5 November 2024

# Investor Strategy

The latest market insights from Richardson Wealth

# Halloween puts a scare in markets

## Executive summary

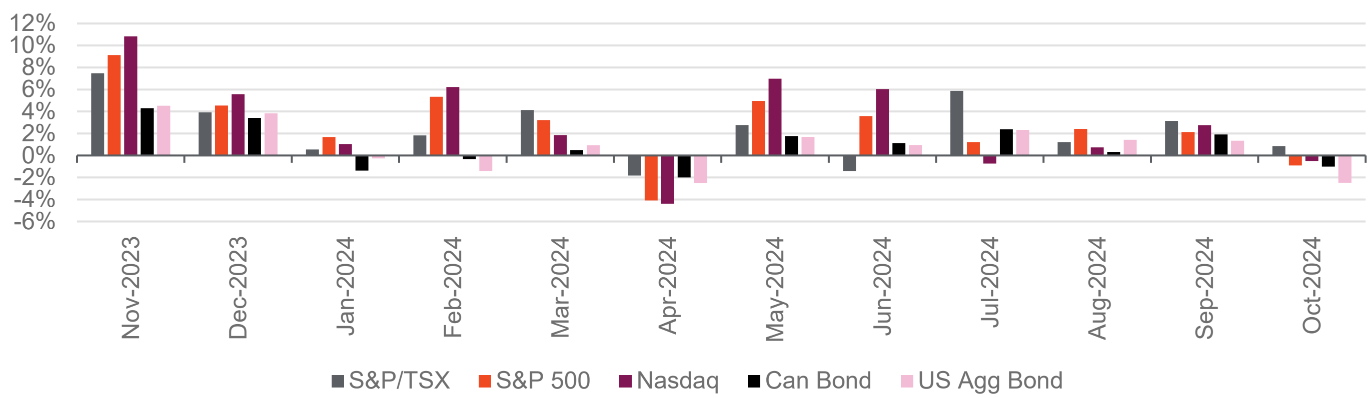
1. Spooky end to October
2. Time to go small?
3. Market cycle
4. Final thoughts

We are not going to say ‘volatility ahead’, because we think everyone always says this and it’s market commentary filler. Instead, recession risk low, inflation still cooling, earnings growing (albeit a bit slower than before for 2025) all makes for a pretty good backdrop. Countering this we have the elevated geopolitical risks, a market that may have priced in a lot of good news already and the election. And even with a weak finish, should that transpire, it’s been a really good year so far.

# Spooky end to October

October was shaping up to be a solid month for equities as central banks continued to lower interest rates, economic data was suggesting that a soft landing may be possible, and corporate earnings were proving resilient. That all came to a grinding halt on the last day of the month, which saw indexes notch their worst sessions since early March, with North American indexes having their monthly gains wiped out in one fell swoop. Post-earnings slumps in major tech names dragged the S&P 500 and Nasdaq down, with investors also appearing cautious ahead of the U.S. presidential election. It's clear that expectations for mega cap names are high, with big tech earnings expectations becoming harder and harder to beat. This is what we saw at the end of the month, with investors souring on Meta and Microsoft, despite better-than-forecasted results. The S&P 500 declined -1.9% on the last day of the month, pushing the index down -0.9% total return for the month, while the Nasdaq declined -2.8% in just one day, ending the month down -0.5%. It has been a while since we've seen U.S. markets in the red, this is only the second negative month for the S&P 500 in the last year. The Nasdaq is a little worse with three negative months. Not a bad batting average for positive returns. Closer to home, the TSX managed to stay positive for the month, eking out a total return gain of 0.9%.

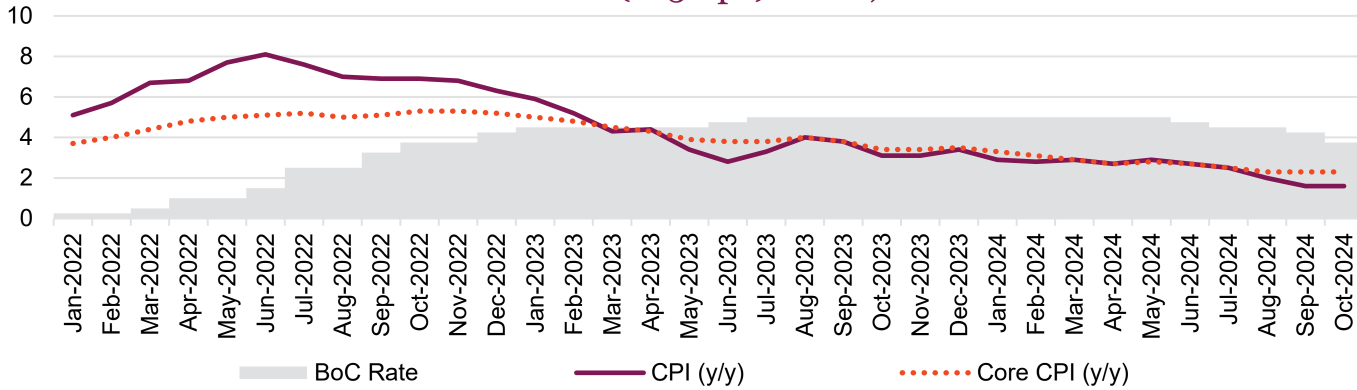
## Despite weakness in October, markets have good batting average for positive monthly returns in past year




