, allowing survivors to prosper and even to lock in low borrowing rates in 2021. Inflation can be a positive for credit, given that nominal revenues and EBITDA (earnings before interest, taxes, depreciation and amortization) generally increase with rising prices—even if margins are compressed—while debt loads remain fixed. Finally, perhaps more time is needed for the typical bad corporate excesses that are usually seen late in a credit cycle to emerge.

U.S. fiscal largesse continues almost unabated—and is set to increase

A third explanation of the U.S. economy's resilience is the increasingly unsustainable fiscal largesse of its government. The long tail of various stimulus programs is contributing to the U.S. economy's continued growth, helping defy the historical recession playbook. U.S. federal government stimulus has contributed to the creation of excess consumer savings levels that are still being drawn down, acting as a cushion for consumer spending. That said, indications are that these excess savings are starting to run out.

Figure 7: Due to pandemic stimulus, U.S. consumers still have excess savings



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

Indeed, according to the Federal Reserve Bank of San Francisco, any excess consumer savings from pandemic-era stimulus will likely be fully depleted by the end of 2023.

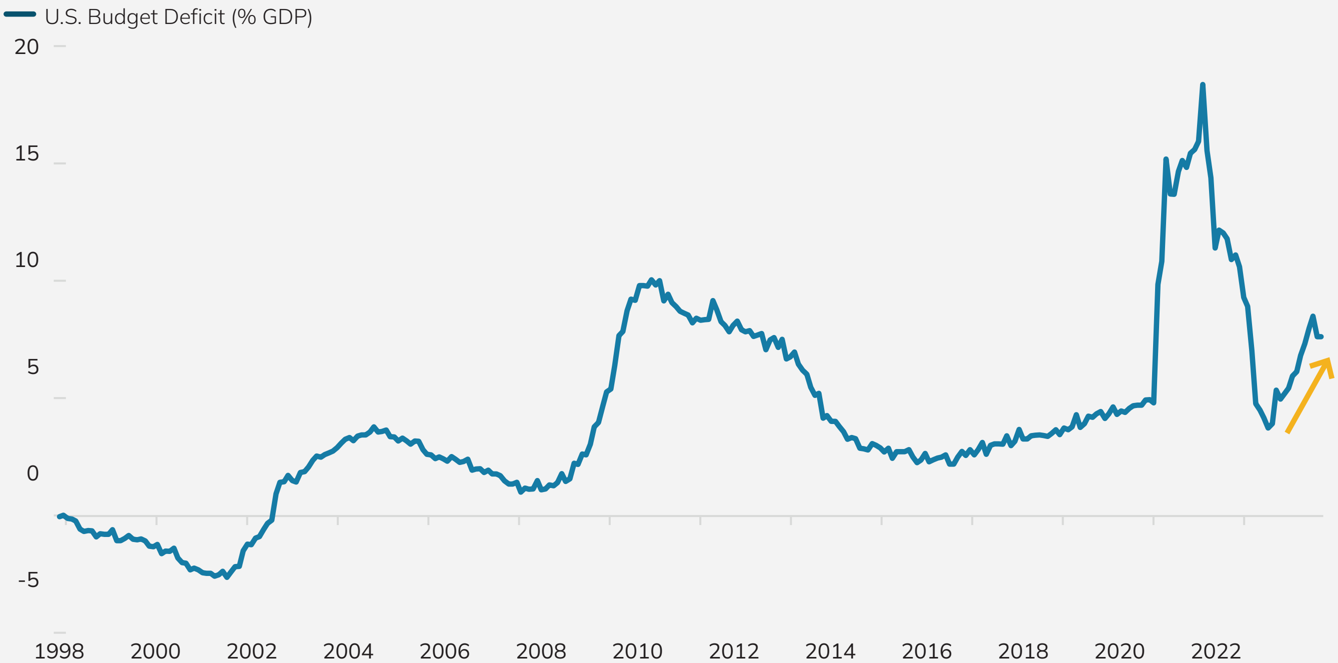
Our estimates suggest that a relatively small amount—around $190 billion—remains in the overall economy, and we expect the aggregate stock of excess savings will likely be depleted during the third quarter of 2023—that is, the current quarter—for which initial data will be released later.[1]

-Federal Reserve Bank of San Francisco

[1] Excess No More? Dwindling Pandemic Savings | San Francisco Fed (frbsf.org)

While the U.S. federal government's deficit spending has already been a tailwind for growth, it is now set to go into overdrive: the budget deficit is no longer falling and has reversed sharply higher this year. The Employee Retention Credit alone might put US$220 billion into the economy (with US$118 billion seen year-to-date). This more than offsets expected student loan repayments of US$70 billion that are about to set in.[2]

Figure 8: The U.S. budget deficit is increasing once again



Source: Bloomberg, L.P., PMAM research. Jan 1998 to Aug 2023.

Meanwhile, the recent Infrastructure Investment & Jobs Act, together with the Inflation Reduction Act, is expected to boost fiscal stimulus even further.

Consider the following quote from the CEO of Eaton Corporation, a power management company set to benefit from higher infrastructure spending:

> *"We're showing an updated look at expected spending tied to the Inflation Reduction Act. Most of the spending is focused on improving U.S. infrastructure. And as you can see, the estimates have increased significantly. At the time of passage, estimates on the cost impact, including credits and incentives, was $271 billion. The legislation was recently re-scored and government spending is now expected to be $663 billion, up nearly 2.5 times due to really what is an uncapped program. Importantly, these tax credits, because they're uncapped, are expected to continue to grow. These dollars are naturally a strong catalyst for infrastructure spending, much of it targeted at industries where Eaton will be a significant benefactor. The implementation of the IRA is in the very early stages, and we think will provide significant tailwinds over the next 10 years. Very little of this impact is currently in our order book and none of it has impacted revenue yet."*[3]

[2] Goldman Sachs, US Daily: The Surge in Student Loan Payments, September 1, 2023.
[3] Source: Eaton, Eaton Q2 2023 Earnings Call, August 1, 2023.

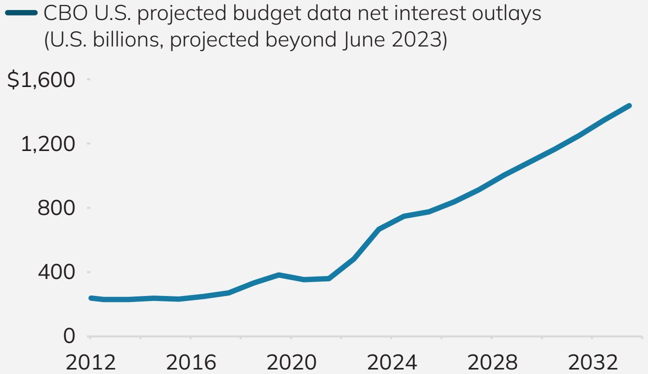
But U.S. budget deficits of this magnitude are unsustainable

We believe these levels of U.S. federal government spending are unsustainable. As of June 2023, the U.S. Congressional Budget Office (CBO) estimates that the national debt-to-GDP ratio is expected to reach an all-time high in just five years. Annual budget deficits are projected to rise over the next ten years, climbing from US$1.6 trillion in 2024 to US$2.9 trillion in 2033, with spending exceeding revenues by 40% that year. Relative to the size of the economy, the CBO projects that the nation's budgetary shortfall will climb from 5.8% of GDP in 2024 to 7.3% in 2033. Interest costs would nearly triple in the next decade.[4]

If this continues, trust funds for both Social Security and Medicare will likely deplete within the next decade or shortly thereafter. The CBO projects that the balance of Social Security's Old-Age and Survivors' Insurance (OASI) Trust Fund will be depleted in 2032. In addition, the CBO projects that Medicare's Hospital Insurance (HI) Trust Fund will be depleted shortly after the end of the ten-year period in 2033. The Highway Trust Fund is projected to be depleted in 2028.

This structural mismatch between federal spending and revenues, along with the recent rise in interest rates and therefore federal borrowing costs, will likely pose significant challenges if left unaddressed.

Figure 9: With rising rates, servicing U.S. debt is becoming increasingly expensive



Source: Bloomberg, PMAM research. Jan 2012 to Sept 2023.

In other words, the current fiscal largesse is like a sugar high for the economy: it can provide temporary enjoyment, and then potentially lead to a significant longer-term letdown. Moreover, at this point in the cycle, we believe this excessive spending is very counterproductive when the Fed is aggressively trying to slow the economy.

Upcoming election is a big incentive to keep the stimulus going

President Joe Biden is up for re-election in 2024. Few incumbents are re-elected in a recession, which means that the current administration has every incentive to keep the fiscal largesse going for at least another year. Strategas Research Partners argues that Biden has at least eight possible tools to prevent a pre-election recession: 1) drawing down the Treasury General Account (TGA); 2) continued coordination between Fed Chair Jerome Powell and Janet Yellen; 3) striking an accord with China to remove certain economic restrictions as Beijing boosts its stimulus; 4) automatic fiscal spending in the U.S. that starts in 2024 as part of earlier Biden directions; 5) minimizing student loan payments; 6) a bipartisan tax deal; 7) catch-up spending in 2024, should a government shutdown occur for any length of time in 2023; and 8) negotiating a Russia/Ukraine ceasefire that lowers commodity price premiums.[5]

While we believe that current levels of U.S. fiscal spending are unsustainable in the longer term, they are unlikely to be addressed in the next year ahead of the U.S. election. The impact on the economy will likely continue to be a positive tailwind in the short run, even as the Fed tries to slow things down.

