PICTON MAHONEY

THE 2025 PICTON REPORT

Undeniable Froth: Navigating the Brewing Bubble

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01. Executive Summary

Foreword from David Picton

I'm proud to introduce you to the very first edition of The Picton Report.

In this document you'll read our firm's big picture views on the economy and stock market—just like you always did in our prior quarterly outlook pieces. You will also hear from our fund managers, as they walk you through the investment landscape for their strategies and tell you how they're positioned.
This is truly an all-encompassing report:

- **Our equities team** highlights the risk that the momentum factor has become crowded, raising the possibility of a significant correction. Given market valuations, they see opportunities for long-short strategies. They also offer deep dives into the life insurance sector as well as the evolution of artificial intelligence.
- **Our fixed income team** notes that long-term bonds may have already priced in U.S. Federal Reserve (Fed) rate cuts. Yields may rise, not fall, if inflation surprises to the upside. Meanwhile, credit spreads remain very low by historical standards.
- **Our multi-strategy team** lays out various market scenarios, explains their current weights relative to a 40/30/30 benchmark, and details what alternatives they like as we enter 2025.
- Finally, **our portfolio construction team** will offer their thinking on asset allocation for today's world, with insights on how alternatives can help Canadians prepare for retirement.

> *As we close the books on 2024, we see the emergence of a large—and growing—**equity bubble**.*
>
> *It's a bubble most likely concentrated in U.S. large caps, of which **high-flying technology stocks** are the most prominent.*
>
> *This bubble has attracted quite a crowd, as bubbles tend to do.*

David Picton
President and CEO

As we close the books on 2024, we see the emergence of a large—and growing—equity bubble. It's a bubble most likely concentrated in U.S. large caps, of which high-flying technology stocks are the most prominent. This bubble has attracted quite a crowd, as bubbles tend to do.

Institutional, retail, and foreign investors have all flocked to the party. The euphoria for equities is being driven by continued belief in the soft-landing narrative, bullish projections for artificial intelligence, and optimism over what Donald Trump's election could mean for the economy.

Unfortunately, it seems that all the good news has been more than priced in by the market. In fact, valuations are in the vicinity of previous major U.S. equity bubbles that resulted in serious drawdowns. Sentiment, meanwhile, is exuberant, another telltale sign of a potentially significant market top. This is not to say that the peak is necessarily imminent: investors could keep bidding the market up in the near-term, particularly if they're aiming for the kind of gains that the late stages of a bubble can generate.

Yet at this point, we believe longs are playing a dangerous game given how divorced the market is from its underlying fundamentals. The important thing to remember is that all bubbles burst, and those who get greedy at the top can suffer large losses.

What could deflate the current euphoria? Geopolitics could intrude upon investor complacency. Trump's policies may turn out to be much less market-friendly than the bulls expect. And then there's the Fed. In our minds, the most likely catalyst for bursting the equity bubble is if stubbornly high core inflation continues to go in the wrong direction, leading to the U.S. central bank dialling back on projected interest rate cuts.

Given this backdrop, we have been adding to hedges. We're willing to buy equities on a sizable correction but are mindful that the market could ultimately be in store for something much greater than a typical 10% pullback.

Our advice to investors is to be mindful of the potential risks they may be exposed to considering the size of the bubble we see.

In our view, the current set-up presents a compelling argument for including alternatives in a portfolio. If inflation does stay elevated, fixed income may not play the role it once did in counteracting equity volatility.

Stocks and bonds may simply go down together. A decent allocation to alternatives strikes us as the answer to this dilemma.

> *"The current set-up presents a compelling argument for* ***including alternatives*** *in a portfolio."*

02. Macro Outlook

Undeniable Froth: Navigating the Brewing Bubble

01/

The Soft-Landing Narrative is Intact

Resilient U.S. economic data, an accommodative Federal Reserve and continuing fiscal largesse helped investors keep the faith in a soft-landing scenario.

02/

But the Market has Priced in the Good News

Equity market valuations are at extremes, positioning is on the full side, and sentiment is exuberant.

03/

Inflation Could End the Party

Resurgent inflation may lead to the Fed reassessing its planned dovishness, dashing the hopes of investors and ending the equity bubble.

Be Ready for What's Brewing

Investor optimism for equities (especially those in the U.S.) was virtually unabated through most of 2024 and surged in the fourth quarter post the election of U.S. President-elect Donald Trump. As the year progressed, a soft-landing or no-landing narrative took hold given resilient U.S. economic data, an accommodative Federal Reserve joining other central banks already in rate-cutting mode and continued fiscal largesse from most governments around the world. In the fourth quarter, bullish predictions for the economic benefits of unleashed "animal spirits" and tax cuts in a Trump presidency only added fuel to investors' bullishness.

Unfortunately for investors, especially in large cap U.S. stocks, the market has priced in much of the good news around this narrative. Equity market valuations are at extremes, positioning is on the full side, and sentiment is exuberant. In other words, the current setup for the U.S. market is not attractive relative to history.

So, investors are faced with an attractive "Goldilocks" economic narrative that keeps them bullish but face a current investing backdrop that is unattractive on most normal measures. Either stock markets need a significant correction to improve the setup for success or investors must embrace the equity market entering some sort of late cycle bubble phase to remain bullish.

Either way, we believe market participants are now in a high stakes game of seeing how high this bubble can blow – and most of the players are long U.S. equities because that's where the excitement is. It appears that many investors do not want to sell at this point, believing that the later stages of a bubble can be very rewarding for those sharp and nimble enough to time a perfect exit from the game.

We have reduced our exposure to U.S. equities and have been using lower volatility levels associated with investor complacency to add hedges to portfolios where applicable. It appears that the Fed may have become a little less comfortable with all the enthusiasm and tried to throw a little cold water on the narrative at its December Federal Open Market Committee meeting. This might shake out some investors and create an opportunity near-term to re-load positions on some of the long-term winners as they pull back.

However, barring a 10% plus correction to improve the investing backdrop, we suggest that this is a good time to consider other hedges or less beta in long-term portfolios. There are several risks that could send droves of investors fleeing from the market at a moment's notice. We are particularly concerned about an unexpected increase in core inflation that, if it were to materialize, could end the bubble quickly causing significant losses for those still all-in U.S. equities.

> "*The current setup for the U.S. market is **not attractive** relative to history.*"

The Foundations of the Bullish Narrative Are Intact

Probabilities of Soft Landing Have Increased

The world's engine – the U.S. economy – remains impressively buoyant even as the lagged effects of previous monetary tightening work their way through the system. A strong third-quarter GDP print, coupled with a fall in the unemployment rate, shows that American households have benefitted from lower interest-rate sensitivity compared to the rest of the world. U.S. consumer demand is now building on itself as surging equity markets have created an above-trend wealth effect, which makes middle- and higher-end consumers even more confident to spend.

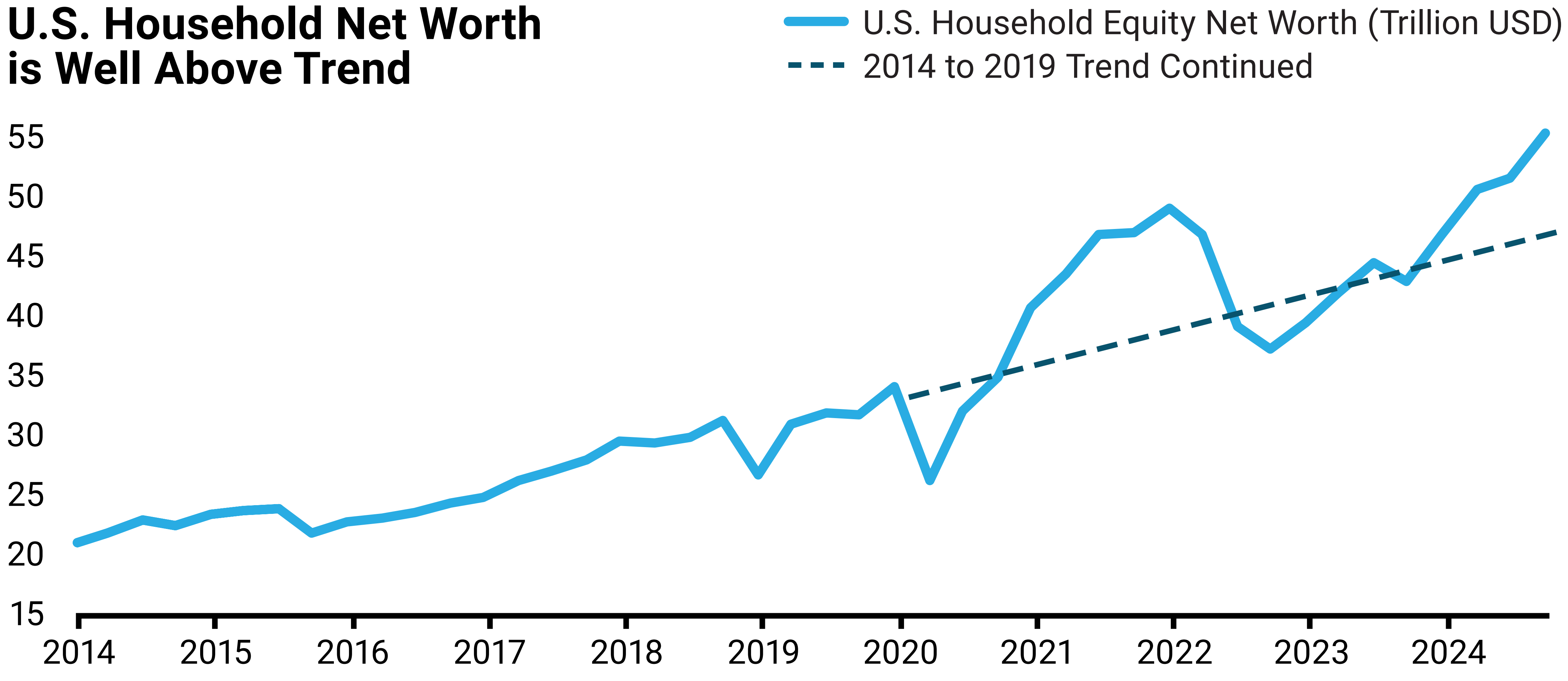
These constructive U.S. economic trends were largely in place before the Fed decided to reverse policy tightening and begin cutting interest rates this past September. This added fuel to beliefs that a recession would be averted and drove equity markets even higher.

Fiscal policy has also played a key role in buoying the economy. Sky-high deficit spending has meant that fiscal policy has been wildly out of sync with tighter monetary policy, adding fuel to GDP growth at a time when the Fed was trying to slow things down.

> *The world's engine - the U.S. economy - remains* ***impressively buoyant****.*

FIGURE 1

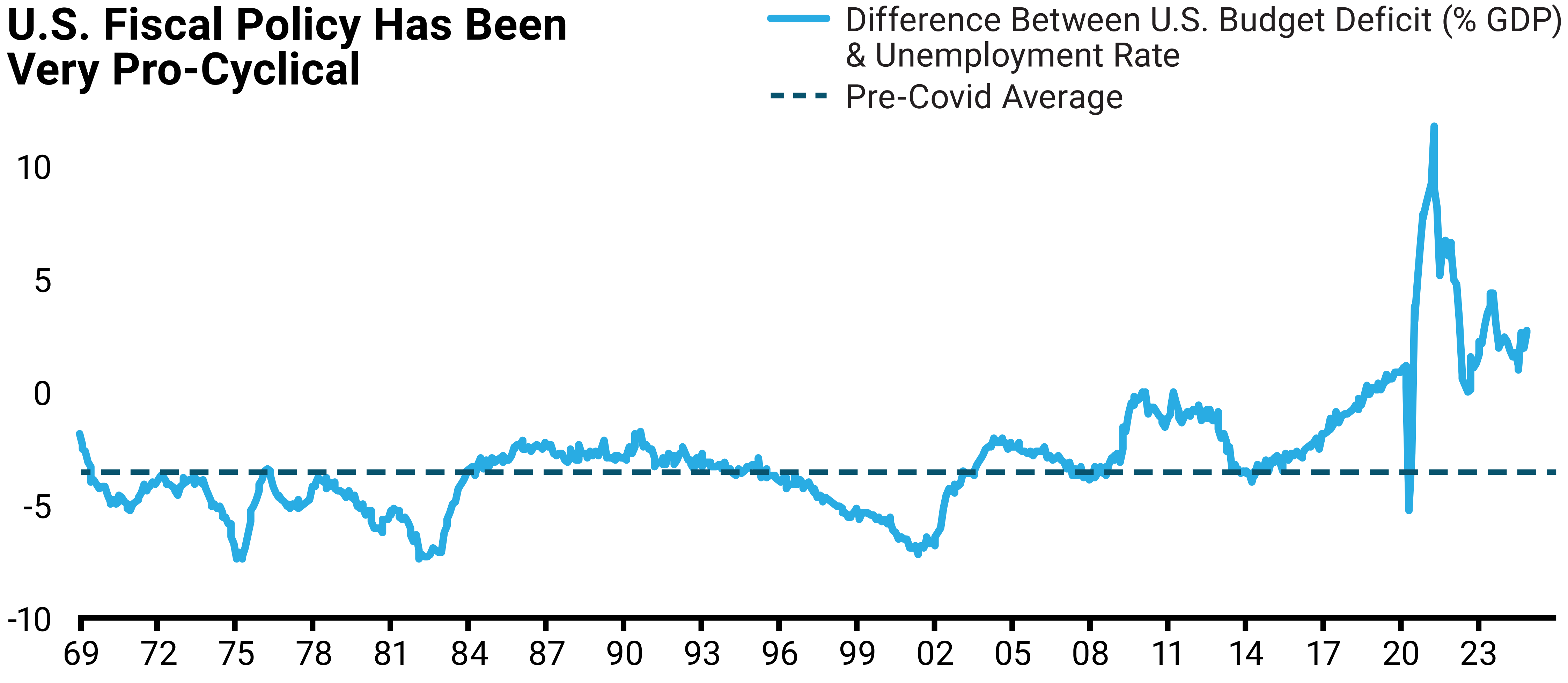
U.S. Household Net Worth is Well Above Trend



Source: The Federal Reserve, Picton Mahoney Asset Management Research. Q1 2014 to Q3 2024.

FIGURE 2

U.S. Fiscal Policy Has Been Very Pro-Cyclical



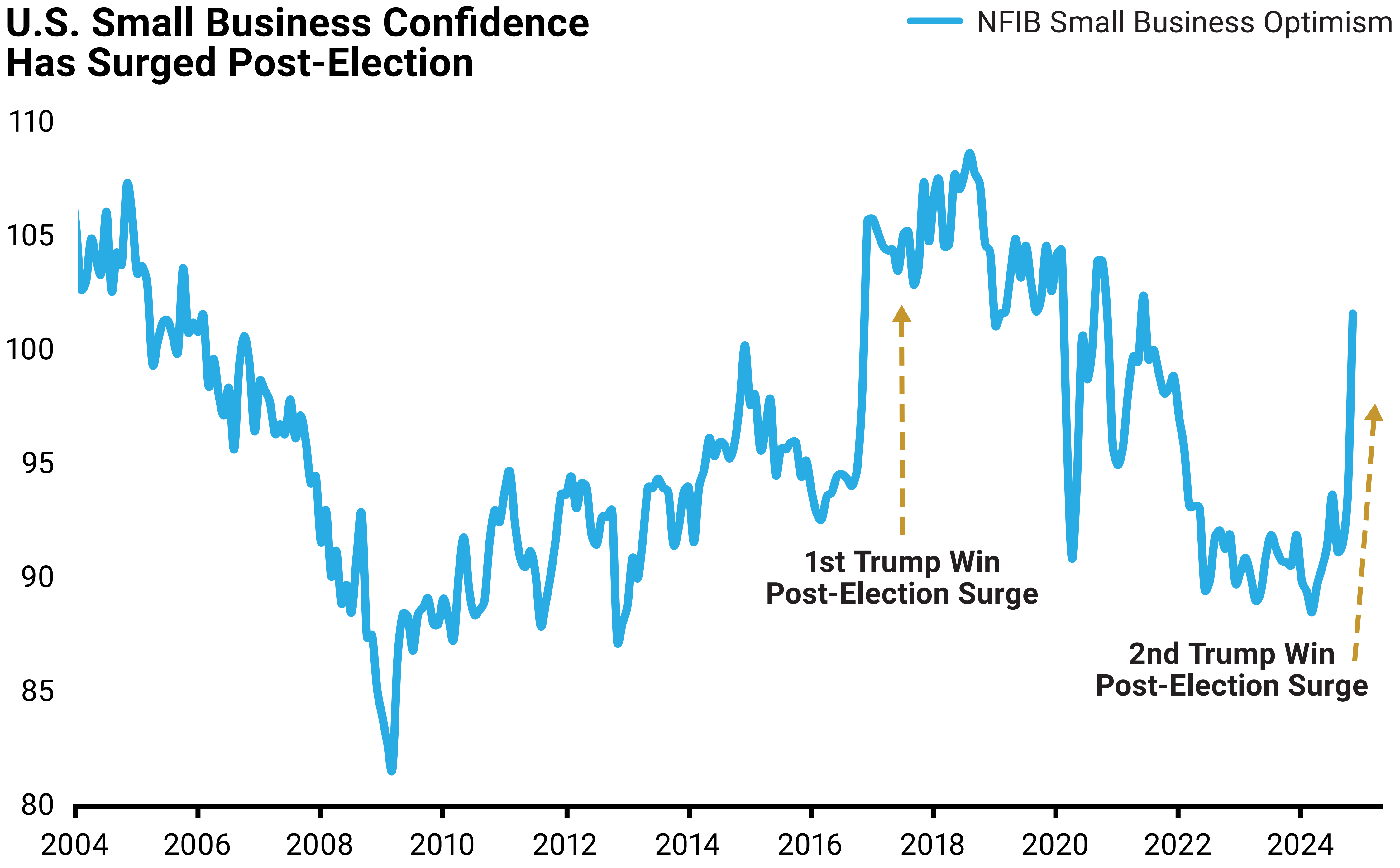
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1969 to Nov 2024.

Cementing the current attractive economic growth narrative was the recent election of Donald Trump as U.S. President. While many aspects of his platform could damage the economy and boost inflation, the market has seemed to embrace his pledge to maintain prior tax cuts and implement even more while cutting regulation at the same time.

This has spurred “animal spirits” even further. For instance, a December report from The National Federation of Independent Business (NFIB) showed that U.S. small-business confidence surged to its highest level in almost three and half years post the election. Of course, stock markets and speculative cryptocurrencies also rallied post the election.

FIGURE 3

U.S. Small Business Confidence Has Surged Post-Election



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2004 to Nov 2024.

> *A December report from the NFIB showed that U.S. small-business confidence* ***surged to its highest level*** *in almost three and a half years.*

Equities Have Outperformed the Typical Soft-Landing Script
(Although Bonds Are a Different Story)

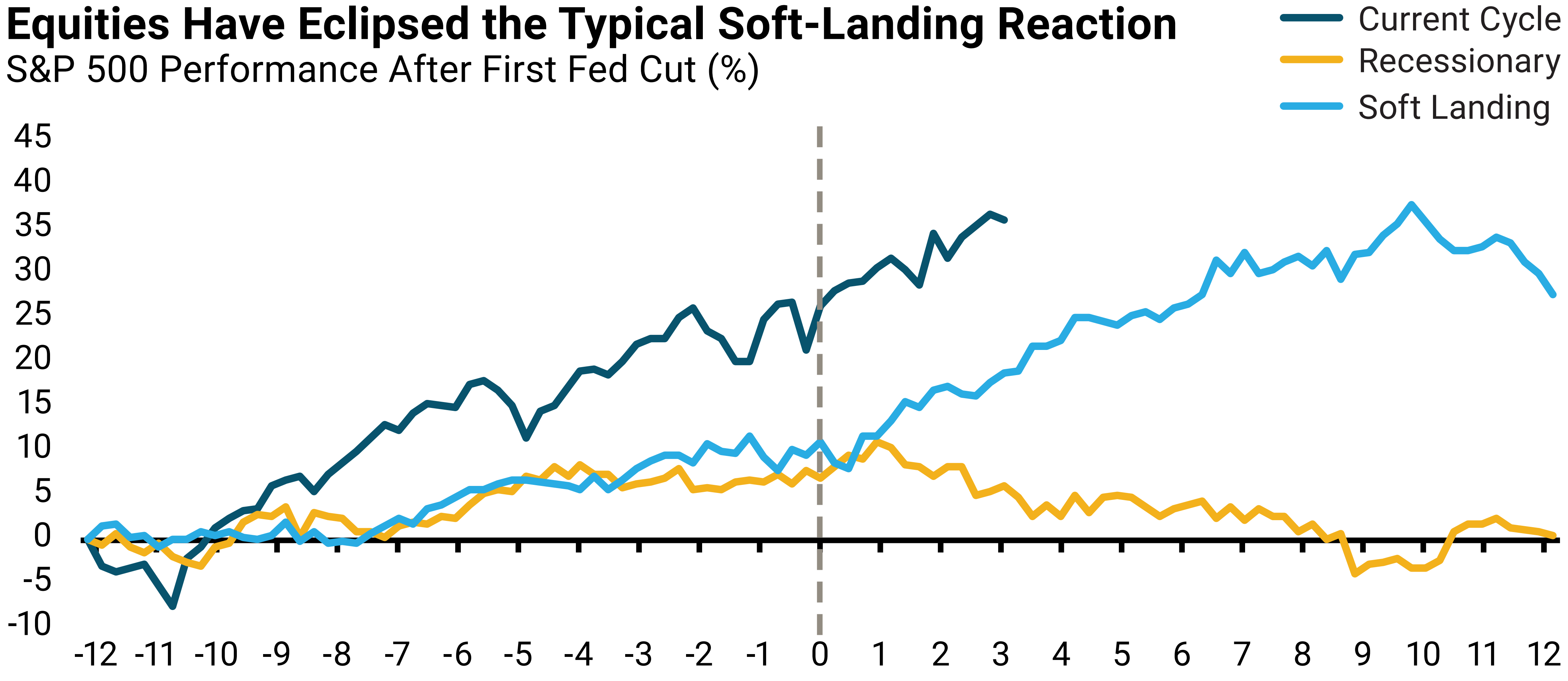
The U.S. stock market surged in the year leading up to the first Fed interest rate cut in September. And even as the Fed finally followed through on rate cuts that had long been priced in by investors, risk assets surged even higher and then went into overdrive following President Trump's election win.

But while equities have outperformed the typical soft-landing script this cycle, bonds have deviated from it. Compared to previous cycles, the action in fixed income has been very unusual. While credit spreads have tightened, long-term treasury yields have risen since the first Fed rate cut. Historically, when the Fed starts an easing cycle (whether in a recession or soft landing), long rates usually fall or at least stay flat.

FIGURE 4

Equities Have Eclipsed the Typical Soft-Landing Reaction

S&P 500 Performance After First Fed Cut (%)

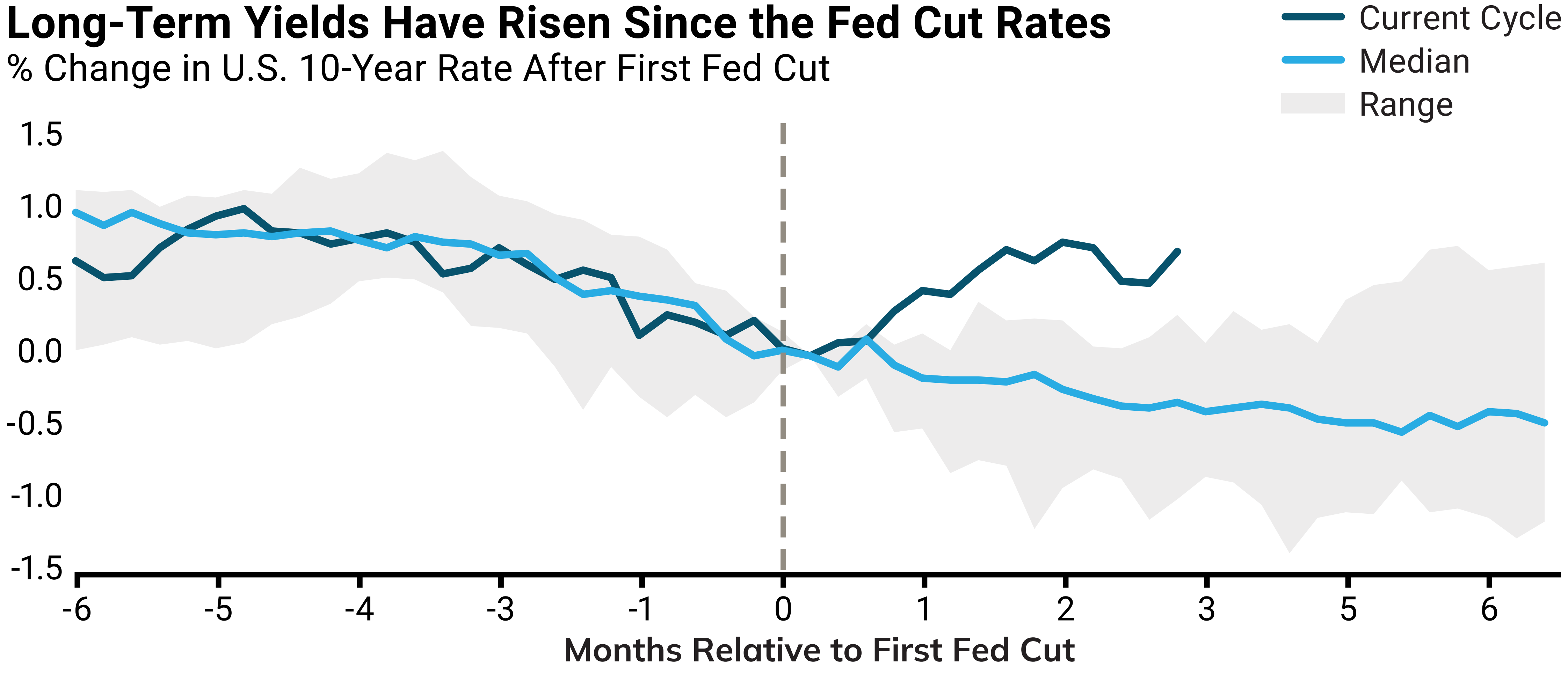


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1984 to Dec 2024.

FIGURE 5

Long-Term Yields Have Risen Since the Fed Cut Rates

% Change in U.S. 10-Year Rate After First Fed Cut



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1984 to Dec 2024.

Central Banks Have Shifted to a Focus on Employment

We think that at least some of the divergence between the performance of equities and bonds thus far in this easing cycle can be explained by global central banks (including the Fed) shifting their focus from fighting inflation to supporting employment even before inflation hits many of their stated targets. Perhaps the market is sniffing out that central banks may have shifted too early, creating a tailwind for equities but a headwind for bond prices.

Fears around the sharp unwinding of the yen carry trade in early August seemed to precipitate this potentially early policy pivot. The brief turmoil, which sent risk assets plunging around the world seemingly overnight, motivated Japan to back off from its tightening process and may have influenced an earlier than necessary policy easing by the Fed.

While Japan may have had little choice in backing of its tightening process given underlying deflationary trends that exist there, the U.S. may have had more time to reflect about next steps than was thought at the time.

While the Fed came to the rate-cutting party in September, other central banks have been at the punch bowl for a while now. There have been 153 rate cuts around the world in 2024. A further 124 cuts for 2025 are currently priced in by markets.

Most of these penciled-in cuts make sense given the greater risk of recession in certain countries. The Canadian and EU economies, for example, are especially rate sensitive, and have been hit harder from prior central bank tightening than the U.S. Policy rates in these two jurisdictions are already lower than in the U.S., a trend which could become even more pronounced in 2025.

It makes sense that many central banks should be cutting interest rates to buoy their economies. But did it make sense for the Fed also to shift its focus toward emphasizing full employment instead of the battle against inflation? This pivot reflects what Apollo Global Management recently described as the U.S. central bank's "very asymmetric view on its dual mandate":

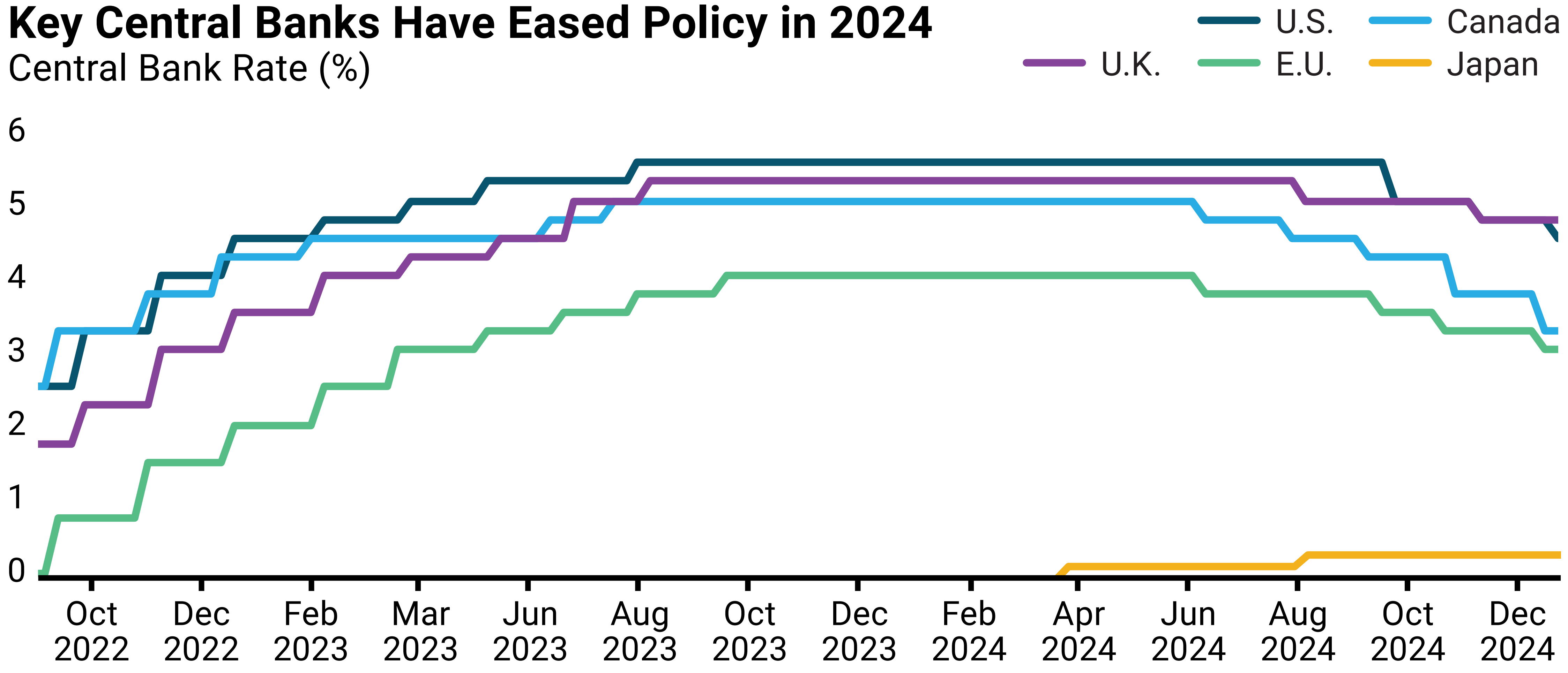
Sometimes, FOMC members think the risk to their inflation forecast is to the upside, and sometimes, they think the risk to their inflation forecast is to the downside. This is in sharp contrast to their views on the risks to the unemployment rate.

- *The number of FOMC members who think the risk to their forecast for the unemployment rate is weighted to the upside is always much higher than the number of FOMC members who think the risk to their unemployment rate forecast is to the downside*
- *In other words, the Fed has a very asymmetric view on its dual mandate, putting much more weight on low unemployment than on getting inflation to stay at 2%.*[1]

FIGURE 6

Key Central Banks Have Eased Policy in 2024

Central Bank Rate (%)



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

[1] Apollo Global Management, Inc., Asymmetric Dual Mandate, Dec 1, 2024.

Are We Seeing a Replay of 1998/1999 Bubble Build?

