iA Global Asset Management

Monthly Macro & Strategy

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Highlights

- We provide a comprehensive overview of the U.S. labour market and its influence on the global economy.
- We examine labor market dynamics within the different phases of the business cycle.
- Macroeconomic signals suggest high risks ahead, so investors should remain cautious and closely monitor the economic and financial data.

In recent months, we've introduced you to our frameworks and focused on crucial developments in the financial markets.

What better time than mid-summer to propose an intern's guide on one of the most important components of the macro story: the labour market.

We'll focus specifically on the U.S. labour market, because the global economy and markets are more sensitive to its ebbs and flows than to any other geography. It will also be a very sensitive topic in the coming quarters, given the accumulated monetary tightening over the past 16 months.

Whether the global economy hits a soft patch in the coming quarters will depend largely on the health of the U.S. labour market. Thus far, the labour market's strength has kept consumption and general economic activity elevated, such that inflation has remained above the Fed's target range. Yet, to overcome the challenge of rising inflation, the labour market must begin to cool.

Keep reading to gain a thorough understanding of this integral component of the U.S. economy.

Global Asset Allocation Views (August 2023)

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Asset Classes						
Money Market				■		
Fixed Income				■		
Equities		■				
Alternatives			■			
Relative Equity						
Canadian Equities			■			
U.S. Equities		■				
International Equities			■			
EM Equities			■			
Relative Fixed Income						
Government Bonds					■	
IG Corporate Bonds				■		
HY Bonds	■					
Other						
Oil				■		
Gold			■			
USD (trade weighted)				■		
CAD/USD			■			

U.S. labour market indicators: the many facets of the job market

To understand the complex economic landscape of the U.S. labour market, it's essential to analyze various data series and statistics. The major labour market indicators published by government agencies, such as the Bureau of Labor Statistics (BLS), private companies and independent organizations, provide a comprehensive view of the market's evolution. But before we explore how the labour market fits into the broader business cycle framework, let's delve into the key metrics that can help paint an accurate picture of the overall workforce and economy.

The unemployment rate, an all-important measure of the labour market's health, is determined by the BLS's Current Population Survey. It indicates the percentage of the labour force actively seeking, but unable to secure, employment. That being said, this figure doesn't account for underemployment or discouraged workers who have stopped looking for work. The BLS also collects data on the number of unemployed persons, offering a more precise measure of the labour market, although this information also has its limitations.

Another important aspect of the labour market is underemployment, which refers to involuntary part-time workers and those marginally attached to the workforce. These individuals might not be classified as unemployed but

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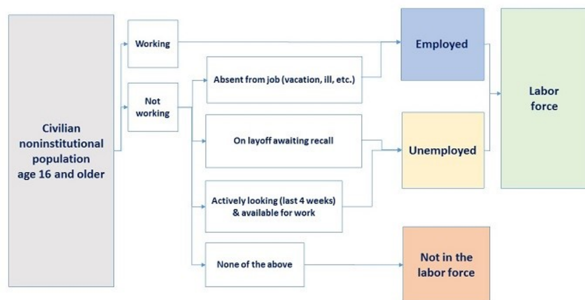
could be working in positions that underutilize their skills and qualifications.

The labour force participation rate is vital for an understanding of labour market dynamics. It captures the proportion of the population aged 16 and over who are employed or actively seeking work. This metric can be influenced by demographic shifts and changes in education levels but still offers valuable insights for labour market analysis.

Other important labour market indicators include nonfarm payroll employment, job openings, hires and separations, which are measured by the BLS's Job Openings and Labour Turnover Survey (JOLTS), and average hourly earnings of all employees on private nonfarm payrolls. Each of these metrics provides unique insights into various aspects of employment trends, wages and labour demand across different sectors.

