PICTON MAHONEY
Asset Management

Q4 2024

Investment Review & Outlook

Soft-Landing Odds Improved, But Largely Priced In:

Will An Asset Bubble and/or Inflation Follow?

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Picton Mahoney House Views October 2024

	PMAM vs. Consensus
Risk	
Macro risk spiked in the third quarter of 2024 from low levels and peaked near extremes in the first week of August as the combination of weak labour market data and a Japanese rate hike introduced volatility into risk markets not seen in years, causing investors to question the economic outlook and the yen carry trade to unwind.	Higher +
Macroeconomic	
Global Real GDP Global growth continues to diverge, and emerging economies look better positioned. Brazil is raising rates in the face of rising growth prospects, while China is attempting to stabilize its markets with new stimulus measures.	Same
U.S. Real GDP The U.S. consumer remains a bright spot even as global manufacturing and industrial production seem to be hitting another air pocket. The 12-month rise in U.S. unemployment above 0.5% is suggestive of softening economic prospects.	Same
Canadian Real GDP GDP per capita remains in contraction and inflation has fallen back to target, while calls are increasing for the Bank of Canada (BoC) to make larger rate cuts.	Lower –
U.S. Inflation Energy and core goods are still a negative contributor to inflation, but more progress is needed on the services side; core services inflation rose as shelter costs inflected higher.	Same
Equity Returns	
U.S. Equities The start of the U.S. Federal Reserve cutting cycle has helped lift economic sentiment, although equities are already pricing in a benign economic outcome. The election will likely be a top risk this quarter. We believe there is little room for a misstep, with sentiment and positioning already at extreme highs, and long-term valuation at century's highs.	Same
European Equities We believe European Central Bank rate cuts need to continue amidst signs of deteriorating economic sentiment after a hopeful start to the year.	Same
Canadian Equities The Canadian economy will eventually benefit from BoC rate cuts, although much bigger cuts will likely be needed to stabilize the economy and Canadian equities.	Lower –
Bond Yields	
Treasuries (U.S. 10-yr) Lower rates are on the horizon: the rate cut cycle has started in the U.S., which has joined other countries that are cutting rates, although Japan is wary about normalizing its policy rate any further. Still, treasury demand imbalances will potentially put a floor on treasury rates.	Lower –
Investment-Grade Corporate Bonds Falling government rates should offset any widening of spreads for investment-grade yields in the event of rising risk aversion.	Same
High-Yield Corporate Bonds Rising Chapter 11 filings may begin to weigh on the higher-risk segments of high yield.	Higher +
Other	
WTI Crude Oil OPEC (Organization of the Petroleum Exporting Countries) continues to balance supply in the face of uncertain demand with the goal of keeping prices stable.	Same
EPS Growth (S&P 500) There are increasing expectations for earnings growth, but many things would have to go right for them to be realized.	Lower –
P/E (S&P 500) We expect extreme equity valuations to normalize over time.	Lower –

PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at September 30, 2024.

Overview

Virtually every correction in a bull market can feel like the end of the run when you're in the middle of it. The sell-off experienced by equities in early August was no exception, and certainly seemed more dire than the correction that occurred in the previous quarter. This time the CBOE Volatility Index (VIX) spiked to extreme levels, suggesting that panic was spreading and that a recession was finally at hand.

However, markets yet again shrugged off the negativity and rallied back to new highs by the end of the quarter, suggesting that the soft-landing narrative was back in vogue. To the bulls' credit, economic data (although somewhat mixed) still seems to favour a Goldilocks outcome, especially as central banks around the world come riding to the rescue. Perhaps this past quarter's market sell-off even contributed to the more determined pace of monetary easing that has begun.

While many global economic indicators aren't great, the always critical U.S. economy does not appear to have any dangerous excesses that could lead to a deep or prolonged recession. On the contrary: solid household balance sheets, significant wealth effects and structurally tight labour markets could limit any real economic downturn to something shallow and quick to recover from. Meanwhile, the higher interest rate sensitivity that created significant drags on much of the rest of the world's economy will likely start becoming a tailwind as most central banks continue their easing. The Chinese authorities' recently announced bazooka-sized fiscal and monetary stimulus programs should likely contribute to shore up flagging growth in China and the world as well.

While markets have responded bullishly to these developments, the problem for investors at this time is that the set-up for boosting risk in most markets isn't great. Valuations are rich, with a lot of the soft-landing narrative already priced in, investor positioning is stretched, and unfriendly autumn seasonality, combined with U.S. election concerns, may create near-term downside pressures on markets. And before the economy starts responding to the lagged effects of the new monetary stimulus, investors will likely have to look past labour markets that are cooling, manufacturing output that is heading in the wrong direction and new bankruptcy filings that are steadily rising.

Given these near-term hurdles, we believe patience is currently the best approach for investors. With the U.S. Federal Reserve (the Fed) put back in place, buying on pullbacks in risk assets could be attractive. We are also willing to consider the possibility that markets won't correct much and actually begin to "melt up" into 2025 as the economy shows signs of improving. This would likely be a concerning development, since we expect acceleration in global growth and increasing wealth effects will end up pulling forward the timeline in which inflationary forces begin to reappear, bringing the party to an abrupt end.

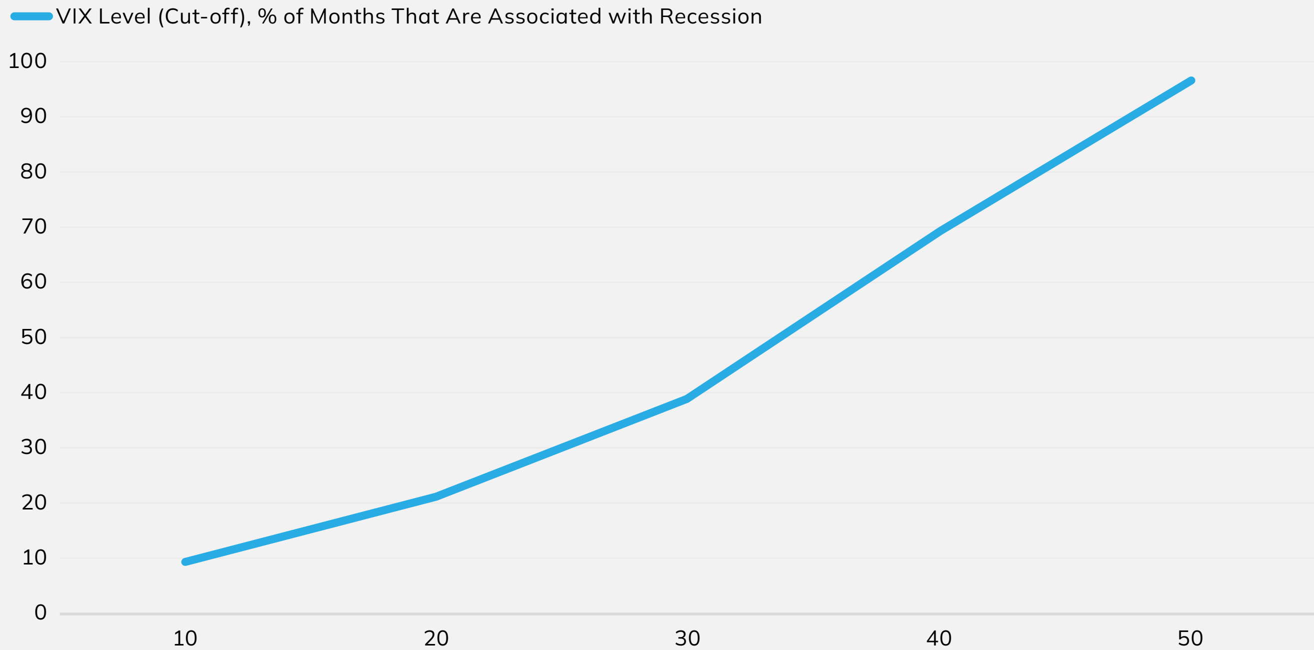
August's Correction Felt Different—But Again Resolved to the Upside

We also viewed the set-up for equities as unattractive, as last quarter got underway. And while markets continued to march higher in early July, they swooned dramatically at the beginning of August, before staging another strong reversal. But this correction felt different than the one in the preceding quarter:

- There was a greater sense of panic, with the VIX spiking to multi-year highs of 65 intra-day on August 5 (a level last seen during the early days of the pandemic in March 2020).
- Volatility-of-volatility (i.e., the cost of buying options on the VIX index) also spiked to a high of 192 on that day—again, a level not touched since March 2020.

The more recent correction may have been more dramatic, given it showed previous monetary policy tightening was finally creating stresses in the financial system. A surprise Bank of Japan interest rate hike and surge in the Japanese yen led to the rapid unwinding of the yen carry trade, in which large amounts of money were borrowed in Japan to finance higher-yielding assets purchases in the rest of the world. At the same time, investor concerns about an impending recession also increased: there was a good reason, given that spikes in the VIX have historically, since 1990, been connected to periods of economic contraction.

Figure 1: **Spikes in the VIX Have Historically Been Associated with Recessions**



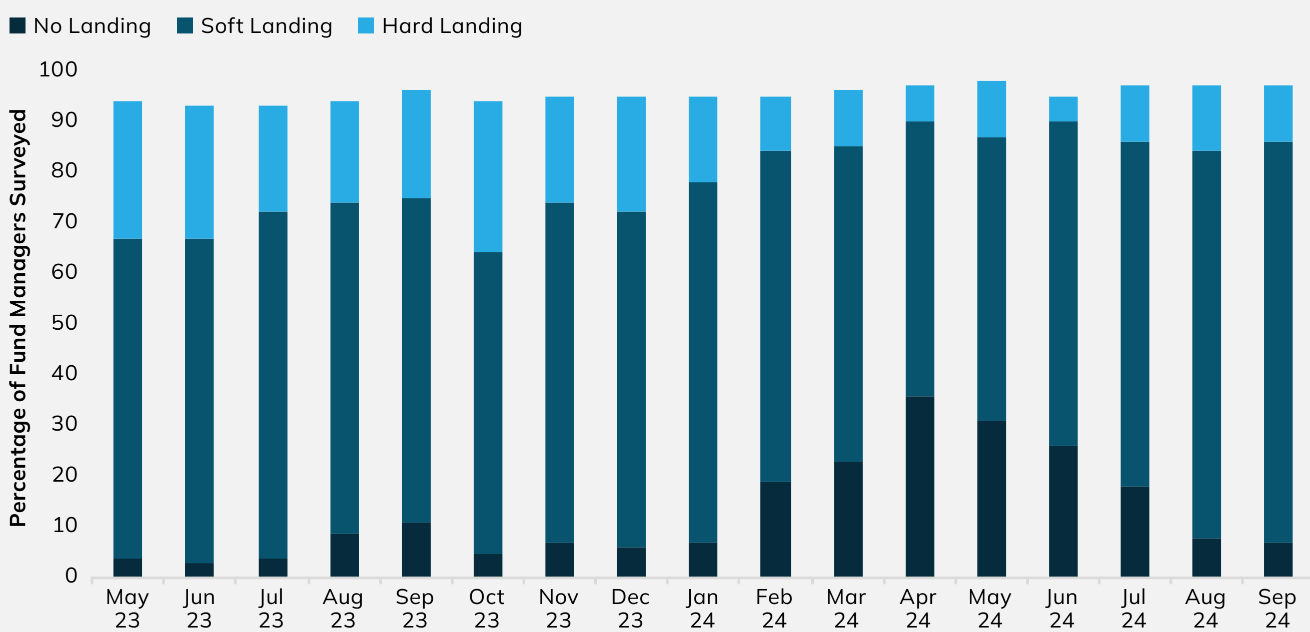
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1990 to Sept 2024.

The soft-landing narrative started to give way to a recession story when the U.S. unemployment rate jumped over 50 basis points (bps) from the previous year. In the past 50 years, a jump of this magnitude has always corresponded to recession. The Fed responded by shifting its focus away from just fighting inflation to gearing up as well to deal with rising unemployment rates. Investors seem to begin to remember that the start of a Fed rate-cutting cycle has not always been a source of comfort historically, as the first cut is often (although not always) associated with an economic contraction.

