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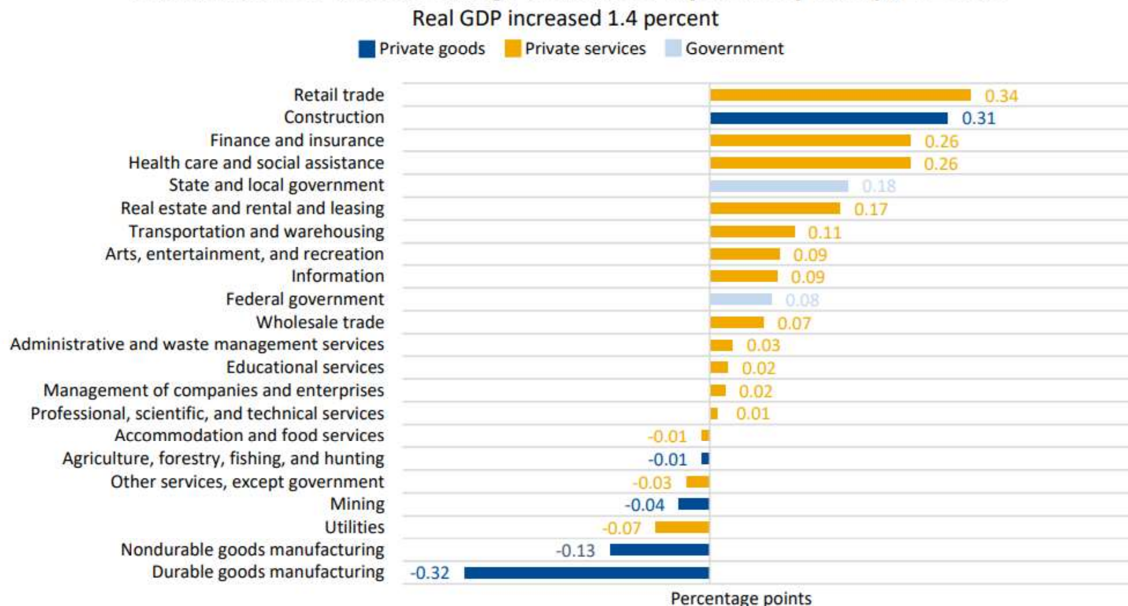
BMO Nesbitt Burns

July 2024 Newsletter

We write to you halfway through the year and trust you all are enjoying the summer so far. 2024 has experienced continued market strength particularly in the US markets, with many of the 2023 themes spilling over and continuing through this year. The conversation and rhetoric has shifted from 'how high' central bank rates could reach, to 'when' the inevitable rate cuts will happen in the US, Canada, and around the world. Markets had high expectations priced in at the beginning of the year with hopes of up to 4-6 rate cuts through 2024 by the US Federal Reserve. While we have had two rate cuts by the Bank of Canada, we still have yet to see a single rate cut by the US Federal Reserve with the market now expecting 1-2 cuts in 2024 – and that is not necessarily bad. The reality is that the US economy is actually doing *OK*, certainly on a relative basis, and because of this there hasn't been an immediate need to reduce rates. Keep in mind that lower rates over the past 5+ years were a large source of the inflation we still have today, and lessons can be taken from the Volker era of the 1970s where when they reduced rates too far and quickly, inflation came back 3-fold and crippled the economy for years.

Americans do not face the same mortgage renewal terms as Canadians, therefore existing homeowners have not felt the shock of higher interest rates like many Canadians have, especially the variable-rate mortgage holders. The US economy has real GDP growth that is exceeding expectations, which is supported by a resilient and broad consumer profile. While areas of the economy and some cross-sections of sectors have slowed down, it has been offset by higher growth in other areas of the sector or economy. Given the +2.8% Q2 GDP print as well as Personal Consumption Expenditure (PCE, another measure of inflation) data having no surprises, there is an expectation for a rate cut in the US come September. Jerome Powell has also signalled to the market 100-125bps of rate cuts through 2025, but of course the economy needs to keep trending towards the soft-or-no landing scenario.



