AGF INSIGHTS

OUTLOOK 2024

How High for How Long?

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How High for How Long?

The anticipated end to the rate-hiking cycle of the past two years could be an important tailwind for financial markets in 2024. But how much of a boost it gives may largely depend on the economic backdrop that unfolds – and how low central banks are willing to go if they do start cutting rates.

BY KEVIN McCREADIE

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Investors should be feeling better about financial markets heading into 2024 than they did this time last year, when stocks and bonds were still mired in the mud of a punishing bear market. But while stocks have rallied and bonds are now rebounding, the past 12 months hasn't exactly been a cakewalk. Markets have remained volatile, and positive returns, if any, have lacked breadth within and across asset classes. On the plus side, that leaves room for improvement and the possibility of even more opportunities to make gains in the new year.

How well markets perform most likely lies in the hands of the world's central bankers, who continue to fight inflation while trying to navigate a soft landing for the economy and avoid a deep recession. Nowhere is this more evident than in the United States, where the U.S. Federal Reserve (Fed) has already raised interest rates from near zero to 5.5% and helped cut the country's inflation rate by more than half, to just above 3% in October, all without seriously hindering economic growth just yet.

The questions now are whether the Fed's tightening cycle has peaked, given its recent decision to pause on further rate hikes, and, even more importantly, when it might start loosening policy by cutting rates – and by how much.

To that end, we believe the Fed is most likely done raising rates (or near enough to it), which could be a positive for markets in and of itself. After all, most of the volatility over the past two years has been arguably caused by the speed and magnitude of the rise in rates, and not the ultimate level of them. But whether interest rates have truly peaked remains largely dependent on the still-uncertain trajectory of both the economy and inflation.

Moreover, because of that uncertainty, we believe current expectations of four or more rate cuts in 2024 should be tempered for as long as inflation remains elevated above the Fed's 2% target and economic growth stays resilient. In fact, this could be true even in the case of a recession next year. Despite the central bank's past propensity to immediately cut rates at the first sign of an economic downturn, that's hardly a given this time around. We believe the Fed is likely to be much more deliberate in its actions.

Granted, this potentially delayed response may only be a matter of degree and timing. In our opinion, it's still probable that interest rates will be lower by this time next year – not just in the U.S., but in many countries, notably Canada, where growth already turned negative in Q3 – and is expected to start dropping in an eventual response to slumping economic growth that raises unemployment rates, but keeps inflation in check.

The questions now are whether the Fed's tightening cycle has peaked, given its recent decision to pause on further rate hikes, and, even more importantly, when it might start loosening policy by cutting rates – and by how much.

In this scenario, markets are likely to remain volatile in the short term yet could find better footing in the second half of the year. Equity markets, for instance, often fall heading into recession and may tumble again if earnings expectations adjust downward to reflect economic conditions. But that weakness should give way to a more

constructive period, guided by looser monetary policy and the anticipation of an economic recovery. That, in turn, could give a lift to a much broader swath of stocks and sectors than the handful that have largely driven the rebound in equities this year.

Meanwhile, bond markets could benefit in 2024 from their traditional role as a haven during times of increased economic uncertainty, but also because central bank interest rate cuts would make existing bonds issued at higher rates generally more attractive. This would be a welcome development for many fixed income investors, particularly those who have suffered through negative returns in the past three years.

Still, investors shouldn't rule out a soft-landing scenario entirely, especially in the U.S., where growth is expected to moderate this quarter, but still remain positive. And should the Fed reach its 2% inflation target and not cause a recession, it could lead to a much different – albeit still promising – backdrop for markets. Namely, interest rates may not fall as much as they would otherwise, but neither would investors likely demand that they do if they are convinced economic growth can be sustained longer term.

Either way, while the path might be different under these two scenarios, both equity and fixed income markets could eventually end up in a better place than they are now. Yet, that's hardly a guarantee, especially if other factors come into play and change the trajectory of the current backdrop. In particular, close attention still needs to be paid to the geopolitical climate, which due to the wars in Ukraine and the Middle East continues to be rife with risks. At the same time, next year's U.S. presidential election could set the stage for increased volatility, especially in the case of another contentious result.

Practically speaking, then, there is still grounds for caution heading into 2024, even as market dynamics seem pointed in the right direction.

Practically speaking, then, there is still grounds for caution heading into 2024, even as market dynamics seem pointed in the right direction. As such, we believe a neutral stance on equities and underweight to bonds should at least for now be offset by a slightly larger-than-normal allocation to cash within a 60/40 portfolio. But as next year progresses, we fully expect to become more aggressive in our asset allocation and put more money to work in what should end up being another year of improvement for financial markets in our opinion. ■

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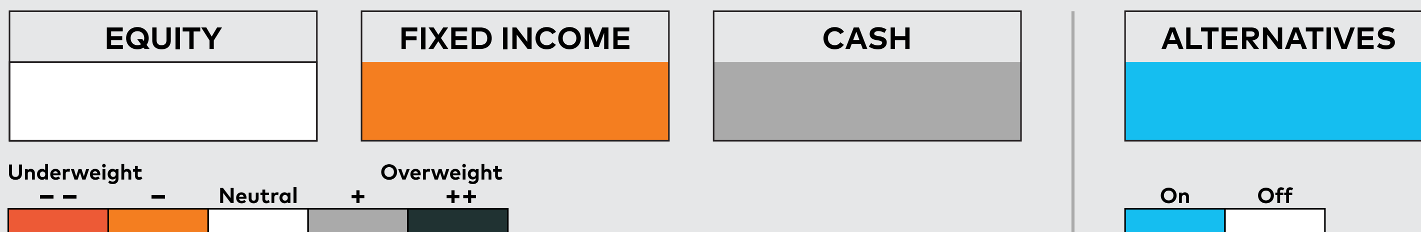
Asset Allocation Overview



Source: AGF Asset Allocation Committee Fourth Quarter Update (as of October 1, 2023). Based on a 60/40 portfolio mix of equity and fixed income. For Illustrative purposes only.

Asset Class Roundup

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BY STEPHEN WAY, TRISTAN SONES, TOM NAKAMURA, SHERRY XU, STEPHEN BONNYMAN, ASH LAWRENCE

Equities

Looking Further Afield for Opportunities

U.S. equity opportunities may lie outside the narrow group of stocks related to artificial intelligence, while equities in Europe, China and Japan could offer additional prospects for returns in the year ahead.

By Stephen Way

Global equity markets posted positive returns in 2023 despite meaningful uncertainty stemming from bank failures, geopolitical events and a slowing economic environment that faced decade-high inflation and rising interest rates. U.S. equities experienced one of the narrowest markets in decades, sparked by a sharp rally in artificial intelligence (AI) and large-language model related stocks early in the year. Consequently, large-capitalization stocks outperformed small-cap stocks, supported by the frenzy over AI and by investor preference for the perceived safety of the big names in an uncertain environment.

The question is whether markets will remain a "land of the giants" going forward. We have some doubts and believe there are better U.S. opportunities outside the narrow group of AI-related stocks.

We expect core inflation to remain persistent next year, which could force central banks to maintain higher policy rates for longer than the market expects.

The resilience of the American economy in 2023 took many by surprise. It was supported by a robust labour market, a surplus of consumer savings from the 2021 stimulus and unexpected liquidity injections as policymakers bailed out regional banks. We believe some of those tailwinds could transition to headwinds next year, as the ripple effects of stimulus and savings fade. Historically, U.S. election years – and 2024 is one – have correlated with heightened volatility in equity markets yet, paradoxically, have also demonstrated a more favourable environment for stock picking. Interestingly, from a historical perspective, a split U.S. Congress has resulted in the best market outcome, with an average annual return of 11% in election years since 1928. Those factors may function on a broad level in U.S. equity markets, suggesting investors could benefit from expanding their focus beyond mega-caps in 2024.

Several global central banks continued to raise policy rates in 2023 due to inflationary pressures. We expect core inflation to remain persistent next year, which could force central banks to maintain higher policy rates for longer than the market expects. Still, the full impact of central bank tightening has yet to be seen in several countries, given long lead and lag times on the economy. While there is growing consensus that a "soft landing" may occur in the U.S. in 2024, they

Equities

are quite uncommon from an historical perspective, occurring only four times in the last 75 years, according to Ned Davis research. We anticipate a mild recession is more likely, given the speed and intensity of recent monetary tightening, and other cautious forward-looking economic indicators.

Capital expenditure (capex) is poised for a continued revival, driven by the imperative of security in the global geopolitical landscape. Two supportive U.S. industrial policy statutes, passed in 2022, are expected to continue supporting the capex cycle. The Inflation Reduction Act (IRA) and the Creating Helpful Incentives to Produce Semiconductors and Science Act (CHIPS) have provided billions of dollars to manufacturers to produce in the United States, and they have helped to attract foreign companies to build U.S. production facilities.

Themes with broad support include re-shoring, U.S. manufacturing and defence spending, with a low risk of defence spending cuts even by deficit hawks. We believe all these trends are bullish for equities and gross domestic product (GDP) growth. Capex guidance remains strong, particularly from the biggest technology companies. The upgrade cycle and domestic investments amid re-shoring could indicate a potential and substantial boost to productivity ahead.

The upgrade cycle and domestic investments amid re-shoring could indicate a potential and substantial boost to productivity ahead.

Economies in Europe fared better than expected in 2023. In equity markets, eight of the 11 Global Industry Classification Standard sectors outperformed in Europe relative to the United States. However, European stocks still underperformed relative to the United States, in large part because of the U.S. Information Technology (IT) sector's strength and European markets' meaningfully smaller exposure to IT. We anticipate that European earnings could roll over in 2024 as the central bank monetary policy tightening further weighs on the corporate sector.