Markets and the Economy are Still in Goldilocks Mode

But as quickly as the market panic surged, it abated. Japanese monetary policy makers backed off from their tightening intentions, the Fed cut rates by 50 bps, and Chinese authorities increased stimulus measures significantly. Despite their brief flirtation with a recession narrative, investors seem to be overwhelmingly in "Goldilocks" mode. Underscoring this is the Bank of America/Merrill Lynch's September fund manager survey, which showed that 79% of respondents believe the global economy is headed for a soft landing. The percentage of fund managers believing that the world is headed for a hard landing has remained relatively constant for the last three months. Increasing faith in a soft landing—up 11% since July—is the result of many "no landing" adherents capitulating to the majority view.[1]

Figure 2: Fund Managers Overwhelmingly Believe in a Soft Landing

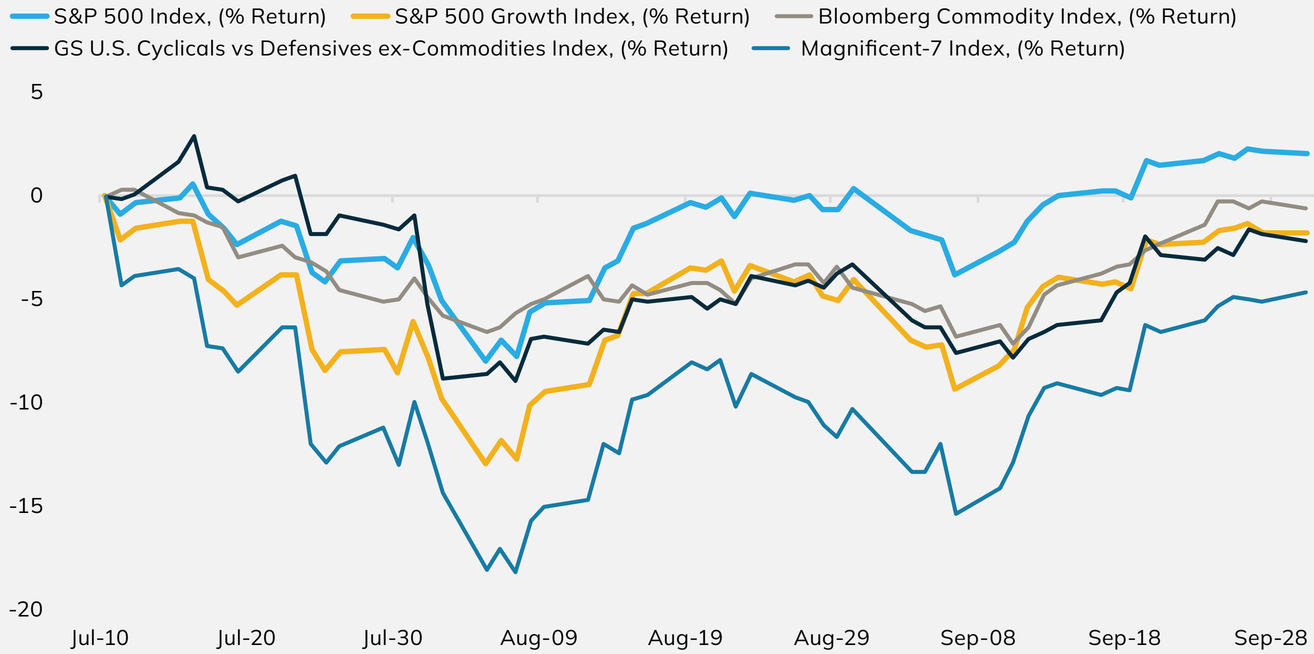


Source: Bank of America Global Research. May 2023 to Sept 2024.
Note: Fund managers were asked "*What is the most likely outcome for the global economy in the next 12 months?*"

[1] BofA Global Research, Global Fund Manger Survey, Sept 2024.

Market internals also reflect the soft-landing consensus. Technology stocks and cyclicals, for example, which had underperformed from July 10 onward, found their footing in early September. It's another sign that the early August fears of a major slowdown are now largely in the rearview mirror.

Figure 3: In Early September, Investors Returned to Growth Stocks



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jul 10, 2024 to Sept 30, 2024.

Indeed, there is an improving case to be made for an economic soft landing as we enter the fourth quarter. U.S. retail sales for August came in stronger than expected. The month-over-month sales increase of 0.1% beat consensus estimates of a 0.2% decline. Sales ex-gasoline and autos have now increased for the last four months. Meanwhile, "control group sales", which are used in the calculation of gross domestic product, rose 5.7% from June to August, the fastest pace since August 2023, according to Bloomberg.[2] Given how important the consumer is to the U.S. economy, this improvement is worth noting.

[2] Bloomberg, U.S. Retail Sales Post Surprise Gain, Helped by Online Stores, Sept 17, 2024.

Central Banks Have Helped Support the Soft-Landing Narrative

Key central bank actions since the August sell-off have also supported the likelihood of a soft landing. The U.S. central bank decided to jumpstart its rate-cutting cycle with a 50 bps move (with one dissenter who only wanted 25 bps). The Fed expects to cut 50 bps more this year and 100 bps more next year, eventually getting to 3% the following year.[3] It's quite possible that the market correction early in August helped influence the Fed's decision to opt for a larger-than-expected cut.

The main message from the September Federal Open Market Committee (FOMC) statement is that while both inflation and employment are not quite where the Fed wants them to be, its concerns about each are balanced:

- Inflation has made progress but remains somewhat elevated.
- Job gains have slowed, and the unemployment rate has moved up, but remains low.

Defending the action, Fed Chair Jerome Powell said that the

> *"U.S. economy is in a good place, cut is to keep it there."*

The Fed "put" seems like it's back, and Powell's Jackson Hole speech in late August suggested that the Fed will strengthen its backstop even further if needed to combat recession risks. First, he noted that,

> *"We do not seek or welcome further cooling from labor market conditions."*

Then he turned to possible Fed action, stating,

> *"There is ample room to respond to any risks we may face, including the risk of unwelcome further weakening in labor market conditions."*[4]

[3] Board of Governors of the Federal Reserve System, Federal Open Market Committee, FOMC Projections materials, Sept 18, 2024.
[4] Board of Governors of the Federal Reserve System, Federal Open Market Committee, Press Conference, Sept 18, 2024.

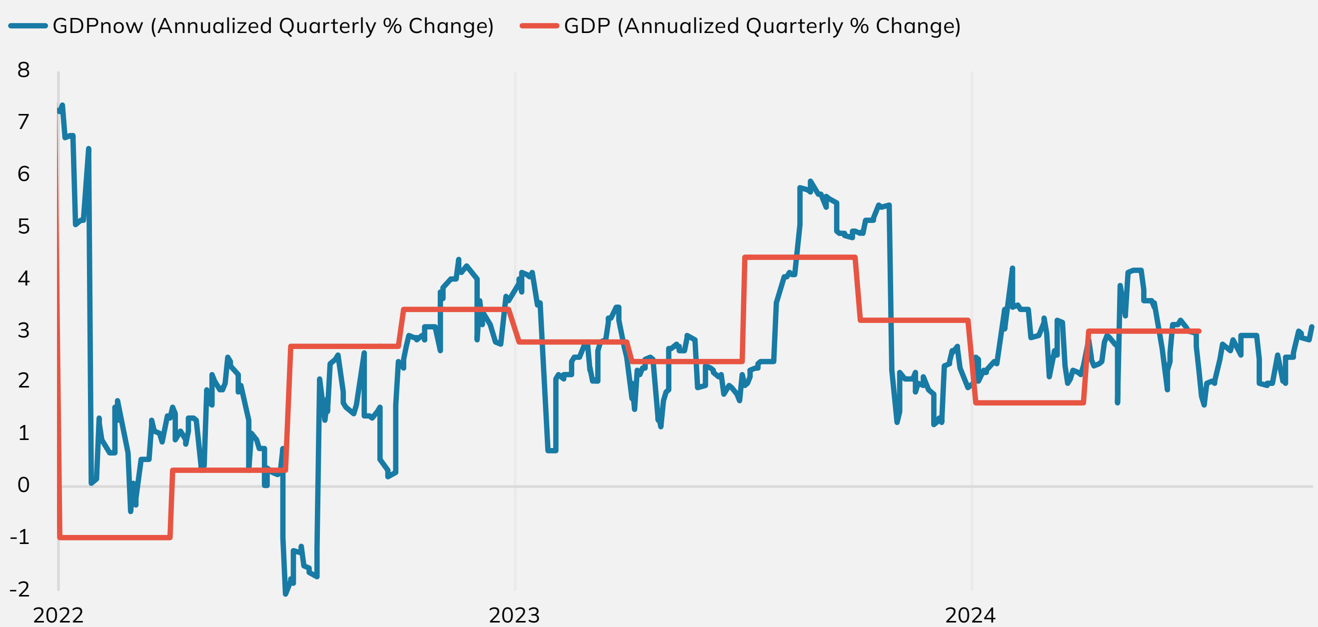
The rebounding soft-landing narrative is well articulated by the team at 22V Research, who wrote:

> *The current Fed cut cycle is more about maintaining/supporting growth than pushing back against a sharp slowdown, which is different from most historical periods. So, historical studies, which already suffer from a small sample size, maybe even less relevant today…*
>
> *Overtime, the number of cuts matters less than how economic activity responds to the easing of policy. For context, the futures-implied path of cuts is milder than in 2001 and 2008, and stronger than 1990, 2020, and 1995 easing cycles. 1995 is the only example of a cutting cycle without a recession, making it a natural anchoring point."*

What's more:

> *Expectations for growth remain strong based on the Atlanta Fed's GDP Nowcast and the reading has been in an uptrend recently. That is consistent with the Fed's observation that economic activity has continued to expand at a solid pace…Put simply, the Fed is cutting into an improving economy where inflation is stable. That is MUCH different than most cutting cycles, which were meant to offset realized weakness in growth and inflation."*[5]

Figure 4: The Atlanta Fed's Nowcast Suggests a Still-Strong Economy



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2022 to Sept 2024.

[5] 22V Research, Quant Market Diagnostics: Factor & Sector Reactions After First Rate Cuts, Sept 22, 2024.

Other central banks around the world have also been in easing mode lately. Even the Bank of Japan effectively pressed pause on its tightening campaign. In a press conference following the September 20 decision to leave short-term rates unchanged, Bank of Japan Governor Kazuo Ueda said there was "time to maneuver" before deciding to hike rates again, and that even if the probability of reaching the 2% inflation target increased, that didn't necessarily mean a rate increase would immediately follow. He also, quite tellingly, observed that "financial markets remain unstable," suggesting that the rapid yen increase seen in August is still fresh in the minds of central bank officials.[6]

A Bazooka from the Chinese Authorities

It's no secret that China's economy has languished, weighed down by a housing crisis, persistent oversupply and significant indebtedness among local governments. For some time now, the Chinese authorities have preferred targeted stimulus measures, opting not to unleash a bazooka to kickstart growth.

All that changed on September 24, 2024. In one fell swoop, the Central Bank of the People's Republic of China (PBOC) announced a series of policies to support the economy. PBOC actions included a 50 bps cut to existing mortgages, a reduction in down payments for second homes, a reduction in bank reserve ratios, the provision of a liquidity backstop for securities firms, fund managers and insurance companies to purchase stock, and a lending program for equity buybacks. Other than the last two initiatives, most of these policies have been tools that the PBOC has used previously to support the market or economy.

In the past, these measures have not had much of a lasting effect, because investors generally viewed these monetary policies as not bold enough to address the long-term challenges in the property market. However, the Politburo followed those measures up with an even greater sense of urgency, by suggesting a number of fiscal measures would also be implemented to aid growth. Their communiqué mentioned "adjustment on both monetary and fiscal policy," the need to "help property market to stop falling" and the need to "help private enterprises deal with operating difficulties." While details were not released, news articles are suggesting that China will be issuing special sovereign bonds (up to two trillion yuan, or US$285 billion) and injecting half of these funds (one trillion yuan) into the six major banks.[7] This announcement, which remains scant in detail, was enough to propel the Chinese stock index up 5% on September 24 alone.

[6] Bloomberg, Bank of Japan maintains interest rate at 0.25%, saying it has "time to decide" on raising interest rates; yen plummets to 143 yen level, Sept 20, 2024.

[7] Bloomberg, China Unleashes Stimulus Package to Revive Economy, Markets, September 24, 2024.

