



## 1<sup>st</sup> Quarter North American Market Commentary – 2024

### Key Take-aways:

- Markets have shifted from pricing in 7 interest rate cuts to pricing 2 cuts with them beginning in the latter half of the year, GDP and inflation estimates continue to move higher, S&P500 EPS trends are holding positive and reflecting acceleration, Government spending is not expected to be reduced, at least not in a pre-election year and the no/soft landing narrative remains consensus positioning.
- The inflation scare of 2020 to present day 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.
- Elevated inflation and lower unemployment rates continue to constrain the FED's ability to cut rates and keep the pressure on for longer as interest rate cuts continue to be pushed back. Expectations as of today are 47% July cut and 67% chance of two cuts by December.
- Geopolitical risks are rapidly escalating. War in Europe and the Middle East used to provide a consistent bid for bonds, but apparently no longer. Bonds continue to be an unfavourable asset allocation and financials remain vulnerable.

### Positioning:

- Fiscal policy has not been aligned with monetary policy. Record deficits and government spending have masked the effects of monetary policy, leading to higher GDP growth and more stubborn inflation.
- The CBOE Volatility Index (VIX) breached the 20-level in April leading to a retreat in the S&P500 performance in Q2. Corporate earnings appear to be bottoming and elevated inflation support allocations to energy, commodities, low beta equities, and high quality select growth opportunities focusing on investible volatility.
- Canadian equities remain attractive destinations of capital in comparison to US equities.
- Shorter dated Treasuries (2 year or less) are offering highly competitive 5%+ returns and can contribute to results of a competently assembled portfolio.
- After more than 2 years of broad deceleration, the cyclical economy is flashing stabilization, and the tone has shifted to less bad. High Yield and Industrials can now be accumulated.
- Corporate profits, global Industrial, global manufacturing & commodity recession of 2022-2023 bottomed in Q4 of 2023.



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In the US, headline CPI for March (includes food, shelter and energy) increased 3.5% year over year, above consensus expectations of 3.4%. The annualized core CPI (excludes food and energy) increased 3.8%, above consensus expectations of 3.7%. Cumulative inflation since 2020 now sits at 20.68%. This means that today's prices are 1.2068 times as high as average prices since 2020. In Canada, cumulative inflation since 2020 is 16.98%. This means that today's prices are 1.1698 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. Inflation for each person is individualized and cumulative. Real inflation simply means the destruction of the purchasing power of the currency. The level of arrogance out of the FED and Washinton is at all time highs (rising money supply and ridiculous deficit spending leads to persistent inflation prints). Inflation only falls when there is a reduction in aggregate demand. And if that is taking place, the consumer is not in good shape. The point is, underlying inflation has remained elevated and has already begun to reaccelerate while geopolitical events are again threatening supply and delivered a meaningful setback to the FED's hope of dialing back some of the past year's interest-rate increases.

The CPI prints have been persistent and well above the FED 2pct target and shows early signs of potential re-acceleration in Q2. If we look ahead and think about the components of CPI we need to finally accept the fact it will be extremely difficult to get back to this magical 2pct and we should discontinue with this narrative that rate cuts are around the corner. The markets' expectations of rate cuts have been incorrect and disappointing (began the year with 7 and currently at 3 moving quickly to 2). This shift in market expectations highlights the dynamic nature of the inflation paradigm. The takeaways are we are going to stay higher for longer, any particular month can come in lower or higher relative to expectations, but the trend is clear, these inflation prints will stay elevated for some time which has implications for bond yields and implications for FED policy reaction and finally implications for equities. And while the FED can speak to taming inflation all it wants the data suggest if they decide to cut rates it is because the economic indicators are worsening. The FED has put themselves in a difficult position, they will need to choose between tackling elevated inflation or focusing on deteriorating economic indicators. Based on the latest US FED Chair Powel speech where he finally softened his stance on his 2% inflation goal he appears to be focused more on the deteriorating economy, finally coming around to the idea that inflation at 2% is likely unavailable for now. The bond market seems to agree as the



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10 and 30 year yields rise to uncomfortable levels to reflect an increasing fear of sustained inflation above 2%. The 2-year yield is currently at 5.00% and the 10-year yield is currently above 4.70% as the Bond Market indicates to the FED and Washington their views on inflation is offside and rates will stay higher for longer. FED monetary policy has disappointed us for a long time, especially since COVID. It has only perpetuated currency debasement and given rise to alternative choices, namely the strength in Gold and Bitcoin.

