



2nd Quarter North American Market Commentary – 2024

Key Take-aways:

- The official unemployment rate in the U.S. has risen from 3.4% to 4.1%, which while still low in absolute terms, is headed on an upward trajectory. The FED's focus is shifting from battling persistent inflation to managing employment levels. FED officials have signaled they could begin to cut interest rates even as inflation remains well above their 2% target. Once again, without fail, the FED's credibility has come under pressure, and they may regret not staying disciplined.
- The U.S. is likely to spend a good portion of the remainder of 2024 with both economic growth and reported inflation ebbing and flowing between slowing and accelerating. The 10/2 yield curve remains inverted confirming for us the bond market understands the growth slowdown and higher for longer rate / inflation scenario.
- Looking ahead, barring an exogenous event, the broader outlook remains unremarkable. Despite mixed and sometimes disappointing macro data releases, realized equity volatility remains low, resulting in no significant selling flows. All eyes focused on the U.S. election and with geopolitical risks rapidly escalating, the risk for higher volatility persists. We remain in extraordinary times. Patience is advisable in this environment.

Positioning:

- The CBOE Volatility Index (VIX) began the year at 11 and is approaching the 20-level post Q2 leading to sloppy trading of late in the equity markets. There is still potential downside before reaching oversold territory. Upside volatility is still volatility.
- Canadian equities remain attractive destinations of capital in comparison to US equities.
- Corporate earnings appear to be improving and benign inflation prints support allocations to energy, rate sensitive utilities and REIT's, low beta equities, and high quality select growth opportunities focusing on investible volatility.
- 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 financials can now be accumulated.
- FED policy moving from restrictive to supportive is bullish for high growth, rate sensitive equities. As rates are expected to come down later this year and yields on money market funds decline, we believe capital will find its way back into high-growth assets.



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In the U.S., Headline CPI for June came in at +3.0% year over year, versus 3.3% year over year previously, and 0.1% lower month over month. Recall, Headline CPI measures the total change in the cost of all goods and services purchased by households. This includes all categories, such as food, energy, housing, apparel, transportation, medical care, recreation, education, and other goods and services. In contrast, Core CPI excludes food and energy prices and includes all other categories, such as housing, apparel, transportation (excluding fuel), medical care, recreation, education, and other goods and services. Core CPI is often used by policymakers, like central banks, to gauge underlying inflation trends and to make decisions about monetary policy. It is considered, by them, an appropriate measure for setting interest rates because it is less affected by transitory price shocks, such as weather conditions and geopolitical events. While Headline CPI provides a full picture of inflationary pressures faced by consumers, the FED suggests Core CPI offers a clearer view of the persistent inflation trend by filtering out the noise from the most volatile components. Core CPI came in at +3.3% year over year, versus +3.4% year over year previously. So, on the headline report the number was dovish, but Core Services Ex-Shelter, which is reportedly a major focus of the FED, remained high and sticky at 4.9%. At face value, the prints were deflationary and the immediate reaction in the FED Funds Futures market was an

increase in probability of a September cut to ~100%, with the bond market beginning to price a rising probability of even a 50bps rate cut.

June Canadian CPI data came out at 2.7%. Mortgage costs, rent, food away from home, fuel and auto insurance contributed to the upward pressure while telephone, internet, clothing contributed to the downward pressure. Grocery inflation in Canada increased by 2.1% year over year in June, accelerating from 1.5% in May. After nearly a year of decelerating trends, June was the second consecutive month of acceleration. Grocery inflation in Canada has been a larger political issue than in the U.S. and has drawn more public scrutiny in Canada and a reacceleration will bring the grocers more scrutiny. On June 5th and July 24th the Bank of Canada cut its benchmark interest rate by 25pbs each time. What is being reported is this decision reflects the central bank's observation that inflation has cooled whereas we take the opinion this decision reflects the Canadian economy faces significant upcoming headwinds and the Bank of Canada sees this and would like to get in front by reducing the cost of borrow.

