4th Quarter North American Market Commentary – 2023

Key Take-aways:

- Inflation remains elevated, not transitory as some believe. We also have a Federal Reserve with an obsession with its 2% inflation target.

- The inflation scare of 2020 to present has likely spooked central bankers thinking that they can stimulate economies with ultra low interest rates without consequences. Central bankers are unlikely to repeat the gravity of this past policy error. A FED pivot back to extreme accommodation looks unlikely.

- Headlines are selling a false soft landing narrative (raising rates to counter elevated inflation into an economic slowdown without triggering a recession). The economy and North American consumers are not in great shape. The economic data being released is deteriorating and we could make the transition from gradual to suddenly uncomfortable by the end of Q1.

- Yield curve dynamics represent a crucial macro variable, as they inform us on today's borrowing conditions and on the market's future expectations for growth and inflation. When the yield curve inverts investor's worry (FY2022). The FED stands ready to lower rates (FY2024), especially if the employment backdrop worsens (FY2024). When a recession hits, the FED cuts rates and the curve steepens and that is when you position defensively and brace.

Positioning:

- Monetary policy is still very restrictive and damage to the economy is still rolling through but with a considerable lag. The way forward is risk managing a recession.

- Fiscal policy has not been aligned with monetary policy. Record deficits and spending have masked the effects of monetary policy, leading to higher GDP growth and more stubborn inflation.

- Weaker corporate earnings support allocations to cash, utilities, low beta equities, high quality select growth opportunities focusing on investible volatility and reducing net market exposure.

- Canadian equities remain attractive destinations of capital in comparison to US equities.

- Money market and/or Treasuries are offering highly competitive 5%+ returns and can contribute to results of a competently assembled portfolio.

- Current market consensus is as polarized as ever. Positioning on Wall Street has shifted significantly towards max net long. Looking ahead, there are reasons for optimism. While Q1 appears to be a challenge, Q2 and onwards show us the comparable appear to be easier and prime for a better outlook. The potential cycle inflection comes into view as we push past 1Q24.

In the US, CPI increased 0.3% in December and 3.4% from a year ago, compared with respective estimates of 0.2% and 3.2%. Cumulative inflation since 2020 is 18.63%. This means that today's prices are 1.1863 times as high as average prices since 2020. In Canada, cumulative inflation since 2020 is 15.35%. This means that today's prices are 1.1535 times as high as average prices since 2020. Inflation is a regressive tax, impacting households regardless of income, yet doing so with varying degrees of relative magnitude, is gradual and cumulative. As such, disinflation from record-high price levels offers little relief. Cost of things are not deflating, they are simply inflating less. A Bankrate survey found that more than two-thirds of Americans believe their cost of living has worsened since 2020. The point is, underlying inflation has remained sticky and across a number of key concurrent and leading series, has already begun to reaccelerate while geopolitical events are again threatening supply/inflation shocks.

There were 8 FED meetings held in 2023, 4 of which ended with 0.25% increases, 4 of which ended with no increases. In all 8 meetings, the FED showed concern on the topic of inflation. Federal minutes, held October 31st and November 1st, showed Federal Open Market Committee ("FOMC") members still worried that inflation could be stubborn or move higher, and that more rate hiking may need to be done. The minutes gave no indication that members even discussed when they might start lowering rates. Officials also said they expect economic growth to "slow markedly" and risks to broader economic growth was probably skewed to the downside, while risks to inflation are to the upside. One month later Chair Powell went on to say:

"It would be premature to conclude with confidence that we have achieved a sufficiently restrictive stance, or to speculate on when policy might ease. We are prepared to tighten policy further if it becomes appropriate to do so."

Chair Powell, December 1st, 2023 Atlanta, Georgia

In a bizarre twist of events and only 12 days apart from that public statement and 44 days from the previous FOMC meeting, on December 13th the Federal Reserve rate-hiking cycle appeared to have come to an end as the FOMC indicated they have now begun to speak to rate cuts. The FED went from being concerned about inflation and leaving the possibility of rate hikes on the table to discussing rate cuts. FED officials now expect three rate cuts in 2024 and four more in 2025 meanwhile the new projection implies fewer cuts than what the markets pricing in. Markets are now pricing in a rate cut at every FED meeting this year beginning in March 2024 (7 cuts!). Markets are telling us that interest rates will move straight down even though the current official unemployment rate is under 4% and reported inflation is still 2x higher the FED 2% target. One must not forget this same group of FED officials were the ones who

declared steady rising inflation between 2020 and 2022 as transitory. No policy maker seriously committed to fighting rising inflation would publicly announce an intention to start cutting rates before even achieving their very own price stability target of 2%. Once again, without fail, the FED's credibility has come under question and they may regret not staying disciplined.