We are reinforcing our message that rates are expected to remain high for an extended period. The outlook for US inflation to retreat to 2% this year is not particularly encouraging all while the government's deficit is on track to balloon further. The latest economic data is suggesting rate cuts would be the wrong path forward at this point. With one of the top leading inflation indicators having inflated approximately +25% in the last 3 months (WTI Oil), shelter inflation continuing to be elevated and higher shipping costs beginning in the back half of this year, but especially in Q4 and into Q1 of next year will put significant upward pressure on inflation to the tune of a full percentage point increase, it will be mathematically impossible for CPI inflation to slow in the second half of 2024 to support market expectations for multiple rate cuts. The math is straightforward, current rates of 5.00% to 5.25% versus the FED funds neutral target of say 2.75% would suggest rate cuts

should take place. However, if you factor in current unemployment rates (so low we would suggest maximum employment levels) and latest inflation readings along with projections, the current level of interest rates does not seem to be a problem for the economy or financial markets. In other words, the neutral rate should be much higher than the suggested 2.75% range. If we take the approach long run inflation rate is not 2.0% but closer to 3.5%/4.0% and factor in a cushion of +0.75% which gets us very close to the current rates range of 4.50% to 5.00%. Meaning while 5.0%/5.25% can be viewed as restrictive it only means at best 2 rate cuts might be needed and not the 7 the market was begging for back in January. This is where we differ significantly with the FED narrative. Extending this discussion to equity valuations could tell us American markets are already fairly valued, quite possibly overvalued and due for range bound trading. Wall Street is trapped in the FED narrative essentially believing the FED at its word.

On March 6<sup>th</sup> the Bank of Canada kept its key policy rate unchanged, its target for the overnight rate at 5%, with the bank rate at 5.25%. The bank is continuing its policy of quantitative tightening. The council is still concerned about risks to the outlook for inflation, particularly the persistence in underlying inflation. Governing Council wants to see further and sustained easing in core inflation and continues to focus on the balance between demand and supply in the



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economy, inflation expectations, wage growth, and corporate pricing behaviour.

At some point, and April's drawdown of 6pct could be the start, the markets will need to wake up to the notion the return of easy money may not come as quickly as they are positioned for. On interest rates, the market is positioning for multiple rate cuts and a soft landing. Never in history have the two happened at the same time. No central bank has ever acted pre-emptively. If the FED cuts rates aggressively it is because they have advance knowledge of deteriorating data and reduction in demand by the private sector. In other words, if the US economy remains stable due to government spending intervention and bloated GDP disguise and CPI index drops or remains stable with money supply growth it is highly unlikely the FED cuts interest rates the number of times the market is positioning for. If you are in the rate cut camp this really means you are also in the hard landing scenario (data deterioration is severe, recession on its way and this drives rate cuts). And finally, to add to the confusion, the FED has never taken aggressive action on cost of money and supply of money in an election year.

Overall, it was an exceptionally strong Q1 for the S&P 500, which was up over 10% on the year. Up to March 31<sup>st</sup>, 77% of S&P 500 components posting positive returns. This market strength reflects investor belief the USA is on the path to either a soft landing or no landing that will be the reason for a

meaningful decline in interest rates. To us, the risk of a downside surprise is a concern as we believe investors have priced in very optimistic expectations, in particular that interest rates will decline as rapidly as some anticipate. As we have been saying for a while now, the reason why interest rates get cut is more important than the when. If economic growth is positive, inflation stabilizes, and employment rates don't deteriorate materially then the FED will not have a reason to act aggressively in cutting as they did in raising. Instead, the FED will need to be patient and do nothing. And if interest rate cuts begin and continue with pace it is because the FED sees economic weakness. A notable acceleration or deceleration in payrolls is likely enough to make the rate cut decision for the FED. And finally, we need to keep in the back of our minds, based on history, the FED needs near 500bps in future cuts to fend off the next financial crisis.