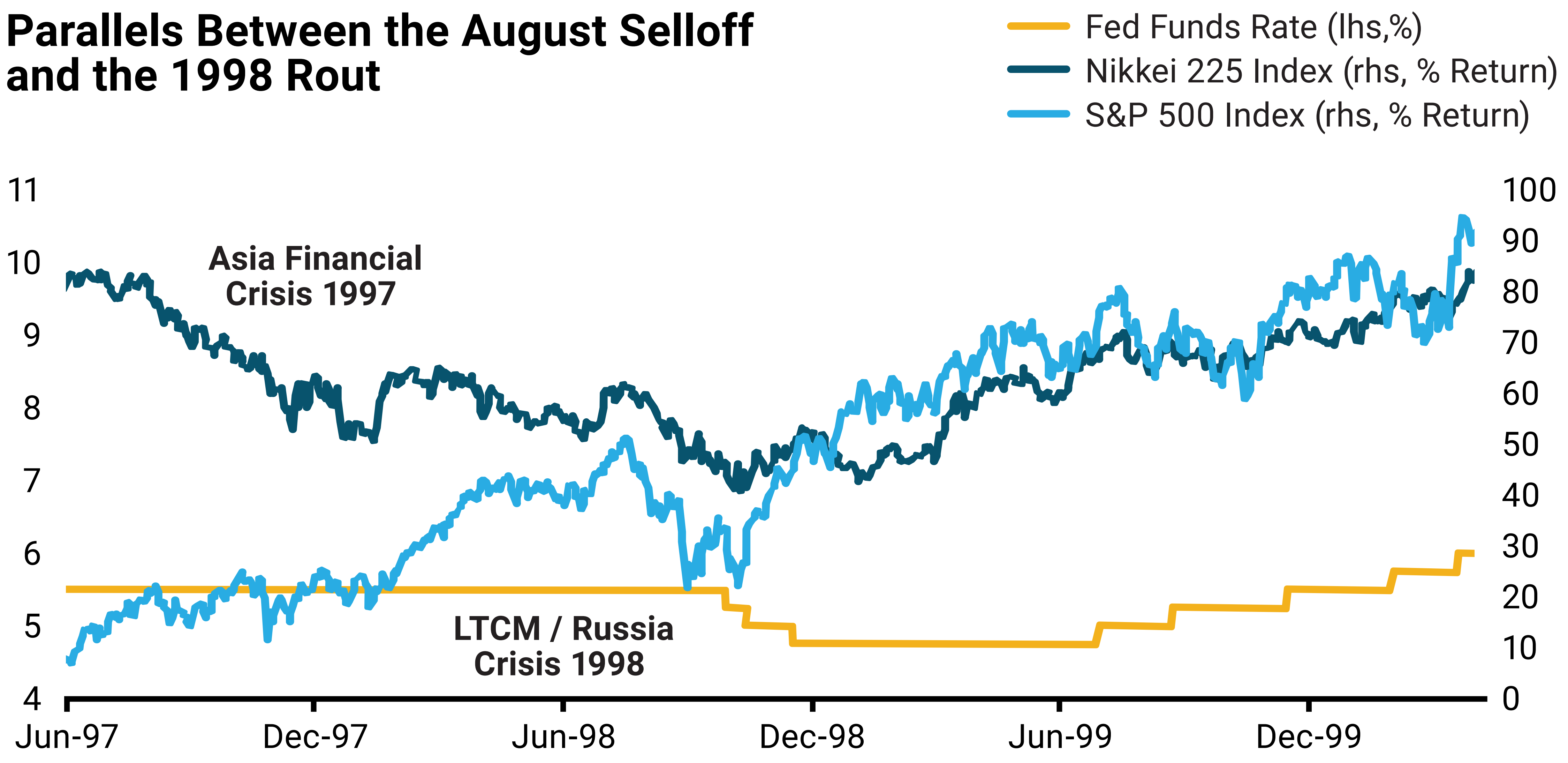
If you squint hard enough, you can see some parallels between the current economic and financial backdrop in the U.S. and that which existed in the 1998/1999 bubble era. Back then, the Asian Financial Crisis, Long-Term Capital Management failure, and Russian debt/rouble crises were the catalysts that sent markets spiralling lower. Perhaps the brief Japanese carry trade unwind was a similar catalyst this time around.

The 1998 rout, which hit markets around the world, spurred a quick 75 basis points of Fed rate cuts that helped equities put in a bottom setting the stage for a massive rally that would drive them to a bubble peak in March 2000. Markets back then were buoyed by the frenzy surrounding the commercialization of the internet which has some parallels to the advances in artificial intelligence that are currently capturing the attention of markets.

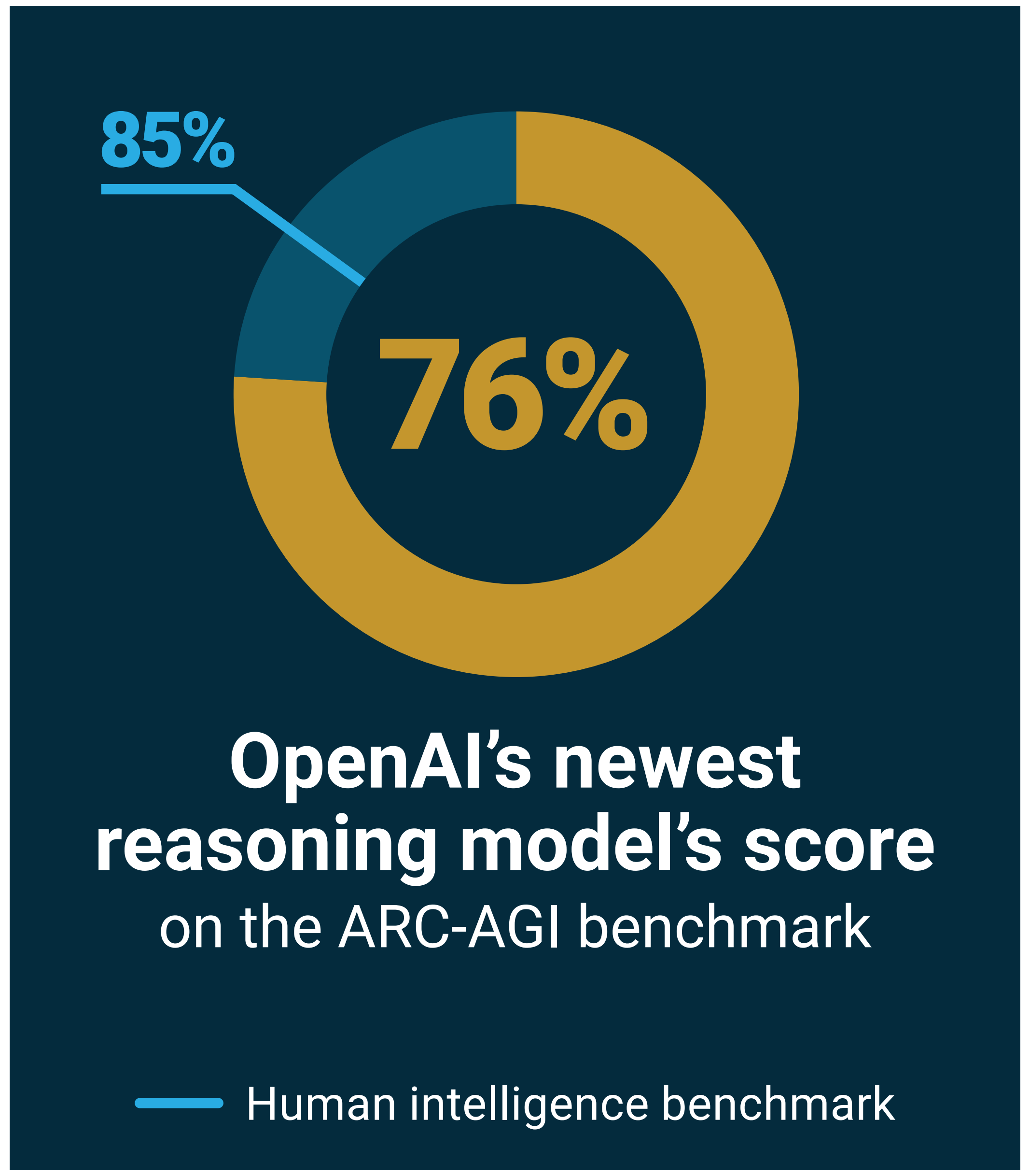
If 1998/1999 is any guide, it appears that the conditions for the last run in an equity bubble are forming again. Even against the backdrop of solid economic growth in the U.S. and above target inflation readings, the Fed seems intent on further loosening of monetary policy.

FIGURE 7

Parallels Between the August Selloff and the 1998 Rout



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



This new stimulus is coming on the heels of continued excessive fiscal spending by the U.S. government. Meanwhile, President Trump's election victory has sparked a new wave of "animal spirits", adding fuel to an already bullish fire.

The artificial intelligence theme has been a big driver of stocks over the past year and a half but could add yet another leg to the bubble's expansion. It appears that the AI narrative is shifting from building to now using large language models (LLMs) in new ways to boost productivity.

There are also predictions for big breakthroughs from new AI models that add reasoning skills to the equation. For example, just before Christmas, OpenAI demonstrated its newest "reasoning" model which showed a step function improvement in capabilities.

This model had a 76% score on the ARC-AGI benchmark which tries to measure general intelligence of an AI system. This was significantly higher than previous models and approaches human intelligence, which scores 85% on the same test.

Related to this, the market is anticipating shortages of electricity on the horizon to power these AI developments which have created new related themes in electricity production and infrastructure development to capture investor attention.

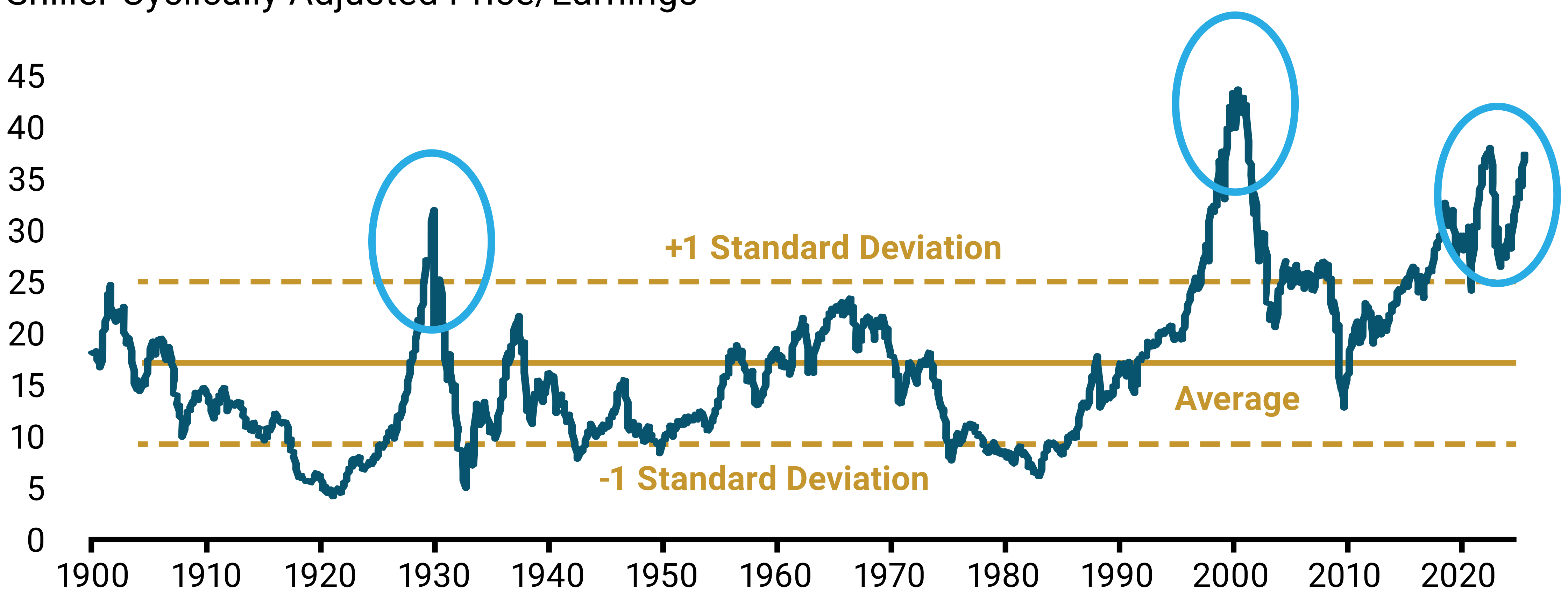
In another parallel to the late 1990s bubble, some pundits suggest we could be entering a new potential productivity surge which could drive corporate margins and earnings higher, taking stock market indices along as well.

The Bubble is Clearly Inflating

From many vantage points, there is already an apparent bubble in the U.S. stock market. Overall market valuations are very elevated, with the cyclically adjusted P/E ratio sitting at a lofty 38x. Even if a soft landing occurs this time around, the starting point for valuation expansion is much higher than previous instances where the Fed began an easing cycle.

FIGURE 8

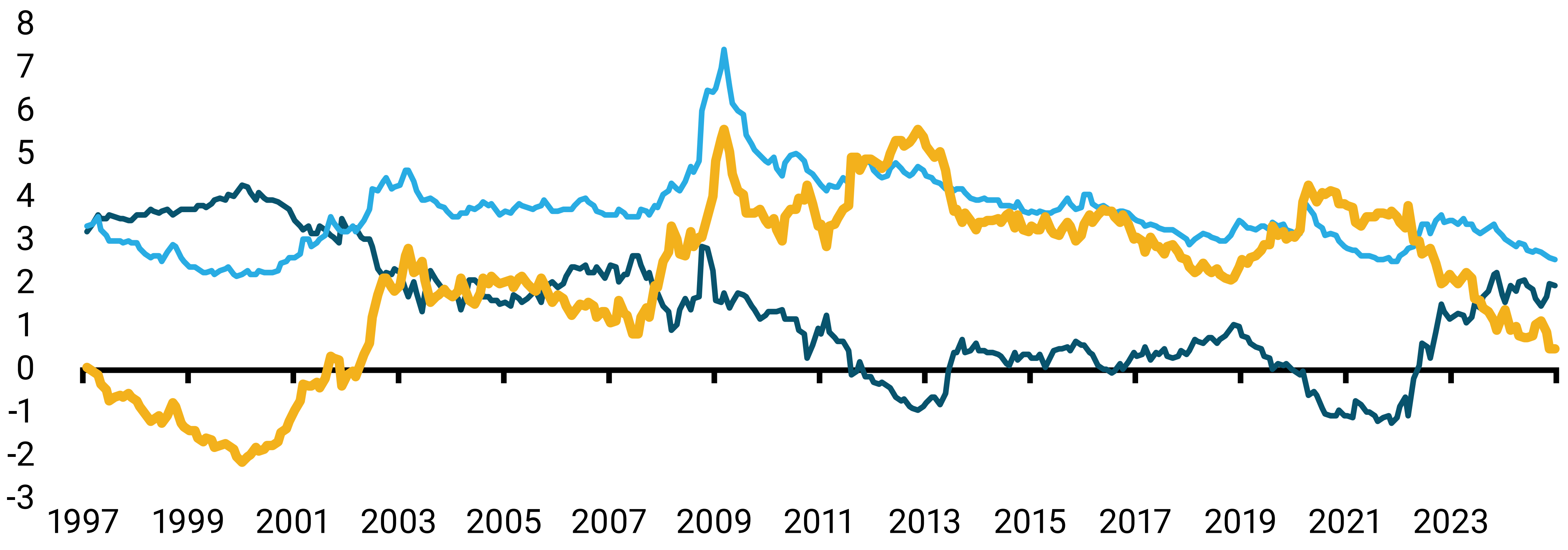
The Cyclically Adjusted P/E Ratio is Very High
Shiller Cyclically Adjusted Price/Earnings



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

FIGURE 9

The Equity Risk Premium is Plumbing Multi-Decade Lows



Source: Robert Shiller, Picton Mahoney Asset Management Research. Jan 1997 to Dec 2024.

As we have shown in the past, removing the high-flying technology sector still leaves multiples well above norms. And with bond yields rising instead of declining post the Fed's new rate cutting cycle, the equity risk premium now sits at multidecade lows – a condition seen in prior bubbles as well.

Another sign we're in bubble territory is that investor positioning on the long side of their portfolios is full. Bank of America/Merrill Lynch's latest Fund Manager Survey shows that post-election optimism is dominating investor expectations. Most respondents expected a stronger economy and have positioned for this outcome.

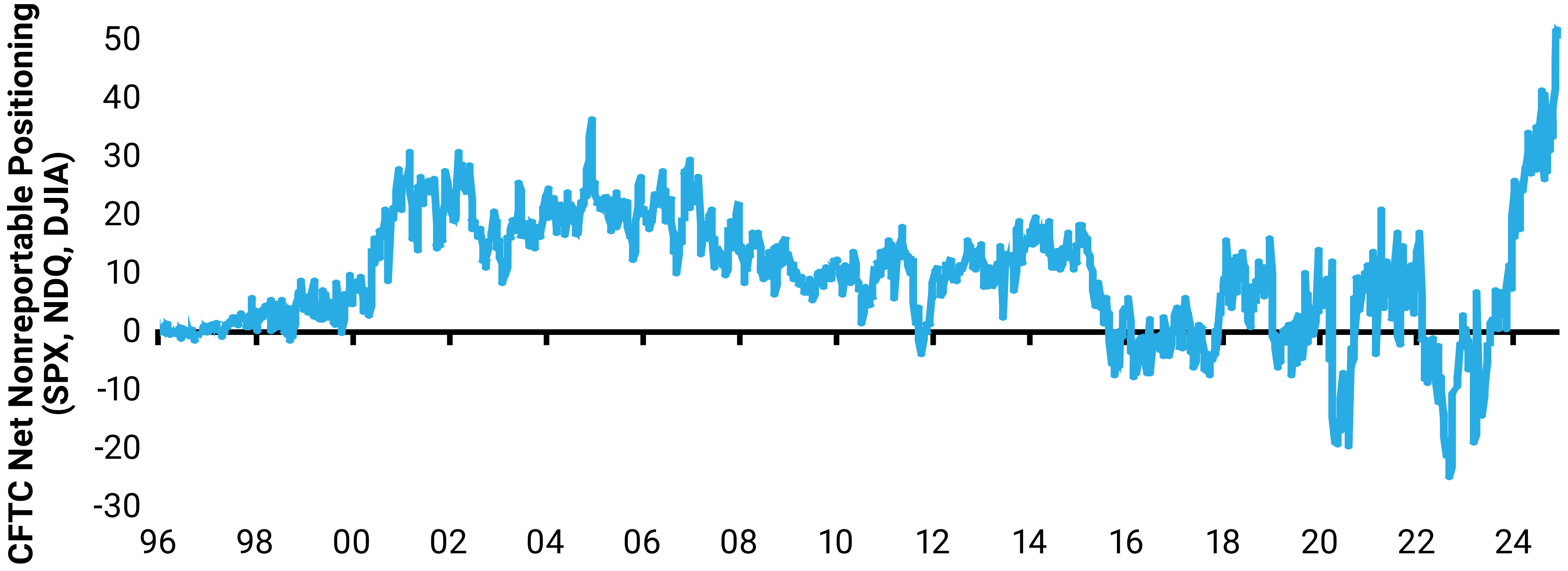
The survey revealed that fund managers' equity positioning has surged to 11-year highs while cash positions are as low as they get. Private client holdings mirror the fund manager results, with equity allocations at 63% (vs. 20-year high of 66% and 20-year low of 39%).

Institutional fund managers are also all-in on U.S. equities as per Commodity Futures Trading Commission futures data, which shows that holdings are at a record 1.1 million net long contracts (up nearly 50% in the last year alone).[2]

[2] Bank of America, Global Fund Manager Survey, Dec 2024.

FIGURE 10

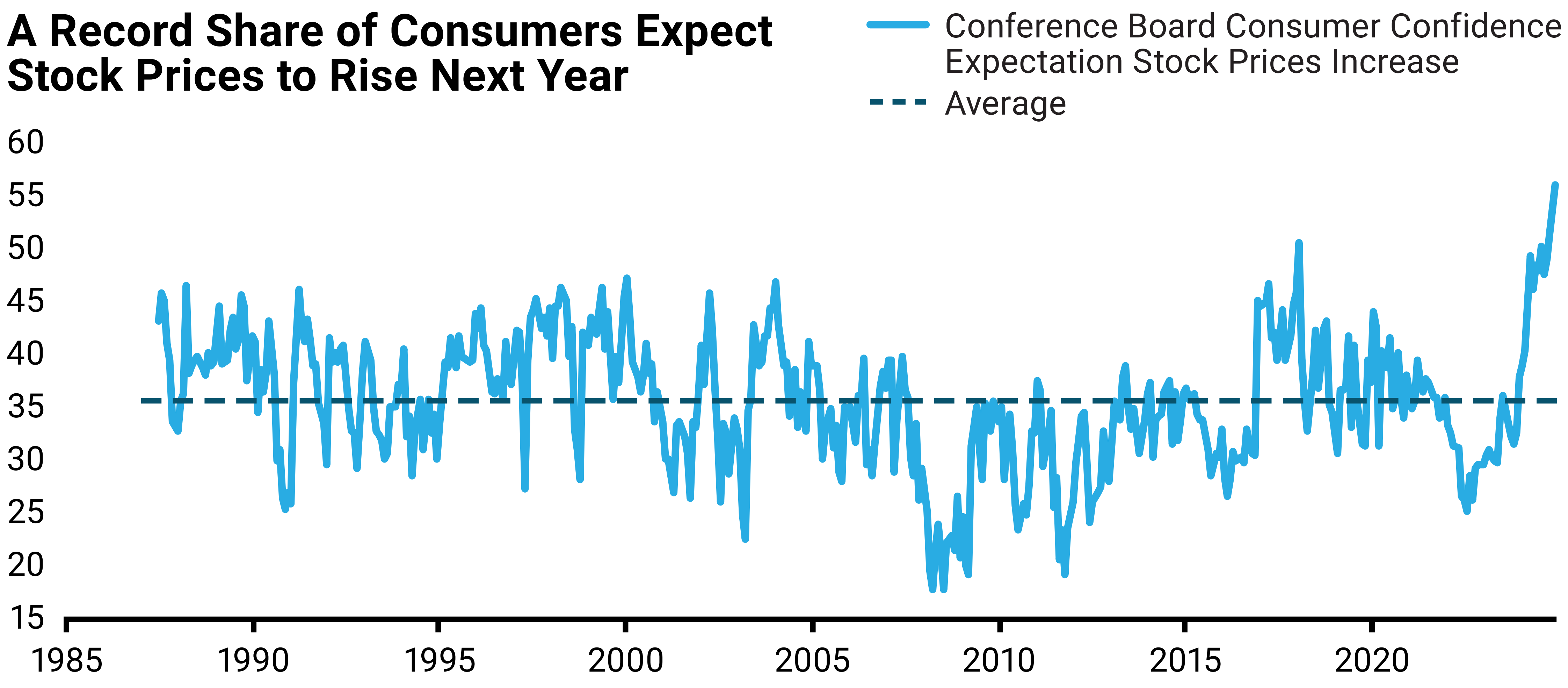
In U.S. Futures Markets, Small Speculators Have a Giant Long Position



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1996 to Dec 2024.

FIGURE 11

A Record Share of Consumers Expect Stock Prices to Rise Next Year



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. June 1987 to Nov 2024.

Meanwhile, in addition to professional money managers, small investors are also chasing the market. Total speculative positions among this cohort have blown past previous record highs and now reside in rarified air.

Foreign investment in U.S. stocks has also surged – typically an ominous sign. According to EPFR, net monthly inflows into U.S. equity funds jumped to 140 billion USD in November, a multi-year high. This is in contrast to net *outflows* from the rest of the world during the same period.

The divergence in performance in November between U.S. stocks and the rest of the world was 6.2% – the widest gap since 1998.[3]

Market optimism is also flourishing among the public, another telltale sign of a bubble. A record number of Americans are bullish stocks, just like the last time President Trump was elected. Unfortunately for the optimists this time around, valuations were quite a bit lower back in November 2016 than they are now.

> *The divergence in performance in November between U.S. stocks and the rest of the world was* **6.2%**

[3] Financial Post, Investors pour US$140 billion into U.S. stock funds after Trump's Win, Dec 6, 2024.

Bubble Characteristics

It is difficult to predict and invest in a bubble. The early stages of the runup are typically based on normal reactions to improving economic conditions and/or cheap valuations in the market.

However, at some point investors become more excited than normal about something like a new invention or an abrupt change in economic policy. This is a phenomenon economist Hyman Minsky coined “displacement”.[4]

Displacement is followed by a boom and then at some point an orderly boom gives way to unbridled (and largely unjustified) euphoria.

Stock prices become detached from their underlying fundamentals as speculative fervor takes hold. Wild predictions, whether for a company, sector or the overall market are tossed around.

In the latter stages of a bubble, talk of a “new era” can be heard, one in which the old rules about valuations supposedly don’t apply.

Case in point: at the end of the “Roaring Twenties” on October 16, 1929, the *New York Times* quoted economist Irving Fisher predicting that stock prices had reached “what looks like a permanently high plateau”.[5] We all know what happened next.

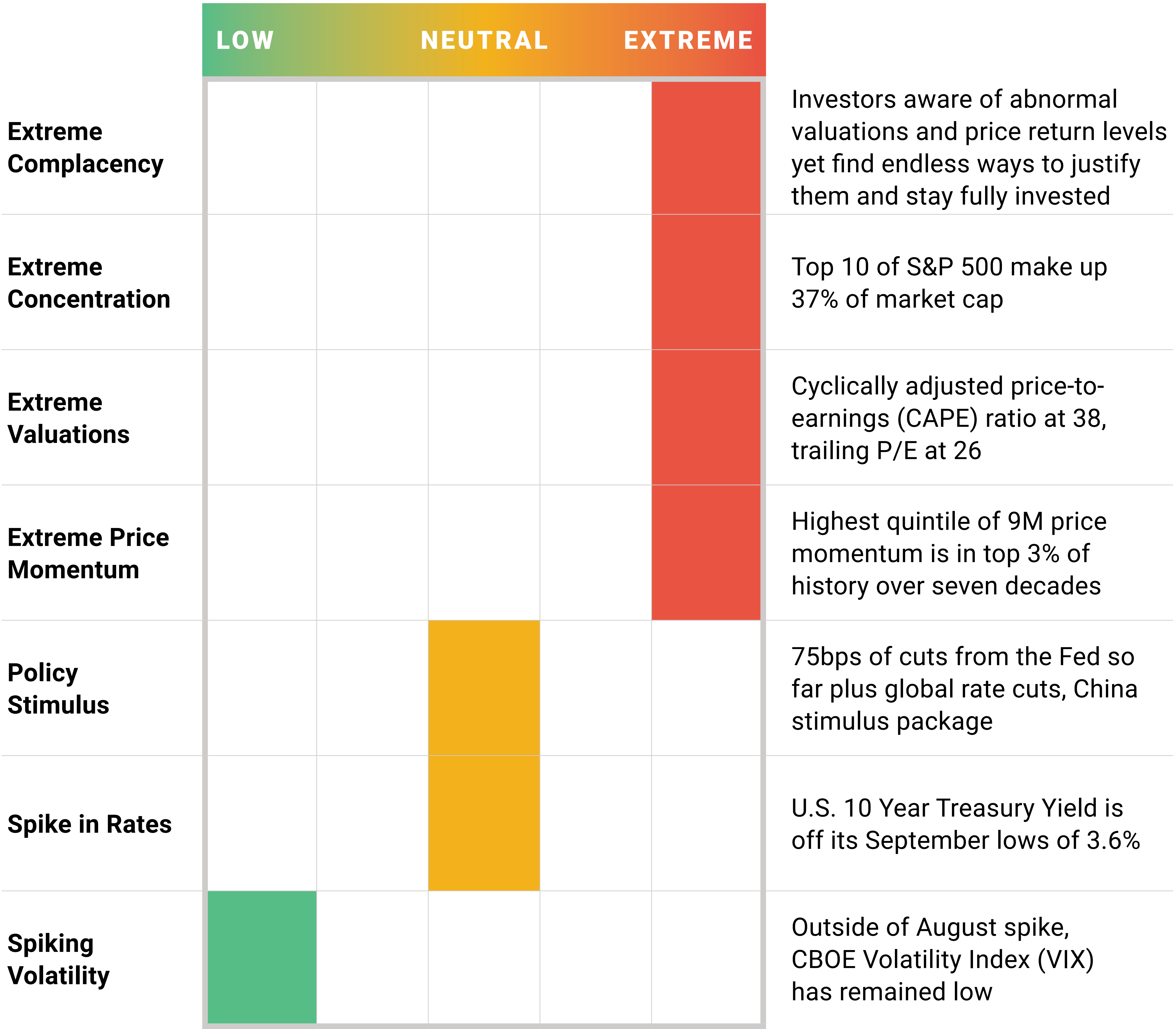
A crucial, and dangerous, element of a bubble’s parabolic move is that it has no relationship to what stocks ought to trade for based on their future cash flows. Rather, speculators tend to extrapolate past price performance into the future and bid up stock prices ever-more feverishly. “Fear of missing out” (FOMO) also plays a part in the bubble’s dynamics.

Another factor at play is what John Maynard Keynes described as the beauty contest, where the game for investors is to buy stocks that they believe others will also accumulate – as opposed to investing in stocks where fundamentals are attractive in and of themselves.

Bubbles, particularly the last part of their run, can be great quick money-making environments, if you’re able to correctly ride the trend. Betting against them, by contrast, can be hazardous to one’s wealth: as Keynes once remarked, “The market can stay irrational longer than you can remain solvent.”[6]

FIGURE 12

Picton’s Bubble Top Checklist Suggests Caution is Warranted



Source: Picton Mahoney Asset Management Research, as at Dec 2024.

[4] Perry Mehrling, Boston University, Fellow Travelling Theorists of National and International Financial Instability, March 2023.
[5] The New York Times, FISHER SEES STOCKS PERMANENTLY HIGH, Oct 1929.
[6] John Maynard Keynes.

The difficulty in staying long on stocks in a bubble is that there needs to be a lot of positive tailwinds in place to attract ever increasing amounts of money into the fray. As discussed previously, there are indeed a lot of economic tailwinds today. However, when valuations become excessive and everyone is “all in”, it doesn’t take much to end the mania and usher in rapid and/or significant market declines.

As we can see from our firm’s “Bubble Checklist” (Figure 12), four key hallmarks of a bubble top are already screaming red – Extreme Complacency, Extreme Concentration, Extreme Valuations, and Extreme Price Momentum. However, there are three other characteristics we track (Policy Stimulus, Spike in Rates, and Spiking Volatility) that are not yet appear to be in the danger zone.

Why the Bubble Might Have More Room to Grow

There are some other characteristics of a typical bubble top that are still absent. Evercore ISI notes that M&A transaction values, though rising, are well off record highs. In addition, despite the artificial intelligence frenzy, IPOs for AI companies are few and far between.

Contrast this with the Internet stock bubble of the 1990s, when countless dot-com ventures were listed on the Nasdaq and traders quickly bid them up far beyond their initial public offering price.

Another hallmark of bubble tops is that bears are few and far between. And though positioning data is crowded to the long side, the recent American Association of Individual Investors survey revealed that 40% of respondents are cautious on stocks at the present time.[7]

Near the peak of the tech bubble of the late 1990s, this reading was consistently under 15%. Margin debt could also keep expanding.

As Evercore ISI argues:

“A rise in FINRA margin debt near $1T (well above trend) within the next year would indicate ***accelerating FOMO*** *as well as investors chasing upside.*

Rising margin transactions could also be spurred by rate cuts which ease financial conditions.”[8]

[7] Bloomberg L.P., American Association of Individual Investors Survey, Dec 2024.
[8] Evercore ISI, Through the Roaring 20’s, Dec 2024.

Past Bubbles Offer Clues to How Long the Current One May Last

Although a very inexact science, we have looked at six big bubbles from the past (Figure 13.1) to get some guesstimates as to how much longer it might take to get to a real blow-off top should the current market bubble persist. We have aggregated their performance in Figure 13.2.

The current trajectory of the NASDAQ Composite Index is following a similar pattern. If we data mine a little bit and line up recent NASDAQ performance with the average or median of past bubbles, it suggests a possible blow-off peak by mid 2025 before the air comes out of the market. Of course, the top could come sooner or later. Bubbles are rooted in human behaviour, after all.