[4] Congressional Budget Office, The 2023 Long-Term Budget Outlook, June 2023.

[5] Strategas Research Partners, Policy Outlook, September 13, 2023.

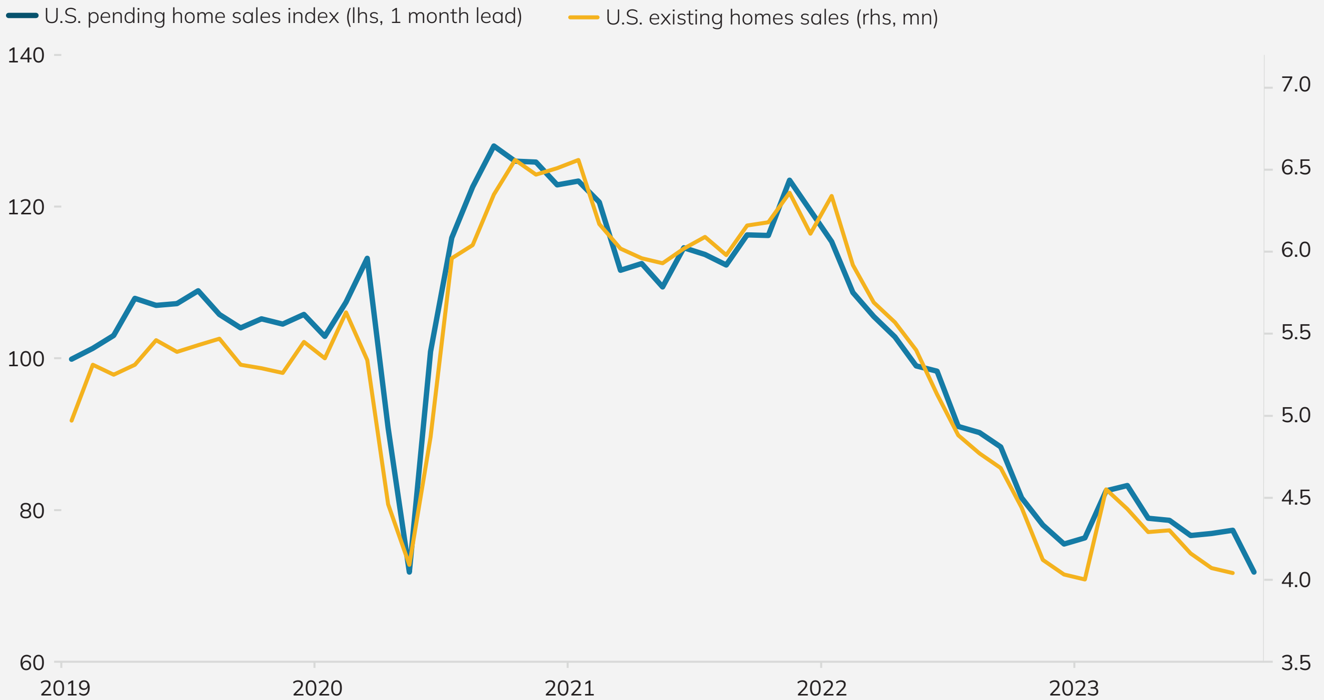
The Fed's lever is the labour market

Normally the Fed is expected to cut rates fairly quickly in response to disinflationary or recessionary signals; that was certainly the case when Alan Greenspan and Ben Bernanke were Chair of the Federal Reserve of the United States. But this time around, it appears that the bar for beginning rate cuts is higher, given concerns that current inflationary forces are more sustainable than those of the past couple of decades.

The Fed is less able to affect certain components responsible for this potentially more sustainable inflation. For instance, there is nothing that Fed Chair Jerome Powell and his colleagues can do to produce more oil, copper or other commodities that are in short supply now, and could become even more scarce when the economy recovers in the next cycle.

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 continue to increase. Existing homeowners may emerge virtually unscathed by rising rates—if they took on 30-year fixed mortgages when rates were low. But prospective homebuyers are faced with historic unaffordability, which has decimated home sales.

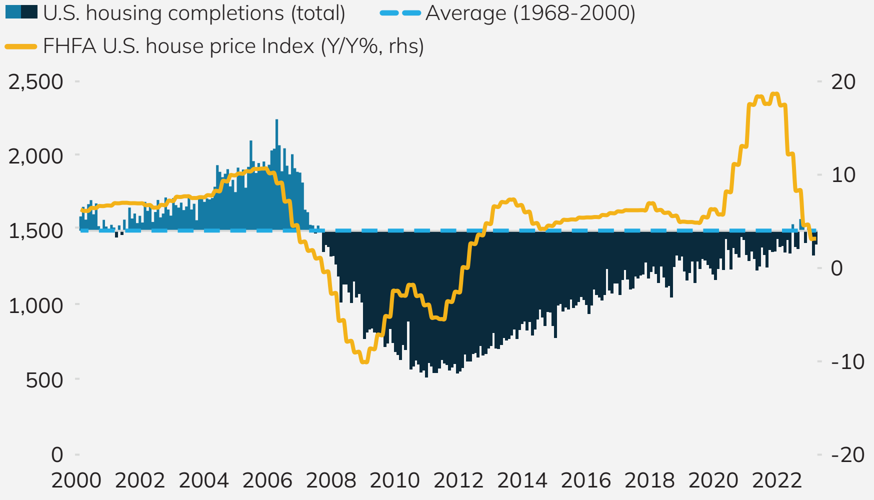
Figure 10: U.S. home sales have plunged due to high rates



Source: Bloomberg, L.P., PMAM research. Jan 2019 to Sept 2023.

Unfortunately, Fed policy is proving counterproductive in this regard. As a result of Fed hawkishness, the housing completion rate is stalling, and the problem of the underlying supply shortage is not being addressed. Instead, it is likely being exacerbated.

Figure 11: The U.S. housing market is still undersupplied

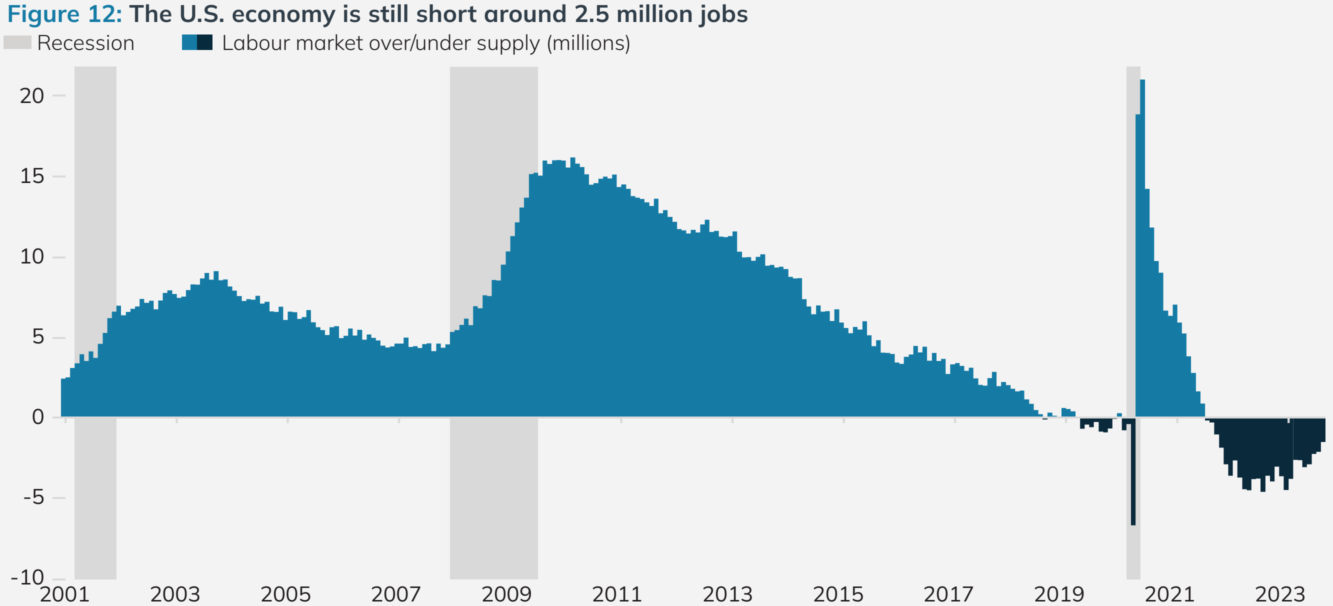


Source: Bloomberg, L.P., PMAM research. Jan 2000 to Aug 2023.

Labour market is a key focus for the Fed

What the Fed can affect more directly is the labour market, and that seems to be its best lever for bringing inflation back down to target levels. We believe that once the unemployment rate starts to rise and the open job rate has fallen to levels that better match the supply/demand for labour, the Fed's narrative will change and its mandate will become more balanced again, with rate cuts finally back on the table. However, we're not at that point yet. The U.S. economy is still short approximately 2.5 million jobs. That said, a fair amount of progress has been made in bringing the labour market back into balance, as that number peaked at 4.5 million open positions in the second quarter of 2022.

