Monthly Macro & Strategy

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Highlights

- Canadian inflation slowed in January, providing positive news for the start of 2024.
- The Bank of Canada has opened the door to rate cuts despite sticky inflation, as it is looking beyond the shelter and demographic components.
- We turned more optimistic on equities and slightly cautious on sovereign bonds. Our negative bias towards low-quality corporate bonds remains in place.

Winter is leaving, rate cuts are coming

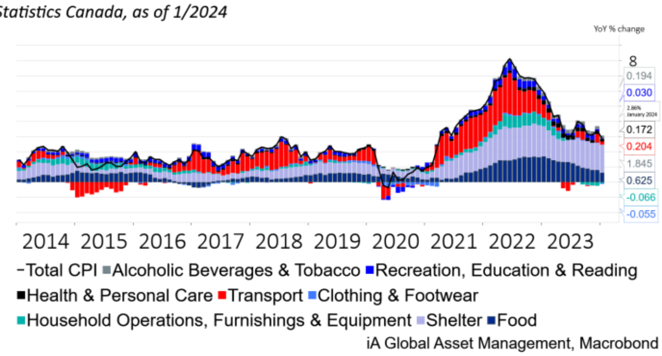
The year began with the good news that Canadian inflation slowed abruptly in January.

The most recent inflation figures, and the last ones before the March 6 decision by the Bank of Canada (BoC), were positive in several respects. At 2.9% in January, the current pace is already comfortably lower than 3.2%, the latest forecast for the first quarter in the BoC's January 2024 Monetary Policy Report (MPR).

Food prices are also coming back down to earth, recording their weakest monthly print since March 2021 (0.1%) and their slowest annual print (4.0%) since November 2021. Given the importance of food prices in household perceptions of total inflation, these data bode well for coming surveys. We still think total inflation will average about 3.0% in the first half, owing to wage pressures, a lack of productivity gains and shelter costs, but we're keeping an open mind.

Canada: Contributions to Inflation

Statistics Canada, as of 1/2024



After all, the country's historically high population growth is fuelling shelter inflation (6.2% year over year and still rising), with the charge being led by rent (7.9% year over year) and mortgage interest costs (a hefty 27.4% year over year).

Outlook on global asset allocation (1-3 months)

MARCH 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					
OTHER					
Oil					
Gold					
USD (trade weighted)		→			
CAD/USD					

Demography is squarely behind the pressure on rents, and elevated interest rates have become inflationary as mortgages are renegotiated at higher rates AND housing starts crumble under the weight of elevated financing costs.

The question we ask is: Would lower-than-expected inflation in the first half mean that the rate cuts we're expecting this year will be expedited? One could interpret the knee-jerk reaction of the bond market as an indication that the BoC will start moving earlier to ease financial conditions. That being said, our answer is: Not really.

Why the BoC will most likely start cutting rates this summer?

The latest communications from the BoC have made it clear that monetary policy is a blunt tool, and lower interest rates are not the silver bullet that some are hoping for. Sure, we can all agree with the BoC; but, when delving into the inflation data, we're starting to see the pieces of the puzzle come together for an easing cycle that will begin this summer, even if inflation remains stubbornly close to 3.0%.

The BoC acknowledged in its January MPR that inflation across a wide range of goods and services had eased in response to elevated rates (ex-shelter inflation has cooled quite a bit and currently sits at 1.5% year over year), meaning that monetary policy is working. Shelter inflation, in contrast, remains too high and is easing more slowly than in previous cycles because of the demographic forces at work.

Given that the BoC has a mandate to keep total inflation on target, Canadian monetary policy has become a tricky endeavour. Demography, which the BoC has absolutely no control over, is seen as keeping the targeted measure of inflation higher for longer. In short, the BoC is being partly blamed for the housing crisis and is looking to get off the hot seat. Breaking down the sources of inflation into two parts (shelter and ex-shelter) is an efficient way to open the door to rate cuts despite sticky inflation.

Our reading of the BoC's latest communications is that the governing council is preparing a breath of fresh air for the suffocating Canadian economy (which has been in a per capita recession for more than a year) and, hopefully, will alleviate some of the pressures on housing. But convincing Canadians and markets that it is prudent to start easing monetary policy before total inflation is firmly headed toward its target (meaning, among others, before wage growth falls below the 5% threshold) will take time and a fair amount of skill. In hindsight, the December 2023 speech by Deputy Governor Toni Gravelle was the first step in that process.

So, yes, rate cuts are coming, and we have the July 24 interest rate announcement circled in our calendars as the likely start of the normalization process. We expect cuts at every subsequent meeting in 2024, for a total of four cuts. But this view is not set in stone; a sharp deterioration of the macroeconomic landscape or a few more surprisingly friendly inflation reports could bring the cuts forward into the first half.

So, the question is not so much when, but why cuts are coming. This time, given the perfect storm of booming demographics and elevated rates that is battering the housing market, the right course for the BoC is probably to get its message across in the coming quarter and position itself to start moving as early as this summer.

