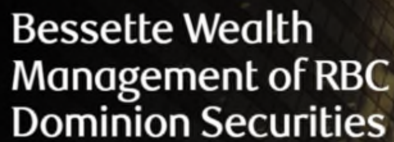

Momentum Continues in Market Leaders and Laggards – Perhaps Not for Long

Global asset prices continued to demonstrate many of the same themes in the second quarter. The stock market was once again led by the tech heavy NASDAQ index in the U.S., up 8.5% including dividends. This propelled continuing U.S. stock market leadership, up 4.3%. Gains were also achieved in global stock markets overall and emerging markets, up 2.8% and 5.3%, respectively.

For context, the current bull stock market in the U.S. has resulted in over 350 days without a price correction of 2% or higher. This is now a top 10 longest daily streak without such a fall in close to 100 years. The last time a period like this occurred was between May 2003 and February 2007 preceding the Great Financial Crisis period.

As Canadian investors are all too familiar with lately, the Canadian stock market lagged on the quarter, down a modest 0.5% on a total return basis. Similar returns after coupon payments were also experienced in global bond markets which were down 1.1% in Q2. The U.S. bond market was flat during the second quarter while the Canadian bond market posted a modest total return of 0.9% propelled by a June cut.

Through the time of this writing, year-to-date the U.S. stock market is now up 19% in price while the Canadian stock market is up a strong but lagging 9%. Most promisingly, the tides for bonds and the broader global stock market have been shifting meaningfully in the first half of July as described below.

The Economic Backdrop is Generally Stable but Importantly, We See New Signs of Strength

We have been pointing to continuing U.S. economic leadership as a significant driver of global growth in light of weakness across Europe, Asia and much of the emerging economy landscape. This trend seems to be in the early innings of reversing as of late, with significant potential implications for interest rate cuts, asset price performance and currency movements.

There are recent signs that the American consumer has been feeling the strain from elevated inflation and high interest rates. We are seeing wage growth falling from post-Covid highs in recent quarters, and more recently we are beginning to see signs of labor market strain. Unemployment has crept up to 4.1% in the U.S., still strong relative to long-term history but certainly noteworthy off a level of 3.5% in early 2023. Much of the continuing job strength is coming from the public sector while the private sector contracts, a development we will be watching closely in the months ahead.

This slowing of the U.S. economy is combining with falling inflation, most recently at 3% year-over-year, matching its lowest level in the past three years. This is now the third below consensus Core CPI reading in a row, with each of these seeing a faster decline in inflation than the prior. It is not just in the U.S. that inflation headwinds have turned into tailwinds, where already we are seeing Central Bank easing of interest rates in Europe, Canada and abroad. GDP expectations globally are mostly accelerating into 2025 from anticipated 2024 levels, save for the U.S. where consensus expects a lesser 1.8% growth rate next year versus the anticipated 2.3% in 2024. While the U.S. was a lone bastion of strength in 2023, it looks to be on equal footing with major economies by 2025.

The combination of improving economic activity across much of the world (albeit with a generally stable but slowing U.S. engine) and falling inflation with corresponding monetary easing (which looks to now include the U.S. given domestic labor market softening) is setting up favorably for asset prices and potential future economic stimulus through lower interest rates. The combination of these influences has shifted fairly subtly in recent months but has potentially important implications for foreign currencies and asset price performance.

Shifting Landscape

In our prior quarterly letters, we have voiced our concerns that the U.S. economy would continue to outperform weakness across much of the rest of the world. Ongoing American labor market strength would diminish the probability of Federal Reserve interest rate cuts. While other countries cut and the U.S. held in a higher for longer pattern, we saw no discernible near-term catalyst to a weakening U.S. dollar.

