QUARTERLY ASSET ALLOCATION

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April 2024: Getting Closer to Rate Cuts

Summary

The first quarter of 2024 was much stronger than expected. We had anticipated that weak global growth and tight monetary policy would nudge Canada and the U.S. into mild recessions, but we actually saw much more resilient consumer spending and GDP growth. The S&P 500 and TSX Composite continued to run higher (+10.6 per cent and +6.6 per cent, respectively in local currency) following already dramatic increases in 4Q23. Enthusiasm for U.S. equities has remained high and broadened out slightly to include energy, financials, and industrials, but the positive earnings revisions so far have still been primarily in the A.I.-focused technology names. More broadly, profitability continues to be under pressure for most companies and sectors, although investors are starting to look for an overall improvement into 2025, hence the positive market outlook. In Canada, the best performing sectors have been energy, health care, and industrials. Despite a weaker growth outlook through the remainder of 2024, we continue to see optimism towards improvements in 2025.

We continue to expect policy rate cuts in the second half of 2024, potentially starting in June. As we started 2024, we saw the U.S. financial markets pricing in 6-7 rate cuts through the year. Just a few months later, with a resilient economy, still relatively strong labour market, and stubborn inflation, many forecasters are floating the possibility that the Federal Reserve (Fed) may not even cut rates at all this year. According to the dot plot, four out of the 19 Fed officials are also in the 0-1 cut camp, up from three officials in December. Our U.S. economics team still maintains that the Fed will cut three times in 2024, but it also has the potential to defer those cuts, given the still strong U.S. economy and low unemployment rate. We have also shifted our forecast from expecting the mildest recession in U.S. history to a soft landing scenario, with a slight uptick in our U.S. GDP forecast, from 1.7 per cent to 2.1 per cent. In Canada, we see more justification for rate cuts, with weaker economic growth than the U.S., a higher and increasing unemployment rate, and recently better inflation numbers.

Key Takeaways:

- **U.S. Economy:** Expectations have shifted from this being the mildest recession in U.S. history to a soft landing scenario. Continuing economic growth with still low unemployment has investors excited about improvements in earnings and broadening out of the markets, despite the potential for the Fed to further delay the start of interest rate cuts.
- **Canadian Economy:** Despite some better than expected results through the first half of 2024, the economy is likely to continue weakening through the remainder of the year, driven by tight monetary policy. Some sectors are benefiting from the strength in the U.S., and certain commodity prices, but still high rates have slowed the Canadian economy much more than the U.S. economy.
- **Central Bank Decisions:** Our U.S. economics team expects three rate cuts in 2024, starting as early as June, as GDP softens to just under 1 per cent growth in Q2 and Q3. Although this is much more modest than the consensus expectations of six rate cuts coming into the year, more market watchers now seem to be more conservative, increasing the possibility of fewer or even no cuts in 2024 as the Fed has the luxury of pushing out that decision given that the economy has not been overly strained so far, and as employment has remained resilient. In Canada, our fixed income team is similarly looking for three rate cuts before the end of the year, although the possibility of receiving fewer is rising quickly. Many Canadian market watchers seem hopeful of more cuts, and starting sooner rather than later.
- **Canadian Equity Positioning:** Our forecast for the S&P/TSX Composite in 2024 is 22,000, implying a total return, including dividends, of just over eight per cent from the beginning of the year, although we foresee increased volatility. Future returns are expected to be mainly driven by P/E expansion and dividend payments, as valuations tend to rise when investors anticipate a new business cycle. The anticipated lower interest rate in the second half of the year should also support higher equity valuations. On the other hand, EPS growth faces pressure from the economic slowdown. Sectors with higher exposure to the U.S. and/or ones that are less affected by a slowdown in discretionary spending, notably info tech, industrials, and consumer staples, are expected to outperform, while the energy sector continues to benefit from an increase in global oil demand.

- **U.S. Equity Positioning:** Our U.S. investment strategy team has increased its 2024 EPS target for the S&P500 from US$225 to US$240. This should be driven by a broadening out of positive earnings revisions as more sectors are starting to show benefits from resilient U.S. GDP growth as well as the already positive gains from technology (specifically A.I.) through Q1. This translates to an S&P 500 target of 5,200, up from 4,850. This is now closer to our quantitative/technical analyst's unchanged target of 5,466. Both still imply positive, although modest, further gains in the S&P 500. Looking at sectors, our U.S. team likes earnings growth potential in info tech, industrials, and health care. Our U.S. strategist additionally calls out sectors that should benefit from our expectations of declining interest rates, being consumer staples, health care, utilities, and real estate.
- **Fixed Income Positioning:** With overall expectations for rate cuts on both sides of the border, both Canadian and U.S. fixed income markets stand to benefit from the currently elevated coupon rates and yields, and capital appreciation as bond prices start to rise as interest rates fall. This may favour longer duration bonds. With relatively tight spreads, investors are not currently being adequately rewarded for taking on the risks associated with high-yield bonds, and therefore we would favour either government or higher-quality corporate bonds.

Market Commentary

RJL Investment Strategy Team

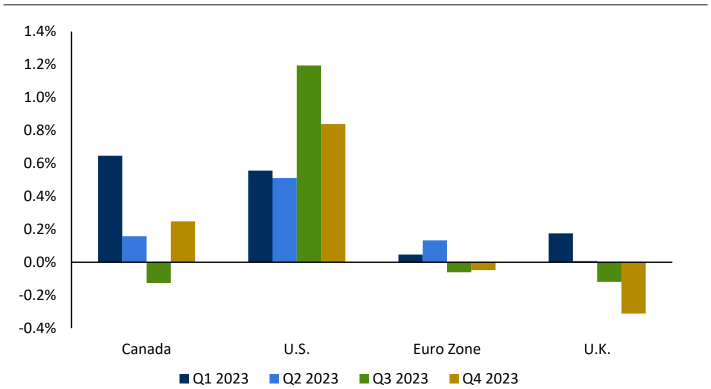
In our last quarterly report, we discussed how restrictive monetary policies had been used by many governments to tackle inflation brought on by the pandemic. As governments try to gracefully return to a more normal environment, we evaluate how much damage might have been done to the economy and consequently how quickly or significantly central bankers will lower rates, and to what ultimate levels. Wrapping up the first quarter of 2024, we have yet to see the recessions that we expected for Canada and the U.S., although some economic pressures we previously identified still exist. We continue to see indicators of the economies slowing, more so in Canada than in the U.S. We now expect the U.S. to avoid a recession, in favour of a soft-landing scenario, while we still see a higher likelihood of a recession developing in Canada.

The U.S. economy appears to be the strongest among developed markets, with solid GDP growth recorded in all four quarters last year (Chart 1). This can be attributed to resilient consumer spending, a substantial amount of government expenditure, and contributions from net exports, which we have not seen at this level in over a decade. Canada is also holding up relatively well, with a strong contribution from net exports. However, Canadian consumer spending's contribution to GDP growth declined significantly in 2023 to 0.9 per cent, compared to 2.8 per cent in 2021 and 2.7 per cent in 2022, falling below its long-term average of 1.4 per cent. Additionally, private sector investment tanked in 2023, dragging down overall GDP growth. In the euro-zone, GDP growth has been stagnant, with certain countries already experiencing recessions. While the recovery is slowly underway, there are expectations for the European Central Bank (ECB) to potentially start cutting rates before the U.S. In the U.K., according to Capital Economics, inflation is likely to drop below the two per cent target in 2024. With full-year growth of 0.1 per cent in 2023 and forecasted growth of 0.5 per cent for 2024, the Bank of England (BoE) could consider rate cuts to stimulate the economy soon.

So, what are the underlying reasons for the greater resilience of the U.S. economy compared to Canada and other developed markets? Perhaps the following factors, strongly associated with various components of GDP, support the recent U.S. economic "exceptionalism."

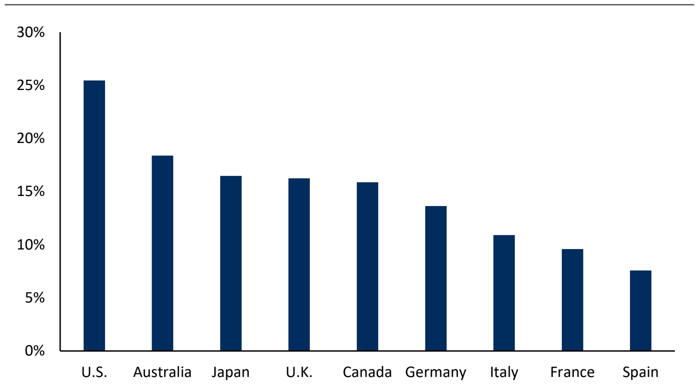
First, one of the main reasons behind the robust consumer spending in the U.S. is the accumulation of households' "excess savings" resulting from the COVID-19 pandemic. According to the International Monetary Fund (IMF), the U.S. government's fiscal response to COVID-19, including additional spending and forgone revenue to support households and businesses, surpassed that of other major developed economies (Chart 2). Additionally, U.S. households show a greater willingness to use up these excess savings compared to households in other major developed economies. This is evident in their low savings rate. Over the past two years, the average personal savings rate in the U.S. has been about 3.9 per cent, lower than its pre-COVID average of 5.8 per cent (1990 – 2022). In contrast, the savings rates in most other major developed economies have either remained the same or increased from their pre-COVID levels, with Canada now at 6.2 per cent and euro-zone countries typically above 10 per cent. Additionally, the proportion of U.S. households participating in the stock market, both directly and indirectly, reached a historic peak of 58 per cent in 2022. Given the ongoing 18-month bull market, this trend may have contributed to a psychological sense of wealth among households, therefore fostered their willingness to spend. This might help to explain why U.S. personal consumption expenditures remained robust in line with its long-term trend in 2023, unlike elsewhere. Nonetheless, we still anticipate a slowdown in U.S. consumer spending in 2024, as consumers allocate more of their income to servicing debt and current purchases potentially dampen future spending as bills become due.

Chart 1 - Real GDP Growth (q/q)



Source: FactSet; Raymond James Ltd.; Data as of December 31, 2023.

Chart 2 - Fiscal Stimulus During COVID-19 (% of GDP)



Source: IMF; Capital Economics; Raymond James Ltd. Percent of GDP are based on June 2020 World Economic Outlook Update for 2020.

Apart from consumer spending, another major driver of the U.S. economy is business investment. We expect it to play a more crucial role in supporting economic growth as 2024 progresses, transitioning from a consumer-centric to an investment-centric economy. This is also one of the main reasons why we anticipate the U.S. to achieve a softer landing than Canada.

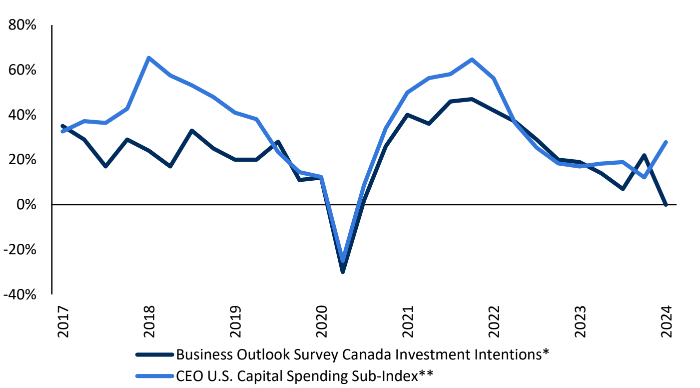
Given the similar interest rate environment, both the U.S. and Canada experienced weakened business investment intentions during the rate hike cycle. However, while the U.S. has shown greater resilience and has begun to rebound, investment intentions in Canada continue to weaken, currently standing at 0 per cent; below its long-term average of 16 per cent (Chart 3). According to the latest Business Outlook Survey conducted by the BoC, many Canadian firms are focusing their investment plans on simply repairing or replacing machinery and equipment to maintain current capacity due to soft demand, fewer binding capacity constraints, and high borrowing costs. On the other hand, several industrial policies, such as the CHIPS and Science Act and the Inflation Reduction Act, enacted by the federal government, have maintained a remarkably robust level of non-residential investment in the U.S. This explains the recovery in investment intentions even amidst otherwise high interest rates (further elaboration on this topic can be found in the U.S. Economic Outlook section). Business investment not only impacts current-year GDP growth but also serves as a forward-looking indicator of potential future growth rates. Therefore, we believe that business investment can serve as a larger cushion for the U.S. compared to Canada as the economy navigates the current landing.

The surge in U.S. oil exports is also noteworthy, as it has certainly benefited the U.S. economy, and we anticipate this trend will continue. Since the repeal of the crude oil export ban in 2015, U.S. crude oil exports have surged nearly eightfold, reaching an all-time high in 2023, even surpassing those of Canada (Chart 4). Unlike the U.K. and euro-zone countries, which rely on energy imports and are grappling with the energy crisis and soaring prices following Russia's invasion of Ukraine, the U.S. has managed to maintain relatively low domestic gasoline prices to tame inflation by ramping up production. Moreover, from a geopolitical perspective, the U.S. aims to supply oil and gas to Europe and other nations previously dependent on Russia. There is already strong evidence of this transition taking place. While there has been reduced demand from India due to its importation of discounted crude oil from Russia, this has been offset by increased demand from other regions, particularly Europe. Despite appearing contradictory to the clean energy pivot, we expect this trend to continue in the foreseeable future and act as a tailwind of the U.S. economy, given ongoing geopolitical tensions in the Middle East and efforts to combat inflation.