FIGURE 13.1

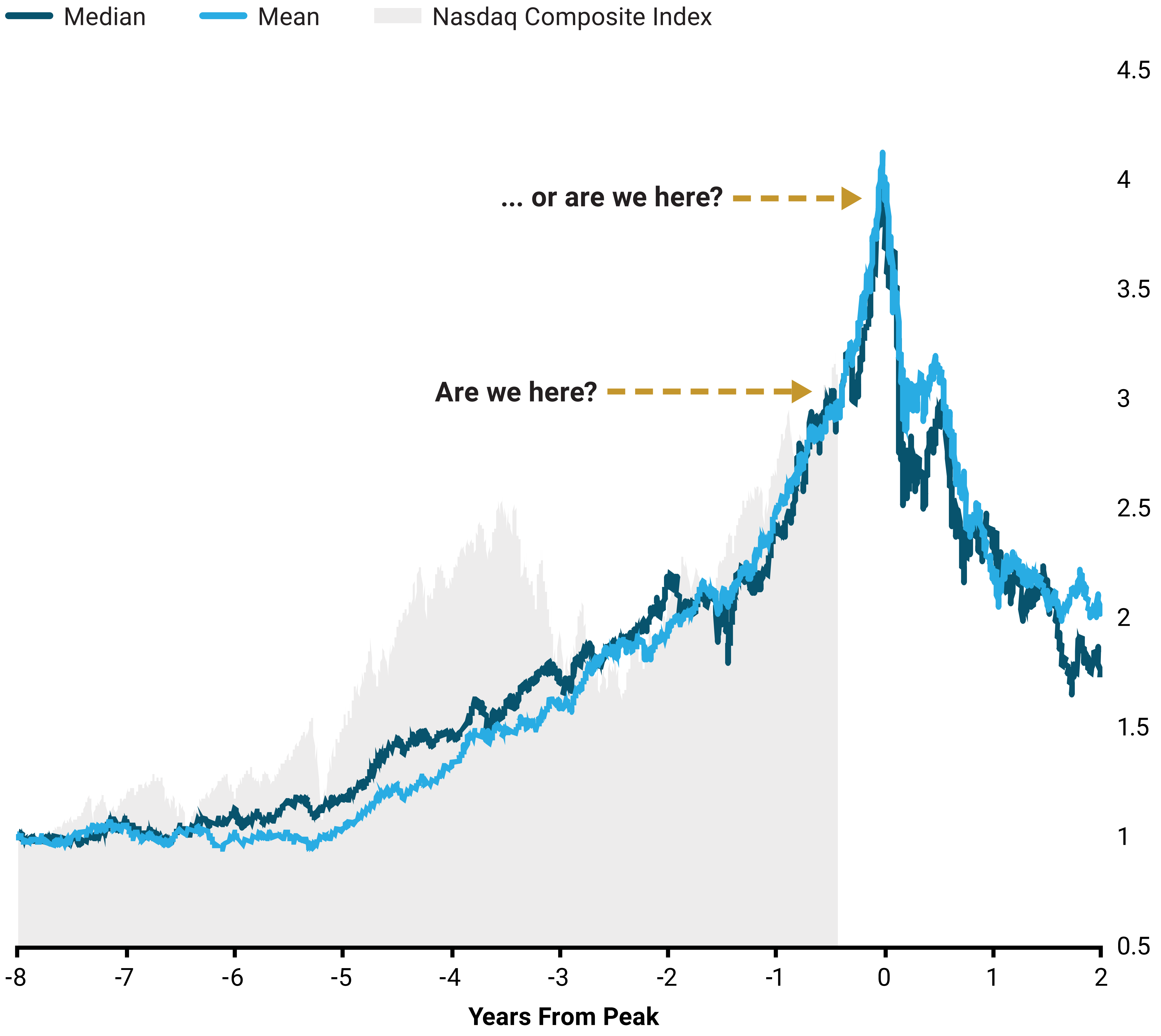
Taking Stock: Comparing the Current Bubble with Prior Ones

THE SIX BUBBLES			
01	**End of the Gold Standard**	= Gold Bullion	1/27/1972 – 1/27/1982
02	**Oil & Commodity Bubble**	= Reuters CRB Index	7/8/2000 – 7/8/2010
03	**The Dot-Com Bubble**	= NASDAQ	3/18/1992 – 3/18/2002
04	**Chinese Stock Market Bubble**	= MSCI China	11/5/1999 – 11/5/2009
05	**The Roaring Twenties Stock Market Bubble**	= Dow Jones Industrial Average	9/9/1921 – 9/9/1931
06	**Japanese Asset Price Bubble**	= Nikkei 225	1/9/1982 – 1/9/1992

FIGURE 13.2

Taking Stock: Comparing the Current Bubble with Prior Ones

Average of Six Bubbles vs. NASDAQ Today (Assuming Peak on May 31, 2025) (%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1972 to Dec 2024.

What Could End the Party?

So, what could dent the current exuberance, especially for U.S. large cap stocks?

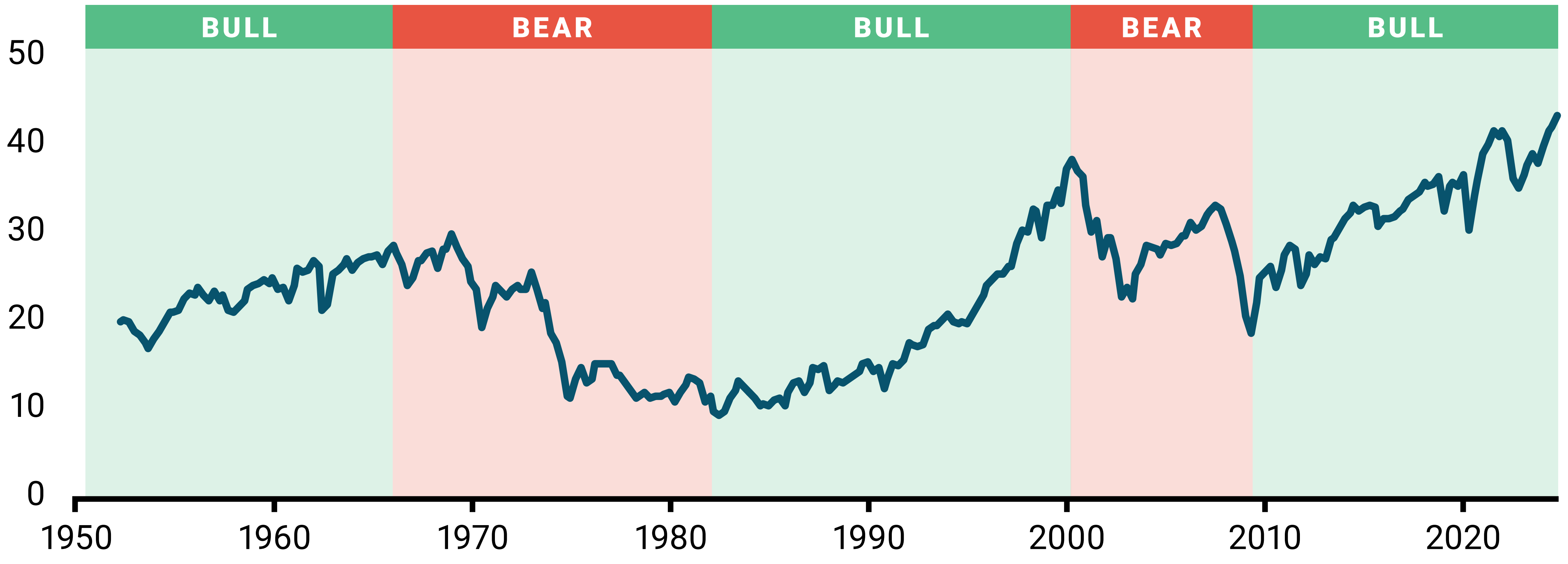
We believe there are a few potential catalysts on the horizon that could trigger at least a normal correction in stocks given their current unattractive setup. We also believe a flare-up in inflation could trigger something even worse should it occur.

Although not a catalyst per se, investors should be getting worried that long-term returns have been at least pulled forward somewhat, which implies growing risks in the short- and medium-term. For example, equities as a percentage of household financial assets are at peaks that usually precede periods of prolonged weak equity returns (i.e., end of a secular bull market and start of a secular bear). Indeed, similar levels were seen around the 2000 bubble peak.

FIGURE 14

U.S. Household Equity Ownership is at Prior Bubble Peaks

U.S. Household Equity Ownership as % of Financial Assets



Source: The Federal Reserve, Picton Mahoney Asset Management Research. Q1 1952 to Q3 2024.

[9] Business Insider, DOGE tracker: A running list of what Elon Musk and Vivek Ramaswamy say they will change. Dec 2024. Rolling Stone, Musk Says Trump Win Would Result in 'Hardship' for Some Americans, Oct 2024.

Trump's Agenda Could Weigh on the Economy at the Get-Go

One possible risk to the bubble is if the sequencing around Trump's agenda turns out to be disruptive to the economy out of the gate, rather than positive for growth as many expect.

It's not difficult, for example, to imagine the Trump agenda starting with executive orders on items that could immediately harm the economy such as tariffs and mass deportations. These could occur well before action on tax relief can be implemented.

Another long-shot possibility is that the Department of Government Efficiency (DOGE) is actually able to identify and then muster enough support for meaningful fiscal retrenchment.

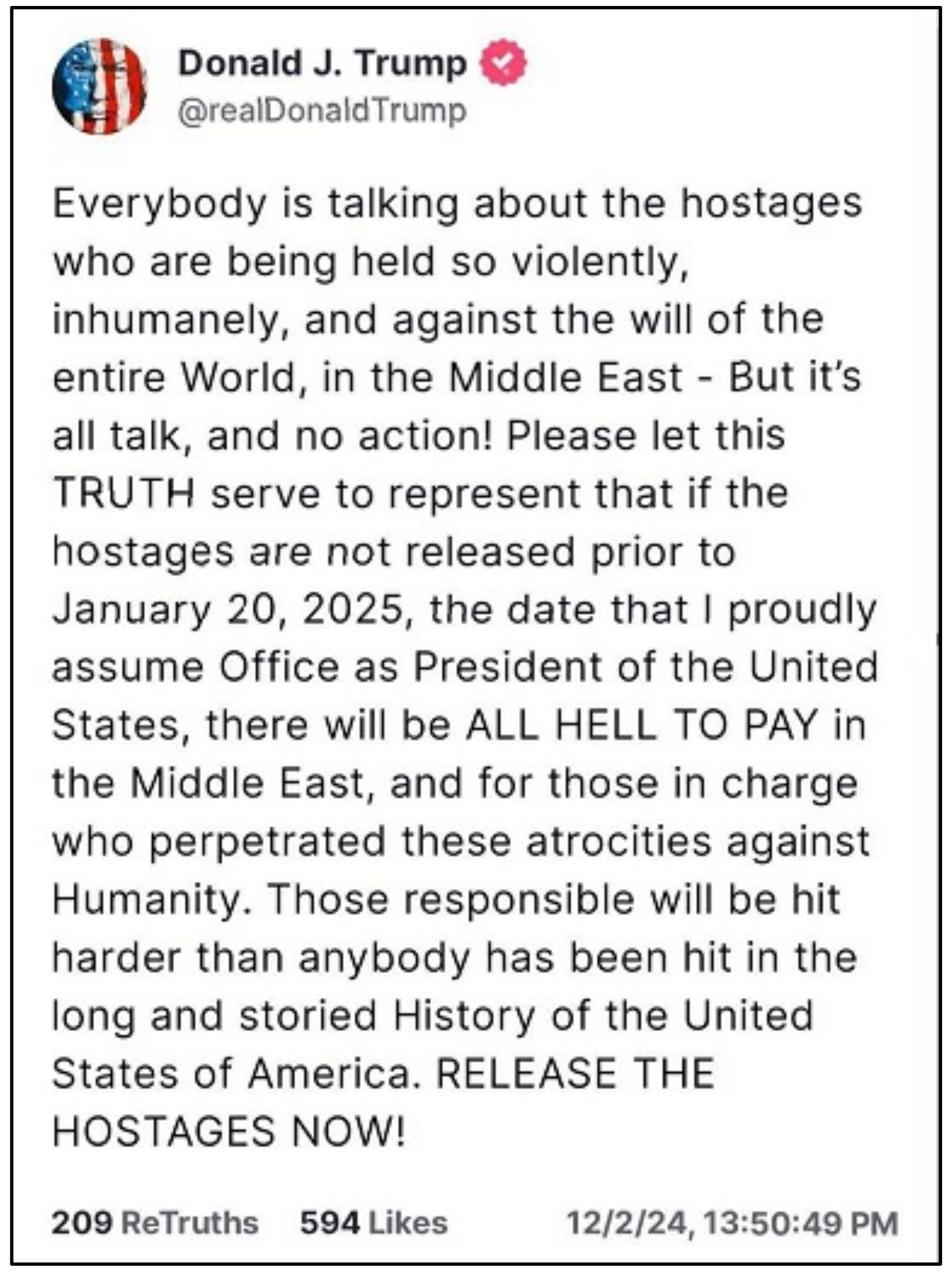
We doubt this will happen, but Elon Musk has promised pain up front:

Elon Musk and Vivek Ramaswamy have big plans for the Department of Government Efficiency. The two have promised to significantly reduce the federal budget, ***with a goal of cutting $2 trillion in spending****.*

Musk promised that DOGE will send "shockwaves through the system, and anyone involved in Government waste, which is a lot of people!". Musk said that he would "balance the budget immediately," adding: "Obviously, a lot of people who are taking advantage of government are going to be upset about that. I'll probably need a lot of security, but it's got to be done. And if it's not done, we'll just go bankrupt."[9]

Geopolitics May Send a Jolt Through Risk Assets

Once Trump is inaugurated in late January, we may see geopolitical risks shake current market complacency. There are at least a few potential flashpoints, but the Middle East is likely the top of the list:



Donald J. Trump
@realDonaldTrump

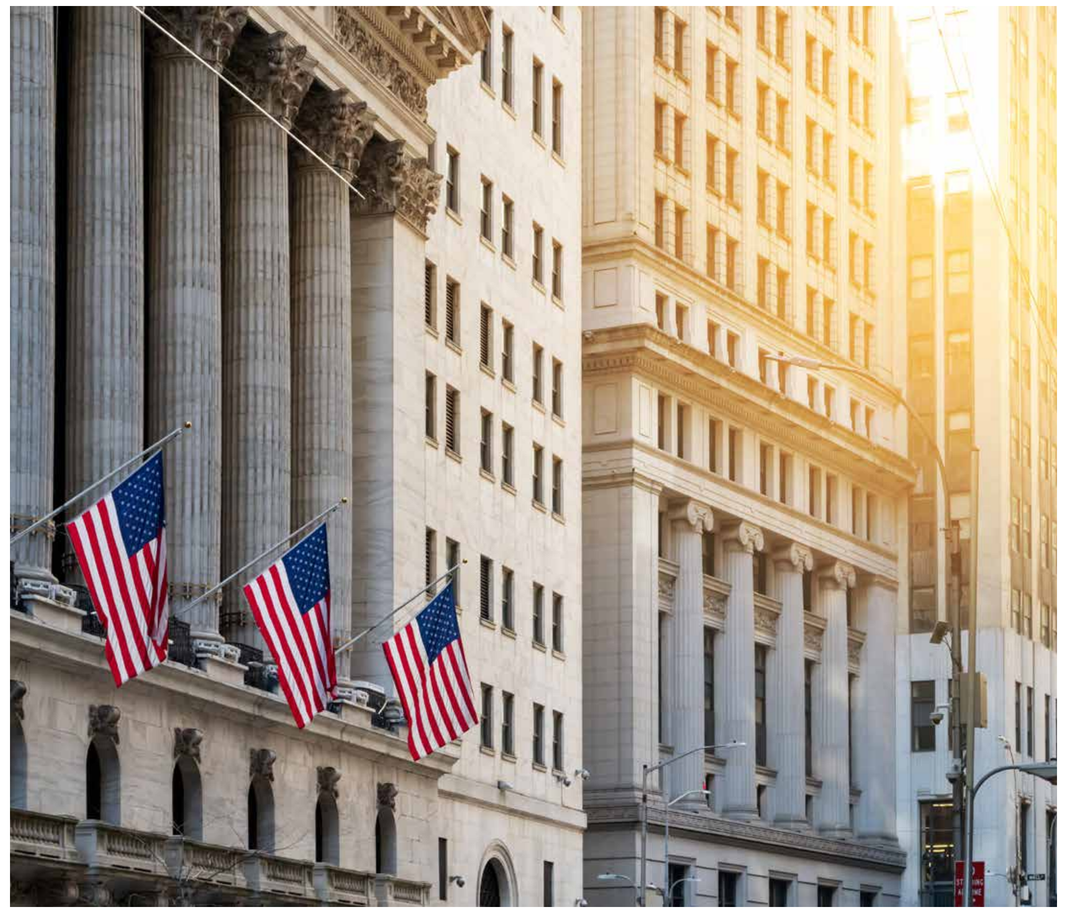
Everybody is talking about the hostages who are being held so violently, inhumanely, and against the will of the entire World, in the Middle East - But it's all talk, and no action! Please let this TRUTH serve to represent that if the hostages are not released prior to January 20, 2025, the date that I proudly assume Office as President of the United States, there will be ALL HELL TO PAY in the Middle East, and for those in charge who perpetrated these atrocities against Humanity. Those responsible will be hit harder than anybody has been hit in the long and storied History of the United States of America. RELEASE THE HOSTAGES NOW!

209 ReTruths 594 Likes 12/2/24, 13:50:49 PM

Source: Truth Social

But, Has the Fed Seen the Error of Their Ways in Time?

Bulls seem to assume the U.S. central bank will continue to be market friendly providing more fuel for a move higher. However, the December FOMC meeting saw a marked change in the Fed's tone as they seemed to pivot back to inflation fighting versus worrying as much about potential increases in the unemployment rate. Chairmen Powell pointed out that the economy is "strong overall" while "consumer spending remains resilient".



On inflation, however, Powell said getting to 2% inflation may "take another year or two" and that "as we think about further cuts, we're going to be looking for progress on inflation... We have been moving sideways on 12-month inflation."

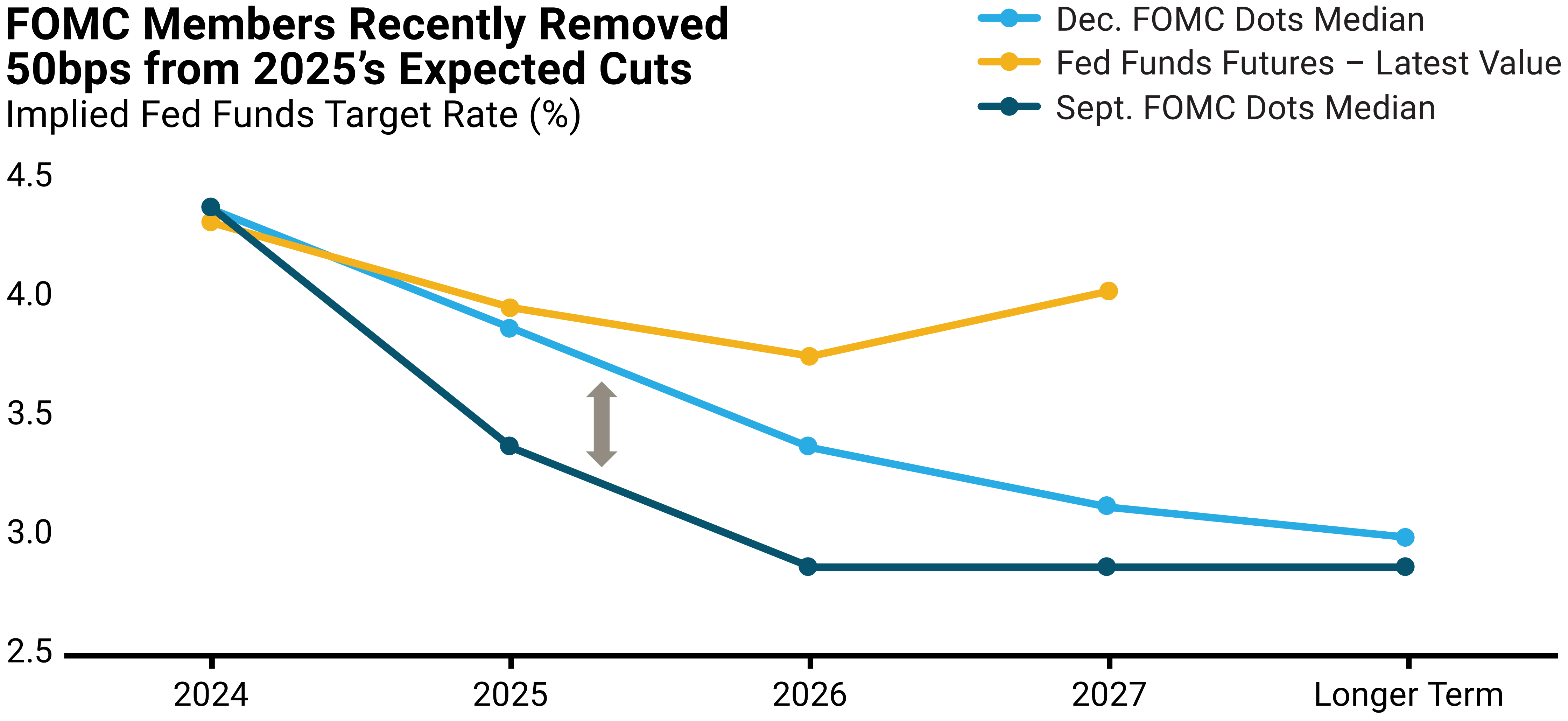
To that end, in their Statement of Economic Projections, FOMC members kept their expected unemployment rate steady at 4.3% for the next few years, while increasing expected inflation to 2.5% in 2025, only falling to 2.0% in 2027.[10] They also nudged up their expectation for the Fed Fund rates, removing 50bps from next year's expected cuts (as shown in Figure 15).

> "*Getting to* ***2% inflation*** *may take another year or two.*"

FIGURE 15

FOMC Members Recently Removed 50bps from 2025's Expected Cuts

Implied Fed Funds Target Rate (%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2024 to Dec 2024. All data beyond 2024 are estimates.

[10] Board of Governors of the Federal Reserve System, Federal Open Market Committee, Press Conference, Dec 18, 2024.

All-in-all, the message was received as quite hawkish, as it marked a turn in policy direction and signaled a possible end to the rate cutting cycle if inflationary pressures persisted. But even before this latest FOMC meeting, concerns were developing about the need for further rate cuts. Evidence of this shift could be seen in Governor Michelle Bowman's speech on November 20, where she remarked:

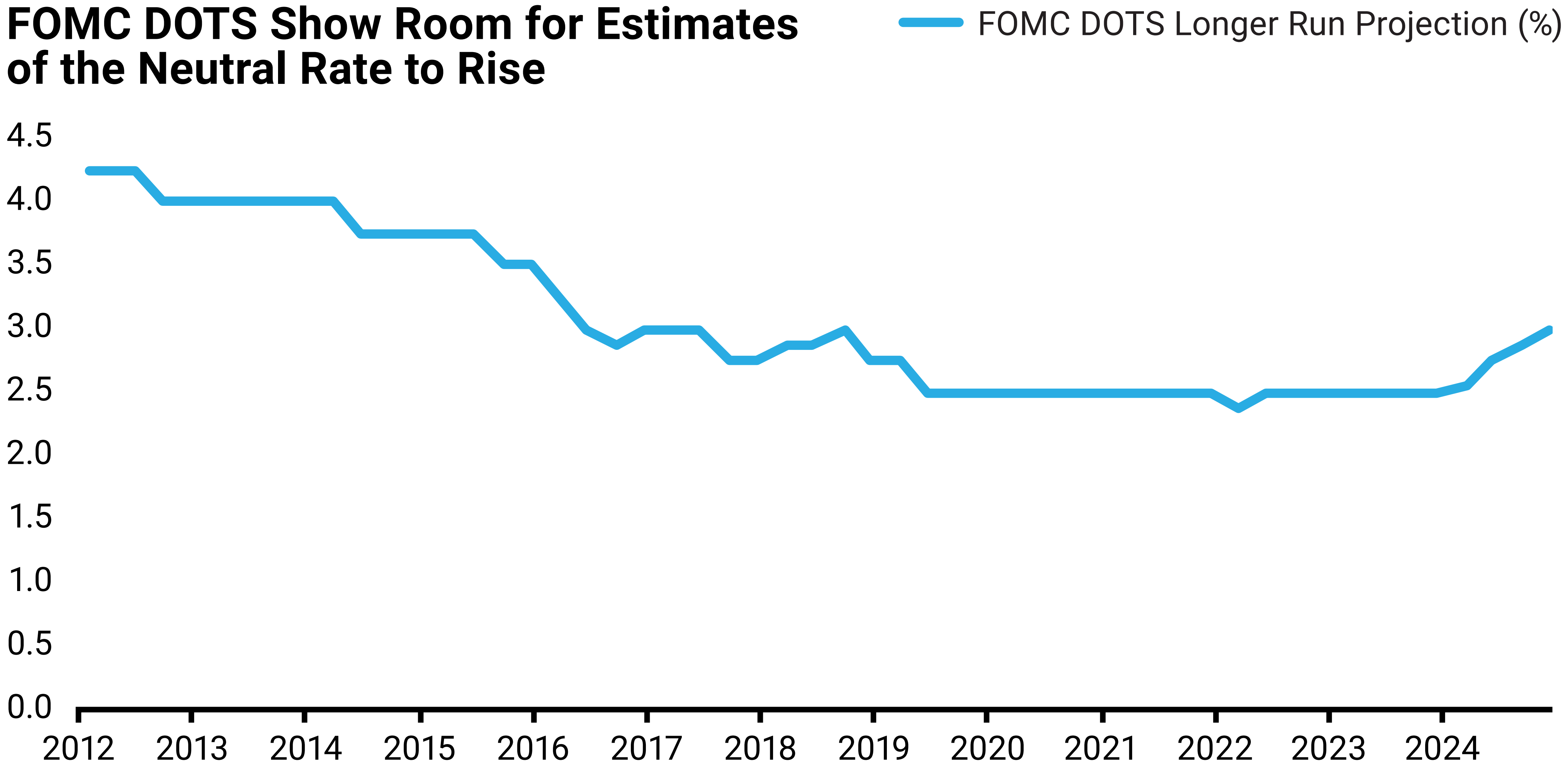
> *"My estimate of the neutral policy rate is much higher than it was before the pandemic, and* ***therefore we may be closer to a neutral policy stance than we currently think****. I would prefer to proceed cautiously in bringing the policy rate down to better assess how far we are from the end point, while recognizing that we have not yet achieved our inflation goal and closely watching the evolution of the labor market. We should also not rule out the risk that the policy rate may attain or even fall below its neutral level before we achieve our price stability goal."*[11]

Six days later, on November 26, FOMC minutes further suggested they may be setting up the backdrop for raising their estimate of the neutral rate from the current 3.0%:

> *"Many participants observed that* ***uncertainties concerning the level of the neutral rate of interest complicated the assessment of the degree of restrictiveness of monetary policy*** *and, in their view, made it appropriate to reduce policy restraint gradually."*[12]

FIGURE 16

FOMC DOTS Show Room for Estimates of the Neutral Rate to Rise



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 2012 to Q4 2024.

You only have to go back a decade or so to find a neutral rate estimate that was over 4%. With this in mind, it is easy to build out a narrative of why the underlying economy is actually stronger and more inflationary today than in 2012-14 when the neutral estimate was deemed to be over 4%.

If you were to use a 4% neutral rate, then the rate hiking cycle since 2022 hasn't been nearly as restrictive as it's looked to the market at the time.

This offers a very plausible explanation as to why U.S. monetary policy hasn't hurt the economy as much as expected or why inflation remains stubbornly above the Fed's target.

Could the current interest rate policy in the U.S. actually be too accommodative at this time? If so, we don't think risk assets are pricing in much potential for a sudden end to easing and/or increases in short term interest rates.

[11] Board of Governors of the Federal Reserve System, Governor Michelle W. Bowman, Speech, Nov 20, 2024.
[12] Board of Governors of the Federal Reserve System, Federal Open Market Committee, Meeting Minutes, Nov 26, 2024.

Tighter Policy Leads to U.S. Dollar Strength – and Trouble Elsewhere

Another possible risk to the bubble is that U.S. dollar strength leads to a sovereign debt crisis somewhere else in the world.

China is already considering a weaker yuan policy in response to tariff threats but would need to manage any U.S. dollar-denominated debt it might still hold.

Many emerging markets tend to feel funding pressures when the Greenback is higher. This is because any foreign debt held in U.S. dollars becomes harder to pay off. Sometimes, the combination of a plunging local currency plus U.S. dollar debt becomes a severe problem (think Mexico's Tequila Crisis in 1994).

In addition, a higher U.S. dollar lowers domestic purchasing power in emerging markets, which increases their cost of imports.The resulting inflation (which is usually already higher than in developed markets) forces the central bank to raise rates, creating additional economic headwinds and eventually market turmoil.

Inflation Returns Faster Than Expected

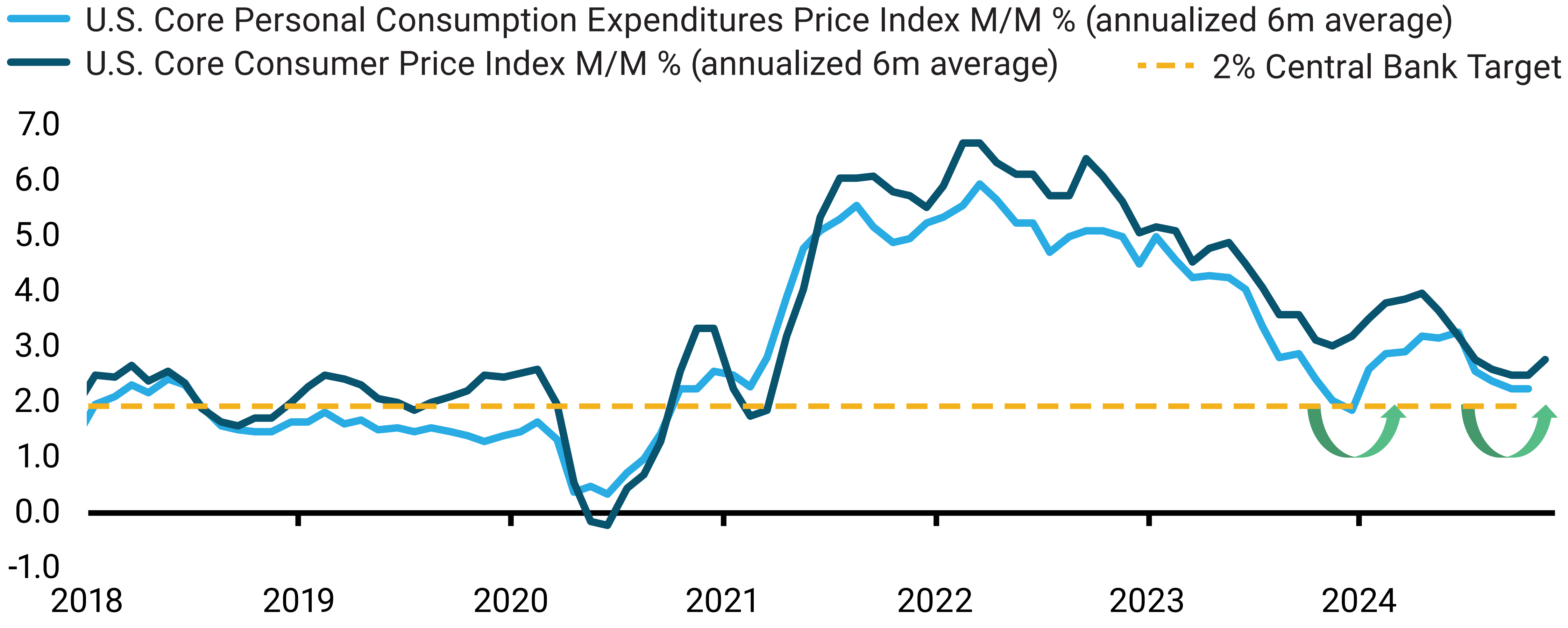
As discussed earlier, the Fed may have just "re-pivoted" back to worrying as much about inflationary pressures as employment. Indeed, current inflation data is drifting upwards and back out of the soft-landing zone the equity market is banking on.

Part of the reason that inflation is now moving higher can be traced to goods prices. The November Consumer Price Index (CPI) report confirmed that the negative contribution from goods pricing is fading. A re-acceleration in global manufacturing could push goods pricing back into positive territory, driving overall inflation even higher.

> *Current inflation data is **drifting upwards** and **back out** of the soft-landing zone the equity market is banking on.*

FIGURE 17

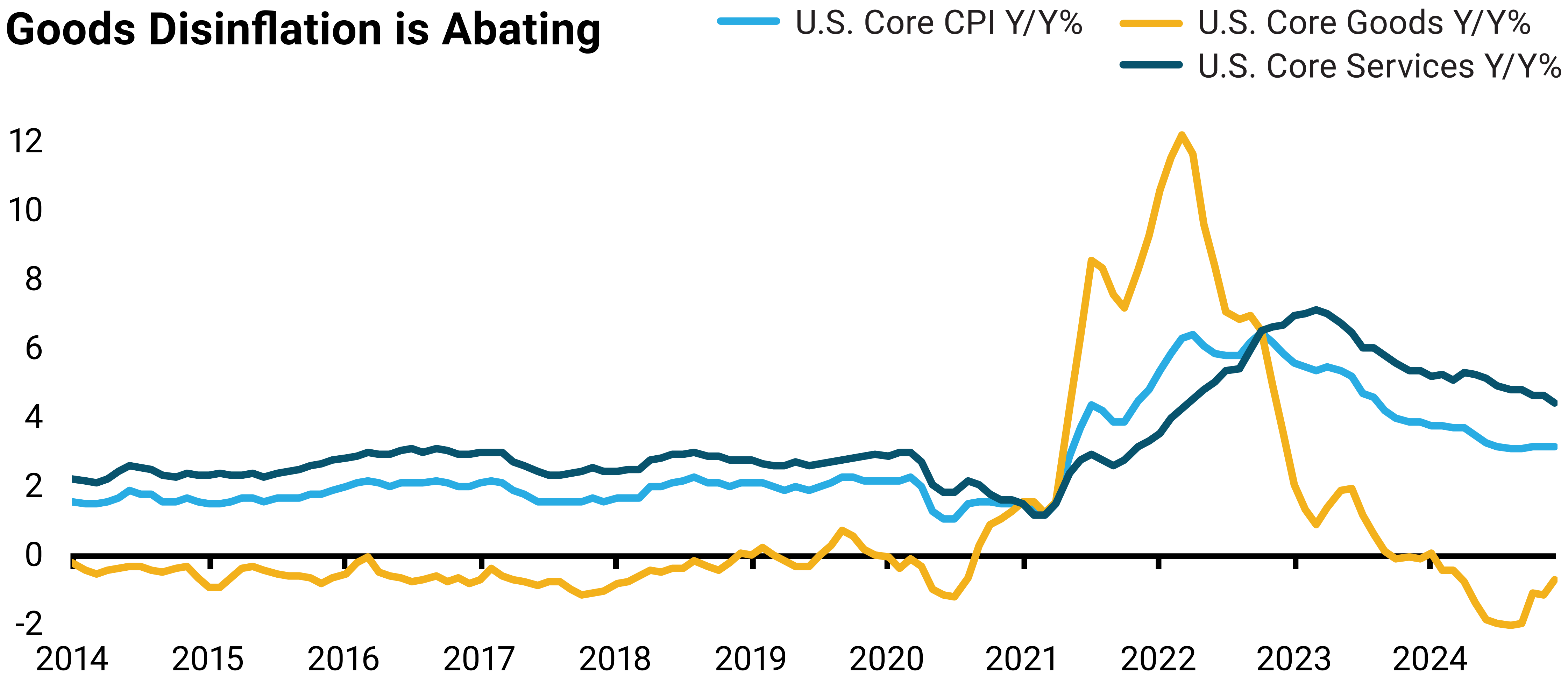
U.S. CPI is Still Elevated – And Going Back Up



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2018 to Nov 2024.

