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Q2 2024 MARKET AND ECONOMIC REVIEW

PREPARED BY ENCASA FINANCIAL

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Executive Summary

- Inflation is coming down but remains above central banks' target levels; goods inflation is back to pre-pandemic levels, but housing and services prices are keeping inflation above 2%
- Economic growth and demand for labour have slowed
- The faster-growing US has been the exception, but there are hints that US growth may be softening
- The Bank of Canada has delivered one 0.25% rate cut; further cuts will depend on the Bank remaining "confident" that inflation is continuing downward. Despite the cut, interest rates for longer maturities ended Q2 close to where they started
- In the US, the Fed remains on hold, but markets expect at least one rate cut before year-end
- Equity markets around the world continue to be driven largely by AI optimism, but interest-rate sensitive and defensive sectors are showing some strength

Capital Market Returns Q2 2024[1]

Product Name	QTD	YTD	1 Year	3 Years	5 Years	10 Years
Cash Equivalents: 3 Month T-Bill	1.2	2.4	5.0	3.2	2.2	1.5
Short-Term Bonds: FTSE Canada Short-Term Overall Bond Index	1.2	1.6	5.6	0.6	1.4	1.7
Canadian Bonds: FTSE Canada Universe Bond Index	0.9	-0.4	3.7	-1.8	0.0	1.9
Canadian Stocks: S&P/TSX Composite	-0.5	6.1	12.1	6.0	9.3	6.9
US Stocks: S&P 500	5.4	19.6	28.8	13.7	16.1	15.7
International Stocks: MSCI EAFE	0.9	9.7	15.9	6.9	8.0	7.5
Developed Market Stocks: MSCI World	3.9	16.3	24.9	11.0	13.4	12.5

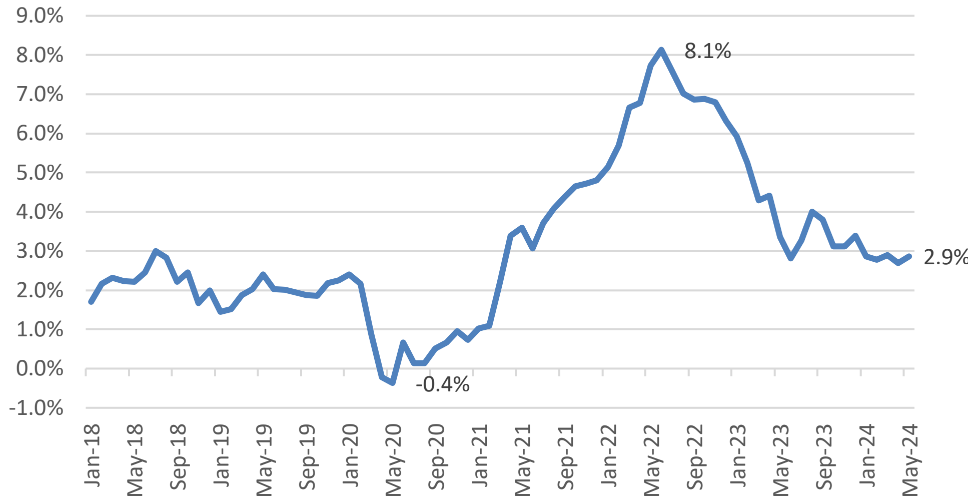
(1) All returns in Canadian dollars
(2) Bank of Canada 3-Month T-Bill

Both Short-Term and "Universe" bond indices (which includes bonds of all maturities, from short to long) delivered solid returns in Q2, while stocks were more divided. Canadian stocks lagged, but US and global stocks rose. Once again, the two major themes in markets were inflation and Artificial Intelligence (AI), which helped the US markets outperform Canadian and international stocks.