Throughout the month, economists in the U.S. were frantically adjusting their interest rate expectations, parsing each data print for clues on what the Fed's next move will be. The Fed's preferred inflation measure, the core personal consumption expenditures index, rose by 0.3% in September, marking a 2.7% increase year-over-year and suggesting the economy continues to power ahead from resilient consumer spending. Adding to this, the U.S. economy continued to grow at a healthy pace, advancing at an annual rate of 2.8% in Q3, slightly down from last quarter's reading of 3.0% and below economists' GDP forecast of 3.1%. The U.S. economy has been resilient the last two years, with a recession yet to materialize, despite growing expectations that high interest rates would pressure the consumer sufficiently to slow growth. Recent data suggests that the Fed may adopt a cautious pace in cutting rates, which led Treasury bonds to post their worst month of returns in nearly two years. So how bad were bonds this month? The U.S. aggregate bond index fell -2.5% over the month but is still up YTD with a total return of 1.9%.

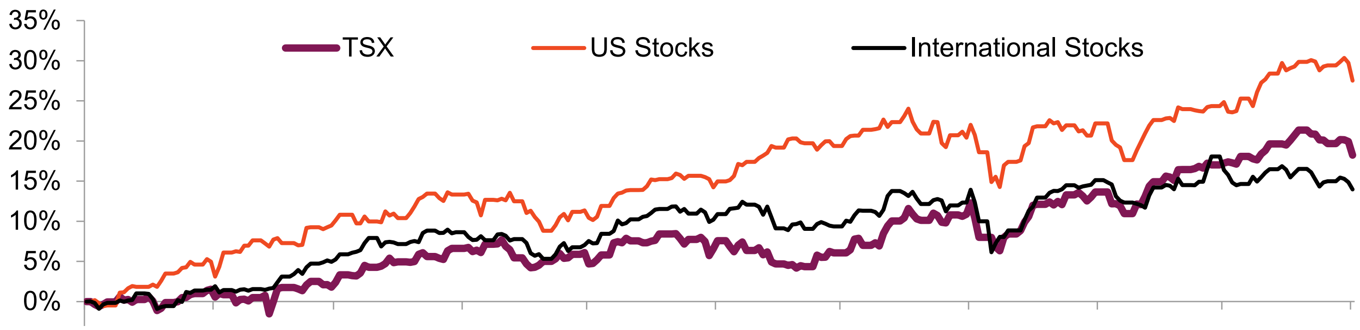
Canada on the other hand appears to be in a different boat. The Canadian economy grew at a modest 1% annualized rate in Q3, falling short of the Bank of Canada's 1.5% forecast and below economists' expectations of 1.2%. Preliminary data for September showed a 0.3% increase in GDP, with growth led by finance, insurance, construction, and retail. Despite recent rate cuts, growth remains subdued, prompting further anticipated cuts to stimulate economic activity. Economists are noting that these weak figures, along with downward-trending inflation figures, reinforce the BoC's commitment to additional rate cuts to support growth. The BoC did announce a jumbo 50 bps rate cut on October 23 brining the key interest rate down to 3.75%, and it looks like rate markets are pricing in more reductions before the end of the year. Still, Canadian bonds lagged over the month, falling -1.0%.