China's economy could still face considerable challenges over the long term, including too much focus on production, compared with consumption, and a very dismal demographic outlook over the next twenty years or so. Nonetheless, we believe the PBOC's policy changes are a significant plus in the short run, and could help to stabilize the country's domestic growth while also boosting the odds of a soft landing for the global economy.

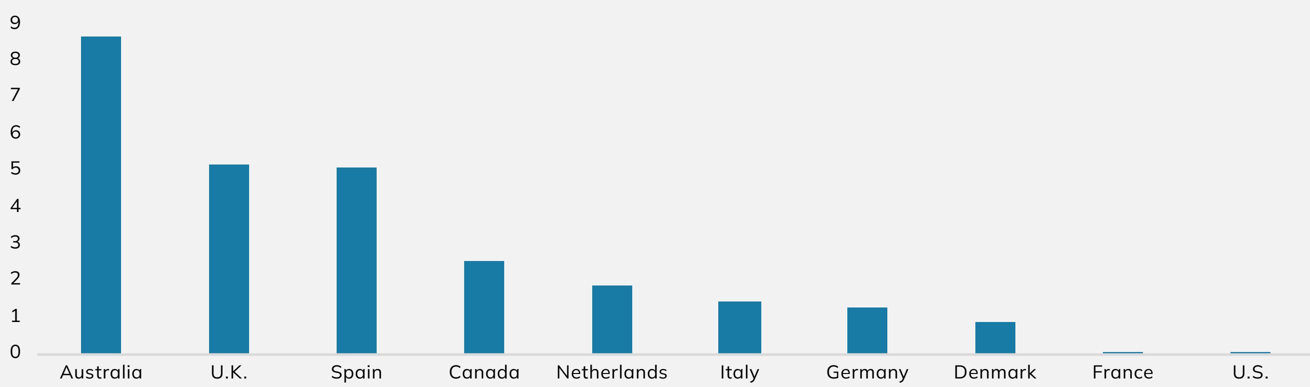
Other Economic Tailwinds Ahead

Central banks couldn't be aggressive with interest rate cuts unless inflation rates were coming down. Inflation is now falling closer to target ranges, and that should also provide some support for consumer confidence. Both inflation rates and consumer confidence should also be positively affected by the recent declines in oil prices. In addition, the U.S. dollar is falling, which can likely help to relieve financial pressures in emerging markets that are sometimes forced to issue U.S. dollar-denominated debt to fund their budgets.

Rate-Sensitive Economies Will Likely Benefit from Fed Easing Cycle

We have written previously about many countries whose economies were far more exposed to rising interest rates than the U.S. These countries were effectively at the mercy of U.S. monetary policy as the Fed led the charge in a global hiking cycle. The good news is that this dynamic should now work in reverse. Countries such as Canada, Australia and the United Kingdom all saw large amounts of mortgage debt build up in the early stages of the pandemic as rates fell. The spectre of this debt renewing at much higher rates has depressed consumer confidence and the countries' overall economies. Many borrowers are now looking at relief coming in the form of lower monthly interest payments, which should help provide significant tailwinds for consumer spending.

Figure 5: Some Countries Are Very Rate Sensitive. Others, Not So Much.
Debt-Income Impact of a 3% Rate Hike (%)



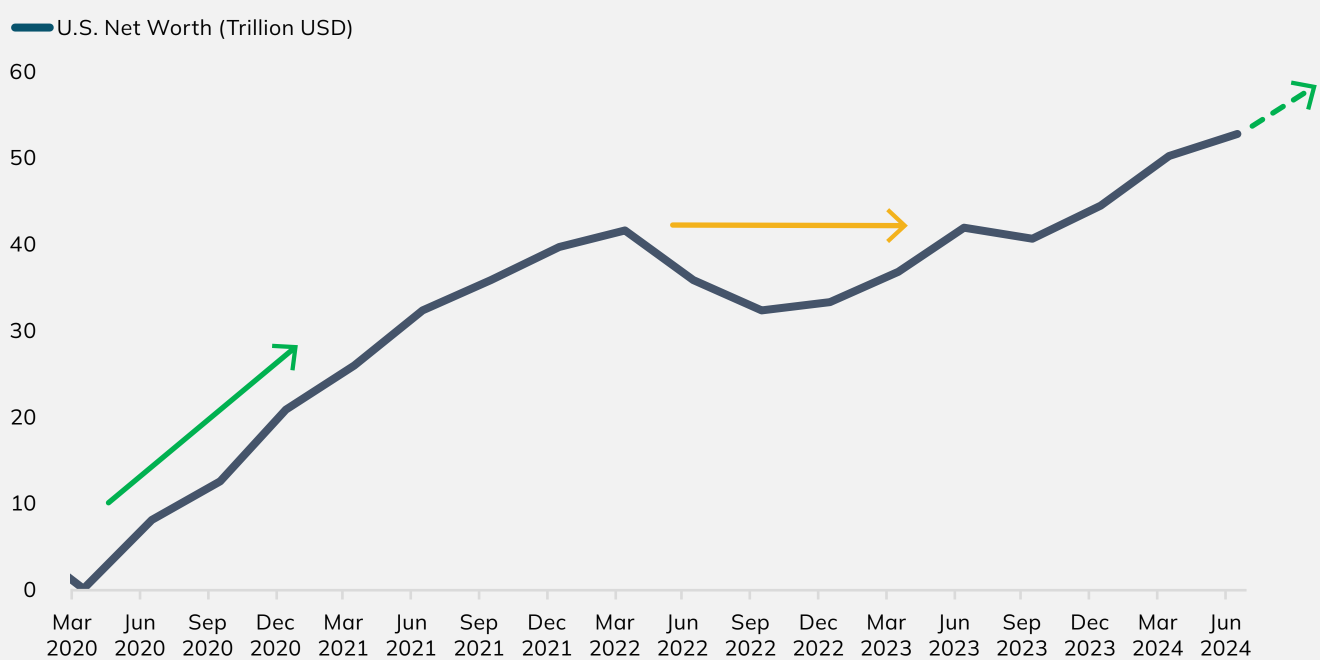
Source: Fitch Ratings Inc., Picton Mahoney Asset Management Research. 2022.

Longer-Term Positives Should Support the Economy

The good news is that no significant excesses seem to exist in the U.S. economy at this time—other than, perhaps, ballooning government debt levels. We believe deficits and the national debt should be a concern, but the reserve currency status in the U.S. likely means it has significant running room before these issues start to roil markets.

While COVID-related government support has dried up, consumer spending has longer-term tailwinds from significant wealth effects: both equities and real estate have driven U.S. household net worth significantly higher since the pandemic began.

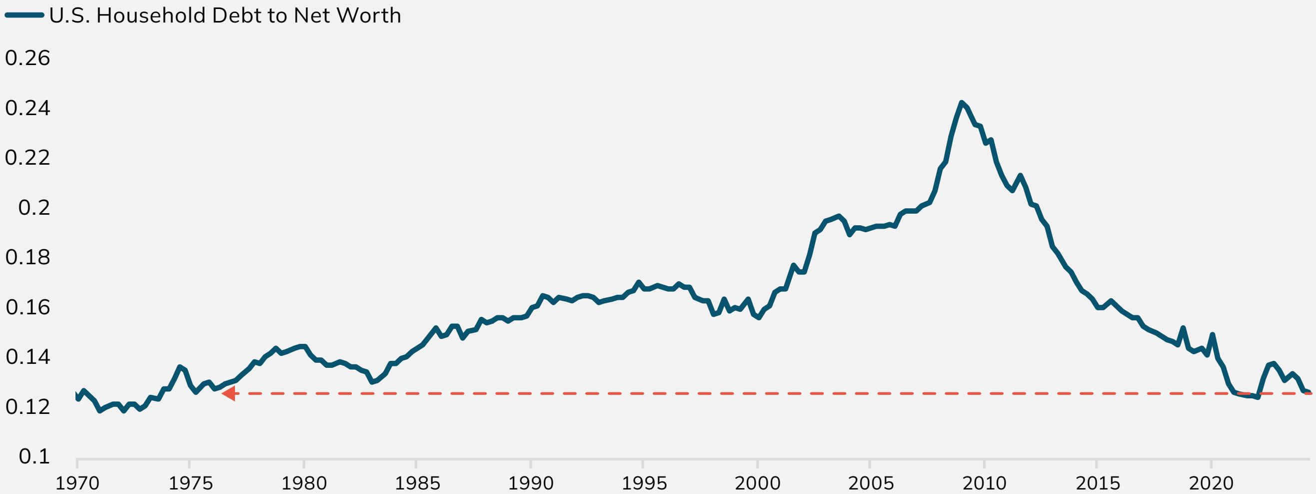
Figure 6: Surging Asset Prices Have Propelled U.S. Household Net Worth



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q2 2020 to Q2 2024.

Deleveraged household balance sheets also suggest the consumer should fare well during any economic slowdown and bounce back relatively quickly.

Figure 7: U.S. Household Balance Sheets Are in Good Shape



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 1970 to Q2 2024.

BUT, the Soft Landing Is Priced In

While the case for a soft landing has strengthened with the recent monetary policy shifts around the world, equity markets and high-yield spreads have already tracked almost all of the typical movements that occur after a Fed tightening process ends and the economy avoids a recession.

Figure 8:
Equities and High Yield Have Followed the Soft-Landing Script. But Interest Rates Suggest a Hard Landing.

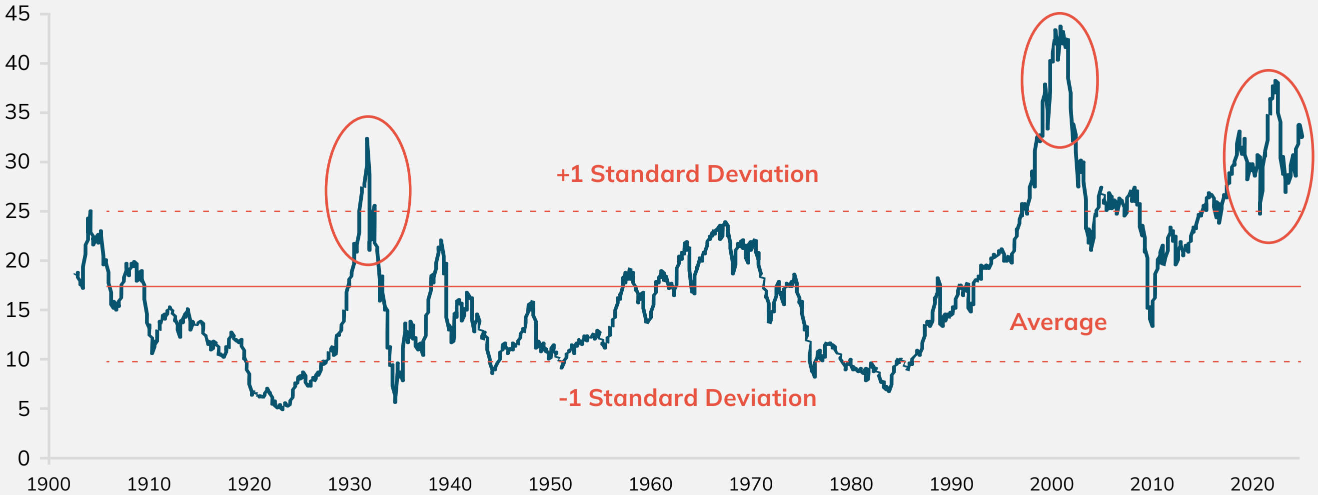
	S&P 500 Equal Weighted Index	S&P 500 Index	S&P/TSX Composite Index	MSCI World Index	U.S. 10 Year Bond Yield	U.S. 2 Year Bond Yield	10/2 Year Yield Curve	High Yield Credit Spread	U.S. Unemployment Rate
Last 6 months	6.5%	9.9%	9.4%	9.5%	-0.44%	-1.02%	0.58%	0.00%	0.4%
Fed Pause (pre-recession)									
Prior 3 months	5.1%	3.1%	2.2%	1.0%	0.13%	0.39%	-0.26%	0.65%	-0.1%
First 3 months	3.8%	8.3%	9.2%	2.4%	-0.58%	-0.55%	-0.03%	0.06%	0.0%
Following 6 months	5.3%	-0.2%	-2.7%	1.4%	-0.53%	-0.98%	0.45%	0.10%	0.2%
Fed Pause (re-acceleration)									
Prior 3 months	5.0%	7.9%	1.9%	4.2%	-0.24%	-0.10%	-0.14%	0.06%	0.0%
First 3 months	8.4%	6.9%	5.0%	4.8%	-0.78%	-0.92%	0.14%	-0.04%	0.0%
Following 6 months	8.9%	12.5%	9.1%	8.2%	-0.71%	-0.66%	-0.05%	-0.32%	-0.1%

Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. June 1982 to Sept 2024. Last 6 months is as of Sept 30, 2024. **Fed pause** is defined as the last hike of a continuous hiking cycle. **Fed pause (pre-recession)** is a Fed pause that eventually led to recession and **Fed pause (re-acceleration)** is a Fed pause where the economy then avoided recession and accelerated.

