Monthly Macro & Strategy

July 2024

iA Global Asset Management

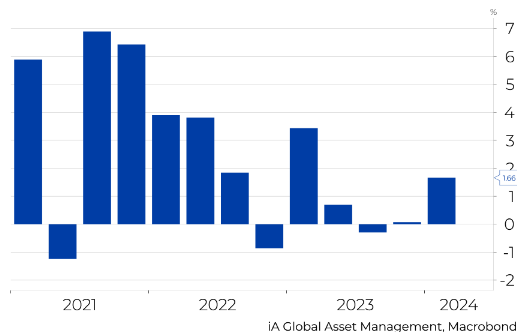
Under Pressure: Canada’s Rate Cuts and Economic Revival

The Bank of Canada became on June 5 the first G7 central bank to start its post-COVID rate cuts, in a move that was widely anticipated. As we opined here, the rate cut was needed to give the ailing Canadian economy a breath of fresh air.

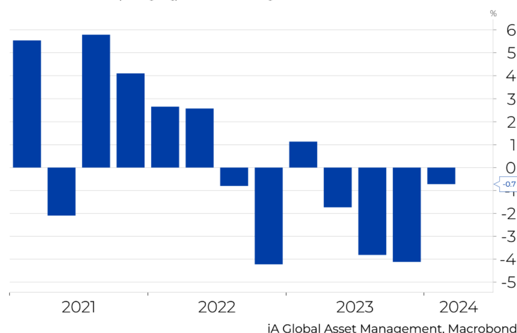
Stagnant GDP Growth amid Rising Interest Rates

Since the Bank of Canada began hiking interest rates in the first quarter of 2022, Canada's GDP growth has noticeably stalled. The aggressive monetary tightening aimed at curbing inflation inadvertently pushed the economy into what can be described as a per capita recession. Even though aggregate GDP figures may not reflect a severe downturn, when adjusted for population growth, the economic picture is less rosy.

Canada: Real GDP Growth
Statistics Canada, % QoQ, SAAR, as at 2024 Q1



Canada: Real GDP per Capita
Statistics Canada, % QoQ, as at 2024 Q1



Highlights

- We expect a second rate cut on July 24, with a total of four cuts for the year and a steady pace of cuts towards the neutral rate looking ahead to 2025 and 2026.
- As the monetary easing cycle starts, we expect a higher contribution from the fixed income portion to the portfolio's returns.
- Our positioning remains relatively unchanged, with a slight reduction in the overweight equities and a decrease in the underweight fixed income.

JULY 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*

As can be seen from the charts above, the quarterly growth rate of Canadian GDP stalled in the second half of 2022, just as interest rates began to rise. The combination of galloping inflation and higher debt costs crushed the post-COVID impulse.

Canada's demographic expansion, driven by robust immigration policies, has partly masked this underlying economic weakness. As the population grows, GDP figures are buoyed by the sheer increase in the number of consumers and workers; but, on a per capita basis, economic activity has actually been negative in six of the past seven quarters.

The main reason is that the country is struggling to integrate the massive immigration wave of recent years, when population growth has surpassed even the baby-boom years. Note that, in the 1950s and 1960s, population growth was mostly through births, meaning the size of the average household was growing. Now, demographic growth is mostly through immigration, meaning that the total number of households is rising, and with it pressure on the housing market, leading to more cost-of-living issues.

Demographic Growth: A Double-Edged Sword

Canada is recognized globally for its success in attracting and integrating highly educated immigrants. This strategy has long been a cornerstone of its economic policy, addressing labour-market shortages and fostering a diverse, skilled workforce. The influx of talent has brought numerous benefits:

1. *Enhanced labour-market dynamics*: Immigrants contribute significantly to various sectors, particularly high-skill industries, such as technology, health care, and engineering.

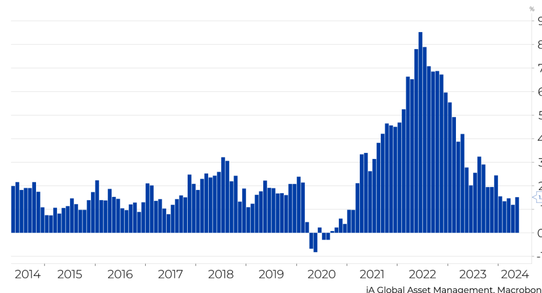
2. *Innovation and entrepreneurship*: Many immigrants bring entrepreneurial spirit, start new businesses and drive innovation.

That being said, rapid population growth has also led to significant challenges, particularly in the housing market. The demand for housing has skyrocketed, outpacing the supply and leading to sharp increases in property prices and rents. These frictions have become a critical issue, affecting affordability and overall economic stability.