In addition to government sources, data from private organizations, such as the ADP National Employment Report and the Challenger Job-Cut Report, offer valuable perspectives on the labour market. Moreover, real-time data sources, such as the LinkUp Job Market Data and the LinkedIn Economic Graph, extract information from online platforms to enhance our understanding of job postings skills and demographic trends.

Even though these data series may not capture the entire labour market landscape, they form a detailed portrait of the current situation and trends. As we explore the position of the labour market within the wider business cycle framework, understanding these key metrics helps us build a more precise picture of things to come.



The labour market's place in the business cycle

The labour market cycle is similar to the credit cycle framework (discussed in our May 2023 issue), which consists of four main phases: expansion, peak, contraction and trough. During each phase, labour market indicators, such as employment, unemployment, wages and labour force participation, display distinct dynamics.

During the expansion phase, the economy experiences sustained growth, marked by increases in production, demand and consumer spending. In the labour market, job creation goes up as businesses expand their operations and hire more staff. As job opportunities increase, the unemployment rate declines, and more people find work. The growing job market attracts more people to the labour force; people enter the job market for the first time or re-enter it after periods of absence. Wages tend to rise during this period as companies are forced to compete to attract and retain workers.

The peak of the business cycle represents the highest point of economic growth before the unavoidable slowdown. At this stage, the labour market often experiences plateaued growth and becomes saturated, creating fewer job opportunities. Unemployment rates are typically at their lowest during the peak, reflecting a strong labour market. Labour force participation rates are also high owing to the abundance of job opportunities. Even so, wage growth may start to slow as employers become concerned about economic prospects or feel pressure to manage costs more tightly.

As the economy enters the contraction, or recession, phase, growth slows and job losses become more common as businesses struggle with falling demand and shrinking profits, leading to a decline in the hiring rate. These job losses result in higher unemployment rates, with more people searching for work without success. As job opportunities become scarce, discouraged workers may exit the labour force, leading to decreased labour force participation. With a surplus of job seekers and companies focused on cost-cutting measures, wage growth may stagnate or even decline during a contraction.

The trough represents the low point of the economic cycle when the economy endures its steepest decline, followed by a slow rebound in growth. In this phase, job losses may persist, but the decreasing pace typically signals stabilization of the labour market. Unemployment rates generally peak during the trough, as the labour force grapples with the burden of economic contraction. Moreover, the labour force participation rate tends to reach its lowest levels as disheartened workers leave the job market. Wages might stagnate or hit rock bottom before commencing a gradual revival, as businesses start to reconstruct their operations.

As the economy progresses through the various phases of the business cycle, labour market behaviours change in response to the evolving economic conditions. To predict trends and to make informed decisions, policymakers, investors and businesses must monitor labour market indicators closely.

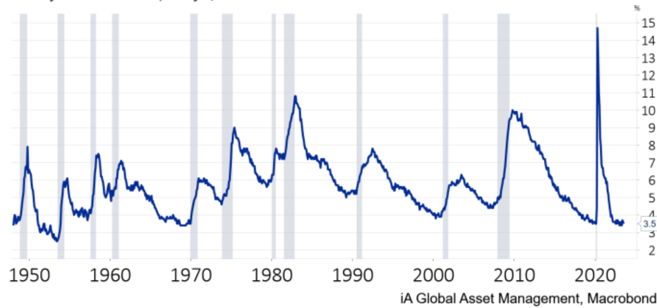
The current state of the labour market

The U.S. labour market continued to show strength in July, with total nonfarm payrolls increasing by 187,000. The unemployment rate held steady at 3.5%, while long-term unemployment and labour force participation rates remained stable. Growth was broadly based in the governmental, health care, social assistance and construction sectors. Average

hourly earnings and the average workweek for private nonfarm payrolls also rose modestly. Even so, industries such as mining, manufacturing and finance saw little or no change, and part-time employment for economic reasons increased.