Equity Valuations Very Frothy

This year's rally in U.S. equities has sent valuations (as measured by the Shiller cyclically adjusted price-to-earnings (CAPE) ratio) back to levels seen only a few times in U.S. economic history—none of which ended well for investors.

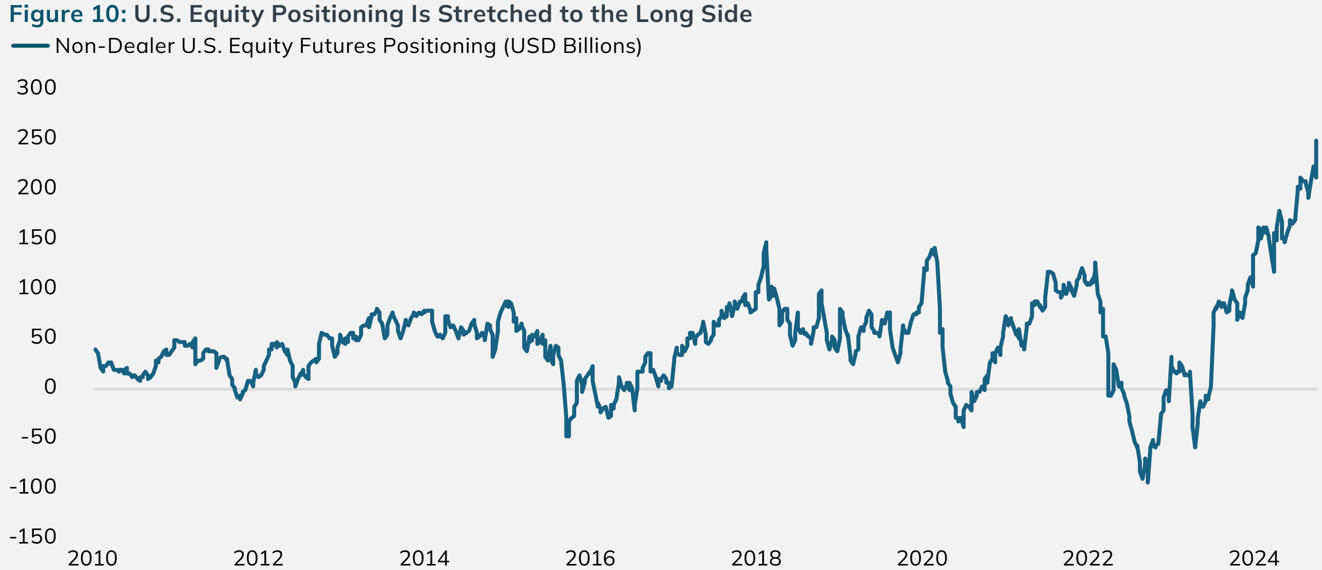
Figure 9: The U.S. Stock Market Is Still Historically Pricey
Shiller Cyclically Adjusted Price/Earnings



Source: Robert Shiller, Picton Mahoney Asset Management Research. Jan 1900 to Sept 2024.

In addition, speculative positioning is very elevated, which may present a near-term risk to equities.

Figure 10: U.S. Equity Positioning Is Stretched to the Long Side



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2010 to Sept 2024.

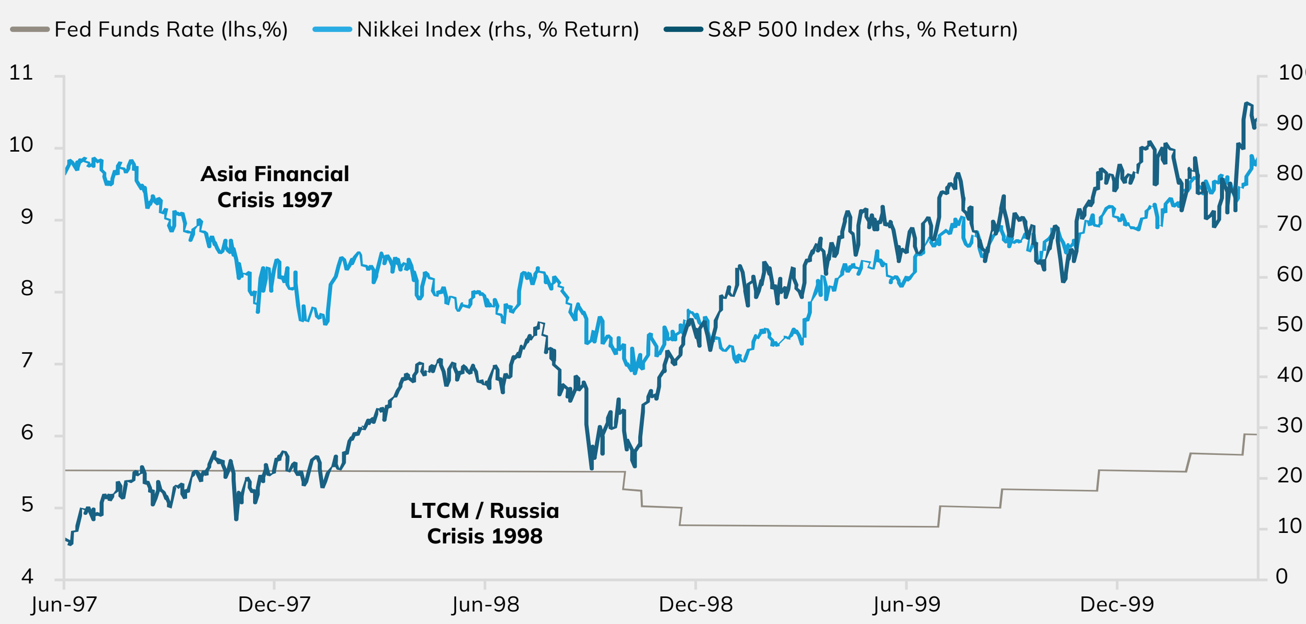
Shades of 1998-2000?

In 1998, a U.S. monetary tightening process (accompanied by a surging U.S. dollar) finally caught up with the global economy and markets. There were clues from the Asian financial crisis in 1997 that stresses were building, but that wasn't enough to dissuade the Fed from continuing its tightening policy. However, the Russian bond default/ruble collapse in 1998, along with market turmoil regarding systemic concerns about highly levered (and off-side) positions at Long-Term Capital Management L.P. (LTCM), sent equity markets plunging.

Interestingly, the yen carry trade was also unwound that time in a violent fashion, sending the Japanese currency higher. The Fed quickly injected liquidity into the market, cut interest rates and arranged the bailout of LTCM. With that, markets were off to the races, especially in the U.S., where the internet bubble helped drive the S&P 500 Index to new highs for prices and valuations.

No two environments are alike, but the August 2024 correction and subsequent central bank reactions have some parallels that are worth noting and perhaps monitoring. It's clear that tighter monetary policy in Japan contributed to yen strength and another unwinding of the yen carry trade in early August. As previously discussed, volatility levels spiked dramatically in a very short period of time, reaching levels last seen during the COVID pandemic. The turmoil helped lead Japan to back off from its tightening process, and may have even contributed to the outsized policy easing by the U.S. Fed against the backdrop of a reasonably sanguine economic backdrop.

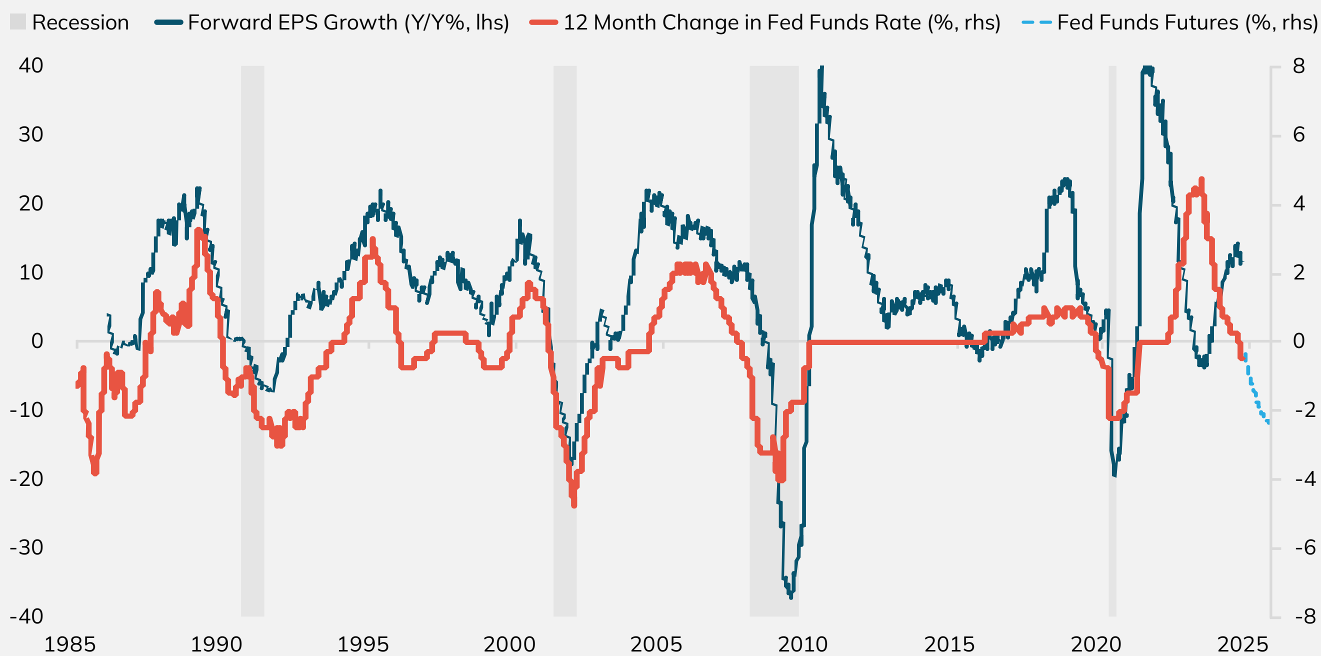
Figure 11: 1998–2000 A Roadmap for the Present Day?



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jun 1997 to Mar 2000.

Perhaps what transpired after the 1998 market swoon will serve as a potential roadmap for the next 12 to 24 months. Just as in the 1998 market swoon, the S&P 500 Index very quickly regained its losses, and is has moved to new all-time highs this time around as well. And this occurred without the Magnificent 7 or the artificial intelligence theme leading the charge. In addition, against the backdrop of softening economic data, S&P 500 Index earnings are still forecast to grow 12% in the coming year, even as a new Fed cutting cycle is underway.

Figure 12: Fed Cuts + Rising Earnings Per Share (EPS): A Potential Double Tailwind for Markets



Source: Absolute Strategy Research. Jan 1985 to Sept 2024.

So, while equity valuations are expensive at this time, it is possible that they could get even more expensive, if investors really embrace the stock market, given falling interest rates and stable to potentially accelerating economic growth.

