Monthly Macro & Strategy

September 2024

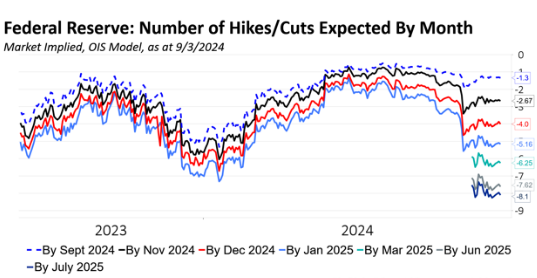
Is the U.S. economy suddenly not so exceptional?

The U.S. economy has outperformed most of its peers in recent years, leading to the emergence of the term "U.S. exceptionalism" as a carry-all concept for everything from the government's ability to inflate its public debt to the expensive valuation of its stock market. Even the Summer Olympics seemed to confirm this exceptionalism, with the United States recording yet another dominant performance.

But it seems the bond market is expressing nascent doubts about how exceptional the U.S. economy will remain in the coming years, with abrupt market moves that temporarily pushed the VIX, Wall Street's fear index, to crisis levels in August.

Of course, the unwinding of the yen carry trade, and the usually low liquidity of August proved to be fertile soil for exaggerated market moves (for example, the Nikkei plunged by 20% in three days, its worst selloff since 1959, before regaining most of the losses in the following weeks). That said, the macro signal to extract from a busy August is that investors are rethinking their views on the resilience of the U.S. economy and, incidentally, the expected behaviour of the Fed.

In late August, the markets were pricing in four 25-basis-point cuts at the three meetings left this year, with sizeable odds of a jumbo 50-basis-point cut along the way, a far cry from the two cuts priced in for the remainder of the year back in June. The markets are now pricing that the Fed to cut until it brings the key rate down to about 3%, which would be in line with the Fed's assessment of the neutral rate whereby monetary policy is neither restrictive nor stimulative. In other words, the markets still don't think the Fed will need to flip its stance on its head and fight a recession in the coming 24 months.



Highlights

- Despite growing fears of an American recession in 2025, we believe that the world's largest economy is in the middle of a normalization process.
- Recent yield curve movements suggest investors are doubtful of the Federal Reserve's ability to achieve a soft landing.
- The honeymoon between Kamala Harris and American voters continues, but the electoral college still favors Donald Trump. The most likely scenario is a divided government.

September 2024	--	-	N	+	++
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			■		
OTHERS					
Oil			■		
Gold				■	
USD (trade weighted)	■	←	←		
CAD/USD		→	■		

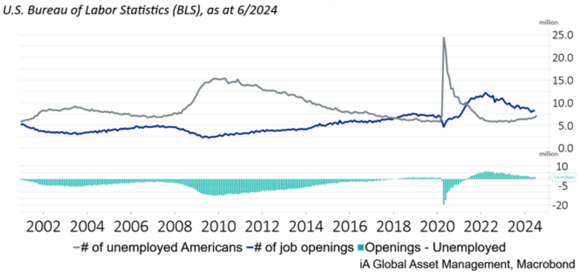
** Japan*

So, we ask the question: Is the U.S. economy suddenly heading for a recession? Or were these market moves simply a reflection of low liquidity in a market that was priced for perfection?

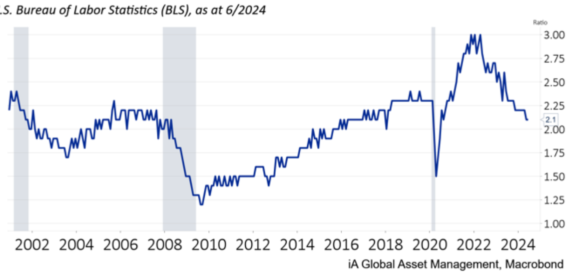
The Labour Market and Recession Odds

The U.S. labour market continues to exhibit resilience, despite the lingering recession fears of recent years. Even though some analysts have recently sounded the alarm on the possibility of a recession, we maintain that the odds remain relatively low. Key indicators such as job openings (still above pre-COVID levels, and 1.4 million higher than the unemployed population) and the quit rate (back to pre-COVID levels) suggest that the labour market is normalizing rather than deteriorating. Wage growth is moderating but continues to support consumer spending.