US Unemployment Rate

Bureau of Labor Statistics, as of 7/2023



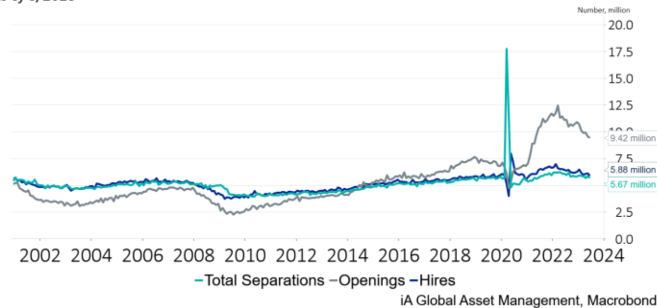
Despite the economic challenges posed by high interest rates, elevated inflation and uncertainty over the Fed's interest rate policies, various industries keep adding jobs and restoring their workforces to pre-pandemic levels. This strength in the job market fosters sustained consumer spending on services, providing reassurance against an imminent economic downturn.

Still, we can see that tight monetary policy is slowly having an impact with its usual lag of 18 to 24 months.

The number of jobs that are open but unfilled has been sliding over the past 12 months (there are 3.87 million more jobs open than there are Americans looking for work) and the quits rate (the percentage of job leavers who have not already secured another position) has also fallen. Still, both measures remain above their pre-pandemic levels, suggesting that the adjustment process is in the early phase.

Bureau of Labor Statistics Openings, Hires and Separations

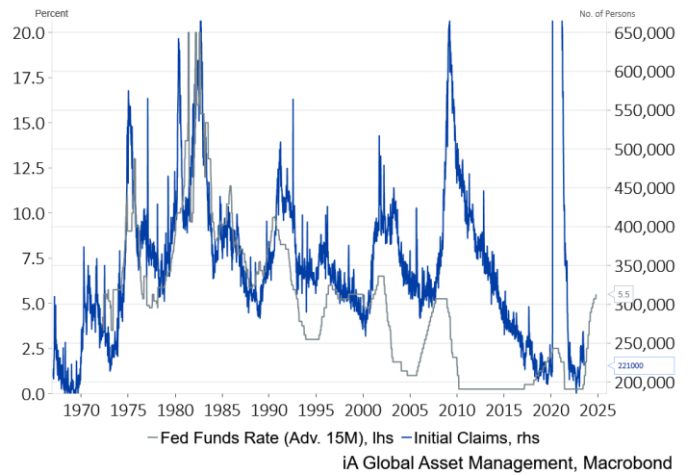
As of 6/2023



Initial jobless claims tend to be the first labour market indicator to change direction when the tide turns, and we're seeing what looks like the beginning of an uptrend. The labour market is well known as a lagging economic indicator, as illustrated in the chart below, which shows that claims tend to react to the federal funds rate with a lag of 15 months. The Fed's first hike of this cycle came in March 2022 (as of this writing, 16 months ago), and history suggests that the upward trend will continue and will solidify in the coming quarters.

U.S.: Jobless claims lag Fed rate by 15 months

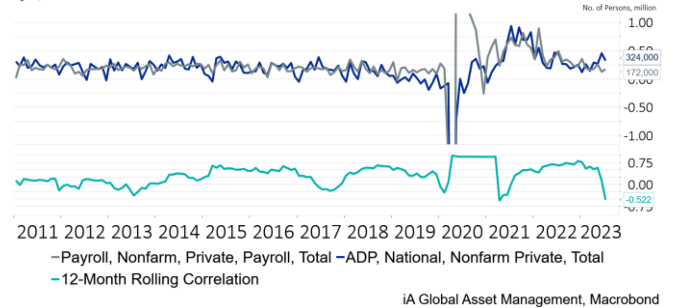
U.S. Department of Labor, Federal Reserve, as of 7/24/2023



All in all, we expect that consumer credit, delinquencies, business investment and confidence surveys will most likely have to show sustained (or, given the speed of this monetary tightening cycle, swift) weakening before we truly see the labour market break, given its nature as a lagging economic indicator.