In the U.S., cumulative inflation since 2020 now sits at 21.39%. This means that today's prices are 1.2139 times as high as average prices since 2020. In Canada, cumulative inflation since 2020 is 17.64%. This means that today's prices are 1.1764 times as high as average prices since 2020. Inflation is a



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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, Washinton, Ottawa and the Bank of Canada 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 the cumulative decline in purchasing power of US dollars and CDN dollars remains a major concern for consumers and investors.

We are reinforcing our message that rates are expected to remain high for an extended period. The beginning of a rate cutting cycle does not change our view. The outlook for U.S. inflation to retreat to 2% this year is not particularly encouraging all while the government's deficit is on track to balloon further. The official unemployment rate has risen from 3.4% to 4.1%, which while still low in absolute terms, is headed on an upward trajectory. The trade deficit is widening. As inflation moderates for the moment, and as the labor market softens, the FED's mandate is shifting from being entirely focused on

fighting inflation, to a more balanced approach of managing employment vs inflation. Therefore, they have signaled that they could begin to cut interest rates even as inflation remains above their 2% target. The large fiscal deficits and a weaker consumption economy will likely lead the FED to go back to balance sheet expansion to keep U.S. Treasury markets liquid and stable, and to keep the banking system smooth and well-functioning with ample reserves. 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. 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. We say, don't be fooled, when the FED cuts it will not be because they believe inflation is headed to their 2pct target.

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. The last time a normalization cut occurred was in 2019 before COVID, when Chair Powell announced a "mid-cycle adjustment" rate cut. Equity markets reacted positively. And if interest rate cuts begin and continue with pace it is because



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the FED sees economic weakness, better known as panic cuts. The 2008 Great Financial Crisis and the 2020 COVID Crash are clear examples of panic cuts. Typically, it is during panic cuts that equity prices move lower as liquidity and cash holdings become more important. As it stands today, the economy is slowing but still growing, unemployment is increasing higher but is still low at 4.1% in absolute terms. 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. Despite mixed and sometimes disappointing macro data releases of late, corporate profits, global Industrial, global manufacturing & commodity recession of 2022-2023 bottomed in Q4 of 2023 which suggests any potential upcoming rate cut(s) will be a normalization cut and not a panic one.

For period ending June 30th, the market cap-weighted S&P500 is up over 14%, the equal weight RSP500 had only managed to climb 3%. At the core of understanding whether we are in a healthy bull market we must visit the current distortion between S&P500 (market cap) and the RSP500 (equal weight). The market cap-weighted S&P500 is outperforming the equal weight index by nearly 11%, following 12% outperformance in 2023. Since 1971 the only back-to-back years with higher combined outperformance was 1998-1999. This significant disparity has

driven the correlation between the S&P500 and its equal-weighted counterpart to a record low, underscoring how index concentration has led to a drastically different market since early 2023. Despite this strength and the S&P500 reaching a new all-time high, overall market breadth remains low, with only 10% of S&P 500 stocks at their respective all-time highs. Market breadth is a measure for assessing the overall health and direction of the stock market based on the ratio of advancing to declining stocks. It offers insights that go beyond what major indices alone can reveal. For example, if the market index is climbing but market breadth is weakening, it could signal an impending downturn. Unless the broader market starts to catch up, this presents an uncomfortable setup for the mega cap bulls.

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 July 11th, active managers increased their equity exposure to 104%. Market participants were essentially at maximum equity exposure. Historically, this level of exposure has been a contrarian indicator, suggesting that high exposure often precedes market pullbacks. In fact, the previous three instances when



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the index exceeded 100 saw the S&P500 retrace by 6% (Jul 23'), 3% (Dec 23'), and 5% (Mar 24') within days. This pattern highlights the potential for near-term market corrections following periods of elevated active manager equity exposure, as excessive optimism generally signals an overbought market ripe for a pullback.

