



Cozying up for fall(ing policy rates)

Equities

The third quarter of 2024 was a fine one for developed stock markets, with the S&P/TSX Capped Composite Index rising 10.5%, the S&P 500 Total Return Index gaining 4.5% and the MSCI EAFE Total Return Index gaining 5.9%, all in Canadian dollar terms — a slightly stronger Canadian dollar reduced these gains from 5.9% in the US and 7.3% in international markets, respectively, on a US dollar basis.

Central bank interest rate cuts, marking an end to the rate hiking cycle seen in 2022 and 2023 and supporting stock markets, in particular, sparked gains in yield-sensitive sectors such as Financials, Real Estate and Utilities, all of which reported double-digit gains in the quarter within Canada. It also prompted a move in gold stocks, a group of significance domestically, and propelled a double-digit gain in the Materials sector. At the other end of the spectrum, Energy stocks generally underperformed in the quarter, deflated by speculation that Saudi Arabia may set aside supply constraints aimed at achieving a US\$100 oil price, and instead look to compete via rising output, contributing to a 16% decline in the price of West Texas crude oil in the quarter.

These market gains conceal some considerable gyrations that occurred during the quarter. A decision by the Bank of Japan to increase interest rates for the first time in 17 years triggered a tumultuous move in Japanese currency and equity markets in early August, with a dramatic fall on the Tokyo Exchange which was entirely reversed over the following two months. Late in the quarter, announcements from the Politburo in China had a notable influence on markets, particularly those in Europe and Asia — the series of supportive measures, including an interest rate cut, a relaxation of bank lending rules and a government fund to support capital markets triggered a flurry of buying that created the strongest week for Chinese equities in more than a decade. The impact of these initiatives, critical to the business environment for companies worldwide, remains to be seen and will likely take time to materialize.

In the meantime, equity market performance in the coming months will likely reflect continued interest rate cuts in North America and Europe, the ongoing conflicts in the Middle East and Ukraine, and the outcome of the US presidential election. Amidst all of these uncertainties, a favourable starting point for investors is reasonable valuations that should provide support for most of the global stock market universe.

Fixed Income

Bond markets turned in their best quarter of the year so far in Q3 as cooperative inflation data permitted more global central banks to begin to move toward less restrictive policy stances while rising concerns about the strength of underlying macroeconomic momentum led markets to once again ramp up expectations for even more near-term rate policy rate cuts.

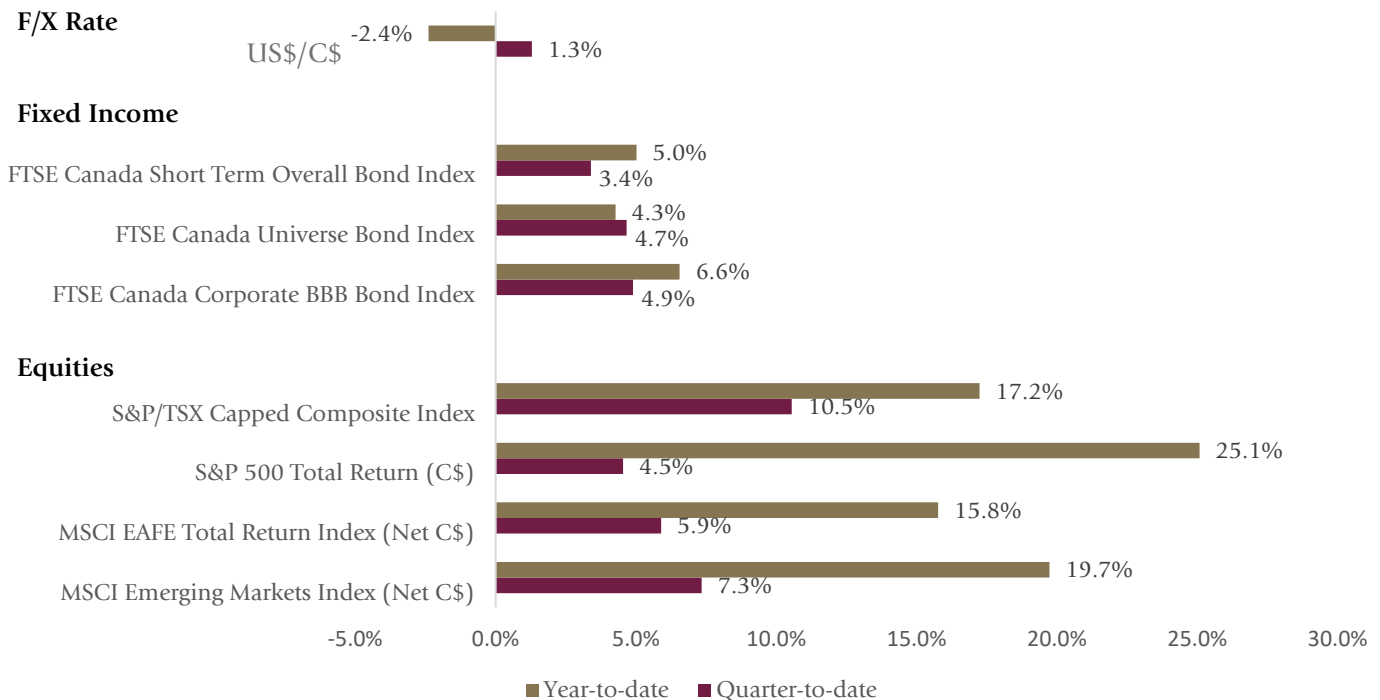
The downward move in the expected path for policy rates drove broader market interest rates sharply lower across the curve over the three months ended September — the more policy-sensitive front-end of the curve recorded the largest declines and actually pushed the gap in yields between the 10-year and 2-year Government of Canada notes back into positive territory for the first time since June 2022.