FIGURE 18

Goods Disinflation is Abating



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

Sticky Inflation Woes Continue

Not only is goods pricing changing, but the sticky components of inflation remain too high for the Fed's comfort. These components of CPI, which are best described by the "super-core" inflation measure (which removes shelter, in addition to food and energy), are all largely wage-driven.

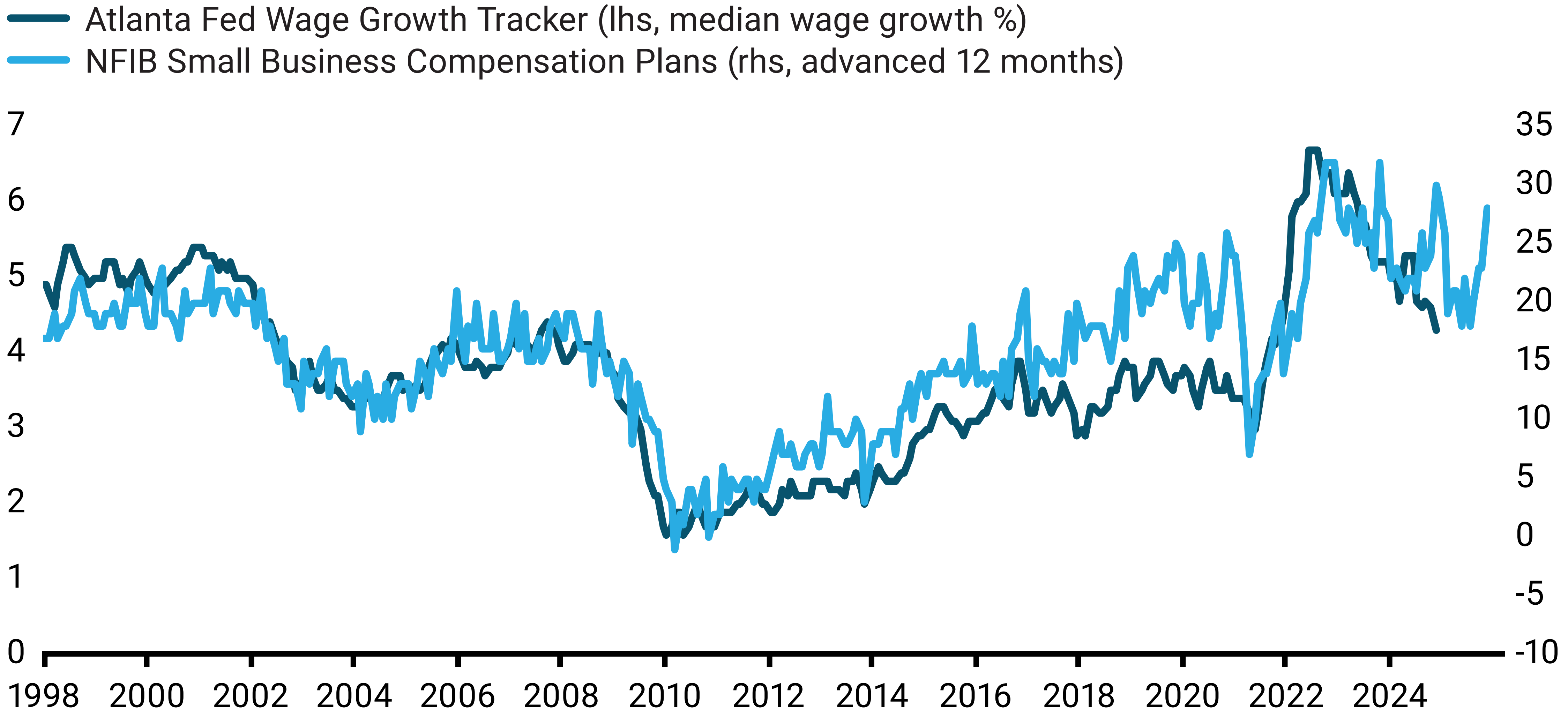
Workers are still trying to recoup losses in purchasing power from the last inflation surge and aren't likely to settle easily when their current contracts expire.

It could take significant job losses (and an undermining of the soft-landing narrative) to defeat these wage pressures.

Even now, the November small business survey from the National Federation of Independent Business (NFIB) shows a spike in expected compensation plans, which could lead wage growth even higher from current levels.

FIGURE 20

Is Wage Growth Set to Accelerate?

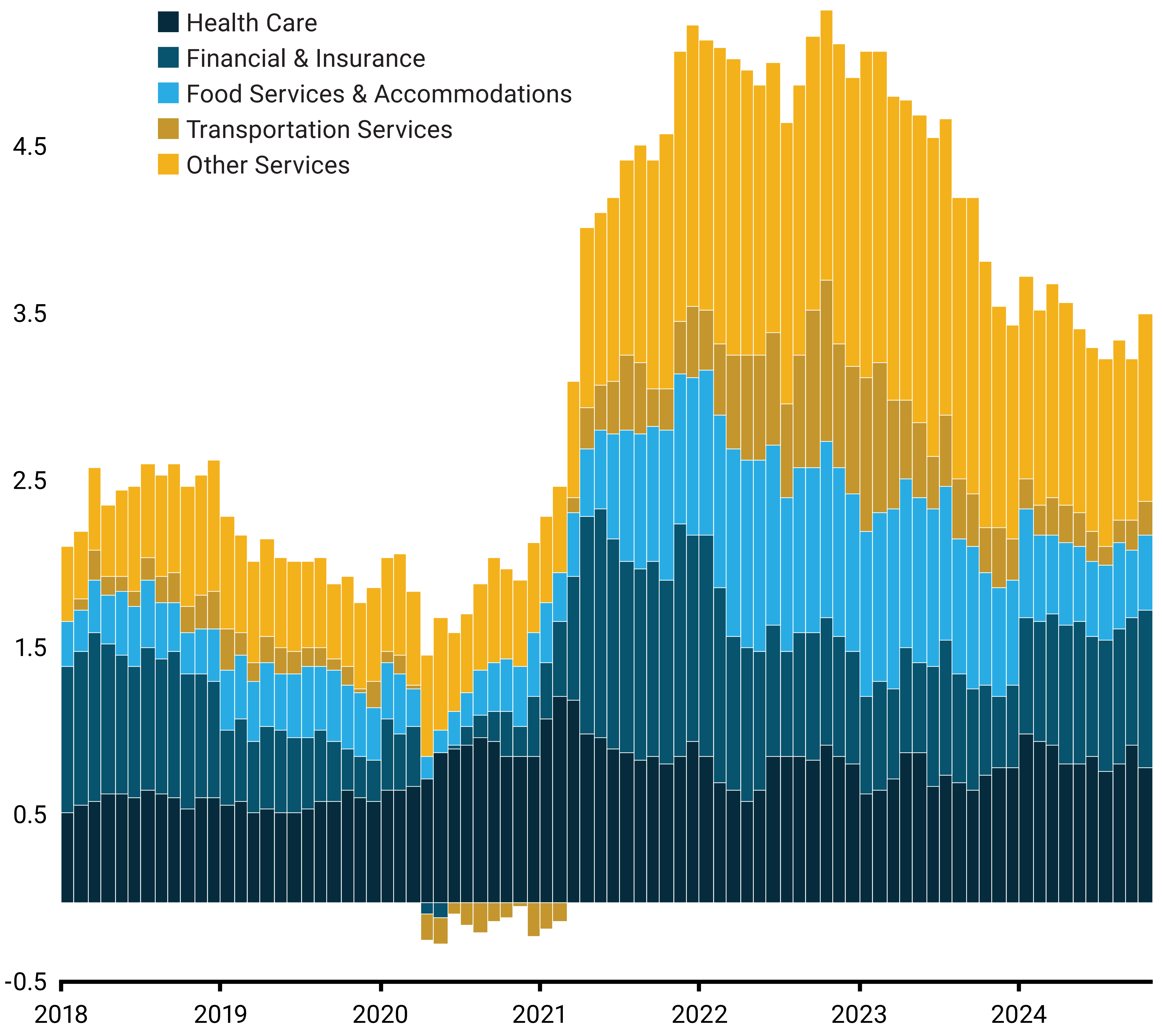


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1998 to Nov 2024.

FIGURE 19

The Sticky Components of Inflation Are Uncomfortably High

Contributions to 12-month "Supercore" Services PCE Inflation (%)



Source: Federal Reserve Bank of San Francisco, Picton Mahoney Asset Management Research. Jan 2018 to Nov 2024.

Trump's Deportation Plan Proves to be Inflationary

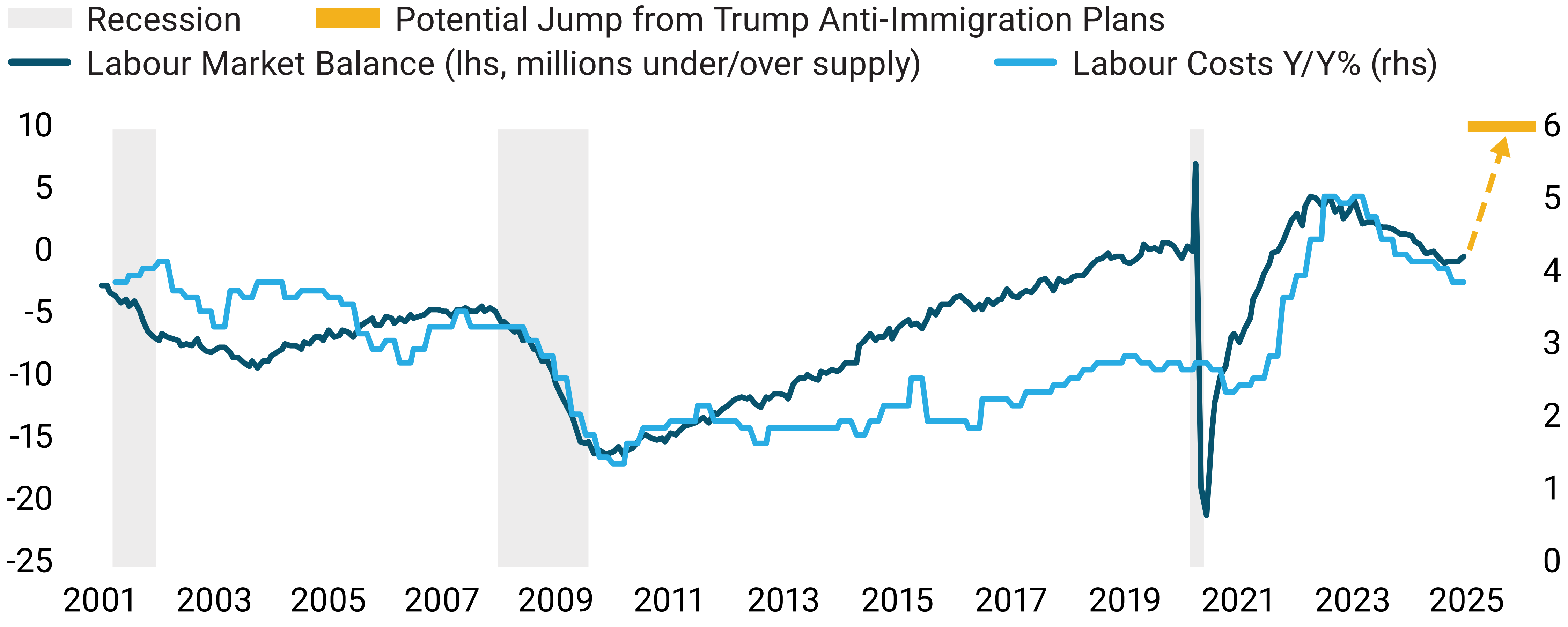
Trump has promised to swiftly deport millions of undocumented immigrants. This poses upside risks to inflation.

As we can see in Figure 21, overlaying labour costs vs. excess labour could cause wage growth to jump from 4% to 6%.

Rates, both at the short and long end could rise as a result, weighing on equities.

FIGURE 21

Mass Deportation Would Lead to Higher Labour Costs



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2001 to Nov 2024.

Other Longer-Term Supply Shortfalls Have Not Been Resolved

In addition to potential labour shortages that drive wage pressures even higher (especially against a mass deportation back-drop), we still believe there are supply issues that haven't been resolved and won't be in the near term.

We see housing shortages continuing for some time in the U.S. given family formation trends combined with under-trend housing construction since 2008.

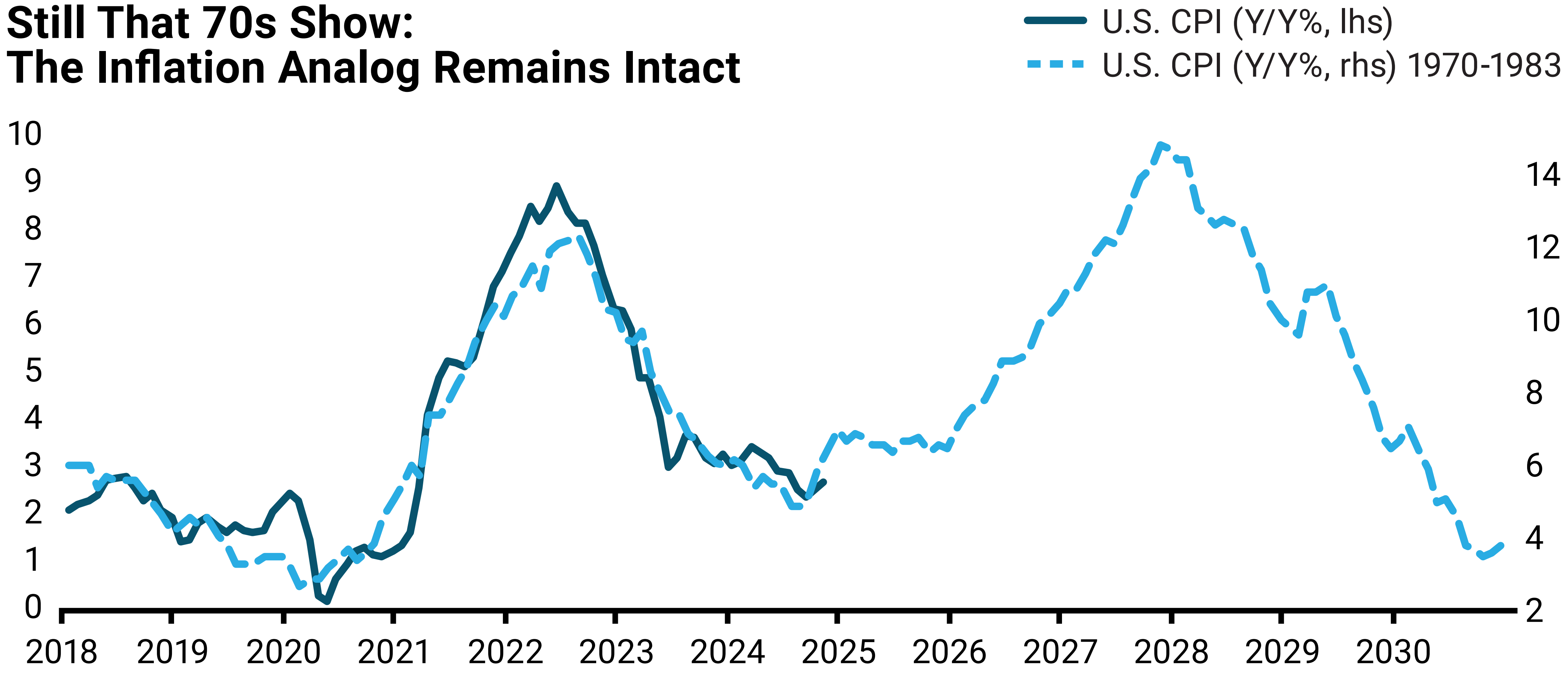
Long-term commodity investment cycles now show a lack of investment in important commodities such as copper, especially in the new AI and data center world.

Overall, we think there are some parallels to the waves of inflation that existed in the 1970s that were certainly not conducive to equity valuations.

We don't expect the second surge to be as strong as the first one, but if inflation were to move even a point or two higher, we think the markets would respond quite negatively.

FIGURE 22

Still That 70s Show: The Inflation Analog Remains Intact



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

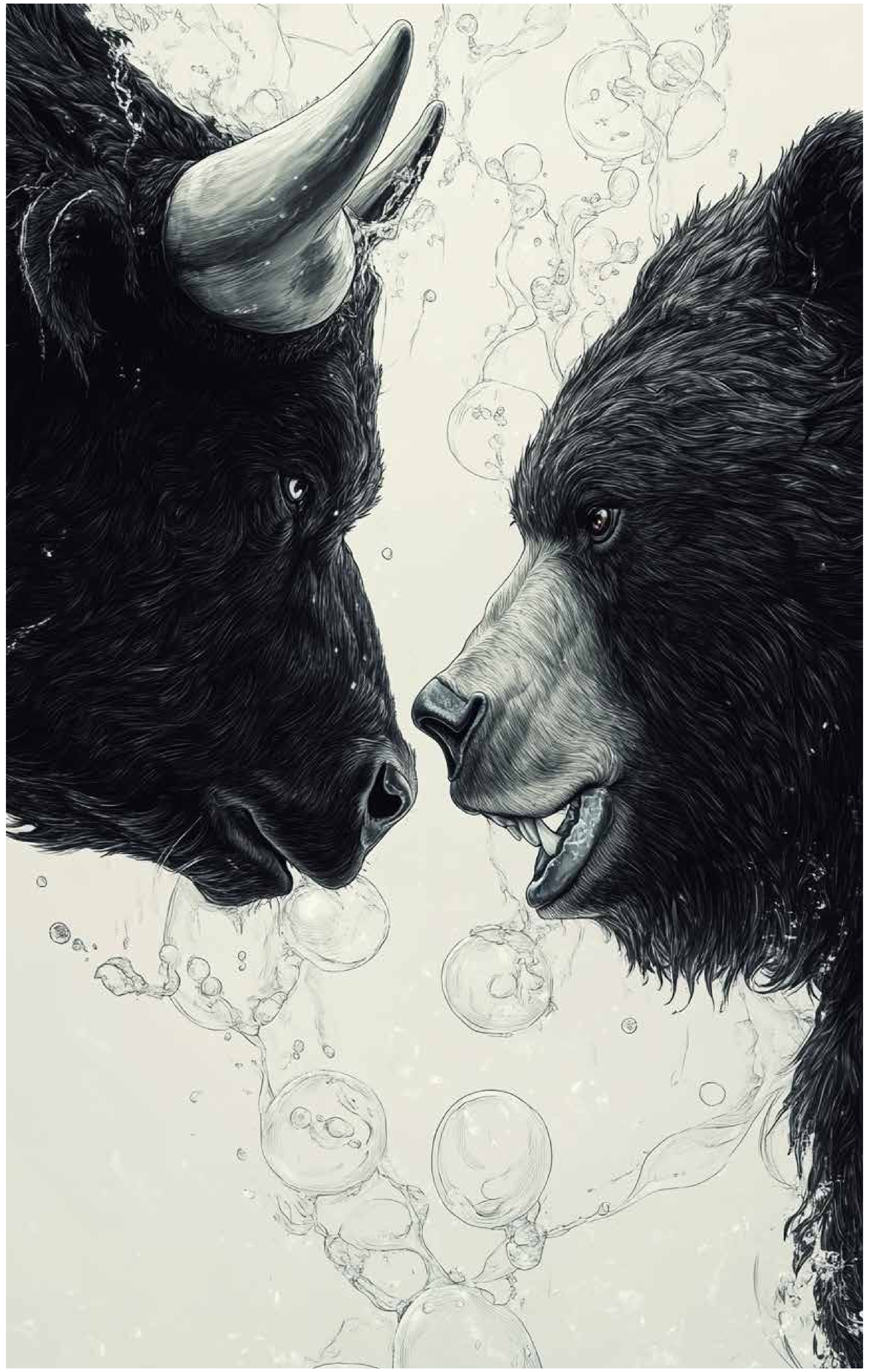
Final Thoughts

The soft-landing or no-landing narrative remains intact in the all-important U.S. economy and should probably gain increased support from the rest of the world as monetary policy easing spreads. However, equity market valuations are at extremes, positioning is reasonably full, and sentiment is exuberant.

In other words, the current setup for the U.S. market is not attractive relative to most other points in history. We believe either stock markets need a significant near-term correction to improve the odds of investment success or investors must embrace the equity market entering some sort of late-cycle bubble phase to remain bullish.

Either way, we recommend considering taking a few chips off the table, especially with the Fed seeming to back off its easing process somewhat following the latest FOMC meeting. This might shake out a few investors with weaker hands and create an opportunity to re-load positions on long-term winners.

> *Equity market valuations are at* ***extremes****, positioning is* ***reasonably full****, and sentiment is* ***exuberant****.*



> *We suggest this is a good time to consider* ***other hedges and less beta*** *in long-term portfolios.*

Barring a 10% plus correction to improve the investing backdrop, we suggest this is a good time to consider other hedges and less beta in long-term portfolios. It is possible that current market exuberance could continue to grow given the generally favourable economic tailwinds that currently exist and the hope of even stronger winds to come. However, when investing turns from purchasing companies based on their company-specific fundamentals to purchasing expensive companies with hopes that the market will take them even higher, the endeavour becomes much riskier and more resembles speculation than traditional investing.

We think now is the time for all investors to look at their holdings and ask themselves if they are comfortable with all their positions should the market narrative suddenly change. We are prepared to buy a nice correction in equities, but also believe there are a number of risks that, should they emerge, could send droves of investors fleeing from the market at a moment's notice.

03. Equity Insights

Is MOMO Turning into FOMO?

Be Ready for What's Brewing

Momentum has led style factor returns in 2024. Unlike the late 1990s, momentum is not expensive relative to other style dynamics, and the diversity of the sector has improved to include non-technology companies. Today's momentum stocks also have better fundamentals and significantly better profitability than those in the dot-com bubble.

However, as investors chase performance in the late stages of 2024, there is a growing risk that momentum has become increasingly crowded. MOMO (Momentum of Missing Out) may have morphed into FOMO (Fear of Missing Out), raising the risks of a large correction in 2025. Higher inflation and a less dovish Fed policy than the market currently expects could be catalysts for an unwind.

We believe the backdrop of an uncertain macroeconomic environment, volatile interest rates, and changes in market structure have created favourable conditions for long-short strategies.

A Year of Momentum

2024 has been a strong year for equity markets, with the S&P 500 index up 25% and the S&P/TSX Composite index up 22%. Momentum has led style factor returns as winners have kept winning, with stocks in the highest quintile of nine-month price momentum, outperforming the market by 23 percentage points over the past 12 months. Momentum's strong outperformance resembles the late 1990s, leaving some investors to question if it will be sustained.

> *There is a growing risk that momentum has become* ***increasingly crowded***.

Our View

Unlike the late 1990s, momentum is not expensive relative to other style dynamics, and the sector diversity of the high momentum has widened beyond technology. Stocks in the top quintile of price momentum as of December 20 have capitalization-weighted free cash flow margins of 25%. This compares quite favourably with the peak of the dot-com bubble when the same figure was negative 2%[1].

Today's momentum stocks simply have better fundamentals and significantly better profitability than that prior era. However, as investors chase performance in the late stages of 2024, there is a growing risk that momentum has become increasingly crowded, which could lead to heightened volatility and potential market corrections.

[1]Source: National Bureau of Economic Research, Empirical Research Partners Analysis.

Paying up for Growth

While overall equity valuations for the S&P 500 are rich from a historic perspective, there has been significant divergence between valuation expansion for growth compared to value stocks (Figure 1).

Investors in 2024 have been paying up for growth exposure as highlighted by the expanding forward P/E points per percentage point of differential in growth (Figure 2).

This increase in premiums for growth stocks has been driven by a combination of macro uncertainty and AI hype.

> *Investors should be **cautious** of the potential for a valuation reset.*

Our View

The Fed's current rate-cutting campaign is potentially fueling exuberance in equity markets as it's leading to higher multiples.

However, this window of exuberance may be limited. There are growing risks of a pull-forward in the timeline of structural inflationary forces, which could change the narrative on central bank easing in 2025.

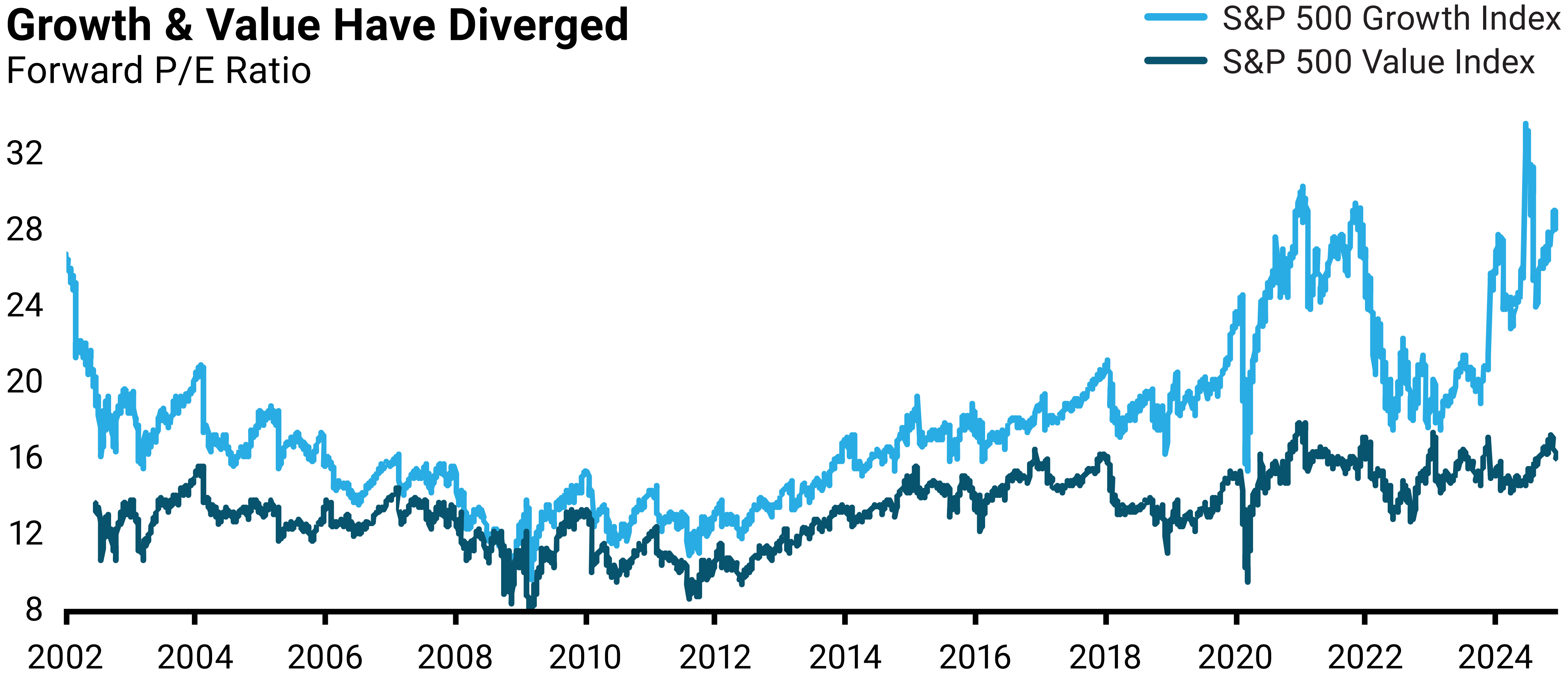
This shift in monetary policy expectations could lead to a reassessment of growth stock valuations, particularly if interest rates remain higher for longer than currently anticipated.

Investors should be cautious of the potential for a valuation reset if the macroeconomic environment shifts unexpectedly.

FIGURE 1

Growth & Value Have Diverged

Forward P/E Ratio

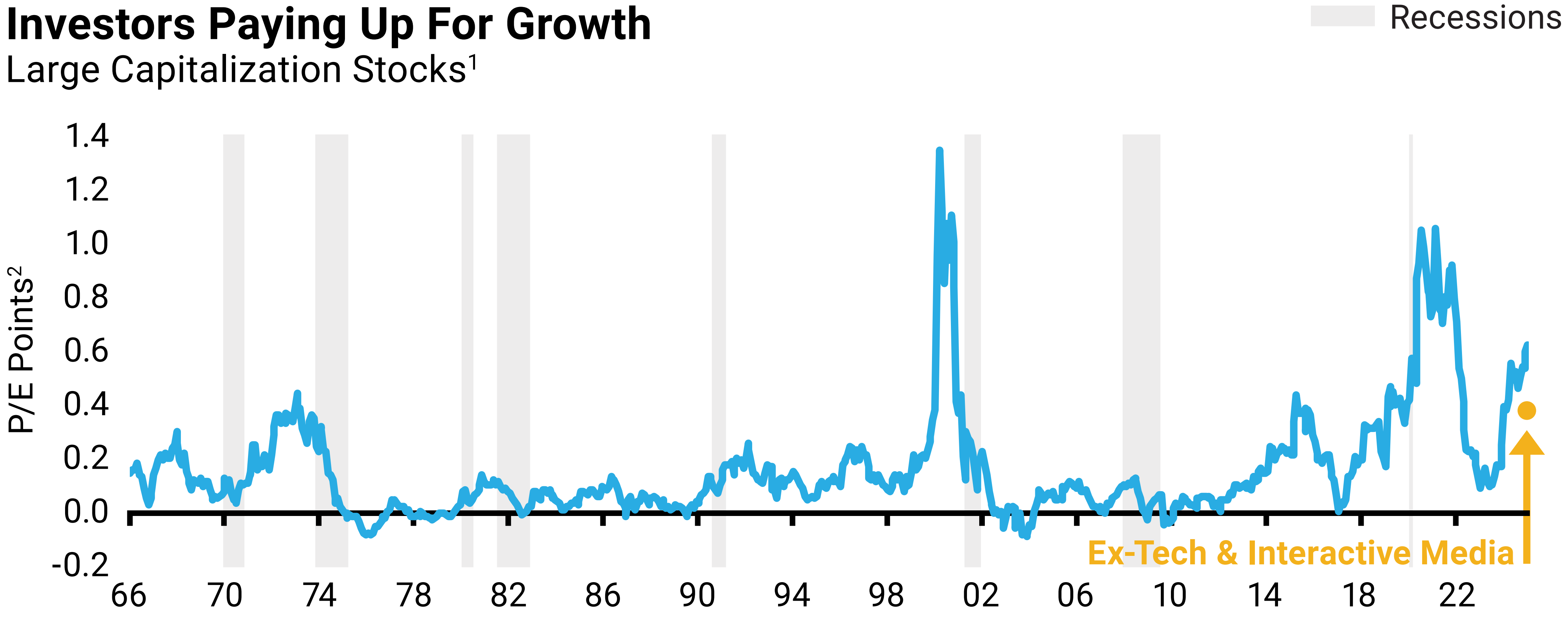


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. 2002 to 2024.

FIGURE 2

Investors Paying Up For Growth

Large Capitalization Stocks[1]



Source: National Bureau of Economic Research, Empirical Research Partners Analysis. [1]Excludes financials. [2]Impact of a one-point differential in revenue growth on forward P/E/ ratios. Based on cross-sectional regression of forward-P/E ratios onto trend revenue growth over the prior two years. Trailing PEs are used before 1977.

Are investors still on the sidelines?

Our View

We see extended North American equity positioning across multiple cohorts heading into 2025.

Commodity Trading Advisors (CTAs) are generally holding near-maximum lengths in major equity index futures, while volatility-targeting funds have significantly increased their equity weights since the summer, coinciding with a sharp decline in volatility.

North American hedge funds are generally maintaining gross weights and long/short ratios around the 90th percentile and CFTC E-Mini S&P500 Asset Manager Net Total Futures Positioning is at nearly all-time highs (as of Dec 20).

While there's no apparent catalyst for a positioning unwind, the current high levels of combined length suggest limited fuel for further rallies.

> *"The current high levels of combined length suggest* ***limited fuel*** *for further rallies."*

A challenging backdrop for most active managers, but a strong opportunity set for others

Much of the equity market narrative has focused on the concentration of market leadership, with the top 10 companies outperforming the broader S&P 500 by 218% over the past decade. This dominance has made it challenging to manage portfolios against market-cap weighted benchmarks.