In Asia, Japan has emerged from three decades of economic stagnation while seeing an acceleration in corporate reform, which could continue to support Japanese equities. However, the Bank of Japan will likely end yield curve control (YCC) at some point in 2024, which could put upward pressure on global bond yields as Japanese yields continue to rise. Encouragingly, we believe the Japanese government is trying to promote an equity culture in Japan to rectify decades of corporate inattention to shareholder returns. That will go hand in hand with policy normalization.

In contrast, China has experienced a disappointingly slow reopening recovery amid structural headwinds from high debt levels, demographics and deflation, as well as geopolitics. So far, authorities in China have employed relatively modest monetary tools and fiscal measures to stimulate the economy, leaving markets somewhat underwhelmed. A substantial stimulus similar to those seen during the 2008-2009 and 2015-2016 downturns appears improbable. However, we expect China will continue to build on its recent policy momentum, aiming to boost sentiment, stabilize property markets and support overall economic growth. ■

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Fixed Income

Is the Hurting Over?

The prospect of the U.S. Federal Reserve being on hold could be a positive for many markets, particularly in those countries where central banks were early to tighten.

By Tristan Sones

2024 may be the year that central banks generally stop being a headwind for government bond performance, but the question of whether they can morph into a tailwind is largely a regional and country-specific one.

Global growth in 2024 should continue to be impacted negatively by the lagged effects of all the tightening done so far. These after-effects are being felt across the world to varying degrees.

Those countries that took a proactive approach to tackling inflation and aggressively raised rates early on are now feeling more of the impact of that tightening, with their economies showing signs of a slowdown. Parts of Latin America and Eastern Europe fall into this category. On a more positive note, inflation in those regions declined enough in many cases to support a shift to easier monetary policy. Yet while markets gradually bought into the rate cut enthusiasm, it was quickly replaced by skepticism as U.S. growth continued to surprise many with its resiliency earlier this year, leaving the black cloud of further tightening by the U.S. Federal Reserve (Fed) still on the horizon.

More recently, however, America's economy seems to be finally showing signs of slowing, and with that comes a higher likelihood the Fed stops hiking interest rates. We have been here before, though, and markets are once again getting excited and bringing forward the timing of rate cuts. Should U.S. growth continue to soften, the prospect of rate cuts starting in 2024 is valid, but it's shaping up to be a second-half story at best. Inflation, though falling, still needs time to prove itself more broadly benign and to reach a more comfortable level in absolute terms. It's hard to envision the Fed cutting rates materially when inflation is still above target, so markets should not ignore the possibility of few – or even no – rate cuts in 2024.

America's economy seems to be finally showing signs of slowing, and with that comes a higher likelihood the Fed stops hiking interest rates.

The Bank of Canada might be in a better position to gradually ease policy rates in 2024 because the Canadian economy has seen virtually no real growth for much of 2023. Additionally, a large portion of higher-cost mortgage renewals will be coming due over the next year, which will put even more pressure on an already stretched consumer.

Fixed Income

The back-and-forth debate between easing policy rates or keeping them restrictive is a probable scenario for the first half of the year. It seems probable that the Fed will throw cold water on the market's desire for an early ease. Still, the prospect of the Fed on hold could be a positive for many markets, particularly in those countries where central banks were early to tighten. Countries such as Mexico and Brazil have very high real rates and may be able to gently ease policy rates if the Fed is indeed done.

Western Europe is experiencing slower growth already, which has put the European Central Bank (ECB) in a holding pattern. Much of this slower growth profile can be attributed to a lacklustre Chinese economy. The Asian region has been generally running counter to its European and American counterparts, in that inflation has not been as much of an issue. As a result, central banks in the region never implemented the same degree of policy tightening.

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The Bank of Japan (BOJ) is an outlier, having made only small adjustments to its yield curve control strategy despite elevated inflation. In 2024, a meaningful change to its policy stance is likely, however, with an effective end to yield curve control and a positive policy rate for the first time since 2015. That said, the BOJ will probably move more slowly and gradually than most expect, with more minor implications for global rates markets.

Irrespective of what happens in 2024, government bond yields at close to 20-year highs are giving investors a head start. Running yields are providing a competitive return, with the added benefit of a potential risk offset should growth really deteriorate. However, volatility may remain elevated on the ebb and flow of the growth-versus-inflation narrative, exacerbated by the higher cost of deficit funding that virtually all countries face. This lack of fiscal space is another reason why the growth picture overall could be more muted than markets might hope. ■

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Currency

Time to Re-Focus

Carry strategies in foreign exchange markets may be at risk, and a more diversified approach to currency management may be key.

By Tom Nakamura and Sherry Xu

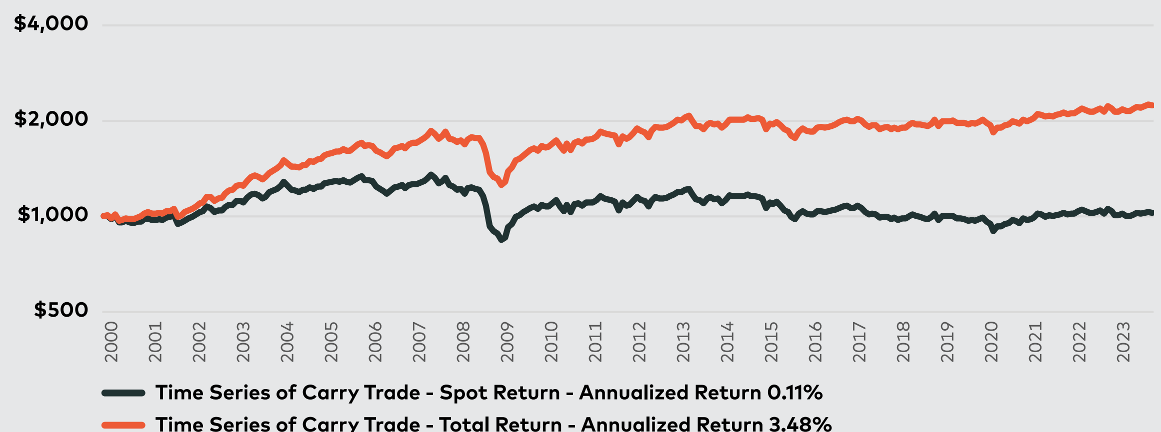
In photography, there is a concept called bokeh. Essentially, it is having your subject in focus but the background in a dreamlike blur. This popular effect draws the viewer's attention to the subject and eliminates distraction. The more smoothly blurred the background, the better the bokeh.

Currency markets often exhibit this state of heightened focus. While investors are aware of risks, they tend to lie outside of the focal plane – they're blurry, in other words – until one day they take over as the subject or, in some cases, subjects. And then they become clear.

In 2024, we believe that carry strategies in currency markets are at risk, and a more diversified approach to currency management may be key. Carry is what currency markets usually focus on. It is easy to understand, measurable, and generally works. A carry strategy is to go long (buy) a currency with a high interest rate while going short (selling) a currency with a low interest rate. Since interest rates are readily observable in the market and their drivers (what makes them go up or down) are well understood, carry is often appealing to market participants. At the heart of this strategy is that exchange rates (what we refer to as spot rates) are expected to be revert to the mean. That is, a carry strategy does not expect, or need, exchange rates to move in a favourable direction.

To illustrate this, we constructed a simple carry strategy and charted the results. The strategy chooses from nine developed market currencies, and each month ranks and then buys the three highest yielding currencies and sells the three lowest yielding currencies, in equal proportion. The total return of this strategy since January 2000 is 3.5% annualized (orange line). The black line in the chart represents the spot rate return, which had a significantly different experience. The spot (exchange rate) moves alone are not appealing. The difference between these two lines is the carry return, which is what carry strategies are focused on capturing.

Carry Trade Performance



Source: Bloomberg LP as of October 31, 2023. All figures are denominated in Canadian dollars. The nine currencies used in this analysis are the U.S. dollar (USD), Euro (EUR), Japanese yen (JPY), British pound (GBP) Australian dollar (AUD), Swiss franc (CHF), Swedish krona (SEK), New Zealand dollar (NZD), and Norwegian krone (NOK).

Currency

The trouble is, carry strategies can break down when spot rates decline significantly. We can see several episodes where the total return of the carry strategy is dragged down by the spot rate return. The market environments that frame such episodes are typically related to downside economic concerns that arise during periods like the global financial crisis. The greater the concern about the risks in the economy, the more likely that the downside in spot rates overshadows the expected carry gains. These are the types of environments that expose the risks to carry strategies.

When carry strategies start underperforming, it is often because the markets have shifted focus to more fundamental factors, with particular attention to country risk.

When carry strategies start underperforming, it is often because the markets have shifted focus to more fundamental factors, with particular attention to country risk. Similar to credit investors, currency investors will look critically at the creditworthiness of countries, the sustainability of the interest rates being offered and what demand and supply factors are at play. When countries with high carry currencies are riskier than those with low carry currencies, this can result in adjustments that are negative for the spot rate returns. Often, higher-risk countries are higher yielding, much as they are in credit markets.

The pandemic response from both fiscal and monetary authorities provided a good environment for carry strategies, but most of these policies are in the process of being reversed. Several high carry currencies, including the British pound and our Canadian dollar, have enjoyed relative outperformance in the developed market space in spite of a weak economic profile. Likewise, strong carry returns have been enjoyed in Emerging Markets, particularly in Latin America and Eastern Europe.