U.S.: ADP vs Nonfarm Private Payrolls

As of 7/2023



Although the National Bureau of Economic Research (NBER) puts ample weight on employment in its call for recession start and end dates, the peculiarities of the current cycle could very well mean that we'll face a "jobfull" recession in the coming quarters, with consumption and GDP growth slowing to a crawl without breaking the labour market. Such a recession would be seen as a non-event by most economists (no worries if unemployment rises to 4.5% because it will still be low by historical standards!). But the direct impact on business earnings in the context of elevated valuations should still bring a healthy dose of volatility.

Strategy

As we navigate the complexities of macro strategy, it's essential to understand the factors that influence market movements.

Looking at the story of the year, artificial intelligence (AI), we would argue that a fair share of the transformative impacts on industry is already priced in. We, too, are bullish on the game-

changing potential of AI, but the recent hype surrounding the technology may be overstated because of the popularity of chatbots, and the almost 60% year-to-date rise in the seven large AI-linked names could be due for a reversal.

As has often been the case historically, potential game changers tend to be met with a period of exuberance that pushes valuations to elevated levels before the realization sets in that the gains might not be as immediate as expected, leading to profit taking and a partial reversal.

The following chart illustrates how swift and powerful the multiples expansion has been on the Nasdaq over the past 6 months, with forward price-earnings ratios rising by about 10 points, a feat typically seen after a recession. (chart?)

To see such powerful margin expansions while central banks are still engaged in one of the most aggressive monetary tightening cycles in history seems peculiar; therefore, we continue to advise investors to tread lightly.

Even so, investors need to recognize momentum and have a flexible mindset. Being a contrarian can certainly be a winning strategy, but leaning against strong winds can be a challenging endeavour that requires accurate timing. Acknowledging the importance of patience can improve one's trading strategy significantly, as being right too early may very well still result in losses. Listening to our own advice, we have recommended riding some of the recent momentum in U.S. equities while keeping a slight bias toward prudence.

We don't have a crystal ball but we expect the path of least resistance in the second half of 2023 to be sideways at best and most likely lower for U.S. equities, coupled with a return of volatility as the recent enthusiasm eventually fizzles. Instead of being surprised by this development, investors should see it as an opportunity to assess the market's value. The current market enthusiasm may prove unsustainable if it lacks a solid foundation in economic fundamentals, and the S&P 500's dependence on a few key stocks exposes it to the risk of a significant downturn if those stocks face hurdles.

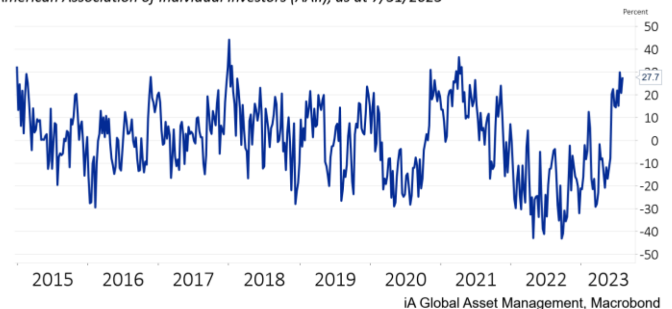
Adding to market noise and uncertainty are the tight monetary policies implemented globally by central banks. A cautiously optimistic attitude is advisable in such a climate.

The current setup seems to be conducive to disorderly market moves.

For example, the bull-bear spread from the American Association of Individual Investors (AAII) survey has been positive for 8 consecutive weeks, reaching 27.7, the most bullish stance since April 2021. Extreme levels of sentiment have often signalled a potential reversal of market trends. The prevailing bullish sentiment may have led to overconfidence and overinvestment, suggesting overextended market moves. As sentiment eventually exhausts itself, so could the market trend.

