Wealth Management
Dominion Securities

Volume 33 | January 2024

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Markets find their second wind in the home stretch

KEY INSIGHTS

- Equities end the year on a strong note
- Bond prices rise as buyers are willing to pay up for yield
- Central bankers expected to begin lowering rates soon
- Economists are split over recession or not
- Geopolitical risks abound as the US political circus gears up

Markets finished 2023 on a high note following a surge in November and December that took North American equity indices close to all-time highs. The mood was starkly different on December 31st versus October 31st as investors began to believe that central bankers had reached the top of their interest rate tightening cycle.

In our last newsletter, the first two key insights called for "*rate hikes getting close to the end and cuts anticipated next year*", and that "*higher interest rates create opportunity in fixed income and equities*". That was 3 months ago and, as it turns out, this is exactly what occurred. As popular opinion shifted to the concept of lower interest rates in 2024, markets scrambled to get ahead of that trade. Income investors hoovered up bonds, pushing bond prices higher and, as a result, yields lower. Equity investors bought with both hands in anticipation of the Fed cutting rates and the resulting economic and earnings growth that often accompanies cheaper money.

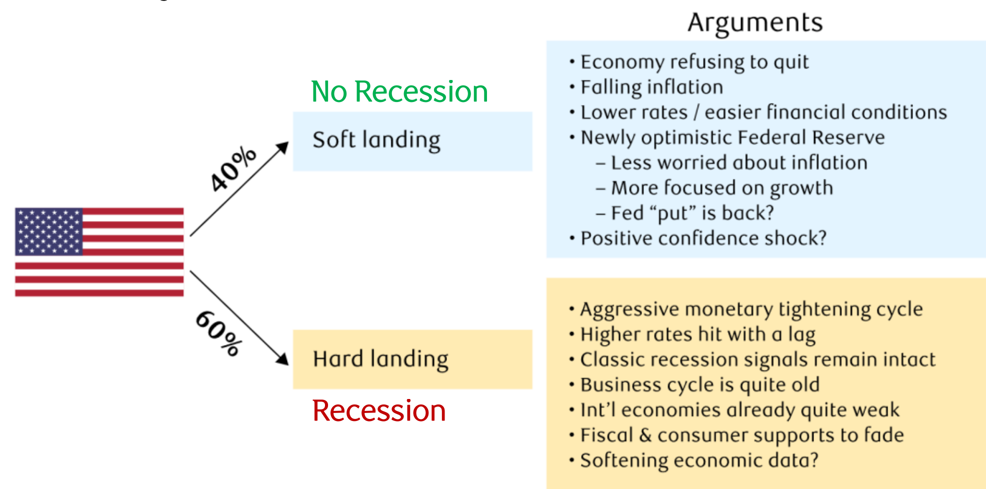

***Figure 1**: RBC's two main macro scenarios for the U.S. in 2024 (Source: RBC GAM)*

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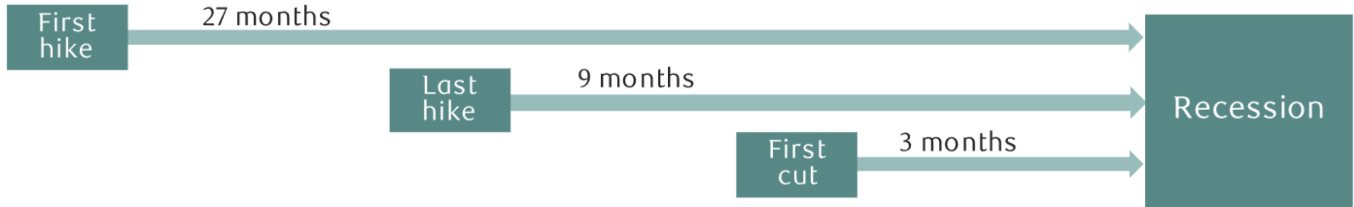

***Figure 2**: Historical monetary cycles pointing to Spring 2024 recession (Source: RBC GAM)*

Recession Watch

But wait……not so fast. To be clear, we are optimistic as we look ahead to the coming year, but as usual, markets tend to swing too far one way followed by too far the other. The double-digit percentage gain of November and December is clearly not a sustainable trajectory, and we likely need to take a breather here. Keep in mind that many economists and strategists are still calling for recession (see *Figure 1*).