Now, however, the fiscal and monetary landscape seems poised to change. Central banks are eager to get policy back to "normal," and that is starting to weigh on the outlook for economic performance. Meanwhile, aggressive government spending is creating the risk of fiscal headwinds in many developed and emerging economies.

In our view, 2024 seems bound to be a year in which fundamentals come into sharper focus, and that means markets may be over-exposed to carry. Now may be a good time to look into that blurry background and measure risks accordingly. ■

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Real Assets

Investing in a Real World

Real Assets may be well-positioned to play an important role in portfolios over the next cycle.

By Stephen Bonnyman

The inflation and interest rate moves over the past year have induced substantial volatility in global equity markets, forcing the reset of many valuation parameters and influencing market performance and breadth. While interest rates may contract from existing levels, we believe the very low rate environment of the past decade is unlikely to come back anytime soon. Inflation might well be harder to tame than implied by the broader market or by the U.S. Federal Reserve (Fed)'s goals, and inflation protection may be a potential consideration in portfolio construction over the medium term.

This backdrop, coupled with the rising risk of an economic recession, could drive investors to seek opportunities with stable and growing yields, lower volatility earnings and lower correlation to the broader equity market. Real Assets (i.e. Commodities, Real Estate, Infrastructure, Utilities) have traditionally offered all those qualities, and, in many instances, these opportunities are currently available at undemanding valuations.

In short, an actively managed allocation to Real Assets may prove critical to investment performance over the next cycle, allowing investors to both participate in emerging trends and protect their portfolios from near-term economic risk.

Globally, for example, the Utilities sector has suffered some of its worst years of underperformance as rising rates and narrow market breadth pushed investors into fewer sectors and stocks. The global Utilities sector now trades at some of its lowest observed multiples in many years (relative both to itself and to the broader market), even though margins and earnings for the group are improving. The largely capital-intensive Real Asset universe has broadly suffered from a lack of reinvestment funding over the past decade, which has allowed increasing pricing power to incumbent providers and created the potential of new opportunities for greenfield and brownfield investment.

Additionally, Utilities have traditionally outperformed in periods of falling inflation and falling rates (which would lead to the soft landing the market is looking for), and the opportunity for steady earnings, solid balance sheets and stable dividends may be the catalyst for investors to return to

Real Assets

the group. In our opinion, a properly structured Real Asset portfolio can provide investors with the possibility of positive real returns, solid inflation protection, lower recession risk, lower volatility returns and meaningful diversification from the broader equity market.

While often forgotten, Real Assets also form the backbone for most of the thematic developments that dominate the existing news cycle. In the years to come, therefore, we believe they should play a key role in energy pricing and scarcity (Energy and Utilities); the dependence of electric vehicle production on lithium, nickel and other metals (Mining); renewable power and electrification's need for generation and grid stability (Utilities, cables and towers); the unique power requirements and reliance on data centres of artificial intelligence (Real Estate); the expanding shortage of housing; and the ongoing challenge of food supply and food inflation (Fertilizers, farmland, logistics).

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Private Markets

A Turn for the Private Good

The potential end to the rate-hiking cycle could be a positive catalyst for some private market investments in 2024.

By Ash Lawrence

The past 18 months have been challenging for most sectors in the private markets after more than a decade of positive performance, according to Preqin data. Like most asset classes, private alternatives are not immune to a macro climate of persistently high inflation and rising interest rates. This environment has a knock-on effect that slows asset realizations, which reduce distributions and subsequently reduces net new fundraising. Coupled with negative impacts on performance of this environment and predictions of a slower economy, this has led to a slower pace of growth than was the average in the back half of the last decade. For the first time in a long time private assets are facing an uphill climb as we look to 2024.

However, despite the tougher backdrop, private markets have maintained positive momentum. Assets under management are still expected to grow by an annualized rate of 11.9% over the next four years, adding to an already impressive trajectory that has seen the size of the alternative investment class almost double since 2018.

And while the current environment has resulted in some decidedly mixed returns to date, an expected end to the rate-hiking cycle could be the catalyst for an increase in positive outcomes as capital sitting on the sidelines is re-deployed across a broader swath of strategies, including those that invest in privately held equities and credit.

Total global assets under management (AUM) expected to reach **US$18.3 trillion** by the end of 2027, from **US$9.3 trillion** at the end of 2021. This represents a compound **annual growth rate of 11.9%** between 2021 and 2027 (**from 14.9% between 2015-2021**).

Source: Preqin, *Future of Alternatives 2027* report, October 5, 2022.

Private Credit: More of the same solid returns?

Of all the various flavours of private market investments, private credit has been one of the biggest beneficiaries of the recent rate-hiking cycle. While certainly some of this growth is a result of climbing yields in the sector, there has been an expansion of the opportunity set for private

Private Markets

lenders as tighter lending conditions from traditional counterparts has created an attractive pool of under-served borrowers. Multiple factors have played a role in setting this dynamic, but it has been particularly noticeable since the collapse of Silicon Valley Bank in April, which resulted in many mid-sized U.S. regional banks curbing their loan activity to avoid a similar fate. In fact, recent data from the U.S. Federal Reserve shows that growth in traditional bank lending has been cut in half across almost all types of loans this year. We have seen a similar trend in Canada as banks have looked to reduce exposure, focus on higher margin clients and respond to regulatory changes in their capital requirements.

In turn, that has created the potential of more opportunities for private lenders who may be the only option for corporate borrowers needing to raise capital right now. Moreover, that trend could be expected to continue if economic growth weakens in 2024 and overall lending conditions tighten further.

Still, the near-term outlook for private credit isn't without risks. For one, the threat of a severe economic downturn sometime next year will undoubtably increase the strain on borrowers. In fact, we have seen signs of this already, yet this strain has remained relatively benign despite higher debt servicing costs from rate hikes that have taken place to date. Of particular concern should be strategies that invest in private loans with weak collateral and covenants, and/or rank low in the capital structure of the companies they lend to.

Perhaps more importantly, investors may need to spend the time understanding the lending approach taken by the managers they select to invest their capital. When there is a level of stress in the environment, private lenders need to have the skills necessary to properly underwrite and stress test a borrower's credit and to structure loans that provide the right protections and risk mitigation to avoid negative outcomes.

Either way, 2024 should continue to buoy private credit as it doesn't appear traditional lenders will be in growth mode until much later in the year. We believe the potential for solid returns remains mostly intact from still-attractive yields and a growing demand for the asset class among institutional and retail investors wanting greater diversification in their portfolios.

Private Equity: Cue the comeback?

If private credit has been a beneficiary of the current rate-hiking environment, private equity has been just the opposite and may gain more from a pivot in monetary policy next year.

Indeed, 2023 may end up being the bottom to one of the worst stretches for selling portfolio companies in a decade, according to PitchBook, a private market data provider. Higher rates have stunted the transaction market given the leverage used in most asset acquisitions. This has created a wide gap between buyers and sellers' price expectations.

That said, we are seeing some thaw in the market for transactions as buyers and sellers adjust to the new cost of capital realities and this could continue into 2024. Should we continue to see a pause in hikes from central banks and start to see rates move downward toward the second half of 2024, we may see a a boost to activity in the private equity sector.

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Moreover, while the prospect of an economic slowdown in the new year could result in more downward pressure being exerted on existing portfolio valuations, it could also be the catalyst for a new buying cycle later in the year. Downturns more often than not tend to produce opportunities for those who have dry powder (i.e. cash) to deploy and are ready to get it wet.

Ultimately, there is the potential that 2024 could end up being a turn for the better in private markets versus 2023, one that sees further gains for private credit and the performance of private equity staging a comeback, all while assets under management continue to grow globally and reach new heights.

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Racing Uncertainty

The 2024 U.S. presidential election could have far-reaching implications for financial markets. Here's an "early-days" primer on what investors need to know about the race to the White House.

BY GREG VALLIERE

Greg Valliere
Chief U.S. Policy Strategist
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Never in U.S. political history has a presidential race looked like the one that apparently will be inflicted on the American public in 2024 – Joe Biden, 81, against Donald Trump, 77. Both candidates are so gaffe-prone that voters are clamoring for another choice, but that is a very long shot. It's looking like Biden vs. Trump in a race that once again could inflame the country.

Is there any alternative? Filing deadlines have come and gone and it's very unlikely that a new candidate – or a third party – could emerge to change the outlook. A Constitutional challenge to a Trump candidacy is unlikely to prevail, and even if Trump is convicted of a federal crime next year, he could drag out the legal appeals process for months or even years.

Could Trump serve as president while in jail? Most legal experts say yes. Could he work with a pliant Justice Department to pardon himself? Most legal experts expect this to happen.

As of now, Trump is the narrow frontrunner to win the presidential election; he's ahead in some of the so-called battleground states (Pennsylvania, Georgia, Arizona and Michigan). Trump is far from a shoo-in, and Biden can take some credit for presiding over a surprisingly solid economy.

But Biden faces several obstacles, not just his age. Thousands of illegal immigrants pour into the U.S. daily, gun crime is pervasive in urban America, economic anxiety persists, and there's the likelihood that the business activities of Biden's son, Hunter, will continue to attract congressional scrutiny.

What are the policy implications of the presidential election?

A Trump victory would usher in a laissez-faire regulatory climate, which would be a plus for energy companies, the tech sector and health care. Trump would push hard for an extension of his tax cuts because many of the provisions will expire in 2025. More tax cuts and a Trump proclivity to spend may send the budget deficit soaring; it already is close to US$2 trillion annually. Deficits may rise under Trump, but he has never been particularly concerned about federal red ink.