The positive news for Canada is that, despite the U.S. transitioning into a net crude oil exporter, its imports from Canada have been steadily increasing while its imports from OPEC have declined. This shift is due to the fact that imports from Canada mainly consist of heavy crude oil, whereas those from OPEC primarily consist of light and medium crude. Although the U.S. has increased its domestic production of light crude oil, it has not done so to the same extent for heavier crude oil. Additionally, many U.S. refineries are still designed to process heavy crude. The lower landed costs for crude oil imports from Canada, compared to other countries, along with the strategic alliance between the two nations, have encouraged U.S. imports of Canadian crude oil. Therefore, if this trend continues, we believe Canada's energy sector will also benefit.

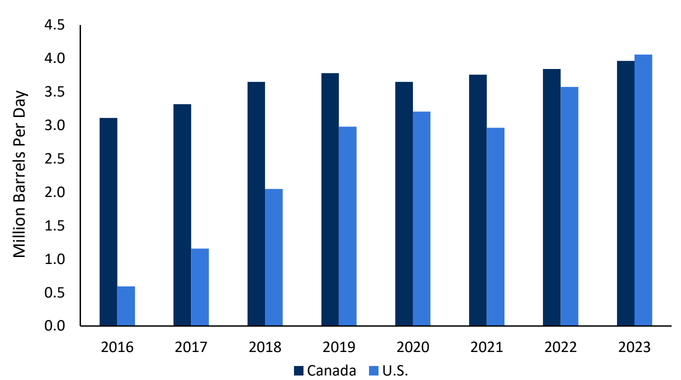
With a positive energy outlook, relatively stronger consumer spending, and business investments, driven by Fed legislation, we expect the U.S. economy to fare better than other developed countries during the slowdown period. This optimistic outlook on the U.S. should also perhaps provide some support to the Canadian economy, given the strong ties between the two countries.

Chart 3 - Contrasting Recent Business Investment Intentions: U.S. vs. Canada



Source: Bank of Canada; Business Roundtable; Data as of March 31, 2024. Percentage of firms expecting higher capital spending minus the percentage expecting lower; *Over 12 months; **Over 6 months.

Chart 4 - From Ban to Boom: U.S. Crude Oil Exports Reached All-time High in 2023

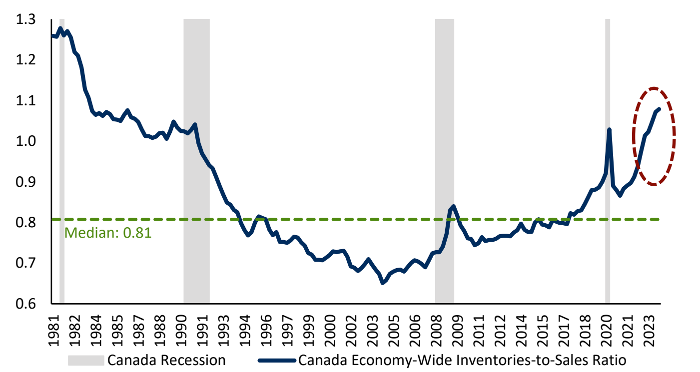


Source: Statistics Canada; The U.S. Energy Information Administration.

Now, with the economy in the U.S. and Canada having suffered less damage than expected, the question remains: how quickly and significantly will central bankers reduce interest rates? We anticipate the BoC initiating rate cuts at the June 5 meeting and continuing with subsequent cuts, totaling three reductions of 25 basis points each by the end of 2024, resulting in a year-end rate of 4.25 per cent. Meanwhile, in the U.S., the resilient economy affords the Federal Reserve more leeway to adopt a cautious stance on rate reduction, particularly in light of three consecutive 0.4 per cent month-on-month increases in core CPI throughout the first three months of 2024. Despite this freedom on the Fed's part, we still see progressive dovishness, with our U.S. Economics team still forecasting three rate cuts before the end of the year.

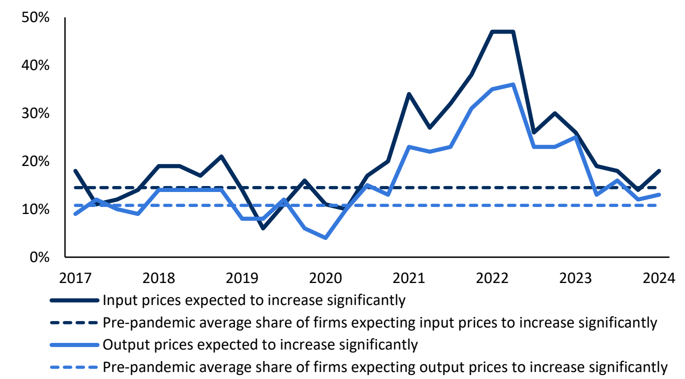
In our April Insights & Strategies report, we thoroughly discussed our belief that the Bank of Canada (BoC) should cut interest rates sooner rather than later. The rate hiking cycle has generally been effective, except in the shelter sector, and household financial health has shown signs of weakness, with a noticeable increase in missed credit card payments and consumer insolvencies. Furthermore, the inventory-to-sales ratio has continued to surge to 1.08, significantly surpassing its long-term median of 0.81. This suggests that manufacturing capacity and available products exceed consumer consumption levels (Chart 5). This observation aligns with our earlier discussion regarding the primary reasons for the decline in business investment in capital spending; notably softer demand. We believe the normalization process is well underway, as evidenced by both input and output prices not expected to increase significantly, returning to pre-COVID levels (Chart 6). Finally, firms in Canada have not been facing labour shortages since Q4 2023; in fact, the share of firms experiencing labour shortages now is well below the historical average.

Chart 5 - Canada's Inventory-to-Sales Ratio Continues to Surge, Far Exceeding Long-term Median



Source: Statistics Canada; Data as of December 31, 2023. Data range for long-term median: 1/1/1981 - 12/31/2023.

Chart 6 - Expectations for Significant Increases in Costs and Selling Prices Are Near Normal Levels



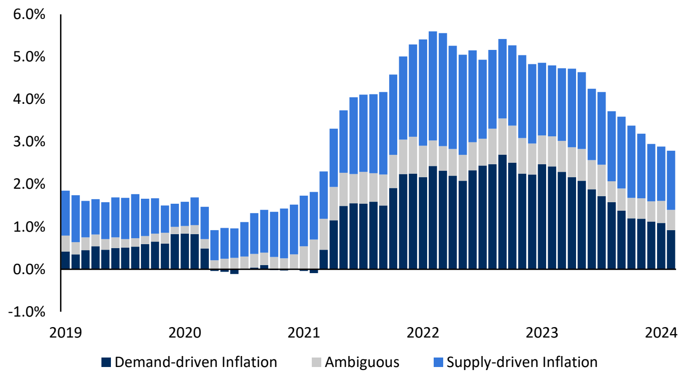
Source: Bank of Canada, Business Outlook Survey; Data as of March 31, 2024.

The situation in the U.S. is different. We see the rate hiking cycle as having been less impactful on consumer spending. One reason is the substantial amount of "excess savings" and households' willingness to spend, as discussed earlier. Another factor is that household debt levels are relatively low, given that U.S. households have been deleveraging since the 2008 global financial crisis. Coupled with the prevalence of longer-term fixed-rate mortgages, this makes U.S. households less susceptible to changes in interest rates. However, it's crucial to keep in mind that there are two sides to this equation—demand and supply. After all, the surge in inflation was initially caused by disruptions in supply chains during the COVID-19 pandemic. While it's currently not fully convincing that inflation driven by demand has been mitigated by elevated interest rates, the situation on the supply side of the equation may be somewhat more encouraging.

The Federal Reserve Bank of San Francisco categorizes contributions to the Fed's preferred inflation measure, core PCE, into supply-driven, demand-driven, and ambiguous categories (Chart 7). During the lockdown period from April 2020 to early 2021, we observed the absence of demand-driven inflation, while supply-driven inflation slowly built up. Soon after that, as shops and stores gradually reopened, supply-driven inflation spiked due to supply chain disruptions, hindering the ability to meet extremely pent-up demand. The situation became worse with Russia's invasion of Ukraine in February 2022. Currently, supply-driven inflation in February sits at 1.4 per cent, down from its peak but still higher than its historical average of 0.9 per cent. This suggests there's still some potential on the supply side to help reduce overall inflation. Despite recent geopolitical tensions in the Middle East and low water levels impacting volumes through the Panama Canal, the supply chain has mostly normalized over the past two years (Chart 8). Besides supply chain normalization, other factors also contribute to lowering supply-driven inflation, such as immigration and increased productivity. A post-pandemic immigration surge has allowed employers to fill roles at pay levels that have kept overall price growth in check. Additionally, increased productivity means maintaining labour hours unchanged while increasing unit supply, thus better meeting growing demand and reducing inflationary pressures.

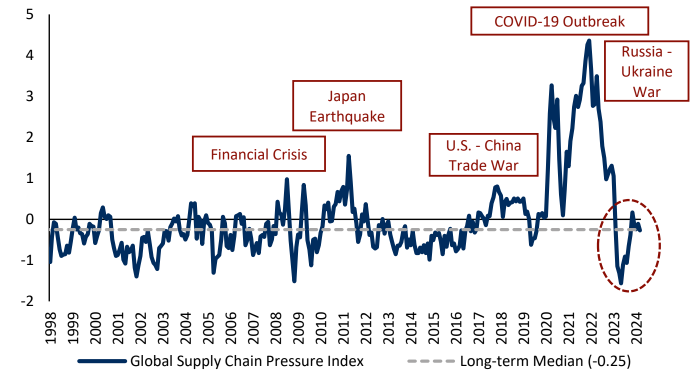
As 2024 progresses, we expect consumer spending to slow down, input costs to stabilize, supply chains to continue normalizing, and productivity to grow. Therefore, we still believe the fundamentals are consistent with inflation returning to the two per cent target on a sustained basis. Our U.S. economics team maintains that the Fed will cut rates three times in 2024, but the resilient U.S. economy does make the timing of rate cuts more uncertain than in other major economies, as it keeps increasing the potential to defer rate cuts.

Chart 7 - Supply- and Demand-Driven Contributions to Core PCE Inflation (y/y)



Source: Federal Reserve Bank of San Francisco; Data as of February 2024.

Chart 8 - Normalizing Supply Chain: A Key Driver of Lower Inflation in 2023



Source: Federal Reserve Bank of New York; Data as of March 31, 2024.

The strong performance seen in the equity market last year has extended into 2024. In the first quarter of this year, the majority of major global equity indices delivered solid positive returns, particularly led by the U.S. and Japanese markets, which currently trade at a premium, while the Chinese and Hong Kong equity markets remained relatively muted.

Several factors are behind the strong performance of U.S. equities in the first quarter. First, the stock market is benefiting directly from better-than-expected GDP growth, as the resilient economy provides a better outlook for corporate earnings. While tech firms have been leading in earnings growth, there's also optimism for broader growth across various sectors as the year progresses. Looking ahead, we anticipate that future increases may be primarily driven by earnings growth, considering the already elevated P/E levels. Second, the enthusiasm for A.I. continues to fuel that driver, with most tech firms attracting capital inflows and delivering strong performance. In terms of market breadth, the *Magnificent Seven* made a significant contribution of 60 per cent to the S&P 500 total return in 2023. Although they're still significant players in the first quarter, their contribution has declined to about 40 per cent. This change is partly due to the underperformance of Apple and Tesla. Even if we exclude these two from the Magnificent Seven, they accounted for only about 50 per cent of the S&P 500 total return. Therefore, we consider the difference here also indicating healthy broader market growth.

Across various sectors, most areas are experiencing improvements. Energy is seeing the most significant improvement, thanks to a less severe slowdown than expected in the manufacturing sector in the U.S. and China, which has boosted oil demand. Regarding market capitalization and equity style, large-cap and growth stocks continue to outperform. Growth stocks, in particular, are favoured because many tech companies fall into this category. Small caps are facing challenges, dealing with financial strain in a high-rate environment due to variable rate financing and lower margins. If the Fed remains cautious and continues to postpone rate cuts, it could mean further difficulties for small caps.

Moving forward, we anticipate that volatility in the U.S. equity markets will increase as much of the positive news has already been factored in. Moreover, the upcoming election and rate announcements are expected to introduce additional uncertainties to equity performance. Nevertheless, it's typical to encounter three to four intra-year pullbacks of five per cent and historically, the average maximum drawdown in a given year has been around -13 per cent.

Despite the absence of a semiconductor sector, the TSX Composite still delivered a solid return in the first quarter, primarily driven by strong performances in the energy and industrials sectors. Once again, the increasing global demand for energy products, particularly strong exports to the U.S., significantly boosted the energy sector's performance, accounting for approximately 17 per cent of the TSX Composite's weight. Additionally, the Industrials sector led the index performance, benefiting from its substantial exposure to the U.S., which represents almost half of the sector's revenue. Furthermore, given the weaker macroeconomic backdrop in Canada, we anticipate that the Bank of Canada may lower rates this summer. This could potentially benefit small caps, leading to further recovery this year.

