Equitable Asset Management Group

Market Comments

January 2024

Rates & Credit – Interest rates decreased sharply in Q4 as the market priced in aggressive interest rate cuts by central banks in 2024. The prospect of lower interest rates also drove a strong risk-on tone to the market, with the risk premium on corporate bonds grinding tighter as prospects for a "soft landing" improved. The rally in interest rates resulted in the best quarter for bonds over the past 15 years, with the FTSE Canada Universe Index returning 8.3%. Corporate bonds modestly underperformed the Universe Index with a return of 7.3%. The lower return for corporate bonds was primarily driven by the fact that the corporate bond index is less sensitive to interest rate movements (as compared to the government index), partially offset by the risk-on tone to the market. Within corporate bonds, lower-rated BBBs outperformed higher-rated A bonds. Industries with higher interest rate exposure such as infrastructure, energy, and communications outperformed those with less exposure (notably financials and securitization), consistent with the overall shift in the yield curve.

	4th Quarter Change	2023 Performance
US 10 Year	-69 bps	0 bps
Canada 10 Year	-92 bps	-19 bps
Canada Aggregate Bond*	8.4%	6.4%
US Aggregate Bond*	6.8%	5.7%

*Returns are calculated based on representative ETFs

Santa Came to Town – Moving in sync with bonds, global equities jolted higher into the end of the year with cooling inflation data and dovish comments from central bankers. The U.S. market outperformed most regions last quarter with the S&P 500 returning 11.7% in USD terms, bringing the total return in 2023 to 26.3%. The TSX added 8.1% in Q4, boosting the total annual return to 11.8%. Meanwhile, major developed economies from Europe, Australasia, and the Far East (EAFE) gained 5.0% in local currency terms over the quarter, helping the region produce a 16.8% return from the year prior. Prospects of interest rate cuts by the Federal Reserve saw the Loonie rally into year-end and resultantly, investors of Canadian dollar securities witnessed enhanced returns. Strong domestic U.S. economic data helped value pockets of the market outperform. That said, this was not a synchronized trend as China's economic disappointment weighed on the performance of EAFE.

	4th Quarter Total Return	2023 Performance
S&P 500	11.7%	26.3%
S&P/TSX Composite	8.1%	11.8%
EAFE*	5.0%	16.8%

*Local currency returns

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U.S. Fundamentals – Our work shows that investors are shifting their focus away from operating margins and towards the ability to sustain debt levels ahead of renewing debt obligations. Corporate earnings beat modest expectations last quarter, contracting by less-than-expected on a year-over-year basis. Resilient operating margins continue to attract investors into equities. After three consecutive quarters of improving forward earnings guidance, we observed that the number of major companies expecting deteriorating financial performance grew to ~35%. We note that this is a sharp contrast relative to the optimistic run-up in equity valuations. In general, corporate pessimism has been underpinned by concerns for the health of the consumer, increasing wage pressures, and inflation.

U.S. Quant Factors – While mega-cap technology stocks gave back some ground in the second half, crowding into the magnificent 7 remains noticeable with the cap weighted S&P 500 outperforming the equal weighted index by 12.5% last year. That said, value areas of the market – which underperformed through the first three quarters of the year – were top performing companies last quarter as the prospects for an economic "soft-landing" improved with U.S. inflation continuing to ease without substantial deteriorations of employment or output data. Quality-growth businesses initially outperformed as the higher-for-longer narrative continued to drive investors toward large cash-rich companies with stable margins. That said, this basket of companies gave back relative returns into quarter-end as weakness in operating margins persisted, making fundamentals appear stretched. Low volatility stocks (i.e. stocks with lower sensitivity to broad market movement and lower price volatility) rallied to start the quarter before dovish comments from central bankers improved risk-sentiment and ultimately pushed this basket lower on a relative basis. Lastly, dividend growth companies, which include businesses with a lengthy and established history of increasing dividends, underperformed the broader index as market participants punished businesses that slowed capital growth projects during the rising interest rate environment. While operating margins have declined, the basket's strong cash flow and low debt burden may be advantageous if the market's anticipation of impending interest rate cuts proves to be incorrect or mistimed.