We take a contrarian view that Biden would be better for the defense sector because Trump would capitalize on the mood of isolationism in the country, while Biden would push for more aid to Ukraine and Israel. We have little doubt that geopolitics will be a major issue. Trump says he could end wars and defeat enemies within days, while Biden will rely on huge outlays for defense. We think Pentagon spending will exceed US$1 trillion annually within two or three years.

Even Democrats agree that U.S. shipbuilding now lags far behind China's, and spending will surge in this crucial sector. We don't think there will be overt hostilities with China; both sides will talk but there's little hope for a real thaw between Washington and Beijing any time soon.

As for the hotspots, it's difficult to imagine any improvement in relations with Russia as long as Vladimir Putin is still in power, and Iran will remain a great threat to stability in the Persian Gulf as the Ayatollahs get closer to developing a crude nuclear bomb.

These issues are deadly serious, but there's growing support for isolationism in America. There probably will be decent support in Congress for aid to Israel, but support for Ukraine has waned as the war with Russia has hit a stalemate.

What about the U.S. congressional elections?

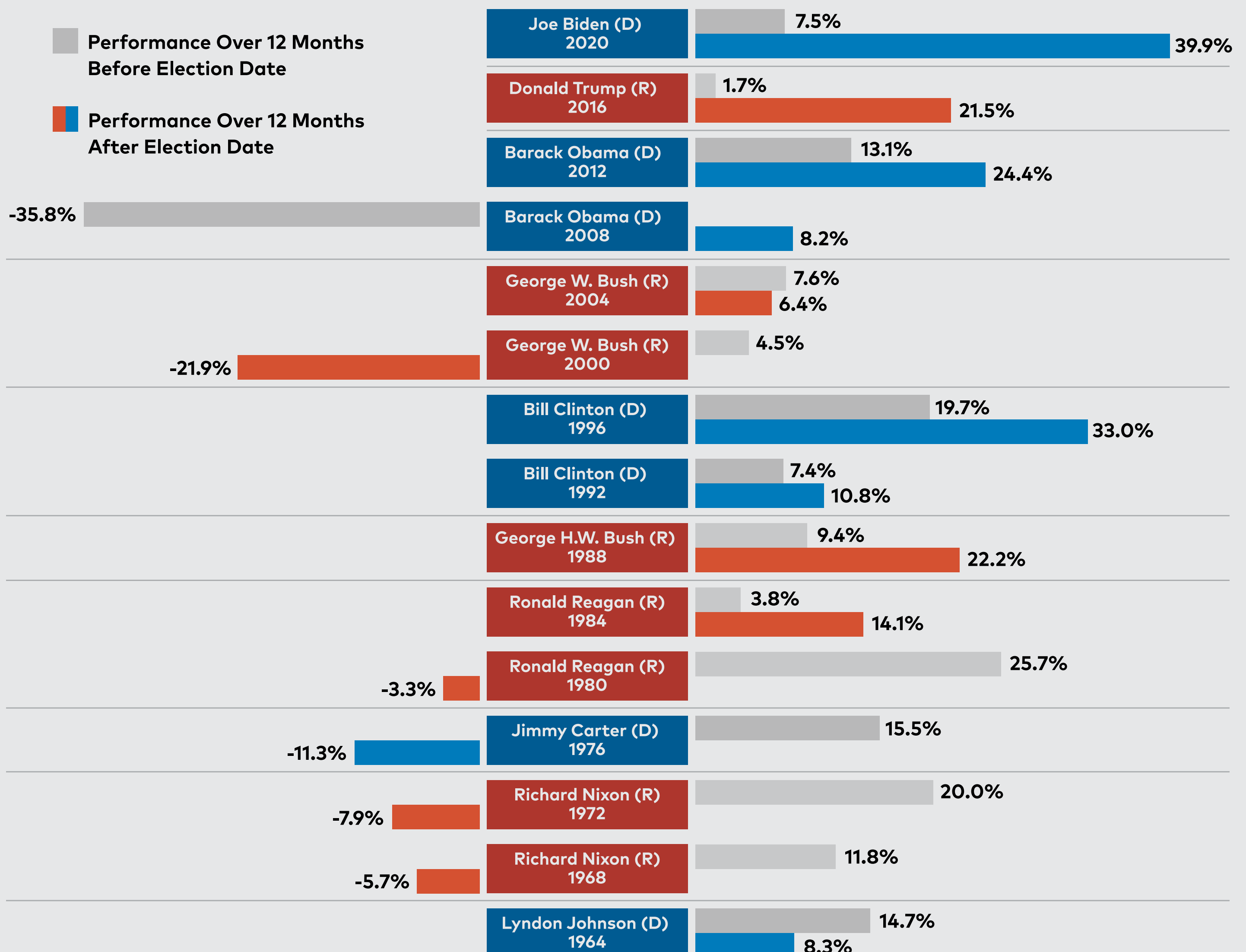
There will be another major U.S. election next year – the congressional elections, also held on November 5, 2024. We think the Republicans have a very good chance of re-capturing the Senate, largely because the mix of candidates up for re-election favors the "Grand Old Party" (GOP). On the other hand, the Republicans could lose their shaky hold on the House, largely because voters are strongly opposed to the GOP's radical anti-abortion policies.

Regardless of who wins the presidential election, the country will immediately focus on who could win in 2028; U.S. campaigns never end. Our early favorites to watch are Kentucky Governor Andy Beshear, 45, a Democrat, and Nikki Haley, 51, the former Republican governor of South Carolina. Imagine that – an election between two candidates under the age of 60. ■

Please see Disclaimer section for full disclosure.

Before and After

S&P 500 Index returns one year before election date and one year afterward.



Source: Bloomberg LP. **Past Performance is not indicative of future results.** One cannot invest directly in an index.

The Slow Divorce in Emerging Markets

The bifurcation of equity returns was striking between some of the world's developing nations in 2023. Here's why an emphasis on strong fundamentals may hold the key to investing in EM's changing landscape going forward.

BY REGINA CHI

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Emerging Markets (EM) are poised to end 2023 with a bang, but not a relatively loud one. While the MSCI EM Index has rallied in November, it is up 6% year to date, which is hardly terrible, but certainly not good when compared with the MSCI U.S. Broad Market (+14%) or MSCI World (+19%) Indexes.

This should probably not surprise investors. A strong U.S. dollar and rising U.S. bond yields through the year hit EM currencies and limited the ability of central banks to cut rates. More recently, the geopolitical crisis in the Middle East sparked a modest flight to quality in global markets. And Chinese equities, which comprise nearly 30% of the MSCI EM index, have turned in a very disappointing year, down nearly 11% through November. Now, as the new year approaches, the question for investors is whether EMs can stage a sustained rebound – or whether their losing streak will resume.

There is some reason for optimism. Rate hikes from the U.S. Federal Reserve (Fed) may be at or near an end, with the prospect of cuts increasingly coming into focus for 2024, giving EMs room to cut rates themselves. A "soft landing" in developed economies, if it occurs, would give a cushion to EM economic performance going forward. Some Emerging Markets are in a better fiscal and current account position than they have been for a long time. And underlying a brighter outlook for 2024 is the potential for China to bounce back, something that has yet to occur in the post-pandemic period.

On the other hand, worse-case scenarios abound. Inflation and higher rates might buck current expectations and persist into next year. China might disappoint – again. Given these uncertainties, the counterbalance of opportunities and risks suggests that prudent EM investors may benefit from focusing on fundamentals and careful stock selection in 2024.

But first, let's consider the "better-case" scenario, beginning with China. It is hard to overstate how much of a drag Chinese equities have been on overall emerging-market equity performance in 2023. China's economy emerged from the COVID-19 lockdowns deeply scarred, and those scars have not yet fully healed. Post-pandemic, policy stimulus was initially much weaker and less effective than expected – our forecast for Chinese gross domestic product (GDP) growth in 2023 is just 4.7%, down a full percentage point from the start of the year. We believe China's most difficult economic challenge remains over-reliance on fixed asset investment; it needs, as it has for several years now, to rebalance its economy towards consumption.

...as the new year approaches, the question for investors is whether EMs can stage a rebound...

Despite those challenges, it's possible that China is near the bottom of a cyclical slowdown rather than in the midst of a structural downturn. Manufacturing purchases, industrial production and retail sales picked up through the late summer and autumn, while consumer spending, which cratered in the middle of the year, has started to climb back. Macroeconomic policy has become more supportive, as China's central bank has cut rates and reduced bank reserve requirements. Beijing has taken several steps to support domestic demand, including incentives for homebuyers and the potential development of sizeable urban housing tracts. Remarkably, China's fiscal deficit shrank by 4.7% between mid-2022 and mid-2023 (compare and contrast to the U.S., which grew its deficit by nearly the same percentage); recently, however, the government appears to have changed course, and

economists forecast a fiscal deficit of 3.5% for 2024. That could set the stage for an economic rebound and an uptick in Chinese equity performance.

If Chinese stocks come back – at long last – then that may provide a significant tailwind for EM equities overall. Yet in some important ways, we believe China matters less to other Emerging Markets than it used to. One reason is simply that China's recent slowdown is being driven largely by domestic, not global, factors, explaining the marked lack of "market spillover" from the troubled superpower. Meanwhile, developed economies have increasingly tried to de-risk from China by moving supply chains to friendlier shores, which has directly benefited emerging economies like Mexico and India.

