Perspective

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The U.S. Federal Reserve Positioned to Deliver Victory Cuts

Despite last year's exuberant ending, as 2024 gets underway, the global geopolitical environment remains tumultuous, plagued with military conflict and contentious elections around the world. The post-pandemic inflation surge led to one of history's fastest interest rate increases. Between March 2022 and July 2023, the U.S. Federal Open Market Committee (U.S. interest rate policymakers) raised the federal fund target rate by 525 basis points, marking the most aggressive tightening cycle in four decades and a severe challenge for bond markets. The Fed's decisive action, now seemingly concluded, tested the resilience of the economic recovery in 2022 and 2023.

Now, as rate hikes seem to be in the rear-view mirror, multiple waves of geopolitical upheavals, including the Russia-Ukraine conflict, war in the Middle East, the effective closure of the Red Sea to international shipping, and tensions between China and Taiwan, continue to test economic resilience. Amid these challenges, investors have oscillated between caution and optimism, mirroring the complex interplay of global events and policy responses.

ECONOMIC OUTLOOK

The Fed's recent rate hikes and global geopolitical events shape the current economic environment. The recent moderation in inflation, especially notable in 2023, and the strong labour market are key factors influencing the Fed's future policy decisions. Chairman Powell's assertion that the policy rate is likely at or near its peak underscores the Fed's readiness to adapt its policy in response to economic developments. While Fed rates may not rise further, the outstanding question is whether we'll see victory cuts or defeat cuts. In other words, if the Fed cuts rates because inflation remains tamed while the economy continues to expand, equity markets will likely trend higher. However, if the Fed is defeated and must cut interest rates to defend against an economic slowdown, company profits will decline, along with equity markets.

Inflation, a dominant concern in recent years, has been moderating. Paradoxically, the U.S. labour market has remained strong despite rising interest rates, with unemployment remaining below 4%. Canada has not faired quite as well, where the unemployment rate has drifted sequentially from 5% to almost 5.8%. While still low by historical standards, the trend is not encouraging. Unfortunately, economic growth may continue to be hampered by Canada's low productivity, which, as shown in the graph below from Bloomberg, has stagnated since 2015. The red line shows the historical trend, while the green line shows the current levels against 2015. In stark contrast U.S. productivity has grown on average by 1.6% per quarter over the same period.

While we expect continued expansion into mid-2026, the environment is uncertain, with the Canadian economy likely to underperform the U.S.

INVESTMENT OUTLOOK

The Federal Reserve's policy path in 2024 is pivotal. While there's anticipation of rate cuts, the Fed's approach will likely be cautious, focusing on balancing

inflation control with economic growth. The stock and bond market rallies since late 2023 are consistent with expectations for more lenient interest rate policies. Still, the Fed's decision will hinge on economic data, particularly unemployment and inflation trends. We do not expect a Fed rate cut until the second half of the year. The Bank of Canada may be willing to cut sooner, perhaps by the second quarter, to defend against weaker underlying conditions.

The S&P 500's performance at the end of last year is indicative of economic and investor resilience despite geopolitical and economic headwinds. When we look beyond headline valuations, equities seem reasonably priced.

For example, according to FundStrat, the S&P 500 price/earnings ratio, ex-FAANG (Facebook, Apple, Amazon, Netflix, and Google) is around 15 times this year's consensus earnings. That's attractive while, by historical standards, with the U.S. government 10-year yield around 4%. This is back to a more normal range after a period of "free" money. Assuming yields remain around 3.5% to 4.5%, U.S. stocks are attractive.

Even FAANG prices seem reasonable-ish on a GARP basis (growth at a reasonable price) with a P/E around 25X this year's consensus earning. FAANG and similar businesses are some of the best companies in the world with quality earnings growth that will benefit disproportionately from advances in artificial intelligence.

To help better understand broad valuation metrics of the average U.S. listed company, it is worthwhile to consider the S&P 500 Equal Weighted Index (EWI). For reference, the S&P 500 index most commonly quoted is market cap weighted, meaning it is dominated by 10 of the 503 company index. So, its performance is highly skewed to a few companies.

For a more balanced gauge of valuation, the 2024 consensus earnings per share estimate for the EWI is ~ 21% higher than in 2021. Meanwhile, the EWI index price is now 5% below where it was at the end of 2021 – further evidence of reasonable valuation.

Despite reasonable valuations, the recent rate of index appreciation is due for a pause or, more likely, a consolidation. The periods often occur after a significant upward or downward movement in stock prices. During consolidation, prices tend to fluctuate within a limited range without a clear trend, upwards or downwards. It's seen as a period where the market 'catches its breath' after a big move, and investors reassess their positions and the market's future direction.

While we expect a period of consolidation in the first half of 2024, better performance is likely to follow in the latter half of the year, with U.S. equities reaching new highs and outperforming Canada.

CAUSE FOR CAUTION

The investment landscape in 2024 is laden with risks. Hawkish Fed talk, a cooling Canadian economy, partisan political paralysis in many parts of the world, and sovereign fiscal challenges loom large. Geopolitical risks, particularly the ongoing Middle East conflict and China's posturing towards Taiwan, add additional complexity to our outlook. Therefore, while we have a favourable outlook, we remain cautious. Post-consolidation, the market is expected to resume growth, with the S&P 500 potentially reaching new heights by year-end. We will remain vigilant, balancing optimism with a keen awareness of the evolving geopolitical and economic landscape.

With cash yields around 5%, we are overweight to defend against an equity market consolidation and bond yields moving temporarily higher. In balanced portfolios, fixed income is underweight, and equities are defensively positioned. Equity-focused portfolios are modestly underweight stocks in favour of cash.