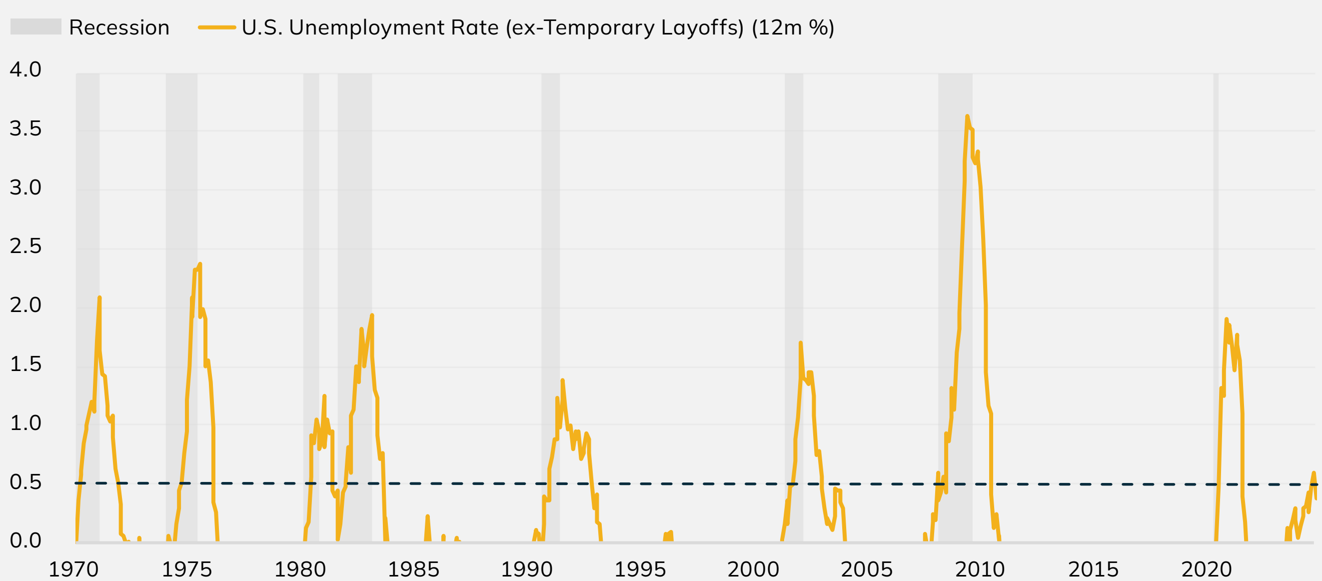
Near-Term Risks Could Bring Volatility and Better Buying Opportunities

Despite the compelling evidence that the U.S. economy may be headed for a soft landing, risks remain, particularly in the near term. For starters:

- The yield curve has "un-inverted", as historically it has happened just before a recession.
- U.S. ISM manufacturing inventories spiked as sales totally dried up, indicating that the manufacturing uptick seen in the first half of the year isn't being sustained.
- U.S. election risks and geopolitical concerns are in focus.

The Fed didn't decide to drop interest rates by 50 bps just because inflation was lower. Inflation is only one of two parts of its mandate. The second part is trying to maintain full employment, and recent economic data on that front have deteriorated.

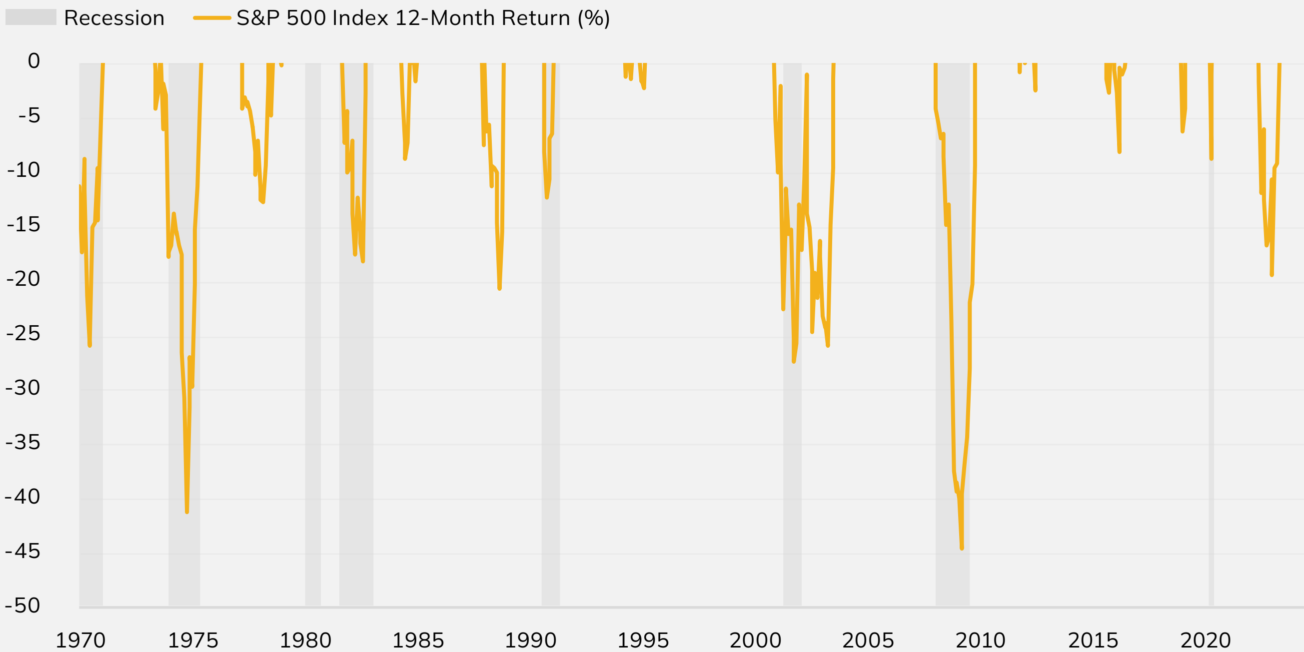
Figure 13: The U.S. Unemployment Rate Is Climbing



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1970 to Aug 2024.

Indeed, since 1970, a 12-month rise in U-3 unemployment rate above 0.5% (such as we are seeing now) has always been associated with a recession. What's more, this sort of development has also been accompanied by a market sell-off. The length and depth of such drawdowns varies by period, and in accordance with the depth and length of the recession.

Figure 14: **Recessions Have Historically Been Accompanied by Market Sell-Offs**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1970 to Aug 2024.

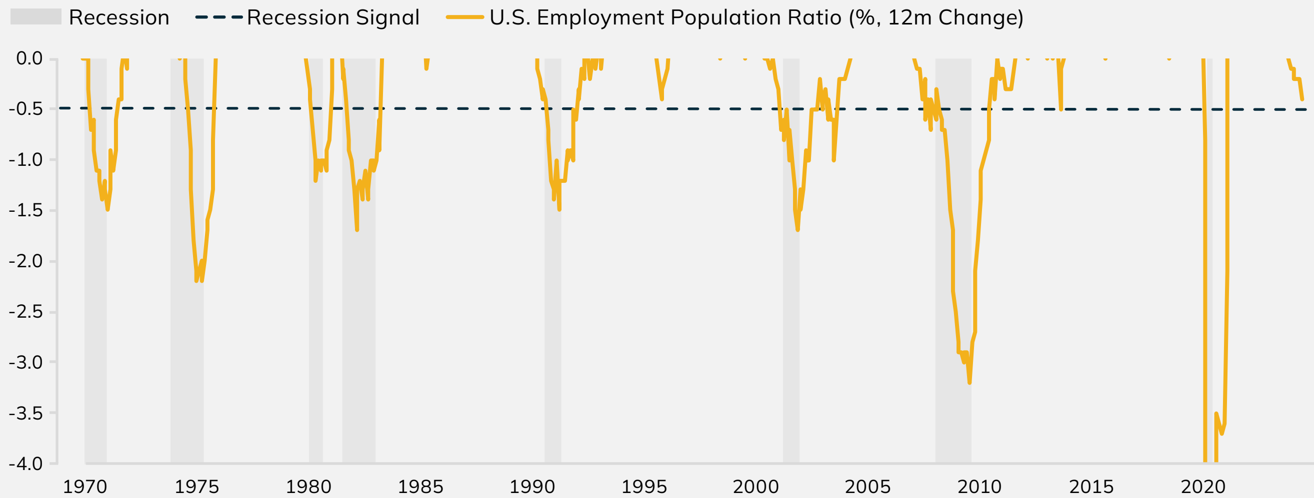
So far, the current environment has been a bit unusual, in that the rise in U.S. unemployment is occurring without the broad economy slipping into recession. Also, broad market sell-offs have been limited, and the Fed has only just started its rate-cutting process.

Claudia Sahm (of the famous "Sahm Rule") notes that the recent rise in the U.S. unemployment rate may be driven by an influx of workers rather than a decrease in labour demand. It's the latter condition that traditionally signals a recession. Sahm's analysis suggests that looking at a fuller definition of the labour pool may be appropriate when assessing whether the U.S. is about to tip into recession.[8]

The most comprehensive view of unemployment might be the employment-to-population ratio. This ratio simply takes the entire workforce and divides it by the whole population. We see that directionally it has moved in a similar fashion as the U-3 and U-6 unemployment rates. However, in terms of magnitude, the ratio has not fallen quite as much: it has not yet crossed the -0.5% mark (although it is getting very close).

[8] Bloomberg, My Recession Rule Was Meant to Be Broken, Aug 7, 2024.

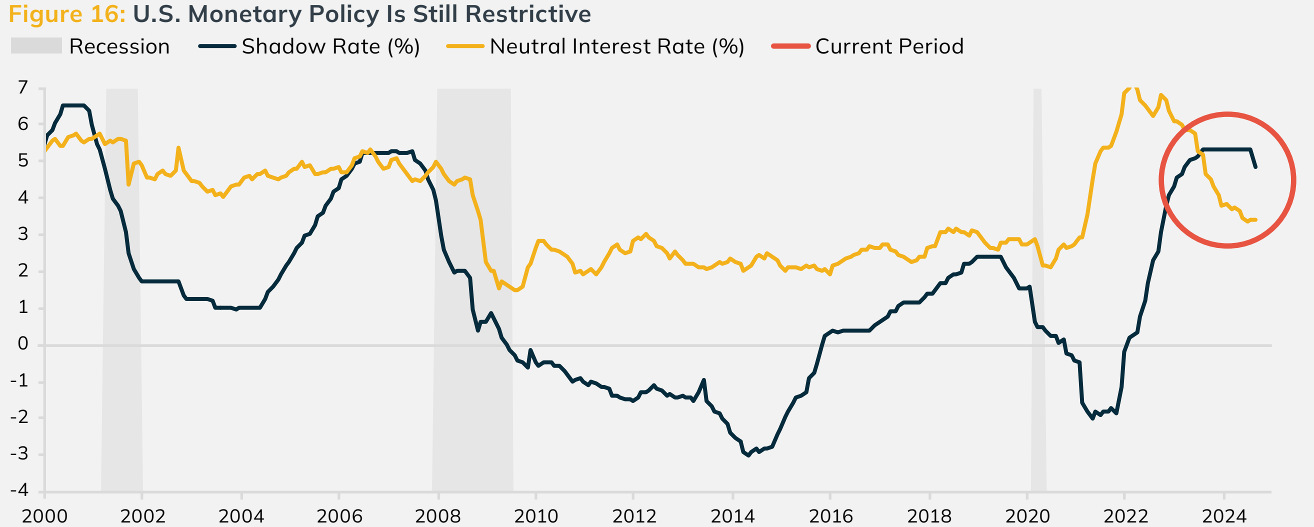
Figure 15: **The Employment-Population Ratio Is Close to Signalling a Recession**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1970 to Aug 2024.

While the Fed has just begun to ease its monetary policy, interest rates are still much higher than they have been. There are likely lagged effects from previous tightening that are still working their way through the U.S. and the global economies. If the market expects that the neutral interest rate is closer to 3%, a Fed funds rate at 4.75% to 5% still suggests a high level of restrictiveness.