U.S.: AAII Bull-Bear Spread

American Association of Individual Investors (AAII), as at 7/31/2023



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Bottom line

Equities

Given the current market environment, we prefer Canadian and global equities over U.S. equities, because valuations are stretched in the United States. Furthermore, we are neutral on emerging markets, partially because of China's disappointing growth numbers, but we remain open to reassessing our position in light of the country's recently announced stimulus package, which could spark a reversal of this trend.

We also acknowledge the momentum in U.S. tech stocks, and the challenge of accurately calling a top on such strong momentum-based themes. With this in mind, we emphasize the importance of exercising patience in making investment decisions and remain tactically close to neutral on U.S. equities, despite what we see as an unfavourable backdrop.

Index	As of July 31st, 2023	
	Current NTM Fwd P/E	Current historical percentile
NASDAQ	27.3	86
Russell 2000	23.0	77
S&P 500	19.7	83
Nikkei 225	17.9	69
MSCI ACWI	16.7	81
S&P/TSX	13.8	29
S&P/TSX Small Cap	14.2	14
MSCI EM Ex-China	13.4	84
MSCI EAFE	13.2	43
MSCI ACWI Ex-U.S.	13.0	52
MSCI Europe	12.7	47
MSCI EM	12.3	41
MSCI China	10.9	43

Looking at the S&P 500's recent runup, we think the market could be poised for a pullback. Instead of being dismayed by this development, investors should accept it as an opportunity for profit taking and portfolio rebalancing. The current market

enthusiasm may prove unsustainable if it lacks a solid foundation in economic fundamentals, and the index's dependence on a few key stocks exposes it to the risk of a significant downturn if an idiosyncratic event materializes.

Fixed Income

As we were expecting, Canadian inflation slowed sharply this summer on an annual basis as the headwind from gasoline prices reached its apex in June (inflation at the pump was -20% in June). Still, the resilience of the monthly inflation figures in 2023 suggest that the lows for the year might be in, and we could very well see inflation rebound in the second half.

That is precisely why the Bank of Canada ended its pause this summer with two more rate hikes and maintains a hawkish tilt. The central bank's recent forecasts show it expects inflation to hover around 3% over the next year before just about reaching the 2% target by mid-2025.

The U.S. inflation picture remains somewhat more vivid than in Canada. In June, core CPI, which excludes fluctuating food and energy prices, increased by 0.2% month-over-month and 4.8% from a year ago. Food prices also experienced an uptick, but energy prices saw a marked increase.

In July, we maintained our fixed income positioning by keeping an overweight in long-duration sovereign bonds and an underweight in high-yield corporate credit. This decision was driven by the attractive value proposition offered by both U.S. and Canadian 10-year yields.

Furthermore, all-in rates in the corporate credit space have become quite generous, with more than 5% for investment-grade products and about 8% for high-yield offerings. Even though we recognize the attractiveness of these rates, our view is that expected returns, adjusted for swings in capital gains, favour the higher-quality end of the spectrum. The reason is that high-yield spreads tend to widen to a range of 800-1,000 basis points during periods of economic turbulence.

If our macro framework proves accurate, and market volatility increases, we think higher-quality bonds will outperform despite their lower spreads. By maintaining this positioning in fixed income, we aim to balance our portfolio and capitalize on the attractive returns offered by long-duration sovereign bonds, while minimizing the potential risks associated with high-yield corporate credit.

Commodities and foreign exchange

As global equity markets soar to new heights, we acknowledge the potential opportunities in the commodities sector, which has recently seen a notable decline in prices. This sector could represent an attractive value proposition enabling us to diversify our portfolios and potentially capitalize on undervalued assets.

Several factors have contributed to the recent drop in commodity prices, such as slower global economic growth, the redirection of crucial commodity exports and a general easing of supply constraints.