Our own RBC experts believe that a U.S. recession is the most probable outcome in the coming quarters (see article that follows). In the past, a combination of high interest rates and restrictive bank lending standards—factors that are in place today—has been a recipe for recession. These conditions are already taking a toll in Canada, the UK and Europe. The US economy thus far remains resilient.

While talk of recession (and we have been talking about it now for about two years!) sounds scary, it need not necessarily be. If we do experience a recession in 2024, the most likely outcome is that it will be brief and shallow. In fact, it may even come and go without us knowing. In the US, the official start date of a recession is called by the National Bureau of Economic Research. However, this typically comes about a year after the fact and as such, is pretty useless from an investing perspective.

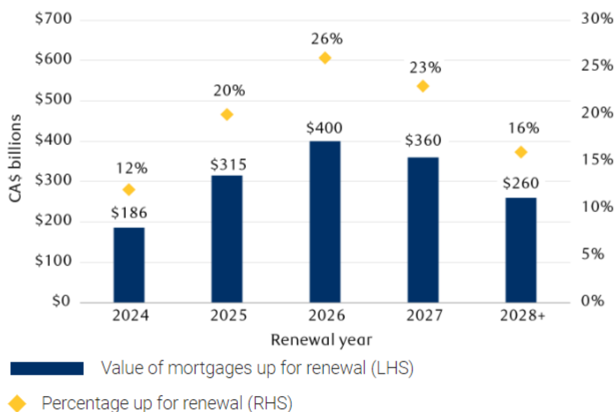

***Figure 3**: Canadian mortgage renewals, 2024-2028+ (Source: RBC GAM)*

We know that markets are forward looking and tend to look through and beyond the current environment. In this regard, we would not be surprised to see strength should the Fed make further comments that support interest rate cuts. In a face-off between a mild recession and dovish Fed, investors will place their bets on the Fed.

What about interest rates?

Forecasting the future of interest rate policy is a recipe for disappointment, but the Fed has openly discussed lowering in 2024 and the market has been quick to get on board. Current market expectations in Canada are for more than five 0.25% cuts (1.25% total), and for six cuts (1.5% total) in the US. This would take target rates north and south of the border into the mid to high 3% range, down from a current target of 5% to 5.5%. Keep in mind that the first rate cut has, on average, preceded the onset of recession by about 3 months (see *Figure 2*).

Clearly, lower rates will be a big positive for many homeowners in Canada where we have an upcoming wall of mortgage renewals (see *Figure 3*); not to mention a large cohort exposed to variable rate mortgages. Already we have seen several institutions, including RBC, lowering rates on more than one occasion. Please speak to us if you or a family member needs assistance with a mortgage. We have recently helped some clients negotiate favourable terms on new and renewing mortgages.

Over the past year we have actively lengthened our average bond maturity. Last Fall, with rates near their highs, we added some 5, 6 and 7 year bonds to portfolios.

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Those purchases now look very timely since yields available just three to six months ago are no longer on offer. In our October newsletter we wrote "*we are eager to take advantage of higher rates and the certainty of income that bonds provide. If and when interest rates start coming down, we will be thankful to have secured some longer bonds. You may have heard the term "higher for longer" used in the context of central bank interest rate policy, but we can play that game too!*". Needless to say, we are very pleased to have added longer bonds to our portfolios.

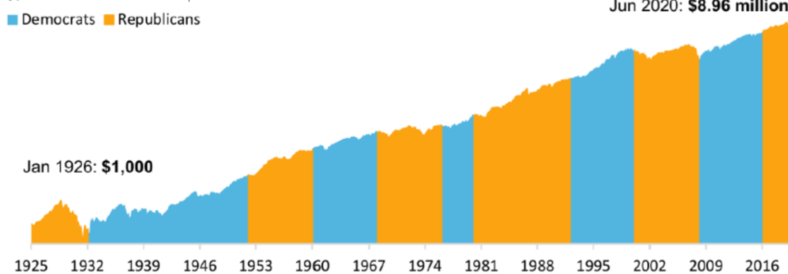

Figure 4*: S&P500 1926 - 2020 (Source: RBC Wealth Management)*

Look away!