## BoC: Four cuts (125 bps) down, more to come

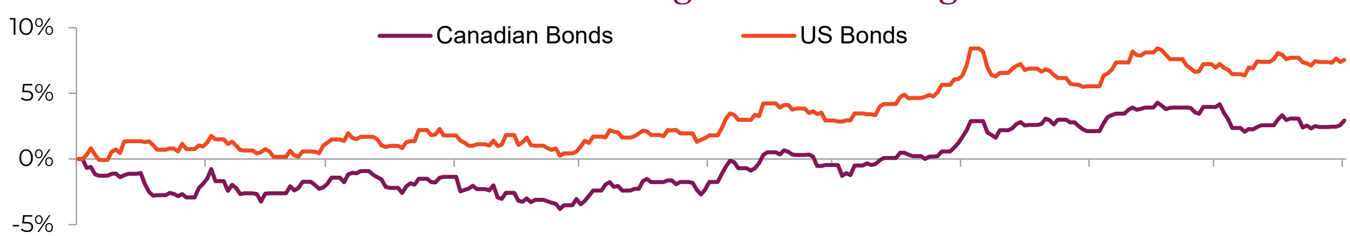



Currency moves deserve an honourable mention. The U.S. dollar was strong, likely due to softening rate cut expectations and the presidential election. Meanwhile, the Canadian dollar was weak for a host of reasons – from weak oil prices, likelihood of our very own election, softer economic data, the list goes on. The good news? The U.S. market that was down in October was up in Canadian dollar terms.

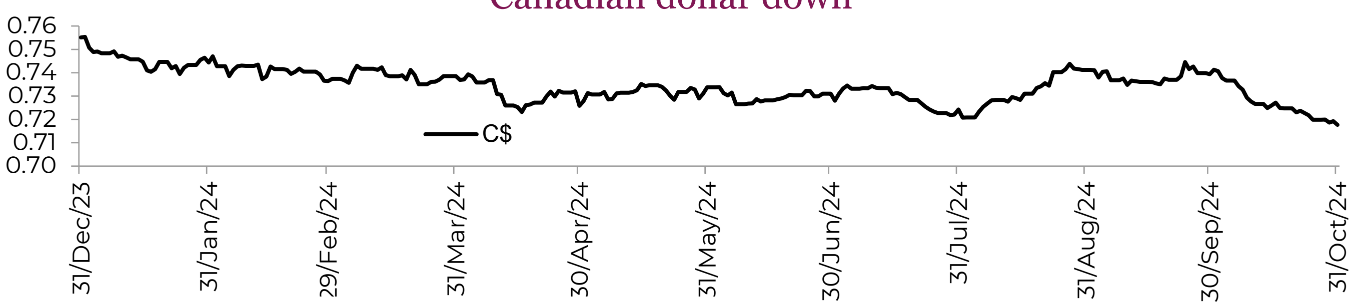
## Markets drop into the end of the month, but really still such a good year




## Bonds back to being nice and boring



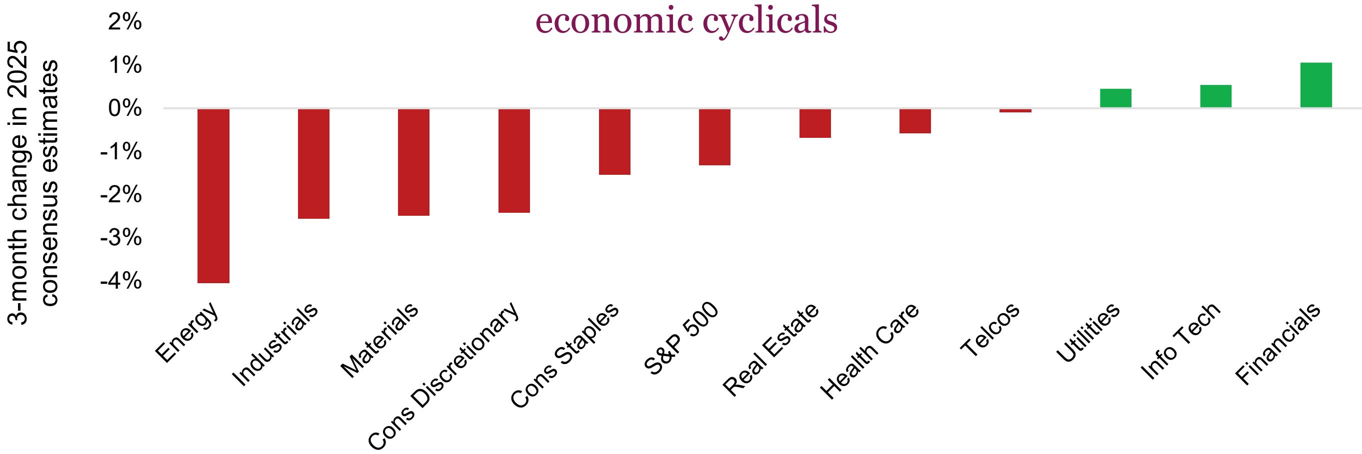

## Canadian dollar down




Source: Bloomberg, Purpose Investment

Earnings, regardless of who sits in the White House, matter. And this market is starting to react. The Q3 earnings season is about 70% complete and as usual, companies are consistently beating consensus estimates. The issue has become guidance resulting in analysts continuing to revise down earnings expectations for 2025. It is relatively broad based with the more economically cyclical sectors down a bit more.