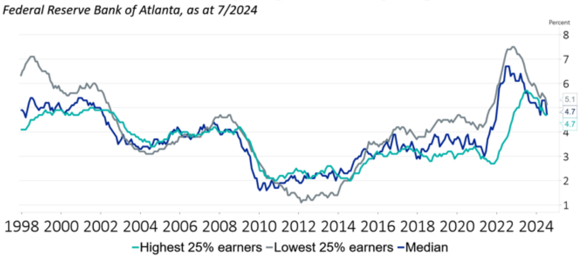
U.S.: Looking for Work vs Jobs Openings
U.S. Bureau of Labor Statistics (BLS), as at 6/2024



U.S.: Quits Rate
U.S. Bureau of Labor Statistics (BLS), as at 6/2024

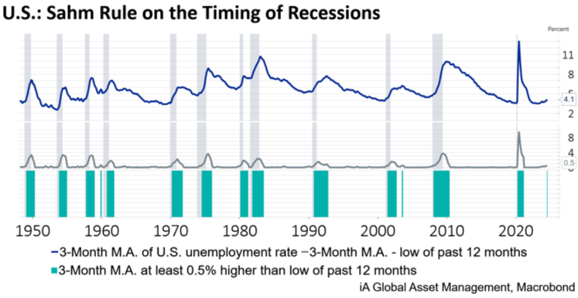


U.S.: Median Annual Hourly Wage Growth by Wage Level
Federal Reserve Bank of Atlanta, as at 7/2024



One historically useful early recession indicator is the Sahm Rule, which tracks the three-month moving average of the unemployment rate relative to its low over the past year. Historically, a triggering of the rule has been a reliable signal of a recession, but the current environment is defined by a rise in the working-age population from immigration, which is pushing unemployment higher owing to an expansion of the labour supply, which in and of itself is a growth-positive development. We argue (like Claudia Sahm, the originator of the rule; see here) that this context is more reflective of labour market normalization than of an impending economic downturn. Several unique factors, including the post-pandemic labour-market adjustments and strong consumer demand, suggest that this signal should be interpreted with caution.

U.S.: Sahm Rule on the Timing of Recessions



Thus, we think the risks of a recession in the coming 12 months remain low, most likely in the 25-to-35% range (which is not materially different from the odds of recession in most years), and that the labour market is simply normalizing amid a broader economic stabilization process.

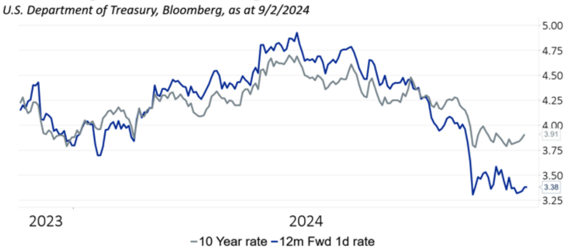
Tales from the Yield Curve

The recent moves of the U.S. yield curve have been telling an interesting tale of changing expectations regarding the U.S. economy' ability to achieve a soft landing without a rapid drop in real rates.

Until this summer, the yield curve had mostly moved in parallel because there had been little doubt that inflation would remain manageable; rather, the main question was the level of real policy rates required to achieve this goal. Since early July, the short and long ends of the yield curve have stopped moving in synchrony, and the curve has steepened considerably.

This suggests that the markets are seeing a greater urgency to get moving and ease monetary policy but have a less pessimistic view on how low the key rate could ultimately go.

U.S.: Changes in short and long rates since late-2023
U.S. Department of Treasury, Bloomberg, as at 9/2/2024



iA Global Asset Management, Macrobond

Today, the markets see the Fed as the most lagging central bank among the majors, with, on average, the most cutting to do in the coming six, 12 and 24 months. Put differently, the concept of U.S. exceptionalism has all but left the bond market, which now suggests that lower real rates are quickly needed for the Fed to achieve its inflation target in a soft landing.

	Current Rates		Level of Fwd Policy Rate			Expected Policy Rate Change		
	Effective policy rate	10Y bond	6M fwd	12M fwd	24M fwd	6M fwd	12M fwd	24M fwd
USA	5.32	3.85	4.06	3.38	3.09	(1.26)	(1.94)	(2.23)
EUR	3.66	2.52	2.87	2.30	2.16	(0.79)	(1.36)	(1.51)
JPN	0.23	0.93	0.38	0.47	0.62	0.16	0.24	0.39
GBR	4.95	3.99	4.36	3.91	3.61	(0.59)	(1.04)	(1.34)
CAN	4.53	3.09	3.47	2.99	2.68	(1.06)	(1.54)	(1.85)
AUS	4.34	4.00	4.06	3.55	3.28	(0.28)	(0.79)	(1.06)

So, is the market suddenly too worried? Our analysis suggests that too much hurry may be priced into the markets, and that the Fed might not deliver such a precipitated rate cut cycle. Odds are that market expectations for short rates will have to reprice higher in the short run, although the size of the repricing should not be sufficient to create bouts of volatility.

We note, however, that the Fed has shifted its focus from inflation to growth, with significant portfolio construction implications for fixed income – a topic we explore later in this document, in the section on our current positioning.

The Road to the U.S. Election

The Harris honeymoon continues

The presidential race has become a closely contested battle. Recent national polls indicate that Vice President Harris continues to enjoy a honeymoon, with the Democratic candidate leading by about three percentage points.