Japan's Nikkei index finally surpassed its 1989 levels in February and has been keeping pace with U.S. equity indices over the past two years, even when measured in dollar terms. In addition to improved corporate governance, which has boosted corporate profits, Japan's equity market is also heavily weighted towards technology. This positioning should benefit from continuing A.I. enthusiasm in the coming quarters. Turning to developments in China, despite weak credit demand, we've witnessed increased activity since the second half of last year, buoyed by the government's supportive stance. Moreover, the government's injection of a rescue package into the stock market has led to a rebound since the end of January. While the immediate effects of the rescue package may be short-lived, the signals of support from policymakers and the improving narratives surrounding China's economy are somewhat encouraging. With this support, we anticipate that valuations may rise from their current low levels, potentially leading to further growth. European blue-chip stocks showed strong performance in the first quarter, whereas U.K. large caps fell behind. Due to the expectation that corporate earnings growth in Europe will continue to lag behind that in the U.S., given the relatively weaker economies in Europe and the smaller weight of the info tech sector, we anticipate that European equities may underperform compared to U.S. equities.

Table 1 - Global Equities Performance

Select Global Equity Indices	1Q24 (in LCL)	1Q24 (in USD)	1Q24 (in CAD)	2023 (in LCL)	2023 (in USD)	2023 (in CAD)	Current PE NTM	Historical PE Median	Premium (RED) / Discount (GREEN)
Canada									
S&P/TSX Composite	6.6	3.9	6.6	11.8	14.8	11.8	14.8	14.5	0.2
S&P/TSX 60	6.3	3.6	6.3	12.1	15.1	12.1	15.0	14.3	0.7
S&P/TSX Small Cap	7.9	5.2	7.9	4.8	7.7	4.8	14.7	16.8	-2.1
Canada Growth	7.5	4.7	7.5	15.8	19.0	15.8	21.7	18.2	3.5
Canada Value	5.3	2.6	5.3	5.1	8.0	5.1	11.7	12.1	-0.4
U.S.									
NASDAQ Composite	9.3	9.3	12.2	44.6	44.6	40.8	27.6	19.7	8.0
S&P 500	10.6	10.6	13.5	26.3	26.3	22.9	21.0	16.3	4.8
S&P Mid Cap 400	10.0	10.0	12.8	16.4	16.4	13.3	16.0	13.6	2.4
S&P Small Cap 600	2.5	2.5	5.2	16.1	16.1	12.9	14.7	14.9	-0.2
S&P Composite 1500	10.3	10.3	13.2	25.5	25.5	22.1	20.4	16.0	4.5
S&P Composite 1500 Growth	12.7	12.7	15.5	29.0	29.0	23.9	26.6	18.7	7.9
S&P Composite 1500 Value	7.6	7.6	9.8	21.6	21.6	16.0	16.1	14.0	2.1
Europe									
Euro STOXX 50 (Europe)	12.9	9.9	12.8	23.2	23.4	20.1	14.6	13.2	1.4
FTSE 100 (U.K.)	4.0	1.9	4.6	7.9	10.0	7.0	11.5	12.4	-0.9
CAC 40 (France)	9.0	6.6	9.4	20.1	24.4	21.0	15.1	13.4	1.7
DAX (Germany)	10.4	7.9	10.8	20.3	24.5	21.2	13.0	12.6	0.4
Asia Pacific									
Hang Seng (Hong Kong)	-2.5	-2.7	-0.2	-10.5	-10.5	-12.9	8.3	12.5	-4.2
Nikkei 225 (Japan)	21.5	13.2	16.2	31.0	22.6	19.3	21.2	16.6	4.6
MSCI China (China)	-2.5	-2.5	0.1	-11.2	-11.2	-13.6	9.2	10.7	-1.5
Major Aggregates									
World (Global)*	8.9	8.9	11.8	24.0	24.0	20.6	18.6	15.8	2.9
EAFE (DM ex U.S. & Canada)*	6.0	6.0	8.8	18.4	18.4	15.2	14.4	13.5	0.9
EM (Emerging Markets)*	2.2	2.2	4.8	9.0	9.0	6.1	12.2	11.7	0.5

Source: FactSet; Raymond James Ltd; Total returns, data as of March 31, 2024. LCL: listed in local currency. Historical P/E Median: 1/1/2000 – 3/31/2024. *Indices are represented by their corresponding iShares ETFs, serving as proxies.

Canadian Economic Outlook

RJL Investment Strategy Team

Canadian Economy Stronger Than Expected, but Employment is Weakening

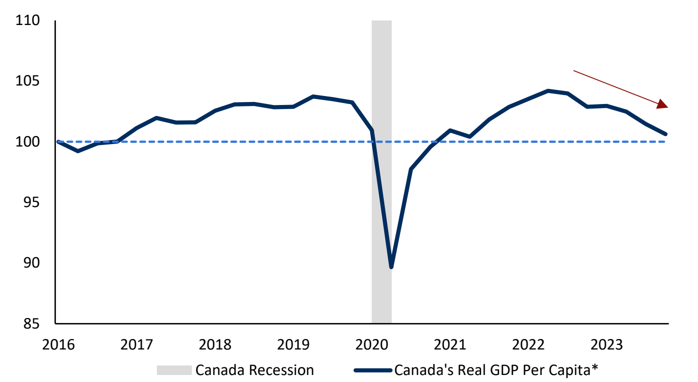
Gross domestic product (GDP) growth in January (+0.6 per cent m/m) and February (flash estimate of +0.4 per cent m/m) was better than previously expected, and broadly-based, rising in 18 of 20 sectors, even after a downward revision on December's number (to -0.1 per cent m/m, from 0.0 per cent). According to the Department of Finance's new *Budget 2024*, annualized q/q growth in Q1 is estimated at 3.5 per cent, versus the BoC's estimate of 2.8 per cent. Part of the strength in Q1 came from the end of a (educational) public sector workers' strike in Quebec (that contributed +1.9 per cent m/m to the public sector GDP component in January), and an unseasonably mild winter, so there's still reason to expect that this strength might not continue into Q2.

As growth slows through the remainder of the year, the BoC is forecasting 2024 average annual real GDP growth of 1.5 per cent (up from a +0.8 per cent forecast in January) versus actual growth of 1.1 per cent in 2023.

As we describe in a subsequent section, the Canadian landscape is characterized by high rates of immigration. One metric that has been widely discussed is GDP per capita. While rapid population growth (+1.3 million people in 2023) has boosted GDP, which increased 1.1 per cent in 2023, dividing by the total population, the GDP per capita metric indicates that economic output actually declined (Chart 9). This leads to an additional discussion about the decline of productivity in Canada.

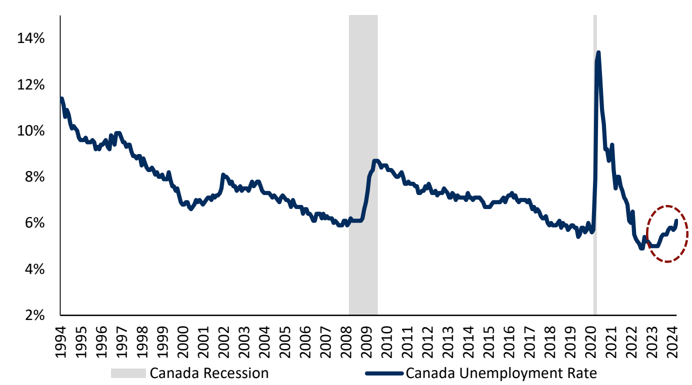
While economic growth has general been good, employment actually decreased (-2,200) in March as the employment rate fell for the sixth consecutive month to 61.4 per cent, and the unemployment rate rose to 6.1 per cent from 5.8 per cent in February (Chart 10). This is up from 5.1 per cent a year ago, and should indicate to the BoC that cracks in the economy have begun to show. . It is worth noting that although there were 324,000 (+1.6 per cent) jobs created over the last year, the increase in the labour force (population aged 15+) of 1 million (+3.2 per cent), pushed up the unemployment rate.

Chart 9 - Canada's Real GDP Per Capita* Growth Is Declining



Source: Statistics Canada, Raymond James Ltd.; Data as of December 31, 2023. *Real GDP per capita calculation: gross domestic product at market prices / population aged 15 to 64 years.

Chart 10 - Canada's Unemployment Rate Jumps to 6.1% in March



Source: Statistics Canada; Data as of March 31, 2024.

Recession Probability

In Canada, we look to the C.D. Howe Institute Business Cycle Council as the arbiter of if and when the country is in recession. The council defines a recession as a period of pronounced, pervasive, and persistent decline in aggregate economic activity. We also generally associate a recession with layoffs and a significant increase in the unemployment rate. We have had many economic downturns over the decades that have not necessarily met all the magnitude, length, and scope criteria required to define a recession, such as the bursting of the dotcom bubble in 2001 and the 2014–15 oil price shock. Unfortunately we cannot always determine if we have been in a recession until it is over. Our expectation continues to be for a mild recession, towards the mid to end of 2024.

Rate Cuts

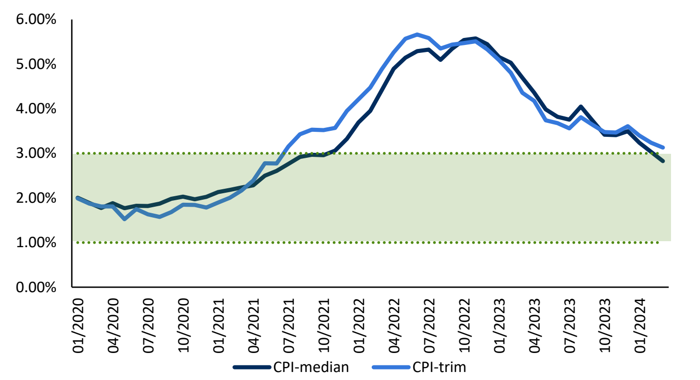
We expect the Bank of Canada (BoC) to start cutting its policy rate at the June 5 meeting, and continue with cuts, for a total of three 25 bp cuts by the end of 2024, to end the year at 4.25 per cent. We see recent inflation data allowing for such a move, and although Q1 GDP growth looks strong, we would expect some weakening into Q2, and with the unemployment rate rising, we see sufficient prompting for the BoC to cut. Still, the BoC has seen little urgency to act to this point, despite the continuing pressure that we have previously described building as mortgage renewal periods will continue to force more Canadian mortgage holders to evaluate their discretionary spending.

Inflation

March's consumer price index (CPI) showed 2.9 per cent growth from a year ago. This was in line with expectations, and follows BoC forecasts of seeing inflation below 2.5 per cent in the second half of 2024, before hitting the 2 per cent target in 2025. We had already been expecting the BoC to start a rate cutting cycle in the second half of 2024, but these results set the stage well for the first cut at the June 5 meeting. The question then surfaces as to if/when we could expect additional cuts through the remaining meetings in 2024, being July 24, September 4, October 23, and December 11.

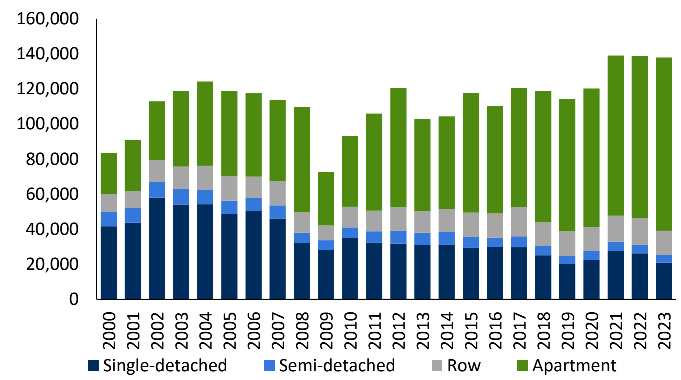
We have observed a consistent decline towards the two per cent goal in the year-over-year growth of CPI-median and CPI-trim, which are the BoC's preferred measures of core inflation, for three consecutive months. In March, CPI-median and CPI-trim hit 2.8 per cent and 3.1 per cent, respectively, marking a level not witnessed since mid-2021, and essentially within the BoC's one to three per cent control range (Chart 11). We also made the point in our April Monthly Insights & Strategies report that we are already at or below the BoC's two per cent target if we exclude the elevated shelter CPI component. Our rationale for this approach is that although elevated interest rates are meant to slow the economy and bring down inflation, we see the current rate environment actually keeping that shelter component elevated.

Chart 11 - Clear Signs of Canada's Core Inflation Cooling Down Year-To-Date 2024



Source: Statistics Canada; Raymond James Ltd.; Data as of March 31, 2024.

Chart 12 - Apartments Were the Only Dwelling Type to See an Increase in Starts In 2023



Source: CMHC; The sum total of housing starts in Canada's 6 largest CMAs, inclusive of all housing tenures (i.e., freehold, condominium, rental and co-op).

Immigration

We have previously discussed immigration, specifically as Canada's liberal immigration and temporary visa policies have significantly increased the number of people in the country, while housing starts have been weak, providing the ingredients of the current and worsening housing (affordability) crisis. Officially, Canada's population to start 2024 was 40.8 million, up 3.2 per cent in 2023, the highest growth rate since 1957. Excluding temporary migration, counting only natural changes and permanent residents, Canada's population would have been up only 1.2 per cent, to 38.1 million.

Most recently, Canada's immigration minister, Marc Miller, announced the intention of bringing the share of temporary workers down to five per cent of the population over the next three years, from a current level of 6.5 per cent or 2.67 million people (as of January 1), which has doubled in the last two years. With the plan still taking shape, and still high immigration rates before the policies would start to take effect in 2025, we could be starting the plan from a position of 3.1 million temporary residents, representing 7.5 per cent of the population. Assuming Canada continues with its plan to take in 500,000 permanent residents each year (472,000 were added in 2023), we would have to remove approximately 250,000 temporary workers each year to achieve that five per cent goal.