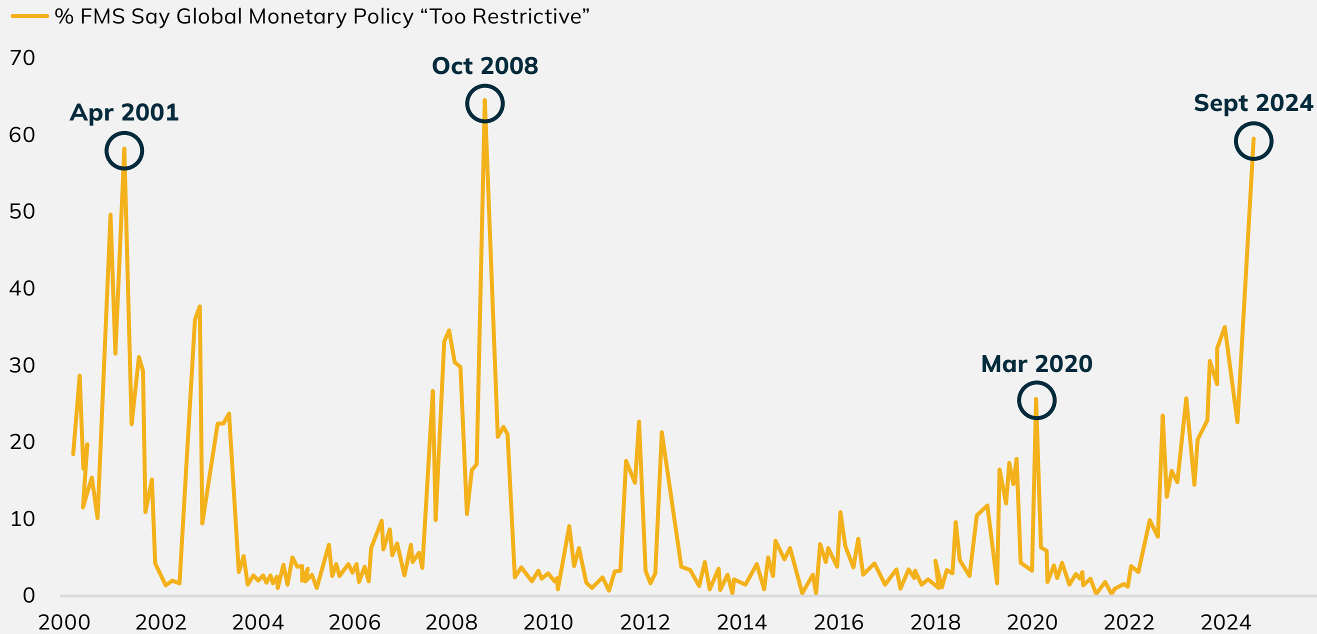
Figure 16: **U.S. Monetary Policy Is Still Restrictive**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to Jun 2024.

This continuing restrictiveness was confirmed by Bank of America's August 2024 fund manager survey, which showed a spike in concerns that the Fed was too restrictive. These concerns may dissipate somewhat when the new survey comes out, now that the Fed cutting cycle has begun.

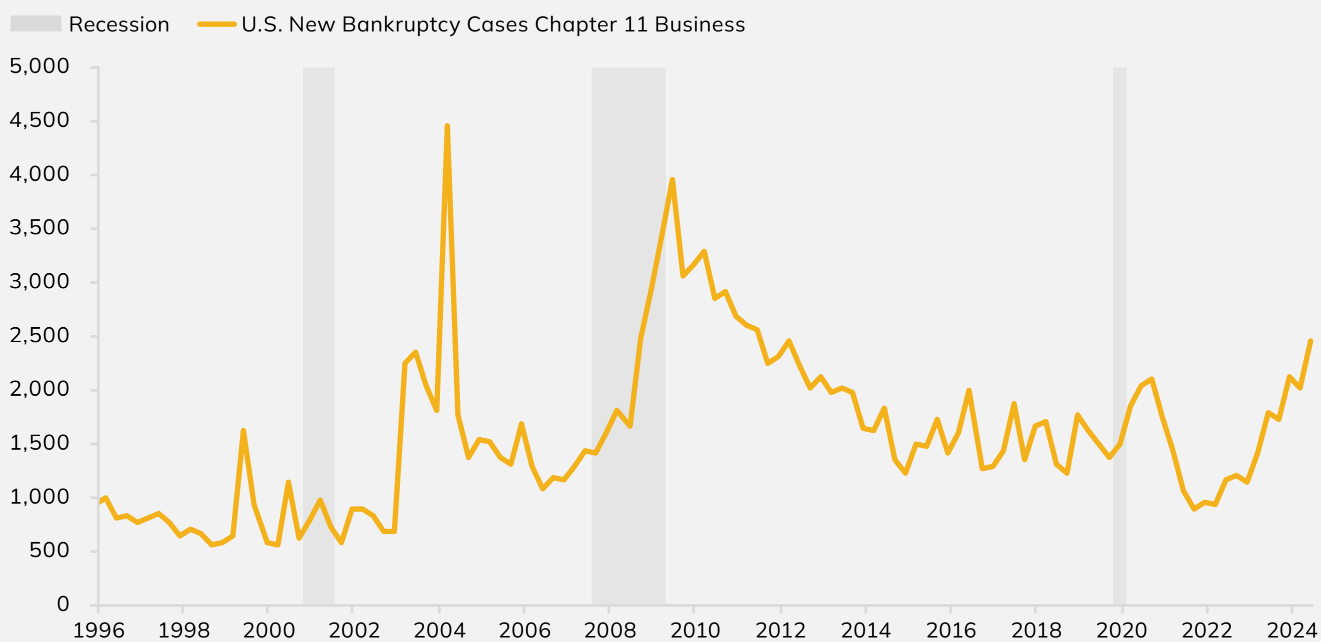
Figure 17: Majority of Money Managers Say the Fed Is Too Restrictive



Source: Bank of America Global Research. Jan 2001 to Sept 2024.

The effects of tight policy have been hitting businesses for some time now. In addition to small business optimism remaining at low levels, Chapter 11 filings are rising.

Figure 18: Chapter 11 Filings Show an Ominous Path



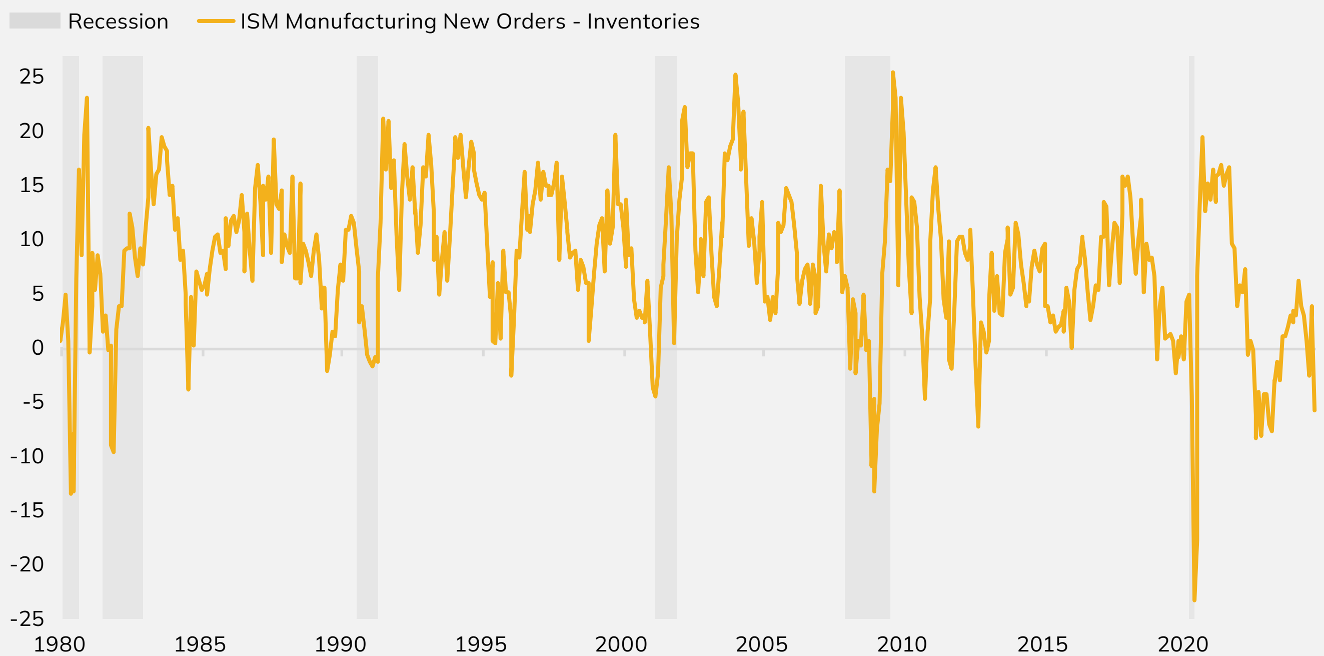
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 1996 to Q2 2024.

Manufacturing is Turning Lower, Again

The economy is decelerating, and the manufacturing cycle is once again turning lower after a brief reprieve during the first half of the year. The ISM manufacturing PMI continues to show weakness, with new orders falling to 44.6 in August 2024, the lowest level since May 2023.

Simultaneously, lower demand is resulting in inventories spiking, making the forward-looking U.S. ISM Manufacturing new orders-to-inventories ratio deeply negative.

Figure 19: **U.S. ISM Manufacturing New Orders Minus Inventories Ratio Is Falling, a Worrisome Sign**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1980 to Aug 2024.

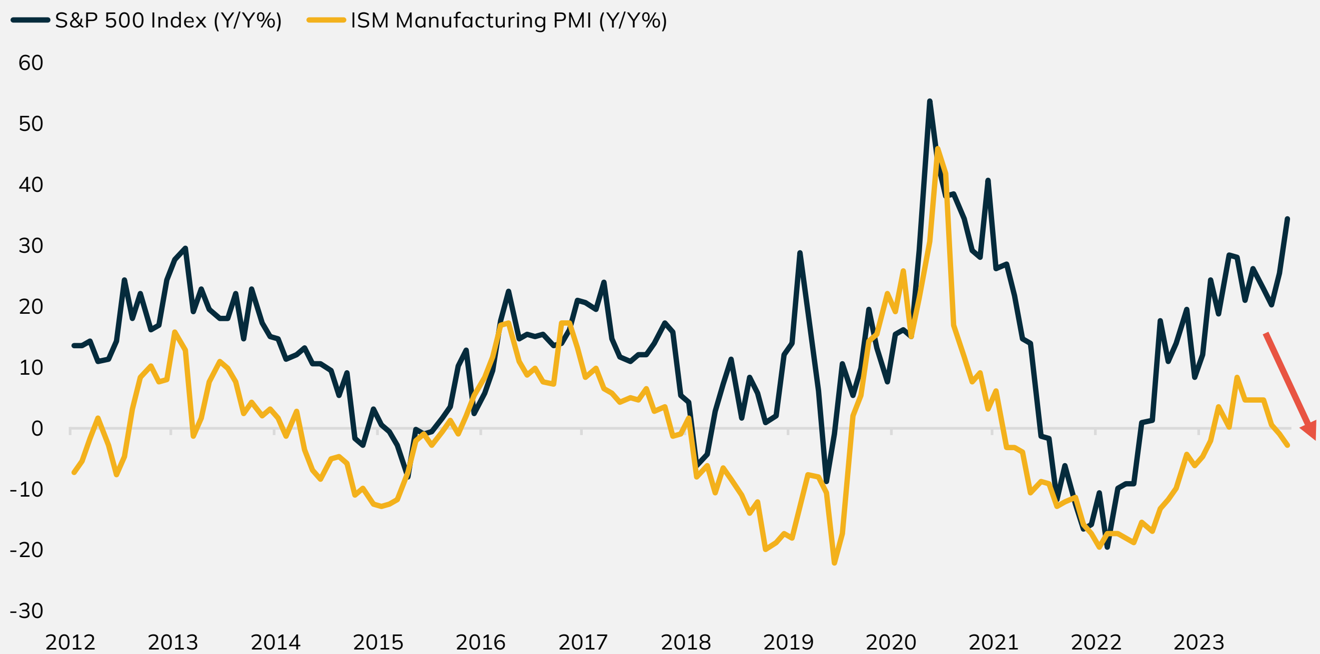
As S&P Global reports:

> *"Slower than expected sales are causing warehouses to fill with unsold stock, and a dearth of new orders has prompted factories to cut production for the first time since January. Producers are also reducing payroll numbers for the first time this year and buying fewer inputs amid concerns about excess capacity. The combination of falling orders and rising inventory sends the gloomiest forward-indication of production trends seen for one and a half years, and one of the most worrying signals witnessed since the global financial crisis."*[9]

[9] S&P Global, US manufacturing PMI sends warning signals on economic conditions, Sept 3, 2024.

The chart below shows how equities are historically directionally correlated to moves in the manufacturing cycle. While the soft-landing narrative is clearly in place, near-term economic disappointment could lead to pullbacks in the stock market.

Figure 20: Downturns in Manufacturing Are Historically Linked with Falling Equities



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2012 to Aug 2024.

Recent monetary policy shifts around the world have likely improved the odds of an economic soft landing. However, the previous restrictiveness is still working through the system, and rates are still tight. It is likely that near-term data will be sluggish—or perhaps even worse. Therefore, good economic news in the near term should be good market news, since it would confirm a soft landing as the likely outcome. However, bad economic news could be bad news for equities, since investors have already priced in a soft landing.

