Monthly Macro & Strategy

May 2024

iA Global Asset Management

Separate ways

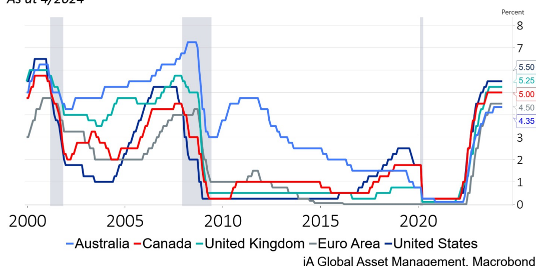
To say that global monetary policies have been coordinated since 2020 is an understatement. In fact, ever since COVID hit the world, pretty much every major central bank has followed the same playbook, with generally predictable outcomes. For more than a year, north and south of the 49th parallel, market participants, especially Canadian homeowners, have been expecting rate cuts to start in 2024, but the picture is getting muddy.

Looking toward the remainder of the year, we see that this coordinated behaviour is about to end. The case for Fed rate cuts in 2024 is fading, whereas the urgency of cuts in Canada and Europe is rising.

If we focus on North America, the contrast between the Canadian and U.S. economies in the post-pandemic period has been stark: the U.S. economy seems to be running on all cylinders whereas Canada's is contracting on a per capita basis.

Canada's population is growing at a near-historical rate, supporting total growth but also putting extreme pressure on housing. The country is also dealing with labour shortages in the construction sector; thus, housing affordability has become a social issue, putting the spotlight on the Bank of Canada's restrictive stance. Finally, Canadian productivity growth has also been sluggish, constraining the country's growth rate relative to its faster-growing neighbour.

The question we ask this month is: Can the Bank of Canada truly diverge from the Fed, with multiple cuts starting this summer (we see a first cut this summer, followed by three more by the end of the year) while the Fed stays put? We think it's not only possible but also essential to get Canada's economy out of its slump.



Highlights

- The synchronization of monetary policies in developing countries is coming to an end.
- As the Bank of Canada is poised to launch a cycle of rate cuts, the Federal Reserve is forced to delay its own.
- The Canadian dollar could dip below 70 cents by the end of the year, therefore supporting returns on foreign investments held by Canadian investors.

MAY 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*

Why the BoC should cut multiple times despite the Fed's stance

The difference between the U.S. and Canadian housing markets explains in large part the diverging performance of their economies in recent years. A well-known fact about Canada is that the nature of its mortgage market has made the country's economy more sensitive to interest rates than the U.S. economy, where mortgages are overwhelmingly at fixed rates with long amortization periods.

As the Bank of Canada tightened monetary policy, with rate hikes totalling almost 5% in less than 18 months, we had to expect that the impact would be swift and severe, because each year about 20% of mortgage holders renew their fixed-rate loans, and those with variable rates are also taking a direct hit. In the United States, where mortgages tend to be of the fixed, 30-year variety, the transmission of monetary policy takes more time.

Households have deleveraged on both sides of the border, but the cost of interest on debt is a much bigger headwind up north. Add to the mix a more sizable pile of excess savings in the U.S., as well as the 5%-plus federal deficit as a share of GDP (Canada's 1.3% deficit pales in comparison, although it seems to attract more headlines), and you get two economies that are heading in different directions, with different reaction functions from their central banks.

But ultimately the inflation picture is central bankers' main concern.

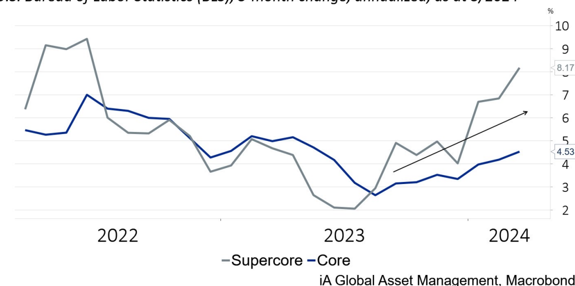
Canada's inflation rate continues to make good progress toward its 2% target. In fact, apart from shelter and transportation, most components are sending "mission accomplished" signals. But the Bank doesn't have the luxury of choosing which inflation measure to target and must abide by its mandate of aiming for 2% *total* inflation.