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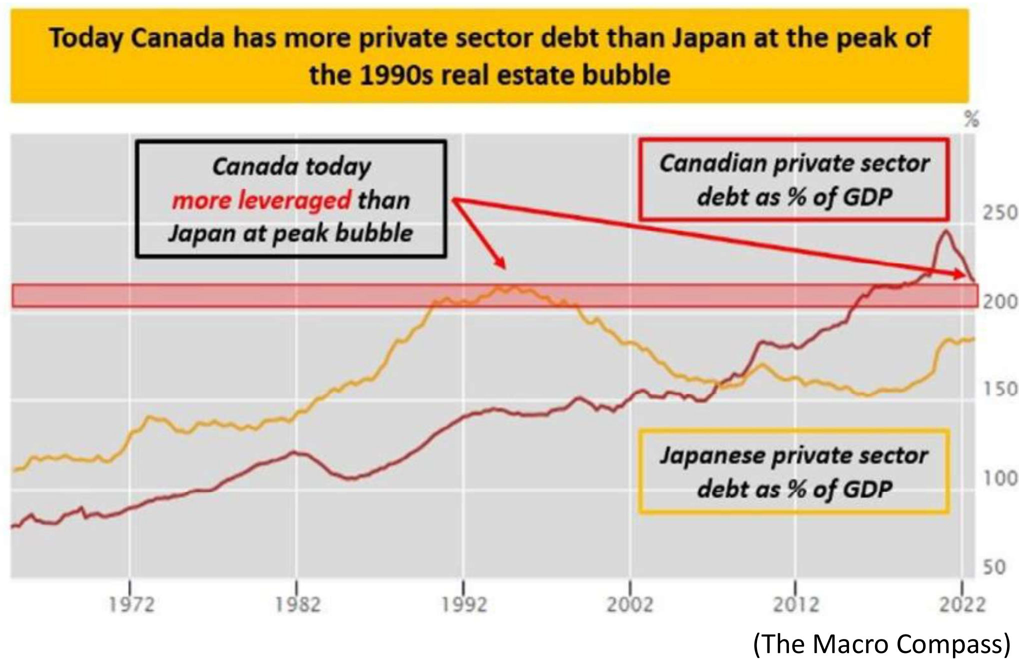
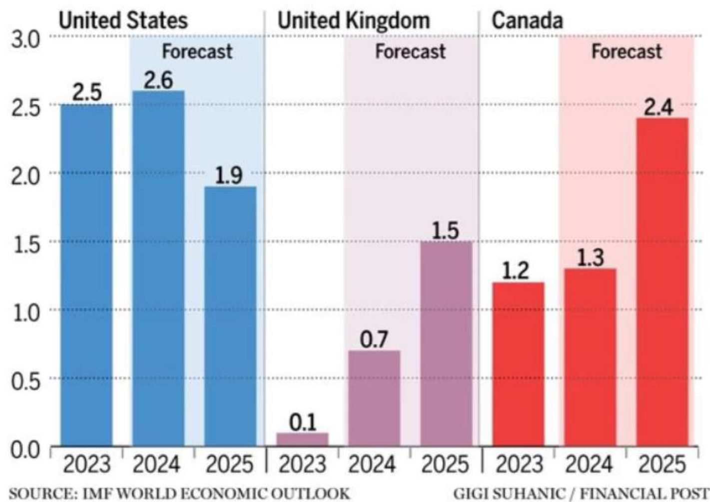
The above contrasts with what we are seeing in Canada, with inflation and general economic slowdown being felt more so. While the IMF is predicting that Canada will be the fastest growing economy in the G7 in 2025 (see below table from the Financial Post), it's hard to imagine the quick economic rebound given the current landscape. Canadian Banks still have their hands tied with loan-loss provisions restricting a HUGE base of capital which would otherwise be used for loans and investments. This coupled with high borrowing rates, a slowing consumer, and persistently higher personal and corporate tax rates, makes for a difficult outlook. We have also seen a huge spike and trend with immigration, but developers already were challenged in creating supply with slow changes to zoning and high construction loan costs – immigration has made the housing crisis worse and has also pushed up rental rates in the process. The commercial/office real estate market and the retail mortgage borrower are the two segments of the economy perceived as a risk by the Canadian Banks, and the loan-loss provisions at the banks will continue until there is both stability and certainty towards a recovery in both areas respectively. The household and private sector debt in Canada is worrisome, and we note that while it has come off from the highs, Canada is still more leveraged than Japan at the peak of their 1990's real estate bubble (see chart below).



(The Macro Compass)

Canada did not have to raise rates as high as the US, and with our -0.50% in rate cuts already this year, the spread on yields continues to grow. This could have two implications: a continued devaluing of the CAD against the USD, and outperformance from Canadian rate-sensitive sectors such as Utilities, Communication Services, and Real Estate. These three sectors are also presenting the most 'value' after having struggled through the drastic rise in interest rates over the last 2+ years. Hence, we are approaching this theme with caution as the risks mentioned earlier remain in the system for now, but balance sheet analysis will be helpful for us to take more exposure with confidence. Canada is still very much a resource-based economy and if there is a hint of a recovery in China for example, we could see meaningful growth in Canada's materials and energy sectors, but this remains a huge 'what-if' scenario.



