The Wrap Up

High for Longer: I'm a Believer

The TSX has gone negative, bonds are having their worst stretch in history and even (perceived) safe equities are behaving more like volatile growth stocks. It is with a heavy heart that the market is pricing in the 'higher for longer' interest rate narrative.

Two weeks ago, Fed Chair Jerome Powell shared the FOMC 'dot plot'; a chart that shows where each FOMC member thinks interest rates will be by the end of the current year and also in two and three years. What the most recent dot plot shows was that all of members expect rates to remain above 4.25%, with the majority seeing them above 5% for the entirety of 2024. For 2025, rates are still expected to be above 3% and even likely to remain above 4%. These expectations were a sobering reminder for market participants that they were perhaps too eager to see the current reality behind them.

We have written about the market's complacency for months; up until a few days ago, the market was pricing in 25% earnings growth through 2025, a 20% oil price drop by 2025, 2.2% long term inflation and 3 rate cuts in the second half of 2024. Those expectations were the base case behind the equity valuations; it would require the data to be better in order for markets to meaningfully outperform. Realistically, how could companies continue to grow their earnings at an above average pace this late into the cycle? Employment may be strong, but real wage gains remained strained and higher interest rates are expected to carve out a portion of future spending. Within the realm of reality, the only short term solution to the problem would be an unprecedent boost in productivity brought on by AI.

While we believe that AI will eventually provide the boost necessary to help us become more productive; help us tackle labour shortages and allow for new ways of creating wealth, this is not an overnight story; we are still a year or two away from beginning to see some of these benefits. In the interim, we have a very real problem wherein central banks are staying committed to achieving their 2% inflation target but are being somewhat ignored by market participants (who still are pricing equities above their medium term average) and by governments (whom are running large deficits). What's most unfortunate about the heavy spending by governments is that it is making the

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central bank's job more difficult; one has their foot on the brakes while the other has their foot on the gas. These deficits need to be funded by more borrowing but most of the borrowing is happening while interest rates approach 20 year highs. The moment that we will require more stimulus (in a recession for example), the government's spending may be constrained because of elevated debt to GDP levels as well as high debt servicing costs.

In anticipation of further market volatility, we pivoted towards income notes and covered call strategies centered around defensive sectors. Although I still believe we have the right idea, utilities are both defensive and yield sensitive; investors buying stocks for a 5% dividend are going to be swayed by 5% yields on safe government bonds. We expected the selling off in the sector as close to being done; utilities were already trading 25% below their average 10 year valuations. Due to the markets' pricing in of higher rates, utilities had their worst weekly underperformance in more than 25 years. The reason why we still feel vindicated holding our income notes related to the sector is the following: holding the stocks outright would have yielded a worse performance as the income notes are still paying us close to 1% per month. Furthermore, other yield sensitive sectors like telecoms, REITs and financials have performed just as poorly: banks are down almost 6% since September 20th, telecommunications are down 5% and REITs are down 7.8%.

Growth stocks have held up better in this environment but that comes with the caveat that after the market has priced in the higher yields, it will have to estimate the impact of higher rates on future earnings. Healthcare has also fared a little better, a sector which we are overweight and use for covered call writing, only down 2.2% in the same time period. No matter which sector, however, or whether you are holding stocks or bonds, there's nowhere to hide other than in cash. I take that back, there is somewhere to insulate yourself from some of this volatility: private assets. Private assets are not unicorns, they are equally sensitive to the economic cycle as publicly traded assets, however, they do not offer daily liquidity, they do not offer daily pricing and they tend to trade at lower multiples; their pricing should not experience the same fluctuations that we see on a daily basis.

The advent of new products, the hard work of our partners trying to get their message out and our relentless pursuit of portfolio optimization has opened our eyes to this avenue. We have already begun conversations around the asset class and will be moving a portion of our discretionary assets towards a private market mandate. There is no reason why we, as wealth managers, should not be offering these solutions to clients; if your pension plan can be 30, 40 or even 50% exposed to private markets, your RRSP portfolio can afford an allocation in that direction as well. Most mandates originally required a minimum investment of several million dollars and were only available for qualified investors. The product innovation cycle has opened the possibility for us to hold these for our discretionary clients because we are the qualified investors. We may then buy in big blocks which can then be allocated to our clients in smaller amounts.

The journey towards normal will continue to be shaky; whether a recession arrives or not is irrelevant at this point. While we firmly believe that a new normal is achievable, patience and understanding will be required. Beyond this current episode, there is still a lot to be excited about in the not too distant future; we mentioned AI previously but changes in energy markets, retail brands and even healthcare will create new opportunities for making money and can even change our lives for the better. We will get there, markets have experienced volatility before, economies have contracted in the past but we keep moving forward. This time, as unique as some of the characteristics are, is no different.

Healthy Distraction

Some retail stocks experienced additional volatility this week because of a comment from President and CEO of Walmart U.S., John Furner. Mr. Furner shared that there was a slight pullback in terms of items purchased and total calories represented by purchases.

There was some growing speculation that the popularization of weight loss drugs could be having an impact on how consumers eat; this may be the first sign. There are estimates that see 7% of the US population on weight loss drugs by 2035, which could lead to a 30% cut in daily calorie intake. These are estimates based on the drugs that exist, there may be further innovations in the years ahead.

As a foodie, my emotions are mixed on the topic; it's great for more people to adopt healthy eating habits. This will prompt a change in the food the market provides; I just do not want to live in a world with pizza shortages.

Speaking of food, this weekend is Thanksgiving (for our Canadian readers at least). To those who get the chance, enjoy the feast and the company of your loved ones!