Bond markets continue to focus mainly on inflation, and Q2 brought some good news with Canadian headline inflation coming in below 3% every month so far in 2024. May saw a slight uptick to 2.9% from April's reading of 2.7%, but on a year-over-year basis the trend is

downward:

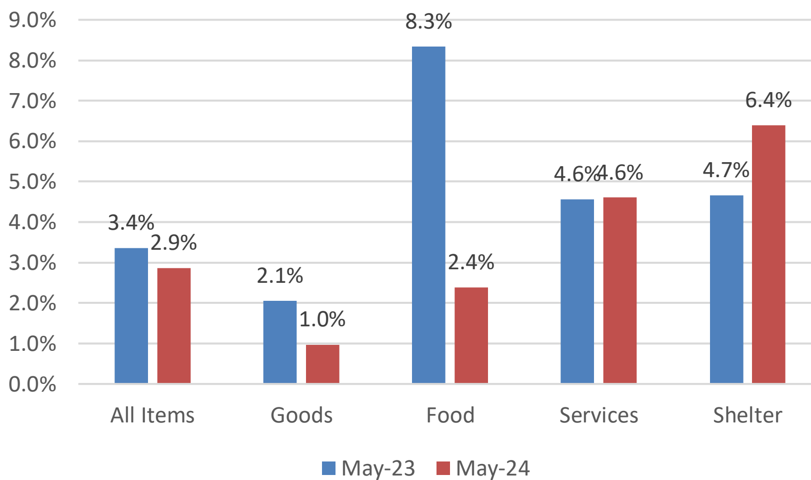
Figure 1. Year-Over-Year Change In the Consumer Price Index (%)



Source: Statistics Canada

In further good news, inflation in goods prices has come down to 1%, which is similar to what Canadian consumers were used to before the COVID-19 pandemic. Food inflation has also come down significantly, increasing at 2.4% year-over-year to June. However, inflation in the price of shelter and other services remains stuck at higher levels, suggesting that higher interest rates alone will not resolve the economic pressures that are raising prices in these areas.

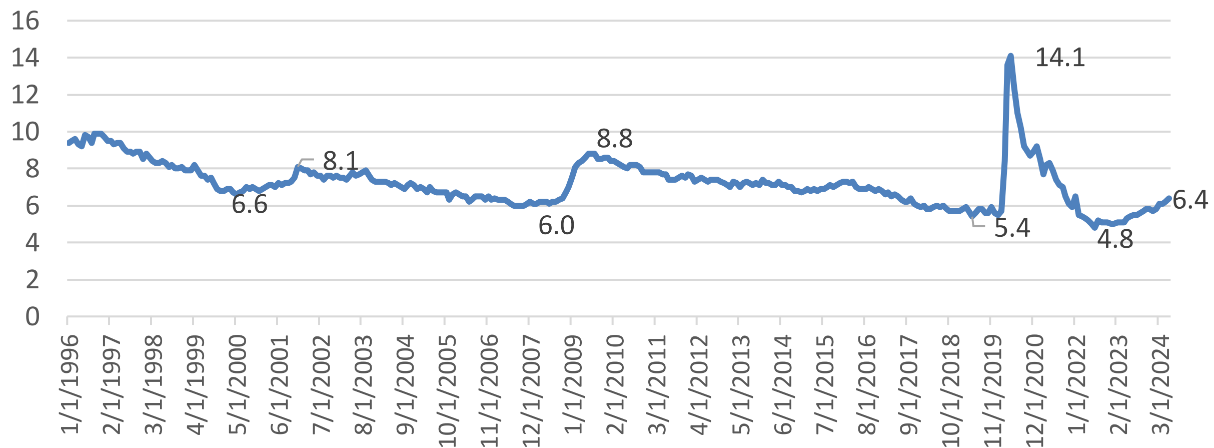
Figure 2. February Year-over-Year Increase in Components of CPI



Source: Statistics Canada

A key driver of inflation in the price of services is the cost of labour. Coming out of the pandemic, the Canadian economy faced labour shortages, which resulted in wage increases as employers tried to attract employees. This led to historically low unemployment, with Canada's unemployment rate falling to 4.8% in mid-2022. However, since then, the unemployment rate has climbed significantly, coming in at 6.4% in June.