S&P 500 2025 earnings estimates coming down, more so for economic cyclicals




Source: Bloomberg, Purpose Investments

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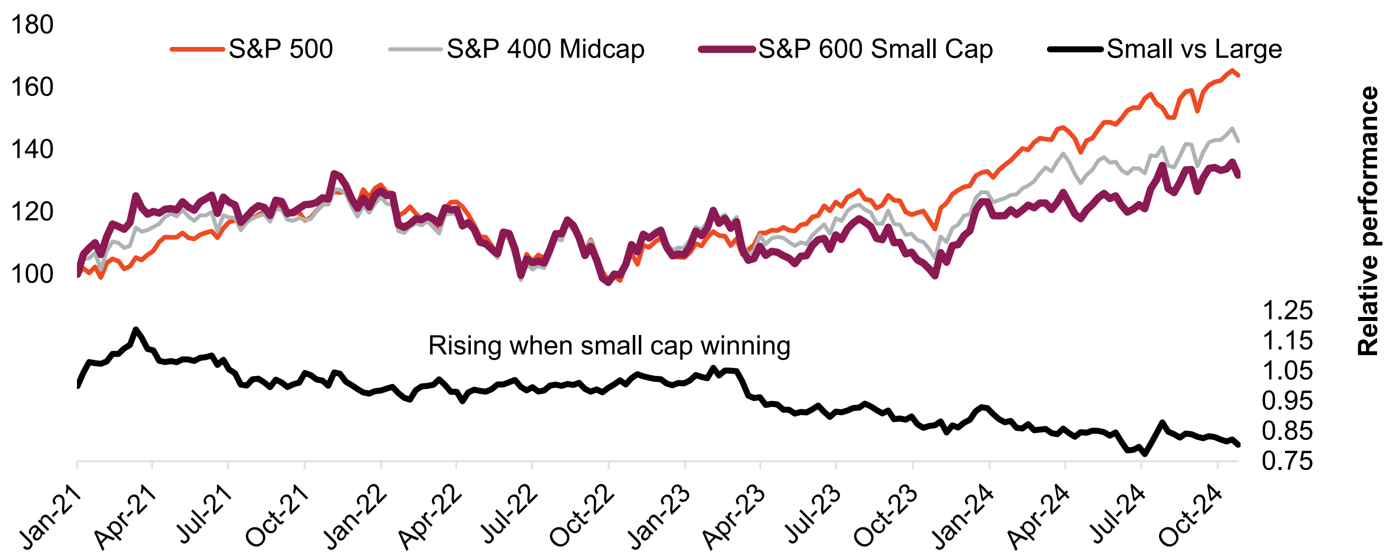
## Time to go small?

The infamous and awesome S&P 500 is actually a subset of the S&P 1500. Sorted generally by the size of the constituent companies, there is a S&P 400 midcap index and a S&P 600 small cap index. S&P 500 + S&P 400 + S&P 600 gets you to