Financial Post

We are focussed on the following three themes that we believe will drive markets in the near-term and in to 2025: Valuations, Interest Rates, and the US Election

Valuations

As long investors it's always nice to see various markets reach all-time highs, but with that comes all-time high valuations. While we haven't reach 'peak value' per se, we find ourselves in the 91st percentile of valuations in US markets, which dates back to 1998. This of course was followed by the great .COM boom/bubble/bust, yet we are not drawing parallels to those markets. The .COM boom was fueled by hysteria, hype, and the unknowns of how the internet could reshape the world as we knew it. Markets today are driven by earnings, balance sheets, and genuine growth of companies and businesses, which has been largely expedited and influenced by technology and innovation. While obvious areas of the market may look overheated and over-valued, these are also the companies who are consistently growing their earnings quarter-over-quarter, while also increasing the guidance and outlook for future earnings. AI is the obvious theme for this discussion and we are acutely aware of the valuations for every position we have. High valuations have driven a lot of the investment decisions and changes over the last quarter, where we have trimmed various names while reinvesting the proceeds in to more undervalued names within the same sector. Earnings season has just kicked off and while the US Banks reported well, both earnings and guidance needs to support current valuations. We remain overweight to the US vs Canada, although valuations are starting to look appealing in select areas of the Canadian market.

Interest Rates

As mentioned throughout the above, central interest-rates are a major (if not *The*) theme driving markets. Central rates affect investment, infrastructure, the consumer, equity markets, fixed income markets – pretty much everything in the investment universe. We have see some of the most drastic rate policy in history but we do believe now and going forward will be steps towards a period of normalization with interest rates. Markets hitting all-time highs without a single rate cut in the US is something no one could have forecasted, and with the proposed dot-plot illustrating a trend of cuts through the next 18 months, this is something for most/all markets to look forward to.

While your savings and GIC rate on cash will go down, bond prices will rise and equity markets will get some balance sheet reprieve with more capital coming back in to the system. This seems to be the likely scenario, but we have seen major adjustments to expectations already so far this year, so we are remaining open-minded.

The US Election

In the last 10 days we have seen an assassination attempt on the former President and current Republican Candidate, and the current President and Democratic Candidate announced that he will not be running for re-election. Wow what a whirlwind!! After the assassination attempt Trumps polling numbers went up, with parallels being drawn from the Reagan era (Reagan won a historical landslide election following an assassination attempt). And after Biden announced he will not run for re-election, as of this morning Andy Laperriere the political expert from Piper Sandler investment firm now pegs the odds at a 60% chance of a Republican win, with a strong possibility for a super-majority (Andy's table is below). While we were thinking about scenarios of a possible democratic OR Republican win, we can likely start thinking about how a Republican government is going to play in to markets. While we know the obvious policies like a lower 15% corporate tax rate, attack on EV industry, anti-trust on big tech, to name a few, Trump is absolutely a wild card and there is almost no telling what bee's nest he will throw rocks at next. We believe that while this could be good for America and manufacturing sectors, tariffs and a protectionist attitude will come at the cost of foreign policy and could also result in more inflation to general goods. We have seen how quickly the election has changed in the last few weeks, and with the Democratic National Convention in a few short weeks, we expect more twists and turns leading to November.

PIPER SANDLER ELECTION ODDS: TRUMP VS. HARRIS

	GOP	Dem
White House	60%	40%
House	55%	45%
Senate	85%	15%

White House	Senate	House	Scenario Odds
Harris 40%	Dem 15%	Dem 15%	Dem Sweep – 15%
		GOP 0%	Divided Gov't – 40%
	GOP 25%	Dem 15%	
		GOP 10%	
Trump 60%	Dem 0%	Dem 0%	
		GOP 0%	
	GOP 60%	Dem 15%	
		GOP 45%	GOP Sweep – 45%

Source: Piper Sandler.

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As you navigate through life's many stages, having a financial plan is more crucial than ever. Whether you're planning for retirement or need cash flow planning, our team is here to guide you every step of the way. If you would like to engage in a new plan or have your existing plan updated, please kindly contact your advisor or alternatively address it during your next review meeting.

If you have any questions, please reach out to any of the team members.

All the best from our team,

Jed, Dave, Marion, Lili, Samantha, Kenzy, Mahad, Ling, Tracy, Kelly, Sarah, Mui and Jennifer

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