Let the Good Times Roll

The historically strong end to 2023 continued through the first quarter of 2024. Global stocks posted a 9% gain in three months, exceeding average long-term annual stock market returns, in just a quarter of the time. Canadian equities delivered 6.6% for the quarter, leading other developed and emerging market indices but once again trailing the U.S. market total return of 10.6% over the same period. Gains in Canada were led by the sectors we are best known for globally, resource driven energy and materials, while the biggest drags on the TSX were sectors once counted on for leadership in the not-too-distant past including telecom and utilities.

Unlike the widespread gains to end last year, global bond markets treaded water to begin 2024, with the Canadian bond market falling 1.2%. Optimism for March interest rate cuts entering the year were quickly replaced by real time central banker decisions to stay higher for longer, leading to global bond market weakness. In our last quarterly update, we outlined "what if all the reshoring of industry to the U.S. and other developed country allies actually results in ongoing labor market strength… and a re-accelerating economy? This is our chief concern". It appears the likelihood of this path is increasing as time passes. An accelerating economy does not necessarily lend itself to aggressive rate cutting.

A Beacon of Light

A rematch of the 2020 election appears to be imminent. We have many clients remark that this feels like crazy town, and yet the U.S. economy is the beacon of light amidst weakness in much of the developed world.

Canada's GDP contracted in Q3 2023 before posting a 1% annualized growth rate in Q4. The investment community continues to believe growth in Canada will remain muted, at or below 1% in the coming quarters as a result of high consumer leverage, high costs to finance this debt, high prices from two years of above normal inflation and a firming housing price landscape. The share of household income required to cover ownership costs in Canada now sits at 64%, with Vancouver (106%) and Toronto (85%) leading the way in lack of affordability.

It is very much the same economic backdrop in Europe, which has been posting GDP close to or at 0% lately. Like in Canada, where consumers can lock in fixed rate mortgages for up to five years to lower interest rate sensitivity, Europeans are typically exposed to even shorter fixed periods in the range of two to three years. We are feeling the cumulative effects of higher borrowing costs and higher goods and services costs from inflation.

This is in stark contrast to a resilient U.S. consumer who de-levered dramatically following the Great Financial Crisis. Fully employed and continuing to experience wage growth near 20-year highs, Americans are feeling as wealthy as ever with their investment portfolios at all time highs combined with significant housing price strength. Unlike in other developed countries, rate sensitivity in the U.S. has become much lower as consumers locked in up to 30-year mortgages at low rates several years ago. They do not feel the pinch to the extent we do north of the border.

As the economic data has unfolded since mid-2023, it appears less and less likely that the economy will contract. Probabilities of recession peaked last summer at a 65% chance, but have been gradually falling ever since and sit at a little over 30% today. Expectations of growth in 2024 continue to re-rate higher, with GDP now forecast at 2.2% after a strong first quarter start. We and others call this the goldilocks economic zone. Not too hot causing a dramatic pick-up in inflation, not too cold creating economic weakness.

As a result, confidence for both the consumer and global investor in this market is fully intact to say the very least.

Be Fearful When People are Greedy?

Investors are now expecting double digit earnings growth in the U.S. in 2024, coming off low single digit profit growth in 2022 and 2023. This re-acceleration of the economy is in large part happening from the large infrastructure build-out required for the current technology boom related to artificial intelligence. There are simply many factories and data centers being built across the country leading to a strong labor market and wage growth.

As a result of this visibility to near-term growth, investor optimism is incredibly high. Across all metrics we track, we find that both investor positioning (in financial instruments) along with investor optimism (through surveys) are sitting at levels that have historically warranted caution. If everyone is optimistic, expectations for the economy and corporate financial performance are high, and financial market positioning reflects this, then there is little needed to upset the apple cart to downside volatility. The reverse of these signals is what has led to this rally in the first place, and we see this pattern throughout the past 25 years of data.

The diverging performance of the U.S. market versus the rest of the world has created risks that crop up rarely, but that have had significant impact on future returns in the past. Across several measures of market concentration, we see that the majority of corporate value in the U.S. has accrued to very few companies, with levels of concentration now exceeding the peak of the Dot Com era and in line with levels at the end of the Roaring Twenties prior to the Great Depression. Both of these periods were underpinned by significant technology related economic booms. The U.S. stock market represented less than half of global market value under 15 years ago, today it is approaching three quarters of the world's value. If you take the value of all the companies in three of the world's largest stock markets (Japan, the U.K. and Canada), the value of just the U.S. market's Magnificent-7 is nearly a match. While concentration of the indices poses one significant investor risk, it is the elevated valuations of these companies that further compound the issue. The S&P 500 index is now at valuation levels hit only during Dot Com and during the post-Covid speculative market in the past 35 years. Both instances led to significant losses thereafter in the early 2000s and in 2022.

While market structure keeps us up at night, we are facing another potential issue on the horizon. When the economy is strong, everyone is employed, and wages are heading higher – inflation may resurface. We see U.S. Central Bankers unlikely to cut with this risk in the near-term. So while the Bank of Canada may want to cut in order to support its struggling consumer which is already in a spending recession, we find them between a rock and a hard place. Cut to support the consumer, and the Canadian dollar will fall. As Canada imports the majority of its goods directly or indirectly in USD, this will create inflation in and of itself. Combine this risk with the potential of a significant increase in housing values from rate cutting stimulus, and we are back to the issue we are trying to mitigate today. It is not unlikely the Bank of Canada will simply have to follow the lead of their largest trading partner, which we see as keeping rates higher for longer. For context, at the end of 2023, the market expected six interest rate cuts (or a cut of 1.5%) in the U.S. in 2024. Today, we are down to less than 2 cuts or 0.5%.

Melt Up Conundrum

Following the significant run in public equities globally this past six months, future expected returns have fallen from high valuations. Investors are faced with a classic late cycle conundrum. Do we continue to invest the next dollar into risk assets like U.S. stocks with diminishing justification, exposing us to a rising risk of a significant pullback? Or do we position for this risk by reducing our exposure and risk missing the ongoing market melt-up potential?

Our primary objective at Bessette Wealth Management is to manage whatever risks and opportunities we are presented with through time. In the context of this cycle, we continue to manage the significant market concentration risk through measured profit taking on names at high valuations, redeploying into more attractive areas of equity markets or other asset classes altogether.

We continue to lock in historically attractive fixed income yields, knowing further hikes do remain less likely than cuts in the coming year while recognizing we may stay at these levels for longer than the market is pricing. If the safest part of our client portfolios can provide risk-free returns close to 5%, then the starting point of client portfolio returns over the coming three to five years is structurally higher than what we could have anticipated not long ago.

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Bessette Wealth Management