Various commodities have witnessed significant price reductions recently, including vegetable oils, with a 48% decline caused by increased supply and rebounding exports, cereals such as wheat and maize, which have seen prices decrease by a quarter from their record highs the previous year, and industrial metals, with copper prices hitting a 6-month low.

Over the past few decades, commodities have shown relatively low correlations with other major asset classes, such as stocks and bonds. This characteristic makes commodities an intriguing option for improving the risk-return profile of our investment portfolio. Moreover, the current pessimism surrounding the commodity sector, amidst the ongoing equity market rally, may in fact indicate a potential contrarian value play on commodities, particularly if economic forecasts continue to be adjusted upward.

Copper Price

London Metal Exchange (LME), USD, as at 8/2/2023

Incorporating commodities into our asset allocation strategy serves as a hedge against inflation and geopolitical risks while capitalizing on the expected global economic recovery.

The U.S. dollar has strengthened against the major currencies for various reasons, including positive economic data, a resilient economy and decisions by other central banks. These factors have led investors to reevaluate their assumptions about the Federal Reserve's interest rate decisions.

In addition to domestic factors, the U.S. dollar has been influenced by developments in other central banks. The euro is facing headwinds as the ECB raised its deposit rate and signs of a slowing European economy emerge. Owing to factors such as record-low loan demands in the second quarter and deteriorating business confidence in Germany, the dollar index has risen against the major currencies, including the euro.

FX Rates: CAD/USD

As of 8/2/2023

Market Performance

(Total return, in local currency)

As of July 31, 2023	MTD%	QTD%	YTD%	Δ1Y%
Equity				
S&P 500	3.2%	3.2%	20.6%	13.0%
S&P/TSX	2.6%	2.6%	8.4%	8.2%
NASDAQ	3.8%	3.8%	44.0%	21.7%
MSCI World	2.9%	2.9%	18.5%	12.7%
MSCI EAFE	1.7%	1.7%	14.0%	13.6%
MSCI EM	5.4%	5.4%	11.4%	9.1%
Commodities				
Gold	2.4%	2.4%	7.7%	11.3%
CRB	2.9%	2.9%	1.6%	-3.2%
WTI	15.8%	15.8%	1.9%	-17.1%
Fixed Income				
FTSE Canada Universe Bond Index	-1.1%	-1.1%	1.4%	-1.8%
FTSE Canada Long Term Bond Index	-2.6%	-2.6%	2.7%	-3.8%
FTSE Canada Corporate Bond Index	-0.4%	-0.4%	2.6%	0.6%
Currency				
DXY	-1.0%	-1.0%	-1.6%	-3.8%
USDCAD	-0.4%	-0.4%	-2.7%	3.1%
USDEUR	-0.8%	-0.8%	-2.7%	-7.1%
USDJPY	-1.4%	-1.4%	8.5%	6.8%
USDGBP	-1.0%	-1.0%	-5.9%	-5.2%

As of July 31, 2023	MTD%	QTD%	YTD%	Δ1Y%
S&P/TSX Sectors				
Financials	3.9%	3.9%	7.7%	6.3%
Energy	4.1%	4.1%	1.7%	-0.1%
Industrials	0.7%	0.7%	9.5%	11.0%
Materials	6.4%	6.4%	7.0%	19.5%
Information Technology	1.9%	1.9%	50.4%	46.8%
Utilities	-1.1%	-1.1%	4.0%	-11.7%
Communication Services	-6.3%	-6.3%	-2.7%	-6.7%
Consumer Staples	-2.2%	-2.2%	2.7%	6.8%
Consumer Discretionary	0.7%	0.7%	12.1%	17.3%
Real Estate	1.8%	1.8%	4.7%	-2.1%
Health Care	21.3%	21.3%	22.9%	11.9%
S&P 500 Sectors				
Information Technology	2.6%	2.6%	45.8%	25.6%
Health Care	0.9%	0.9%	-1.5%	1.3%
Consumer Discretionary	2.4%	2.4%	35.5%	6.3%
Financials	4.7%	4.7%	3.1%	4.9%
Communication Services	6.7%	6.7%	44.7%	19.8%
Industrials	2.9%	2.9%	12.3%	15.6%
Consumer Staples	2.0%	2.0%	1.9%	2.7%
Energy	7.3%	7.3%	-0.5%	11.7%
Utilities	2.3%	2.3%	-5.0%	-9.3%
Real Estate	1.2%	1.2%	3.1%	-13.7%
Materials	3.4%	3.4%	10.2%	9.8%

