(Nearly) Everyone is Winning, Everywhere

One of our investment partners astutely discussed the state of Q3 asset price movements as “nearly everyone winning everywhere”. Global stocks climbed 6% on the quarter bringing year-to-date prices up 17.5%. The global dominating U.S. market finally took a break from its long-standing leadership, gaining 5.5% through September 30th in Q3 while the tech-heavy NASDAQ became the global laggard, up a more modest 2.6%. Even the oft trailing Canadian market saw a significant mean reversion on the quarter, with the S&P/TSX Composite index up 9.7% before dividends.

Bonds the world over joined the party, with the global bond market repricing higher 7%, the U.S. bond universe up 5% and the Canadian bond market up 4%. So indeed, nearly everyone making money everywhere, save the lone major asset of note in the red being WTI crude oil which managed to fall 5% despite multiple conflicts across several oil producing regions in the Middle East.

The absolute gains were quite interesting in the context of several headlines during the third quarter which included the unwind of the Japanese yen carry trade, escalating geopolitical issues in the Middle East, slowing global growth (including U.S. labor market softness) and even the attempted assassination of a former President. Even bad news quickly turned into market highs for many of the world’s major indices.

Following the strong third quarter gains, price gains through September 30th across stock markets include 21% for the S&P 500 and NASDAQ, 17.5% for the MSCI World index and 14.5% for S&P/TSX Composite. Through the first nine months of the year, most bond markets have returned in the mid-single digits including the Canada bond universe return of 4.3%.

The Great Rate Cutting Cycle is Upon Us

Inflation has continued to fall across the world, allowing for a significant easing cycle to occur across most of the world’s Central Banks.

Heavily indebted Canadians were some of the first beneficiaries of cuts in the developed world. Without the ability to lock in for extended periods like their southern counterparts, the Canadian consumer finds itself quite sensitive to high interest rates. The payment shock on mortgages and other floating or maturing fixed rate loans has squeezed consumer wallets, lowering spending and creating disinflationary pressures. As of September, year-over-year inflation sat at just 1.6% which is now officially below the Bank of Canada’s desired target. As a result, the Central Bank has now cut four times, lowering the overnight rate by 1.25% with a further 1% of cuts expected by roughly this time next year.

In the U.S., 2.4% inflation for September has continued to trend towards the Federal Reserve’s target of 2%. We were concerned that nations requiring cuts to avoid recession would be concerned with a currency devaluation in light of strong economic conditions in the U.S. (and thus limited cuts), but that changed quite dramatically during the third quarter given ongoing labor market weakness and other signs of a slowing economy. As the Federal Reserve has a dual mandate of low inflation and high employment, the latter took focus for the Central Bank’s policy path due to growing softness in the formers. With a strong signal of future cuts beginning with September’s 50 basis point cut, the market now anticipates a further 1.25% to

1.5% by this time in 2025. This has begun the process of a U.S. dollar depreciation against global currencies, where against a basket of value weighted global currencies the USD depreciated ~6% during the third quarter and is now down nearly 10% from its 2022 high. Major expected beneficiaries of the weakening U.S. dollar include the euro and yen.

Goldilocks Economy?

In the past several weeks, your BWM team has attended several investment conferences, met with clients and fund managers in Canada and abroad, and has reviewed economic and market research across countless global investment houses. The overarching theme is a soft landing in the U.S. has all but been achieved and that rate cuts will broadly stimulate most of the world's corporations and consumers leading to higher valuations. So far so good for asset prices, with the rest remaining to be seen. We recall the consensus calling for recession in the U.S. not long ago. Financial markets forget fast as many long-term investors know all too well. Conversely, we also acknowledge the too narrowly known fact that being right too early is also eerily similar to being wrong.

From our vantage point, the U.S. economy was running impressively hot through much of the latter half of 2023 and early 2024 despite high rates and inflation. This has begun to soften as we move through the back half of the year. The labor market is one focal point for the investment community, as the unemployment rate has ticked up to 4.2%, well off its low of 3.5% back in early 2023 (Canada finds itself significantly higher unfortunately). There are signs of weakness in consumer spending, increasing debt delinquencies, sluggishness in manufacturing and even 14-year high U.S. bankruptcy rates.

The U.S. Federal Reserve has some difficult choices ahead. Should they loosen policy restraint too quickly (i.e., too many rate cuts), they could unintentionally undo progress on the inflation front and re-accelerate the economy. Growth did very recently accelerate to an annualized rate of 3% after slowing for two quarters in a row before that. On the contrary end of their decisions, move too slowly and employment and economic activity could weaken too much.

Many of our clients have also raised their concerns over a further complicating factor, government deficits. Debt-to-GDP in the U.S. from 2022 through today is now at over 120% which compares to closer to 70% from 1986 through 2019. Historical U.S. government spending is telling when breaking it down by President. The average U.S. government deficit as a percentage of GDP for Trump was 6.6%, modestly better than the 7.5% deficit posted by the Biden administration. For context, the only President dating back to T. Roosevelt (1901-1909) that spent more was President D. Roosevelt (12.2%). Second place goes to President Wilson (4.8%). These Presidents steered the U.S. economic ship during World War II and World War I, respectively. Projections appear to think the next administration will be more of the same, hovering around 7%, no matter the election's outcome.