Small cap has really lagged over the past few years



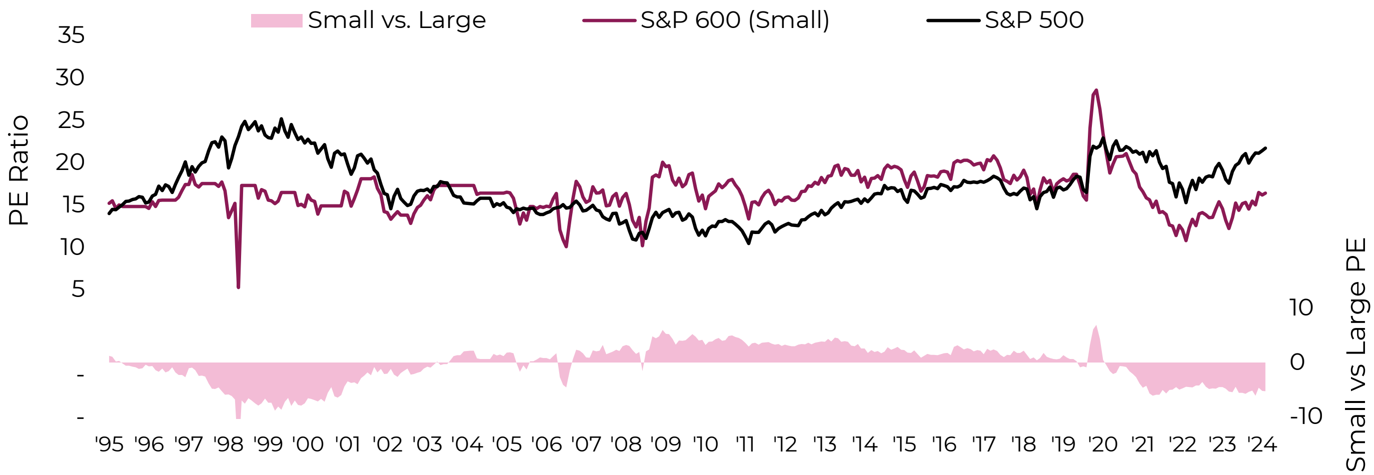

Source: Bloomberg, Purpose Investments

the S&P 1500. The S&P 600 Small Cap index has done alright over the past couple years, annualizing about 10%. But given the large cap S&P 500 has appreciated by 24% (annualized) during the same period, it has really been challenging to tilt towards small cap. The more popular Russell 2000 small cap index has had a similar path to the S&P 600.

There has been an increased number of questions on size, specifically if this is the time to move down the size spectrum among U.S. equities. And there are some rather compelling and some not so compelling factors to consider:

1) **Valuations (mildly compelling)** – The S&P 600 is trading 16.4x forward estimated earnings for the next twelve months, compared to 21.7 for the larger cap S&P 500. That is a pretty high spread, and even more so given small cap usually trades at a premium valuation. However, this isn't new news. The valuation argument has favoured small cap for the past three years, yet small cap has continued to lag. To be honest, it feels like valuations really have not been a good determinant of performance for the past few years… that will probably change someday.

## The valuation spread of 5 points favours small cap, but that isn't new

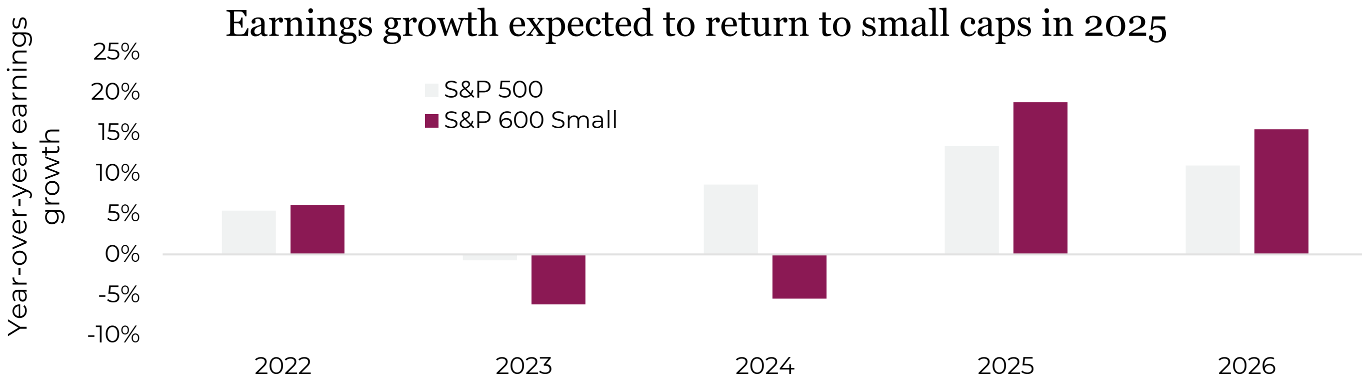



Source: Bloomberg, Purpose Investments

We don't put much stock in the relative valuation argument for another reason. Index valuations are calculated by taking the aggregate earnings of the members, based on weight. Small caps typically have more companies with negative earnings, often because they are at an earlier stage in their growth path to maturity. At the moment, 13% of the S&P 600 index members are money losers compared to only 2% for the S&P 500. These money losers detract from the aggregate earnings for the index, and are one of the main reasons small cap usually trades at a premium.

Complicating earnings a little more, today there is a lower frequency of money losers for both the S&P 500 and S&P 600 small cap index, this is one of the reasons for the valuation spread. So valuations support small cap but we wouldn't put too much stock in this argument.