There's a few potential impacts to consider here. This much more restrictive immigration stance could impact the BoC's population growth forecast that was expected to keep shelter inflation above four per cent until at least 2026. Offsetting this however could be food costs, as temporary workers that support Canada's farming sector might then be in much tighter supply, impacting the supply and costs of food production.

Housing Crisis Continues

Lower population growth might also help reduce the demand for additional housing units, and specifically rental units, although as we have already pointed out in previous reports, achieving the levels of affordability that the government is targeting would require new housing starts to be roughly triple where they currently are. The Canada Housing and Mortgage Corporation (CMHC), in its Spring 2024 Housing Supply Report, noted a seven per cent surge in apartment (purpose-built and condominium) construction, but a 20 per cent decline in single-detached starts (Chart 12). The unprecedented demand for rental units, driven by record immigration, pushed rental construction to new highs. Despite a slew of recent announcements by the federal government in support of affordability and availability measures, we do not see any immediate relief.

U.S. Economic Outlook

Eugenio Alemán - Chief Economist; Giampiero Fuentes - Economist

We are normally reluctant to use trendy phrases to explain either our good and/or bad calls regarding the U.S. economy. However, saying that 'this time is different' is more than fitting today to understand what has happened since the recovery from the COVID-19 pandemic. U.S. economic growth surprised friends and foes during 2023 as both the post-pandemic normalization process continued and the Federal Reserve's (Fed's) attempt to bring down the surge in inflation contributed to the asynchronous performance of the U.S. economy. During a typical economic cycle, as the economy hits the peak of the cycle, the Fed increases interest rates to slow economic activity to avoid inflation becoming a problem down the road. That is, at the peak of the cycle, resources are fully utilized and thus any further pressure on the utilization of these resources typically puts upward pressure on the price of these resources. However, this is not what happened at the end of the pandemic. The truth is that prices started to increase for several reasons, but none related to the actual workings of a typical economic cycle.

Navigating the Perfect Storm

First, the total collapse of global production during the pandemic reduced the supply of goods while at the same time supply chain issues made the remaining goods very scarce and the acquisition of them extremely expensive. This meant that the increase in the price of the goods was not due to high economic growth but more to the inability to acquire goods cheaply and in a timely fashion. Second, the decline in the labour force participation rate due to the fear of contagion, plus all the extra help given by the federal government, meant that firms needed to entice workers to return to the labor force through increases in salaries/wages, especially in the service sector of the economy. This also contributed to a further increase in the cost of production and thus in the price of goods and services. Third, the immense amount of federal income transfers during the Trump and early Biden administrations helped Americans accumulate enormous amounts of money at a time when it was almost impossible to spend because the economy was shut down. This money was accumulated during the pandemic and contributed to putting even more pressure on prices as demand for goods skyrocketed during the pandemic, while demand for services surged once the U.S. economy reopened after the COVID-19 pandemic ended.

Enter the Federal Reserve

Since price stability is one of the two mandates the Fed has, the other being low unemployment, and one of the only instruments the Fed has to bring down prices is by conducting monetary policy to slow down economic activity, the Fed embarked on one of the most aggressive interest rate campaigns in history to rein in prices.

However, the truth is that traditional monetary policy did not work, and it is still not working. The reason for this is that this wasn't a normal cycle where a reversal in monetary expansion, i.e., higher interest rates, would help keep economic growth contained or slow down economic growth to keep inflationary pressures at bay. This cycle was created by the COVID-19 pandemic recession as well as by a massive fiscal expansion. Once the production, supply chain, and labour scarcity generated by the COVID-19 pandemic recession were over, the federal government should have taken back, if not completely, at least partially, the fiscal expansion created during the COVID-19 pandemic recession. Of course, this would have been political suicide, so it was not even discussed, let alone implemented.

But monetary policy has not been benign during this tightening campaign. The housing markets felt the pain and real residential investment remained in recession territory for nine consecutive quarters. Furthermore, last year's banking crisis was also triggered by the inability of some banks to adapt quickly to much higher interest rates by adjusting their investments appropriately. Thus, regulators had to intervene and provide liquidity to stop runs on vulnerable institutions.

Waterfall of Fiscal Spending

As if this was not enough, after the end of the COVID pandemic, the federal government engineered an industrial policy that would keep non-residential investment surprisingly afloat even under otherwise very high interest rates. Both the passing of the Creative Helpful Incentives to Produce Semiconductors (CHIPS) Act, as well as the Inflation Reduction Act (IRA) and, to a lesser extent, the Infrastructure Investment and Jobs Act (IIJA), helped reduce the impact of much higher interest rates on non-residential investment and have contributed to keeping the U.S. economy afloat.

The IIJA is considered a generational investment to rebuild America’s infrastructure, authorizing US$1.2 trillion for transportation and infrastructure spending over five years. The bill included US$550 billion in new federal spending, with US$110 billion for roads and bridges, US$47 billion for energy policy, US$65 billion for high-speed internet access, US$56 billion for airports, and much more. The IIJA was a key component of President Biden’s agenda, but after witnessing the supply chain disruption and shutdowns during the COVID-19 pandemic, as well as the increase of global geopolitical risk, additional efforts were deemed crucial to both U.S. national defense and other critical sectors of the economy.

While semiconductors were invented in the U.S., 90 per cent of the world’s supply and 100 per cent of the most advanced chips are currently manufactured overseas. Therefore, two industrial policy statutes were passed in 2022. First, the IRA provides incentives and uncapped tax credits for sustainability projects, clean technology, EV and battery production, and renewable energy such as solar and wind. Second, the CHIPS Act provides US$39 billion in direct spending on chip production and 25 per cent uncapped advanced manufacturing tax credits.

The benefits of these large investments trickle down to other sectors of the economy through a process called the government expenditures multiplier. The multiplier measures how much each one dollar increase in spending boosts the country’s economic output, essentially measuring the effectiveness of the government’s effort. While it is very complicated to accurately measure this number due to the multitude of factors impacting the economy at any given time, preliminary data suggests that the three packages have had, and will continue to have, an outsized impact on the U.S. economy over the next several years. While the U.S. government hasn’t released many funds yet, private companies have already either announced or started making very large investments in building new factories in the U.S. with hopes of benefiting from the various government incentives. Since the pandemic started, the combination of these three packages has pushed U.S. manufacturing construction spending higher by 175 per cent to US$213 billion per year. Moreover, construction put in place for the manufacturing of computers and electronics has increased by more than 1,000 per cent over the last two years.

Conclusion

The fiscal policies implemented during the pandemic recession helped individuals and firms survive some of the most perilous times in more than a century and helped keep the economy going during the recession. However, many individuals could not spend the funds due to lockdowns and supply chain disruptions, pushing the personal savings rate higher than 30 per cent during the early stages of the pandemic. However, as the limits imposed during the pandemic were lifted and supply chains normalized, the U.S. consumer roared back with lots of excess savings ready to be deployed.

After inflation reared its ugly head during the recovery from the pandemic recession, the Fed could not stand idle and, while late, started raising interest rates. However, few sectors reacted to the increase in rates—mostly residential investment and the housing market—while other sectors were rescued by the three federal government acts that helped keep non-residential investment from reacting to higher interest rates.

The stimulus payments in the hands of individuals and firms, coupled with the effects of the three government acts, rendered monetary policy ineffective. The Fed has increased interest rates to stall and prevent a new monetary cycle from reigniting the inflation fire, but it is currently refraining from further actions until all of these excesses are flushed out of the system.

Consequently, our outlook no longer anticipates a mild recession for the U.S. economy. However, we still expect economic activity to slow down considerably over the next several quarters as high interest rates will continue to keep lending contained. Therefore, while our revised expectations have moved from the mildest recession in U.S. history to a soft landing, our full-year GDP forecast for 2024 has only moved from 1.7 per cent to 2.1 per cent.

Canadian Equities

RJL Investment Strategy Team

In the first quarter of 2024, Canadian equity markets saw a broad total return of 6.6 per cent, following a solid performance of 11.3 per cent for the entire previous year. Sectors carrying the most weight in the S&P/TSX Composite index outperformed or kept pace with the overall market, with energy (+13.1 per cent) and industrials (+11.1 per cent) standing out in particular.

While U.S. large caps are currently trading at a high premium, Canadian equity indices are generally in line with their long-term historical averages. The street consensus for 2024 EPS growth is around four per cent, matching the long-term average pace, after the nine per cent decline in 2023. With our outlook pointing towards an economic slowdown, we anticipate mounting pressure on earnings as the year unfolds. The impact of higher rates will continue to trickle down, weighing on consumption and affecting revenue, along with the added burden of elevated interest payments on financing. However, considering that EPS growth is forward-looking and there are some early signs of strength in earnings growth within sectors like consumer discretionary, consumer staples, industrials, info tech, and a rebounding earnings growth in energy, collectively representing about 50 per cent of the S&P/TSX Composite weight, we anticipate that EPS growth is likely to remain relatively flat this year. That being said, future returns are likely to be driven by P/E expansion and dividend payments. With our expectation of three rate cuts by year-end, a more favourable rate environment could lower discount rates applied to earnings and help support calculations on the present value of future cash flows. Also, as we enter the second half of 2024, investors will be counting on the start of a new business cycle, providing support to valuations.

Our forecast for the S&P/TSX Composite in 2024 is 22,000, implying a total return, including dividends, of just over eight per cent from the beginning of the year. With the first quarter already generating a price return of 5.7 per cent, our target suggests still modest upside, although the expectation of a more volatile market could provide selective buying opportunities. BoC announcements and economic indicator data can heavily impact the market, but keep in mind that volatility is normal. It is not unusual to see intra-year drawdowns in the 10 per cent range, while still enjoying positive returns for the full year. So, it's important to stay invested as it's nearly impossible to time market tops and bottoms.

When it comes to sectors, given the improved economic conditions in North America, especially in the U.S., we anticipate that sectors with higher exposure to the U.S. will outperform the overall index. Among the sectors mentioned earlier, those with resilient earnings growth—info tech, industrials, and consumer staples—have the highest revenue exposure to the U.S. The ongoing enthusiasm for artificial intelligence and substantial investments in industrials and manufacturing may bolster the performance of the info tech and industrials sectors in the coming quarters. Meanwhile, consumer staples should hold up well even during a slowdown in consumer spending. Additionally, the energy sector has been benefiting from the global increase in oil demand, and we anticipate this trend to continue. For more detailed commentary on each sector, please refer to the sector ratings table on next page.

Table 2 - S&P/TSX Composite Sector Ratings Table

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Communication Services	3.6%	-3.9%	-8.5%	14.4x	15.8x	MARKET WEIGHT	▼ UNDERWEIGHT

The Communication Services sector is currently trading at a slight discount, but its performance lagged behind the TSX Composite in the first quarter. The economy's unexpected resilience delayed the onset of the rate cut cycle, which is not favourable for a capital-intensive sector like Communication Services. While dividends remain decent, the rebound in government bond yields has made them less attractive. Increased competition among major players in this sector has also led to a decline in revenue on a per-user basis. With dominant players already established in the Canadian market, gains for one are likely to translate into losses for others, resulting in modest expected growth in new users. The sector may find itself in a better position in the second half of the year when the BoC begins to lower the interest rates, but questions remain about whether intensified competition can be mitigated.

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Consumer Discretionary	3.6%	11.0%	4.5%	15.2x	14.3x	UNDERWEIGHT	▲ MARKET WEIGHT

The Consumer Discretionary sector is currently trading at a modest premium and slightly trailed behind the TSX Composite in the first quarter. With the economy slowing down, we still expect discretionary spending to shrink and consequently have a negative impact on firm performance, though not as significant as we expected at the beginning of the year. However, the sector's substantial exposure to dollar stores and quick service restaurants, known for weathering various economic cycles, adds a layer of defensiveness.

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Consumer Staples	4.3%	12.2%	4.0%	16.6x	15.8x	OVERWEIGHT	OVERWEIGHT

The Consumer Staples sector is currently trading at a modest premium and slightly lagged behind the TSX Composite in the first quarter. Given the macroeconomic backdrop of a slowdown, this sector stands to benefit, as its main industries—such as grocery stores, gas stations, food production, and pharmacies—are essential for everyday life. Therefore, we continue to favour this sector, but the significant exposure to U.S. gas stations may need some attention as fuel margins are expected to normalize over the next few quarters.

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Energy	17.3%	6.3%	13.1%	13.0x	14.7x	MARKET WEIGHT	▲ OVERWEIGHT

Energy is currently trading at a slight discount. It is a highly cyclical sector thus sensitive to global economic conditions. Notably, it has seen significant improvement due to a less severe slowdown than anticipated in the U.S. and Chinese manufacturing sectors, resulting in increased oil demand. Strong exports of heavy oil to the U.S. have also boosted the sector's performance. Looking ahead, with OPEC+ production cuts and ongoing geopolitical tensions, along with the need to refill the U.S. strategic reserve, we anticipate support on oil prices. Additionally, Canadian oil and gas companies have been reducing debt and improving cash flow, leading to more share buyback plans by major players, benefiting investors.