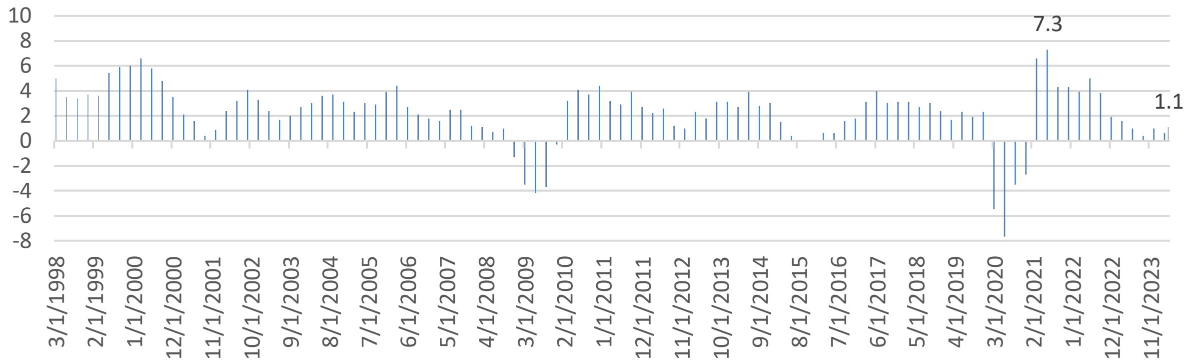
Figure 3. Canadian Unemployment Rate



Source: Bloomberg

This increase of 1.6 percentage points in the unemployment rate is not as large as the 2.8 percentage point increase experienced in the Global Financial Crises of 2008-9, but it is larger than the 1.5 percentage point increase that resulted from the collapse of the Dot-Com Bubble in 2000-1. This suggests that the Canadian economy may be facing some growth headwinds, and in fact we can see this in Canada's reported GDP growth figures, which have fallen since the post-pandemic surge, and now sit in the 1% range:

Figure 4. Year-over-Year Change in Canadian GDP

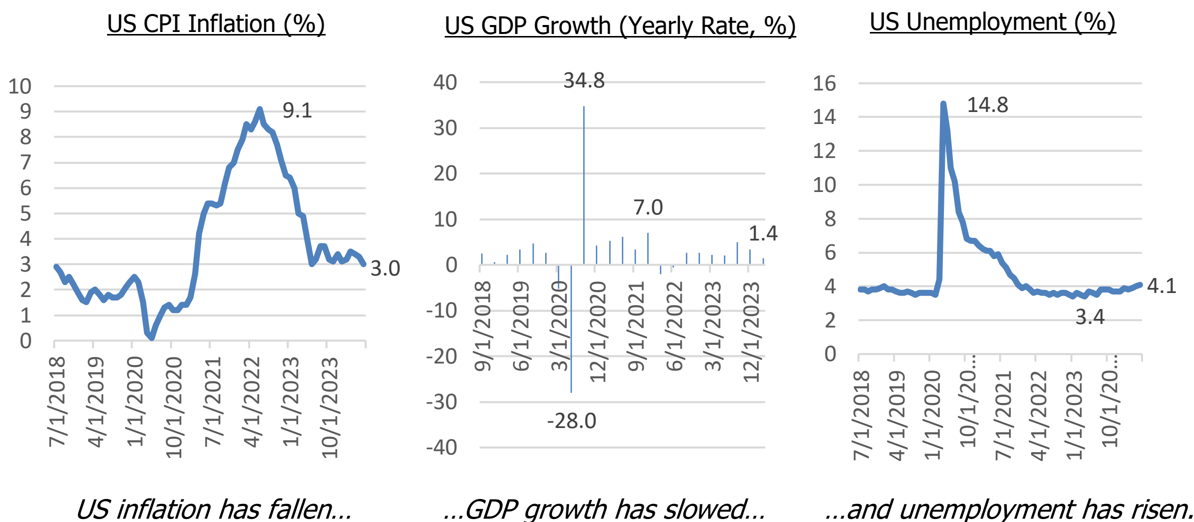


Source: Bloomberg

The rise in unemployment and slowdown in economic growth seem like gloomy developments, but the silver lining is that this is part of how higher interest rates are supposed to bring inflation under control – by reducing the demand for goods, services and labour, higher interest rates reduce the upward pressure on prices and wages. Slower growth and rising unemployment are the unfortunate side-effects of the Bank of Canada's action.