The result: EM ex-China equities have fared just fine in 2023, up about 13% through November. And certain pockets have done far better than that. In fact, the bifurcation of results between China and ex-China are remarkable. Four of the five biggest constituents of the MSCI EM index – India, Taiwan, Korea and Brazil – are poised to finish 2023 in positive territory; China, of course, is the outlier. Other emerging countries more aligned with Europe than with China have performed extraordinarily well; The MSCI Poland and MSCI Hungary Indexes, for example, were up 37% and 41%, respectively, through November, boosted by falling inflation, interest rates and energy prices, as well as relatively cheap initial valuations.

What we may be seeing is a slow divorce between China's growth prospects and stock markets and those of other EMs. Mexico, for example, is clearly benefiting from near-shoring. Its stock market and currency have been performing well in 2023, and it has replaced China as one of the top exporters to the U.S.

Investor interest in India, meanwhile, has been driven by its rising geopolitical influence, structural economic reforms and strong GDP growth (6.5% forecast in 2023); in some important ways, India's future looks much like China's past. Less well-known, perhaps, is the potential in Indonesia, the fourth-most populous country in the world, with a median age of just 30. That huge population remains under-banked (opening huge growth opportunities for banks and online payments firms) and under-connected (with e-commerce comprising only 4% of GDP, versus 11% in China).

Indonesia is also a leading supplier of nickel, a key component of electric vehicle batteries. Add the fact that domestic demand is strengthening, and Indonesia is positioned to turn in sustained 5%-plus annual GDP growth.

We believe Emerging Markets will always present opportunities, however isolated, and a differentiated and disciplined approach that concentrates on strong fundamentals, a good structural story and sizable risk premia, at both the market and the equity-specific levels, will likely be key in 2024.

Put all of that together – the potential for a Chinese economic recovery and pockets of strength elsewhere – and the stage could be set for a sustained EM rebound in 2024. That depends, however, on a number of factors. One of them would be, of course, a rally in China, which may be close now that valuations are attractive, sentiment may have troughed and macro data is turning potentially more positive. Another requirement: a peak in U.S. yields and, relatedly, a relapse in the U.S. dollar. In 2023, Emerging Markets have performed largely according to script – when the greenback rises, EM falls – but if the Fed pauses and/or cuts in 2024, U.S. dollar depreciation and an EM rebound could follow. Finally, an easing of Mideast tensions would also clear some of the concern hanging over EMs.

In short, a few things have to go right for a widespread EM comeback in 2024. And quite a few things could go wrong. We believe one of the biggest downside risks to

EM equities would be a structural shift higher in bond yields, which could occur should inflation once again prove stickier than expected. Higher borrowing costs will lead to weaker fiscal positions, which means EM governments will need to exercise more fiscal discipline (a negative for growth).

Yet in some important ways, we believe China matters less to other Emerging Markets than it used to.

Another downside scenario is the economic slowdown in China proves persistent (though we do not subscribe to this). The Chinese economy still faces deep challenges in terms of debt, demographics and deflation. Its property market is weak – and 70% of China's household wealth is tied up in real estate. The risk of a debt-deflation trap remains in China, and if it occurs it could jeopardize headline growth across EMs.

On balance we believe Emerging Markets will always present opportunities, however isolated, and a differentiated and disciplined approach that concentrates on strong fundamentals, a good structural story and sizable risk premia, at both the market and the equity-specific levels, will likely be key in 2024. ■

Please see Disclaimer section for full disclosure.

Growing Pains

Being a growth investor hasn't always been easy of late, but better times could be ahead if the current rate-hiking cycle is truly near an end.

BY MIKE ARCHIBALD, TONY GENUA AND MARTIN GROSSKOPF

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Members of AGF's Investment Management team sat down recently to discuss their thoughts on the bifurcation of performance in growth-oriented stocks this past year and why short-term challenges can end up being long-term opportunities for those who are patient and take a disciplined approach.

Questions and answers that follow have been edited for clarity and length.

What has been the backdrop for growth investing since interest rates started to climb almost two years ago?

Martin Grosskopf (MG): Growth companies that make longer-term investments are typically challenged as rates go up. And the market has punished growth companies through this cycle that tend to have the least free cash flow. This includes many small and mid-sized companies focused on the sustainable themes that I invest in, many of which represent ambitious secular opportunities but lack capital and are being forced to drain a good part of their free cash flow to fund projects.

In other words, too many investors are just completely ignoring these businesses and are chasing instead larger capitalization growth names that have much smaller capital needs and still generate considerable free cash flow. As such, it's become a bifurcated growth market to some extent, with some large caps seemingly immune from higher rates, but small and mid-caps running into challenges.

Mike Archibald (MA): It's been a good environment in some ways, but extremely challenging in others. On the positive side, there have been a lot of pressures in other areas of the stock market – including the U.S. regional banking crises, the runup in rates that put a lot of pressure on interest rate-sensitive sectors and more – which has made the case for growth ideas more compelling. Yet, on the other hand, the increase in interest rates has also put downward pressure on valuation multiples for many growth stocks, all while half a dozen or so large cap technology companies have captured most of the market's attention (and dollars), which has pulled money away from other high-quality growth names in the process.

So, it's hard to say it's been a bad year for growth investing. It really depends on your style and/or approach. But it's definitely been a narrower market for growth, one that has required a focus on larger companies with strong balance sheets for the most part.

Tony Genua (TG): I like to think of what we're experiencing so far this decade as being similar to the 1920s, which was a roller coaster for stocks. Investors have been through a number of twists and turns since the beginning of the pandemic, and just in the past two years, we've gone from suffering through a difficult bear market to a recovery that has major equity indexes like the S&P 500 once again flirting with all-time highs.

Granted, to the extent that rates have gone from low to high over the past two years, it hasn't been a very good environment for the majority of growth stocks. And as Martin alluded to already, the rebound has been fuelled mostly by only a handful of stocks, specifically some of the world's largest "tech giants" who have been rewarded for having strong recurring revenues and higher cash balances, as well as for being connected – in most instances – to the burgeoning trend of artificial intelligence (AI), which has been a major catalyst.

MG: To that end, when I look at the electric vehicle (EV) universe of stocks, sentiment has been abysmal for most of the names, mainly because fundamentals are not very good. Yet the EV market leader is up something like 70% because it's linked to the handful of tech names that investors have been piling into over the past year. The dynamic in and of itself is sucking capital away from other growth opportunities.

MA: The challenge of the big tech names is that it has been a gravitational pull away from almost all other equity investments, styles and sectors. Those stocks have done so well – having very strong balance sheets and decent growth themselves – that they have overwhelmed other, generally smaller, growth names. And because they are large components of the index, as they go up, more and more managers are forced to participate in those names. This performance has masked a much less robust equity market under the surface.

How has your management style changed considering some of the difficulties you have faced?

TG: A year like this can be humbling, but it has not changed my approach one iota and we will continue to focus – among other things – on growth stocks with fundamentals momentum as opposed to just price momentum. In particular, we're interested in companies that have earnings growth that exceeds their price appreciation, which hasn't been the case for some of the market's best performing names this past year.

MG: I don't think it's reasonable to anticipate a specialty mandate that is focused on sustainable themes like mine to just suddenly adopt a different process because the market dynamic is difficult. We take our lumps in certain parts of the cycle, but where we lose the confidence of our clients is by adding names to our universe that weren't there before.

I've seen that happen in some other sustainable strategies that have done relatively well over the past couple of years, but, to me, it's a sign of capitulation and the risk is that you miss out on the rebound when the market starts to broaden to the areas that you told your clients you were going to invest in.

MA: In Canada, I'm still looking for "growth compounders," or companies that have consistently shown an ability to grow sales and profitability metrics over time. These tend to be more mid-cap in size but over time may grow into larger cap companies. We also tend to focus on names with a lower capital intensity profile, higher margins and, where possible, recurring revenues, but pay careful attention to when the forward outlook of high-growth companies starts to slow versus its history and that of its peers.

I don't think it's reasonable to anticipate a specialty mandate that is focused on sustainable themes like mine to just suddenly adopt a different process because the market dynamic is difficult.

Historically, we have found many of these ideas in sectors that include Industrials, Consumer Discretionary and Staples, and Technology, all of which are areas that exhibit above-average growth rates versus other industries and the broader S&P/TSX Composite Index.

MG: I'll just add that we traded more actively this year than we did in the immediate aftermath of the pandemic when it was important to wait for meaningful data to roll in before making significant changes. It took a while, but there's much more insight into things like inflationary pressures than there was before and, in some instances, we have re-allocated our capital in the near term. That doesn't mean we've lost sight of the names that we believe are future winners but out of favour today. We just have a bit less exposure to them at this time.

Do you expect more favourable macro conditions for growth investing next year?

MA: It's a tough call, but it looks like interest rates may have peaked and that inflation should stay well contained and under control at current levels. And if so, that should result in a better backdrop for risk taking, and by

extension, growth stocks. The real key here is how the economy evolves over the next six months. If the broader U.S economy can remain resilient into next year in the face of elevated rates, then the stock market can do well next year. Meanwhile, some areas of the stock market have de-rated so much that they are now starting to offer interesting prospects for appreciation.

I believe themes like re-shoring will continue to provide opportunities going forward for engineering and construction companies

TG: We're entering the new year in a bit of a soft patch regarding economic growth. Canada, for instance, is already near a technical recession, having recorded negative GDP growth in the third quarter. Meanwhile, U.S. GDP in the third quarter of 5.2% is probably unsustainable, while elsewhere globally, countries like China have been struggling. Still, year-to-year, statistics show that equity markets end up higher 75% of the time, so there's good reason to be positive about 2024. And if we don't have a major push higher in interest rates from here, the valuation story will be good for growth companies that have above-average visibility and deliver on results.