Looking out further ahead, we may have a more interesting setup with 1-month realized volatility for SPX crossing 3-month to the upside. Volatility control funds and passive funds can have a significant impact on market behavior. For example, in periods of high volatility, these funds may sell large amounts of equities to reduce risk, which can exacerbate market declines. Conversely, in periods of low volatility, they may buy equities, potentially driving up prices. This is why we study the options market, the main driver of volatility. Volatility drives flows, which in turn drives prices. The issue we are facing here is that Volatility Control Funds and passive funds are sellers if 1-month realized volatility exceeds 3-month realized volatility. During the final week in July this has taken place. With Systematic funds primed to sell, the likelihood of a self-reinforcing cycle of deleveraging becomes increasingly likely. There would need to be multiple days of significant moves greater than 2%+ to trigger any material deleveraging. We're not sure if this will hold but the conditions are in place for a modest rise in realized volatility.

From a passive fund flow perspective, if 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 fund risk mandates are met. We are still cautious about ongoing job market issues that could hinder a strong and lasting recovery. The U.S. is likely to spend a good portion of the remainder of 2024 with both growth and reported inflation ebbing and flowing between slowing and accelerating. The 10/2 yield curve remains inverted and confirms for us the bond market understands the growth slowdown and higher for longer rate / inflation scenario. 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.

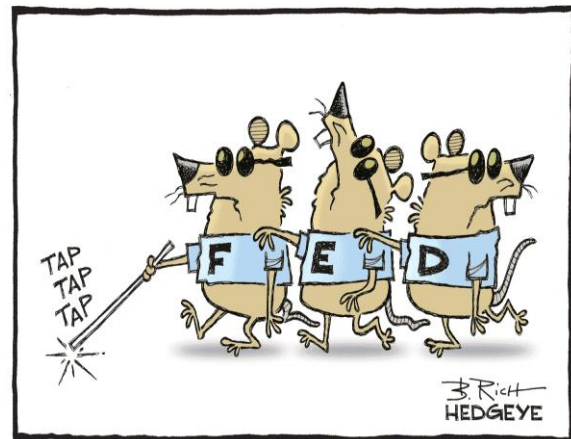
The only reason to be adding risk is when the interest-rate narrative is perceived to be improving, or if the markets reach an oversold/pessimistic extreme. The FED is obviously paranoid on headline CPI prints, and now beginning to worry about economic growth. The FED has spent a year or so relentlessly preparing market participants not to expect rate cuts until inflation printed 2pct. Now they have changed their tune and

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will begin cutting in advance. 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 pressure, and they may regret not staying disciplined. 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.

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. Up to now, markets are not behaving in any way as history has taught us. Governments are able to paper over weakness in data. We have a situation where a government's fiscal policy may end up dictating the direction of monetary policy. How else can we explain the FED's admission they can no longer wait for inflation to run 2pct before beginning their reduction program. Only answer is FED's ability to control inflation and manage the economy is compromised by the government's fiscal decisions, often due to high levels of public debt or large budget deficits. US Debt-to-GDP has climbed very rapidly to around 100% in 2024, an increase from around 35% in 2007. Fiscal deficits require the Treasury to find buyers for the debt. Federal debt held by Foreign and International investors has been in steady decline since its peak of 33% in 2007 and

now stands at 22%. This printing of money to fund the government's spending is inherently inflationary. The FED might be forced to finance government spending by purchasing government bonds, which can lead to higher inflation. This contrasts with monetary dominance, where the central bank can independently set interest rates and control the money supply without being influenced by the government's fiscal position. The main macro headwind as we head into the second half of 2024 is the markets began repricing a scenario of higher for longer rates with slowing growth and elevated inflation, in contrast to the prior view that there would be a rapid cut in rates. 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. We are in extraordinary times. Patience remains our core allocation.





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Sincerely,

Christopher Panagopoulos, CPA, CA, CFA

The Portfolio Management Team

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