We can see similar dynamics at work in the US, where a similar pattern can be seen: inflation has fallen to levels similar to Canada's, while GDP growth has slowed to an annual rate of 1.4% and unemployment has risen from its post-pandemic lows:

Figure 5. Summary of Key US Economic Data

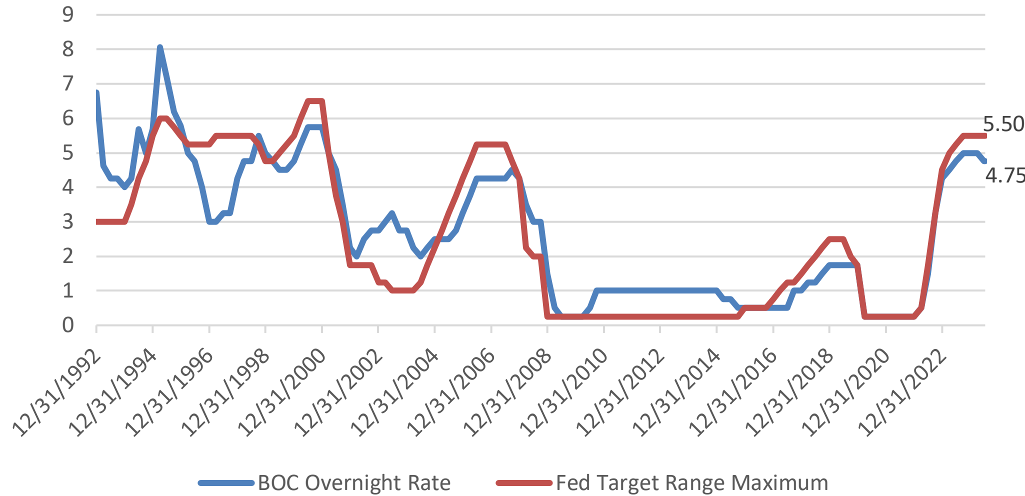


Source: Bloomberg

Although the path of major economic measures has been similar in Canada and the US,

there has been some divergence in monetary policy, with the Bank of Canada deciding to cut its policy interest rate during Q2, while the US Fed held firm:

Figure 6. Bank of Canada and US Fed Policy Rates

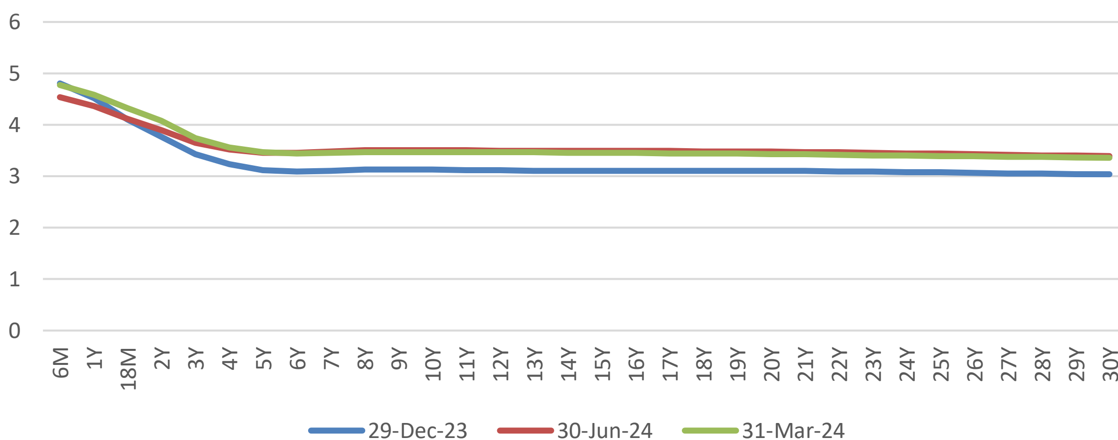


Source: Bloomberg, Bank of Canada

The Bank of Canada's 0.25% rate cut reflects the Bank's assessment that higher interest rates are working to cool Canada's economy; however, since the rate cut, Bank officials have continued to emphasize that further cuts will depend on seeing continued evidence of slowing inflation. Similarly, in the US, the Fed has emphasized that rate cuts will require convincing evidence of slower inflation.