Given the elevated weight of shelter in the CPI basket, the Bank has put in extra work over the past six months to explain why it is reasonable to separate shelter from the other components, taking into consideration the demographic factors at play (factors that monetary policy has no impact on). Our view is that the Bank will start cutting this summer (June or July have elevated and similar probabilities in our book) with a total of four cuts by year-end, bringing the overnight rate down to 4%.

The inflation situation in the United States is going in the opposite direction. Not only have the core and "supercore" measures reaccelerated steadily since mid-2023 (see chart below), but the breadth of inflation has widened, showing that the strong economic performance is fuelling inflation once again. The resolution of supply-side disruptions from the pandemic helped cool inflation in 2023, but the last miles toward disinflation will need a curbing of the demand side, which is still robust. In other words, the Fed's monetary policy might not be tight enough as is and talk of more hikes is starting to percolate.

U.S.: Core & Supercore Inflation

U.S. Bureau of Labor Statistics (BLS), 3-month change, annualized, as at 3/2024



Is a rate of 5.5% restrictive enough if the economy is humming along, asset prices are making new highs and credit spreads are tight? It's highly questionable. In other words, the Fed would be ill advised to please the markets and start cutting too soon. When will the time be right? We think late 2024 at the earliest, amid rising odds that the first cut will not happen until early 2025 and that the cuts will be shallower than the markets currently expect.

What are the implications for the loonie?

The Canadian dollar is, of course, caught in the crosshairs. It would be natural to expect the loonie to depreciate if monetary policies diverge and the Bank of Canada embarks on a steep easing path. There have been some precedents, such as in 2002-2003, when the Bank was hiking while the Fed was cutting. In this period, the loonie rose from a low of 63 cents to 77 cents in slightly more than 13 months.

To estimate the pressure on the loonie, we build a simple model, controlling for multiple factors, such as economic surprises, oil prices, interest rate differentials, inflation expectations and, of course, expectations of future monetary policy.

As can be seen in the table below, the Canadian dollar is quite sensitive to changes in the differential between 5-year rates in Canada and the United States, more so than it is to expectations of the easing differential between the two central banks.

Differential in bps of cuts expected (CAN – US)	Differential in 5-year rates (CAN-US)				
	-120	-100	-80	-60	-40
-100	0.68	0.70	0.72	0.74	0.76
-75	0.69	0.70	0.72	0.74	0.76
-50	0.69	0.71	0.73	0.75	0.77
-25	0.69	0.71	0.73	0.75	0.77
0	0.70	0.72	0.73	0.76	0.78
25	0.70	0.72	0.74	0.76	0.78
50	0.71	0.72	0.74	0.77	0.79
75	0.71	0.73	0.75	0.77	0.79

Let's look at how the loonie might react in our base-case scenario whereby, in the coming year, the Bank of Canada cuts its key rate four times for a total of 100 basis points (bps) or perhaps even five times, but the Fed cuts only once, early next year. At this writing, the overnight indexed swap markets are pricing in about 30 bps of cuts in both countries in the coming year, meaning that the differential sits at close to 0.

But, in such a scenario, we would also expect the 5-year rate differential to widen. If the markets start expecting central bank behaviour to differ by as much as 100 bps in the coming year, the result should be about 20 bps (one-fifth of 100 bps) of further widening in the differential, to -100 bps (it currently sits at about -80 bps).

According to our simple model, assuming no change in the other factors, the loonie could potentially weaken by year-end to about 70 cents on the U.S. dollar, from the current level of 73 cents.

To see further depreciation, we would need a much larger widening of the differential between 5-year rates, an outcome we consider unlikely because we haven't seen the gap widen beyond 110 bps in the past 30 years.

To wrap up, we think the Bank of Canada is set to join the likes of the European Central Bank and start easing somewhat aggressively, while the Fed gets stuck at current levels. Even though the scenario of more Fed rate hikes remains an alternative one for now, it wouldn't take much in terms of inflation surprises for the markets to move toward pricing in no cuts at all in 2024.

An added consideration is that currency depreciation tends to be inflationary because the price of imports rises. It is probable that downward pressures on the loonie would act as a stabilizing mechanism and, incidentally, limit the number of rate cuts from the Bank.

Looking ahead, we would be well advised to expect some deterioration of the loonie, which is favourable to the returns on foreign investments held by Canadian investors.