2) **Earnings growth (compelling)** – This does look more encouraging for going smaller on the market capitalization spectrum. In 2022, there was almost no performance difference between the large cap S&P 500 and S&P 600 small cap. Both sucked, down -17% or so as markets fell on inflation/recession/rate fears. 2023 and 2024 (so far), the large-cap has dramatically outperformed small-cap... and look, relative earnings growth really favoured large-cap. This earnings growth advantage is forecast to flip in 2025 & 2026.



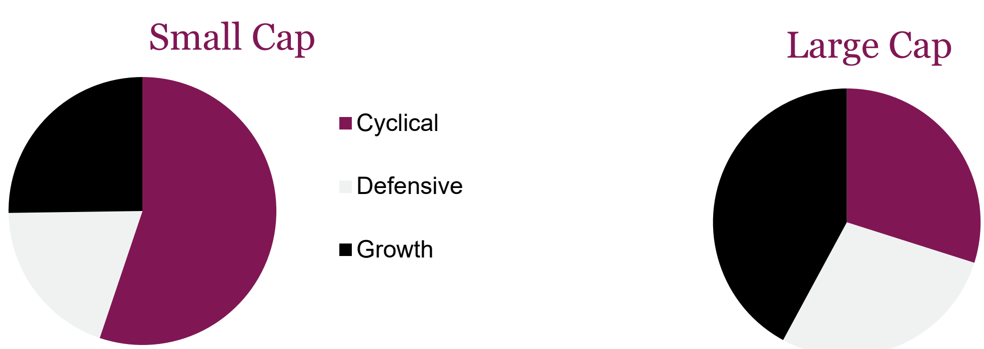

Source: Bloomberg, Purpose Investments

Of course, one risk is that those estimates don't materialize – these are forward consensus forecasts. Nonetheless, the return of earnings growth for smaller companies is a positive factor favouring smaller cap going forward.

3) **The Fed & tariffs (compelling)** – The Fed has started to cut interest rates, as inflation cools. This is good news, more so for smaller companies that are more sensitive to changes in financial conditions. While smaller companies don't necessarily carry a higher amount of debt, compared to their equity or assets, they just have less flexibility or options when financing or re-financing compared to larger companies. This makes them more sensitive to changing financial conditions. The Fed overnight rate does impact financial conditions, as do many other factors from spreads, equity markets, and generally the availability of credit. Financial conditions have actually been more favourable for the past year+, which clearly hasn't translated into a lift for small caps… but it is a positive.

   What we don't know is what trade policies will be enacted. We do know the world continues to move towards more protectionism, a multi-year trend that started with Trump and continued under Biden. A Trump win may kick off another round of tariffs. A Harris win may result in a more gradual move towards more protectionism. Clearly nobody is talking about making trade more free these days. Small caps generate more sales domestically compared to large cap that contain many multi-national companies. The result is more protectionism is favourable for small cap over large cap. It may still be negative, but on a relative basis larger companies are more at risk.

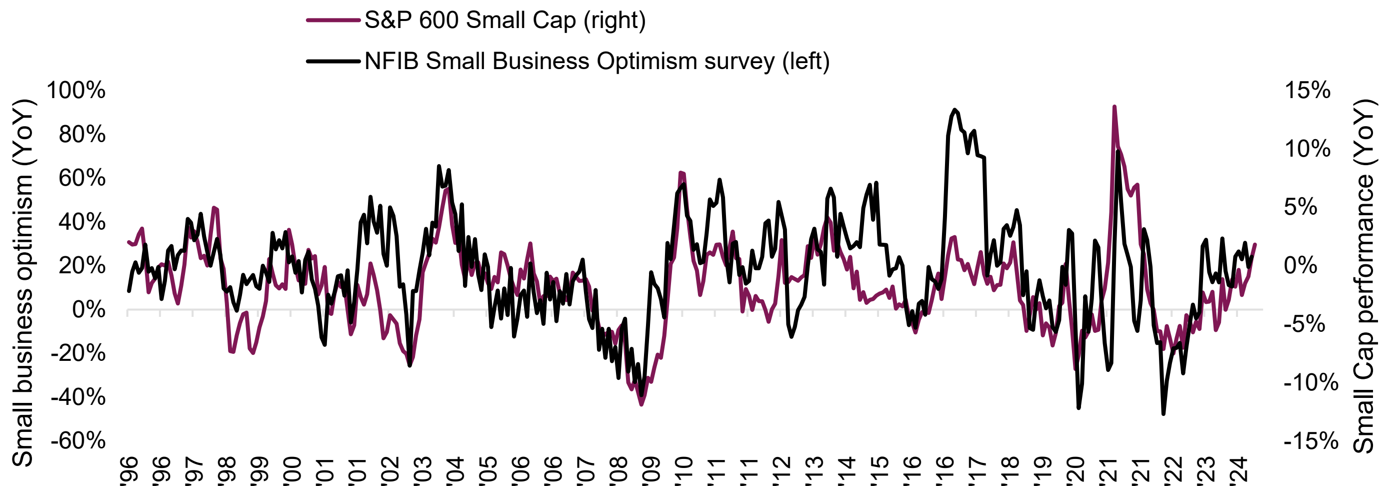
4) **Economic momentum (mixed)** – Small caps are more sensitive to the economic cycle and to accelerating or decelerating economic growth. More exposure to the domestic economy certainly contributes to this differentiation, as does the composition of small caps vs large caps. Small caps have a higher weighting to more cyclical sectors including Financials, Industrials, Energy and Materials. While large caps have a higher exposure to defensives including Health Care, Communication Services and Consumer Staples. Plus large cap has a bit more growth mainly from Technology.