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Financials	31.0%	13.9%	5.5%	10.7x	11.4x	MARKET WEIGHT	MARKET WEIGHT

The Financials sector is currently trading at its historical median P/E level, with performance aligning closely with the TSX Composite in the first quarter. Banks, the largest component of the sector, have actually benefited from higher and longer interest rates in both the U.S. and Canada, from the perspective of net interest margins. While rate cuts in the second half of the year may potentially squeeze their net interest revenue, easing pressures on the loan books would allow banks to further reduce provisions for credit losses. Additionally, as the economy continues to slow down, we anticipate fewer individuals will have discretionary funds to spend on insurance, and potentially leading to withdrawals. Asset management firms may face increasing volatility from the markets for the remainder of the year. Therefore, we maintain a market weight on the Financials sector overall.

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Health Care	0.3%	18.3%	18.4%	6.4x	16.3x	NO RATING	NO RATING

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Industrials	14.2%	11.9%	11.1%	23.8x	15.7x	MARKET WEIGHT	▲ OVERWEIGHT

Industrials are currently trading at a rather high premium, but this can be justified to some extent by its decent EPS growth, and we anticipate this trend to go on for a while. The recent gains are attributed to its significant exposure to the U.S., which accounts for almost half of the sector's revenue. We expect the resilient U.S. economy and the ongoing trends in clean energy and supply chain strengthening in North America to continue benefiting the railway industry. Additionally, the general waste collection industry within this sector can support performance when economic growth slows down in the second half of the year by adding some defensiveness.

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Information Technology	9.0%	69.2%	4.8%	32.7x	22.3x	MARKET WEIGHT	▲ OVERWEIGHT

The Information Technology sector is currently trading at higher P/E multiples compared to its historical median, although it has come down from its peak at the end of 2021. Importantly, it has justified these high P/E multiples through robust EPS growth, which we still see as growth at a reasonable price. We anticipate that the enthusiasm for A.I. will continue to drive the sector's outperformance. With over 50% exposure to the U.S., it's positioned to sustain its performance even as slowdowns become more noticeable elsewhere. We expect growth to pick up in the second half of the year when the rate cut cycle starts. However, the absence of the fastest-growing industry, semiconductors, in the TSX Information Technology sector is likely to result in underperformance relative to its U.S. counterpart.

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Materials	10.4%	-1.3%	5.8%	20.3x	16.9x	MARKET WEIGHT	MARKET WEIGHT

The Materials sector is currently trading at a high premium because of its weak earnings growth since late 2022, and it performed in line with the TSX Composite in the first quarter. In the short term, we anticipate that precious metals, which account for over 40% of the sector's revenue exposure, will continue to perform well due to recent geopolitical tensions in the Middle East and the need to hedge against inflation in the U.S., given concerns about its resurgence. Later in the year, depending on the economic outlook, higher uncertainties generally boost the demand for gold, and vice versa. Declines in real yields and weakening of the USD will also be supportive. Regarding base metals, their short-term performance heavily depends on global economic growth, which is currently slowing down. However, in the longer term, demand remains bullish due to government support for clean energy.

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Real Estate	2.4%	6.9%	1.7%	14.8x	14.7x	MARKET WEIGHT	▼ UNDERWEIGHT

The Real Estate sector is trading at its historical median P/E level but didn't keep pace with the TSX Composite in the first quarter. The main reason for this lag is the delayed rate cuts, which continue to put pressure on developers' financial conditions. Non-residential REITs may encounter greater challenges during the economic slowdown, whereas residential REITs may see better prospects as the rate cut cycle starts in the second half of the year and is bolstered by strong demand. Investors need to be selective as to the type of exposure they are getting in the real estate sector.

Sector Name	Sector Weight	2023 Total Return	1Q24 Total Return	Current P/E NTM	Historical Median	1Q24 Rating	2Q24 Rating
Utilities	3.9%	0.2%	-1.1%	18.5x	17.9x	OVERWEIGHT	▼ MARKET WEIGHT

The Utilities sector is currently trading slightly above its historical median P/E level, but its performance continued to fall behind the TSX Composite in the first quarter. Several factors contribute to this. First, the economy proved to be more resilient than expected, delaying the start of the rate cut cycle, which isn't favourable for a capital-intensive sector like Utilities. Second, the dividend yield of utility companies became less attractive as government bond yields rebounded close to 4%. Third, drought in western Canada and other unusual weather conditions led to a significant decline in electricity generation and additional costs for importing more power. However, we still anticipate utilities to stabilize as the BoC begins to lower the policy rate in this summer, and we still see long-term opportunities in Utilities related to the clean energy trend and rising electricity demand.

Source: Raymond James Ltd. Historical P/E Median: 1/1/2000 – 3/31/2024.

U.S. Equities

Tavis McCourt, CFA - U.S. Institutional Equity Strategist

Q1 was another strong quarter for U.S. equities, though quite narrow, with growth and large cap indexes doing far better than small cap and value indexes, as higher rates in Q1 impacted many areas of the market, while continued investor fervor over the benefits of artificial intelligence sent a handful of companies meaningfully higher, driving overall indexes higher in the quarter. Equity performance has been narrow, but EPS growth has been very narrow as well as we enter the sixth consecutive quarter of EPS being down y/y for the average public company.

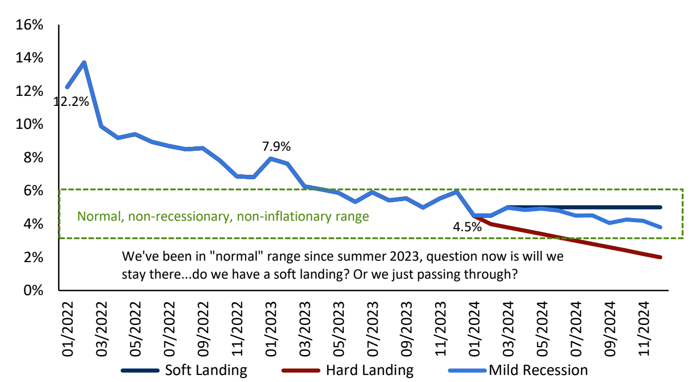
Equities have increasingly been pricing in a “soft landing” in the economy since October of last year, and the earnings trend is expected to turn broadly positive as this year progresses. Economically in Q1, it appears as if the economy is decelerating a bit as consumer spending was a bit softer than expected the first two months of the quarter, though an optimist would say this is related to weather than any meaningful change in spending outlook as job growth and wage gains remain strong enough to expect consumer spending to continue at the current pace (Chart 9).

Our overall views of 2024 are that inflation will progress lower, rates will also be reduced (3.5-4.0 per cent 10-Year Treasury by year-end after a small rise in 1H24), and that U.S. equities will be somewhat flattish from current levels, with overall corporate profitability (EPS) relatively flattish y/y (but improving through the year), but with strong P/E multiples reflective of the lower interest/discount rates, with the financial markets looking forward to improved growth in 2025. We note S&P 500 index level EPS will likely be up due to the EPS impact of a handful of AI-impacted stocks (Chart 10).

The biggest influence in U.S. equity markets will likely be how quickly the Fed recognizes that the inflation problem has been resolved and that it’s time to lower rates. By some measures, specifically replacing shelter cost inflation with more real-time data, we could argue that we are already near the 2.0 per cent target, and at a minimum we are on our way there. Our biggest concern that would prevent rate cuts, which will be needed to support the economy and financial markets, would be a spike in commodity prices, likely in the energy space, as a result of supply disruptions and/or geopolitical tensions. The second biggest influence in U.S. equity markets is the hundreds of billions of investment dollars that are now being put to work to develop Artificial Intelligence products and services. The success of this investment is still uncertain, and any delay or failure to develop enough productivity enhancing applications from all this AI spending will surely create a hangover. If applications drive significant productivity, it likely ushers in a far better future for equities over the next several years than would have existed without AI.

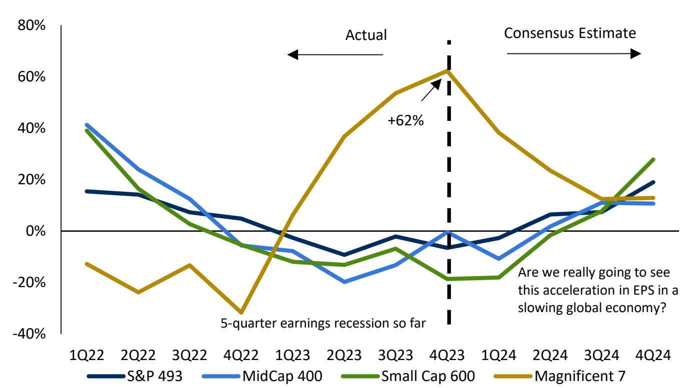
Our outlook for 2024 is for a base case of a modest slowdown in the economy (but no major labour market dislocation), with consensus EPS expectations pretty flattish broadly, but with AI-driven large cap names keeping S&P 500 EPS positive on the year. After a slight increase in rates in 1H24, we should see rates coming down in this scenario in 2H24 providing some cushion for the market as EPS likely comes in a little disappointing relative to consensus expectations of a significant H2 ramp. In this environment, rate sensitive sectors should outperform (staples, health care, utilities, real estate) along with secular growth, though any positive or negative change in the market’s expectations for AI is likely to impact tech and growth stocks more than rates.

Chart 13 - Consumer Spending Is Slowing, Will It Stabilize Now Or Continue To Slide



Source: FactSet, Raymond James Research.

Chart 14 - Consensus Quarterly YoY EPS Large, Mid, Small And “Magnificent 7”



Source: St. Louis Federal Reserve, Costar, Raymond James Research.

Technical Analysis

Javed Mirza, CMT, CFA - Quantitative/Technical Analyst

Summary

Looking Forward: Seasonality suggests another positive quarter is looming for equity markets, within the context of the "boring middle" of a new 4-year cycle. The Vanguard Total Stock Market ETF (VTI) historically supports positive seasonality through April and May, before stalling in June (Exhibit 1). The VTI is composed of a variety of large, mid, and small cap stocks in both the growth and value categories. This implies the path of least resistance for equity markets is likely to remain higher through the bulk of Q2.

Our technical work suggests that equity markets are in Phase 2 of the market cycle model, which we view as the "boring middle" as the underlying economy begins to show signs of strengthening and is typically marked by leadership in information technology, industrials, and basic materials. As a result, the bulk of our best ideas for Q2 2024 (see below) are direct beneficiaries of this potential sector rotation. Our technical work indicates that the equity market correction that developed from late July – October 2023 marked a transition from Phase 1 to Phase 2 of the market cycle model.

Our longer-term cycle work supports a 2024 year-end S&P 500 target of 5,466 or 14.6 per cent upside from the December 29, 2023 close. The fourth year of the Presidential cycle typically sees choppy price action from January to May (see red box, Exhibit 2); we view this weakness as an opportunity to add equity exposure as this is historically followed by a glide path higher into the end of the year (see blue arrow, Exhibit 2). Our longer-term cycle work supported a 2023 target for the S&P 500 of 4,864 or 27 per cent upside from the December 2022 close. The S&P 500 closed out 2023 near 4,770, for a yearly gain of 24 per cent.

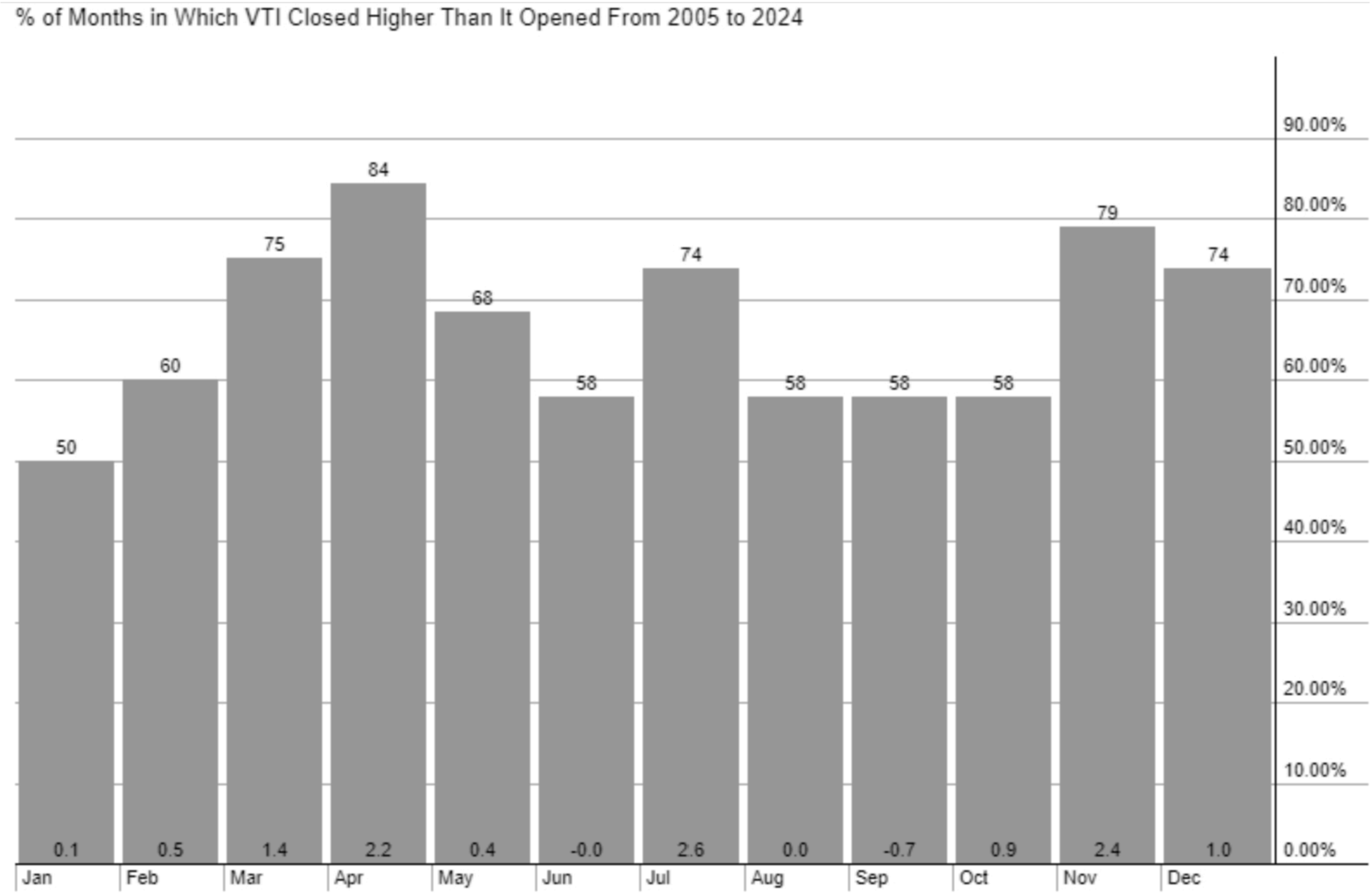
Our longer-term cycle work suggests a new 4-year cycle (3-5 year cyclical bull market) began at the October 13, 2022 low and has upside, by time, into H2 2025/H1 2026. We are calling this new 4-year cycle the higher for longer (HFL) cycle as our technical work strongly suggests this cycle has ushered in a long-term secular shift to higher yields.