Canadian Fundamentals – Although Canadian companies exceeded bleak forecasts last quarter, earnings continue to contract on a year-over-year basis. Return on equity (ROE) – a gauge of how efficiently a corporation generates profits – continued to decline last quarter while corporate costs of capital remain elevated. In essence, Canadian companies are generating less value relative to their financing cost. Value creation underpins the sustainability of dividend payments, which are a unique and desirable attribute of the Canadian market. Meanwhile, the Bank of Canada held its overnight interest rate unchanged with market participants forecasting a higher probability of interest rate cuts in 2024. On the expectations of easing monetary conditions, dividend yields compressed while earnings forecasts improved with analysts predicting that index aggregate earnings will grow 6% to 8% in 2024. At a

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sector level, the energy industry's financial performance normalized – in line with expectations – as weakening oil demand expectations overshadowed geopolitical conflict in the Middle East, ultimately pushing crude prices ~21% lower last quarter. The industrials and financials sectors beat expectations, helping offset softer-than-expected results from the consumer staples and technology sectors.

Canadian Quant Factors – The Canadian banks underperformed for most of the year as they reported increasing provisions for nonperforming loans, reflecting forecasts of worsening economic conditions. That said, expectations of interest rate cuts in 2024 helped tame recession fears and eased concerns of slowing loan growth, propelling banks higher in the fourth quarter as they appeared more stable and therefore favourable than prior estimates. The high-quality basket underperformed last quarter as improving risk sentiment in the market reduced the attractiveness of secure companies with lower earnings variability. Furthermore, high dividend payers with solid growth prospects outperformed in the fourth quarter as market participants rewarded companies that demonstrated a strong ability to support future dividends and punished high yielding businesses with less certain financial capabilities.

Views From the Frontline Rates – Interest rates declined sharply in Q4 as inflation continued to trend lower, fears of excess bond supply declined, and the Federal Open Market Committee signaled that the next change to their overnight policy interest rate would likely be lower. Labour market and consumer spending data remain resilient however businesses have indicated slowing across industries, more price-sensitive consumers, rising delinquencies, and concerns about the high cost of debt. Central banks remain committed to achieving their 2% inflation target and most acknowledge that interest rates have likely peaked.

Credit – The risk premium for corporate bonds (versus government bonds) tightened materially over the quarter, with a strong risk on tone to the market as investors priced in lower interest rates in 2024 and a "soft-landing" to economic concerns. Corporate bond supply was well received by the market. On the balance, we do not think the current risk premium adequately compensates for downside risk, and as such, we remain cautious on corporate bonds and have a bias towards higher-quality, shorter-dated credit where we view the risk / reward dynamic as being more favourable.

Equity – In the U.S., we allocated exposure to value names which outperformed over the quarter as the macroeconomic outlook improved on the backdrop of rate cut expectations. Looking forward, we expect that margins will continue to normalize as Covid-induced pent up demand fades. While we do not forecast margins to compress at an alarming rate, we believe sticky wage and input costs will continue to pressure businesses while consumers exhibit further exhaustion. As such, we are shifting our focus toward the balance between company reinvestment in capital projects and upcoming debt refinancing requirements. In line with this view, we favour businesses with stable cash flows and decreased debt loads as we believe they present an attractive contrarian opportunity if soft-landing projections prove to be overstated. Within Canada, we remain attentive to the inverse movements of ROE relative to financing costs over 2023. With the excess between ROE and financing costs compressing, businesses' ability to create value appears more stretched than earlier in 2023. Therefore, we continue to favour high quality companies in Canada, which is typically defined by high ROE, stable earnings variability, and low financial leverage. Geographically, the U.S. economy appears to be in healthier condition with inflation easing while employment and output data remain stable and hence, our focus will be on capital expenditures. EAFE – which is generally more economically linked to China than North America – contains a large bucket of stable, high-quality businesses that may benefit from any upside economic surprises out of China. Lastly, through the lens of a Canadian investor, the Loonie's relative value versus other major currencies presents another resource in our investment mandate to derive excess return.

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