Source: Bloomberg, Purpose

The U.S. economy grew by 2.5% in 2023, with this year expected to finish off around 2.6%. Currently expectations are for a deceleration into 2025 to 1.9%, which is not overly supportive. However, a good trend has been gradually improving small business optimism. The National Federation of Independent Business has a monthly survey and the overall optimism among respondents tracks very well with the performance of small caps. Of course we can't say if folks will become more optimistic or less going forward, but the improving trend over the past few quarters is encouraging. So too is the economic data during the past couple months which has been consistently coming in better than expected. Perhaps those forecasts for 2025 GDP will be proven too conservative.

Rising small biz optimism is positive for small caps



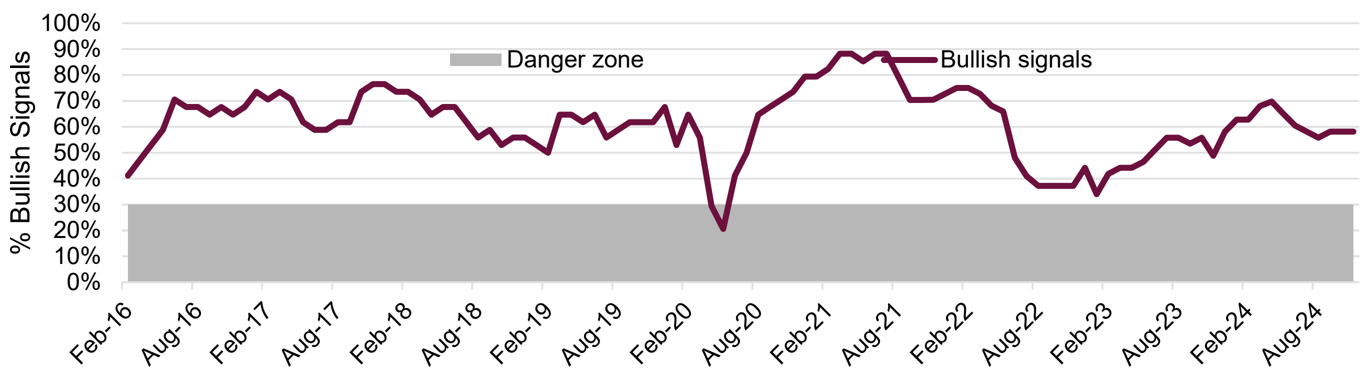

Source: Bloomberg, Purpose Investments

Add it all up, we are still a bit mixed on going too far down the size spectrum. For our U.S. equity exposure we remain tilted to more equal weight within the S&P 500 complemented with some market cap exposure and the dividend factor. Overall, this reduces the concentration risk given the size of the megacaps, but remain in larger companies.

# Market cycle

Things are alright. In case you are wondering why this market has been so resilient to the yen carry trade blowup, election risk (hopefully that lasts), rising geopolitical tensions, or other scary developments, it's simply a healthy backdrop. Overall, our market cycle indicators are stable within a healthy range.

Market cycle indicators - AOK




Source: Purpose Investments, Bloomberg

The rates backdrop is more encouraging given rate cuts are the norm. While the yield curve inversion is still negative, it's become less inverted. The U.S. economy picked up a bit including manufacturing. Housing slipped a bit but the overall was net positive. Weakness came on the global economy side with copper dropping, emerging markets weakening and Baltic freight prices dropping. Fundamentals weakened a bit too, as negative earnings revisions for international equities slipped into the red.