MG: I believe central banks are close to being done raising rates. At the very least, the volatility associated with the rate-hiking cycle should decline in 2024, which would likely be positive for a broader swath of growth companies. That's not only potentially good for a sustainable strategy like mine, but the overall economy as well, in my opinion.

TG: This time next year, I would expect us to be talking about a globally synchronized recovery and a broadening out of the market to non-growth names.

What growth themes or trends are you most focused on going forward?

MG: Decarbonization is obviously the biggest overarching theme impacting my strategy, but related to that is the potential catalyst of more government spending being allocated toward sustainability projects and technologies. Take the Inflation Reduction Act (IRA), for instance. I believe this to be a generational piece of U.S. legislation that could end up re-shaping the North American manufacturing landscape despite the near-term concerns associated with cost inflation and project permitting. We believe some companies will benefit enormously from the IRA in the end and want to leave positions in the portfolio to maximize this long-term potential while minimizing the short-term myopia that is hurting some of these names now.

TG: My growth strategies typically focus on multiple themes, including AI, which I started investing in years ago –well before it was popularized. The trend toward sustainability is another theme I like longer-term despite near-term challenges, and several growth opportunities are likely to emerge from the accelerating health and wellness trend, including in areas like precision medicine where interest has already ramped up significantly in GLP-1 drugs that are being used to treat diseases like diabetes and obesity. Finally, re-shoring is another trend to watch over the next few years. It could net potential opportunities in certain Industrials stocks and/or semiconductor companies opening new manufacturing facilities in different parts of the world.

MA: Agreed. I believe themes like re-shoring will continue to provide opportunities going forward for engineering and construction companies as the runway for growth in that space is many years in duration. The backlogs of those businesses are as good as they've ever been because global governments continue to ratchet up infrastructure spending around the world.

Ultimately, being a growth investor hasn't always been easy of late, but we believe better times are ahead for those with patience and a disciplined approach. ■

Please see Disclaimer section for full disclosure.

Who's Going to Fund the U.S. Deficit?

Higher yields may entice investors to step up their buying of U.S. Treasuries and the timing couldn't be much better.

BY DAVID STONEHOUSE

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For much of the past two years, investors have been fixated on the U.S. Federal Reserve (Fed). After March 2022, when it began raising interest rates for the first time in four years, the big questions became "How high would rates go?" and "When would the Fed stop?" Now, as we approach a new year and the rate-hiking cycle seems to have paused, the question has shifted to "When will the Fed start cutting?"

Certainly, these questions matter. As it leads the global monetary policy charge to contain inflation, the central bank of the world's largest economy can have a substantial impact on both global equity and fixed income markets. Yet, as important as the Fed undoubtedly is, investors may potentially benefit from paying more attention to another public institution as they look forward into 2024: the U.S. Department of the Treasury.

It doesn't attract all the headlines the Fed does, but the Treasury plays a vital role in the U.S. financial system and in interest rate dynamics. Basically, it is the financial arm of the U.S. government, and one of its jobs is managing America's federal debt instruments. When Washington wants to spend more money than it gets in revenue (from taxes, largely), the Treasury issues debt in the form of marketable securities such as bonds and Treasury bills. These bonds pay interest set by the Treasury as the coupon, but their yield is determined by supply and demand. If demand is high and/or supply is low, yield goes down; if demand is low and/or supply is high, yield goes up. And it's here, in the supply-and-demand world of Treasuries, that some very interesting, and perhaps unsettling, dynamics are playing out.

For one thing, the U.S. Treasury has been very busy lately, because the federal government has been spending money and running deficits. Big deficits. Government borrowing spiked during the COVID-19 pandemic and has just kept on growing since then. In fact, over the past 10 years, the U.S. federal debt has nearly doubled, reaching US$33.4 trillion as of mid-November, up from US$17.2 trillion in 2013.

Meanwhile, the federal deficit as a percentage of U.S. Gross Domestic Product (GDP) will grow from 5.4% in fiscal 2022 to 6.3% in fiscal 2023, marking the first increase in deficit/GDP since the pandemic year of 2020. And it could keep growing. The Congressional Budget Office's (CBO) perhaps conservative forecast from June 2023 has the federal deficit rising steadily over the next several decades, hitting 8% of GDP by 2053. The deficits in 2024 and 2025 are projected to be in the range of US$2 trillion each year.

It doesn't attract all the headlines the Fed does, but the Treasury plays a vital role in the U.S. financial system and in interest rate dynamics.

Does it matter? Proponents of Modern Monetary Theory, or MMT, would claim that it does not – that governments can always just print more money. But it is difficult to ignore the probable costs of such continued fiscal laxity. True, a U.S. government default seems like a remote possibility, notwithstanding regular congressional debates over the debt ceiling. Yet running ever-higher deficits means that the Treasury must issue more and more bonds. The increased supply puts upward pressure

on yields, which, along with those swollen deficits, will likely mean the government will pay more and more in interest. According to the CBO, interest payments comprised about 10% of overall federal spending in 2023; they are forecast to rise to nearly 15% by 2033 and 23% by 2053. To make those payments, the government may have to issue even more bonds, putting further upward pressure on yields.

Of course, the U.S. government could do something about the deficit crunch: cut spending and/or raise taxes. Yet successive administrations and Congresses, Democratic and Republican, have shown little commitment to either approach. And if, as some observers still think is likely, the U.S. economy plunges into recession in 2024, then we believe the political pressure to increase spending and keep taxes low will probably be acute – especially in an election year.

As a consequence, we believe the elevated supply of federal bonds may contribute to yields being higher than they otherwise would be based solely on the underlying economic fundamentals. This situation is exacerbated by the fact that governments in other parts of the world are also running deficits, contributing further to the supply of sovereign bonds.

There are, however, dynamics at play on the demand side, too – namely, some traditional buyers of U.S. debt are rethinking their commitment to Treasuries.

In recent years, foreign buyers have been paring their holdings of U.S. government bonds. Foreign holdings as a share of all U.S. public debt have declined generally over the past decade, and the net sellers include Japan and China – the two largest foreign holders of Treasury securities. Japan is starting to normalize interest rates, but at a very gradual pace, and its still-low interest rates have required it to defend the yen, which has resulted in periodic selling of U.S. Treasuries. Between September 2022 and September 2023, Japan lowered its holdings of U.S. debt by 2.5%. The more dramatic reduction has been from China, which trimmed its U.S. Treasury holdings by US$123 billion over the same period – a reduction of nearly 14%. Several factors are at play, including geopolitical tensions and a desire to establish the renminbi as a reserve currency to rival the U.S. dollar and the euro.

Meanwhile, other significant buyers of Treasuries might not be so active going forward. U.S. banks must hold a certain amount of government securities to meet their reserve requirements, but they have been cutting their holdings recently, and will likely only need to increase holdings gradually in the coming years to meet their regulatory capital hurdles. And the "big daddy" of bond buyers from 2008 through the pandemic – the Federal Reserve – has of course switched to quantitative tightening. From June 2022 to mid-November this year, the Fed reduced its Treasury holdings by nearly US$1 trillion, which has not only removed a major source of demand but has actually added further to supply and contributed to the rise in yields.

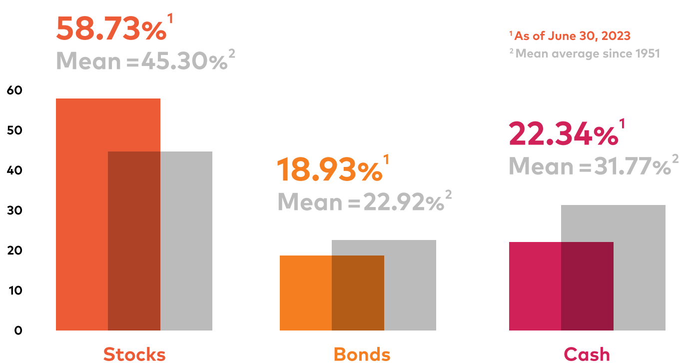
This all leads to an important question: If China, Japan and the Fed are net sellers of Treasuries, who is going to buy them? One answer is financial institutions like insurance companies, which cover their liabilities by holding long-term debt and stand to benefit from higher yields. There's another natural buyer pool, too, and it's massive: investors, including pension funds, institutions and individuals.

Foreign holdings as a share of all U.S. public debt have declined generally over the past decade and the net sellers include Japan and China

One might assume that the aggregate of investors could never rival the bond-purchasing power of foreign governments and the Fed, but in fact, investors have historically been the largest lenders of choice to the U.S. government. Interestingly, the pool of household capital encompassing retail, institutional and pension investors has been overweight in equities and materially

underweight in bonds in recent years, which is perhaps not surprising given fixed income's terrible performance over the past three years. Yet to shy away from bonds now may be to ignore the fact that for the first time in nearly 20 years, yields – even for "risk-free" Treasuries – have returned to historic norms, which represent far more attractive levels. There are signs investors already realize that. For instance, a November survey by Bank of America suggests that fund managers are turning more bullish on bonds than at any time since 2009.

U.S. Household Asset Allocation



Source: Ned Davis Research, June 2023. Chart shows quarterly data from December 31, 1951 to June 30, 2023.

To be clear, other countries around the world also face similar issues as government spending swells across the developed world, but it's not quite to the same degree as in the U.S. where the outlook for debt, deficits and the bond market appears to be the gravest of all. Too many bonds and too few buyers rarely makes for a good outcome. But there is a less dire possibility, and it's a strong one: namely, that where Japan, China and the Fed step away from Treasuries, investors will step up. In the end, the supply-demand dynamics that are so challenging to the U.S. government's balance sheet and driving up interest rates might actually work to investors' benefit – at least for those who are willing to set aside recent history and turn back to bonds.