According to the S&P Indices vs. Active Funds (SPIVA) mid-year 2024 report, 85% of active U.S. large-cap equity funds underperformed the S&P 500 index over the last 10 years.

Our View

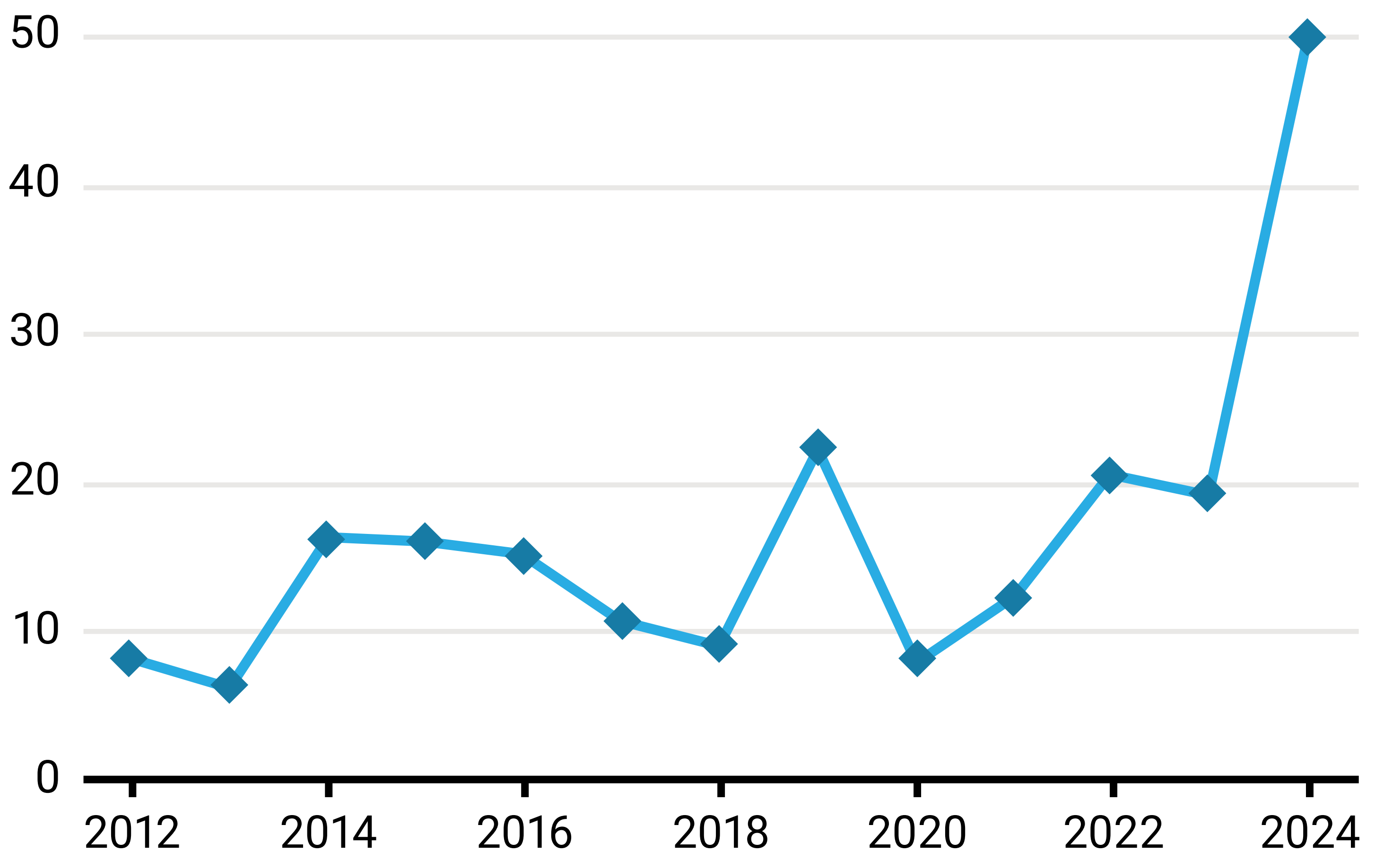
Buy Alpha! This challenging environment for long-only managers contrasts sharply with the opportunities for long-short strategies. The backdrop of an uncertain macroeconomic environment, volatile interest rates, and changes in market structure have created favourable conditions for this approach.

These factors have contributed to reduced correlations (stocks moving less in tandem) and increased dispersions (wider variation in performance), providing skilled long-short managers with enhanced opportunities to generate alpha through security selection (Figures 3 & 4). For example, the spread between the top and bottom performing "Big 6" Canadian banks widened to above 50% in 2024 (Figure 5).

FIGURE 5

Canadian Bank Stocks Going Their Own Way

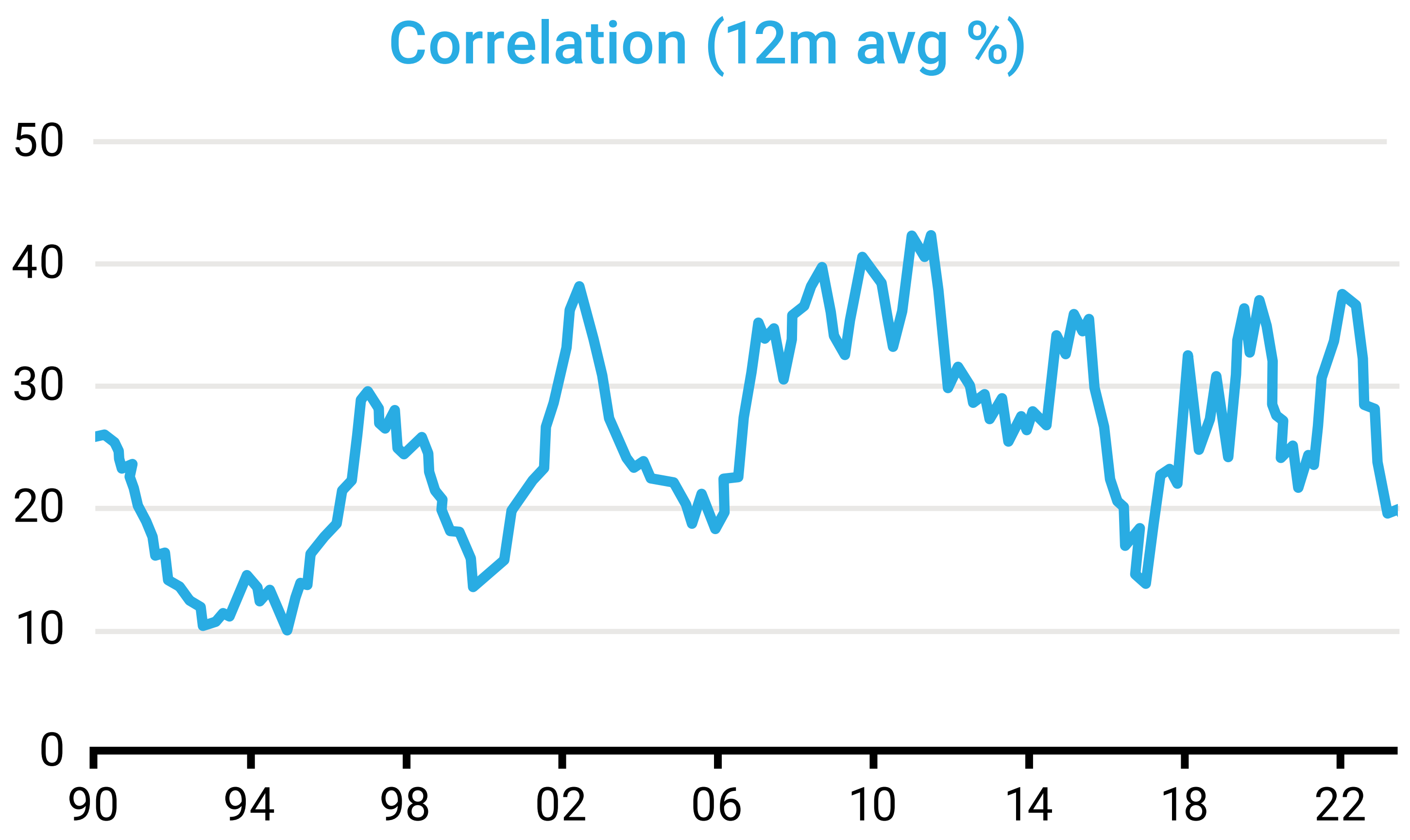
12m Price Differential Between Top & Bottom Performers (%)

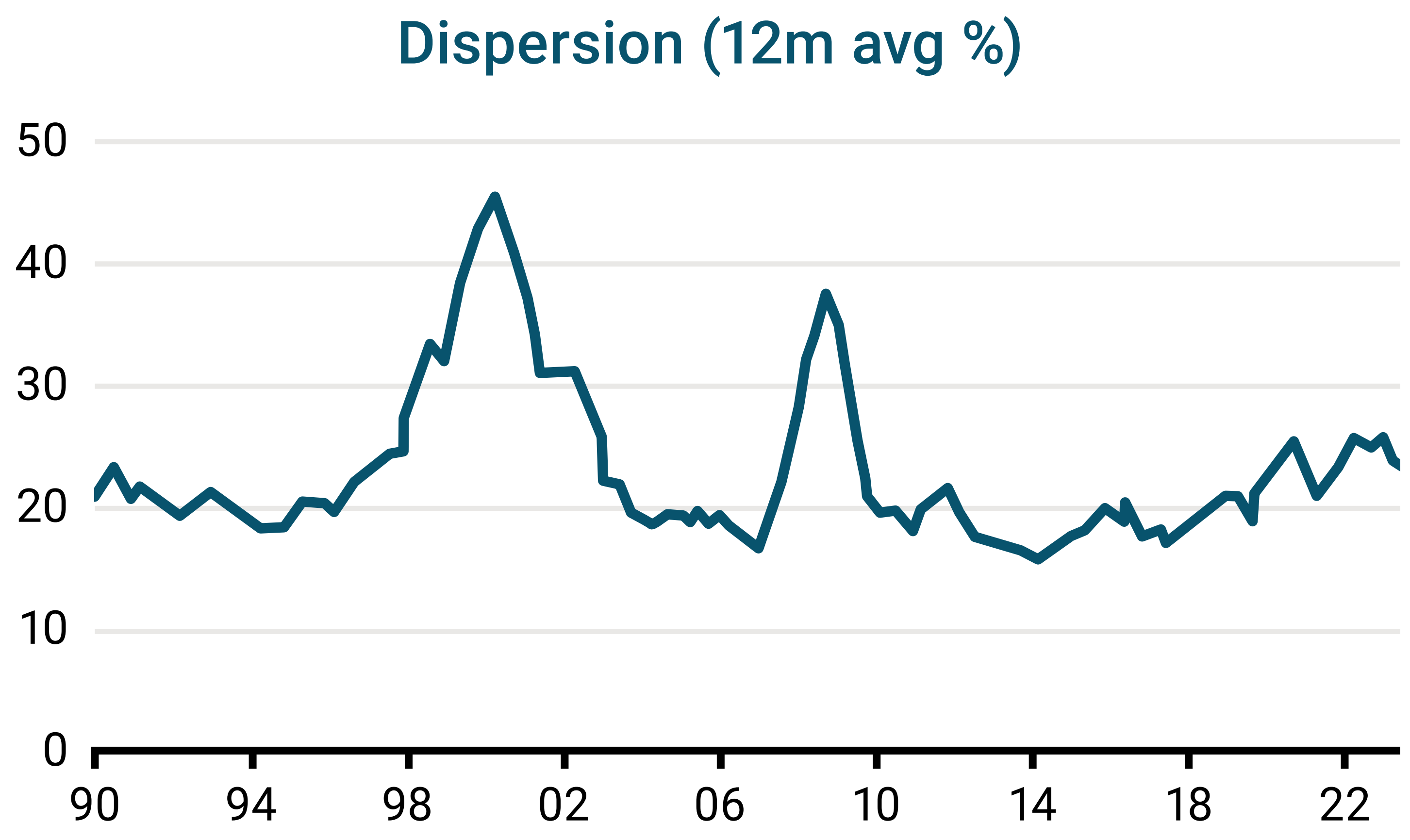


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Dec 31, 2011 to Nov 29, 2024.

FIGURE 3&4

Equity Correlations Have Fallen While Dispersions Have Increased





Source: S&P Dow Jones Indices. Dec 31, 1990, to Nov 29, 2024.

Source: Index Dashboard: Dispersion, Volatility & Correlation, Nov 29, 2024. Link to article.

Dispersion for each index is the annualized, index weighted standard deviation of the index constituents' full month total returns. See "Dispersion: Measuring Market Opportunity" for a formal definition of dispersion and more information on its uses.

Correlation for each index measures the correlation among the daily returns of the index constituents during the month, calculated via the ratio of index variance to the index weighted average constituent variance. See "At the Intersection of Diversification, Volatility and Correlation" for a more detailed explanation of the calculation.

04. Fixed Income Insights

Played Out. Priced In. Now What? Could Inflation, Issuance and Spread Moves Push Bond Yields Higher in 2025?

Be Ready for What's Brewing

Even though policy rates may move lower in 2025, there's a risk that the long end of the curve moves higher. Resurgent inflation and questions regarding fiscal sustainability loom large.

Growing divergences between the U.S. and Canadian economies may lead to the Fed and Bank of Canada (BoC) embarking on different paths.

With regards to credit, be careful with index-level or passive exposures. We believe credit spreads are pricing in nearly zero risk of a 2025 recession as well as little risk of inflation re-emerging. We are focusing portfolios on short duration, high quality coupon clippers, and event-driven situations. We are also shorting lower quality names that have rallied aggressively in recent months.

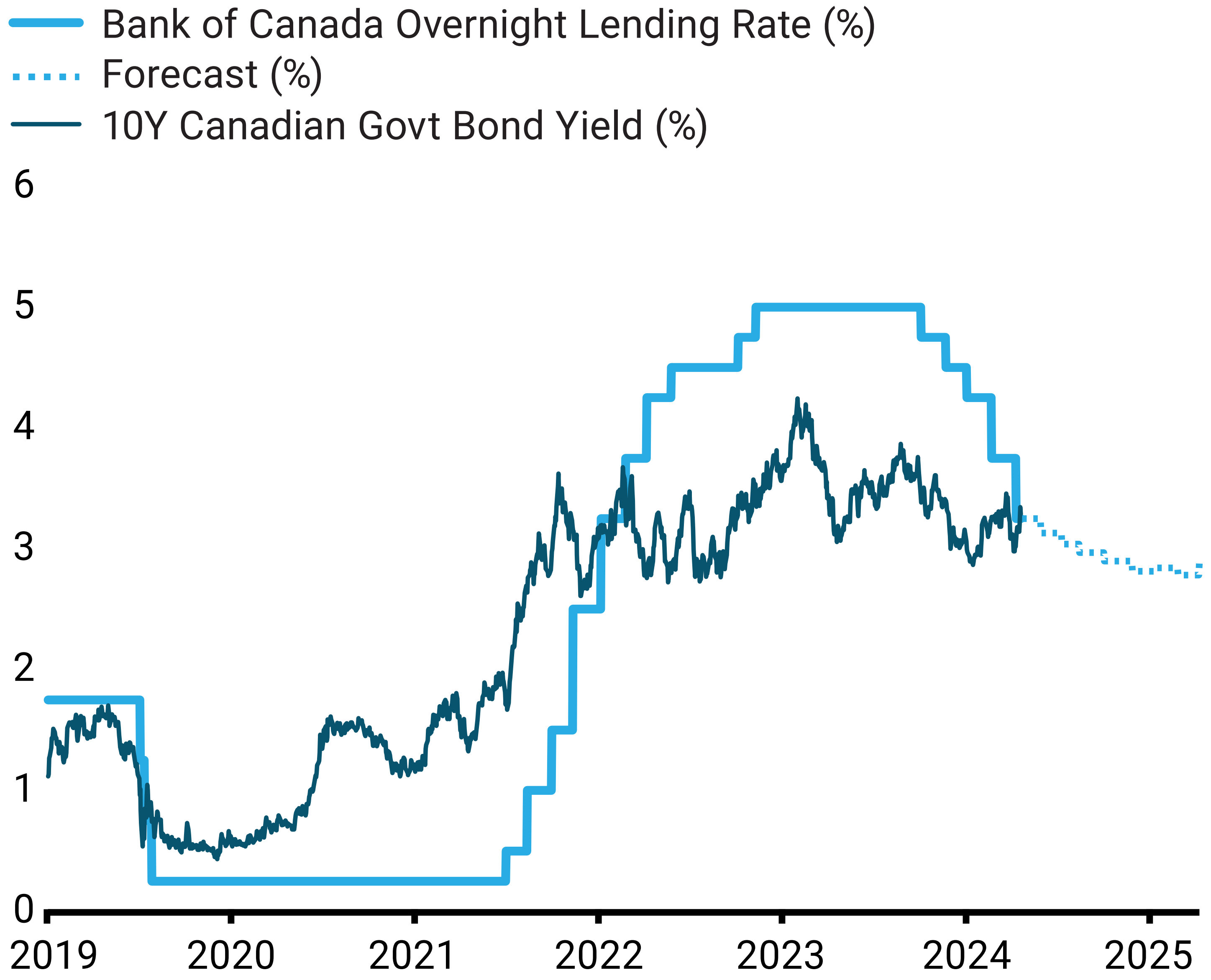
We believe the above factors point to increased fixed income volatility and a steepening of yield curves in 2025.

The Bond Market May Have Already Priced-in Rate Cuts

We could see long-end bond yields drift higher despite the front-end moving lower with policy rates.

FIGURE 1

Long-Rates Could Drift Higher Even if the Bank of Canada Eases in 2025



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. As of 12/20/2024. Sep 2019 to Oct 2025. Post dated data are forecasts.

Growing Divergences: U.S. and Canadian Economies May Force Different Paths for the BoC and Fed

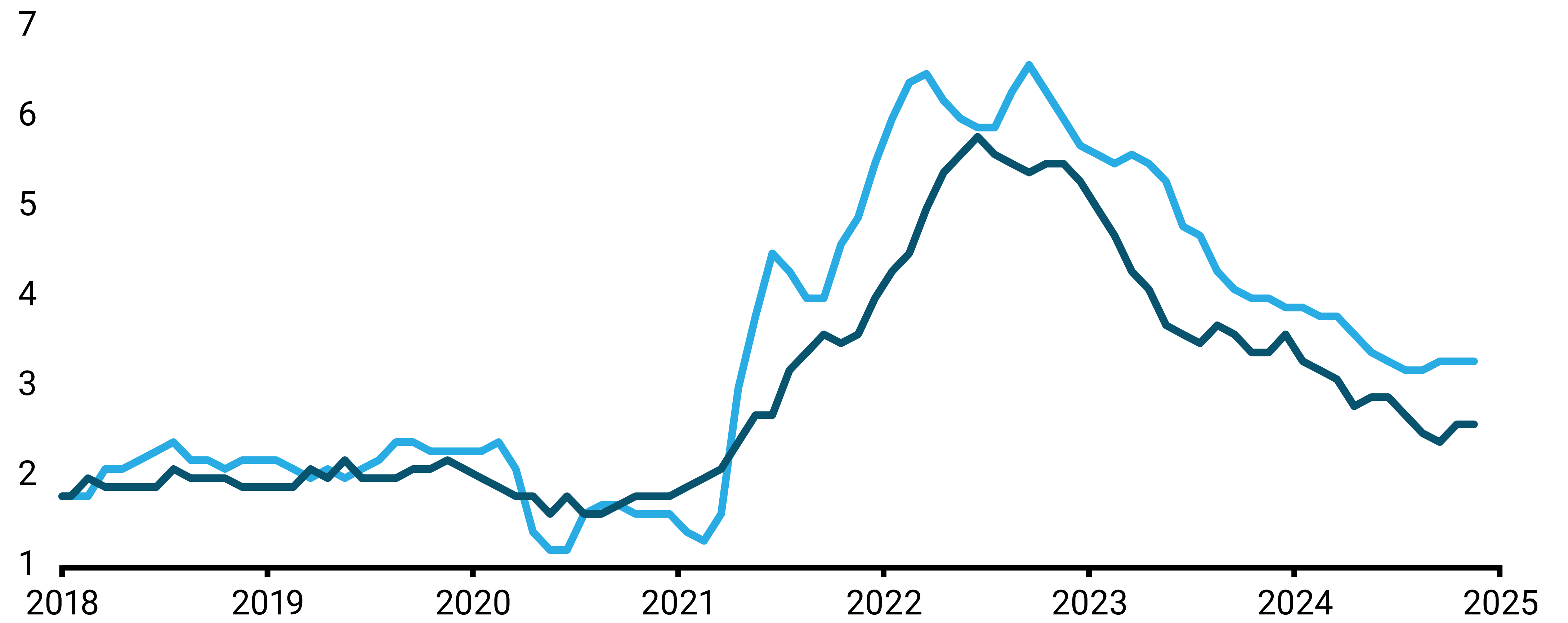
We see scope for the BoC to cut more than market expects, while the Fed may be forced to pause at a higher level than is currently priced in.

> *We believe a stimulative and inflationary policy mix would be a* ***toxic combination*** *for bonds.*

FIGURE 2

U.S. Core Inflation Remains Above Canada...

Core Inflation (YoY, %)

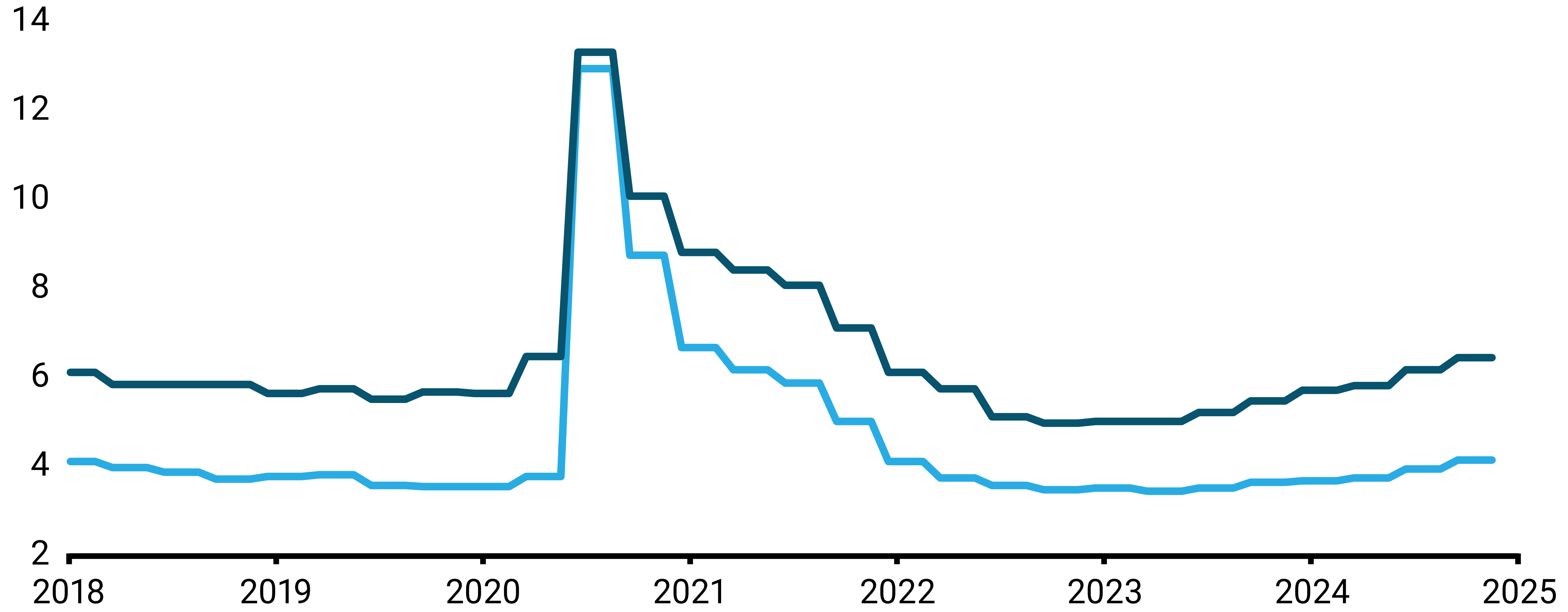


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2018 to Nov 2024.

FIGURE 3

...While Canadian Unemployment is Notably Higher

Unemployment Rate (%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2018 to Nov 2024.

Challenging Environment: U.S. Policies Likely to Pressure Fixed Income

It remains to be seen what exactly is enacted, but we believe a stimulative (tax cuts and de-regulation) and inflationary (tariffs and immigration) policy mix would be a toxic combination for bonds and limit the Fed's ability to cut.

Market Focus: Fiscal Sustainability Poised to Take Center Stage

There's potential for a supply-demand imbalance of U.S. government debt as well as elevated debt and interest levels relative to gross domestic product (GDP) (e.g. U.K. in 2022).

FIGURE 4

The U.S. Fiscal Deficit is Elevated

Fiscal Deficit % of GDP

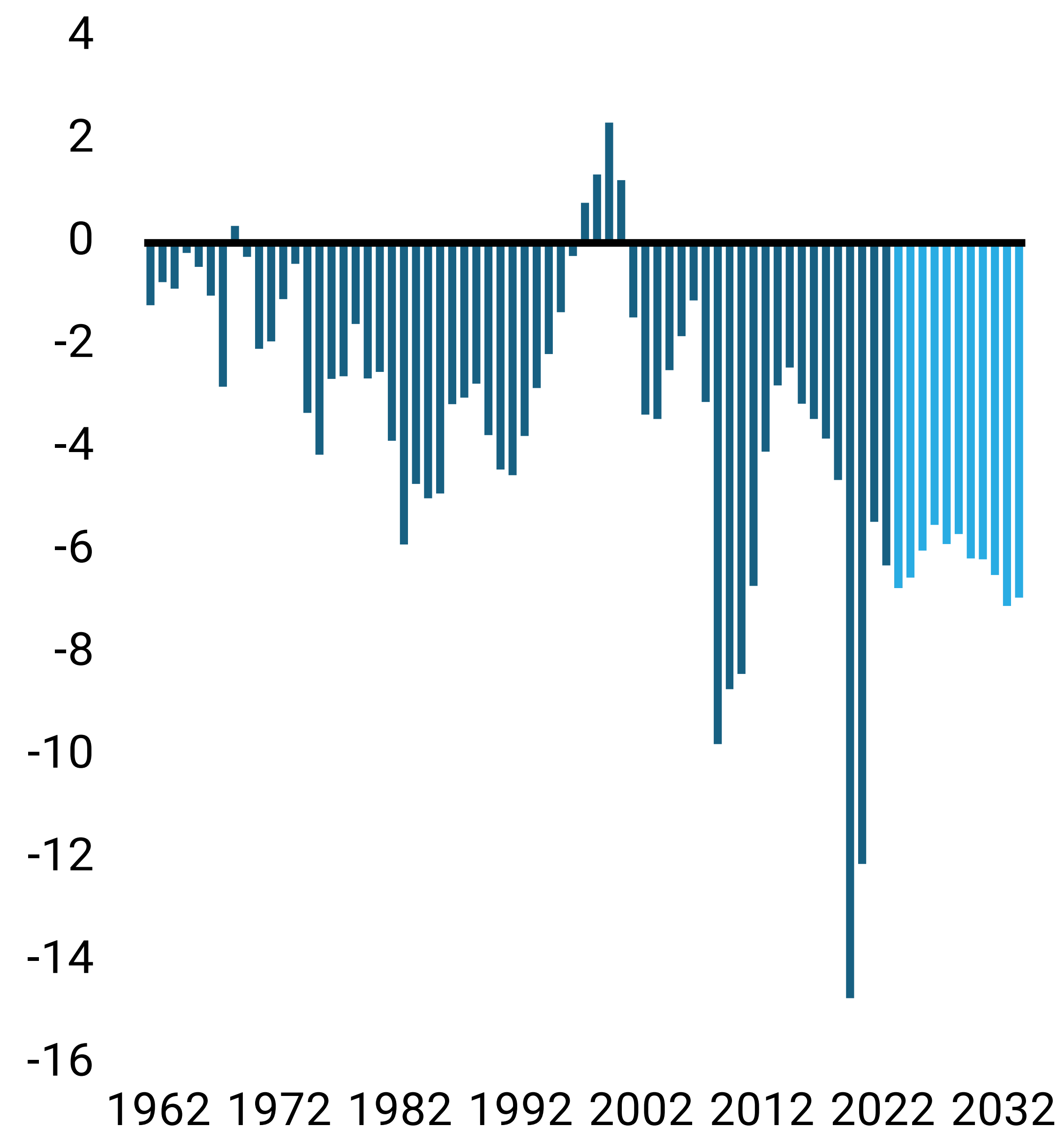
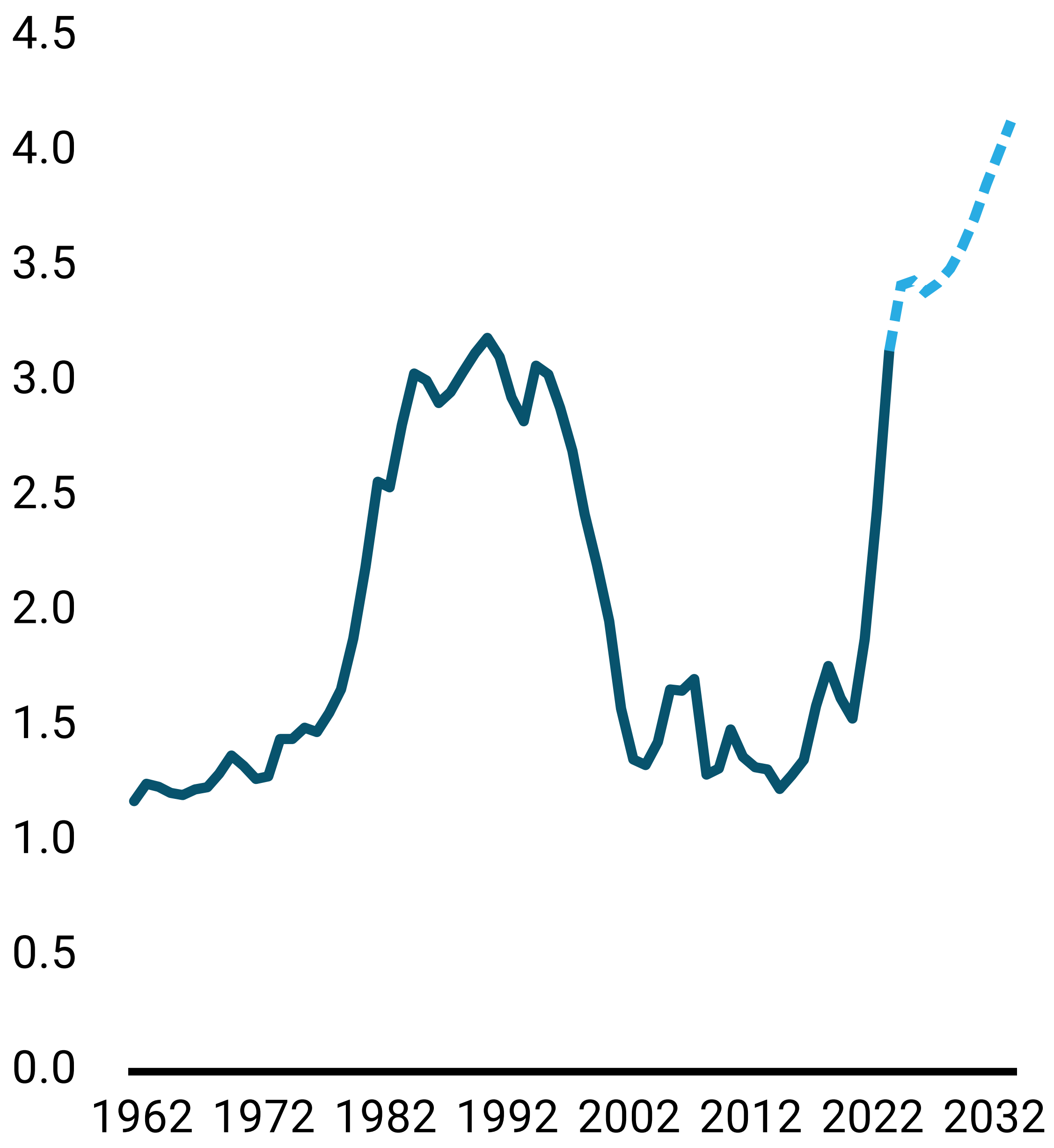


FIGURE 5

Interest Payments are Soaring

Net Interest % of GDP

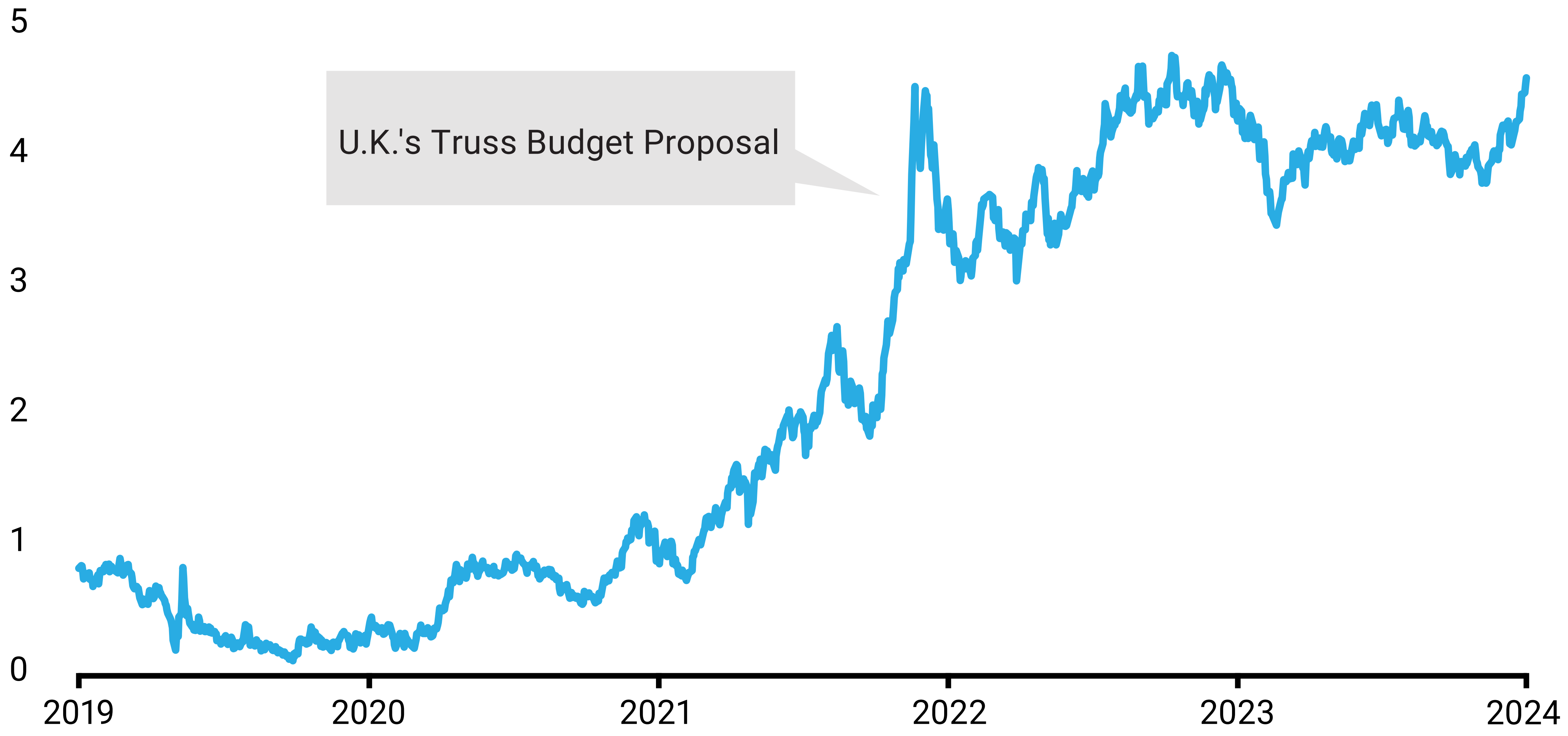


Source: Congressional Budget Office. Data are annual. 1962 – 2032. Post-2024 data are forecasts from the Congressional Budget Office.