Our current views

Our view on equities remains constructive, despite the significant rally since the fourth quarter of 2023. The equity rally is broadening beyond the "Magnificent 7" companies, driven by improvements in global manufacturing production, which has increased market participants' positivity and taken valuations higher. The relatively benign earnings outlook creates a supportive environment for equity markets. We have an overweight position in Japanese equities owing to favourable monetary policy, contained valuations, and increasingly shareholder-friendly behaviour.

In contrast, our view on fixed income remains cautious owing to the Fed's challenge in conducting "adjustment rate cuts" amid sticky and persistent inflation. The challenge is compounded by a higher-for-longer interest rate regime in the United States, which acts as an anchor for global bond markets. As a result, we have a slight underweight in bonds, considering their relatively attractive real yields and their effectiveness as a hedge against unforeseen shocks.

Although we still have a position in gold, we reduced its size in April owing to the metal's increasing popularity and pricing.

Even so, we remain constructive on gold as a hedge against equities in a more inflationary environment. We also initiated a position in copper, given the broadening of the global industrial production cycle and potential supply shortages amid significant capital expenditures on electrification.

Lastly, owing to monetary policy divergences, we are slightly underweight the loonie versus the greenback, in the expectation that the Bank of Canada may be in a better position to cut rates than the Fed.

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Market Performance

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

	MTD	QTD	YTD	1Y
EQUITIES (LOCAL CURRENCIES)				
S&P 500	-4.1%	-4.1%	6.0%	22.7%
S&P/TSX	-1.8%	-1.8%	4.7%	8.7%
NASDAQ 100	-4.5%	-4.5%	3.7%	31.7%
MSCI World Net	-3.2%	-3.2%	6.5%	20.2%
MSCI EAFE Net	-0.9%	-0.9%	9.0%	15.2%
MSCI EM	1.4%	1.4%	6.1%	13.4%
COMMODITIES (USD)				
Gold	2.5%	2.5%	10.8%	14.9%
CRB	1.8%	1.8%	7.0%	-0.2%
WTI	-1.5%	-1.5%	14.3%	6,7%
FIXED INCOME				
FTSE Canada Universe	-2.0%	-2.0%	-3.2%	-0.9%
FTSE Canada Long Term	-4.5%	-4.5%	-7.9%	-5.6%
FTSE Canada Corporate	-1.2%	-1.2%	-1.2%	2.8%
CURRENCIES				
DXY	1.7%	1.7%	4.8%	4.5%
USD/CAD	1.8%	1.8%	4.0%	1.7%
USD/EUR	1.2%	1.2%	3.5%	3.3%
USD/JPY	4.3%	4.3%	11.9%	15.8%
USD/GBP	1.0%	1.0%	1.9%	0.6%

	MTD	QTD	YTD	1Y
SECTORS S&P/TSX				
Financials	-2.8%	-2.8%	2.6%	11.3%
Energy	1.1%	1.1%	14.3%	18.9%
Industrials	-6.1%	-6.1%	4.3%	8.9%
Materials	5.9%	5.9%	12.1%	-0.9%
Information Technology	-5.8%	-5.8%	-1.3%	30.1%
Utilities	-3.3%	-3.3%	-4.4%	-12.4%
Communication Serv.	-1.8%	-1.8%	-10.2%	-20.5%
Consumer Staples	-0.8%	-0.8%	3.2%	5.9%
Consumer Discretionary	-0.9%	-0.9%	3.6%	8.4%
Real Estate	-6.8%	-6,8%	-5.3%	-5.4%
Health Care	-5.3%	-5.3%	12.1%	24.5%
SECTORS S&P 500				
Information Technology	-5.4%	-5.4%	6.5%	37.1%
Health Care	-5.1%	-5.1%	3.3%	6.9%
Consumer Discretionary	-4.3%	-4.3%	0.4%	24.3%
Financials	-4.2%	-4.2%	7.6%	23.3%
Communication Serv.	-2.1%	-2.1%	13.4%	41.3%
Industrials	-3.6%	-3.6%	6.9%	23.0%
Consumer Staples	-0.9%	-0.9%	6.3%	1.7%
Energy	-0.8%	-0.8%	12.8%	13.0%
Utilities	1.6%	1.6%	6.3%	0.2%
Real Estate	-8.5%	-8.5%	-9.0%	-0.7%
Materials	-4.6%	-4.6%	3.9%	12.3%

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.

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