Tactical Ideas - Q2 2024

- *Gold Miners beginning to glitter* – Materials – materials remain one of our favoured sectors for Phase 2 of the market cycle model. Seasonality remains favourable versus the S&P 500 in Q2 for the VanEck Vectors Gold Miners ETF (GDX, Exhibit 3). We feature the strengthening technical profile of the GDX (Exhibit 4).
- *Seasonality supports real estate "catch-up" trade* – Real Estate – Our technical work is showing signs that the rally is broadening (Exhibit 5), which suggests a "catch-up" trade is underway. In addition, seasonality versus the S&P 500 for the Real Estate Select Sector SPDR (XLRE, Exhibit 6) is likely to be a tailwind for Q2. We highlight the strengthening technical profile of the XLRE (Exhibit 7).

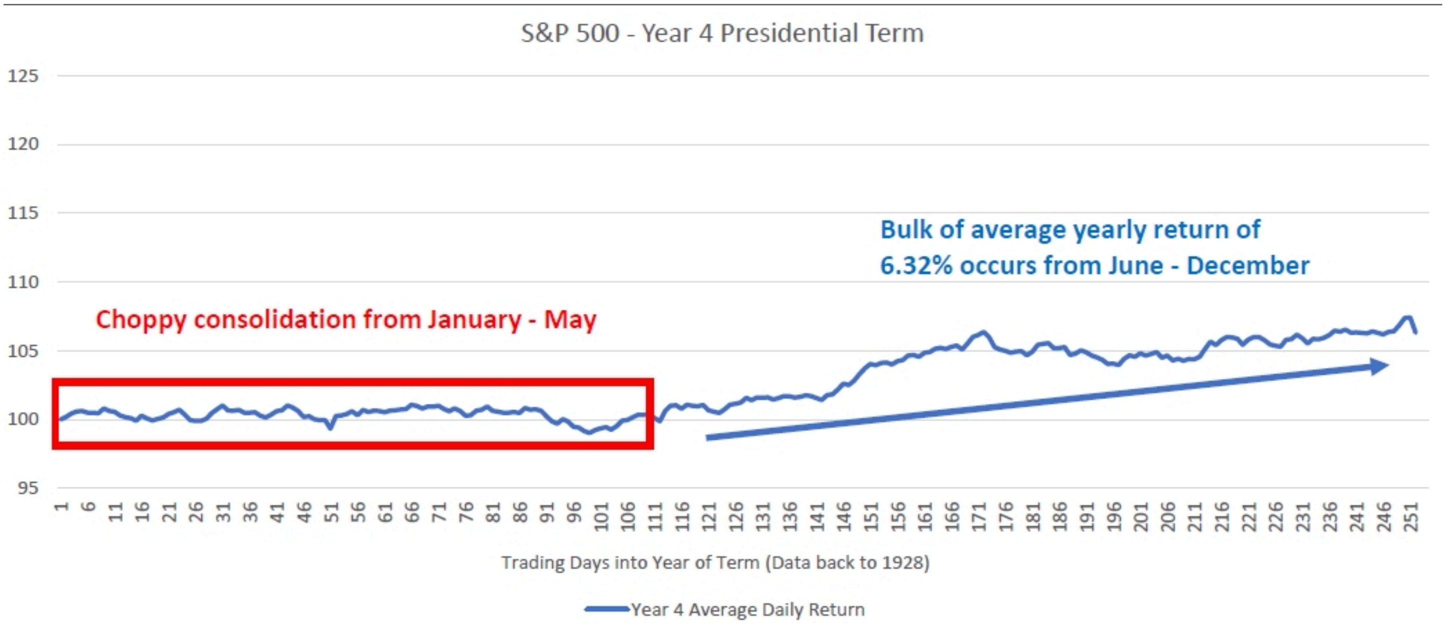
Raymond James clients can refer to Javed's regular weekly reports for more details and insights into his charts and models.

Exhibit 1 - VTI - Seasonality – 20-Years – Monthly – Positive Seasonality Supports Further Upside Through Q2



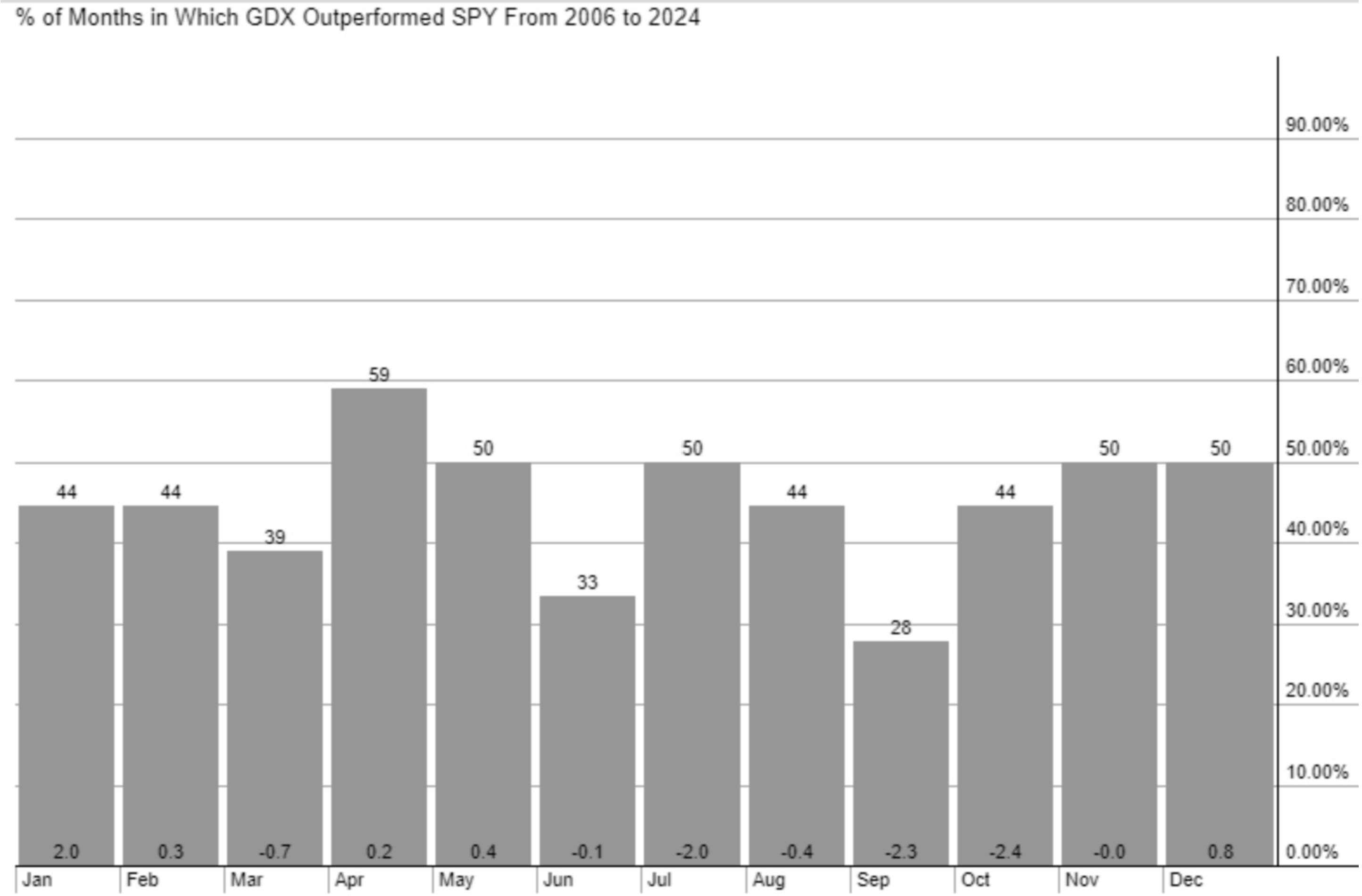
Source: StockCharts.com, Raymond James Ltd.

Exhibit 2 - Cycles – Presidential Cycle – Year 4 Offers Positive Returns as 4-Year Cycle Peak Looms in H2 2025/H1 2026



Source: Raymond James Ltd.

Exhibit 3 - GDX - Seasonality – 20-Years – Monthly

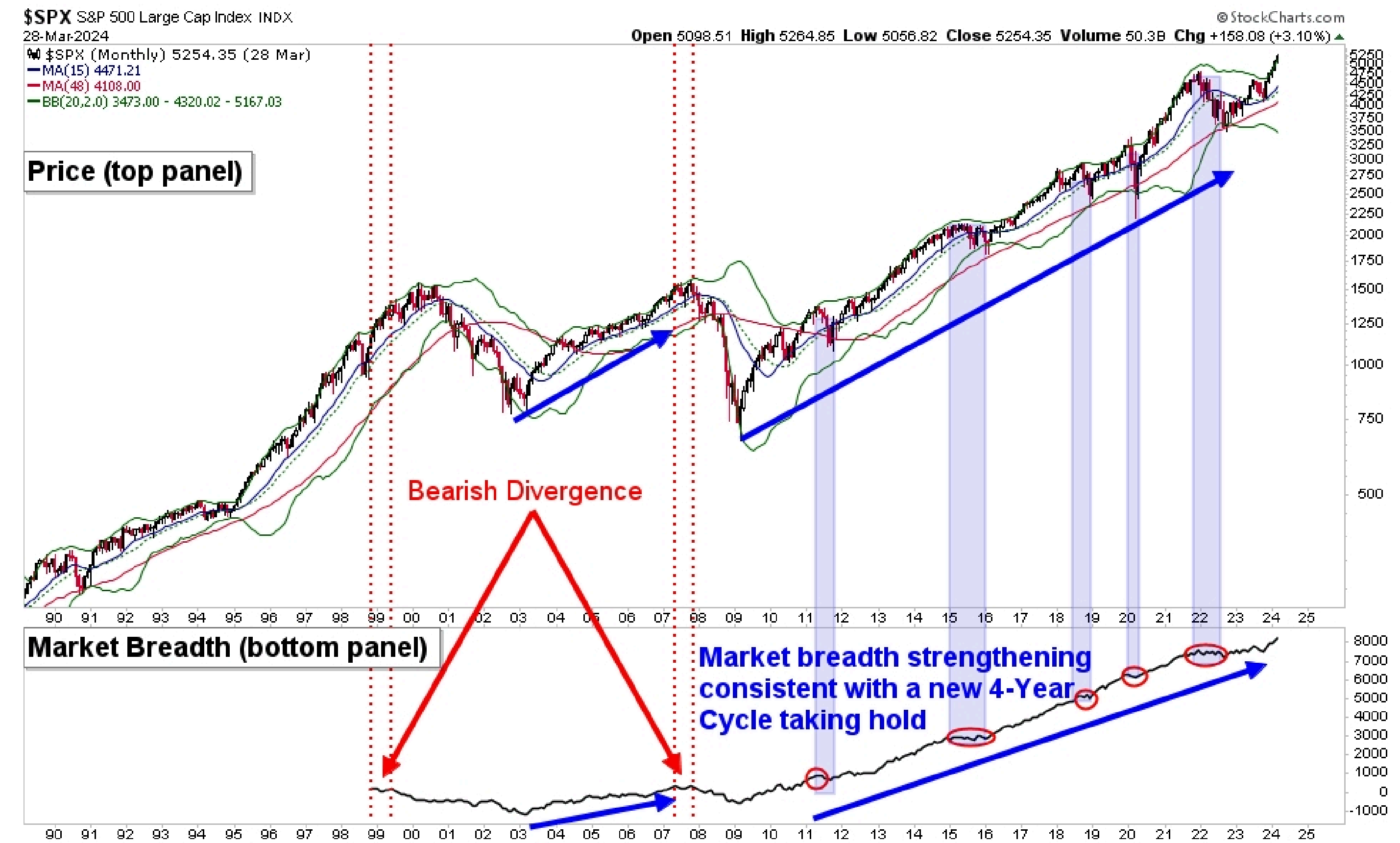


Source: StockCharts.com, Raymond James Ltd.

