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Wealth Management
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Quarterly Update

Over the past three months, markets have experienced all-time highs, a correction, and rapid recovery. Depending on which news outlet you follow for information, you could hear a range of different reasons for these events – from the beginning of a recession to a market rotation to a growth scare or a correction. In our view, there are factors that support the idea that this will play out as a pullback or correction rather than the start of a bear market. Most notably, market breadth has not yet triggered a negative signal, and overall S&P 500 earnings trends and consensus earnings growth forecasts remain too relatively stable for us to think otherwise. While market corrections are not always easy while they're happening, it is important to remember that they are normal. Since 1980, the S&P 500 Index has fallen an average of about 14.0% in any given calendar year, but is positive 75% of the time with an average return of about 10.0%. With the global economy continuing to grow, inflation normalizing, earnings expanding, and what looks like the start of the rate cut cycle, we believe there is more room to run.

We see more confidence now that inflation is on track to stabilize near the 2% target and mounting signs that labour market conditions have reached greater balance. This was shown when the U.S. Federal Reserve (the Fed) cuts rates by 50bps in September. Markets are currently pricing in another 200 bps of cuts through the end of 2025. Despite a weak jobs report in early August, most of the data since then — including inflation, income, and consumer spending — suggests that the U.S. economy is shifting into a slower but steadier growth trend. Notably, solid wage gains, which have been outpacing inflation since Q1 2023, should help reinforce household spending that contributes roughly 70% of the U.S. GDP.

Equities after the first rate cut

In the 11 instances of Fed easing cycles that we have identified since 1970, the S&P 500 has often delivered positive returns in the 12 months following the initial rate cut, with a median price return of 11.9% (see chart). However, the macro context behind monetary easing matters a great deal, which is why outcomes around these policy turning points vary so widely. In cycles where rate cuts were able to prolong economic expansion and keep corporate earnings on an upward trend, equities have tended to perform quite well. However, in cycles where monetary stimulus was unable to

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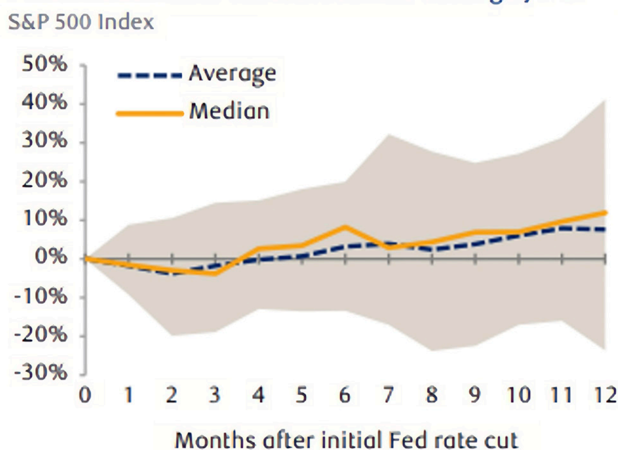
prevent an economic downturn, equities have typically recorded losses in the 12 months after rate cuts began as corporate profits come under pressure. Beyond that, every Fed easing cycle is different, so starting conditions likely have some influence as well. The recent run of economic data broadly suggests the U.S. economy is on reasonably firm footing, which, if sustained, should bode well for corporate profit growth to remain a tailwind for equities in the coming quarters.

Bonds after the first rate cut

In the nine instances of Fed easing cycles that we have identified since 1980, for which bond index returns data is available, we have found that the performance of high-quality bonds around these transition points to monetary loosening has historically been more consistent. While the upside in bonds is more moderate compared with equities, with a median total return of 7.9% in the 12 months after the first Fed rate cut, the performance patterns for bonds through these periods lean more positively, with fewer instances of negative returns for high-quality bonds. From a relative standpoint, bonds meaningfully outperformed the S&P 500 in three of these nine rate cut cycles (1981, 2001, and 2007), coinciding with U.S. recessions and equity bear markets. On a median and average basis, bonds underperformed the S&P 500 by 0.4% and 4.2% in the 12 months after the start of rate cuts.

Some nuance to the data

The usual caveats with these types of analysis apply here —no cycles are completely alike, and there is a small sample size. Navigating the pivot to monetary easing requires investors to delve into the different economic settings behind each cycle, which are more relevant in shaping market trajectories. For now, the balance of evidence aligns with market expectations of a "soft landing," where the economy remains resilient, inflation steadies near target levels, and the Fed implements rate cuts. This backdrop, characterized by ongoing economic growth coupled with lower rates, tends to be a productive setup for both stocks and bonds. In the near term, the precise number of rate cuts may be less important than the visibility that interest rates are heading lower. Beyond that, we believe recent conflicting messages about the strength of the U.S. labour market merit close attention. Given that valuations across asset classes appear to reflect a "soft landing" as the base case, we believe quality remains a worthwhile theme in portfolios. In equities, this can be achieved by emphasizing companies with strong fundamentals better positioned to withstand a slower economy. In fixed income, favouring higher quality corporate and government bonds, along with extending duration, can help enhance defensive qualities that can benefit portfolios during periods of market volatility.



What are we doing?

At the beginning of August, we experienced sell offs in global markets in a rather short period of time. Unemployment was rising, business confidence was decreasing, and the markets hung on Fed Chair Jerome Powell's words of whether rate cuts were imminent. Due to how quickly the sell off was, and our belief that the economy is still on good footing, we used that opportunity to build to our equity names. Our increase in equities ranged from initiating positions we've been looking at for some time, such as Loblaws, to increasing to our existing positions, in companies like Nvidia. On the fixed income front, we continue to re-invest any maturities from our 2024 corporate bonds into high quality bonds maturing in 2029. This allows us to take advantage of higher rates for longer while reducing interest rate risk with our laddered approach. We are very confident with our current asset allocation, and will continue to be vigilant in our approach as we probably face continued volatility into year end.

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