This section will be short and sweet - do yourself a favour and ignore coverage of the US election. The media is about to kick into overdrive, and their job is to convince you that every twist and turn leaves the economy hanging in the balance. It doesn't! Markets only really care about corporate earnings. Great businesses like Apple, Mastercard, Amazon and Costco don't wait around to see who wins an election. They come in every morning with a relentless drive to build their company's earnings - regardless of the political backdrop. Corporate North America has proven again and again to be nimble, creative and ingenious. *Figure 4,* while a little dated, highlights well that over the past 100 years, markets have risen steadily regardless of who is in office…plus ça change.

All the very best,

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	Q4	YTD
Indices		
S&P/TSX	7.25%	8.12%
Dow Jones	12.48%	13.70%
S&P 500	11.24%	24.23%
Nasdaq	13.56%	43.42%
Euro Stoxx	8.31%	19.19%
Japan Nikkei	16.23%	28.24%
India Sensex	9.74%	18.74%
VIX (Volatility)	-28.94%	-42.55%
Commodities		
Gold	11.60%	13.10%
Silver	7.29%	-0.66%
Copper	3.06%	1.19%
Oil	-21.08%	-10.73%
Natural Gas	-3.73%	-26.70%
Currency		
CAD	2.53%	2.34%
EUR	4.41%	3.12%
JPY	5.90%	-7.04%
AUD	5.86%	-0.01%
GBP	4.36%	5.36%

Values as of December 31st, 2023

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GLOBAL Insight

RBC Wealth Management

Global Equity Perspective

January 2024

More to come

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The hard versus soft landing debate about the expected path of the U.S. economy is still going strong. We don't think it will be settled definitively until we get an official recession "start date" decision from the National Bureau of Economic Research. However, this typically comes about a year after the fact which makes it largely unhelpful from an investor's tactical standpoint.

For our part, we are persuaded that the combination of high rates and restrictive bank landing standards in place today makes a U.S. recession the most probable outcome. It is important to note that the Federal Reserve had already been cutting funds rates immediately before the start of nine of the past 10 recessions since the 1950s, so the arrival of the first Fed cut should definitely not be interpreted by itself as "Recession Avoided."

Meanwhile, the presence of similar conditions, i.e., high interest rates and restrictive lending, is already taking a toll in Canada, the UK, and the eurozone. GDP growth in all three was no more than a shadow of U.S. growth over the first nine months of 2023.

Of course, one can never rule out the possibility this time will be different. The extreme supportive monetary and fiscal policies introduced in response to the pandemic could conceivably linger long enough to keep the all-important household spending (70% of U.S. GDP) from outright retrenchment. Instead of a multi-quarter decline in GDP, the U.S. economy may do no worse than slow down this year.

That could be enough to keep S&P 500 earnings growing, although probably not by as much as the current consensus estimate for 2024 ($244 per share, up approximately 11% from 2023's expected $220) would suggest. (RBC Capital Markets' estimate sits at $234, up a more modest 6.4%.) We think any earnings growth would leave room for share prices to advance between now and the end of 2024, even if the path for getting there remains in debate.

For now, we recommend remaining sufficiently committed to stocks

Equity views

Region	Current
Global	=
United States	=
Canada	=
Continental Europe	–
United Kingdom	=
Asia (ex Japan)	=
Japan	+

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

For important and required non-U.S. analyst disclosures, see page 4.

All values in U.S. dollars and priced as of market close, Dec. 31, 2023 unless otherwise stated
Produced: Jan. 9, 2024 1:09 pm ET; Disseminated: Jan. 9, 2024 2:45 pm ET
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to take advantage of the distinct possibility of the S&P 500 and other major indexes reaching a new all-time high ground in the coming few months. However, we would consider limiting individual stock selections to companies an investor would be content to own through a recession, which, in our view, is the most probable economic outcome in the coming quarters. For us, that means high-quality businesses with resilient balance sheets, sustainable dividends, and business models that are not intensely sensitive to the economic cycle.

Perhaps the most compelling reason for focusing on resilient, high-quality businesses is that the economic and market valuation headwinds gathering will, in our view, run their course and probably fully dissipate later in 2024 or early 2025. Equity markets typically have anticipated the start of a new economic expansion several months before it gets underway. In our opinion, portfolios that have held their value to a better-than-average degree will be best equipped to take advantage of the opportunities that are bound to present themselves when a stronger pace of economic growth reasserts itself.