Exhibit 4 - GDX 10-Year – Monthly – Improving Technical Profile and Positive Seasonality in Q2 and Supports a "Catch-Up" Trade

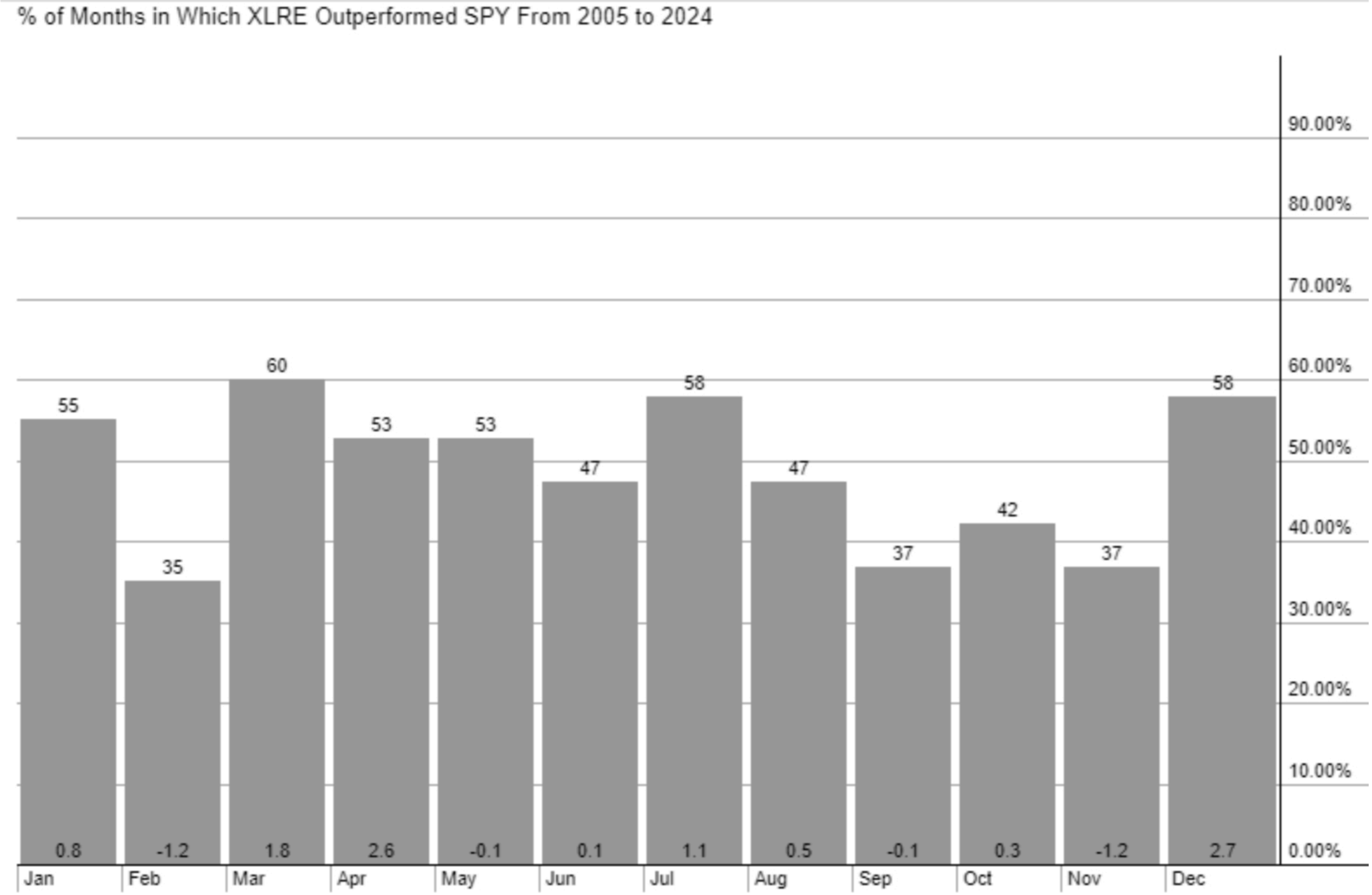
Source: StockCharts.com, Raymond James Ltd.

Exhibit 5 - Sentiment – Market Breadth: S&P 500 Advance-Decline – Accelerating Breadth Confirms New 4-Year Cycle Is Underway



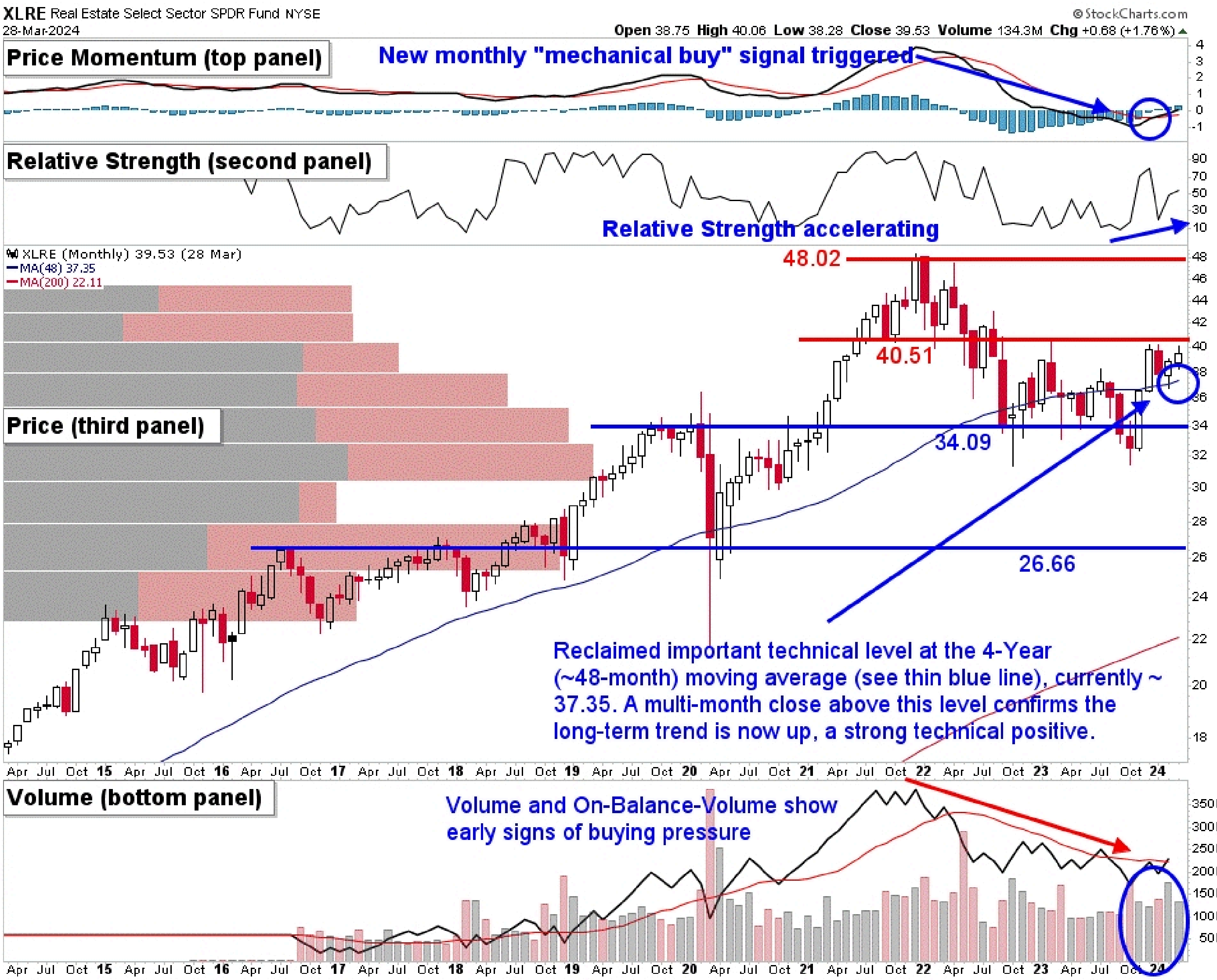
Source: StockCharts.com, Raymond James Ltd.

Exhibit 6 - XLRE - Seasonality – 20-Years - Monthly



Source: StockCharts.com, Raymond James Ltd.

Exhibit 7 - XLRE – 10-Years - Monthly – Improving Technical Profile and Positive Seasonality in Q2 and Supports a "Catch-Up" Trade



Source: StockCharts.com, Raymond James Ltd.

Canadian Fixed Income

Charlotte Jakubowicz, CMT, CIM - VP, Fixed Income and Currencies

In 1Q24, Canadian fixed income markets saw higher yields across the curve, with minor steepening as well. Given the inverse relationship between yields and prices, fixed income prices trended lower. This all occurred despite the widely-held view that the overnight rate, set by the Bank of Canada, should fall in 2024 - perhaps the lack of clarity on the timing of the first rate cut is complicating matters. No matter the reason, securities exist not in a vacuum but a live market, and periods of price action that move contradictory to the longer trend are not unexpected.

This sentiment may also be magnified by the expectation of the start of falling rates continuously being pushed out; based on the outlook from December, we should have already seen our first cut by now (it was predicted for the April 10 meeting). Today, a rate reduction is expected to occur during a summer meeting, many targeting June or July, however the landscape is ever-shifting. In our last quarterly asset allocation, we believed that June was a safe bet, and although this is still a possibility, inflation pressures are still present despite their large decline from its peak. To reiterate our broader view from the previous publication, we still believe “the Bank of Canada will take a more cautious approach, pausing and waiting to see how the market and economy reacts to the change before cutting again”. This stance was reflected in the Bank’s communication associated with the April 10 decision, which was reflected in consensus views where economists had extended the arrival at meaningful lower rates in 2024. It is possible that we receive a series of quarter-point reductions once the BoC begins this next phase, however as more and more meetings conclude without action, we may just run out of meetings in the calendar year and the reduction in 2024 may be lower than forecast. We would not be surprised with three rate cuts in 2024, but the possibility of receiving fewer is rising.

It is hard to determine which factors are most heavily weighted in the minds of our central bankers. Are they satisfied with CPI-trim, a favoured metric for core CPI, decreasing but still hovering slightly above the upper threshold of their one to three per cent band mandate (and thus will move ahead with rate cuts earlier)? Is the recent rise in energy costs causing concern for future spikes in inflation (thus delaying the start even further)? How does shelter CPI play into the whole equation? (For more on this last topic, refer to April’s Insights and Strategies.)

Although a number of factors are uncertain, what is certain is that rates have maintained an elevated level longer than most expected. Translated for investors, there is still time to purchase fixed income securities, with the suggestion to extend duration and lock into historically high rates for a greater period. There is also the potential to profit if a held bond moves as anticipated throughout the back half of the year. If clients are uncertain on the future needs for cash and prefer to take a more conservative approach, investing in a ladder could be considered. Under this strategy, tranches are purchased across a number of maturities and thus funds are available for reinvestment or other uses every year.

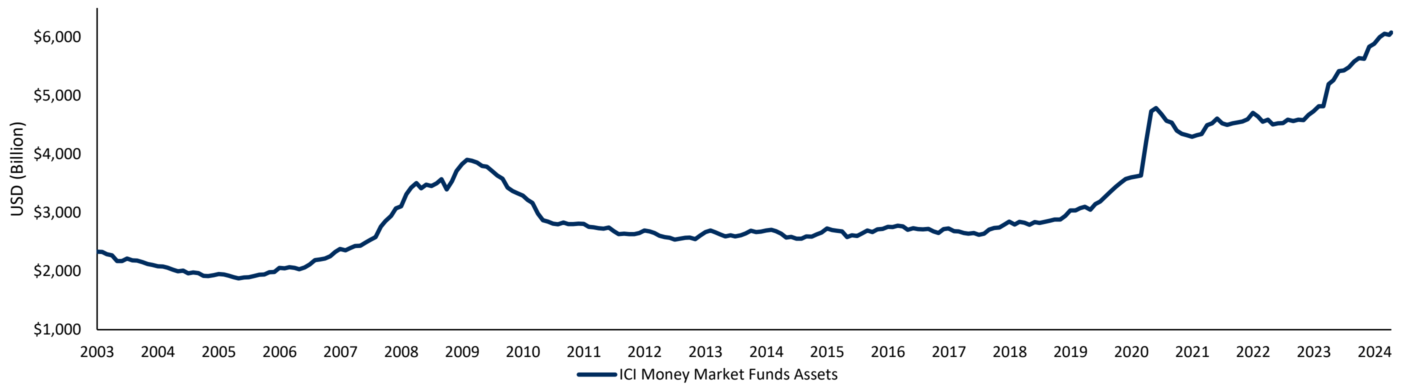
U.S. Fixed Income

Douglas Drabik, CFA, CMT - Senior Retail Fixed Income Strategist

For lack of a better word, the fixed income mantra is getting stale. Interest rates have peaked although they remain at elevated levels, allowing investors to take advantage of higher income and ample cash flow. Before boredom influences investment behaviour and dismisses this opportunity in hand, digest the positive long-term potential effect that this carries. It has been nearly two decades since investors have had the opportunity to capitalize on yields at these levels, yet questions abound as to the timing of implementing such a strategy. The perplexity is amplified by the resounding projection from economists and pundits alike, that conditions exist to suggest interest rates are likely to decline over the next year. In addition to all this is the fact that an average investor might have roughly 40 years (ages ~25 to ~65) to optimize the dollars put aside for investing for a lasting retirement plan.