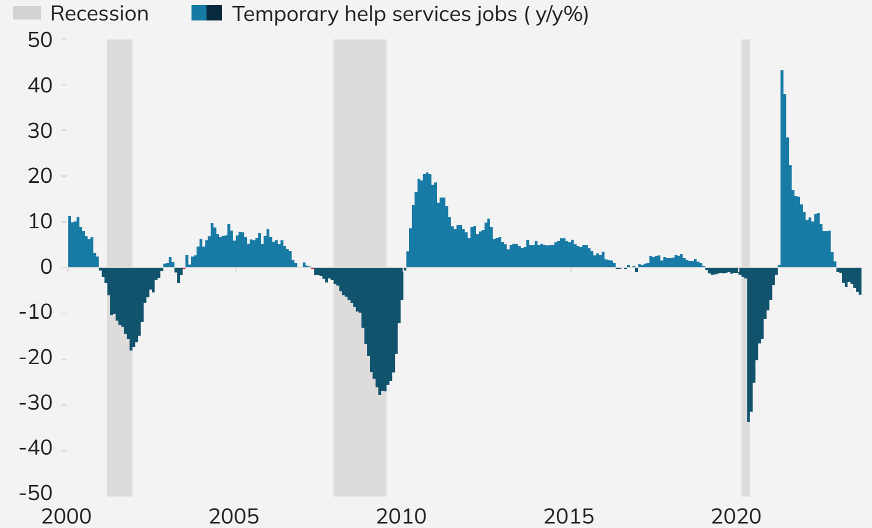
Figure 12: The U.S. economy is still short around 2.5 million jobs



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

So far, the Job Opening Rate has fallen without much of a rise in the unemployment rate. However, the fringes of the labour market are exhibiting more weakness, with a drop-off in both underemployment and temporary help. These are potential canaries in the coal mine, suggesting that slack in the labour market could soon broaden out.

Figure 13: Temporary jobs are on the decline, suggesting a weakening labour market

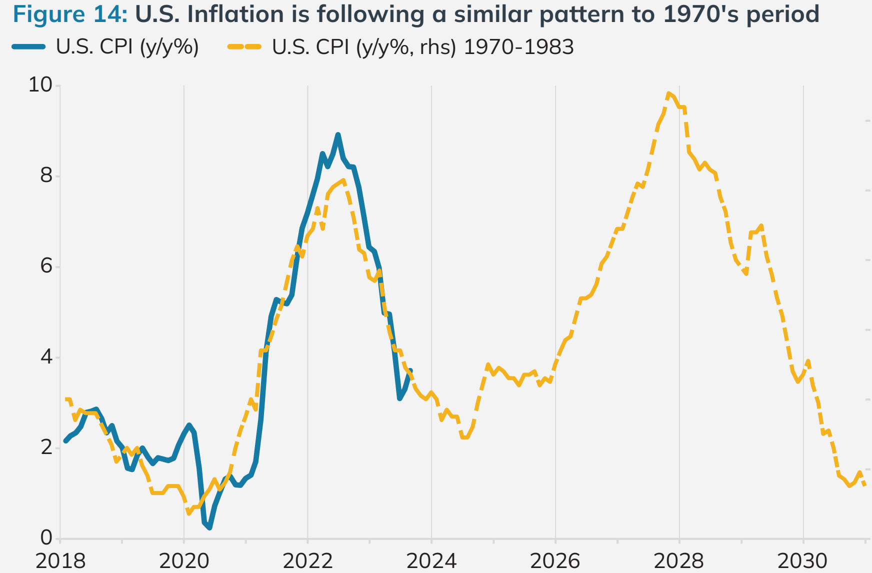


Source: Bloomberg, L.P., PMAM research. Jan 2000 to Aug 2023.

That '70s Show

These structural inflationary forces related to housing, commodities and even labour, to a certain extent, are similar to those that existed in the 1970's. At that time, the Fed was confronted by a quicker resurgence in inflation each time it tried to ease monetary policy. It took about a decade for these structural shortages to be addressed so that underlying inflationary forces could be quelled. During that period, the economy had much shorter cycles, which boosted the volatility of stock and bond markets. We think this 1970's pattern could repeat itself in this cycle, unless the Fed is intending to cause enough damage to the economy up front to allow supply to catch up with underlying demand.

Figure 14: U.S. Inflation is following a similar pattern to 1970's period



Source: Bloomberg, L.P., PMAM research. Jan 2018 to Aug 2023.

Why Powell won't back down from the inflation fight

The Fed is in a tough spot. Fed Chair Powell probably has a big personal incentive to ensure that inflation is quelled. As former Dallas Fed President Richard Fisher noted recently on CNBC, Powell has already made one mistake by assuming that higher inflation was "transitory." He will not want to go down as the central banker who gave up the inflation fight too early—and made a second career-defining mistake in the process.

Thus, the odds of an early cut are likely very low, unless economic conditions deteriorate considerably, possibly as a result of some unforeseen accident. In a subsequent CNBC appearance after the Federal Open Market Committee's (FOMC) decision on September 20, 2023, Fisher poured cold water on the notion that a Fed pivot is imminent, or that Powell will move the goal posts on the Fed's inflation target:

"The Chairman, and he's got unanimous support so far on the FOMC, is determined to make sure that they slay the inflationary dragon...They are now just trying to assess whether they need to go further, or whether they should pause. And if they pause, I think Chairman Powell made it very clear, they're going to pause for longer. They will not, despite market participants asking this question over and over again...they will not abandon the 2% inflationary target. He has two-and-a-quarter years left as Chairman. My strong personal feeling is that under his Chairmanship that [2% target] will not be abandoned...obviously the dot plot is signalling they might do another quarter, and 2024 is likely to be a period where they hold."[6]

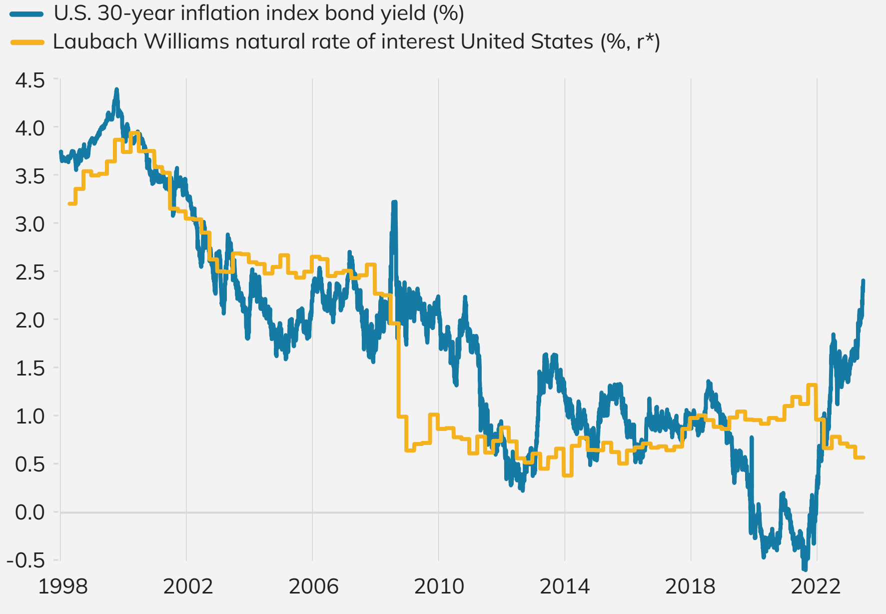
Accordingly, we think the market needs to build in a significant equity risk premium to account for Powell's slower reaction function in this cycle, compared with the past.

The Fed might turn the screws even more

While nominal interest rates have soared in the U.S., real rates have also increased considerably.

If inflation keeps falling, but the Fed continues to hike rates, real rates will continue to rise. Indeed, even if the Fed holds rates steady, falling inflation will likely result in higher real rates. Think of this latter scenario as Powell and colleagues being "passive-aggressive."

Figure 15: Monetary conditions are very restrictive on a real basis



Source: Bloomberg, L.P., PMAM research. Jan 1998 to Sept 2023.

[6] https://www.cnbc.com/video/2023/09/21/powell-will-not-abandon-2percent-inflation-target-ex-dallas-fed-president.html

But the rest of the world is more rate-sensitive—and other central banks are mirroring the Fed

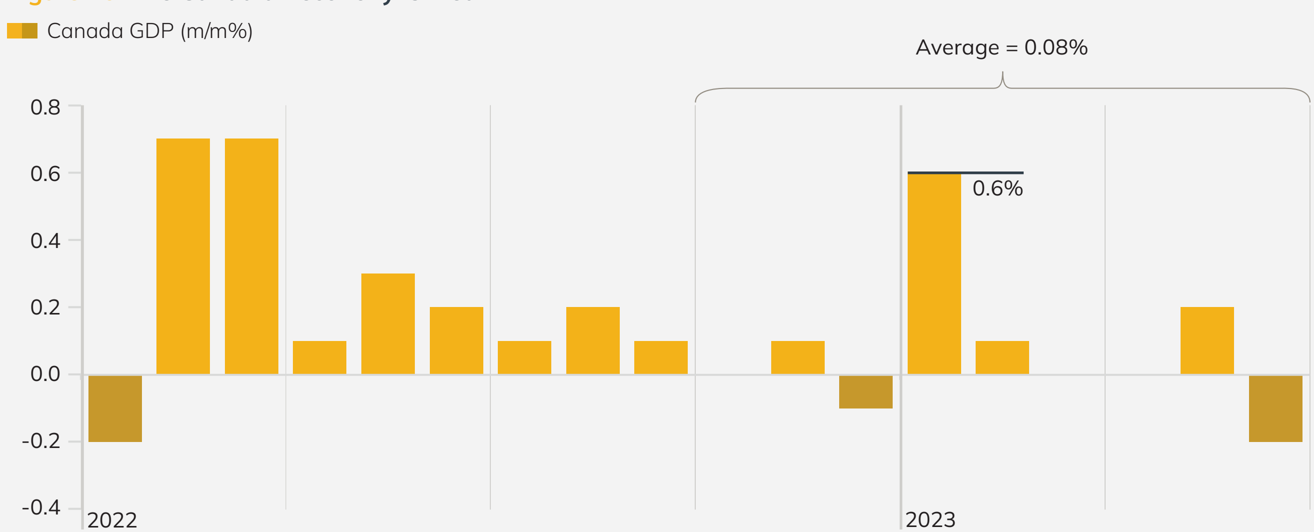
Powell's Fed has tightened monetary conditions considerably since 2022, and other central banks have followed suit, effectively mirroring U.S. policy. However, while the U.S. has some built-in resilience to handle a rate shock, other countries aren't in such a favourable position. This is why we believe that the U.S. resilience will translate to economic pain for the rest of the world.