U.S. Election and Fiscal Cliff Both Pose Risks to the Economy

The U.S. presidential election poses risks to the economy, no matter who is victorious. If Donald Trump wins, his promised tariffs on Chinese goods could result in materially higher U.S. inflation. And if Kamala Harris wins, her promise of tax hikes could cause more economic weakness.

Polls suggest the election should be tight, which should mean both the economy and markets will have to grapple with considerable policy uncertainty in the near term. This uncertainty would grow considerably if one party were able to claim the presidency as well as both the House and the Senate. Presumably, that party would be able to implement its agenda much more readily, regardless of how market unfriendly it was. Of course, that party could also implement very constructive policy that improves U.S. productivity, and maybe even deal with the building deficit and debt issues—but there has been no discussion of that in either party's platform. A government gridlock would mean much more of the same, something markets would likely embrace more positively.

Regardless of who triumphs, the U.S. economy faces a significant post-election fiscal cliff. Notably, some individual tax cuts enacted in 2017 are set to expire in 2025; TD Cowen estimates that could amount to a US$3.5 trillion tax hike over 10 years.[10]

[10] TD Cowen, TAXMAN: $3.5T TAX CLIFF ON 1/1/26 FOR INDIVIDUAL RATES, MORTGAGE, ESTATE & SALT, April 30, 2024.

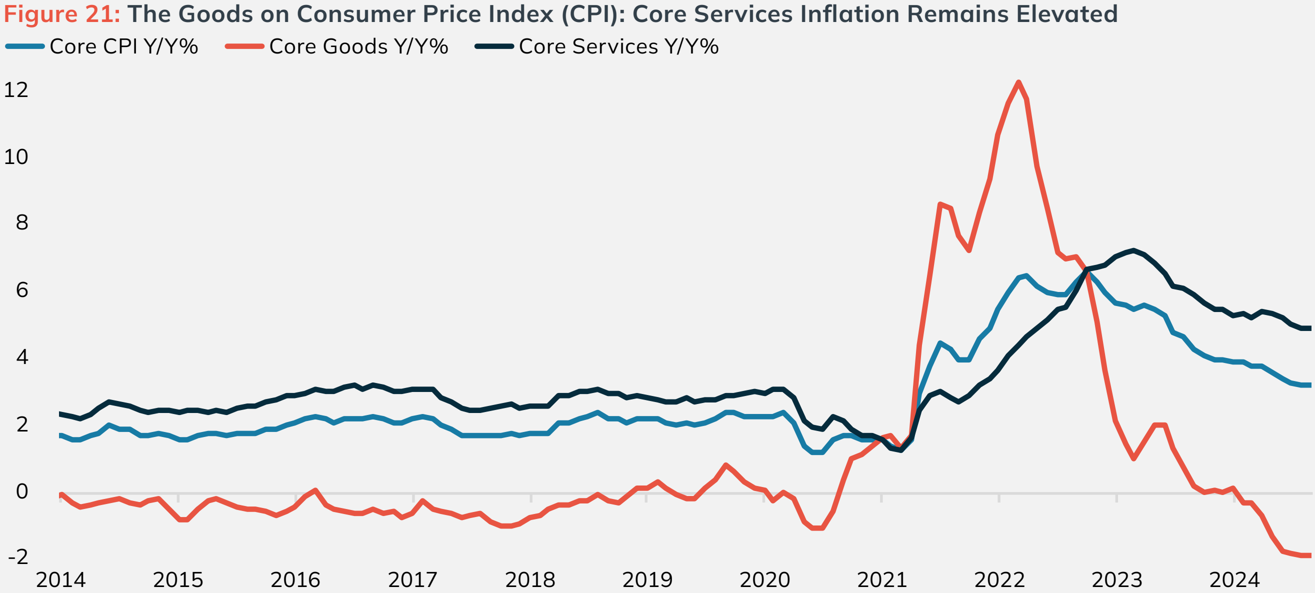
Inflation Watch Next Year?

Central banks around the world are now in rate-cutting mode, which is increasing the probability of a soft landing. Near-term economic headwinds will likely become tailwinds as more rate cuts are made over the next year or two. At that point, we believe improving demand may begin to overwhelm available supply in housing, commodities and even skilled labour, and that could regenerate inflationary pressures much more quickly than in more recent cycles. That would likely not be well received by markets, especially if valuations remain as elevated as they are now.

A Tale of Two Inflations

U.S. inflation has become decidedly bifurcated since 2022. Goods prices have been in outright deflation as of late, aiding the Fed's efforts to bring consumer prices back to target. Complicating matters, unfortunately, is services inflation, which has proven to be both elevated and stickier.

Figure 21: The Goods on Consumer Price Index (CPI): Core Services Inflation Remains Elevated

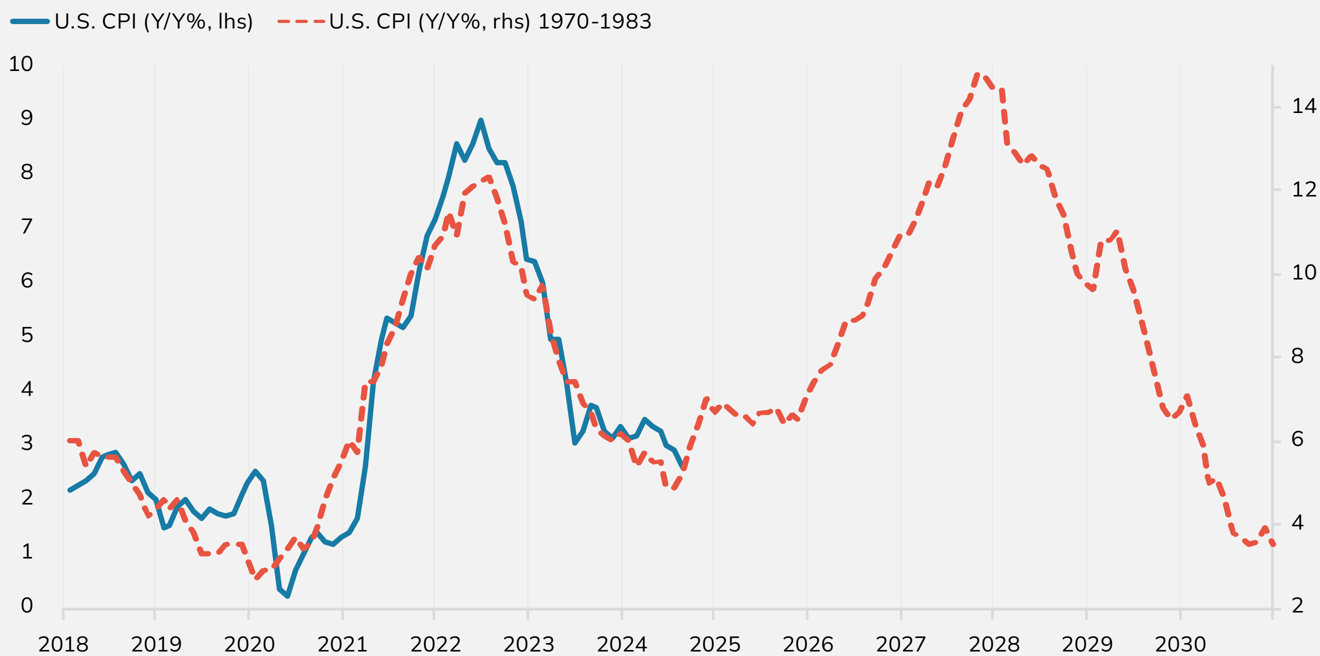


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to Aug 2024.

Longer Term Supply/Demand Imbalances Remain

As we have written previously, there are some similarities between the inflation trends of the 1970s and what is occurring today.

Figure 22: **A Re-Rerun of That 70s Show? U.S. CPI Following a Familiar Path.**

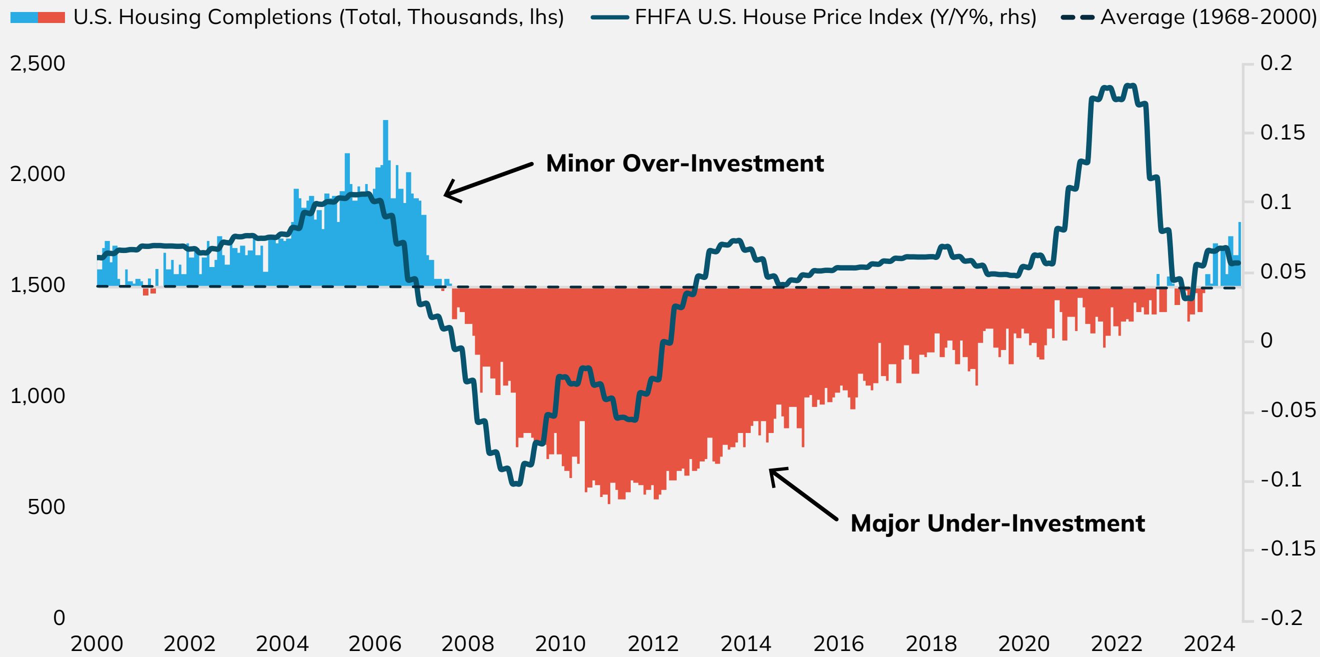


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1970 to Aug 2024.

Just as in the 1970s, the U.S. faces potential shortages in key parts of the economy that could become an issue once the U.S. and global economies begin to reaccelerate. Electricity and copper are examples of commodities that are already in short supply and that could become even more scarce when the economy reaccelerates and/or recovers in the next cycle.

A structural shortage of U.S. housing also poses challenges for the Fed. U.S. home prices and rents continue to increase. But as a result of high interest rates, the housing completion rate is stalling, and the problem of the underlying supply shortage is not being addressed. Instead, it is likely being exacerbated.

Figure 23: The U.S. Housing Market Is Still Undersupplied



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to Aug 2024.

When the central bank eased policy to support the economy during the 1970s, price pressures soon re-emerged. With the Fed now focused on averting a recession and easing monetary policy, we believe there is potential for a mini rerun of the 1970s experience.

Conclusion: Stay Patient

While we expect near-term economic headwinds will continue, new monetary policy easing around the world has boosted the probability of a soft landing, especially in the critical U.S. economy.

Markets have responded bullishly to these developments, leaving investors with a not particularly great set-up for boosting risk in most markets. Valuations are rich, with a lot of the soft-landing narrative already priced in, investor positioning is stretched, and unfriendly autumn seasonality, combined with U.S. election concerns, may create near-term downside pressures on the markets.

Given these near-term hurdles, we believe patience is currently the best approach for investors. With the Fed put back in place, buying on pullbacks in risk assets could be attractive. While an economic soft landing could support risk assets, we expect acceleration in global growth and increasing wealth effects will end up pulling forward the timeline in which inflationary forces begin to reappear, bringing the party to an abrupt end.