The race in crucial swing states has also become more dynamic, with nearly 100 electoral votes now representing a margin of less than two percentage points. Pennsylvania is shaping up to be the decisive state, with Vice President Harris currently leading Trump by a mere 0.5 percentage points.

That said, Democratic gains from this point may be more modest because a significant portion of the current shift came from third-party supporters and undecided voters, with fewer now remaining. Additionally, Democrats who now support their candidate reflect margins similar to previous elections. Despite the noticeable change in the polls, the level of support remains uncertain, especially considering the substantial polling inaccuracies of the previous two presidential elections.

Vice President Harris has made significant progress, but she still lags President Biden's 2020 pre-election polling (+7 pp) and is close to where former Secretary Hillary Clinton was in 2016 (+3 pp). Even though economic data will play a crucial role on election day, there is minimal evidence to suggest any impact so far, although we note that polling suggests an improvement in voter trust regarding Harris's management of the economy.

Betting odds suggest a divided government

According to the latest data from Polymarket, the race is tight; the candidates are neck and neck, but with a slight 51 to 47% lead for Trump. This represents a significant shift, considering the odds of a Trump win were as high as 70% just a month ago. That being said, it's essential to note that prediction markets such as Polymarket provide a real-time sentiment gauge; therefore, they can be volatile and influenced by short-term events.

The race is further complicated by the odds for control of Congress. According to betting odds from Polymarket, Republicans currently have a 72% chance of securing the Senate, while the House remains more uncertain, with 62% odds of a Democratic majority.

Putting everything together, the odds of a divided government stand at 46%, followed by 32% odds for a Republican sweep and 22% for a Democratic sweep.

Potential Economic Implications

Trump Victory with a Divided Congress: A Trump win with a divided Congress would most likely lead to a politically fractious environment characterized by frequent standoffs between the executive and legislative branches. This scenario could result in limited legislative achievements, particularly regarding major policy initiatives, such as tax, health care or immigration reform. The ability to negotiate smaller, bipartisan measures could still allow for some fiscal stimulus or targeted economic support, but large-scale initiatives would probably be off the table.

Harris Victory with a Divided Congress: Should Harris win with a divided Congress, we could see a continuation of gridlock on major fiscal policies with notable changes being centred on expiration of the upper-income section of the 2017 tax cuts by the end of 2025. Investors should also expect stability in existing regulations.

Trump Victory with a Republican Sweep: In contrast, a Trump victory coupled with a Republican sweep could lead to significant tax cuts and deregulation efforts, coupled with increased tariffs on imports, especially from China. This scenario might boost business confidence in the short term but would also increase fiscal deficits and lead to renewed inflationary pressures.

Harris Victory with a Democratic Sweep: A scenario whereby Harris wins alongside a Democratic sweep is expected to bring about significant fiscal reforms in 2025, including an increase in the tax rate on corporate income and upper-income households, encompassing investment income. Additionally, fiscal transfers to households, such as the child tax credit, are likely to be augmented, and new benefit programs, such as subsidized childcare, are expected.

Current Outlook and Positioning

In these pages, we've alluded in recent months to a gradual shift in our fixed income positioning. We started 2024 with a sizeable underweight in this asset class because we thought U.S. inflation would remain stickier than the market was pricing in at the time; seven Fed rate cuts were priced in for 2024, which we considered excessive in light of elevated inflation and resilient growth.

As the year progressed and the yield curve hinted at fewer cuts, we took note of a moderation in inflation dynamics, with goods disinflation proceeding at a solid pace and service-sector inflation moderating. Accordingly, we reduced our underweight position in fixed income. This culminated in the past month with Fed Chair Jerome Powell's Jackson Hole Symposium speech, which did two things: 1) cement the coming cycle of "adjustment rate cuts"; and 2) communicate to the markets that the Fed's primary focus had shifted squarely from inflation to growth.

As stated above, we doubt we will see a 50-basis-point rate cut by the end of the year.

Even so, the Fed's shift from inflation to growth is meaningful to us and signals a bit of a cyclical change in the role that fixed income can play in portfolio construction. In a world more concerned with growth than with inflation, fixed income can act as an effective hedge for an equity-centric portfolio, because the central bank can provide a buffer to a slowing economy by cutting rates, leading to fixed income gains that can cushion equity volatility. In an uncomfortably inflationary world (for example, 2022), this is not the case. This renewed focus on growth risks has prompted us to rethink our stance on fixed income, and we've shifted to an overweight position in U.S. and Canadian government bonds. We remain underweight bonds in some markets, such as Europe and Japan, where we don't think the central banks can provide that buffer to growth.