Overall, the domestic benchmark FTSE Canada Universe Bond Index was up 4.7% to finish Q3 at its highest level since December 2021. All major sub-components finished the period with near-uniform, solid performance — more rate-sensitive longer duration bonds (FTSE Canada Long Term Overall Index +5.7%) outperformed their shorter duration counterparts (FTSE Canada Short Term Overall Bond Index +3.4%), while Corporate bonds (FTSE Canada All Corporate Bond Index +4.7%) kept pace with the gains in government bonds in the period (FTSE Canada All Government Bond Index +4.7%) in Q3.

The near-term outlook for fixed income securities remains constructive as the anticipated continued moderation of inflation and further easing of monetary policy look as though they will maintain downward pressure on rates and support further positive performance for bonds. As well, the ongoing risks over the outlook, including elevated geopolitical uncertainty against the upcoming US election, appear likely to support investor demand for the safe, income-generating and increasingly uncorrelated asset class to offset riskier portions of portfolios.

Market Indices Performance (as of September 30, 2024)



Source Bloomberg: All figures stated in Canadian dollars as of September 30, 2024



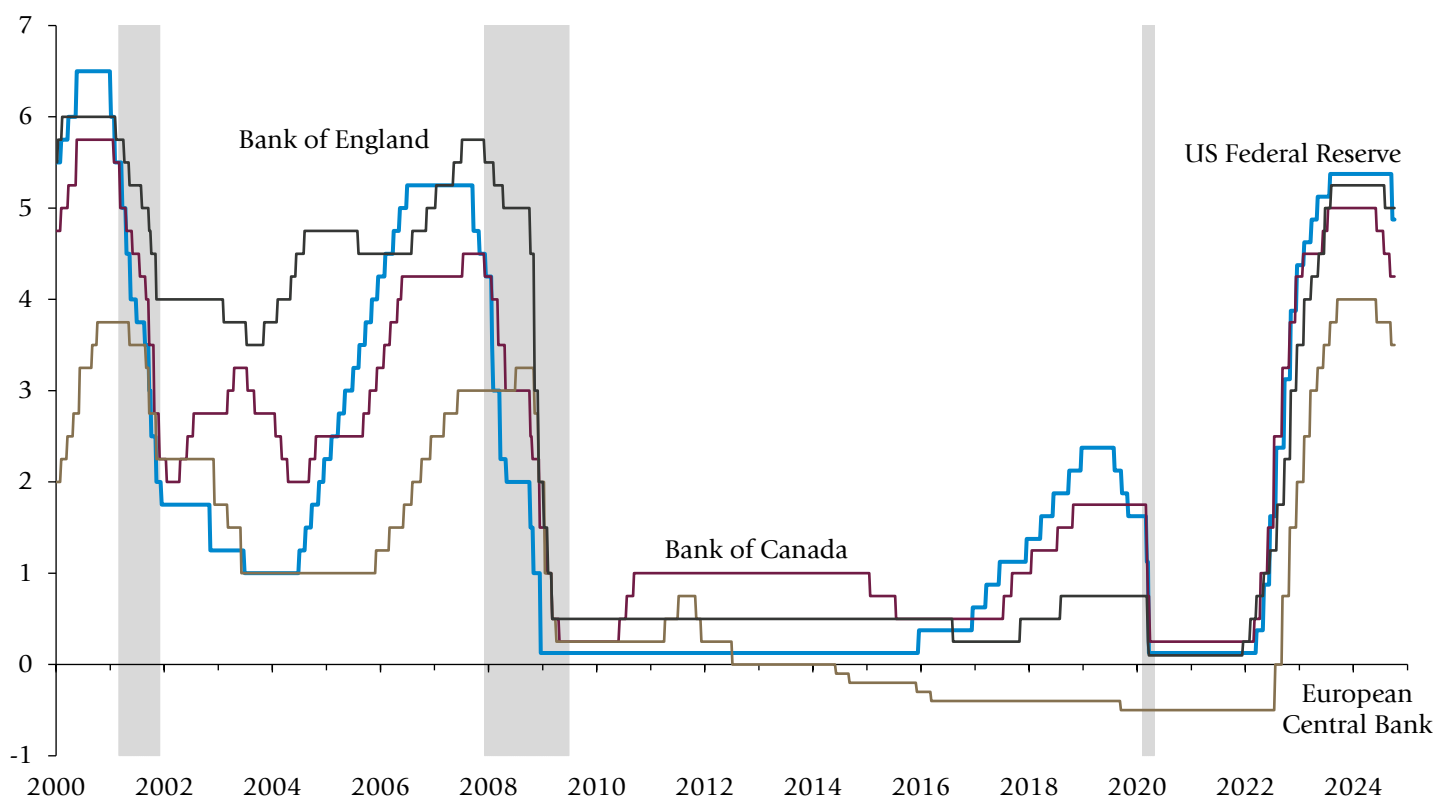
Commentary

The US Federal Reserve (Fed) joined the ranks of the Bank of Canada, European Central Bank, and Bank of England (as well as the central banks for other Developed Markets such as Switzerland, Denmark, and Sweden, and a host of Emerging Markets such as Brazil, Mexico and South Africa) in September in cutting its policy interest rate.

The move by the world's most important central bank — and the most significant influencer of market interest rates worldwide — unofficially marks the end of the globally synchronized and historically aggressive monetary tightening cycle worldwide that began in earnest in 2022.

Starting their descent

(central bank policy interest rates; percent)



Source: Guardian Capital based on data from Bloomberg to September 30, 2024

Financial markets have so far cheered the move away from highly restrictive policy toward a less tight stance — the MSCI World Index closed September up 2% and at an all-time high, while bond benchmarks hit their highest levels since the beginning of 2022 — but those with an eye on history are warranted in being cautious.

IN REVIEW:

QUARTER 3



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Previous periods of declining policy interest rates, particularly those instances where central banks decided to make “larger” moves like the Fed’s 50 basis point cut on September 18, 2024, (other central banks have been moving in 25 basis point increments), have been followed by negative market performance. For example, following the 50 basis point cuts that kicked off the 2001 and 2007 easing cycles, the MSCI World was down 12% and 10%, respectively, six months later and 18% and 22% after a year. Over the last 35 years, the median decline in the Developed Market equity benchmark one year after a (not just the first move) 50 basis point or greater rate cut by the Fed is 13% (the average decline is 5%).