FIGURE 6

Could the U.S. Bond Market Experience a Replay of Gilts in 2022?

U.K. 10-Year Gilt – Yield (%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Nov 2019 to Nov 2024.

Supportive Outlook: Credit Fundamentals Remain Strong

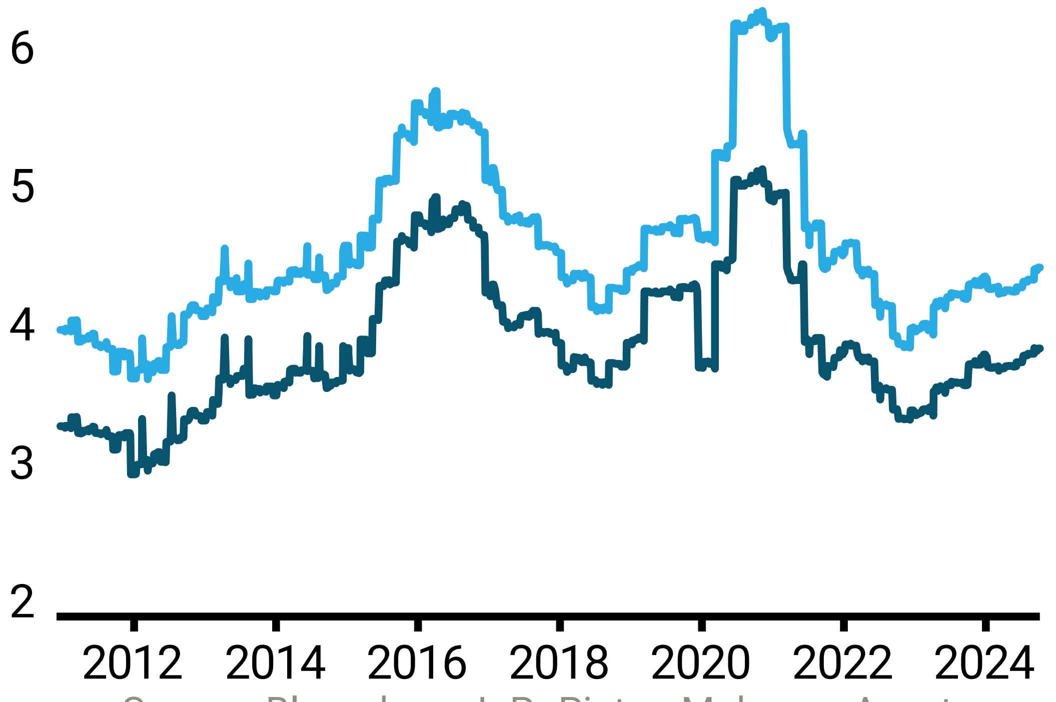
Leverage and interest coverage ratios have deteriorated slightly compared to 2023 but remain healthy relative to historical ranges. Strong capital markets throughout 2024 have helped ease concerns about a near-term maturity wall.

Overall, high-yield quality has improved, with an increased presence of higher-quality (BB) and secured issues, alongside reduced CCC and private equity-sponsored representation. Private credit has stepped in to finance weaker credits, including CCC-rated and private equity-sponsored issuer bonds. Pockets of distress are isolated, with bonds from those issuers already pricing in a high likelihood of restructuring.

The insatiable demand for yield continues to create a very strong technical backdrop. All-in yield buyers are driving large and persistent inflows into corporate bonds, which are expected to keep supporting prices as all-in yields remain attractive.

FIGURE 7

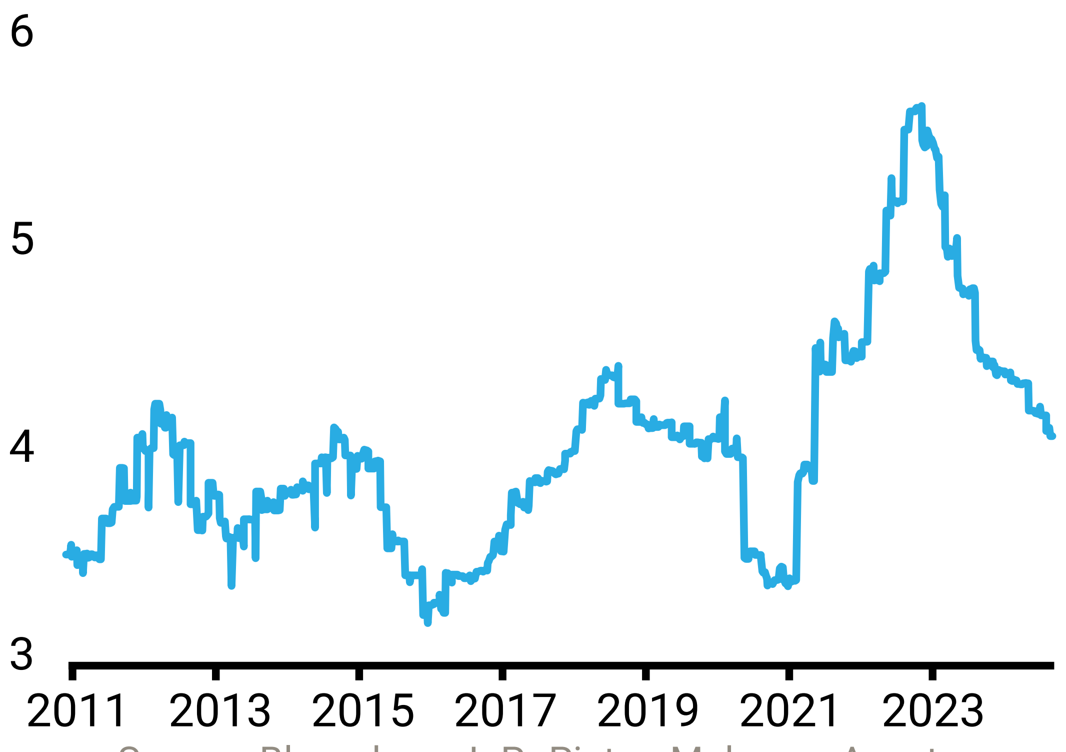
U.S. High-Yield (HY) Leverage Ratios Remain Healthy Vs. History



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Feb 2011 to Nov 2024.

FIGURE 8

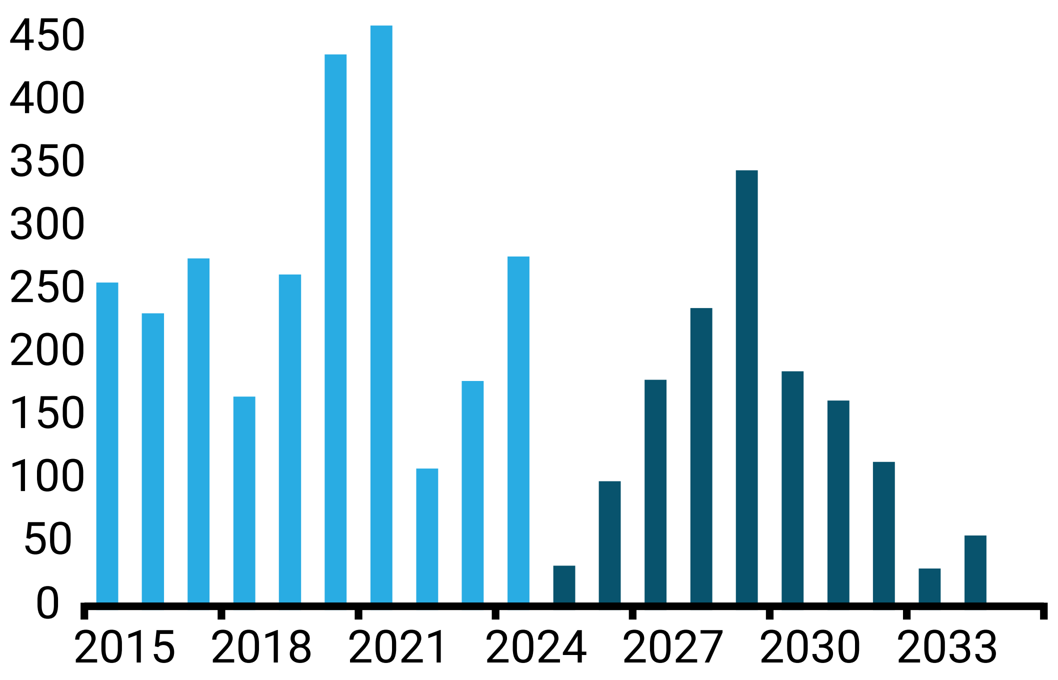
High-Yield Interest Coverage Ratio Shows Little Stress



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Feb 2011 to Nov 2024.

FIGURE 9

Demand for High-Yield in 2024 Offset Maturity Wall Concerns

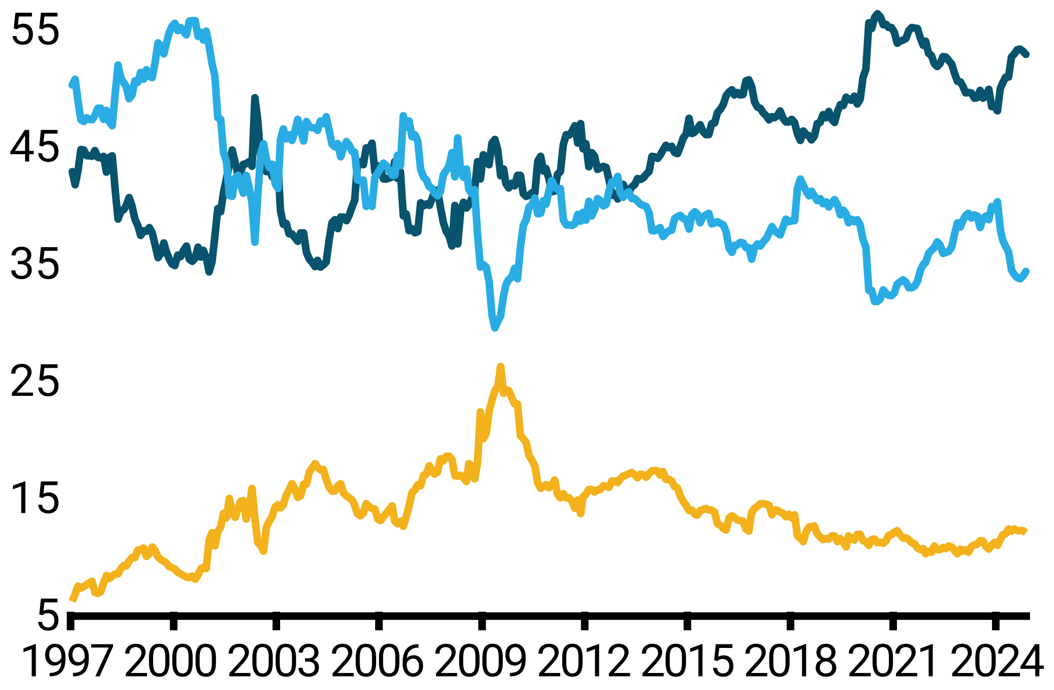


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Feb 2011 to Nov 2024.

FIGURE 10

Overall High Yield Quality Has Improved

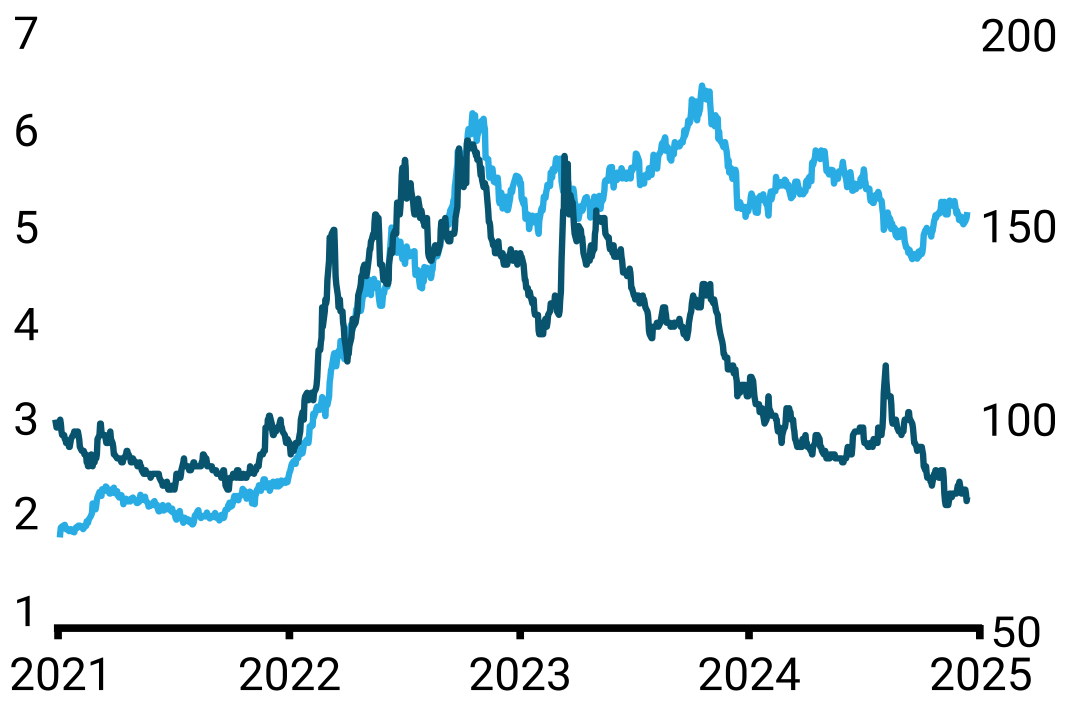
U.S. High Yield – Ratings Breakdown



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Feb 2011 to Nov 2024.

FIGURE 11

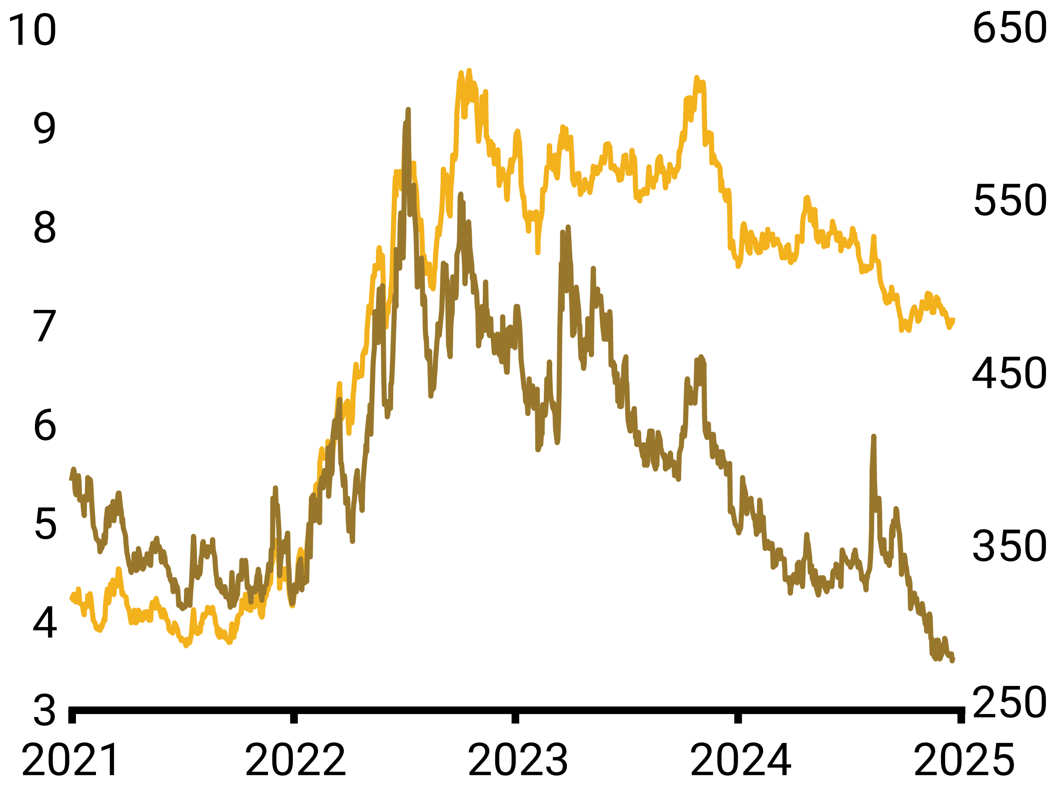
U.S. Investment-Grade Credit Still Looks Attractive...



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2021 to Dec 2024.

FIGURE 12

...As Does U.S. High-Yield



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2021 to Dec 2024.

Credit remains expensive, with much of the positive outlook already reflected in current spread levels.

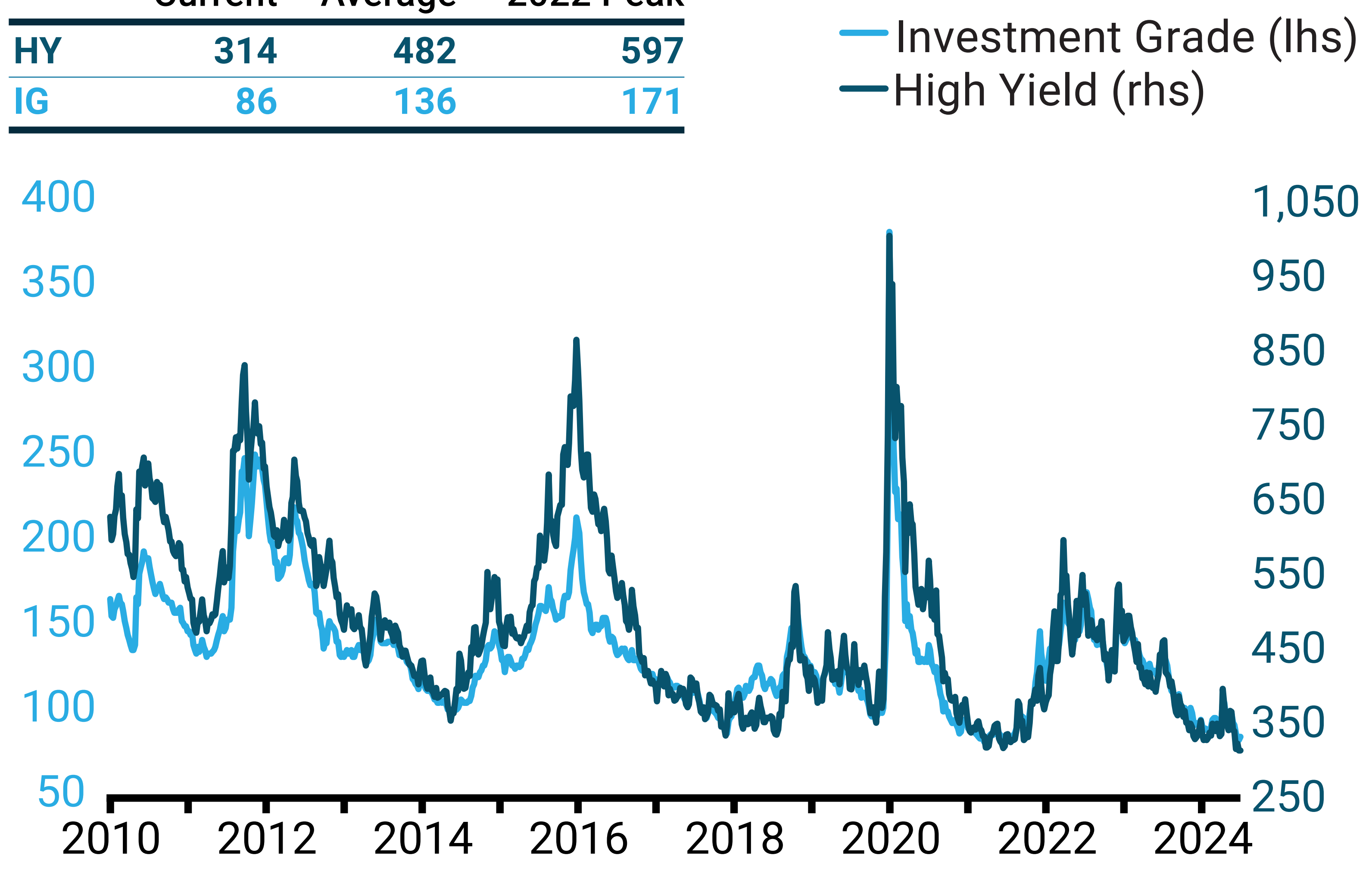
We believe credit spreads are pricing in almost no risk of a recession or the re-emergence of inflation. While there are still single-name idiosyncratic opportunities in the market, we advise exercising caution with index-level or passive exposures within the credit market. Additionally, we anticipate growing divergence between individual names, making credit selection increasingly important.

FIGURE 13

Nearly as Good as it Gets? Credit Spreads are Very Low

Credit Spreads (bps)

	Current	Average	2022 Peak
HY	314	482	597
IG	86	136	171



Source: Bloomberg L.P. Investment Grade is represented by the ICE BofA US Corporate Index, and High Yield is represented by the ICE BofA US High Yield Index.

Implications to our Fixed Income Portfolio

RATES

Shifting the portfolio to be more CAD focused

We have been rebalancing out of USD into CAD given the diverging macro environment as well as elevated FX hedging costs.

Active Duration Management

While underweight duration, we're using hedging tools to be attentive to signs of a turning point.

CREDIT

Less Beta, More Alpha

- We have been steadily reducing our exposure to generic credit risk, especially anything in the U.S. index or related ETFs
- We are focusing portfolios on the following areas:
  - Short duration, high quality coupon clippers where we expect low volatility
  - Event-driven situations where we expect upside alpha from a specific catalyst

With Shorts and Hedges

- We're taking advantage of the complacency we see in credit markets by shorting lower-quality names that have rallied aggressively in recent months
- We're also adding to portfolio hedges with significant put options in place on HY ETFs as well as High Yield Credit Default Swaps (HY CDX)

05. Sector Outlooks

KEY THEME 01

A New Era of Life is Upon Us: Structural Re-rate Call on the Life Insurance Sector

In a market where growth at a reasonable valuation is harder to come by, we are increasingly confident in our longer-term structural re-rate call on the North American life insurance sector. We believe the current macro backdrop – higher and longer-term rates, demographic trends, and generational wealth transfer – presents a tremendous tailwind for the life insurance group, which has been largely out of favour for the better part of two decades.

The Post-GFC Era: A Challenging Decade

After the global financial crisis (GFC), we experienced more than a decade of near-zero interest rate policy as central banks embarked on multiple instances of quantitative easing. This environment proved to be challenging for the life sector. The present value of liabilities ballooned while new money yields dramatically fell, straining balance sheets. Products rich with features such as variable annuities with guaranteed minimum withdrawal benefits (GMWBs) and long-term care insurance policies with lifetime benefits and inflation riders became increasingly capital-intensive. This ultimately led to many insurers exiting these product lines or moving them into run-off portfolios.

During this period, most of the life insurance space focused internally on shrinking balance sheets, reducing risk, and returning any excess capital to shareholders via buybacks – with growth becoming an afterthought.

The New Era of Life: A Shift in Strategy

The life insurance landscape has shifted significantly. Companies today have materially reduced tail risk through risk-transfers and spinouts. Product design has been drastically de-risked. Moreover, the era of easy financial conditions (quantitative easing, zero interest-rate policy) likely appears to be behind us. This could create favourable asset/liability dynamics for life insurance companies.

In response, life companies have shifted their strategy from shrinking balance sheets and returning capital to growing once again. Recently, several of the largest North American life insurance companies have increased their earnings growth algorithms and longer-term return on equity (ROE) targets, including Manulife Financial Corp, Sun Life Financial Inc, Reinsurance Group of America, and most recently, MetLife Inc.

These targets signal high-single-digit to low-double-digit earnings per share (EPS) growth and ROEs in the high teens – profiles that haven't been seen since pre-GFC. This shift supports our view that the current environment will usher in a new era for life insurance companies.

> *We believe life insurance companies are well-positioned for a transformative period of sustained earnings growth.*

Favourable Comparisons to Banks and P&C Insurers

Additionally, these earnings algorithms screen much more favorably than both banks and property & casualty (P&C) insurance companies, which currently trade at sizeable premiums to the life insurance space (29% and 30% respectively).

This discrepancy highlights an opportunity for life insurance companies to capture increased market attention and valuation re-rates.

29%

Banks trading premium to life insurance.

Valuation gap that presents an opportunity for life insurance companies to gain market attention and potential valuation re-rates.

Our View

A New Era Brings New Opportunity

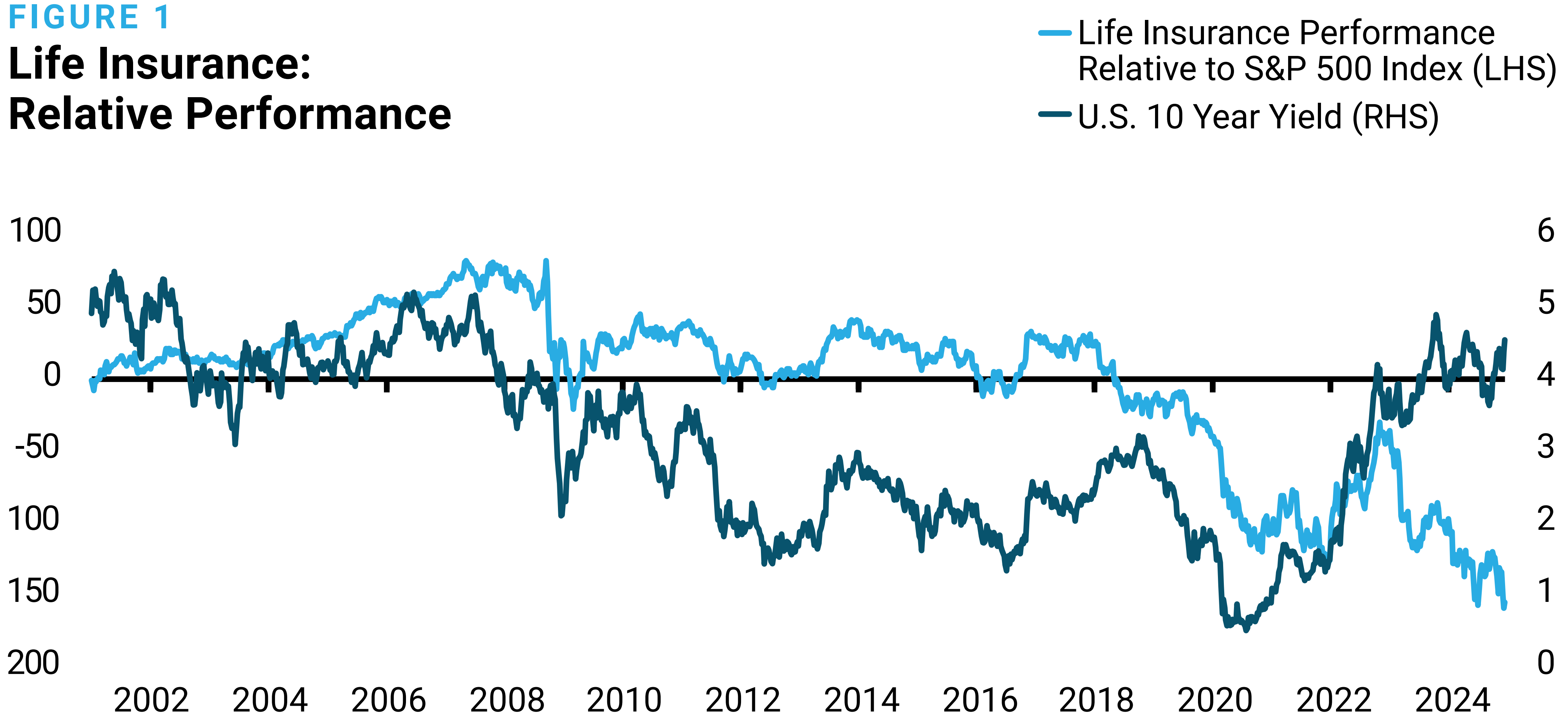
We are big fans of structural re-rates driven by positive fundamental change, especially in areas of the market that have been largely ignored for the better part of the past two decades.

With the tailwinds of higher rates, de-risked products, and a renewed focus on growth, we believe life insurance companies are well-positioned for a transformative period of sustained earnings growth and improved ROEs.

This new era of life insurance could offer compelling opportunities for investors seeking exposure to a sector on the cusp of re-rate potential.

FIGURE 1

Life Insurance: Relative Performance

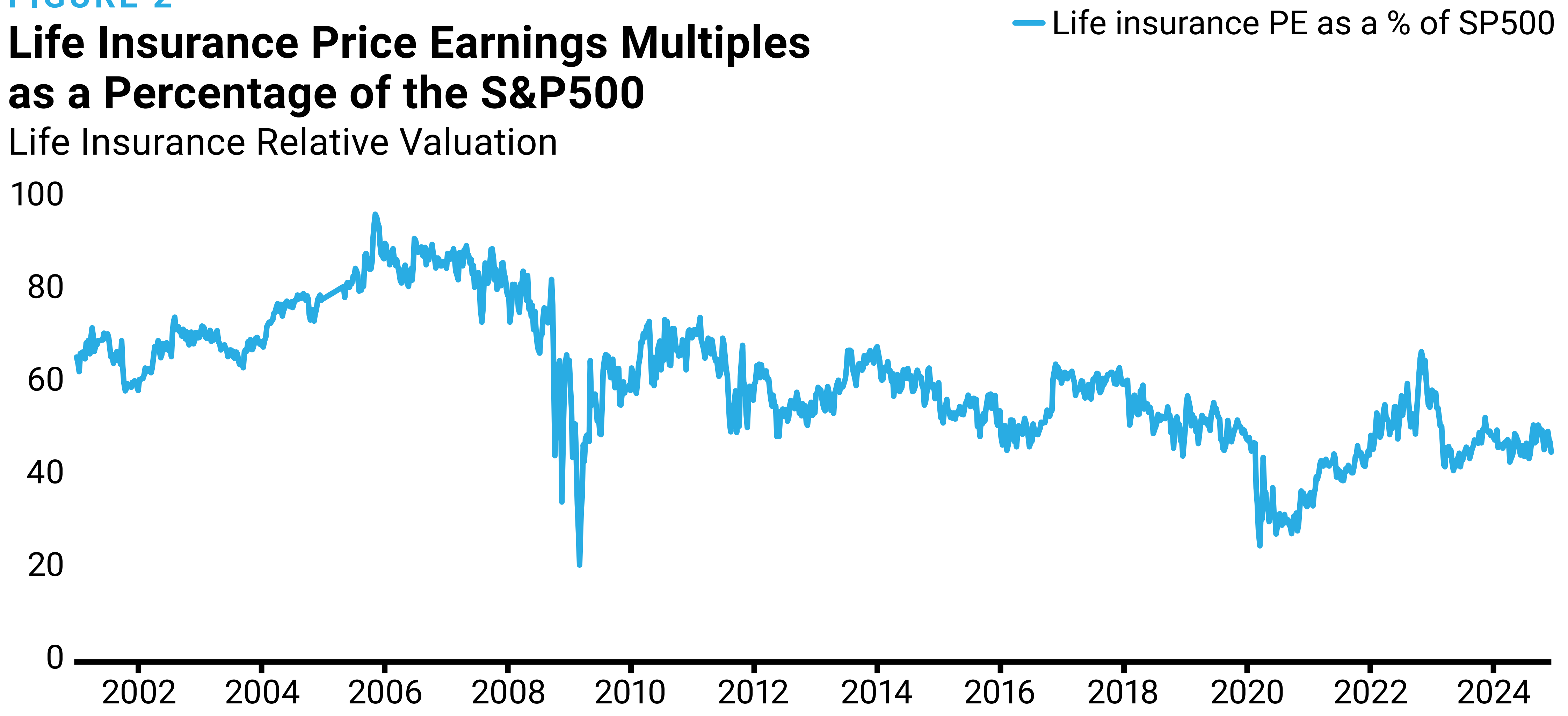


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2001 to Dec 2024.