Our fears of the above macro backdrop are beginning to rescind amidst recent global economic data and Central Bank policy decisions and forward guidance. Canada's high probability of a second interest rate cut of 0.25% on July 24th combined with no cut south of the border was setting up a weakening Canadian dollar. That future path has now dimmed, with markets now anticipating nearly a 100% chance of a Federal Reserve cut of 0.25% of its own in September. The abrupt repricing of U.S. cut chances could lead to weakening of the world's strongest performing currency over more than the past decade.

In looking back to the early 1970s, we have found that U.S. stock market leadership almost always coincides with USD strength. The reverse was true where USD weakness coincided with international equity market leadership. This held for all periods save for 1988 to 1992. We are currently on the longest USD bull market in modern history, which is lining up with U.S. equity market leadership since the bottom of the Great Financial Crisis. A weakening USD could catalyze a change in stock market leadership away from the U.S. based on the historical record.

Putting the Puzzle Together

At the same time, the U.S. market looks expensive on a valuation basis relative to its own past. The market sits at a P/E ratio of 22.7x, 33% above its median ratio dating back to 1990. The high valuation of the S&P 500 is in stark contrast to other stock markets. We find that developed markets outside the U.S. are trading at a 35% discount to the S&P 500 when normally they trade at just a 5% discount. This is an all-time low in our dataset going back to 2004. This same heavy discounting is occurring in Canada where the TSX is nearly 30% below the U.S. market, and over time it has actually traded at a 6% premium. It is not just international equity markets that look attractive, the average U.S. company (as measured by an equal weighted S&P 500 index) is trading nearly 20% below the headline index. Taken in full, global equity markets including the average U.S. stock are trading at or below their long-term averages while those areas of the economy are generally strengthening. This should fundamentally improve corporate profits and cash flows.

Elsewhere, bonds had been weak for the majority of three years given increasing interest rates followed by higher for longer rates than the market was anticipating. This appears set to reverse to some extent. In just the first three weeks of July, we have watched the U.S. treasury yield curve shift down across the board. Five-year yields have moved from 4.4% to 4.1% while 10-year yields have fallen from 4.4% to 4.2%. By the end of the year, the market is now anticipating over two cuts of 25 basis points in the U.S. and a further two to three cuts (0.5-0.75%) in Canada beginning on July 24th. This should result in yields continuing to fall across the global bond market, marking potential for meaningful price gains for the first time since before inflation began making headlines. Overall, we see attractive investment opportunities across much of the corporate world and in fixed income markets.

Adjustments in our portfolios reflect the changing times. While we were entering and adding to IT and growth tilted equity names in mid to late 2022 and into 2023, we are now taking profits from rich areas of

the market and redeploying into equities with better risk-reward prospects in light of a strengthening global economy.

An example of our investment includes the growing identification of a valuation disparity between large and small companies in the U.S. stock market. The largest 20% of stocks on the S&P 500 recently carried a nearly 200% premium to that of the smallest 20% of stocks on that index. As a result, we recently added smaller company equity exposures for many clients through further additions and entries into several alternative managers that invest into small and midcap U.S. equities. Falling interest rates combined with a generally accelerating global economy should bode well for the average company as opposed to just the AI and tech giants. This appears to be the case in earnest early, as from July 9th to July 16th the U.S. small cap index (Russell 2000) appreciated 11.5% while the large cap S&P 500 index was up a lesser 1.6%.

While we make these changes, we acknowledge the timing is never known in advance. Concentrated market leadership could very well continue for longer than expected and to levels that we believe are unlikely today. In looking at the current elevated U.S. market valuation for example, there could be a further ~30% increase in the P/E multiple before we are back to levels experienced towards the end of the Dot Com bubble. That upside potential becomes significantly higher if AI delivers what it could – increased global GDP growth, increased productivity, resulting expanding operating and cash flow margins and a super charged economic landscape. This may surpass significant upside disruptions from past technological progressions including the internet and smart phone market developments. Rest assured, we will remain exposed to both sides of this evolving economic and financial landscape.

Bessette Wealth Management

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