12-month market scenarios (as of August 2023)

Scenario	Description
Baseline (50%)	The North American labour market is more resilient than expected, and the resulting wealth effect may be enough to help the macro landscape avoid a recession in 2023. That being said, the recent turmoil in banks shows that the massive liquidity injections from 2020 to 2022 are creating issues for banks, as deposits flee, causing an interest rate mismatch on their balance sheets. Banks tighten their lending standards, and the credit cycle slows abruptly. This context is raising recession risks for 2023, making the risks more balanced than expected last month. Global inflation remains more persistent than market participants currently expect. Base effects should bring annual inflation to between 3 and 4% by mid-year, before we see a slight reacceleration in the second half. The Fed and the ECB think their work isn't done and continue to tighten in the first half of 2023. The Bank of Canada stays on the sidelines, as the risks to the financial system lead to tighter lending conditions. The first rate cuts by central banks do not come until 2024, when inflation finally gives evidence of being tamed. The housing slowdown caused by the accumulation of higher rates creates a negative wealth effect, keeping the global economy relatively soft. Unemployment rates rise slightly in the second half of 2023, when the full impact of the 2022 rate hikes is felt. China's reopening gives some support to global growth but does not change the overall trajectory. The war in Ukraine, global droughts and high fertilizer prices continue to put upward pressure on food prices. The bear market in equities continues to its resolution in the form of a capitulation event, with a likely bottom in 2023. Sovereign yield curves remain inverted for most of the year. Long rates have risen substantially and present an interesting value proposition, given the growth and monetary policy outlook. **Overweight duration and U.S. dollar, underweight equities.**
Bearish: sticky inflation and banking turmoil (25%)	Sticky inflation remains above central bank targets, and key rates are hiked higher and faster than the market currently expects. Elevated short rates drive money out of bank deposits and into money market funds, pressuring bank balance sheets and causing more turmoil for U.S. banks. Canadian banks remain in good shape and do not face such hurdles. Central banks keep their key rates at the terminal level well into 2024 and use other programs, such as the Bank Term Funding Program (BTFP) and their discount window, to provide liquidity and to avoid bank runs. The economy slows significantly in the second half of the year, leading to a more material deterioration in employment. The recession is deeper in Europe and, with fiscal space being limited, governments have less room to stimulate the economy. The bear market continues, but drawdowns are larger. The absolute low for equities moves to 2024. The bond bear market is prolonged as market participants are forced to reprice bonds in the wake of higher terminal rates. **Underweight equities, duration and fixed income. Overweight cash and U.S. dollar.**
Bullish: falling inflation and pivot (10%)	Inflation returns to target more quickly than expected, allowing central banks to start easing in the second half of 2023. The pressure on banks subsides, and bank failures are limited to specific cases in the United States. Less monetary tightening is necessary over all, and terminal rates are slightly lower than currently expected. Most advanced economies avoid a recession. Energy prices are supported by strong demand. Base metal prices enter a new super cycle, given their role in the energy transition. The stock and bond markets rebound as a recession is avoided. **Overweight equities, base metals and bonds. Underweight cash and U.S. dollar.**
Other (15%)	Banking crisis Escalation or resolution of the conflict in Ukraine. Escalation of tensions between China and the United States. Faster-than-expected global economic slowdown.

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Rooted in history, innovating for the future.

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