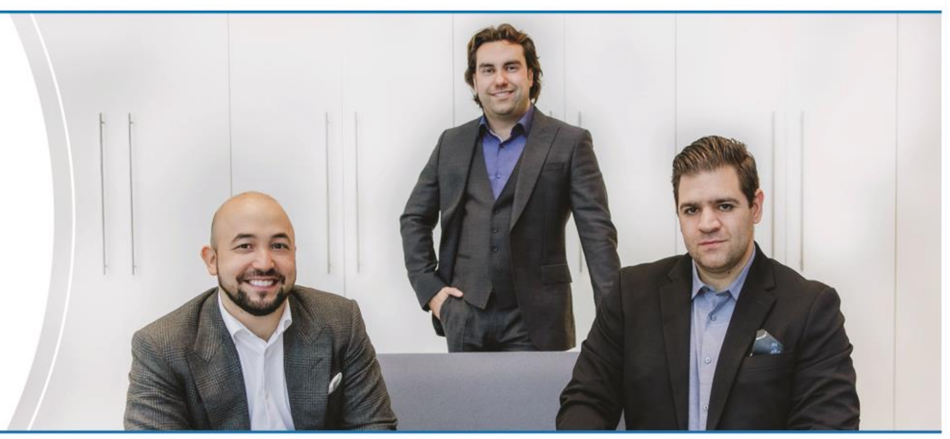
The Wrap Up



If You Start Me Up, I'll Never Stop (Rising)

After a volatile August-October period, November has been the exact opposite as indices have gained, in two weeks, what they lost in those previous three months. The question that we've been hearing and what we wish to address today, is this the start of a new cycle?

A quick reminder that when combatting inflation, any signs of economic moderation, are seen as positives; you want to see signs of the economy cooling and not falling off a cliff (i.e. the soft landing constantly repeated ad nauseum). The American economy seems to be building towards that. In November 2nd, third quarter productivity growth came in at 4.7% (the best since Q2 2020). While salaries have increased 3.9%, unit labour costs (the cost for a worker to produce one unit of output) actually declined to 0.8%, giving us both a positive in that salaries increased but output costs fell. The October jobs data came in below consensus at 150,000, with unemployment rising to 3.9%; another positive for the markets. Recall that tight labour markets have amplified inflationary pressures; not only do salary increases in this kind of environment struggle to keep up with the pace of inflation but many projects are delayed or cancelled due to lack of available workers.

In the optimistic scenario, the labour market cools with small increases in unemployment or small decreases in hours worked but never evolves into something dramatic where we see a major increase in job losses. Another component of this goldilocks scenario is seeing a cooling in inflation. Well, October inflation was flat and below expectations. Year over year inflation decelerated to 3.2% from 3.7% in September and core inflation came down to 4% from 4.1%. A large drop in gasoline prices (5%), as well as decreases in airline fares, used and new car prices, commodities and education all contributed to what was a welcomed inflation report. Shelter and services inflation were still positive, however, both were down to 0.3%, from 0.6%. The downtick in inflation was coupled with a soft retail sales report for October, a 0.1% month over month decline (compared to a surge of 0.9% in September).

Again, we are in a period where we need to see some moderation in aggregate demand in order to have meaningful progress on the inflation front; retail sales growing at 2.5% year over year is low enough to accomplish that

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but also high enough to keep confidence elevated. The ISM services PMI (purchasing managers' index) data was a little more mixed at 51.8 (anything below 50 is contractionary); new orders picked up sharply but business activity dropped. Together, the employment, retail sales and PMI data all confirm a (so far) unalarming and welcomed slowdown in economic activity, giving the Fed confidence that it is achieving its (what seemed close to impossible) soft landing. It is premature to declare victory on this front, yet markets have (rightfully) taken note of this positive progress and have chosen to adjust their expectations around the direction of interest rates.

Central banks use interest rates to cool inflation in a manner similar to how firefighters use water to extinguish fire. The risk with interest rate increases is that it has other unwelcomed consequences: increase in defaults and market volatility. While defaults have increased, they are still fairly subdued while markets have exhibited significant volatility since the beginning of the rate hiking cycle in early 2022. Most of the volatility was caused by asset repricing; when interest rates are higher, asset valuations need to come down. If you consider equities, earnings over the last two years have been fairly healthy: the drop in share prices was not associated with a drop in earnings. The same thing with bonds; we did not have a large uptick in defaults and credit downgrades; the bonds dropped in value simply because interest rates rose rapidly and made existing bond investments less desirable to hold. The softening in economic data has prompted a decrease in the 10 year rate from 4.934% on October 31st to 4.43% this morning. More investors are convinced that we are done with rate hikes and are now increasing their conviction in future rate decreases with the average market participant seeing the first rate cut as early as July 2024.

Almost automatically, equities and bonds rallied in response to the drop in market rates. The S&P 500 are up 7.8%, the Nasdaq are up 9.8% and long term (20 year) treasuries are 7.5% in the just the last 17 days. With a strong response like this, should we assume that the worst is over? Our response is, not yet. While our confidence levels have risen, there are still many unknowns and risks in the current environment and, most importantly, we want to highlight that a slowing down in economic activity could mean either a soft landing or the start of a more meaningful slowdown. At this point, we (we being everyone in this industry, not just Leon and myself) simply do not know how much things are going to slow down from here. While we have been happy to participate in the recent rally and while we have recently deployed some funds into the market, we are still happy to remain cautious in the current environment. What we are exercising today is a textbook reminder why investors ought to remain fully (or close to fully) invested at all times: dipping in and out would have likely left some on the sidelines throughout the month long rally. Now that some have potentially missed on a 7-10% increase in their portfolios, what do you do now? Do you jump back in? Do you wait another month to see if things will go down from here? It's a psychological game that can't be computed or quantified; if you are managing money this way, it's really your emotions that are doing the managing.

Let's call it what it is; this month has been a welcome change of pace and something we hope can be built upon in the months ahead. We like what we see but we want to avoid prematurely celebrating as inflation is still above target, interest rates are still elevated and risks should not be crowded out by short term euphoria. We ensure our clients that we remain level headed in this environment, but after so many months of our cautious tone, we are elated to have more positive outlooks to share. Our base case scenario (moderate recession) has not changed but we are open to being convinced otherwise. One last point to share, this entire perspective is based on US data; we did not discuss Canada or Canadian markets this week because the narrative is not quite the same. Notwithstanding some major development that needs immediate addressing, we will look at the Canadian side of the story next week.

Healthy Distraction

This week we pivot from joyful topics of holidays and gift giving towards more tragic news. Earlier this month, 29-year-old Adam Johnson, a professional hockey player, lost his life on the ice to a freak accident. Our thoughts go out to his family and all the hockey community. Immediately after the event, there were calls for mandatory neck protectors. This also caused some people to question if they should limit their children’s, family or friends exposure to these types of sports and risks.

We believe that safety and caution come first in any type of activity, however we also believe in statistics when assessing risk. This accident, along with the unfortunate turn of events that have affected lives such as those of Prichard Colòn in 2015 or even Superman himself Christopher Reeves in 1995, are outliers. Without belittling or forgetting what has happened to them, we must learn from these sad events and remember that there are more healthy and leisurely benefits to carrying out these activities than negative risks.

This situation allows us to bring up a story told by Will Smith (search - Will Smith Sky Diving speech to hear for yourselves) where the key conclusion states ' the best things in life are on the other side of your maximum fears.’

So, we say, go for it! Embark on your new business venture! Practice your favorite sport! Live an experience you've been putting off for years! Be safe, be cautious, be well guided but have fun and live on the other side of your fears.

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