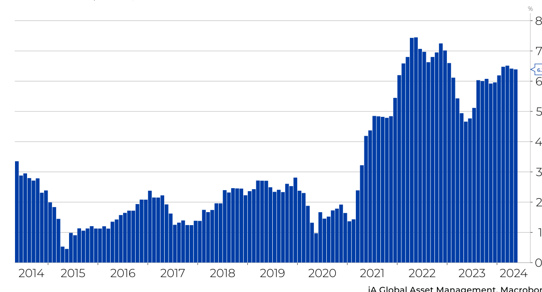
The Housing Market Conundrum

The strain on the housing market underscores the need for a nuanced approach to inflation measurement and monetary policy. Shelter inflation, driven by rising housing costs, has been a major component of overall inflation. However, using monetary policy - an inherently blunt tool - to address housing inflation can have widespread, often detrimental, economic effects.

Canada CPI: Total less Shelter YoY%
Statistics Canada, as at 5/2024



Canada CPI: Shelter YoY%
Statistics Canada, as at 5/2024



We argue that the Bank of Canada had to separate shelter inflation from total inflation in its policy framework, which it rightly did in concluding that the time for rate cuts had come. Even though the Bank of Canada has a single mandate, namely to bring total inflation down to the 2% target, the distinction between shelter and total-ex-shelter inflation allows it to keep a wary eye on the housing market while avoiding unnecessary economic tightening that stifles broader economic growth.

Time for Rate Cuts

Given the current economic landscape, we expect the Bank of Canada to continue its march toward a neutral policy stance. The aggressive rate hikes have achieved their primary goal of curbing runaway inflation but at a significant economic cost. We think it was past time for the Bank to pivot toward easing.

Now that the first rate cut is in the books, we expect a second cut on July 24, the next decision date, and a total of four cuts for the year, taking the leading rate from 5% only recently to 4% by year-end.

Looking toward 2025 and 2026, we think it is reasonable to expect a steady pace of cuts toward the neutral rate (the rate at which the central bank's foot is on neither the break pedal nor the gas pedal), which is 2.75% according to the Bank of Canada (source: Assessing the US and Canadian neutral rates: 2024 update - Bank of Canada). There are multiple reasons why we recommend that the Bank move at a steady pace.

Beyond the argument that we can now be relatively confident that total inflation is headed toward the 2% target, we think it's possible to unlock the full potential of an economy that is flush with new workers and in need of investment in infrastructure and other productivity-increasing projects. Ultimately, the Canadian economy could outperform over the next few years while the U.S. economy could be dragged down by its low household-savings rate and ballooning fiscal deficit.

Conclusion

The Canadian economy is at a critical juncture. Even though demographic growth continues to inject vitality into the labour market and society, it also exposes underlying economic vulnerabilities, particularly in housing. A nuanced approach to monetary policy, separating shelter inflation from overall inflation, coupled with timely rate cuts, will be essential as the country navigates the path to sustainable growth.

By acknowledging the complexities of the current economic environment and adjusting policies accordingly, Canada can leverage its demographic strengths while addressing the structural challenges that impede its economic potential.

Investment Opportunities

A falling-rate environment is conductive to ample opportunities for investors in fixed income. For a more detailed article on this topic, see here.

As the monetary easing cycle begins, investors should expect an increased contribution from the fixed income portion to their portfolios return. Our strategy will be to add progressively to a position in government and corporate bonds, as more central banks join the movement.

Rate cuts will bring the front end of the yield curve lower, meaning that the price of short-term bonds will rise along with the fall in interest rates. Long-term bonds are also highly sensitive to changes in interest rates. If the Bank of Canada cuts rates as expected, the prices of long-term bonds will most likely increase, resulting in capital gains for investors. Additionally, these bonds offer a stable income stream through coupon payments.

As interest rates fall, corporate bonds can provide attractive yields in relation to government bonds, and their prices are likely to increase. Focusing on investment-grade bonds minimizes credit risk while capturing the benefits of a falling-rate environment.

Finally, a laddered portfolio strategy consisting of bonds with staggered maturities mitigates interest rate risk and provides regular reinvestment opportunities as bonds mature. In a falling-rate environment, maturing bonds can be reinvested into longer-maturity bonds with attractive yields.