Ultimately there is a clearing price (yield) for markets like U.S. Treasuries. While economic variables will have a significant influence on this level, it is also true that once yields rise to a sufficiently enticing level, they will attract enough buying interest from investors to take up the supply. One of the keys for capital markets in 2024 will be what those levels might be. ■

Please see Disclaimer section for full disclosure.

Cutting Through the Noise

AGF Investments' new Macro Regime Model analyzes thousands of data points to develop a picture of the current macro environment, but also its likely direction going forward.

BY BILL DeROCHE AND ANDY KOCHAR

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The world is changing fast. In the past two years alone, we have witnessed the emergence of the global economy from a planet-wide pandemic; the setting-in of higher inflation that hadn't been seen in more than a decade; a dramatic shift in monetary policy as central banks raised rates; and at least two regional conflicts with wide-ranging geopolitical impacts.

For investors, this state of flux might not be anything new – the global economy and markets are always evolving, after all – but the amplitude of the shifts may well be. Even those who conduct careful fundamental research into potential investments, considering factors like corporate earnings and valuations or creditworthiness and yields on the level of individual stocks and bonds, cannot wholly ignore the macroeconomic environment.

Yet that reality also presents challenges. For instance, with so many contributing forces, how can an investor even assess the *current* state of the macro environment? More importantly, since markets are forward-looking, how can they form an actionable forecast for macro conditions? And finally, can they tell which events, trends or data matter? Which developments or issues – an outbreak of war, an environmental disaster, a high-profile corporate collapse or any number of other events – are likely to make a difference to markets, sectors or even individual securities? And which ones are likely not to matter very much? In short, when so much is going on and there are so many potential game-changers to consider, how can an investor separate the signal from the noise?

Macro Regime Model

Over the past several months, a collaborative task force from AGF Investments' Quantitative Investing and Investment Management teams have been working on finding a solution to this problem for our teams. Its goal: to support our investment managers with actionable insights into the macro environment and a functional tool to help them make more informed decisions. The result of their efforts is the AGF **Macro Regime Model**, which analyzes thousands of data points to develop a picture not just of the current macro environment, but also of its potential direction going forward – and, importantly, how that evolving landscape might affect different asset classes differently. The Model is more than a quantitative analysis tool, however, because it also relies on the knowledge and expertise of AGF investment managers. In other words, it hard-checks its approach against real-world experience.

How does it work?

On a basic level, the Model is a "two-by-two" schematic. It analyzes two factors – inflation and economic growth – to develop a picture of the current and future macro environment, or "regime," and also accounts for market and financial conditions.

The approach yields four possible outcomes: Inflation and growth are both increasing (reflation), inflation and growth are both declining (**deflation**), inflation is rising but growth is declining (**stagflation**), and inflation is declining but growth is increasing (**the "Goldilocks" scenario**). It's important to note that these outputs are cyclical, not secular; that is, the various macro regimes reflect states and changes in the economic cycle rather than long-term trends. So, it's perfectly possible for the Model to identify a period of deflation in the midst of secular reflation.

Moreover, as much as macroeconomic conditions matter to portfolio management, they make their way into portfolios through prevailing financial market conditions, which have the potential to extend or contract economic cycles. Macro events are only relevant to portfolios if

they have the strength to reprice risk meaningfully. Otherwise, they are simply noise. In AGF Investments' collective experience, markets and the economy are closely connected, and so the Model captures this reality by including financial market conditions as a third input.

The Model continually analyzes real-time data to calculate probabilities for each regime going forward. That quantitative analysis develops a picture of likely macroeconomic conditions and assigns a level of confidence to that picture – for example, it might assign a 70% probability of inflation and growth increasing together in three months and a 30% probability of a "Goldilocks" environment, with growth accelerating and inflation falling. It is also a flow model, meaning that it forecasts not only change, but also the rate of change – which can help investment decision-makers better assess opportunities and risks. In that way, the Model empowers our portfolio managers to overlay the macro outlook onto their research, using it to inform their decisions in asset allocation, country allocation, portfolio positioning and trading strategies.

But the AGF Investments Macro Regime Model goes one step further. Once it has developed a probability-based forecast for macroeconomic conditions, it then develops an outlook for how different asset classes (equities, bonds, real assets, etc.), sectors (for example, Industrials, Utilities, Technology and so on), investment factors (for instance, value or growth) and regions may perform under a predicted macro regime. To do that, it relies on the data AGF Investments has amassed internally, as well as market information from external sources. Our portfolio managers can then add consideration of historical precedents to their decision-making process. Those precedents are not, of course, guaranteed to be replicated. But as the old maxim goes, "History doesn't repeat itself, but it often rhymes."

Because it analyzes so many indicators – historical, current and leading – the Macro Regime Model can help our investment managers understand what signals are worth paying attention to and which may be irrelevant. For example, when several regional banks collapsed in early 2023, there was widespread fear of spreading instability in the U.S. and global financial system. The crisis came as the macro environment was in a period of deflation (i.e. inflation and growth falling), and equities have historically performed relatively poorly during such periods. However, when the Federal Reserve announced an injection of capital to support the U.S. regional banking system, the Model predicted that the move would herald a macro regime change to a "Goldilocks" environment, which has historically been positive for equities. And that is exactly what happened: economic growth picked up and stock markets rebounded. In short, the Macro Regime Model correctly distinguished an event that mattered for equities (Fed support) from one (the regional bank collapse) that ultimately did not.

While the Macro Regime Model may be predictive, it is not definitive. AGF Investments' portfolio managers are active asset managers with a view to the long term, and many of them practice a "bottom-up," fundamentals-based approach to investment decision-making. The Model is not intended to change that. Yet it is intended to help managers better understand the macro environment now and in the future, as well as how investments may perform in that environment. At its core, it better enables long-term, asset managers like ours to respond to short-term, "macro" probabilities. And it is continuing to evolve, right along with ever more effective ways to analyze and leverage market and economic data.

It's sometimes said that information is power. But real power comes from the ability to gather, analyze, sort and transform information into reliable, actionable insights. That, ultimately, is what the AGF Investments Macro Model has been developed to do. ■

The AGF Macro Regime Model is available but not necessarily utilized in the investment decision making process across all products or services offered by the AGF Investments.

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What if There's a Recession (And Central Banks Start Cutting Rates)?

AGF Investments' analysts explain how an economic downturn and/or looser monetary policy in the United States and other parts of world could impact the equity sectors they know best in 2024.

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HEALTHCARE

Bittersweet Remedy

By Ling Han

Healthcare stocks have a reputation for being inherently resilient in the face of a recession, largely because demand for the sector's services and products tends to remain stable even during bitter periods of negative economic growth. But not all Healthcare stocks are created equally and the potential protection they offer may vary across subsectors in 2024.

Pharmaceutical companies with large market capitalizations, for instance, may be the most defensive, thanks to attractive valuations and a demand for medical innovation that is less sensitive to economic cycles.

The *medical equipment and device* subsectors may also exhibit a high degree of resilience should a recession arise next year, but outcomes could be more mixed. Indeed, while some consumable devices are likely to benefit from an expected increase in procedure volumes next year, more expensive medical equipment is susceptible to potential purchase delays if health providers reduce capital expenditures.

Beyond these subsectors, *managed care* stocks boast relatively stable demand dynamics as well, and could offer investors their own level of defense despite the possibility of an economic downturn that might adversely affect employer-sponsored plans due to increased unemployment.

Meanwhile, the *life science tools* subsector could help further buffer the impact of a recession, but only if it can rebound from a particularly difficult year in 2023. Additionally returns of these stocks may be dependent on bio-pharmaceutical firms increasing their research and development (R&D) spending and putting an end to their inventory de-stocking cycle.

Short of that, the Healthcare sector's overall performance is likely to be influenced by many other factors, including the upcoming U.S. election, which could be a headline risk in the lead up to the vote next November, but more of a positive catalyst in the year following the election if history is a guide.

And if central banks do end up cutting rates in 2024, investors may see a big relief in bio-technology funding that could boost the Healthcare's sector overall ecosystem and fortify its reputation as one of the equity market's better defensive plays in the process.

INFRASTRUCTURE

A Turning Point to Build On

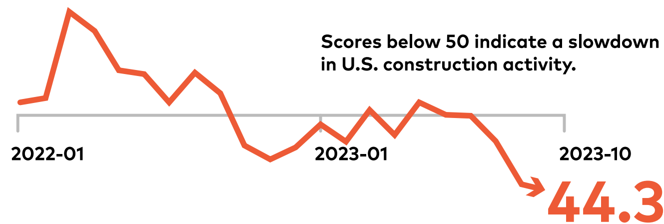
By Wai Tong

It should come as no surprise that the fastest interest rate hiking cycle in U.S. history has led to a huge decline in new construction activity (see chart) and the postponement or re-evaluation of many large engineering developments.

After all, there are few sectors more impacted by higher interest rates than Infrastructure, which is associated with projects that are long in duration, require significant financing and have long gestation periods to unlock returns on investment.

National Architecture Billings Index

The AIA Architecture Billings Index (ABI) **fell to 44.3 in October**



Source: American Institute of Architects as of November 2023. The ABI indicates the spending and demand for non-residential construction activity.