Given central banks' cautious approach to rate cuts and clear signs of slowing economic activity, it is not surprising that the yield curve did not move very much during the quarter:

Figure 7. Government of Canada Yield Curve

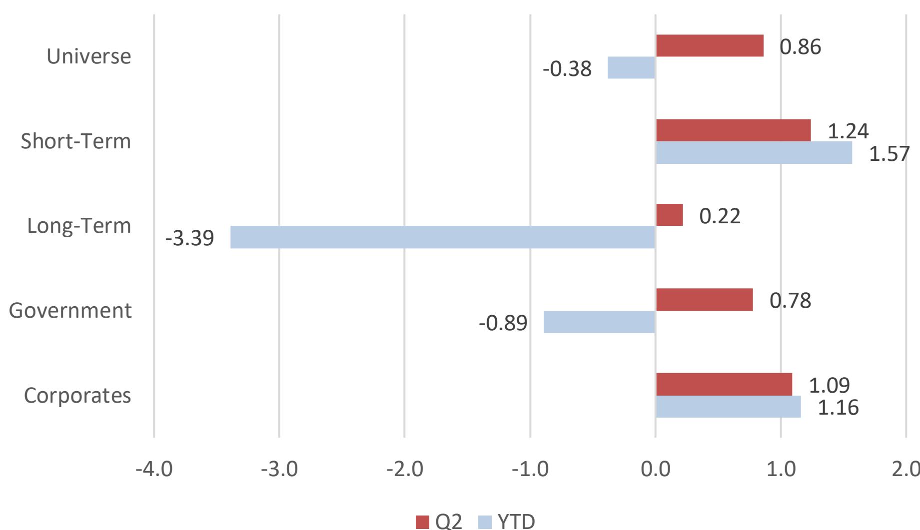


Source: Bloomberg

The effect of the Bank of Canada rate cut can be seen at the short-term end of the curve,

where rates moved down by 0.25%, in line with the cut. The impact of the rate cut declines for longer maturities, to the point where its effect is no longer visible past the 4-year mark. For longer maturities, the yield curve actually rose very slightly during Q2. To put some numbers to that rise, the Government of Canada 10-Year benchmark bond yield rose from 3.47% at the end of Q1 to 3.50% at the end of Q2. The small increases across longer maturities were still large enough to weigh on the returns of long-term bonds, as we can see in the figure below:

Figure 7. Q2 Canadian Fixed Income Sector Returns



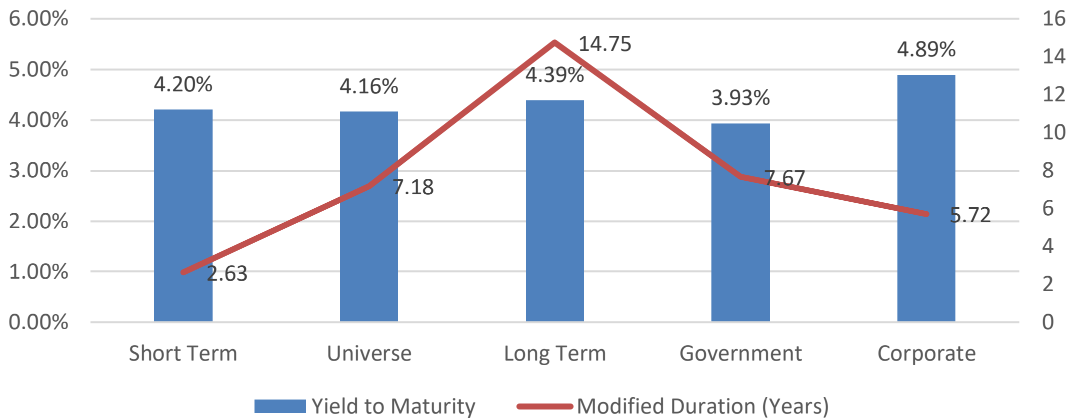
Source: Blackrock

As we can see, all of the key categories of Canadian fixed income delivered positive returns for the quarter, but generally those with less interest-rate sensitivity, such as short-term and corporate bonds, did the best. Government and long-term bonds both felt the drag of slightly higher interest rates. For the year-to-date, short-term bonds still hold the lead, as they were affected less than longer-dated bonds by the rise in interest rates in Q1.

