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Quarterly Update

As we look forward to a new year, we are reminded that the economy always prevails. Looking back to this time last year, we were coming off one the worst years in equity markets since the Great Financial Crisis. The economy was overshadowed by persistently high inflation, rising rates, and falling corporate earnings. These factors clouded investors' mindsets that this time was different. In the middle of uncomfortable times, the pendulum always swings a little too far in either direction but when the dust settles, we always find the equilibrium. Those same things that were a negative catalyst in 2022 are seemingly resolving themselves into 2024. New concerns have appeared in 2024, like the Canadian housing market and the eventual U.S. election later in the year, but this is a good time to remind ourselves that the economy is resilient and will continue to prevail.

No widespread default, but a continued slowdown in housing activity

According to a Bank of Canada (BoC) survey, most homeowners estimate that they have some capacity to absorb higher mortgage payments. This is no surprise considering that the Canadian government imposes a stress test on potential mortgagors to ensure they can withstand a higher mortgage rate than the one they contracted. Consequently, we don't expect widespread mortgage defaults under our base-case scenario. Nonetheless, higher mortgage rates have increasingly pressured housing demand in the context of rising inventories since June 2023. Weak demand combined with elevated financing rates for builders might also dent residential construction, which has been surprisingly resilient in this cycle, and put additional pressure on gross domestic product (GDP).

Since the last BoC interest-rate hike in July 2023, we've been expecting the central bank to ease its policy rate in early 2024. Since mid-October, markets have rallied around this notion of rate cuts beginning in mid-2024. Additionally, markets have now integrated the equivalent of two to three additional cuts in 2024 and two more in 2025. However, we interpret the recent drop in Canadian yields as mainly driven by renewed expectations of U.S. Federal Reserve (Fed) easing rather than being a Canadian phenomenon. Moreover, while slower-than-expected core inflation explains some of the U.S. bond rally, core inflation in Canada stayed relatively sticky in late 2023. Expectations for aggressive BoC rate cuts could therefore be subject to a reversal in the near term if the Fed

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changes course. Nonetheless, we believe that weakening Canadian growth and labour market dynamics will prevail over sticky core inflation for the BoC and, as such, we continue to expect steady policy easing in 2024. In turn, this will support demand in the economy and gradually ease the labour market slack generated early in the year.

U.S. election

The U.S. presidential election will inevitably generate noise. Investors should remember that since 1928, the S&P 500 rose 7.5% on average during presidential election years, and ended the year in positive territory almost 75% of the time. We believe Fed policy and the economic cycle play greater roles in shaping market returns than political party control in Washington, D.C.

The market has performed well under various combinations of party control. In terms of hot-button campaign issues, Wall Street's priorities often differ from Main Street's. Among the policy issues that catch Wall Street's attention, very few end up being primary drivers of stock market or sector returns, especially long-term returns. The Fed, economy, innovation and profits tend to matter more to stock market performance than politics and election outcomes.

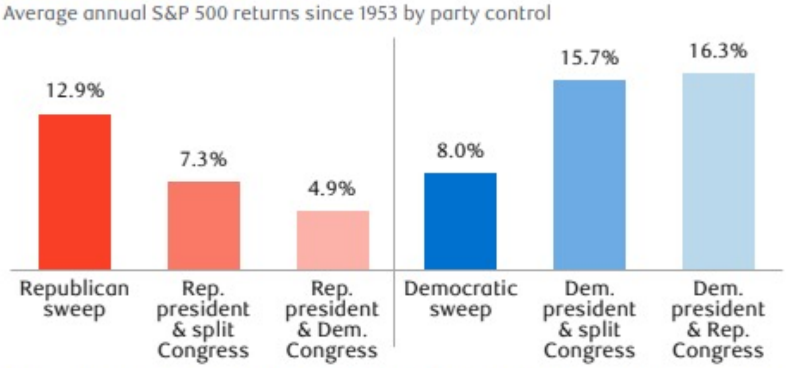
The U.S. stock market has risen during Republican and Democratic presidencies. There were a couple of lengthy periods when the S&P 500 struggled under both political parties. But, by and large, when we consider from 1933 onward, the market rose during several Republican and Democratic presidential periods, and substantially so at times.

Developments at the White House and on Capitol Hill usually don't make or break America's $28 trillion economy or the profits of most S&P 500 companies, in our assessment. Rather, the Fed's monetary policies have historically influenced the economy, inflation, bank lending, and credit availability much more. The Fed's decisions tend to help shape the business cycle, which, in turn, highly influences corporate profit growth.

Likewise, Fed policies have also tended to be major determining factors of U.S. bond market performance, and have increasingly influenced policies of other developed-market central banks and performance of those bond markets. The natural movement of U.S. economic activity from the start of a new growth cycle to midcycle to recession, and back again, has also historically been a major determinant of U.S. financial market returns.

Elephant or donkey—or both?

Average annual S&P 500 returns since 1953 by party control



Source - RBC Wealth Management, Bloomberg; data through 12/31/23; data based on price returns (does not include dividends)

What are we doing?

Our portfolios have continued to grow into the end of 2023 and into the first two months of 2024 off the backs of growing corporate earnings, forecasted rate cuts and falling inflation. Subsequently, this has pushed bond yields down across the curve but still at attractive return levels we haven't experienced in 10+ years. We have been tilting portfolios toward higher-quality segments of the equity market, including those companies with resilient balance sheets, sustainable dividends, and reliable cash flow generation. A lot of talk over the last six months has been around Artificial Intelligence (AI) and specifically the "Magnificent Seven" (Apple, Microsoft, Amazon, Google, Nvidia, Meta and Tesla).

Thankfully for us, these are companies we have had high conviction on for many years, and have held the majority of them in our portfolio before the recent run up. Going forward, we want to look to add to these companies as we believe they will continue to be pillars in the economy. For the first time in more than a decade, bond yields have made fixed income a fully useable and attractive compliment to equities in a balanced portfolio. Bonds provide, as they have traditionally done, a combination of reduced volatility, more predictable returns, and the comfort of a maturity value. We recently had a maturity to one of our shorter duration bonds, and have re-invested back into longer-dated maturities before rates look to fall in the second half of the year.

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