Expectations around the world

Markets have greatly repriced the number of cuts expected this year since we issued our January publication. We were already expecting about four cuts from the BoC, a bit less from the Fed, with the ECB moving first. Market pricing is not completely in line with our take, although it has gotten close.

Number of policy rate hikes (+) and cuts (-) expected in 2024

	Mid-2024	End 2024
Federal Reserve	-1	-4
Bank of Canada	-1	-3
European Central Bank	-1	-4
Bank of England	0	-3
Bank of Japan	+1	+3
Reserve Bank of Australia	-1	-2

Bloomberg, as of March 1, 2024

Current views

We continue to be reasonably optimistic about the equity markets.

Sentiment has shifted in the past few months in response to the reduced odds of a recession, and price-to-earnings multiples have increased accordingly. That being said, there is still a decent chance that the upward trend in markets will persist because: 1) if the inflation deceleration trend continues, central banks could deliver more cuts than expected (not our central scenario, but a possibility), thereby boosting equities; 2) earnings could end up being supercharged by revenues derived from AI, with mega-cap tech companies benefiting; and 3) the equity market rally could broaden beyond Big Tech if the economy reaccelerates.

Hence, even though the rally has been impressive since the fall of 2023, we think it is too early to call for its end.

We have a more neutral to slightly cautious view on fixed income. As stated above, we expect fewer cuts from the Fed (two or three) this year than the markets are currently pricing in (four). Although a gap of 25 to 50 basis points is not significant, the yield curve could reprice slightly higher as a result, led by the front end.

As a result, we have a slight underweight in U.S. and Canadian fixed income. That said, this perceived misalignment of market pricing versus our views remains small, and we do not expect it to pose a significant problem for equity markets as it did in 2022.

Finally, we have a slight underweight in high-yield bonds. This asset class is trading at historically expensive levels, and lower-quality borrowers are refinancing debt at higher coupons. As a result, the prospects for further strong returns in high yield are limited, and we prefer to obtain risky-asset exposure in equities, where balance sheets are cleaner and companies are more exposed to exciting technological innovations.

Market Performance

(Total return, in local currency)

As of February 29th, 2024	MTD%	QTD%	YTD%	Δ1Y%
Equity				
S&P 500	5.3%	7.1%	7.1%	30.5%
S&P/TSX	1.8%	2.4%	2.4%	9.2%
NASDAQ	5.3%	7.2%	7.2%	49.8%
MSCI World	4.6%	6.5%	6.5%	25.1%
MSCI EAFE	3.0%	5.7%	5.7%	14.8%
MSCI EM	5.1%	1.5%	1.5%	10.1%
Commodities				
Gold	0.2%	-0.9%	-0.9%	11.9%
CRB	0.6%	2.8%	2.8%	-4.4%
WTI	3.2%	9.2%	9.2%	1.6%
Fixed Income				
FTSE Canada Universe Bond Index	-0.3%	-1.7%	-1.7%	3.8%
FTSE Canada Long Term Bond Index	-0.6%	-3.9%	-3.9%	3.1%
FTSE Canada Corporate Bond Index	0.2%	-0.5%	-0.5%	6.3%
Currency				
DXY	0.9%	2.8%	2.8%	-0.7%
USDCAD	1.1%	2.5%	2.5%	-0.5%
USDEUR	0.1%	2.2%	2.2%	-2.1%
USDJPY	2.1%	6.3%	6.3%	10.1%
USDGBP	0.5%	0.8%	0.8%	-4.8%

As of February 29th, 2024	MTD%	QTD%	YTD%	Δ1Y%
S&P/TSX Sectors				
Financials	2.3%	2.0%	2.0%	7.5%
Energy	3.7%	5.4%	5.4%	12.2%
Industrials	5.7%	7.9%	7.9%	15.6%
Materials	-2.1%	-8.3%	-8.3%	-10.5%
Information Technology	-1.5%	5.1%	5.1%	56.2%
Utilities	-2.3%	-3.6%	-3.6%	-4.6%
Communication Services	-4.7%	-2.0%	-2.0%	-6.7%
Consumer Staples	5.2%	7.2%	7.2%	16.3%
Consumer Discretionary	2.2%	3.5%	3.5%	10.2%
Real Estate	-1.0%	-0.6%	-0.6%	-4.3%
Health Care	8.5%	4.3%	4.3%	8.5%
S&P 500 Sectors				
Information Technology	6.3%	10.5%	10.5%	58.4%
Health Care	3.2%	6.3%	6.3%	15.9%
Consumer Discretionary	8.7%	4.9%	4.9%	32.6%
Financials	4.1%	7.2%	7.2%	14.6%
Communication Services	5.7%	11.0%	11.0%	58.4%
Industrials	7.2%	6.2%	6.2%	21.5%
Consumer Staples	2.3%	3.8%	3.8%	7.1%
Energy	3.2%	2.8%	2.8%	6.2%
Utilities	1.1%	-1.9%	-1.9%	-1.2%
Real Estate	2.6%	-2.3%	-2.3%	6.2%
Materials	6.5%	2.3%	2.3%	9.2%

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Rooted in history, innovating for the future.