The U.S. benefited from considerable fiscal and monetary stimulus during the pandemic. Other countries, however, did not enjoy that level of support. Nor did many other countries enjoy the favourable refinancing cycle that allowed consumers and corporates 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 toward a recession or deeper into one. In the second quarter of 2023, 28 countries, which together account for 19% of global GDP, had negative growth. Meanwhile many more are nearing zero growth.

Canada is a good example of a country in which keeping monetary policy tight is likely unsustainable, given poor or deteriorating economic data. In the second quarter, Canadian GDP growth dipped into negative territory. And over the last three quarters, there was only one month of strong growth, and that was back in January, which recorded growth of 0.60%.

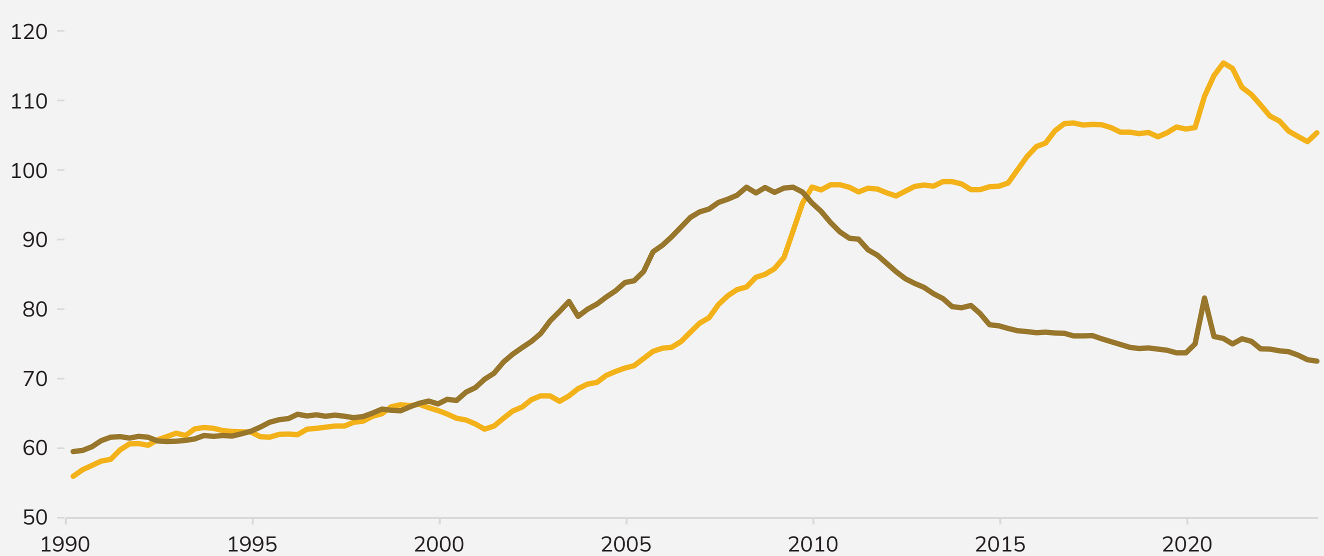
Figure 16: The Canadian econony is weak



Source: Bloomberg, L.P., PMAM research. Q1 2022 to Q2 2023.

Canadian households are much more indebted than their U.S. counterparts and don't benefit from 30-year fixed refinancing ability on their mortgages. Unfortunately, many mortgages in Canada have terms that are now rolling over, which is forcing homeowners to renew at much higher interest carrying costs.

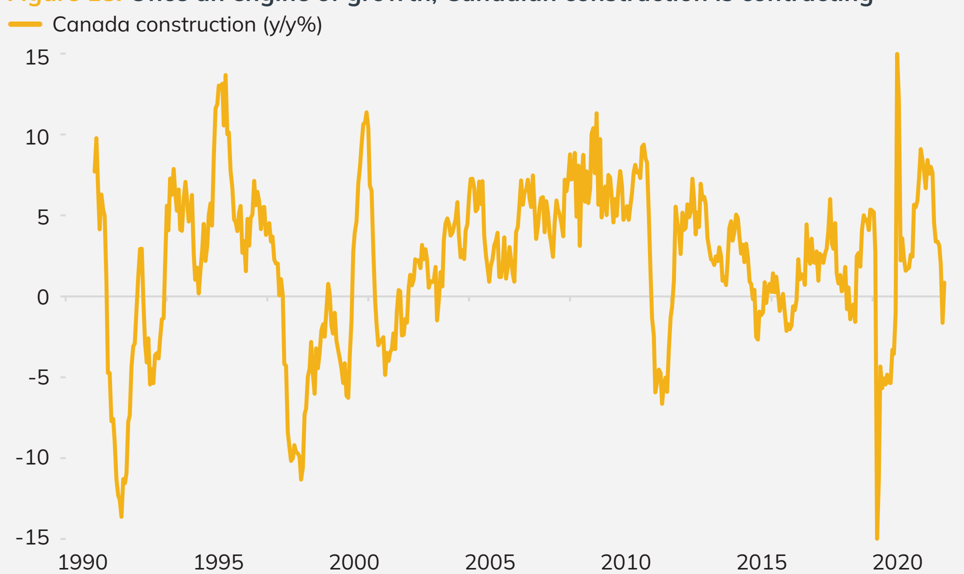
Figure 17: Canadian households are far more indebted than U.S. counterparts



Source: Bloomberg, L.P., PMAM research. Q1 1990 to Q2 2023.

With the full force of rate hikes starting to be felt, Canada's residential housing market is slowing. The booming construction industry recently posted its first month of contraction, suggesting that a key driver of Canadian economic growth may face significant headwinds.

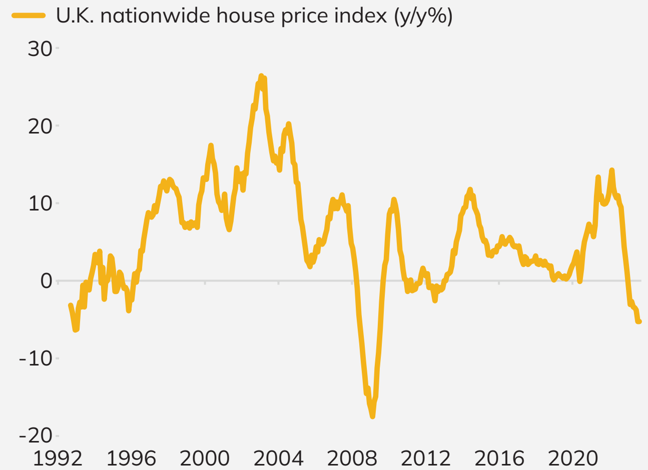
Figure 18: Once an engine of growth, Canadian construction is contracting



Source: Bloomberg, L.P., PMAM research. Jan 1980 to Aug 2023.

In the U.K., the situation is even worse. U.K. households face even shorter mortgage refinancing terms, which typically leads to a quicker push-through of higher rates. That is now being reflected in falling house prices.

Figure 19: The air is coming out of the U.K. housing market

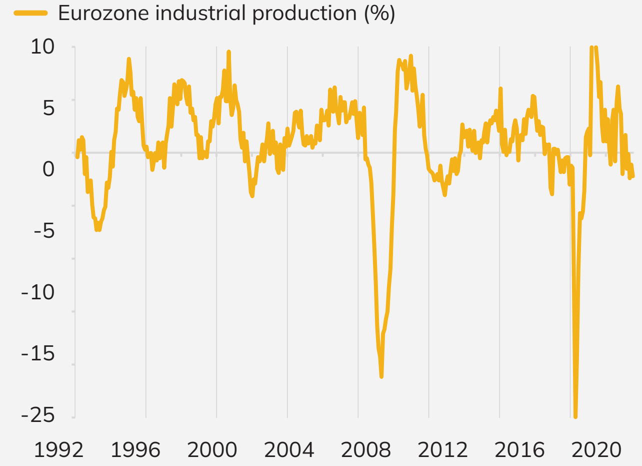


Source: Bloomberg, L.P., PMAM research. Jan 1992 to Sept 2023.

In Australia, low rates led to an explosion of fixed-rate borrowing and refinancing, with many households locking in their rates for two to three years. By mid-2021, about 45% of new loans being written were fixed. Fast-forward to 2023, and 880,000 fixed loans written at rock-bottom interest rates are set to switch to much higher variable rates. The Reserve Bank of Australia estimates that 90% of the fixed-rate loans rolling off this year or next will have mortgage repayment increases of at least 30%. As a result, the country is seeing mortgage risk rising to levels not seen in over a decade.