FIGURE 2

Life Insurance Price Earnings Multiples as a Percentage of the S&P500

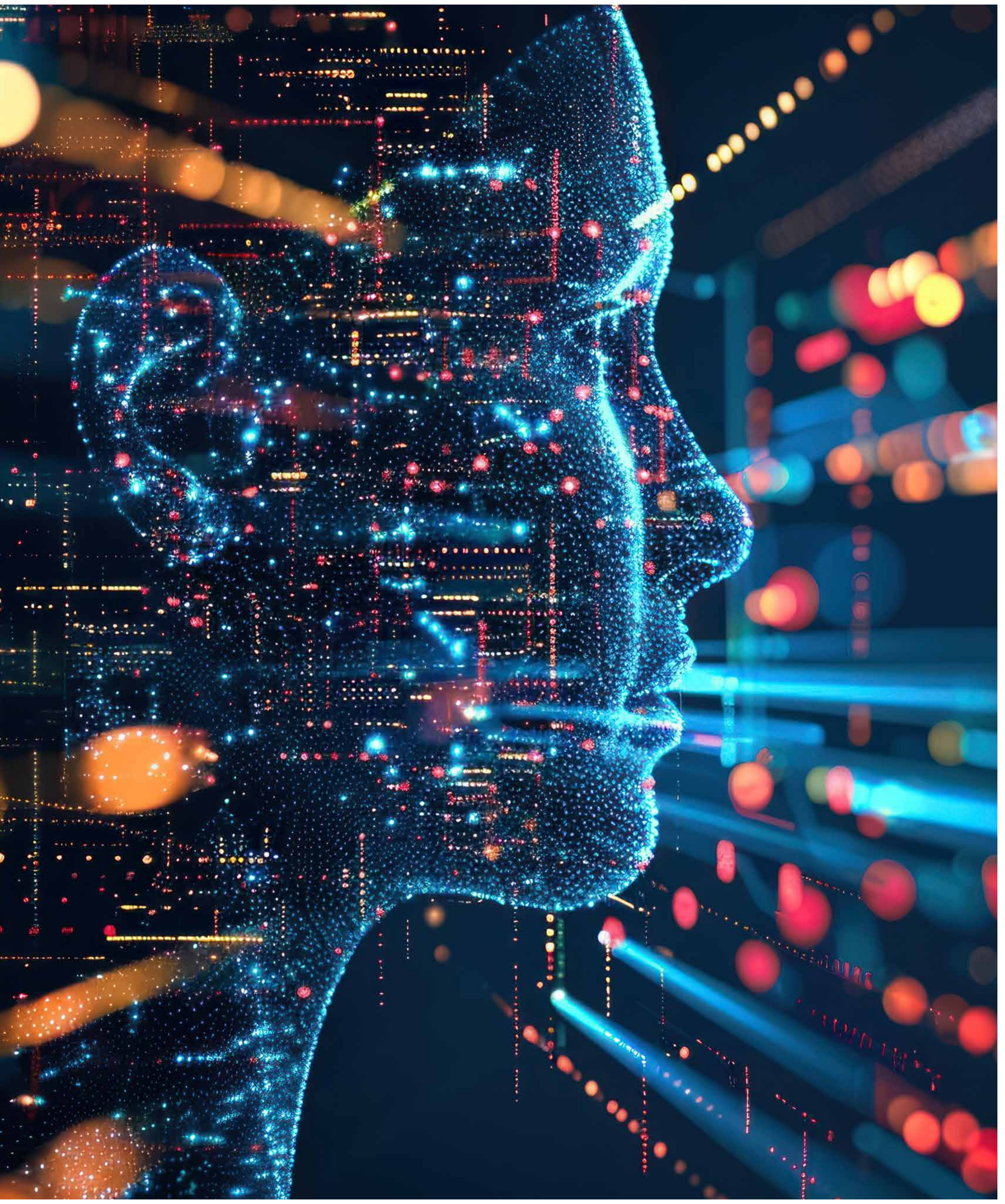
Life Insurance Relative Valuation



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2001 to Dec 2024.

KEY THEME 02

The AI Revolution: Unveiling the Multi-Stage Transformation



STAGE

01

The Infrastructure Buildout

The evolution of artificial intelligence (AI) is unfolding in multiple stages with significant implications across equity markets.

The first stage centered on the large infrastructure buildout by the "Magnificent Seven" to support the compute power needed for training large language models (LLMs).

This stage saw a massive capital expenditure boom, fueling gains in Nvidia Corp and other semiconductor companies as they provided specialized chips critical to AI development.

STAGE

02

Expansion of the Infrastructure Value Chain

In 2024, the AI theme expanded beyond semiconductors to further parts of the infrastructure value chain and energy requirements.

Data center growth, the backbone of AI infrastructure, became a key driver of themes in utilities, natural gas, and uranium equities.

This growth was fueled by optimism surrounding a potential nuclear renaissance to power the energy-intensive data centers required for AI operations.

KEY TAKEWAY

Navigating the Multi-Decade Path of AI Adoption

The evolution of AI is progressing through a multi-stage development process with transformative implications for equity markets.

From the initial infrastructure buildout to the current expansion of value chains and the anticipated monetization via software applications, each phase presents distinct opportunities and risks.

As investors navigate this journey, it is essential to remain mindful of historical parallels and to approach AI-driven opportunities with a balance of optimism and caution.

Our View

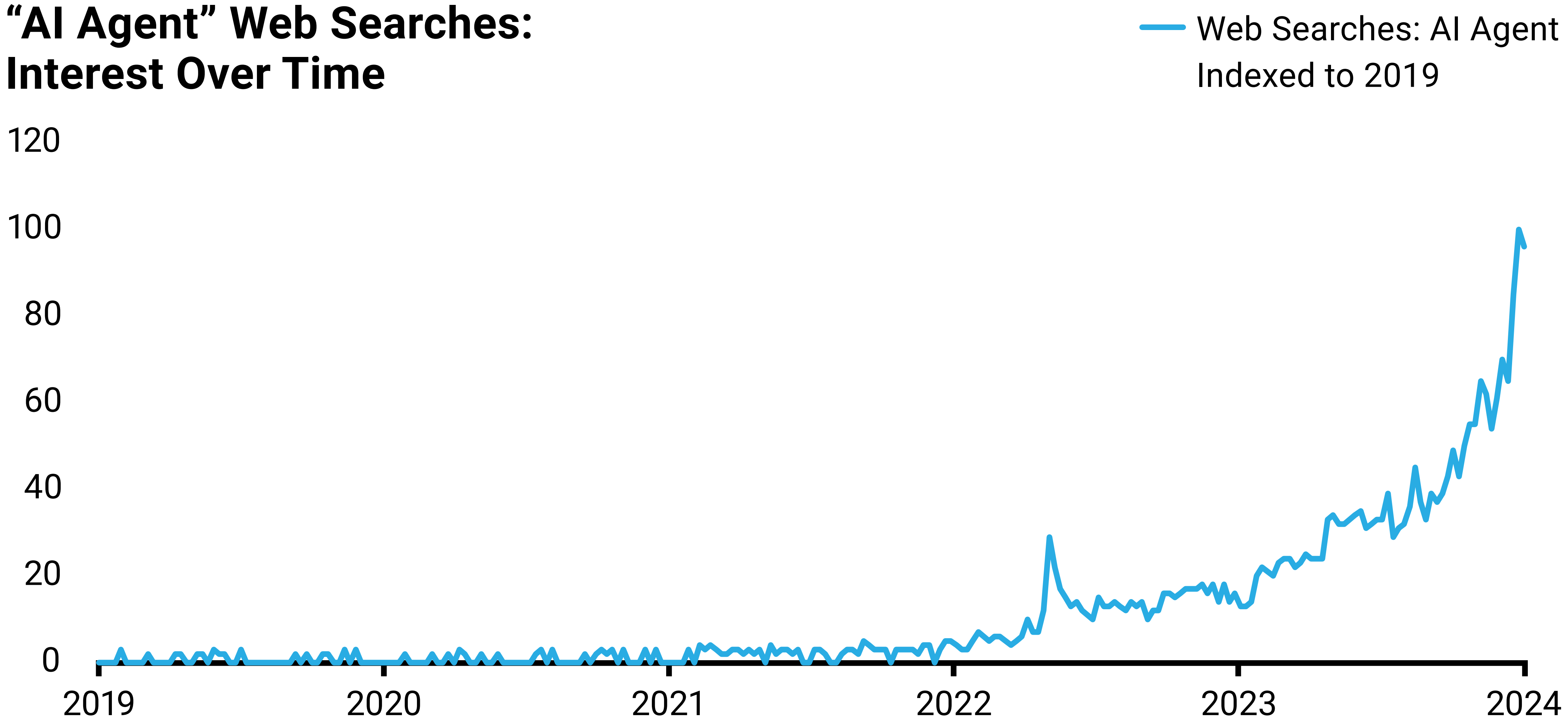
In 2025, early signs of a shift in focus emerged as the market began to question whether the massive infrastructure buildout would pay off through software applications. A notable milestone was Salesforce's announcement of "Agentforce," a labour automation offering initially targeted at customer service. This announcement may have marked the starting point for a broader race to develop AI-driven software applications.

Early success cases in AI software deployment have the potential to spark market froth. If the market gains conviction that AI software can replace labour in a relatively short time span, it could fuel an AI bubble, driving valuations higher for software companies and perceived winners in this space.

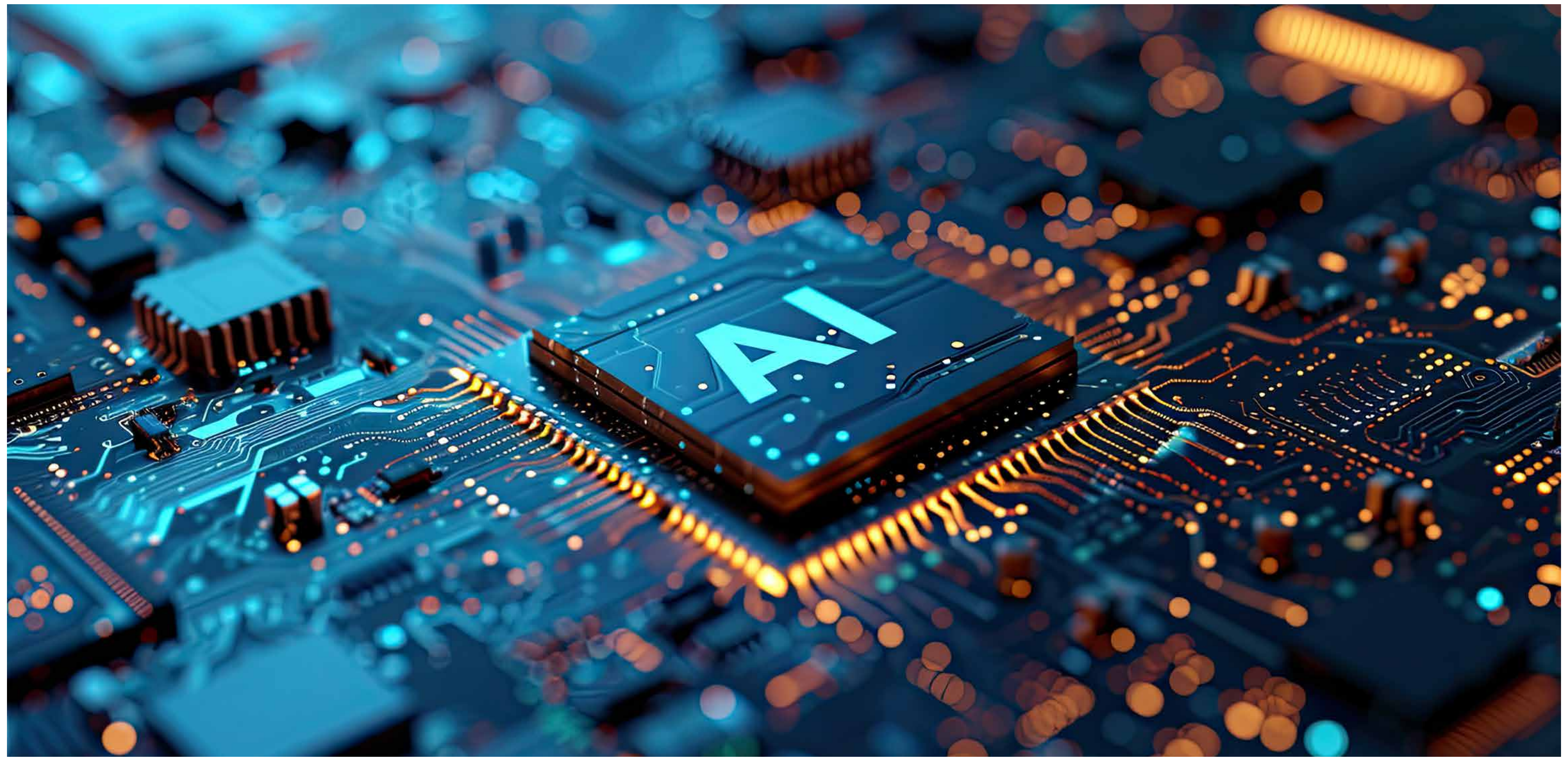
Parallels to the Dot-Com Era: Risks and Cautionary Notes. While enthusiasm for AI has the potential to drive an asset bubble, some parallels to the dot-com era are emerging. During that period, inflated expectations and valuations were driven more by hype than by financial fundamentals. Similarly, the current AI frenzy could lead to over-exuberance as valuations stretch beyond what is justified by near-term profitability.

Investors should remain vigilant, as history shows that excesses tied to new innovations can emerge in equity markets. As with the internet boom, the path of AI adoption and monetization will likely span multiple decades. While the ongoing AI arms race has initiated a capital spending boom, its long-term profitability remains uncertain.

FIGURE 3
"AI Agent" Web Searches: Interest Over Time



Source: Google Trends, Picton Mahoney Asset Management Research. Dec 2019 to Dec 2024.



Industrials

Recently, we've seen industrials stocks waver as the market looks ahead to 2025. Erring on the side of conservatism, we have maintained a short exposure to relatively expensive multi-industrial/third-party logistics 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 refocusing on Canadian airlines, given the valuation gap with their American counterparts, despite similar (if not better) fundamentals.

We've also spent more time on hazardous waste names exposed to growing infrastructure spending and onshoring. We 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.

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 continues to be 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 strong performance in October, rising to a peak of 2,790 USD per ounce due to continued geopolitical uncertainty coupled with dovish commentary from the U.S. Federal Reserve. This price momentum subsequently reversed following President-elect Donald Trump's larger-than-expected election victory, and a Republican sweep, which revived inflation concerns.

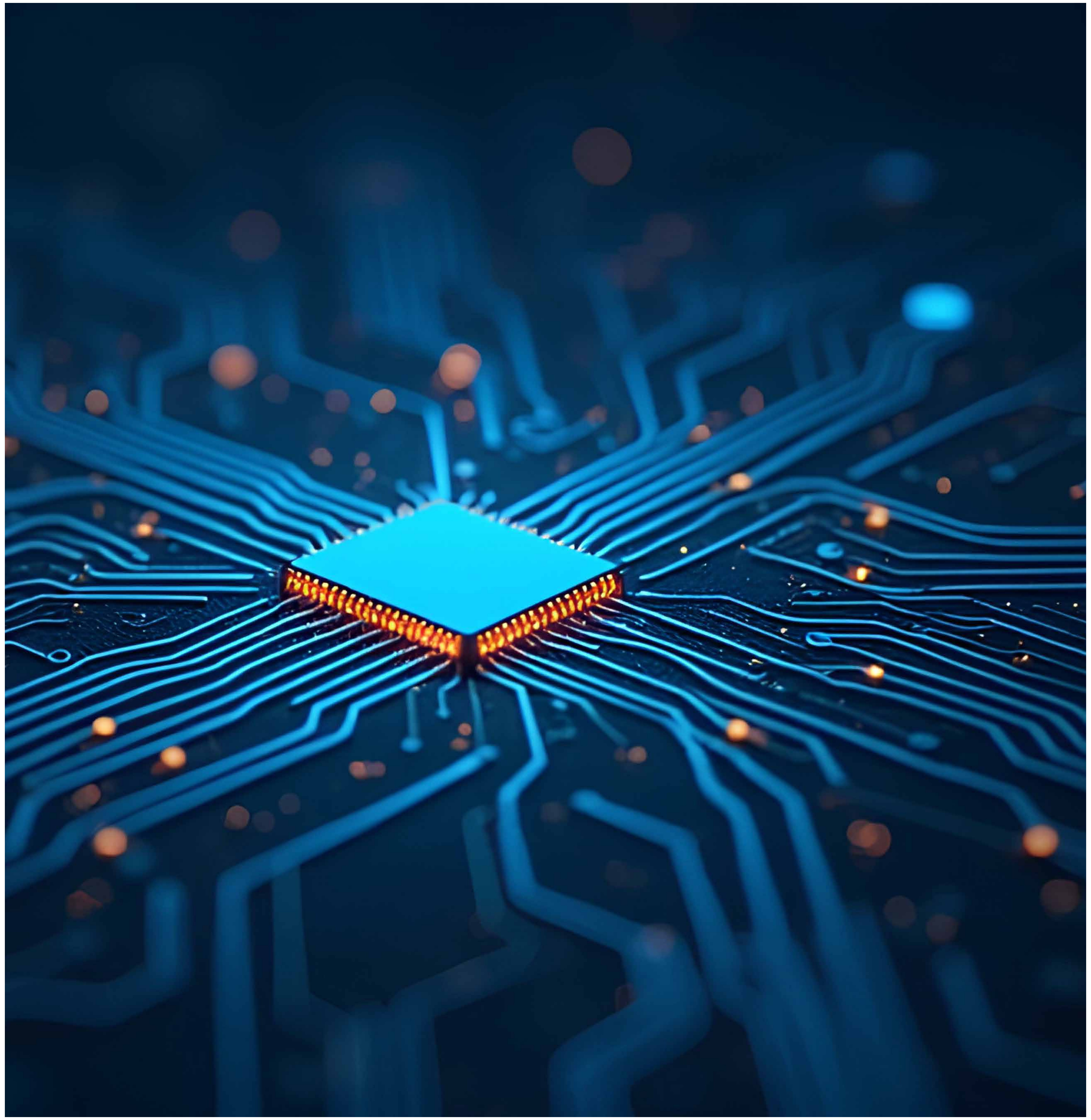
Looking to the first quarter of 2025, we expect a period of volatility, with negative pressure from inflation concerns being met with higher seasonal demand during the Chinese Lunar New Year. Given this expected volatility, we favour gold equities with a robust organic growth pipeline that have industry-leading track records of cost control to offset inflation, such as Agnico Eagle Mines Limited (XTSE: AEM) and Osisko Gold Royalties Ltd. (XTSE: OR).

Copper Market Trends

The correction in the copper market continued in the fourth quarter, with copper prices falling by 11%, largely driven by fears of the impacts of potential tariffs on the global economy. However, with prices approaching 4.00 USD per pound – broadly considered the current incentive price for constructing new projects – we believe the market is nearing a floor.

We therefore view the current market as an attractive entry point for copper equities, which are poised to benefit from a structural deficit, due to historical underinvestment in the sector, coupled with strong long-term demand fundamentals from the energy transition movement.

While we believe it is prudent to own a portfolio of copper equities to capitalize on higher long-term copper prices, we also believe companies benefiting from positive rates of change and strong cash-flow profiles in 2025 will outperform and we therefore view names such as Hudbay Minerals Inc (XTSE: HBM) as well positioned.



Information Technology

The MSCI World Information Technology Index increased by 4.5% for the fourth quarter of 2024, while the Information Technology sector in the S&P/TSX Composite Index increased by 22.1%. Sector performance rebounded after a choppier third quarter.

The best-performing subsector was software, with iShares Expanded Tech-Software Sector ETF up 12%, with excitement about AI monetization boosting names such as Salesforce Inc and Atlassian Corporation.

Internet stocks performed well, with the Invesco Nasdaq Internet ETF up 7.5%, amid healthy e-commerce and advertising demand during the holiday shopping period.

The semiconductor sector was weaker in the fourth quarter of 2024, although generative AI names still outperformed. The VanEck Semiconductor ETF was down 1.3%, weighed on by election-related tariff fears, a rotation into software and a lack of catalysts.

In hardware and networking, results mirrored semiconductors, but with more idiosyncratic winners and losers as debates continue regarding the long-term beneficiaries of generative AI and its overall economic impact.

Our outlook for Information Technology in 2025 remains cautiously optimistic. In the first quarter specifically, we expect some choppiness as the post-election ramp-up in tech stocks is assessed according to January's earning announcements.

We are optimistic on the software space, where early readings of IT budgets suggest a better spending environment with a focus on AI.

In internet stocks, we think market share gainers continue to outperform in a stable consumer spending environment, although valuations appear to be slowing the pace of gains compared with 2024.

We are looking for clues from the rate market as a prediction of consumer wallet shift potential. In semiconductors and tech hardware, we remain cautious on diversified suppliers and bullish on names with high generative AI exposure.

While our positioning here has been consistent for several quarters, we see it as warranted, given that high capital expenditure spending could persist to support more advanced generative AI models and more useful software applications.

Health Care

The fourth quarter was a challenging one for Health Care overall. Material underperformance relative to the S&P 500 Index accelerated following the U.S. election, when investors rotated out of the sector due to a confluence of stumbling fundamentals and a rising tide of headline risk and policy overhangs.

Trump's unconventional nominations for key healthcare government positions, such as Robert F. Kennedy Jr., along with the Republicans' new hold on Congress, have created uncertainty about numerous issues including Medicaid, Affordable Care Act extended subsidies, National Institutes of Health funding, the use of pharmaceuticals, and the future of vaccines.

These concerns have wide-ranging implications across multiple subsectors, especially managed care and hospital providers. Elsewhere, broadly owned names in large cap biopharmaceutical stumbled in the quarter, given concerns about disruption from the new administration.

At the same time, R&D and capital spending austerity in this industry had negative follow-on impacts on clinical research organizations and life sciences tools companies.

On the other hand, medical utilization and procedure growth have remained robust, supporting medical technology and provider fundamentals.

Looking forward, we anticipate continued sluggishness in the sector in the near term as Trump and his new team enter office and as concrete policy proposals materialize. With the spectre of uncertainty hanging over large swathes of the sector, Health Care is likely to remain a major source of funds.

As usual, the J.P. Morgan Healthcare Conference in early January will be important to watch for any meaningful shifts in trends and will set the tone for sentiment at the start of the year.

Longer-term, we continue to favour names with quality growth and positive estimate revisions through innovative product cycles and strong base businesses with defensible moats and opportunity for margin expansion.

We remain opportunistic in catalyst-driven names where risk/reward is favourable.

Consumer Discretionary

The year 2025 is setting itself up to be a "good but not great" year for consumer spending, although the U.S. in particular is likely to show continued resilience. Household balance sheets are clean, with debt as a percentage of disposable personal income now below pre-COVID levels, while household wealth climbs ever higher.

Consumer credit growth has slowed, and debt service costs – both mortgage debt and consumer credit – remain manageable, despite having risen back to pre-pandemic levels over the past three to four years. Housing affordability will likely be a challenge for the foreseeable future, but green shoots of improvement are emerging that could flow through into 2025 as rates move lower and housing inventories build up from their current low levels.

The risk to U.S. consumer spending comes largely in the form of creeping inflation, particularly if new tariffs are imposed and more stringent immigration policies are implemented. The outlook for the consumer and household spending in Canada is generally more subdued: household leverage is higher, the cost of living continues to rise, and a significant number of homeowners could face mortgage resets at materially higher rates in 2025.

Against this uneven backdrop, we expect to see a wide dispersion between winners and losers, and we are focusing on idiosyncratic growth stories, companies that are taking share of wallet and names that can outperform their peers in a stable spending environment.

We are leaning into consumer verticals with less tariff risk – such as leisure stocks – while reducing exposure to the industries that may feel the most impact from a tighter labour market, including homebuilders.

In retail, we expect to see structural share gainers such as The TJX Companies, Inc. (NYSE: TJX) and Walmart Inc. (NYSE: WMT) maintain their premium multiples, supported by strong outperformance in 2024.

Consumer Staples

In the fourth quarter of 2024, U.S. Consumer Staples saw notable underperformance relative to the broad market, while the Canadian sector performed in line.

Canadian staples continue to be led by the grocers, with Loblaw Companies Ltd. (TSE: L) and Metro Inc. (TSE: MRU) continuing to post solid performance. Investors are generally looking for certainty in a time of a slowing Canadian economy.

Grocers can likely provide that certainty and could benefit from a continued flight to safety; there is little debate as to their ability to grow earnings.

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). However, this would widely be viewed as a positive acquisition, if the offer were to be accepted.

In the U.S., staples continued to languish. Walmart Inc. (NYSE: WMT) continues to outperform, consistently gaining share while it remains insulated from consumer weakness and pivots to higher-growth, higher-margin verticals such as advertising.

The rest of the sector, however, is underperforming, especially packaged food, which is battling sluggish volumes as consumers push back on high prices, and is also facing risks from GLP-1 drugs and from political headwinds related to increased regulation of processed foods.

BellRing Brands Inc. (NYSE: BRBR), Freshpet Inc. (NYSE: FRPT) and Performance Food Group Co (NYSE: PFGC) remain winners in this sector; we believe they are insulated from the headwinds, and they have shown impressive resilience despite the well-documented slowdown of the U.S. consumer. We still see a long runway for growth ahead for these companies.

Financials

For the second quarter in a row, Financials outperformed the broader market, after a Republican sweep in the U.S. election reinvigorated a growth acceleration agenda, including tax cuts and de-regulation. More defensive financial stocks, including property and casualty insurance companies and the exchanges, have begun to lag, and underperformed in the fourth quarter.

We remain somewhat cautious on banks in the near term, especially given their recent strength, but are becoming increasingly more positive on the group, because headwinds due to volumes, margins, credit and capital all appear to be abating. Also, market-sensitive businesses such as wealth and asset management are starting to build momentum.

We remain 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.

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 we believe they can 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

In the fourth quarter, 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 -14.4%, underperforming the S&P/TSX Composite Index by about 1800 basis points (bps), driven by concerns about a lack of improvement in pricing and, more importantly, slower population growth.

The year 2024 has been a year to remember for Canadian telecommunications – but not in a good way. We have seen the Canadian telecoms lose their higher growth, oligopoly premium, with companies leaning aggressively on pricing following Quebecor's entry as a fourth player in the market.

Looking ahead, we expect pricing to stabilize as companies realize that re-pricing the backbook punishes profitability, and that their balance sheet positions do not offer very much latitude to absorb a hit on the bottom line.

That said, we prefer to wait before becoming more aggressive, since the pricing aggression has already lasted longer than we originally expected. We are also waiting to see the impact of population growth on evolution of strategy for Canadian telecom companies.

Utilities

In the third quarter, we wondered whether the outperformance in utilities would continue, given the beginning of the rate-cutting cycle.

We got an answer: no. Following a strong quarter of outperformance, utilities stocks struggled to hold their gains in the fourth quarter, and the sector underperformed the S&P/TSX Composite by about 550 bps.

While the sector lagged in aggregate, there were significant intra-sector dispersions, with thermal Independent Power Producers (IPPs) outperforming, attributable to optimism about load growth, and renewable IPPs materially lagging, primarily due to the results of the U.S. election.

We might sound like a broken record, but we have repeatedly said that our preference is for IPPs that can fund growth and for regulated utilities with balance sheets that can fund growth.

Both have performed very well this year, and we don't see any reason why that should not continue in the future.

As for renewable IPPs, we believe the market sees all the names as being the same, notwithstanding geographical differences – a generalization that we believe should correct itself in due course.

Real Estate

The soft-landing optimism that had previously driven the sector's material outperformance of the S&P/TSX Composite Index was overshadowed by an announcement from the Canadian government to limit population growth.

Notwithstanding the rate-cutting cycle, REITs underperformed the S&P/TSX Composite Index by a whopping 1,850 bps: investors who had invested in REITs because of optimism about the superior population growth dynamics compared to other G7 countries likely pulled out their funds.

Looking forward, we expect multi-family, storage and, to some extent, industrial REITs will have to navigate a tricky environment, and will need to prove to investors that a year or so of slowing population growth will not materially alter the long-term attractiveness of these investments.

We believe that retail REITs, however, are somewhat better placed: retail has seen limited or even no supply, and population growth in the near term is more of a second-order factor for the group. Looking ahead, our preference will be to combine value with quality growth.

Energy

The fourth quarter has seen a more subdued North American oil and gas sector, with natural gas developments taking precedence.

Oil prices remained range-bound, influenced by uncertainties surrounding the U.S. presidential election. Following the election, prices continued to fluctuate, due to a combination of geopolitical risks in the Middle East and concerns about a potential surplus in 2025.

Market participants are closely watching OPEC's ability to balance supply and demand amid these uncertainties, which have created a cautious trading environment. In contrast, European natural gas prices have strengthened significantly. This tightening is attributed to robust demand and substantial storage withdrawals.

Currently, European gas storage is below the five-year average, indicating an increased reliance on liquefied natural gas imports. The looming possibility of reduced Russian gas flows, adds another layer of complexity to the supply outlook.

In North America, natural gas prices rallied during the period, driven by weather patterns and long-term demand growth from sectors such as data centres.

The oil and gas producers' segment has experienced widening performance dispersion in 2024. For instance, some Canadian integrated oil companies, such as Imperial Oil Limited, are up 40% year-to-date, while others, such as Cenovus Energy Inc, have seen no growth.

In our portfolio, we continue to favour oil sands producers over mid-cap exploration and production companies. Oil sands producers could offer several advantages, including lower decline rates, longer reserve lives, and higher free cash-flow generation.

We believe these factors could enable them to maintain strong financial performance without resorting to dilutive acquisitions to sustain inventory levels, in contrast to several mid-cap oil-weighted producers.

06. Asset Allocation

Navigating Growth, Inflation, and Interest Rate Risks through a 40/30/30 Lens

Big Picture: What We See Ahead

We believe the underlying economic and market conditions are aligned with an ongoing "risk-on" period – however given valuations and some speculative activity, the market is at risk to external shocks or changes in policy. Examples include the market reaction to the December Federal Reserve meeting and uncertainty around U.S. government shutdown.

Base Case: Economic Growth with Some Friction

Our base case calls for continued economic expansion, with inflation ticking higher, particularly more concentrated in the services sector. This environment supports equities, but elevated valuations may present a headwind limiting upside potential. Meanwhile, economic growth-driven increases in longer-term interest rates (notably a steepening 10-2 Year U.S. Treasury yield curve) could weigh on returns for both stocks and bonds. Eventually, we expect higher rates to puncture the speculative bubble that has inflated equity valuations, leading most traditional asset markets back to more historical norms.

Asset Class Positioning: Where We Stand

In terms of positioning, weightings are discussed relative to a broad 40/30/30 target allocation of equities/fixed income/alternatives based on our belief that this asset allocation approach is a better way to build portfolios that deliver greater certainty.

EQUITIES

Neutral Stance, But Open to Opportunity

- **We Are Neutral.** Valuations remain stretched, but ongoing economic growth could drive broader market participation.
- **Where We're Focused:** We're looking for opportunities across sectors and themes as market leadership broadens.
- **Inflation Impact:** We're tilted toward service-oriented sectors where price pressures are stickier, while being cautious on manufacturing, where inflationary pressures are easing.

FIXED INCOME

Underweight with a Hedged Approach

- **We're Underweight.** Rising government bond yields reduce return potential, especially as inflation risks persist.
- **Credit View:** We view the credit market broadly as overvalued and expensive, prompting our defensive, hedged stance in this sub-asset class.