With that in mind, however, it is important to note that the current easing cycle is taking place against a very different market and macroeconomic backdrop than most of its predecessors.

Historically, the impetus for easing monetary policy has been economic weakness or an emerging crisis that necessitates a policy reaction to mitigate downside risks. More often than not, these problems are a product of earlier central bank tightening causing a rapid unwind of financial excesses (such as the Tech bubble in 2001 and the Housing bubble in 2007) that result in negative repercussions for the broader economy. Since the greater perceived stress results in greater action, it stands to reason that there would be a negative correlation between a downward direction in policy rates and the performance of risky assets.

This go-around, however, rates are coming down even as economic momentum worldwide is being sustained at solid rates, with the uniqueness of the shock from the pandemic and its aftermath creating an environment in which systemic excesses are not prevalent, in addition to relatively strong household and corporate balance sheets.

Indeed, despite ongoing risks to the outlook and related uncertainty, the base case increasingly looks as though the global economy will be able to skirt a recession in the absence of some sort of exogenous shock (such as a potential escalation of already elevated geopolitical stresses) as pressures related to elevated inflation and high interest rates subside.

As a result, unlike previous cycles that saw a rapid series of large cuts that brought rates to their lower bounds, the current expectation is that the “jumbo” move by the Fed will not be repeated and rates will follow a comparably gradual path lower before settling at comparatively higher levels that are viewed as being consistent with a more “neutral” (neither accommodative nor restrictive) stance.

Accordingly, the template of past easing cycles may not be the best fit for the current (less negative) environment. While maintaining a focus on risk management is prudent with respect to building long-term wealth, the outlook remains one in which there is scope for the continued decent performance of financial markets with opportunities in both equity and fixed income that stand to benefit investors in the months ahead.

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All returns are stated in Canadian dollar terms unless indicated otherwise.

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