Europe is also challenged, as it is also fighting high inflation with higher interest rates. Having had negative rates, this hawkish shift is a bitter pill for the European economy to swallow. Several E.U. countries posted negative growth in the second quarter, with industrial production falling for the eurozone as a whole.

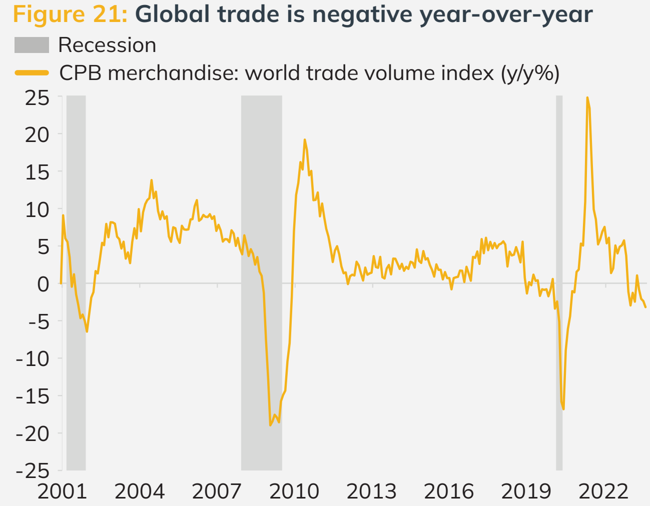
Figure 20: European manufacturing output is falling



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

On a volume basis, falling global trade levels suggest the global economy is at real risk. Asian demand has been particularly weak, as indicated by negative import growth numbers in the largest economies there.

Figure 21: Global trade is negative year-over-year

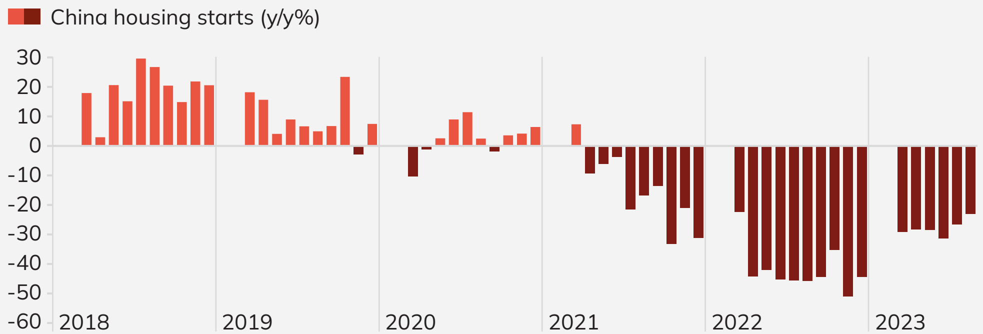


Source: Bloomberg, L.P., PMAM research. Jan 2001 to July 2023.

China's recovery is tepid at best

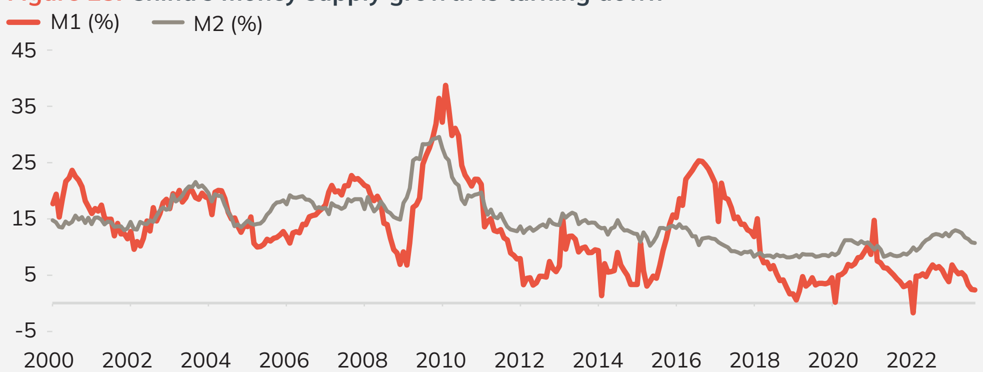
All eyes were on China's reopening earlier this year, but the recovery has quickly fizzled. New stimulus has been focused on the wilting housing sector, but even that has been limited, and housing construction remains in deep contraction.

Figure 22: Chinese housing construction is down sharply



Source: Bloomberg, L.P., PMAM research. Jan 2018 to Aug 2023. Data for Jan and Feb are omitted as the timing of Chinese New Year impacts the data.

Figure 23: China's money supply growth is turning down



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

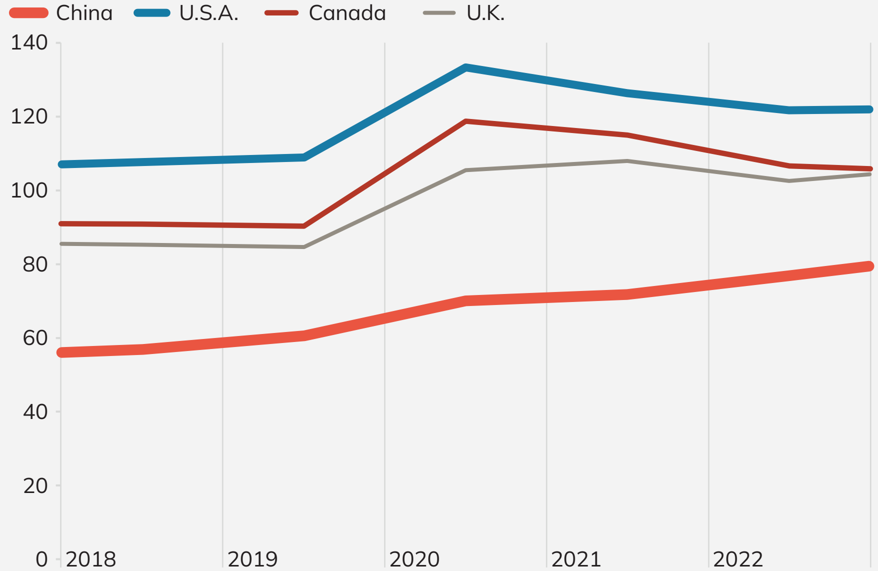
Figure 24: The credit impulse has run its course without much impact on growth

Source: Bloomberg, L.P., PMAM research. Jan 2012 to Aug 2023.

Could China become the next economic accident?

On the surface, China's government debt situation looks reasonable compared with the rest of the world. However, the country's general government debt ratio only includes central and local debt.

Figure 25: On the surface, China's government debt looks manageable (Government debt to GDP %)



Source: Bloomberg, L.P., PMAM research. 2018 to 2022.

Beneath the surface, a more worrisome picture emerges

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. Despite making up only one-third of China's corporate issuers, State Owned Enterprises (SOEs) account for a staggering three-quarters of the total debt (almost US$12 trillion). The problem is that most of these SOEs—especially the smaller ones—don't generate much in the way of profit. In fact, the bottom 90% 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 on the mind of many investors. In 1995, China passed a budget law that forbade local governments to issue bonds, borrow or incur deficits. However, in 2008, in order to support the four trillion RMB stimulus package, many local governments set up these LGFVs as a way to borrow money without violating the rules. Some of these funds came from banks, but a lot 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 (US$4.75 trillion). Some experts believe, however, that the true figure could be three times the official estimate. The upshot of all this: China's debt-to-GDP may be approaching 200%, if we factor in central government, local government, and SOE debt.[7] If loan defaults start to mount, the Chinese government will likely be faced with some hard choices, and it is not clear how it might best proceed. And the recent difficulties of certain Chinese property developers might force the Chinese authorities to make these tough decisions sooner than expected.

[7] Apollo Global Management, Outlook for China, September 2023.

Accident watch in effect

We are concerned that tight U.S. monetary policy and a stronger U.S. dollar may contribute to an unsustainable situation that finally buckles, and potentially even "breaks." The longer this lethal combination continues, the more likely it is that some sort of economic or market vulnerability will be exposed.

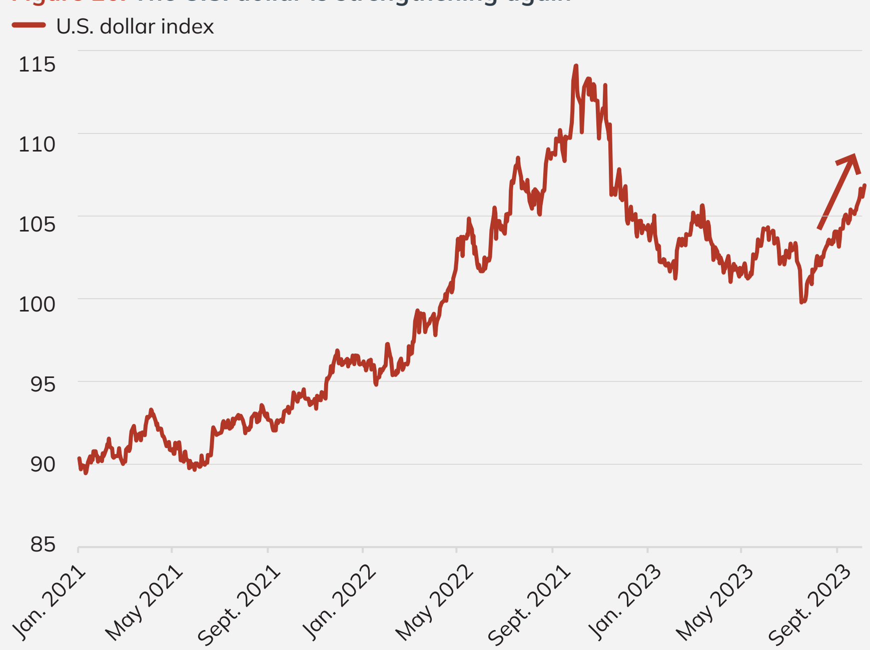
Perhaps it will echo the situation in 1997-98, when a surging dollar and capital outflow wreaked havoc on East Asian economies. Alternatively, it may be that we're in for an episode similar to the fourth quarter of 2018, when equity markets got slammed on fears the Fed had overestimated the level of the neutral rate as it aggressively tightened monetary policy.