This underperformance of longer-term bonds has been a significant factor for much of the post-pandemic period, as rising rates have hurt more interest-rate sensitive bonds. It is noteworthy, however, that on a forward-looking basis, longer-dated bonds are starting to offer more attractive yields. If we look at the yield to maturity of the different categories, we can see that, despite the inverted yield curve, the yield advantage of short-term bonds over the broad bond "Universe" has almost disappeared, with short-term bonds offering only 4 basis points (or hundredths of a percent) of additional yield over the broad Universe index, which includes both short- and long-term bonds. Long-term bonds are now offering more yield than short-term bonds, albeit with considerably more interest-rate sensitivity. For investors who have been considering adding duration to portfolios (for example, because

their expecting holding period is longer than short-term bonds duration of roughly 2.5 years), this could be an interesting time to consider shifting out of short-term bonds and into a portfolio with a Universe-type duration. This could allow them to take advantage of rising bond prices if the yield curve moves lower in response to further Bank of Canada rate cuts or a further economic slowdown. For any organization considering adding exposure to longer-dated bonds, a good first step would be to set up a discussion with your Encasa advisor.

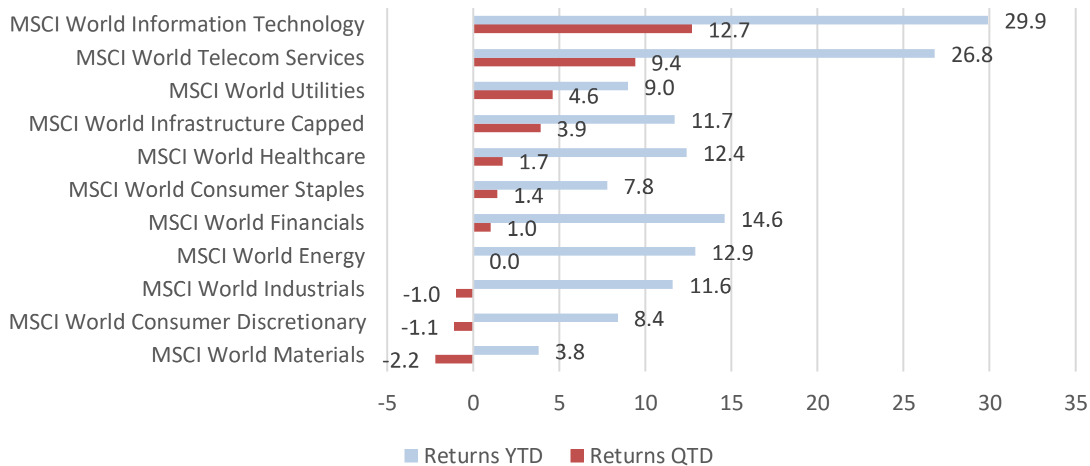
Figure 8. Q2 Fixed Income Sector Yields and Durations



Source: Bloomberg

Turning from bonds to stocks, we can look at the performance of sectors of the global developed market stock index to get some insights into what investors are focusing on. The table shows the sectors in descending order, from the top Q2 performers to the bottom:

Figure 9. Q2 MSCI World Index Sector Returns (%)

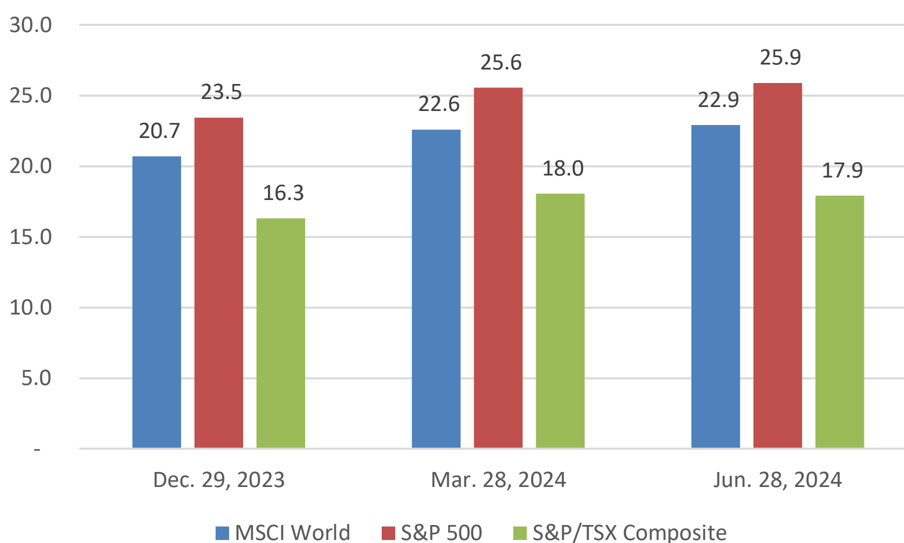


Source: eVestment

Q2 saw some trends carry on from previous quarters, most notably the leadership of technology stocks, with AI still generating considerable excitement. However, several sectors that are traditionally viewed as interest-rate sensitive moved close to the top of the list for the quarter. Telecom, utility and infrastructure stocks all did well, suggesting that stock market investors are positioning portfolios for lower interest rates. Also notable was the relatively weak performance of the sectors that are most heavily represented in the Canadian markets: financials, industrials, energy and materials.