## Market cycle indicators

| Grouping | Metric | | | Better/ Worse |
|---|---|---|---|---|
| **Rates** | | | | **2 / 1** |
| | Net Cuts | ✓ | | - |
| | Yield Curve | | ✓ | + |
| | Yield Curve 3m | ✓ | | + |
| **US Economy** | | | | **13 / 6** |
| | Leading Ind (3m) | | ✓ | - |
| | Leading Ind (6m) | | ✓ | - |
| | Phili Fed Coincident | ✓ | | + |
| | Credit (3m) | ✓ | | - |
| | Recession Prob (NY Fed) | | ✓ | + |
| | Recession Prob (Clev Fed) | | ✓ | + |
| | Citi Eco Surprise | ✓ | | + |
| | GPD Now (Atlanta Fed) | ✓ | | + |
| | US Unemployment | ✓ | | + |
| | Consumer Sentiment (3m) | ✓ | | + |
| **Manufacturing** | PMI | | ✓ | |
| | PMI New Orders | | ✓ | + |
| | Energy Demand (YoY) | ✓ | | + |
| | Truck Demand (YoY) | ✓ | | + |
| | Rail (YoY) | ✓ | | - |
| **Housing** | Starts (6m) | | ✓ | + |
| | Months Supply (6m) | | ✓ | - |
| | Home Sales | | ✓ | - |
| | New Home Sales | ✓ | | + |
| | NAHB Mkt Activity | ✓ | | + |

| Grouping | Metric | | | Better/ Worse |
|---|---|---|---|---|
| **Global Economy** | | | | **2 / 6** |
| | Global PMI | ✓ | | - |
| | Copper (6m) | | ✓ | - |
| | DRAM (3m) | | ✓ | - |
| | Oil (3m) | | ✓ | + |
| | Commodities (3m) | ✓ | | + |
| | Baltic Freight (3m) | | ✓ | - |
| | Kospi (2m) | | ✓ | - |
| | EM (2m) | | ✓ | - |
| **Fundamentals** | | | | **7 / 5** |
| | US: PE | | ✓ | + |
| | US: EPS Growth | ✓ | | + |
| | US: EPS 2FY v 1FY | ✓ | | - |
| | US: 3m EPS Revision | ✓ | | - |
| | Canada: PE | ✓ | | + |
| | Canada: EPS Growth | ✓ | | + |
| | Canada: EPS 2FY v 1FY | ✓ | | + |
| | Canada: 3m EPS Revision | ✓ | | + |
| | International: PE | ✓ | | + |
| | Int: EPS Growth | ✓ | | - |
| | Int: EPS 2FY v 1FY | ✓ | | - |
| | Int: 3m EPS Revision | | ✓ | - |

Source: Purpose Investments, Bloomberg

Once again, it does look like the strong U.S. economy remains the best part of the news. This can be seen as well in economic surprise indices, which in the U.S. is strongly positive, Canada strongly negative and international more mixed. No active changes to our allocations this month, just normal market drift. We are back up to a good amount of cash to provide some optionality should the markets freak out over elections or something else.

## Active Asset Allocation Strategic Guidance

| | House View | Underweight | | Neutral | | Overweight |
|---|---|---|---|---|---|---|
| Overall | Equity | | | ● | | |
| | Bonds | | ● | | | |
| | Cash | | | | ● | |
| | Diversifiers | | ● | | | |
| Equities | Canada | | ● | | | |
| | U.S. | | ● | | | |
| | International | | | | | ● |
| | Emerging Markets | | | ● | | |
| | Style Allocation (Value <----> Growth) | | ● | | | |
| | Size (Small <-----> Large cap) | | | | ● | |
| Fixed Income | Duration (Low <-----> High) | | | | ● | |
| | Government | | | | ● | |
| | Credit | | | ● | | |
| | Credit - Investment Grade | | | | | ● |
| | Credit - High Yield | | ● | | | |
| | Credit - Preferreds | | | | ● | |
| Diversifiers | Volatility Reduction Strategies | | | | ● | |
| | Growth Strategies | | ● | | | |
| | Structured Product / Yield | | ● | | | |
| | Real Assets | | | | ● | |
| | | Passive | | | | Active |
| Act/Pass | Management Approach | | ● | | | |

Source: Purpose Investments

# Final thoughts

Two months to go in 2024, and unless something really bad happens, we will have enjoyed back-to-back strong years. The performance-chasing urge is certainly alive and well, the fear is remarkably muted. That can change quickly. Stay diversified and try to resist the Sirens' performance-chasing songs.

**Source**: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.