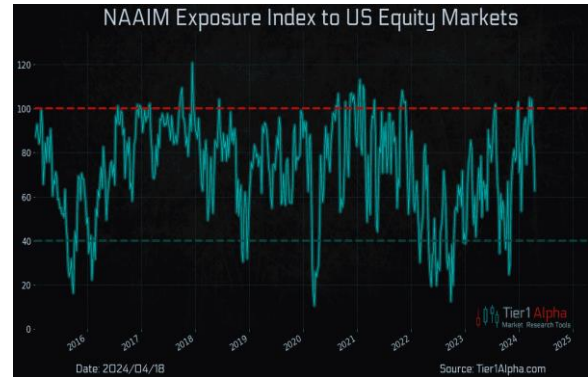
Post Q1, equity markets are having a tantrum with fears of higher-than-expected inflation prints leading to a further FED pause. And to make matters worse, or better depending on your perspective, there is now chatter of another rate hike. April to date and the S&P500 has given back half the gain year to date, or 5% in a matter of days. It is quite evident from market indicators there is excessive optimism amongst market participants in the equity markets. Excessive optimism tends to lead to higher volatility which leads to uncomfortable trading. And



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at this point in the cycle and bottoming process, we would really need to see some sustained volatility rather than the smaller, event-driven clusters we've seen so far this year to be alarmed. We simply remain patient.

Latest Fund Manager Survey shows investor allocation to equities at highest in over two years. National Association of Active Investment Managers (NAAIM) member firms, consisting of active money managers, are asked to provide a number representing their overall equity exposure at the market close on Wednesdays each week. We like to use the index as a contrarian indicator when it reaches extreme levels, either above 100% or below 40% exposure to equities. On March 27<sup>th</sup>, active managers increased their equity exposure to 103%. Market participants are essentially at maximum equity exposure. The S&P 500 topped just a few days later. Recently, NAAIM Exposure Index dropped to 63, a substantial reduction in a short amount of time, but more importantly, leaving them with significant exposure yet to unwind, if needed. The weakness in the broad market over the past month clearly removed excessive optimism. Q2 for the S&P500 has started in negative territory down approximately 5%. Despite the recent strength in equities the setup continues to present significant risks, and if volatility continues to rise, so will the probability of these flows destabilizing the markets.



Looking ahead, there are reasons for optimism. After more than 2 years of broad deceleration, the cyclical economy is flashing stabilization, and the tone has shifted to less bad. The broader economic indicators are showing signs of improvement, albeit at a gradual pace. We are seeing loan growth activity across the banking industry stabilize, albeit at a slower pace. Global Purchasing Managers' Index (PMI), which provides a window to the direction of economic trends in the manufacturing and services sectors, are improving, albeit at a gradual pace. According to the NY FED credit data (Feb), credit availability and consumer financial sentiment was improving. According to Census Pulse Survey for the March data, difficulty paying for usual household expenses & food insecurity was declining (less bad). It has also been reported household balance sheets for 4Q2023, the bottom 50% of households showed the first improvement in net financial position since the hiking cycle began. The Consumer Confidence (University of Michigan) print for

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March saw a sizeable upward revision, rising +2.5 points month over month to 79.4, marking the highest level in 33-months. The point is, we appear to be concluding the bottoming process.

From a passive fund flow perspective, as long as we are not seeing a trend of meaningful layoffs, people are still contributing to 401(k)s, therefore buying stocks at any price with no fundamental view. This is supportive for equity markets. We still monitor higher trending volatility levels as there is a higher probability it may lead to a mechanically-driven feedback loop where selling leads to even more selling, until these funds risk mandates are met. We are still cautious about ongoing job market issues that could hinder a strong and lasting recovery. While we still see both growth and inflation accelerating, we are still cautious with intermittent and elevated growth risk. Inflation in 2024 is estimated to remain higher than it was in 2023. Interest rates might also stay higher for longer because of these inflationary issues. The U.S. government is likely to continue spending (raising its Debt-to-GDP levels), and while there's a chance of economic challenges arising from this, there might not be any big policy changes, especially during an election year.

The divergence of the market from economic fundamentals has been remarkable. 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 appears to have returned. The setup continues to present significant risks, and if volatility continues to rise, so will the probability of selling flows destabilizing the markets. 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. 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. 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,*

*Christopher Panagopoulos, CPA, CA, CFA*

*The Portfolio Management Team*

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