Chair Powell's post-FOMC press conference language on December 13th was incredibly and unexpectedly dovish. In the Federal Reserve's eagerness to stick a soft landing (raising rates to counter elevated inflation into an economic slowdown without triggering a recession) for the US economy, central bank policymakers have made a major pivot in policy and unintentionally increased the risk of a hard landing. The gamble is the US economy has little room for upside without inflation rising again. Realizing their communication error FED speakers have pushed back. Unfortunately for the FED, Powell's words have sparked a rally that no manner of subsequent tempering could control. It is remarkable how tilted Wall Street is to the soft landing narrative when what they are asking for is typically reserved for hard uncomfortable landings. Even though monthly reported inflation remains elevated, the equity market has declared the inflation problem solved and the glidepath to a goldilocks economy all but certain.

The distinction between a rate cut and the elimination of rate hikes must not be ignored. Rate cuts are an expansion of money supply whereas elimination of rate hikes is a continuation of money supply contraction. The concern is in order for this FED to initiate an aggressive rate cutting cycle, as the market is positioned for, we would expect the unemployment rate to rise at a bare minimum north of 5%+ from the current 3.9% and inflation to move towards their 2% goal and it currently remains 2x higher. The recession call would have to play out dramatically and these conditions would not be positive for equities. Equity volatility has been supressed to levels not seen for a long time. Chasing all time highs will only lead to violent breakouts and thus market corrections. Equity volatility tends to elevate once a recession commences. In a recession, equity VIX goes from 15 to 30 incredibly fast.

On the surface 2023 captured remarkable performance for the S&P500. The artificial intelligence excitement turbocharged the Magnificent 7 group (MSFT / AAPL / AMZN / META / GOOGL / NFLX / NVDA) navigating the S&P 500 up +26.2%. Now if you combine it on a 2 year look back and factor in the weak 2022 performance, S&P500 is +3.2% and not as remarkable. In fact, less than what risk free treasuries provide during that same period. Risk-free rates in 2023 were the highest they'd been in many years. Simply investing in US T-bills would have generated a +5.1% total return, which is the highest since 2000. Meanwhile, the broadest

definition of US equity market is the iShares Russell 2000 ETF and for period ending 31-DEC-23, is down –7.1% since January 1st 2022 and down -11.4% from its cycle peak November 2021. The beginning of 2024 too has been weak, down another -5.6%. When we look back on 2023 we'll just see the final numbers but those final 9 weeks as a result of the FED bizarre communication and publicly announced pivot intention really drove returns. The point is it would be easy to say things are healthy because the S&P500 is positive in 2023. This market is overbought especially given the historically high concentration in the market. The concentration in the mega-cap stocks hit the highest level in the past 50 years. The largest 10 stocks currently make up 35% of the S&P500 total capitalization. The performance of the big 7 big tech companies that have driven the equity outperformance this year does not reflect the performance of the economy. We are in an environment with high market concentration, economic and FED uncertainty, multiple geo-political crisises, and equity volatility suppression. The uncomfortable truth is S&P500 valuations are distorted with an environment where if you buy the S&P500 today, you are basically buying a handful of companies that make up 35% of the index and have an average P/E ratio around 46.

Equity markets are ignoring geopolitical risks (Ukraine / Russia; Israel / Hammas; China / Taiwan; Houthi Rebels), slowing consumer, elevated yields, PE expansion instead of profit expansion; alternatives available such as money markets paying north of 5%. Toss in the notion The US Fiscal Deficit in 2023 increased from $1.42Trillion at the end of 2022 to $1.78Trillion. This is occurring while the official unemployment rate is under 4%. Historically speaking, government spending accounts for 17% of GDP and 5% of job creation but government spending in the US has contributed closer to a 1/3rd of the growth in GDP in 2023 and one quarter of job creation. Put simply, that skewed the actual results and cannot be ignored. The deficit is projected to grow every year over the coming decade, exceeding $2.5Trillion annually in just 8 years without ever factoring in a recession. These are remarkable rates of change numbers and unprecedented obligations. Since 1948, there have only been 7 years with larger deficits as % of GDP and those seven years either saw dislocations due to events/recessions (2020, 2021, 2009) or were years marked by unemployment rates ranging from 8% to 11% (1983, 2010-2012). At the current level of unemployment, deficits should be ~1% of GDP, or ~$260 Billion, not $1.78Trillion. This difference would shave 5-6% off of GDP. For the time being, GDP is accelerating so long as you ignore the fact government spending is what is driving it and also ignore the repeated downgrades of US Treasuries by credit firms. To put it another way, the government in 2023 has borrowed more than 3x times the 2008 bailout to fund its deficits and give the

impression of GDP growth. This rate of government spending is giving the appearance the U.S. economy is in far better shape than reality.