ALTERNATIVES

A Vital Diversifier

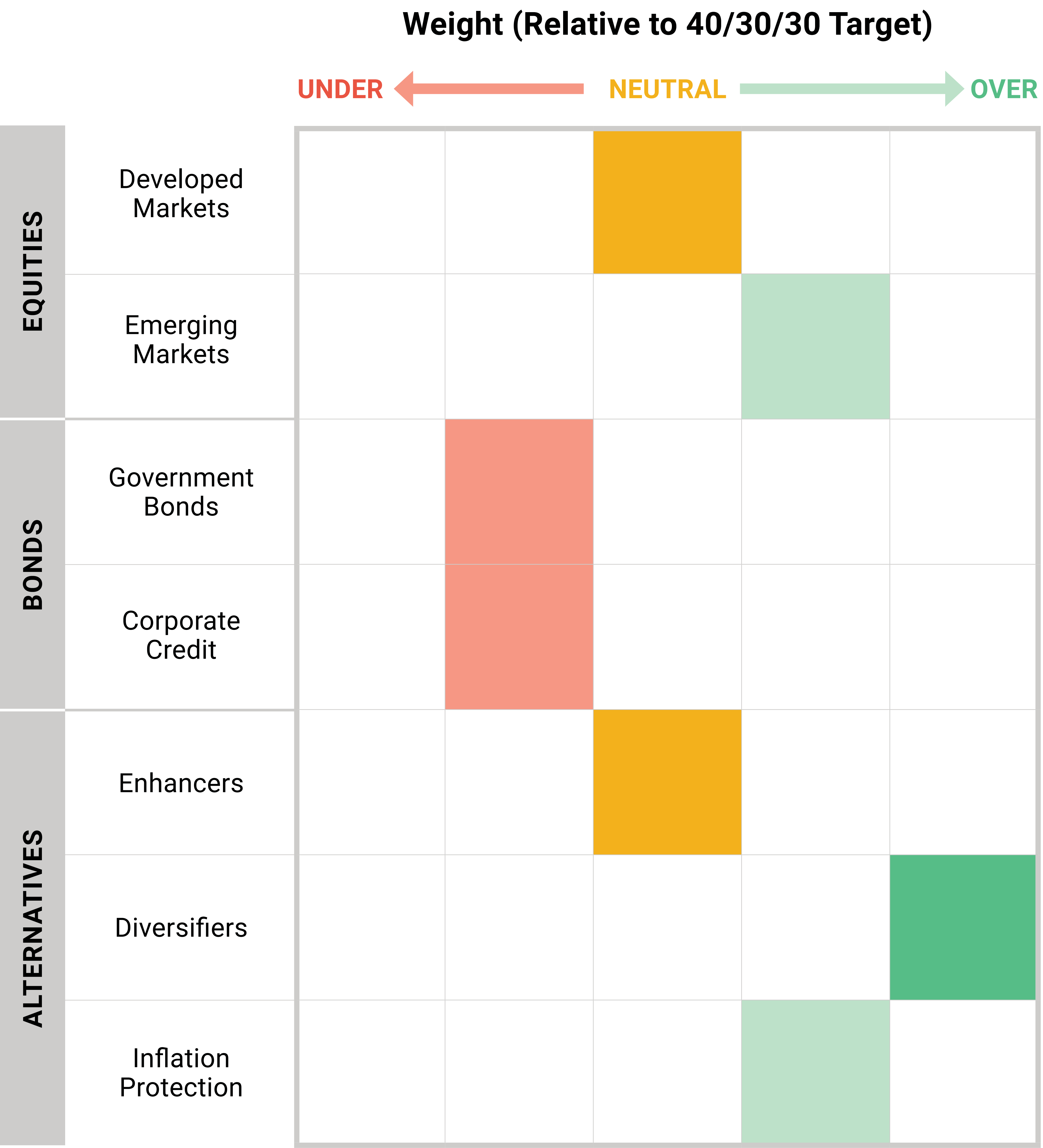
- While our base case leans optimistic, we remain vigilant to tail risks, including unexpected policy shifts from the Fed or geopolitical developments, which could significantly alter the trajectory of markets. These risks are reasonably accounted for in our probability-weighted scenario forecasting.
- With heightened uncertainty around rates and equity valuations, alternatives remain a key pillar of our diversified model. Alternatives are comprised of three components: enhancers which can supplement equity or fixed income risk; diversifiers which provide returns independent of market moves; and inflation protection.
- Within the alternatives, investors may consider shifting their exposure from enhancers to diversifiers which may reduce the beta of their overall portfolio to traditional equity or fixed income risks. For example, a shift from long only equity to long/short strategies, or a shift from long/short exposure to market neutral strategies.
- Consider introducing or maintaining exposure to inflation protection given we see the risk of inflation surprising to the upside.

Key Risks We're Watching

While our base case leans positive, we remain vigilant to potential disruptors:

- **Federal Reserve Policy Shifts:** A sudden change in rate policy could upend market assumptions.
- **Geopolitical Events:** Unexpected developments on the world stage could increase market volatility.

To navigate this landscape, we're staying nimble, leveraging a scenario-based approach that helps prepare for a range of possible market conditions. Our allocation decisions are tied to a core 40/30/30 framework (Equities/Fixed Income/Alternatives), with positioning adjustments as market dynamics shift.



Picton View vs. Consensus

LOWER

Risk
Now that U.S. election risk is behind us, macro risk will likely continue to fall in the first quarter until the Fed upsets the apple cart with a hawkish policy change, an outcome that becomes more likely as the year progresses.

Canada Real GDP
The Bank of Canada's (BoC) larger rate cuts have not yet stemmed the flow of contracting GDP per capita even as inflation has fallen back to target. Paralysis at the Federal Government level is likely an additional risk to the economy until new elections are called.

European Equities
European equities are expected to face challenges due to a less optimistic economic outlook. European Central Bank rate cuts have not been aggressive enough to help Germany's contracting economy turn the corner. The divergence between the U.S. and European economies also negatively affects investor sentiment towards European equities.

Canadian Equities
The Canadian Dollar slipping under $0.70 (nearly a multi-decade low) highlights investors negative sentiment towards Canadian markets, which face increasing economic uncertainty until the BoC delivers more rate cuts and confidence is restored to the Federal government and their policies.

EPS Growth (S&P 500)
Earnings growth expectations are on the rise, but many things would have to go right for them to be realized including a quick turnaround in the AI arena from promise to tangible productivity gains.

P/E (S&P 500)
CAPE (Cyclically Adjusted P/E Ratio) reached 38, a level seen just three times in the past 100 years. Though the catalyst is uncertain, we expect extreme equity valuations to normalize over time.

SAME

Global Real GDP
Global growth continues to diverge, with the U.S. standing out as the best of the developed world, while Japan and Germany slip into contraction. Brazil is raising rates in the face of rising growth prospects while China is attempting to stabilize its flailing property market in the face of shrinking population growth. Potential disruptions from new U.S. policies, such as trade and immigration, could have a negative impact on global growth.

U.S. Real GDP
U.S. GDP estimated for 2024 has risen to 2.7%, and 2.0% for next year, supported by resilient consumer spending and a robust labour market. However, potential risks include higher rates and an abrupt end to the Fed's cutting cycle. The potential stagflationary impact of Trump's policies will likely also play into next year's risks.

U.S. Equities
We are in a bubble environment by most historical metrics, but conditions are not there yet for the bubble to pop (still waiting for the spike in rates and volatility that usually herald the end). New Trump policies are a risk and there is little room for a misstep with sentiment and positioning already at extreme highs, and long-term valuation at century's highs.

Investment Grade Corporate Bonds
Despite healthy fundamentals and strong demand from yield-focused investors, investment grade bond's expensiveness suggests limited room for further tightening.

WTI Crude Oil
Crude oil prices remain in balance thanks to the ability of OPEC (Organization of the Petroleum Exporting Countries) to balance supply in the face of volatile demand.

HIGHER

U.S. Inflation
We anticipate a continued rise in inflation—driven by persistent core services costs, while headwinds from the goods sector may continue to recede. The inflationary impact of any new Trump policies is a new but potent upside risk.

Treasuries (U.S. 10-yr)
The challenges posed by U.S. fiscal policies such as tax cuts and deregulation could push yields higher and limit the Federal Reserve's ability to cut rates. Fiscal sustainability and the supply-demand imbalance remain long-term problems for treasuries.

High Yield Corporate Bonds
High Yields (HY) spreads remain rich at 20-year tights; either higher government rates or a renewed default cycle will likely cause HY yields to rise.

Picton Mahoney view is relative to the Bloomberg Consensus Estimate for each category. As at December 31, 2024.

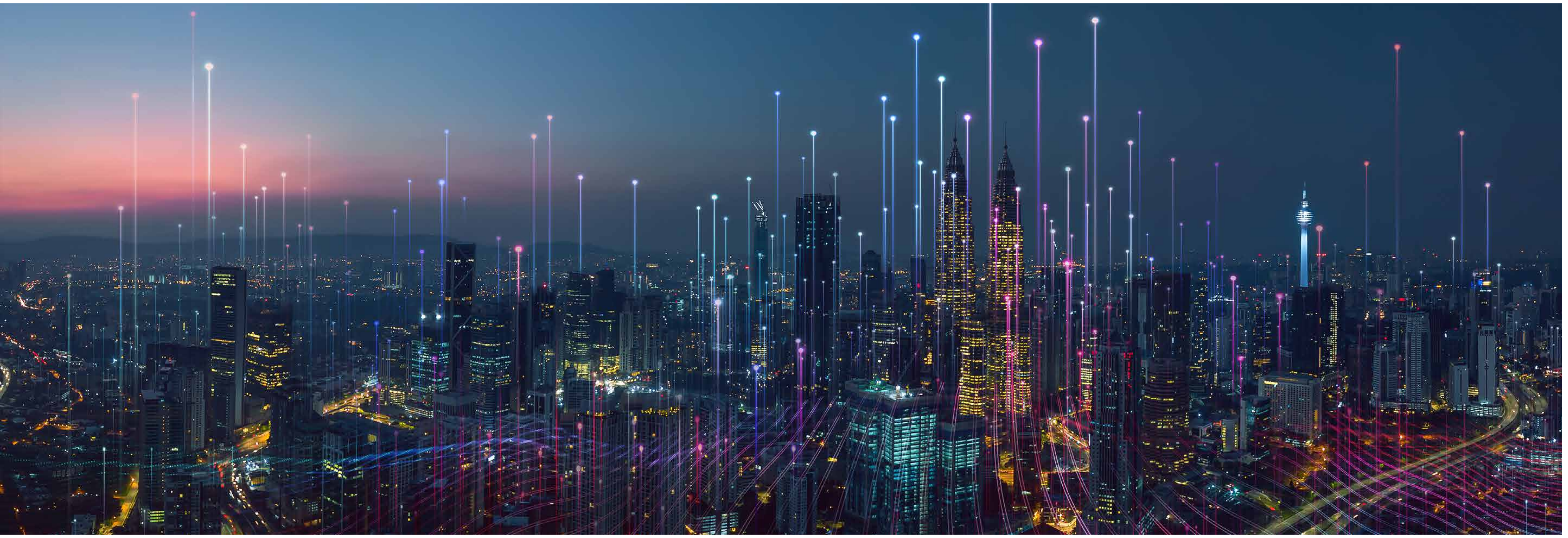
07. Key Portfolio Trends

The Shift from 60/40 to 40/30/30: In Search of The Innovative Portfolio

We live in a world where change is constant, and with it comes uncertainty – nowhere more so than in the investment landscape. As the environment evolves, so must the portfolios we build. Yet, while many areas of society have adapted meaningfully as our understanding of the world has advanced, the average investor's portfolio has remained largely stagnant – anchored to familiar assets and missing out on the benefits of new tools and strategies.

The "Innovative Portfolio" takes a forward-thinking approach to investing, constructing true multi-asset, multi-strategy portfolios. Using an evidence-based, goals-driven framework, it thoughtfully blends traditional and alternative assets with the aim to achieve optimal outcomes.

As we head into 2025, with bubbles brewing across various markets, this leaves investors vulnerable to significant market downturns and limits their potential for enhanced returns.



The 40/30/30 framework redefines portfolio construction, offering:

1 **Broader Diversification**
A framework spanning nine unique asset classes, reducing concentration risk and increasing resilience.

2 **Greater Capital Efficiency**
Higher returns could be achieved by deploying capital more effectively across diverse strategies rather than concentrating on riskier assets.

3 **Greater Fee Efficiency**
Optimized fee budgets prioritize strategies delivering asymmetric, uncorrelated returns while reducing fees per unit of gross exposure.

4 **Rigorous Risk Management**
Risk is actively measured and managed against pre-set targets to avoid outsized exposures.

5 **Total Portfolio Approach**
A "next best dollar" framework prioritizes allocations that enhance the likelihood of achieving portfolio objectives over rigid asset class adherence.

6 **Tactical Adjustments**
Probability-weighted shifts dynamically overweight assets likely to perform well in current market conditions.

7 **Dedicated Diversifiers**
A base layer of alpha-generating "cash beater" strategies could enhance performance across a broader range of scenarios.

2025 Outlook: Preparing for Shifting Market Conditions

With 2025 on the horizon, a range of market-moving forces – from brewing economic bubbles to geopolitical shocks – demand proactive portfolio adjustments. The Innovative Portfolio offers a pragmatic way to fortify client portfolios against uncertainty.

The classic 60/40 portfolio (60% equities, 40% fixed income) has been a long-standing benchmark for asset allocation. But today's political, economic, and market shifts demand a more adaptive approach. That's why investors should consider a 40/30/30 portfolio:

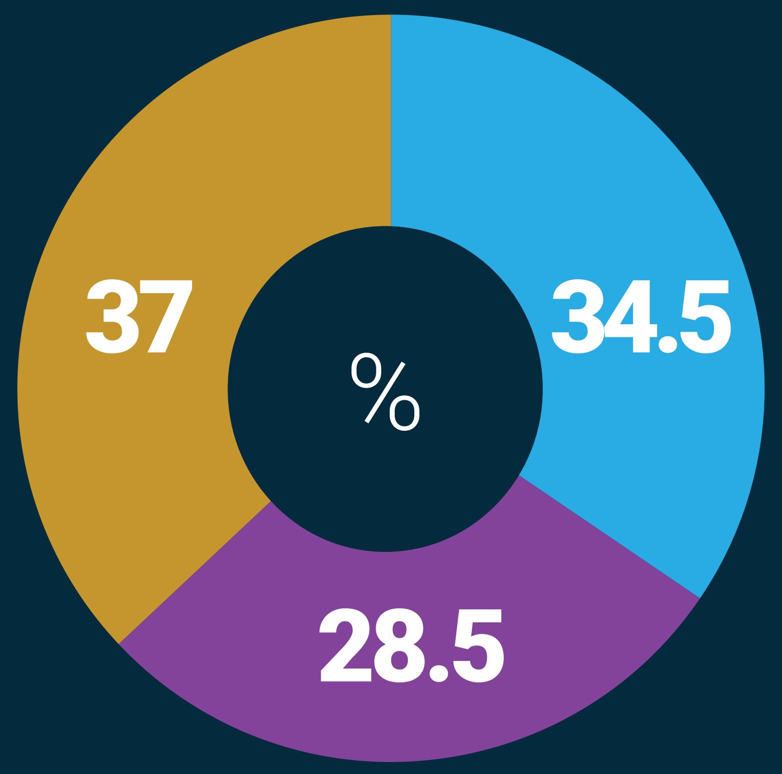
- **40% to Equities**
- **30% to Fixed Income**
- **30% to Alternatives**

With this 40/30/30 framework in mind, we built models of what we consider to be The Innovative Portfolio mix given the current market conditions. We have provided a sample "Optimal" Mix, as well as a model – The "Minimal" Mix – which helps take a step toward a 40/30/30 portfolio in a way that may better fit your mandated investment criteria.

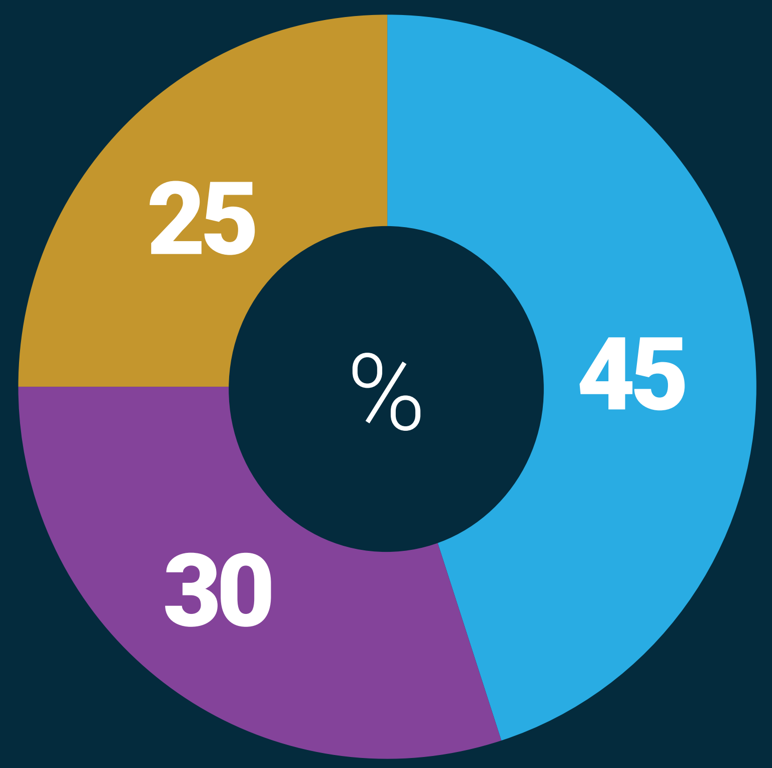
Note: These are illustrative models for discussion purposes only.

The Innovative Portfolio

The "Optimal" Mix



The "Minimal" Mix



The "Optimal" Mix

EQUITIES What's in the **34.5**?

By Geography	By Product Architecture
13.5% US Equity	20.5% Index Equity
17% Global Equity	10% Active
4% Canadian Equity	4% Equity Enhancer

FIXED INCOME What's in the **28.5**?

By Class	By Product Architecture
14% Active Fixed Income	14.25% Index
10% Fixed Income Enhancer	14.25% Active
2.5% Aggregate Fixed Income	
2% Cash	

ALTERNATIVES What's in the **37**?

By Class	By Portfolio Role
27% Alternative Strategies	27% Diversifying Strategies
10% Alternative Assets	10% Diversifying Assets

The "Minimal" Mix

EQUITIES What's in the **45**?

By Geography	By Product Architecture Split
16% US Equity	30% Index
23.5% Global Equity	15% Active
5.5% Canadian Equity	

FIXED INCOME What's in the **30**?

By Class	By Product Architecture
14% Short Dated Fixed Income	15% Index
14% Active Fixed Income	15% Active
2% Cash	

ALTERNATIVES What's in the **25**?

By Class	By Portfolio Role	By Goal
20% Alternative Strategies	10% Enhancers	10% Diversifying Strategies
5% Alternative Assets	15% Diversifying	5% Diversifying Assets
		6% Equity Enhancer
		4% FI Enhancer

Rethinking Retirement Portfolios: Ensuring Golden Years Aren't Tarnished by Bubbles or Inflation

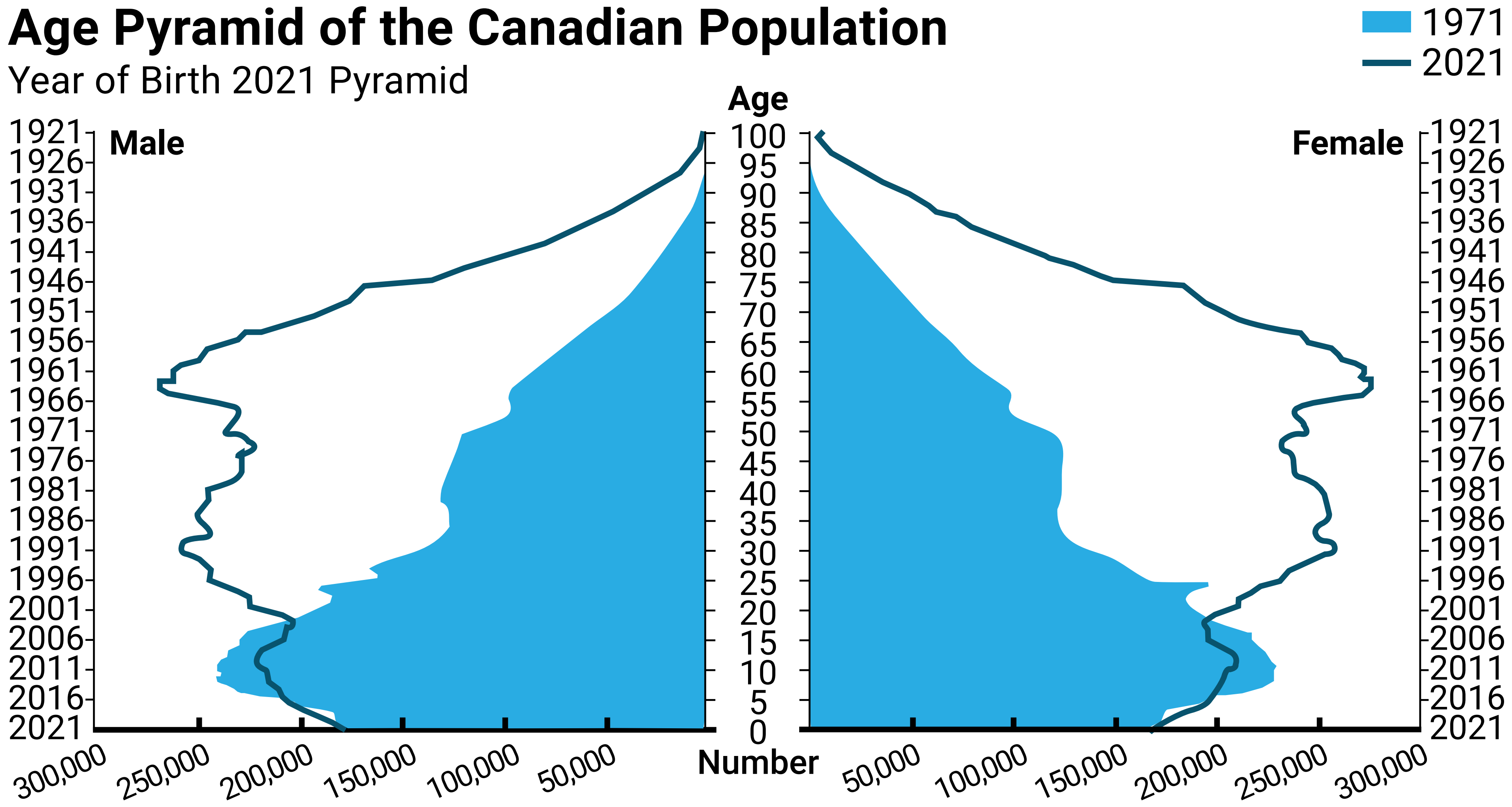
Almost 1 in 8 Canadians are turning 65 over the next decade, triggering a pressing need for guidance on how to construct an investment portfolio that maximizes spending power while minimizing the risk of outliving savings. Well constructed, goals-based portfolios designed to minimize shortfall risk provide greater certainty for pre-retirees and retirees. This is especially true during the critical transition from accumulation to decumulation.

The Problem with 60/40 Portfolios for Retirement

The traditional 60/40 portfolio leaves significant room for improvement in meeting investors' objectives. By limiting investments to stocks and bonds, this classic asset allocation model concentrates risk excessively, only performs well in a narrow set of economic conditions and exposes investors to disproportionate market downside for the returns it offers. A key vulnerability of 60/40 is its reliance on bonds acting as a hedge when equities sell off. Bonds may effectively mitigate growth shocks, but they fail – or even amplify – risk during inflation shocks. The potential for this unforeseen positive correlation can leave portfolios exposed when diversification is most needed.

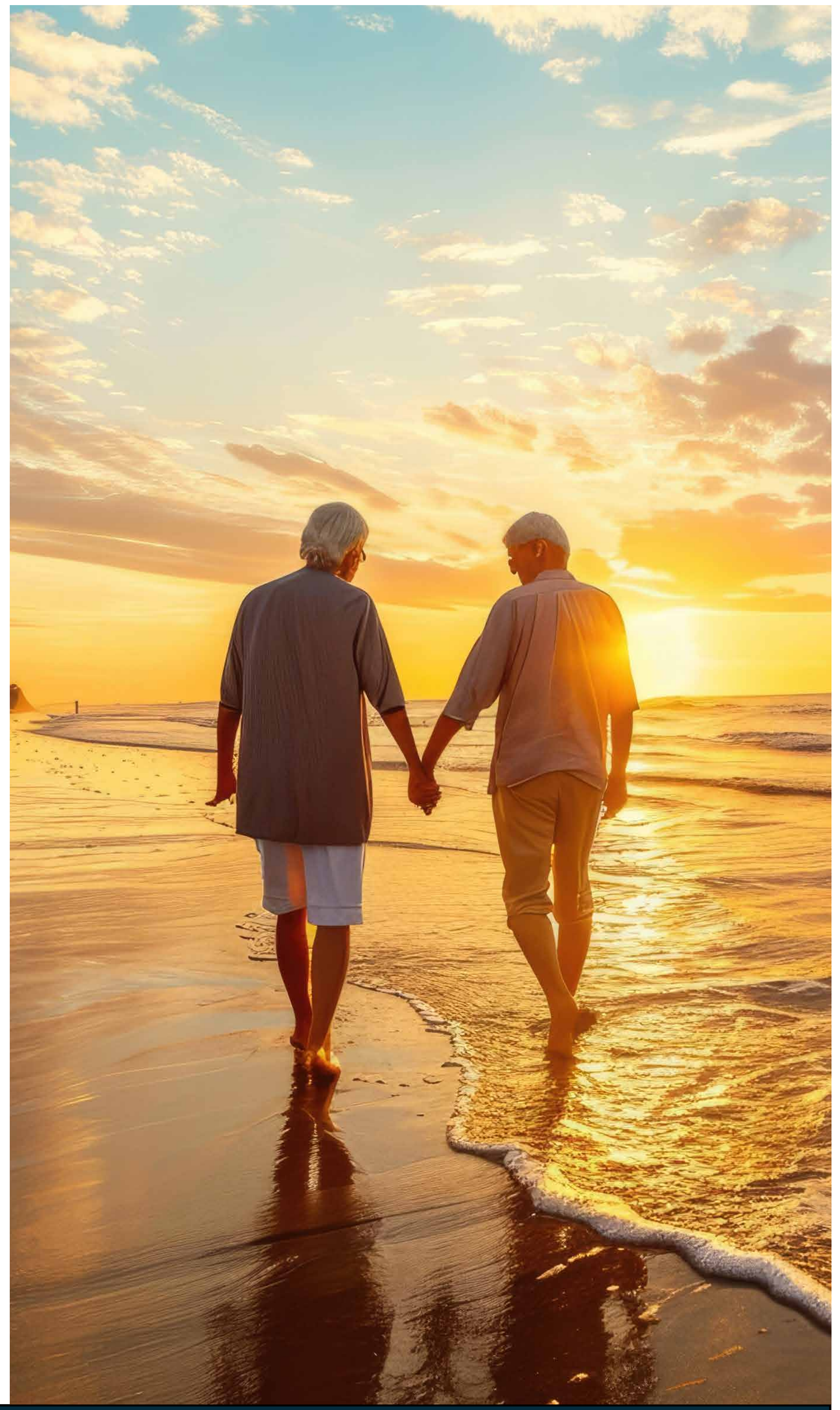
Age Pyramid of the Canadian Population

Year of Birth 2021 Pyramid



Source: Statistics Canada, The 7 million people aged 65 and older represent nearly 1 in 5 Canadians in 2021.

https://www150.statcan.gc.ca/n1/daily-quotidien/220427/g-a002-eng.htm



Why 40/30/30 is the New Approach for Retirement Portfolios

We believe the 40/30/30 model – 40% equities, 30% fixed income, and 30% alternatives – offers investors a more balanced and resilient approach to achieving higher expected returns while reducing the risk of significant losses – particularly early in retirement. Its diversified construction provides broader diversification, greater capital and fee efficiency, higher-quality returns, and the flexibility to navigate a wider range of economic and market conditions effectively.

Key Performance Indicators (KPIs) for Retirement Portfolio Success

We believe key performance indicators should be considered when constructing goals-based portfolios for retirees and those saving for retirement:

01 Growth KPI — Expected Return

The higher the expected return of the portfolio, the more income the portfolio will likely be able to sustain in retirement.

02 Risk KPI — Sequence of Return Risk

The smaller the risk of large losses early in retirement, the more income the portfolio will likely be able to sustain in retirement.

Two Insights to Reframe Retirement Portfolio Construction

01/ The "Retirement Red Zone" Matters Most

- **Provide Resilience Against Drawdowns During the Retirement Red Zone:** The decade before and after retirement is the most critical time to guard against large drawdowns. Shifting from 60/40 to 40/30/30 reduces exposure to market shocks when retirees are most vulnerable.
- **Adjust Equity Exposure Post-Red Zone:** After navigating the red zone, investors may consider increasing equity exposure, as the risk of large losses causing shortfalls diminishes.

02/ Reallocate Risk, Don't Just Add More

- **Identify and Rebalance Key Risks:** The most effective way to enhance portfolio consistency is by identifying its greatest risk, scaling it back, and reallocating capital to exposures that maintain outperformance potential while introducing unique, uncorrelated risks.
- **Leverage Alternatives for Diversification:** Alternative strategies and assets offer access to differentiated exposures, enabling broader diversification and greater certainty in achieving client goals. Additionally, because alternatives often involve lower sensitivity to interest rates and equity markets, they can reduce the risk of investors abandoning their plans during periods of acute market stress.

The Case for Change Through Brewing Bubbles

We believe the 40/30/30 portfolio is a necessary evolution for retirees and pre-retirees seeking greater certainty in achieving their retirement goals. By putting dollars to work across a broader range of exposures rather than by concentrating investor allocations in the riskiest assets, this new approach can offer a more efficient way to deliver on client expectations than the 60/40 model. Dedicated allocations to diversifying strategies and assets also help address the inconsistent relationship between stocks and bonds. In doing so, a portfolio can still meet investor objectives in an uncertain world brewing with bubbles.

08. Conclusion

Pivoting in a Challenging Rate Environment and Bubbling Equity Market

Equity Bubble + Correlation Risk = The Case for Alternatives

In years past, the 60-40 portfolio may have been sufficient – where reasonably priced equities offered significant growth potential and bonds, meanwhile, acted as a portfolio stabilizer in periods of market volatility. Evidence is mounting for a needed shift.

Two reasons explain this shift. First, as we detail in our macro outlook, there is mounting evidence of a speculative bubble in equities. As such, the risk-reward for stocks in the short to medium term is skewed to the downside.

Second, we may have entered a period where stocks and bonds are becoming more positively correlated. Structurally higher inflation may put upward pressure on interest rates, leading to weaker fixed-income prices. Ballooning U.S. deficits and debt may exacerbate this trend.

The upshot is that bonds alone may no longer be as an effective haven when markets experience turbulence. Rather, it's possible that rising rates could be the cause behind equity weakness.

If bonds and equities continue to show positive correlation in the coming years, a new approach is needed to offset this risk.

Portfolio Positioning

In a world of constant change, a diversified portfolio 40/30/30 approach – 40% equities, 30% fixed income, and 30% alternatives – aims to provide greater certainty and adaptability.

In equities, we maintain a cautious risk stance, preserving flexibility to add exposure when market valuations or economic recovery signals warrant it. Given fully valued markets and slowing growth, we prioritize selectivity and agility.

In fixed income, we avoid index-based exposure, which offers a weaker risk-reward profile. Instead, we target front-end Canadian yield curve opportunities, where relative value is strongest. We avoid broad high-yield indices, opting for long-short credit strategies that manage credit risk while seeking alpha.

With inflation moderating – but still at risk of supply-side shocks, such as new tariffs or geopolitical disruptions – we prioritize strategies that could mitigate inflation risk. This reinforces the case for trend-following approaches that adapt to changing market conditions.

Asset Class Positioning

	FROM	TO
Shift from Core Bonds to Short-Duration Investment-Grade (IG) Credit	• Core bonds which face rising headwinds, with tight spreads, elevated duration risk, and yield curve steepening, making them less appealing in today's environment.	• Short-duration IG credit (3-5 years) which could offer attractive yields with reduced interest rate and credit risk. • This could serve as a smart cash alternative and "dry powder" for future opportunities, with low-cost ETFs providing efficient market access.
Shift from Long-Only Credit to Long/Short Hedged Credit	• Long-only credit, which faces challenges as tighter spreads and market complacency reduce opportunities, especially in U.S. index-linked credit and ETFs.	• Long-short hedged credit, which allows for greater flexibility, alpha generation, and mitigation from downside risk. • Focus on short-duration, high-quality coupon clippers and event-driven credit opportunities for lower volatility and enhanced returns.
Shift from Full Beta Equity Solutions to Long/Short Enhancer Solutions	• Full beta equity solutions, which offer broad market exposure but are more vulnerable to downturns, with limited downside risk mitigation.	• Long/short enhancer solutions that maintain core equity exposure while actively managing downside risk. • By incorporating long and short positions, these strategies could reduce volatility, limit drawdowns, and likely to deliver more consistent risk-adjusted returns.

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