Whatever happens, we believe any accident would have to be very material for the Fed to suddenly ride to the rescue as quickly as it has done in previous episodes. This change of central bank character adds another element of risk for market participants.

A strong U.S. dollar will add to global woes

The U.S. dollar has rebounded from its July lows. We believe it will continue to strengthen, given our expectations of growing economic divergence between the U.S. and the rest of the world, which will likely result in higher-for-longer interest rates in the U.S., widening rate differentials and a higher greenback.

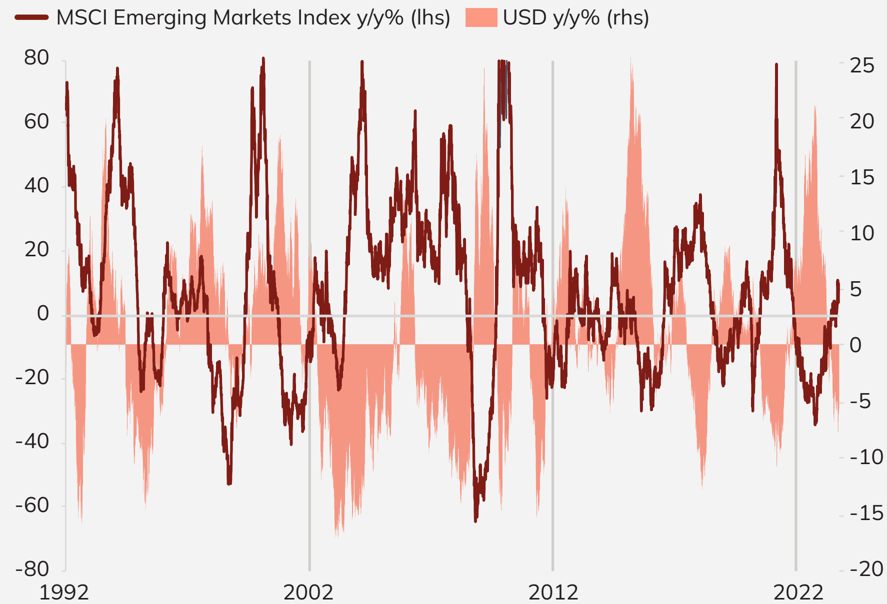
Figure 26: **The U.S. dollar is strengthening again**



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

If we look at historical precedents, a rallying U.S. dollar, combined with tighter monetary policy, is typically a negative double whammy for many countries around the world. Many emerging market economies, in particular, tend to suffer disproportionately.

Figure 27: A rallying dollar usually means falling emerging market stocks



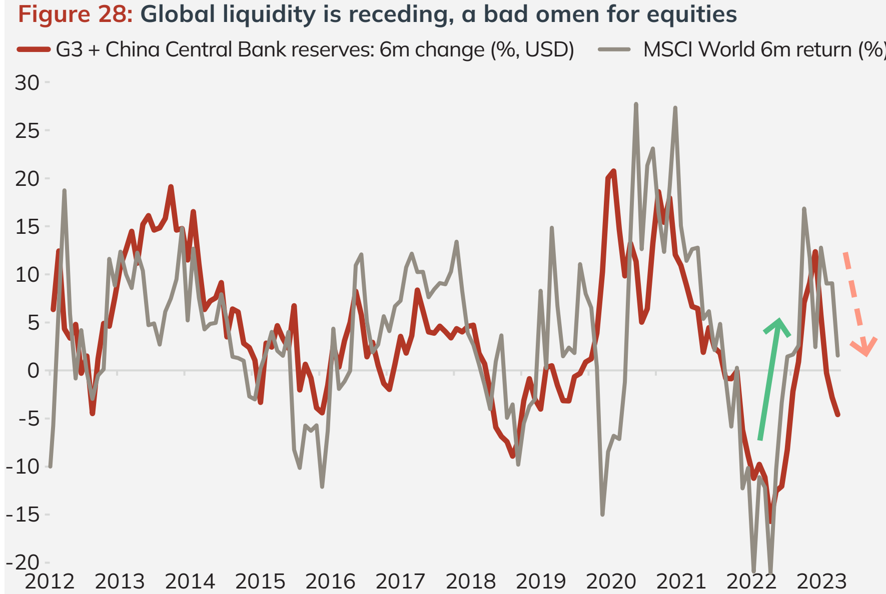
Source: Bloomberg, L.P., PMAM research. Jan 1992 to Sept 2023.

Equity markets face numerous headwinds

Given surging interest rates and the signals flashing "recession," we remain concerned about the risks in global stock markets. Compounding this is the fact that the current setup for equities is far from ideal.

For starters, global liquidity is being drained from the economic system. What was once a tailwind for stock markets has now become a headwind.

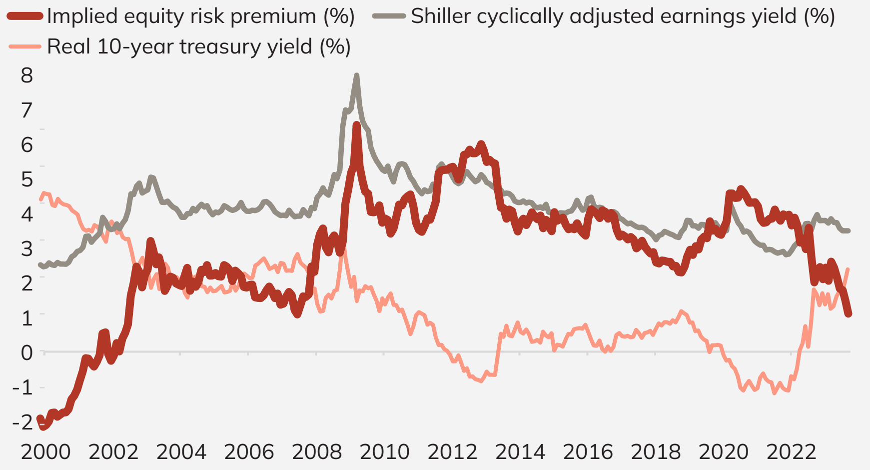
Figure 28: Global liquidity is receding, a bad omen for equities



Source: Bloomberg, L.P., PMAM research. Jan 2012 to Sept 2023.

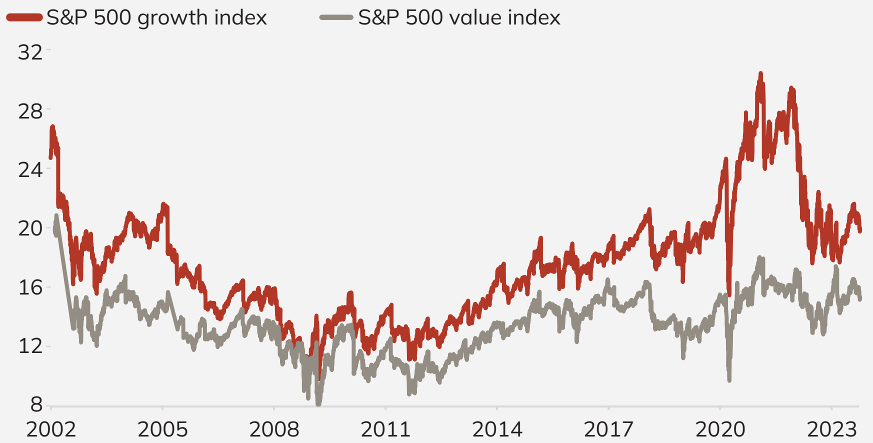
Valuation isn't a friend of the equity markets, either. Price-to-earnings (P/E) multiples remain elevated, even as long-term interest rates have risen. This leaves the implied equity risk premium sitting at lows last seen in 2007.

Figure 29: The implied equity risk premium is at 2007 lows



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

Figure 30: Valuations are elevated for growth, subdued for cyclicals (forward P/E ratio)

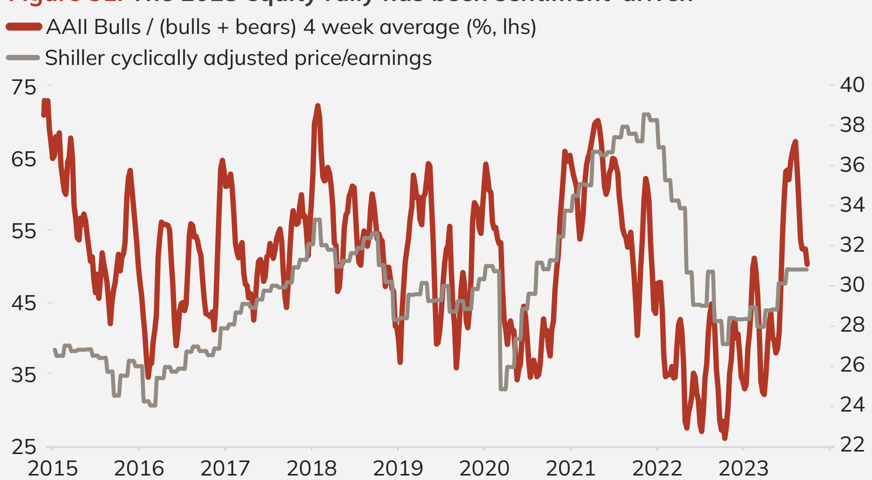


Source: Bloomberg, L.P., PMAM research. Jan 2002 to Sept 2023.