Current Views

Our positioning hasn't changed much in recent months. We remain overweight equities relative to cash, but the magnitude of our overweight has been reduced slightly. The global equity markets have been on a scorching run since 2023, and the consensus of investors is considerably more optimistic about the prospects for equity markets than it was then. We remain constructive on the outlook for corporate earnings but also acknowledge the much improved sentiment and positioning on the part of other investors. Although equities aren't yet in exuberance territory, we want to reduce our overweight position as other investors increase theirs. Notably, we have eliminated our overweight in Canadian equities, reverting to a neutral stance.

Meanwhile, even though we continue to underweight fixed income, the size of the underweight has also been reduced in the past month. As discussed, we hold a relatively dovish view of future Bank of Canada interest rate moves, in the context of a slowing economy and a constrained household sector. Against this backdrop, we have shifted to a neutral tactical position on Canadian government bonds. We remain optimistic about the U.S. economy and continue to think the Federal Reserve will not cut interest rates as much as is currently priced into the yield curve, but we have reduced the size of our underweight position in U.S. Treasuries. A relatively soft CPI print in May indicated that disinflation is proceeding in a way that is relatively encouraging for the Federal Reserve and supports government bonds. We will be watching the labour market closely; it will determine future data releases in core services inflation, which is key to future Fed moves.

Finally, we continue to hold our overweight position in gold. We have taken note of the recently reduced purchases by the People's Bank of China, which have caused the metal to take a bit of a breather after an impressive run (+15% year to date). However, structural and cyclical factors continue to support the case for investing in gold: 1) a possible peak in real interest rates ahead of us; 2) continued diversification of foreign-exchange reserves by central banks in emerging markets; and 3) a geopolitical environment that remains fraught with risk and favourable to gold.

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Market Performance

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

	MTD	QTD	YTD	1Y
EQUITIES (LOCAL CURRENCIES)				
S&P 500	3.6%	4.3%	15.3%	26.7%
S&P/TSX	-1.4%	-0.5%	6.1%	14.2%
NASDAQ 100	6.2%	7.8%	17.0%	31.5%
MSCI World Net	2.3%	3.0%	13.4%	23.0%
MSCI EAFE Net	-0.6%	1.0%	11.1%	15.8%
MSCI EM	4.3%	6.3%	11.2%	16.0%
COMMODITIES (USD)				
Gold	0.0%	4.3%	12.8%	22.0%
CRB	-1.3%	0.6%	5.7%	-1.5%
WTI	5.9%	-2.0%	13.8%	17.2%
FIXED INCOME				
FTSE Canada Universe	1.1%	0.9%	-0.4%	3.7%
FTSE Canada Long Term	1.6%	0.2%	-3.4%	0.9%
FTSE Canada Corporate	1.0%	1.1%	1.2%	6.4%
CURRENCIES				
DXY	1.1%	1.3%	4.5%	2.9%
USD/CAD	0.4%	1.0%	3.3%	3.2%
USD/EUR	1.3%	0.7%	3.0%	1.9%
USD/JPY	2.3%	6.3%	14.1%	11.4%
USD/GBP	0.8%	-0.2%	0.7%	-0.1%

	MTD	QTD	YTD	1Y
SECTORS S&P/TSX				
Financials	-1.8%	-1.2%	4.3%	16.6%
Energy	-3.8%	0.9%	14.1%	26.4%
Industrials	1.0%	-3.4%	7.3%	12.6%
Materials	-4.6%	7.4%	13.7%	14.0%
Information Technology	6.8%	-5.6%	-1.0%	14.7%
Utilities	-2.5%	0.2%	-0.9%	-3.8%
Communication Serv.	-4.6%	-3.4%	-11.6%	-15.8%
Consumer Staples	0.5%	4.1%	8.3%	16.6%
Consumer Discretionary	-0.9%	-1.5%	3.0%	5.1%
Real Estate	0.6%	-5.7%	-4.1%	2.1%
Health Care	1.6%	-18.6%	-3.6%	15.1%
SECTORS S&P 500				
Information Technology	9.3%	13.7%	28.1%	44.2%
Health Care	1.9%	-1.0%	7.8%	13.6%
Consumer Discretionary	4.9%	0.6%	5.7%	14.7%
Financials	-0.9%	-2.2%	9.9%	26.8%
Communication Serv.	4.8%	9.4%	26.7%	45.4%
Industrials	-1.0%	-3.0%	7.5%	17.1%
Consumer Staples	-0.3%	1.2%	8.5%	8.1%
Energy	-1.3%	-2.4%	10.9%	17.9%
Utilities	-5.5%	4.7%	9.4%	9.1%
Real Estate	2.0%	-1.9%	-2.4%	7.2%
Materials	-3.0%	-4.5%	4.0%	11.2%

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.

General Disclosures

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