Sector Outlooks

Industrials

Recently, we've seen industrial stocks tick up as fears of an outright industrial recession have waned. Erring on the side of conservatism, we have maintained our short exposure to more expensive multi-industrial/staffing names, while also hedging cyclical long positions in broader secular themes. We are confident that the businesses we like – including those with cyclical exposure – will continue to meet our long-term return thresholds.

We continue to look for out-of-favour companies with a history of outsized growth, catalyst-driven idiosyncratic rerating angles and/or opportunities to improve structural returns on invested capital. Lately, we have been focusing on hazardous waste names exposed to growing infrastructure spending and onshoring. We also remain bullish on the industrial leasing complex over the long term. We have hedged the cyclicality of rentals with less attractive names that have similar exposures. We have been looking into certain airlines, but are not buying aggressively quite yet, despite their cheap valuations. More recently, we've also gained conviction regarding a couple of lumber-based product manufacturers and distributors. Finally, the merger and acquisition environment for serial acquirers seems quite favourable. Accordingly, we have shored up weightings in companies with a strong track record of acquisition and ample cash on hand.

Materials

Gold Market Dynamics

Gold continued its upward trajectory, supported by ongoing geopolitical uncertainty and anticipation of interest rate cuts by the U.S. Federal Reserve. Gold equities have performed strongly year-to-date, reaching a period of margin inflection. The strength of gold prices has surpassed cost inflation, leading to enhanced margin expansion and improved free cash flow for gold producers.

For gold investments, we continue to favour select gold equities with positive rates of change. We believe examples of such companies include Agnico Eagle Mines Limited (XTSE: AEM), a well-managed producer with a strong track record of operational excellence, and Osisko Gold Royalties Ltd. (XTSE: OR).

Copper Market Trends

Copper and copper equities experienced a correction during the period, primarily due to the unwinding of positions and a temporary slowdown in demand. The market faced headwinds from weaker demand in both China and other global markets, coupled with declining investor sentiment. Despite the recent pullback in spot copper prices, we view the current moment as an attractive entry point. We believe the copper market has entered a new cycle, driven by both massive underinvestment in copper production over the past decade and increasing demand from energy transition initiatives.

In our portfolio, we maintain a long position in a basket of copper equities, to gain exposure to the anticipated rise in copper prices. This strategy allows us to capitalize on the long-term structural trends supporting the copper market while managing short-term volatility.

Information Technology

The MSCI World Information Technology Index rose by 1% for the third quarter of 2024, while the Information Technology sector in the S&P/TSX Composite Index rose by 12%, led by Shopify. Sector performance saw a setback driven by concerns about AI return on investment and about recession and the business cycle. The best-performing subsector was Internet, up 3% for the period. Software stocks were up about 2%, amid a more defensive tilt within Tech. The semiconductor sector saw a 6% drawdown.

Our outlook for Information Technology in the fourth quarter of 2024 remains cautiously optimistic: barring a recession, we expect the worst of the AI sentiment headwinds will pass. Notably, OpenAI's Strawberry release, its recent reasoning and logic breakthrough, indicates a clearer path to high ROI products in the second half of 2025 and beyond. We see a bull case scenario in which lower interest rates and AI technology breakthroughs will drive technology leaders to new highs into 2025, after overhangs like the U.S. election, the pace of Fed cuts and recession fears clear off. Among internet stocks, in a muted consumer environment, we continue to prefer quality share gainers.

In Software, we favour early AI winners and quality and idiosyncratic growth names. We remain guardedly optimistic on semiconductors heading into the fourth quarter. We expect AI leadership to reassert itself as investors become more comfortable with 2025 growth estimates, and barring a recession, we expect to begin to see additional green shoots in non-AI markets as inventory returns to normalized levels. For the same reasons, we are also more positive on Networking, but remain cautious on hardware, where the impact of the economics of generative AI on the industry remain unclear.

Health Care

Through the third quarter, Health Care has outperformed the S&P 500 Index. As hopes for rate cuts have inched higher, investors have warmed up incrementally toward risk-on subsectors within Health Care, while weakness and volatility in momentum names and year-to-date winners have increased incrementally. Especially among large biopharmaceuticals, there has been a broadening out of performance; we have seen a notable bid for defensive value, while quality growth has underperformed.

Biotechnology funding took a pause in August, compared with the first half of 2024; however, there is a typical seasonal weakness in summer funding, so we do not interpret this as a meaningful sign of deterioration in biotechnology fundamentals. Elsewhere, continued strength in medical utilization and procedure growth has generated outperformance in the providers and medical technology subsectors, particularly for names with margin expansion opportunities and innovative product cycles in attractive markets.

We anticipate further broadening of performance in the near to medium term as inflation eases and the interest rate path becomes clearer – assuming recession risks remain low. Lower rates should drive interest and capital toward the riskier growth areas of Health Care, and we are incrementally more bullish on biotechnology and related end markets. Longer-term, we continue to favour names with quality growth and positive estimate revisions through innovative product cycles, as well as strong base businesses with defensible moats and opportunity for margin expansion. More tactically, we remain highly selective among catalyst-driven names where risk/reward is favourable.

Consumer Discretionary

What became quite obvious in the third quarter of 2024 is that there is no "one size fits all" approach to consumer discretionary right now. Some companies appear to be benefiting from a stable consumer and a resilient economy, while others seem to be dealing with a more selective consumer and a challenging macro environment. The consumer, particularly in the U.S., is "good enough" that some companies can continue to take share and succeed, but others that have struggled could continue to do so. We are not in position where "a rising tide lifts all boats" – but not the opposite. We highlighted last quarter evidence of increased value-seeking across the board, and that continued in the third quarter, with value-focused concepts such as Walmart Inc. (NYSE: WMT) and The TJX Companies, Inc. (NYSE: TJX) delivering better-than-expected results. Cruise lines, which offer a discount to land-based vacations, also are benefiting from the trade-down effect.

The fourth quarter will be an anxious quarter and will feel even more condensed than usual. Households are likely to delay holiday shopping until after the U.S. election, leaving a tight run into a short holiday calendar between Thanksgiving and the winter break. With spending back-end-loaded, we expect macro data points such as unemployment, inflation data and consumer confidence to be the main drivers of sector performance in the near term. Rate decisions by the Fed could also contribute to higher-than-usual volatility in the sector. We are becoming cautiously optimistic on names exposed to U.S. housing, and that have strong competitive moats, such as Floor and Décor Holdings, Inc. (NYSE: FND); lead indicators such as existing home sales and housing churn have bottomed, and the worst of the negative earnings revisions appear to be behind us.

Consumer Staples

In the third quarter of 2024, we saw the U.S. Consumer Staples sector outperform the broad market, driven by defensive rotation and falling yields, while the Canadian sector underperformed.

In Canada, underperformance late in the quarter, despite a slowing economy and rising unemployment, was likely driven by profit taking on grocers after their torrid run this year. In addition, there remains a significant amount of uncertainty about an offer by Alimentation Couche-Tard Inc. (TSE: ATD) to purchase Seven & i Holdings Co., Ltd. (JT: 3382) and how Couche-Tard would plan to finance such a large acquisition.

In the U.S., we saw broad-based outperformance, with notable outperformance from the previously lagging packaged food and tobacco segments. Quality retailers such as Walmart Inc. (NYSE: WMT) have also outperformed significantly this year. As an everyday low-price retailer, Walmart has one of the best moats in retail, consistently taking share and remaining insulated from consumer weakness, while being an idiosyncratic profit inflection story as it pivots to higher-growth, higher-margin verticals such as advertising.

BellRing Brands Inc. (NYSE: BRBR) and Freshpet Inc. (NYSE: FRPT) are examples of companies in the sector, which we believe have shown impressive resilience despite the well-documented slowdown of the U.S. consumer. We see a long runway for growth ahead for both companies.

Financials

In the third quarter of 2024, Financials outperformed the broader market as the market gained greater confidence that inflation was under control and that there was a higher probability of a soft landing, combined with 50 basis points of rate cuts in both Canada and the U.S. Banks were a key beneficiary, performing well as the market gained more optimism regarding credit and net interest income trajectories once the rate-cutting cycle had commenced. Relative outperformers in the previous quarters have begun to lag and underperformed in the third quarter, including Canadian property and casualty insurance companies and money centre banks, after the market began to re-risk companies that are rate-cut beneficiaries. We remain a little cautious on banks in the near term, especially given their recent strength, because credit metrics continue to deteriorate, and revenue trajectories seem quite muted in the near term. In Canada, we believe we are headed for a period of more rapid deleveraging that will likely hold back the growth and profitability of the banks' domestic banking businesses.

Among financials, we favour less credit-sensitive companies with good idiosyncratic growth tailwinds, irrespective of the macroeconomic backdrop. We are bullish on life insurance: we believe a structural re-rating opportunity could be provided by a higher rate regime, compared with the zero-interest-rate policy that followed the global financial crisis. Additionally, many of the life insurance companies we like have built large capital-light wealth/asset management businesses that will likely continue to benefit from numerous secular tailwinds and strong growth. We are also positive on alternative asset managers, because they continue to raise significant third-party capital and will be able to deploy it into the next cycle; they also have long-term secular tailwinds for growth as they increase penetration in the retail channel.

Communication Services

An equally weighted portfolio of BCE Inc. (TSX: BCE), Rogers Communications Inc. (TSX: RCI/B), Telus Corporation (TSX: T), Quebecor Inc. (TSX: QBR/B) and Cogeco Communications Inc. (TSX: CCA) delivered +18.5% outperforming the S&P/TSX Composite Index by about 800 basis points, with telecommunications companies among the beneficiaries of a softer rate outlook.

Macro support notwithstanding, we remain somewhat neutral on the group. The pricing environment, although it did not deteriorate in the third quarter, did not see any real improvement either. We have said that we would become more positive on the Canadian sector provided we saw pricing actions like the ones we have seen – and continue to see – among U.S. telecommunication operators, and that remains the case. But we would note that we do see the potential for pricing to start moving higher, given some of the actions taken by the Canadian wireless players; we are waiting for the go-ahead signal to become more bullish.

Utilities

Anticipations of rate cuts and the related optimism made up the theme, with utilities outperforming the S&P/TSX Composite Index by about 570 basis points. The rally was relatively broad-based, with independent power producers being the only group that lagged, following a strong quarter of relative outperformance in the second quarter. With the Fed having initiated its cutting cycle, the question now is, will the outperformance in utilities continue?

We take a very measured approach and believe this is a time to be selective. We have repeatedly expressed our preference for independent power producers that can self-fund their growth, and regulated utilities with solid balance sheets. Year-to-date, we have seen names like that post relative outperformance. We believe, however, that relative outperformance might become more apparent as macro drivers give way to micro and company-specific factors.

Real Estate

We have said before that we believe REITs need a soft landing, backed by rate cuts, to renew investors' interest, and that is exactly what we got in the third quarter. REITs were buoyed by optimism about the beginning of a rate-cutting cycle. Real estate handily beat the S&P/TSX Composite Index (by about 1250 basis points), benefiting both from expectations of lower rates and from fading concerns about a recession, after the Fed initiated its first cut. Quality names and REITs with good growth prospects participated in the gains and were among the leaders of the rally, vindicating our preference for companies with good balance sheets and the potential for positive earnings revisions. Looking ahead, we believe the theme, as in utilities, is to be selective, and to favour growth at reasonable price that is supported by a strong balance sheet.

Energy

The North American oil and gas markets experienced significant volatility over the quarter. Oil prices have declined sharply since early July, with both the Brent and WTI prices falling approximately 20% over the past two months, due to concerns about oversupply, softening macroeconomic conditions, weak markets for refined products and deeper-than-expected economic troubles in China. The recent trajectory of oil prices resembles previous periods of considerable demand weakness, indicating recession-like inventory buildups ahead. In response, OPEC+ announced a delay in its planned output increase, signalling the organization's continued focus on balancing the market. However, there are growing concerns about how long Saudi Arabia will be willing to hold back production while other producers increase output.

We continue to favour companies that have long reserve life indexes and positive fundamental changes in their operations, such as Suncor Energy Inc. (XTSE: SU) and Imperial Oil Limited (NYSE: IMO). In contrast, several mid-cap producers that have underinvested in exploration over the past few years have had to turn to dilutive acquisitions to extend their reserve life, resulting in a delayed return of capital to shareholders.

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