The lack of confidence to implement a fixed income strategy may center around the present-day elongated economic cycle. The bond market has failed dramatically to comply with a society shaped by instant gratification. The Fed was already supposed to have cut interest rates, inflation should have diffused back toward two per cent, consumers should have run dry of disposable income, corporate earnings should have retracted, and unemployment ought to be sharply higher by now. Since none of these events have met their hurried timelines, the economic cycle “must” be off tilt, so consumers doubt that the economic cycle will play out ensues. All is fine and will remain fine?

Chart 15 - Total Assets Held In Money Market Funds Continue to Climb



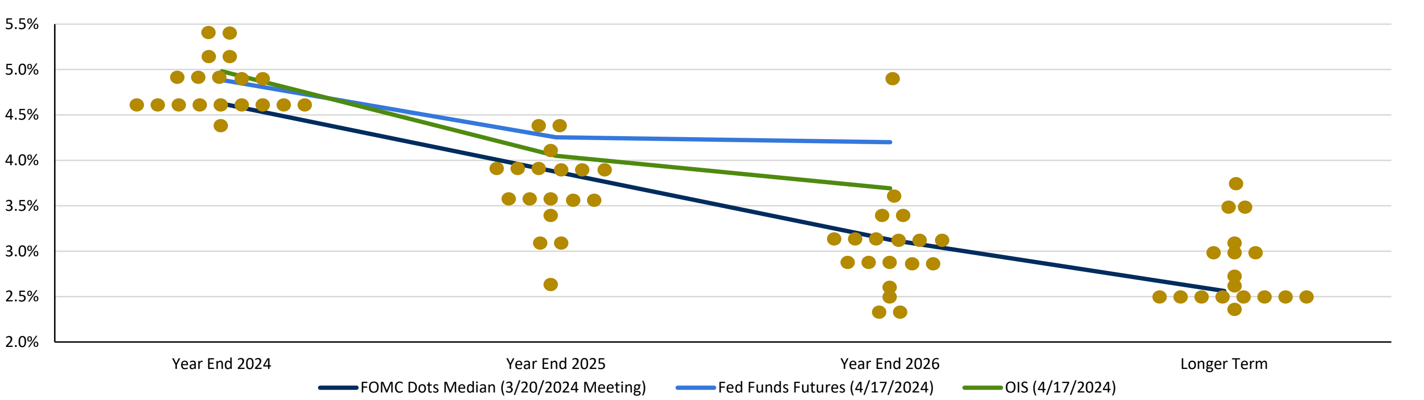
Source: ICI Data, Bloomberg; Data as of April 17, 2024.

Total assets, which include both taxable and tax-exempt funds, held in money market funds continue to climb. They currently sit at over $6 trillion, roughly double the 20-year average. The Treasury market is approaching nearly 1.5 years of being inverted; thus, the high short-term yields are a temptation. Rolling short defers long-term strategy of locking in higher income for longer - the counterpart risk being reinvestment risk.

A more likely reality is that intervention and grossly understated liquidity stockpiles have helped to lengthen our current economic cycle. Despite growing debt, increasing consumer interest payments, and diminishing savings, sidelined cash has pushed stocks to historic highs monopolizing consumer attention and overweighting growth allocations (Chart 11). Stocks have continued to soar during a period when inflation is proving to be sticky, yet consumers continue to spend, and employment is considered full. The Fed has not needed to change policy while individuals have paychecks to spend and the economy sneaks forward. Even the most pessimistic analysts must pause at the robust liquidity.

The window for Fed policy change may be constricting. As things stand, the Fed is not motivated to move while the economy and markets cooperate (Chart 12). Additionally, as we approach the U.S. presidential election, they may be hesitant to make a policy move for fear of interfering with election sentiment. Regardless of the latest predictions for three Fed rate cuts in 2024, the longer the economic backdrop stays the same, the less likely the Fed will change monetary policy at all this year.

Chart 16 - Fed Dots Plot (3/20/2024 Meeting)



Source: Federal Reserve, Bloomberg.

The DOTS plot surveys FOMC members about their anticipation for fed funds, the short-term borrowing rate between banking institutions. Each yellow dot represents a Fed member's position. The embedded line reveals the projected fed funds rate path based on how fed funds futures are trading. Thus, it is based on a live market. Neither are guarantees or reflect any historic accuracy but reveal relevant inside information concerning the potential future rate direction.

Although the economic cycle crawl resists the expert prognosticating pace, there are many indications that history will repeat itself - albeit slowly. Consumption is the major component of U.S. GDP and even hidden liquidity is finite. Inverted yield curves have consistently preceded recessions and growing consumer and government debt will not disappear. However, this will take even more time to play out and filter through the economic data. In the interim, investors can reap the benefits of higher interest rates for longer.

The 10-year U.S. Treasury may stay range-bound through this year (3.75 per cent - 4.50 per cent) despite interim volatility. Liquidity investors continue to benefit from the inverted curve providing higher income streams for short-term investments. Long-term investors can optimize returns through various fixed income opportunities. The corporate curve is flat, yet elevated. High-quality investment-grade credits boast near two-decade high income levels. Longer-term municipal yields benefit from a vastly upward-sloping curve from 15-30 years in maturity, providing attractive taxable-equivalent yields for high earners in the U.S.

If interest rates fall, investors may benefit from increased total returns through price appreciation on holdings. The scenario of lost opportunity may be in a rising interest rate environment, which, most pundits deem unlikely. Even at that, investors keep collecting their elevated income streams through locked-in cash flows. Although the mantra may be getting stale, locking in longer to solid credit-quality, high-income bond opportunities will never get old. Circumstances have extended the window by creating a higher-yield-for-longer environment.

Washington Policy

Ed Mills - Washington Policy Analyst

Prepare For a Sweep? Market Implications of the 2024 U.S. Election

The U.S. presidential election is rapidly approaching, and markets have begun to consider the implications of the various scenarios that lay beyond November. The presidential election is expected to be extremely close, with former President Donald Trump arguably having a slight edge at this point (when considering polling in key swing states), but with President Biden gaining some recent momentum following his March State of the Union address. Many wildcards remain in the election, but one key metric we are watching is which candidate is winning support from voters who have a negative opinion of both candidates. This is important as both Trump and Biden have a negative approval rating by a majority of Americans. These so-called “double haters” could likely decide the election, with Trump winning this group in 2016 and Biden in 2020. Beyond the presidential election, the House and Senate elections should be closely watched, given the implications on the post-election legislative agenda. While we consistently read that a divided government is the most likely scenario, we take a different view and believe the market should prepare for either a Republican or Democratic sweep in November.

A sweep would unlock the possibility of significant partisan policy actions, including through the use of budget reconciliation. At a high level, markets will be focused on the 2025 twin fiscal cliffs of the debt limit and the expiration of the 2017 Trump-era tax cuts. Potential changes to the 2022 Inflation Reduction Act would bring significant industrial, energy, and healthcare implications, while changes at regulators are a top issue for financials. We would also highlight the impact of populist politics on tech and antitrust, as well as amplified tech restrictions and trade spats under a potential Trump win.

State of the race: Biden-Trump rematch locked in. President Biden and former President Trump have crossed the delegate threshold to secure the Democratic and Republican presidential nominations respectively, confirming their widely-expected rematch in November – absent any major wildcards. With their nominations secured, as discussed above, questions are now open around which candidate will be able to win over the “double haters” – voters with unfavourable views of both candidates, who we view as being the most important voting bloc in deciding the outcome in November given sustained low approval ratings faced by most candidates. Biden and Trump’s first matchup in 2020 underscores how close the state of the race is, with less than 45,000 votes across three key states (Arizona, Wisconsin, and Georgia) making the difference in Biden winning a majority of electoral votes.

In Congress, tweaks to congressional district maps, a historically small majority, and past electoral trends give Democrats the edge in control of the House. In the Senate, Democrats have a 51-49 seat majority but are defending a significant number of seats – including in states that the Republican presidential candidate is expected to carry, giving Republicans a strong advantage in the race for the upper chamber of Congress.

Partisan sweep in either direction the most likely outcome. Our analysis of polling, DC sentiment, and historical precedent suggests that Trump currently holds a slight advantage in the race for the presidency, and that the Congressional outcome will likely follow the White House. We give Trump a 55 per cent chance of winning vs. 45 per cent for a Biden victory, and individually view the House as more likely to go to the Democrats (60 per cent) and the Senate to Republicans (70 per cent). In aggregate, we place the likelihood of a partisan sweep at 65 per cent (40 per cent likelihood of a GOP sweep and a 25 per cent likelihood of a Democratic sweep).

A GOP sweep would likely usher in major de-regulatory shifts across key sectors, but elevate certain geopolitical/trade risks under the direction of Trump. We would expect House and Senate Democrats to ride on Biden’s coattails if he were to win the presidency – continuing much of the current status quo, but super-charging debates in the absence of key figures including retiring Senator Joe Manchin (D-WV) and Kyrsten Sinema (I-AZ). While we view a split government scenario as relatively less likely, we could see some restraints placed on the scope of key policy actions – but also the potential for increased volatility around continued showdowns over taxes, debt and spending.

Sectoral implications: tax/debt, the IRA, financials, tech, defense, and U.S.-China relations. The impacts on different policy issues and sectors will vary widely across the range of electoral outcomes post-November. An immediate focus will be the debt limit, which will return in January 2025 and will act as the first post-election fiscal cliff. The resumption of the debt limit fight raises the risk of brinkmanship in a split government scenario, raising risks and headlines around the possibility of a default and placing pressure on both parties to accept serious policy and/or spending concessions. 2025 will also bring the expiration of many of the individual tax provisions of the 2017 Tax Cuts and Jobs Act (TCJA), and we expect the winner of the presidential election to dictate much of the tax debate. A Democratic sweep would unlock the ability to use the reconciliation process to make broad changes to the U.S. tax code; while the TCJA made the changes to the corporate tax rate permanent, a Democratic House and Senate could move to reinstate higher rates (e.g. to 28 per cent) alongside other priorities. We expect that a Republican White House and Congress would move to extend the individual TCJA tax cuts, and a sweep scenario would unlock the ability to use the reconciliation process to achieve this – reducing the risk of Senate gridlock around a potentially thin House Republican majority.

Questions around the fate of the 2022 Inflation Reduction Act (IRA) post-election have also been a key issue for investors. The IRA's clean energy tax incentives in particular have been closely watched for potential repeals given the heightened political attention around its implementation and the cost of the legislation. We view a full reversal of the IRA as unlikely and expect that the clean energy tax provisions will be safe for the next two years. However, the discussion becomes much more nuanced beyond 2025. The specifics of the implementation of the provisions are a more near-term candidate for changes, though we would expect a Democratic sweep to protect the IRA's standing and potentially pave the way for additional incentives. A Republican sweep could see individual provisions targeted, either through rule reversals via the Congressional Review Act (CRA) or through regulatory changes. Parts of the IRA could also be offered up as a "payfor" to extend the 2017 tax cuts, but the national security focus and high proportion of IRA beneficiary projects in Republican-controlled states and districts makes a complete overhaul unlikely, in our view.

Financial regulation has been a key focus in DC given the current regulatory "super-cycle", but we would highlight that a change in administration would bring about the largest overhaul of bank regulatory heads in U.S. history – short-circuiting the current, ambitious regulatory drive. A second Biden administration would likely continue to intensify key supervisory and regulatory priorities, including a crackdown on bank M&A and junk fees. A Republican sweep could see new regulatory appointees move quickly to withdraw the implementation of key market-impactful regulation, as well as the opportunity to use the CRA to overturn any rules adopted in 2H24. On tech, semiconductors and AI have been at the center of tech regulation, with national security, cybersecurity, and consumer data privacy risks receiving the most regulatory attention. We would expect a Biden win to continue these antitrust and privacy efforts, contributing to a continued chilling effect on tech M&A. We would also expect to see DC advance incremental and predictable steps on AI while continuing to regulate tech with China exposure. Under a Republican sweep, we would not expect to see major changes on antitrust – but tariffs and tech restrictions will become key questions. Ongoing reviews of existing tariffs have signaled additional near-term tariff hikes on certain technologies (including electric vehicles, semiconductors, and solar equipment), coming as part of a broader national security drive to onshore critical tech. Another key component of this strategy has been the imposition of export controls and investment restrictions on key tech, which the Biden administration has sought to balance with a desire to restore communications with China and restrict escalation potential. While we do not expect Biden to make China a major part of his policy platform in the run-up to election day, we could see shifts post-inauguration to place new restrictions on other key sectors (e.g. biotechnology and clean technology), additional tariffs, and an enhanced outbound investment screening regime. We view the likelihood of Trump placing elevated tariffs on a broader range of Chinese goods as higher, with goods such as semiconductors, steel, and pharmaceuticals as potential priority areas. While we view tariffs as a likely first-mover issue for Trump, additional entity listings (i.e. restrictions on individual Chinese firms) and export controls remain a risk further into a second Trump administration.

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