On the labour market, the unemployment rate is sitting at 3.9% up from 3.6% the previous quarter end and highest level since January 2022. Labour statistics are released monthly and there has been a suspicious trend of negative revisions all through 2023 (initially reported vs revised). Eight of the nine Non-Farm Payroll reports released in 2023 received a massive downward revision a month later. This is highly unusual and uncommon and looking back at history when you do see them they tend to be in periods of economic stress (1979 / 1982 / 1986 / 1987 / 2002 / 2008 / 2020). The issue is the labour market is a lagging indicator. Looking past lagging labour indicator headlines and focusing on leading indicators (overtime hours, temporary staffing, average hourly work week, job openings) these are moving lower and trending in negative territory. This is in fact what you begin to see when economic growth is slowing. Going back over 70 years this is the classic transition from economic expansion to economic contraction and this is generally what takes place ahead of job cuts as companies realize a recession is unavoidable. The trend is clear, the labour market is deteriorating with the early leading indicators suggesting this strongly. This has all historically coincided with recessionary conditions.

On the US consumer, the narrative spoken by mainstream media and Washington is a tad misleading. According to the New York Federal Reserve, household debt levels increased +1.3% in the quarter to $17.3Trillion. Meanwhile, credit card borrowing rose by +4.7% Q/Q to $1.1 trillion. Both are all time highs. Consumers are relying more on buy now and pay later (“BNPL”) strategies. Payment plans once reserved for big-ticket items like an automobile or tuition are now increasingly being relied upon on everyday purchases. Over half of Gen Z and Millennials say they use BNPL, compared with 35% of Gen X and 24% of Baby Boomers. They are deferring payment because they seem to have no choice and most alarming is 40% miss a meaningful percentage of their scheduled payments. Credit Card Delinquencies, early (30-Day) and serious (90-Day) delinquencies rates both made new cycle highs in 3rd quarter with the breadth of that deterioration wide across demographics. The issue becomes US consumers are relying more on debt and whatever savings they are receiving on merchandise acquisitions they are having to finance with credit card debt that has 3x the interest rate. Credit Card interest rates are currently at 23% and the highest in at least 3 decades according to the latest data from the FED. The result is mounting debt. Tack exorbitant interest rates on top of that money owed, and the deficit can quickly become insurmountable. The American consumer is facing the dual challenges of compounding inflation and elevated interest rates and this combination is making average consumers miserable.

Based on the economic calendar we are likely entering the most difficult part and final phase of the current business cycle where data slows down faster. We expect growth to slow in the first third of 2024. Looking at the brief trading data of 2024, we see utilities strength, commodities weakness, oil weakness, health care strength, US$ strength, these are all results typically associated with a market discounting an economic slowdown. We do admit the equity market has been resilient up to this point, exceeding our expectations in 2023, but we must mention consensus is positioned close to a 3 year net long position which suggests maximum complacency with very little room for disappointment. Net long positioning in Nasdaq futures is currently at the 96th percentile of its trailing 3-year range while net long positioning in Dow futures sits at the 99th percentile of its trailing 3-year range. The catalyst for a buying opportunity for the next leg up could be slowing growth, but the fuel will be the extreme one-sided bullish positioning. This combination of fundamental phase transition (growth slowing) at a point of maximal directional conviction is a recipe for particularly impressive turning points. The concentration risk embedded in the S&P500 is hiding risk. The recession risk has simply been delayed, not avoided. There is no evidence to suggest earnings have bottomed. There will be a moment when we get aggressive and buy pockets of the market we have been short. But we need the market to discount and price in a recession that is evident to anyone who is data dependent. We still have 3, perhaps 4 more months of sloppy data to come out. History has shown that when the FED acknowledges a recession and Wall Street is forced to act, stock price deterioration happens quickly. Looking ahead, there are reasons for optimism. While Q1 appears to be a challenge, Q2 and onwards show us the comparable appear to be easier and prime for a better outlook. The potential cycle inflection comes into view as we push past 1Q24. What is a challenge is determining how long the market will take to price in Q1.

From a top down perspective, the market itself can provide important clues and probabilities as it relates to market moving events. As an example, with measures of volatility at lows, like the VIX is currently at just under 14, the market is, in a sense, telling us that the coast is clear and a negative market catalyst isn't likely to occur. In reality though, low volatility environments may also be mispricing future risk. Historically the S&P500 performance has mirrored job openings. In other words, robust economic growth leads to increases in job openings which the stock market tracks. For some time now, we have witnessed a divergence whereby job openings have come under pressure while the S&P500 continues to move higher.

The divergence of the market from economic fundamentals has been remarkable and sobering. It is important to

recognize this divergence and come to terms with the data and discontinue pointing to the stock market as an economic indicator when in fact, at best, it's a momentum indicator. Current market consensus is as polarized as ever, and that is why volatility may return. Risk happens slowly and then all at once. Macro is the principal risk to outlook, particularly around the Federal Reserve's delicate balancing act of controlling inflation and not harming the expected trajectory of real economic growth. Looking back thru history, since the 1954 there have been 10 recessions and all of them have been proceeded by a significant rise in short term yields. The point is this dynamic has been festering for some time. The US is a very expensive market when benchmarked against risk free rates and even the Canadian and some Emerging markets. We are basically back to peak multiples in the face of an earnings recession. Core message here is rallies not backed by fundamentals may not sustainable and while they can be exciting to watch they are anxious to own. Patience remains our core allocation.

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Sincerely,

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The Portfolio Management Team

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