For the global economy, the European Union forecasted 1% GDP growth for 2024 back in May, but we have since seen the Hamburg Commercial Bank's bellwether Composite Purchasing Managers' index fall to an eight-month low in September. The manufacturing sector continues to demonstrate weakness and even the service sector appears to be slowing. Further east and worth touching on, China's property market and weak consumer confidence is causing such significant distress that the country decided to deploy greater fiscal and monetary stimulus during the quarter in an effort to prop up a very weak equity market and pump stimulus to foster growth.

Canada faces other unique and specific structural challenges. The country's economic weakness is quite broad-based with real GDP per capita declining by a cumulative 3.9% since its 2022 peak. This is the first time this has occurred in the absence of a recession and very likely means the country would have entered a recession of some significance absent historically high immigration relative to population size (according to some the highest 12-month period of immigration relative to population size outside war related displacement in world history). Today, youth unemployment is at a historical high and the social safety net appears to be under pressure from schooling to healthcare and beyond.

Taken together, a slowing global economy combined with rate cuts can be great for asset price inflation, but the global business and consumer community is clearly not chugging along on all cylinders. This is before contemplating the geopolitical considerations related to a Trump victory which could see 60% tariffs on Chinese imports and a further 10% tariff to all other countries' goods. Currently sitting in Canada, we fail to see how this would be a net positive development for the domestic economy. Throw in Israeli conflict already in Lebanon and Gaza and prior to any potential retaliatory measures in Iran. If you couldn't see the daily tickers across your screen, you would be right to think there was some weakness in asset valuations.

Take What the Market Gives You

What is the market presenting as potential opportunity versus uncompensated risk? For starters, stock markets globally are mostly at or above historical valuations now. The world's largest stock market by a wide margin, the U.S., is sitting at ever rising valuations that have been exceeded only twice in the past 35 years. When your historical precedents are valuation highs at the end of Dot Com and at the end of 2021 immediately prior to the market sell-off of 2022, we as stewards of capital take a moment to reflect on prevailing circumstances. It is not just that the U.S. is the majority of the global market (roughly 70%), it is that the U.S. market itself is largely very concentrated in very few companies. We have touched on the Magnificent-7 in prior client letters, today they still represent close to 30% of the U.S. S&P 500 index (and even more of the NASDAQ). We recently had one of the world's largest active equity managers run the math on what growth is implied in these seven companies in order to be even money with the U.S. stock market's long-term growth rate. For valuations to be defensible, they concluded earnings for the Mag-7 would need to grow at nearly 60% over the next five years, over 30% over the next 10 years or 23% per year over the next 15 years. Based on history's best earnings growers, 23% over 15 years is no small feat.

Now all-time highs for stocks don't necessary point to a bad time to invest. Somewhat surprisingly, putting money to work at all-time highs has historically outperformed deploying cash when the S&P 500 is below peak on average. With that said, we have found more compelling investment opportunities outside the "winners of late" and it appears the market agrees as value stocks have been outperforming growth stocks since June. There are other areas beginning to show life, including smaller companies that have finally been outperforming their larger counterparts after years of the reverse. We also find more compelling risk-reward trade-offs abroad, where developed markets like Europe and Canada are trading near lows against the headline U.S. stock market.

Turning to government bonds, the recent rally has made the risk-reward trade-off less appealing than it was not long ago. Today they trade in a normal long-term range and look fairly priced. Historically the bulk of the rise in bond prices (conversely the fall in bond yields) is already behind once policy rates by Central Banks first start their descent. We can make arguments for two-way directional bond prices going forward in the absence of a recession, which would add necessary fuel to their recent price strength fire. Positively, it would be hard to see the repeat of 2022, whereby stocks and bonds both moved in tandem. Today, any negative for stock markets and corporate fundamentals can be met with Central Bank easing. Portfolio insurance is finally back.

Fortunately, absolute bond yields across many parts of global bond markets remain high relative to recent history, providing opportunity for attractive returns in the coming years. We also find the return potentials of many parts of global alternative asset classes to be improving amidst falling costs of debt. The additional benefit they provide in moving independent of whatever the stock market brings is not a characteristic to be overlooked.

It should be no surprise to clients to see the changes in their statements over the past year since the significant rally began. Broadly speaking, we remain optimistic there will be no geopolitical event that creates downwards pressure to asset values and that the global economy will indeed achieve a soft landing with low but positive growth.

We also believe markets at least partially reflect this outcome, with not a lot of room for things to go wrong which is why a general de-risking of portfolios by individual asset classes and at the total portfolio level has been underway in recent quarters at BWM. We would be remiss if we were Cinderella at the ball, waiting for the clock to strike 12 in the absence of a clock.

Bessette Wealth Management

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