Our view and positioning on equities remain broadly unchanged. The outlook for this asset class is influenced by opposing factors: on the one hand, demanding valuations and a consensus that remains very optimistic about future artificial intelligence developments with, on the other hand, a supportive corporate earnings outlook.

The recent August selloff proved to be short-lived, as cash-rich corporations stepped in to buy back their own shares at what they considered a significant discount.

Overall, we still have a relatively optimistic view of the equity markets, with a positive focus on U.S. and Canadian equities. At the other end of the equity spectrum, we are less optimistic about Chinese equities, because the overhang from the property market downturn continues to constrain the economy, and policymakers remain reluctant to provide stimulus.

Finally, we continue to hold our position in gold. Central bank purchases of the metal have paused in recent months, but the current peak in U.S. real interest rates is providing another tailwind for gold and bringing renewed interest from retail investors.

As a store of value that doesn't pay interest, gold does carry an opportunity cost, namely the real interest rates than can be earned on other safe assets. Thus, falling real rates tend to boost gold prices. We also think U.S. fiscal risks remain elevated as we head into the presidential election – a context that should keep gold on investors' radar in the coming months.

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Market Performance

Total returns as of August 30, 2024, in $CA

	MTD	QTD	YTD	1Y
EQUITIES (LOCAL CURRENCIES)				
S&P 500	2.4%	3.7%	19.5%	27.0%
S&P/TSX	1,2%	7.2%	13.7%	18.6%
NASDAQ 100	1.1%	-0.5%	16.3%	26.6%
MSCI World Net	1.9%	3.1%	17.0%	23.7%
MSCI EAFE Net	0.4%	1.2%	12.4%	16.8%
MSCI EM	0.4%	1.1%	12.4%	15.9%
COMMODITIES (USD)				
Gold	2.3%	7.6%	21.3%	28.0%
CRB	0.2%	-0.5%	5.1%	-2.4%
WTI	-5.6%	-9.8%	2.7%	-9.9%
FIXED INCOME				
FTSE Canada Universe	0.3%	2.7%	2.3%	8.0%
FTSE Canada Long Term	-0.1%	3.0%	-0.5%	7.7%
FTSE Canada Corporate	0.3%	2.5%	3.7%	9.7%
CURRENCIES				
DXY	-2.3%	-3.9%	0.4%	-1.4%
USD/CAD	-2.3%	-1.4%	1.9%	-0.3%
USD/EUR	-2.0%	-3.0%	-0.1%	-1.1%
USD/JPY	-2.5%	-9.1%	3.6%	0.0%
USD/GBP	-2.1%	-3.7%	-3.0%	-3.1%

	MTD	QTD	YTD	1Y
SECTORS S&P/TSX				
Financials	2.8%	10.5%	15.3%	26.3%
Energy	0.1%	3.6%	18.2%	17.7%
Industrials	-1.2%	1.3%	8.8%	11.7%
Materials	-0.4%	8.7%	23.6%	17.7%
Information Technology	6.2%	8.8%	7.7%	26.0%
Utilities	1.8%	9.8%	8.8%	8.7%
Communication Serv.	0.8%	7.1%	-5.3%	-5.2%
Consumer Staples	-3.5%	4.7%	13.4%	19.8%
Consumer Discretionary	1.0%	5.6%	8.8%	13.9%
Real Estate	5.0%	16.4%	11.6%	13.8%
Health Care	-2.4%	1.8%	-1.9%	-4.5%
SECTORS S&P 500				
Information Technology	1.2%	-0.9%	27.0%	38.9%
Health Care	5.1%	7.9%	16.3%	18.7%
Consumer Discretionary	-1.0%	0.7%	6.4%	13.0%
Financials	4.5%	11.2%	22.2%	34.2%
Communication Serv.	-1.3%	-2.8%	23.1%	32.3%
Industrials	2.8%	7.8%	15.9%	22.4%
Consumer Staples	5.9%	7.9%	17.1%	17.1%
Energy	-1.7%	0.4%	11.3%	6.5%
Utilities	4.9%	12.0%	22.5%	24.3%
Real Estate	5.8%	13.4%	10.6%	21.1%
Materials	2.4%	6.9%	11.2%	16.1%

About iA Global Asset Management (iAGAM)

Rooted in history, innovating for the future.

A magnet for top investment talent, iA Global Asset Management is one of Canada's largest asset managers, with over $100 billion under management across institutional and retail mandates. We help investors achieve their long-term wealth creation goals through innovative investment solutions designed for today's complex markets. We are building upon our historic success, supporting the growth of our core strengths, and exploring innovative ways to meet investor needs. We are rooted in history and innovating for the future. Our experienced portfolio managers use a proprietary investment methodology, rooted in iAGAM's unifying commitment to strong risk management, analytical rigor and a disciplined, process-driven approach to asset allocation and security selection.