Valuations are most elevated among the large-cap technology leaders, which can likely sustain their growth, and tend to perform well when the economy is slowing. Valuations are cheaper in more cyclical value stocks, but their earnings are obviously much more vulnerable to potential recession. As a result, both present a dilemma for investors at this point.

The summer rally appears to have caused some investors with a bearish view to throw in the towel. As 2023 has progressed, they have become more bullish about the prospects for equities. Investor sentiment had also spiked toward bullish extremes, but now appears to be reversing.

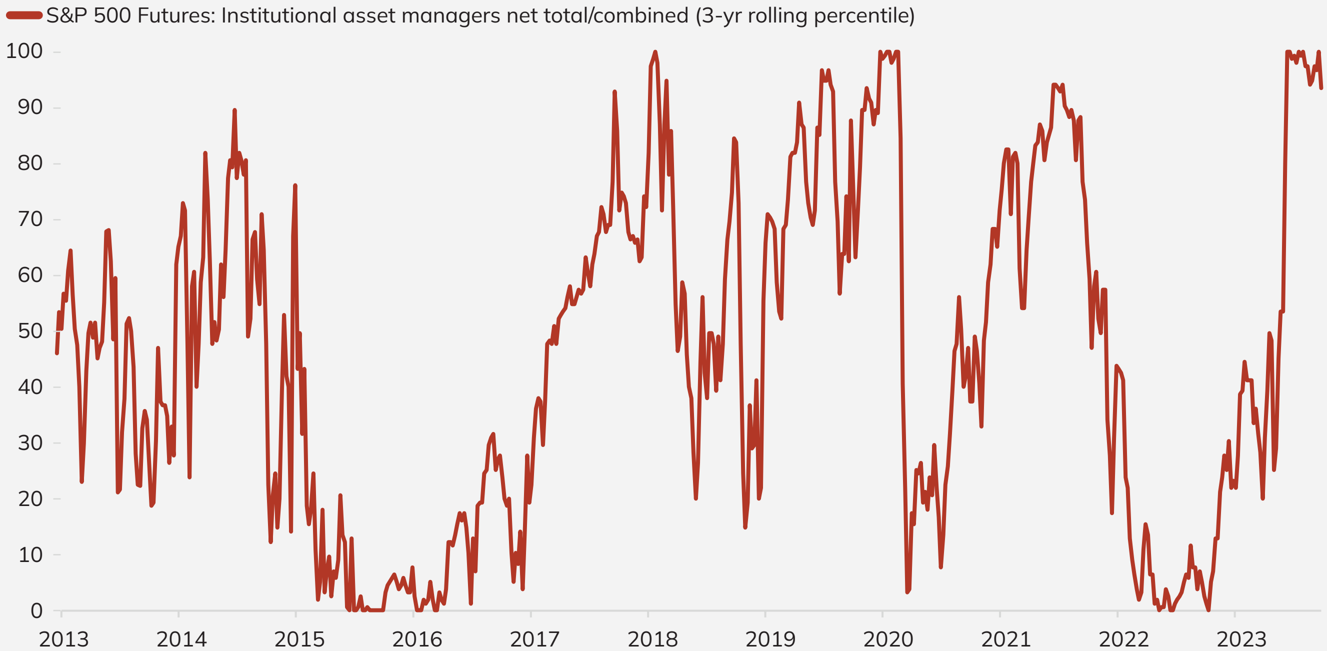
Figure 31: The 2023 equity rally has been sentiment-driven



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

Systematic trend-following strategies have also been pulled into the equity market and are now much longer stocks than they have been for the past year. These strategies have been close to maximizing their long positions in mid-summer, although it has backed off recently. These strategies are still potentially significant sellers of stocks on further market weakness or volatility spikes. Another key tailwind for equities appears to now be in the rearview mirror.

Figure 32: Positioning is close to maximum long (and rolling over)



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

Conclusion

Despite significant monetary policy tightening, the U.S. economy remains reasonably buoyant, defying the historic playbook. While a U.S. recession at some point over the next year can't be ruled out, the rest of the world's economy is already teetering. While the Fed may raise rates further—or at least maintain a higher-for-longer regime—other central banks are increasingly seeking to ease monetary policy. This is a recipe for a potential U.S. dollar breakout. Even at the best of times, a stronger dollar isn't ideal for the global economy. But we think it's of particular concern given the weakening global backdrop.

We believe stock markets are grinding their way through a longer-term trading range as the market adjusts to higher interest rates. At current levels, we would wait for better opportunities to emerge before adding to positions in equities. However, there is the potential for an accident in global stock markets, especially if the U.S. dollar breaks out, that could expose underlying vulnerabilities or weak links in one or more regions or sectors of the globe.

Sector outlooks

Industrials

More recently, we've seen cyclical names rally and then dip on the view that the cycle could be bottoming out balanced by the view that rates may be 'higher for longer', leading to further weakness. Erring on the side of conservatism, we have recently made cautious increases to our short positions in more expensive multi-industrial/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 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. Despite near-term macro weakness, we remain bullish on the industrial leasing complex in the long term. We believe the names we hold that are exposed to rentals will continue to outperform over the longer term. We've hedged the cyclicality of rentals with less attractive names that have similar exposures. Lastly, we see potential downward earning revisions across airlines and have added to our short positions accordingly.

Materials

The S&P/TSX Materials sector ended down 4% for the quarter, largely in line with the broader S&P/TSX Composite Index. After the market sell-off in the second quarter, the Materials sector initially rebounded in July, before fading over the subsequent two months. Fertilizer equities outperformed the sector on optimism that commodity pricing and earnings estimates had bottomed out, along with stronger seasonal restocking and supportive valuations. Lumber names gave back most of their second-quarter outperformance vs. the sector, as the housing market slowed and forest fire risks ebbed. Copper equities were flat: weak operating results and macroeconomic concerns were offset by a bullish structural thesis outlook for the copper supply/demand balance and merger and acquisition (M&A) interest. Precious metals equities were under pressure as higher rates and a stronger U.S. dollar weighed on the price of gold.

In the near term, we expect macro risks to persist for copper, particularly due to the ongoing slowdown in China. However, we continue to believe the demand picture has remained stronger than the market appreciates, and we think ongoing M&A interest could support higher through-cycle valuations. We expect gold to remain range-bound as we await indications of a dovish pivot by the U.S. Federal Reserve (Fed). We note that sentiment on gold equities remains negative, so any improvement in the gold price could be compounded by investors re-engaging in the sector. While valuations for both lumber and fertilizer equities appear attractive, we are waiting for clearer signs that the underlying fundamentals have bottomed.

Information technology

The MSCI World Information Technology Index declined 6.7% for the third quarter of 2023, while the Information Technology sector in the S&P/TSX Composite index decreased by 7.6%. Sector performance moderated after three strong quarters in a row. The best-performing subsector was Interactive Media and Services, up 7.6%, led by Alphabet Inc. (NASDAQ:GOOGL), followed by Communications Equipment, up 3.1%, led by Arista Networks Inc. (NYSE:ANET). The weakest subsectors in the third quarter were Technology Hardware, down 11.4%, and Electrical Equipment, down 7.2%, led by weakness in HP Inc. (NYSE:HPQ) and Keysight Technologies Inc. (NYSE:KEYS), respectively.

Our outlook for Information Technology in the fourth quarter of 2023 remains one of relative caution, as macroeconomic factors may cause companies to be conservative in overall technology spending until 2024. Software companies continue to experience elongated sales cycles along with additional approvals required to close deals. Several networking companies are performing adequately but mostly due to backlog reductions from oversized orders placed in prior periods when products were supply constrained. As those constraints have eased, customers are not placing new orders at the same rates as before which could impact revenue growth in 2024. Some smaller networking equipment vendors have already reported weakness due to spending cutbacks from North American service providers. In the Semiconductor subsector, we focus on secular themes such as AI infrastructure buildouts and silicon carbide adoption while balancing that with some exposure to companies that could benefit from a cyclical recovery. On the positive side, AI monetization opportunities are emerging in the Software subsector as companies begin to launch AI capabilities in the fourth quarter of 2023. We will be monitoring this sector for additional beneficiaries as AI infrastructure continues to ramp up.

Health care

The S&P 500 Health Care sector, down 5.0% year-to-date (YTD), underperformed the overall S&P 500 Index, up 12.1%. Underperformance was seen across most of the subsectors, driven by macro and industry-specific factors. This underperformance is expected to continue to year-end 2023, and a recovery, at least in some subsectors, is expected to begin in the first half of 2024. Factors weighing on sector performance are consistent with the previous quarters, with new additions: China's anti-corruption investigation into procurement at hospitals, a weakening Chinese economy, and positive trial results for obesity drugs. Other factors include macro rotations, recession landing, presidential election-related anxieties, research funding, drug price legislation, uncertainties related to the Inflation Reduction Act (IRA) and regulatory risks with M&A activities.