But 2024 may end up being a turning point for the sector. In fact, with inflation moderating in recent months to just over 3% in the United States, it may be the case that the U.S. Federal Reserve (Fed) is finally done hiking this rate cycle and, based on current market expectations, could end up cutting rates as many as four times over the next 12 months.

Of course, should this happen, it may be a significant tailwind for Infrastructure companies and the sub-sectors that rely on construction activity for business, including industrial distributors, engineering and construction (E&C) firms, construction machinery OEMs and building materials suppliers.

While lower rates will lead to lower financing costs, higher financing availability and better return on investment for these types of cyclical stocks, we are particularly bullish on E&C companies with exposure to U.S. infrastructure construction projects that should be supported for years to come by trillions of dollars in government programs like the Infrastructure Investment and Jobs Act (IIJA) and the Inflation Reduction Act (IRA), as well as ongoing reshoring and energy transition initiatives.

REAL ESTATE

Realistic Expectations

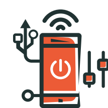
By John Kratochwil

As capital-intensive businesses that rely on borrowing money to fund growth, real estate investment trusts (REITs) flourished on the back of rock-bottom interest rates that defined markets for most of the years since the Global Financial Crisis in 2008. But that all changed starting in March of 2022, when the Fed kicked off its current rate-hiking cycle and dramatically increased its target rate from near-zero levels to a current peak of 5.5%. In fact, from the time that the U.S. central bank began to increase interest rates, the S&P United States REIT index has underperformed the S&P500 by around 25%, the weakest performing sector over that period.

Now though, all indications are starting to point in the other direction, namely because of falling inflation rates, which the market is taking as a sign that the Fed will begin lowering rates sometime in 2024.

While declining interest rates would take time to be reflected in REIT earnings, history suggests that sentiment on the sector begins to turn positive ahead of time, with real estate stocks beginning to bottom approximately 18 to 24 weeks ahead of a rate cut announcement, according to research from UBS.

In our opinion, even moderate interest rate declines would be quite positive for the sector, and 2024 could start a run of outperformance for REITs that has been a long time coming. In particular, we believe Healthcare REITs are set up for a better year of performance, based on improving occupancy levels driving stronger margins.



TECHNOLOGY

Spending and Trending

By Grace Huang

An economic downturn may not be the best of outcomes for a sector that has seen its fair share of struggles in the past few years, but there are several reasons why we remain cautiously optimistic about tech stocks moving forward despite the potential risk of a recession in 2024.

First, while the pace of Information Technology spending is expected to remain below long-term averages next year, it is still set to accelerate from the pace of the past two years and hit 8% year-over-year, according to Gartner, a technology research firm, as businesses continue to make

What About Factors?

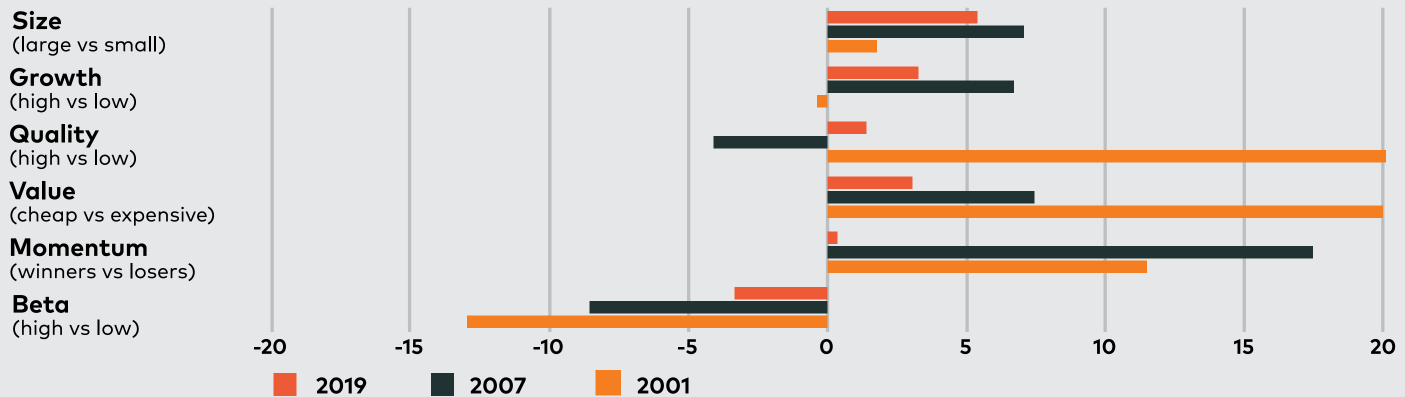
By Abhishek Ashok

As much as a rate cut will impact equity sectors to varying degrees, it could also have a differentiated effect on stocks that are characterized by certain attributes (aka factors).

In fact, based on our analysis of the past three rate-cutting cycles, defense has been a driving force of factor returns. Large cap stocks uniformly outperformed smaller ones following the U.S. Federal Reserve's (Fed) first move, as did high-quality stocks (over low-quality), and low-beta names (over high-beta).

But as the following chart also shows, outperformance (or underperformance) among and across factors ranged widely from cycle-to-cycle and may do so again this time around.

Relative Factor Returns Six Months After the Fed's First Rate Cut



Source: AGF Investments using data from Factset. Factor returns based on historical S&P 500 Index constituent returns, and categorized by the AGF Quantitative team. **Past performance is not indicative of future results.** One cannot invest in an index.

For the purposes of this analysis:

Relative performance spreads are calculated by ordering S&P 500 constituents based on their factor profile within each sector and subtracting the average return of the bottom quintile of ranked names (i.e., the smallest, lowest, most expensive...) from the average returns of the top quintile of ranked names (i.e., the largest, highest and cheapest...).

Size refers to the market capitalization of each stock in the index.

Growth refers to the trailing sales, operating income, and margin growth profile of each stock in the index.

Value refers to the trailing and forward price to earnings profile of each stock in the index.

Quality refers to the return on equity and return on invested capital profile of each stock in the index.

Momentum refers to each stock's 12-month price momentum.

Beta refers to each stock's price variability in relation to the overall market.

technology a strategic priority to enhance competitive positioning and drive business growth.

Technology stocks are also in a relatively good place heading into the new year from a fundamentals standpoint. Largely, that's because many of the end markets associated with the sector have already been through a downcycle over the past two years, including the markets for personal computers and smartphones, which may now have bottomed and look poised for recovery.

Of course, the biggest catalyst of all may be artificial intelligence (AI), which continues to drive growth and create interesting investment opportunities across the sector. In fact, a recent CIO survey by Morgan Stanley notes that 66% of respondents say generative AI (and large language models) are directly impacting their IT investment priorities, while PwC predicts the total AI market to reach US$15.7 trillion in size by 2030.

Ultimately, growing interest in the mega trend of artificial intelligence could bring huge revenue and efficiency opportunities to the Technology sector, and we remain generally bullish on companies that have a legitimate stake in it going forward.

UTILITIES

Power Play

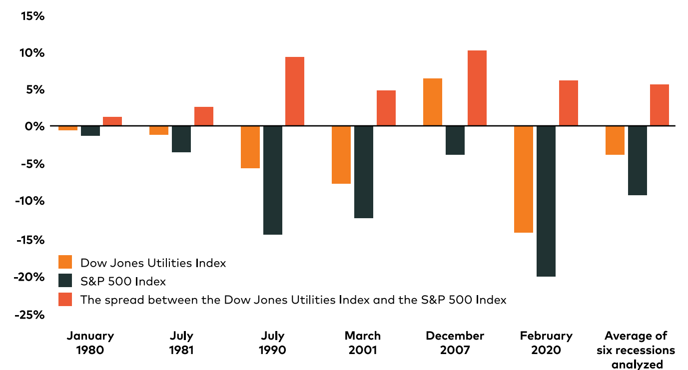
By Georgina Goldring

The S&P 500 Utilities Index is presently trailing the S&P 500 Index by close to 30% this year and is on track for its second-worst year in the past four decades. The underperformance can be attributed to investor preferences for higher-growth, less interest rate-sensitive sectors, yet higher interest rates have also made utility companies' yields look less attractive relative to bonds and have put pressure on utilities' profitability. This is particularly true for renewable power generators, whose capital-intensive projects have been impacted by increased borrowing costs.

But as market perceptions shift toward the idea of interest rates peaking and eventually being cut, utility stocks could soon return to favour with investors. In fact, as rates decline, historically the sector has provided increasingly attractive yields, making it an appealing option for those seeking what has historically been a predictable return stream.

Moreover, Utilities could be one of a few sectors that help shelter investors from the potential fallout of a recession, much like they have in the past (see chart). In particular, traditional utilities offering essential services like electricity, water and gas are generally viewed as defensive investments because they usually generate a set rate of return and provide relatively stable earnings and dividends regardless of economic conditions.

Relative Performance of the Utilities Sector Prior to Recessions



Source: UBS, US Utilities: Halftime 2023, June 6, 2023. Time frame for returns is one quarter before past U.S. recessions noted in the chart were officially declared by the National Bureau of Economic Research. **Past performance is not indicative of future results.** One cannot invest in an index.

That said, not all utility stocks are impervious to recessionary effects, and we believe investors pursuing a more defensive position may need to be selective, starting with a focus on liquid stocks of companies with strong balance sheets operating in constructive regulatory jurisdictions.

A recession and a rate cutting environment could have negative impacts on the overall equity and or bond market. There is no guarantee that the sectors detailed above will be profitable or respond in the way the analysts have described, The comments made above are based on the individual analysts' research and do not necessarily reflect how AGF Investments is invested now or will be in the future.

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