

# Equity and Fixed Income Strategy

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### It's all about those rates

Violence, political upheaval, and interest rate increases. Sadly, those factors have come to define much of 2023. Not surprisingly, investors are in a sour mood and much of the market has been under pressure. The silver lining; however, is that recent weakness has created value in several sectors and stocks although our modus operandi is still very much to be selective. In other words, the focus should continue to be on companies with strong competitive positions, rock solid balance sheets, and reasonably valued stocks. Importantly, the odds of a North American recession in the next year has steadily decreased on our models (now below 45%, but still far from negligible of course). This considerably lowers the odds of a painful bear market at least in the next few quarters. It is also a good omen for the Canadian market (i.e., the S&P/TSX) which is more economically sensitive than the S&P 500 and far less expensive.

### Exogenous shocks do not usually have a long-lasting impact on the market

Looking at the wars in the Middle East and Ukraine (and others such as Sudan and Yemen which do not currently receive much media attention), we have long maintained that exogenous shocks tend not to have a long-lasting impact on the market and that the economic cycle and interest rates are by far the most important drivers of financial asset returns. We stand by that view. Going back to 1940, the median downdraft was 2% in the month leading up to the event, followed by a gain of 10% in the subsequent year.

### Rate stability is at hand which has very positive implications

We believe we are about to enter an era with more interest rate stability. The Bank of Canada (BoC) and the U.S. Federal Reserve (Fed) appear to now be on pause with the caveat that there may be one final increase. Our work has shown that the market tends to act well when interest rates are

stable, which makes intuitive sense since traders and investors at large have historically rewarded visibility and stability with higher valuations. Another key conclusion is that so-called "value" stocks (think banks, utilities, energy producers) tend to outperform expensive growth equities (i.e., tech and some consumer and communication stocks) 12 months after interest rate stability is achieved.

However, the factor to rule them all is longer-term interest rates. In fact, investors have become fixated with 10-year U.S. Treasury rates – the cornerstone of all financial markets – which went above the psychologically important 5% level very recently (from 3.5% as early as May of this year). We are now at the highest level in over 15 years. This matters because bond prices move inversely with interest rates, and long-term bonds are most vulnerable of all. Stocks are also vulnerable to higher rates but in a less direct way. The key reason for this is that higher rates make the present value of years out cash flows less valuable. Also, stock dividend yields become less attractive relative to lower risk government bonds. In the present case, the silver lining is that this math also works in reverse (in a positive way), and we believe we may have reached a near-term peak in yields.

We looked at the impact of higher interest rates on historical sector performance. The most important conclusion is that two years after a 3% increase in long rates (this has only happened on five occasions since the 1970s), the market typically shows healthy returns, albeit with a wide variation of returns among sectors. The top performers have been defensive sectors such as Consumer Staples and Healthcare, along with more cyclical areas like Financials, Consumer Discretionary, and Energy (we are very bullish on Canadian heavy oil producers). The one sector which has systematically underperformed is Technology and we expect this cycle to be no different. Again, we do not recommend avoiding the entire Tech sector, but rather to be particularly sensitive to barriers to entry and valuations.

### Value tends to underperform during tightening but outperforms growth following a fed pause

Valuations, while never a good timing tool, are critical to the success of long-term investments in our view. From that perspective, Canadian bank stocks, telcos, utilities, and pipelines are trading close to the bottom of their historical range (with much better than average dividend yields), which should provide a “margin of safety” from current levels. Fundamentally, these companies operate in rational oligopolies which gives them pricing power and typically allows them to outperform even in tough macro environments.

### Technical analysis

The U.S. 10-year yield – the main driver for equity market weakness since August – looks like it’s in the midst of a topping process. Short-term momentum gauges remain negative after peaking nearly a month ago from the steepest overbought level in a year, and medium-term gauges have rolled over and gone negative too. First support is the 50-day moving average at 4.5%, then the breakout across 4.34%. In fact, the last time medium-term momentum gauges rolled over from such a steep overbought condition it resulted in a six month decline that brought the 10-year, back to its 200-day moving average which is currently at 3.89%.

If that’s what transpires, then expect to see a massive relief rally in interest-sensitive stocks similar to what occurred in Q4 2022, which saw significant gains in these sectors (utilities: +11%, pipelines: +17%, telcos: +18%, banks: +18%, and REITs: +21%). Granted, some of that performance was due to how oversold the broad markets were at the end of the 2022 cyclical bear market, but the set-up in many individual names is just the same as it was one year ago (i.e., a rally into the new year in line with historically strong seasonal tailwinds will likely be driven by interest-sensitive stocks).

### High rates are not the issue!

Higher interest rates are not a bad thing for fixed income investors as they can look forward to lower reinvestment risk, higher income, and higher returns. What has been concerning is the speed at which rates rose, and this is daunting for investors looking to buy today, especially with a time horizon greater than 1-2 years. Understanding the supporting factors of this latest bout of increases may help ease some of the concern. After almost two years of short-term rates adjusting to expectations for higher policy rates, which drove the yield curve to invert further as short-term rates exceeded long-term rates, the roles have started to shift. Since last summer, mid- to long-term rates have been leading the increases, driven by four primary factors: 1) the strong U.S. economy; 2) sticky inflation; 3) central banks’ hawkish narrative threatening to tighten

further; and 4) fiscal policy. No surprise with the first three, but fiscal policy – particularly the importance of U.S. government bond supply – is being pointed to more often recently. However, supply is a relatively known factor and usually does not have a lasting impact on markets. It may be larger in absolute value, but when expressed in terms of 10-year equivalent bonds, we see that supply is likely not a driver of higher rates, contrary to what many think.

Supply does contribute to higher volatility, and this is a factor of the shift in demand that came with the end of quantitative easing from central banks and fewer purchases by foreign buyers who can now look at higher domestic rates.

Where fiscal policies play a role is in the economic growth and inflation (particularly the case in the U.S.) as it adds fuel to a fire that is already burning strong: Q3 U.S. GDP flirted with 5% annualized. When combining these factors with aggressive government spending, it helps to understand the latest longer-term rate adjustments. Sticky inflation may not necessarily lead central banks to hike rates again, but even if the economy slows, they may still not cut rates; hence a higher policy rate for longer. This leads long-term rates to price in what may be a new regime of higher nominal GDP and inflation compared to the last 15 years. This has not been felt as much in Canada despite the rising CPI and that would be explained by the fact that growth basically stalled in the past few months, creating a huge divergence between our two economies and explaining not only the different policy rates but also the lower Canadian yields in general.

So, in our quest to timely increase duration, we realize that we are getting closer but may not yet be there. We do find solace in the fact that historically speaking, interest rates will tend to converge toward the overnight rates as we get closer to the end of the cycle as was observed in the three most recent major cycles.

Assuming this is the case again, we may be fairly close to those peaks and may not want to wait too long before extending maturities. Volatility will remain elevated and higher levels are still possible, but the current yields are offering greater protection against that risk. As proof of this, corporate bonds, which carried higher yields this year, have been significantly outperforming government bonds in the run-up in yields. More importantly, the higher rate environment means that more short-term debt with low coupons are being replaced by higher coupon bonds priced closer to par, swiftly closing the tax-efficient window opportunity that currently exists in the markets.

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