The effect of these moves on valuations can be seen in the figure below. As share prices have risen faster than earnings have grown, the ratio of share prices to earnings (the "P/E ratio") has risen in 2024. This is most pronounced in the strongest market, the US, where P/E ratios have risen from 23.5 at the beginning of the year to 25.9 at the end of Q2. Underperforming Canada has seen the smallest increase, from 16.3 to 17.9.

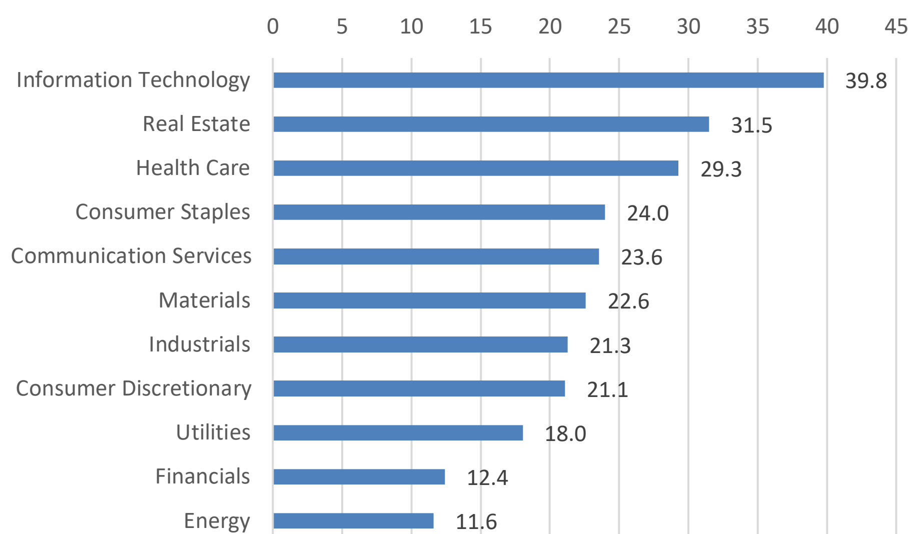
Figure 10. Price-Earnings Ratios for Key Regions



Note: Indices used are Bloomberg World, S&P 500, and TSX 60. P/Es are calculated on trailing 12-month earnings.
Source: Bloomberg

These multiples suggest that stocks are not all that cheap, but it's important to note that valuations vary dramatically across sectors, with some sectors (such as information technology) looking somewhat expensive, while others, such as energy, look quite cheap. We can see this by looking at the P/E ratios of global sectors in the figure below:

Figure 11. Price-Earnings Ratios by Sector



Source: Bloomberg

As we can see, P/E ratios vary from just under 40 for information technology stocks to just under 12 for energy. It is normal for stocks in different sectors (or even within the same sector) to be valued differently, depending on the unique features of their business, their outlook, the quality of their management, etc. What is noteworthy in the current environment is that while stock markets are not cheap on average, there are certainly pockets of value where active managers could find potential to outperform.

Overall, Q2 delivered solid returns for investors, along with a continued slowdown in inflation. There are reasons to be optimistic about potential returns from investments: bond yields remain attractive compared to those of recent decades, the Bank of Canada and other central banks appear likely to reduce short-term rates if inflation remains low, and global economic growth remains positive. There are also reasons for concern – housing and services inflation continue to run hotter than goods inflation, stocks are not cheap, and unexpected geopolitical or economic events could surprise markets. As always, we believe that the best strategy in light of these opportunities and risks is to make sure that your organization’s portfolio is diversified and matched to the time horizon over which cash will be needed. If you have any questions or would like to make sure that your portfolio is properly aligned with your objectives, please contact your Encasa advisor; we are here to help.

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