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“The Federal Reserve cannot solve all the economy’s problems on its own.” - Ben Bernanke

Over the past year, equity markets have rebounded from the price weakness experienced in 2022. The market correction that commenced in November 2021 led to significant declines in equity markets over the subsequent year. The US S&P 500 fell by -12.2%, while the Canadian TSX Composite experienced a more modest decline of -5.8%, buoyed by its heavy exposure to the then robust energy sector. However, during the rebound, energy markets weakened, causing the TSX Composite to rise by 11.8%, while the technology-driven S&P surged by 23.3%. It's important to note that all these returns are denoted in Canadian dollars.

What insights can be gleaned from these fluctuations? Not much. The US and Canadian markets are vastly different, the latter being highly concentrated in financials and cyclicals while suffering from a very narrow opportunity set.

The primary driver of equity markets is valuation, specifically the discount rate applied to future cash flows. As interest rates surged from historical lows in early 2020, equity valuations contracted. This contraction had little correlation with the profitability of the companies in the index or any indications of slowing growth in their respective markets.

To illustrate this, consider the US 10-year bond yield. Forty years ago, in 1994, the yield stood at approximately 13.5%, gradually declining to a low of 1.4% in 2012. Subsequently, over the next eight years, the yield fluctuated between 1.5% and 3.0%, reaching 1.7% in January 2020, before plummeting to 0.5% in March 2020. It then rebounded and steadily rose to the current level of 4.2%.

As for how long the current rates will persist, it's anyone's guess.

The Federal Reserve employs interest rates as a tool to regulate the economy. If domestic growth becomes too

hot, leading to inflation, interest rates are raised to cool things down. Market observers closely monitor statements from the Fed for hints regarding the direction of rates. Therefore, when inflation data began to trend downwards in the fourth quarter of 2023, aligning with the Federal Reserve's preferred inflation gauge of 2%, the central bank's narrative shifted from expectations of higher rates to the possibility of rate cuts in 2024. This shift contributed to strong performance in both equities and fixed income markets in December and into 2024.

Furthermore, in January of this year, US gross domestic product experienced robust growth of 3.3% in the fourth quarter, surpassing expectations. Yet, the yield on the 10-Year Treasury retreated to 3.95% from its peak of 5% in October. This suggests increasing market confidence in a soft-landing scenario, where inflation decreases while the economy continues to grow.

When lower rates eventually materialize, we anticipate that it might broaden market performance and provide support to the overall equity market beyond the dominant players. Although we observed increased market participation towards the end of the fourth quarter in 2023, major tech companies continued to dominate and accounted for most of the major index returns in the US.

What implications does this hold for the small-cap asset class? In the past, we've noted that large-cap stocks, particularly in the US, have outperformed small-caps for over a decade. However, this has led to relatively attractive valuations for small-cap stocks. Presently, the trailing price/earnings ratio of the S&P 500 stands at 24.5x, compared to 17.9x for the S&P 400 mid-cap index and 14.4x for the S&P 600 small cap index.

We believe investors should be paying more attention to small cap stocks as an attractive asset class than has clearly been the case during the past several years. While there will be bouts of volatility ahead, history has shown it pays to be positioned early when the tide turns, and market conditions improve.