In August, Novo Nordisk A/S (DC:NOVOB; up 36.7% YTD) released top-line results showing cardiovascular benefits from its glucagon-like peptide-1 (GLP-1) anti-obesity drug, Wegovy, resulting in the outperformance of some related stocks and the underperformance of obesity-leveraged stocks, primarily small and mid-cap (SMID-cap) medical technology diabetes/insulin device and sleep apnea names, which were down 19.4% overall. At several broker conferences, company management attempted to soothe concerns regarding the disruptive impact of GLP-1s, but the spread between the GLP-1 winners and losers continues to widen. The negative stock reaction of GLP-1 risk names appears to have been excessive, since the penetration of anti-obesity drugs is in its very early innings (only about 0.5% penetration in the U.S.), and will likely face several headwinds related to cost, reimbursement, side effects, weight gain on cessation of the drug and the downstream sequelae of the disease that take many years to manifest, and on which the use of GLP-1s will not have a near- or mid-term impact. One of the near-term negative impacts has been on bariatric surgery procedures with patients choosing to try the pharmaceutical before undergoing surgery. However, this is likely a postponement rather than a cancellation, as many candidates will not likely persist in taking an expensive medicine and will regain weight.

The increased utilization theme (elective procedures) helped related providers and select medical technology companies over the first half of 2023. The theme now appears to be fading, pressuring the providers, which have fallen by the mid to high teens from their June highs. There is ongoing debate about durability of healthy volume growth for hospitals, and whether the normalization/backlog contribution will continue in the second half of 2023 and into 2024, although the providers, payors and device companies were consistent about weakness in their respective subsectors in the third quarter as a matter of normal seasonality. Regarding the procedure backlog, the orthopedic device companies believe that a backlog recovery is likely to persist for at least the next six quarters. Managed care has reversed much of its underperformance (down 4.09% in the first half of 2023 and up 4.5% in the third quarter), largely due to in-line utilization trends and rotation into more defensive health care stocks.

The life sciences and tools subsector, down 9.8% YTD, continues to be pressured by bioprocessing destocking, a weak biotechnology funding environment and weakness in both the Chinese contract manufacturing subsector and the Chinese economy broadly. Bioprocessing destocking is expected to abate by the late second half of 2023, with recovery starting in early 2024. Bioprocessing-leveraged stocks are generally down, on average, in the high single-digit range. The capital equipment segment remains soft due to a continuing weak funding environment.

The macro environment and anti-corruption investigations in China are a new source of uncertainty in several health care verticals, which are citing a negative impact of uncertain duration on revenue growth. The life sciences tools/contract manufacturing companies noted that growth is likely to be flat in 2024 because of a challenged funding and orders environment. China's anti-corruption enforcement campaign is expected to disrupt capital expenditure (capex) and orders in the near term (one or two quarters, based on the last anti-corruption campaign), and will likely affect medical technology companies. The anti-corruption investigation is also slowing down the procedure volumes. The near-term macro outlook, competitive challenges and VBP (volume-based procurement) action is also having an impact on consumer-facing companies and could disadvantage multinational dental brands.

Consumer discretionary

The third quarter saw broader economic concerns filter through into the Consumer Discretionary sector. Although second-quarter earnings were reasonably solid, management teams across the board cited an increasingly "choppy" consumer in August, representing the first real note of caution related to consumer spending heading into year-end. Employment levels remain high, which supports ongoing discretionary spending. However, excess COVID savings have been meaningfully depleted (particularly for low-income households), personal savings rates are running below their long-term averages, and credit card delinquencies are starting to move higher.

With student debt repayments also now resuming, it is difficult to envisage an acceleration in holiday spending this year, and we anticipate a volatile fourth quarter for Consumer Discretionary stocks. Market positioning will be important in the near term and could potentially distort how stocks react to changes in fundamentals, both positive and negative. In the longer term, we remain focused on idiosyncratic growth stories with positive change dynamics, companies that are less reliant on tailwinds from the U.S. or Canadian consumer, especially heading into 2024. These include stocks such as Thomson Reuters Corp. (TSX:TRI) and Restaurant Brands International Inc. (TSX:QSR). We will also seek to make opportunistic additions to small positions in cyclical positive change stories, should a soft landing begin to appear more likely.

Consumer staples

Performance by the Consumer Staples sector has diverged notably in Canada and the U.S., with the Canadian sector modestly outperforming the S&P/TSX Composite Index by 2% in the third quarter, while in the U.S., the sector continued to significantly underperform the broad market, by 2% in the third quarter and about 18% YTD.

U.S. Consumer Staples initially outperformed at the start of the year on recession fears; however, the U.S. economy has managed to avert a recession so far, leading to rotation out of defensive stocks. Rising rates have also hurt the sector, as Consumer Staples act as bond proxies. Top-line growth is slowing for the grocery industry after a couple years of outsized growth driven by inflation-induced pricing. A new development in the sector has been the rise of weight loss drugs, which is leading to concerns about the long-run consumption of salty snacks and sugary drinks and putting additional pressure on the sector.

In Canada, Alimentation Couche-Tard Inc. (TSX:ATD) has driven the bulk of the outperformance in the sector. Fuel margins for convenience stores have structurally increased as smaller operators in the industry feel heightened pressure from labour costs and declining tobacco consumption and try to offset these pressures with higher gasoline prices. Larger players like Alimentation Couche-Tard are better able to mitigate labour and tobacco headwinds and see an outsized benefit from higher industry fuel prices.

Financials

The year 2023 continues to be a rollercoaster 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 that resulted in a handful of banks being put into receivership by the U.S. Federal Deposit Insurance Corporation. These truly unprecedented bank runs sent shock waves throughout the global banking landscape. Although the bank failures were arguably idiosyncratic, the events further strengthen our view that the banking system remains at risk of deposit flows and a remixing into higher costs of funds, given the monetary policy tightening at play, including ongoing quantitative tightening. We remain cautious on banks: yield curves remain inverted, net interest margins have peaked and are declining, loan growth is moderating, deposits are scarce and remixing, credit losses are trending higher, and capital levels remain relatively thin—something with which regulators on both sides of the border increasingly seem to be taking issue.

Additionally, we believe that there will be a few major repercussions over the medium term resulting from the regional bank liquidity crisis. For mid-sized regional banks, liquidity rules are being tightened, and banks with over US$100 billion in assets will no longer be able to opt out of including unrealized losses on available-for-sale securities in capital. This has driven the sector to conserve capital and reduce the extension of credit, tightening lending standards. We also believe that the ongoing tightening of lending standards will play a part in tightening financial conditions and stoke the credit cycle. Areas such as consumer finance are quickly shifting from post-COVID credit “normalization” to “deterioration.”

We favour less credit-sensitive companies with good idiosyncratic growth tailwinds, irrespective of the macroeconomic backdrop.

Communication services

At the aggregate level, it was a difficult quarter for the Communication Services sector as an equally 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) fell by 1160 basis points (bps), underperforming the S&P/TSX Composite Index by about 940 bps. We are attributing the bulk of the underperformance to the significant move of about 75 bps in the Canadian 10-year bond yield.

On the operations side, we had previously said: "While we are not dismissing some of the concerns that have emerged and that we are monitoring, we are currently confident that the chances of sliding into a price war are low." Consistent with our expectation, the back-to-school period has not been marked by any dramatic pickup in promotional activity. Looking ahead, we remain comfortable with our outlook, which is for strong growth in net adds, driven by immigration and flattish average revenue per user.

Utilities

It was a second straight quarter of underperformance for the Utilities sector, which declined by about 1200 bps, lagging the S&P/TSX Composite Index by about 970 bps. As with telecommunication companies, we attribute a lot of this underperformance to the decline in Canadian 10-year bond yields.

With low bond rates ending, we believe it is important to focus on stories that have strong balance sheets which can fund growth. We believe there are opportunities to be selective. That said, for the sector, we don't think our interest returns until bond volatility subsides.

Real estate

Following a weak second quarter, when REITs underperformed the S&P/TSX Composite Index by about 460 bps, REITs had another soft quarter, underperforming the S&P/TSX Composite Index by about 70 bps. In the context of the yield-sensitive complex, however, REITs had a better quarter. Notwithstanding this relative outperformance, we remain concerned about the impact of "higher for longer" interest rates on both earnings and asset valuations, and therefore remain cautious and selective in our selection.

Energy

During the summer, oil prices experienced a substantial surge, driven by a tighter physical market. The shift in market sentiment toward a soft landing for the U.S. economy, combined with Saudi Arabia's extension of production cuts, further bolstered crude markets. While the notable upswing in oil prices is a positive development for energy producers, sustained high price levels could affect inflation and raise concerns about stagflation in the global economy.

For exploration and production (E&P) producers, the prevailing theme continues to be the prioritization of returning capital. Conversations regarding growth capital expenditures remain limited, primarily among smaller producers and those focused on natural gas. Moreover, with improved sentiment in the energy complex, we anticipate a resurgence in mergers and acquisitions activity. Two driving factors behind this consolidation trend are the increasing importance of size for relevance in capital markets and the need for enhanced market positioning in anticipation of Canada's Liquefied Natural Gas (LNG) developments.

Our outlook continues to favour E&P producers over energy infrastructure. In comparison with the previous surge in commodity prices in 2022, energy producers' balance sheets are now in even better shape. With the upturn in commodity prices, the prevailing expectation is that the majority of producers will channel excess free cash flow toward shareholder returns, primarily through normal course issuer bids and, in certain cases, shareholder issuer bids.

In contrast, the largest energy infrastructure companies have struggled to deleverage their balance sheets since the pandemic, resulting in limited buyback initiatives. Key names that continue to stand out in this landscape include MEG Energy Corp., Canadian Natural Resources Ltd. and, recently, Imperial Oil Ltd.

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