2024: Market Insights

QPW Perspectives – April 2024

The first quarter of 2024 was broadly positive for investors and felt much like a continuation of the prior year. This article will provide a brief financial markets recap of 2023 before discussing the most recent quarter, as the key influencing factors were largely the same. It will also highlight some of the key themes to keep in mind for the remainder of the year.

2023

Equity markets posted double-digit positive returns in 2023, with most indices fully recovering from the declines experienced in 2022. The U.S. equity market was a notable outperformer compared to other developed markets, supported by its exposure to technology related companies that benefitted from investor excitement (hype?) around the artificial intelligence (AI) theme. The Magnificent 7 grew to an increasingly concentrated level within the S&P 500 Index and accounted for almost 2/3rds of the 2023 index return, indicating that overall market performance was narrowly driven. In other words, if the Magnificent 7 stocks are excluded, the 2023 S&P 500 Index return would have been approximately 8% instead of 23% (in Canadian dollars).

The broad Canadian fixed income market posted a positive return in 2023 following two years of negative performance, influenced by a higher baseline level of interest rates (higher coupon payments for investors) and the tapering off of central bank policy rate increases. Bond yields declined modestly near the end of the year amid expectations that policy rate cuts could be on the horizon. These expectations were supported by inflation data that declined significantly from peak levels despite remaining above the target level of 2% by year end.

Returns, expressed in CAD	2023	Q1 2024
Canadian equities (S&P/TSX Composite Index)	+11.8%	+6.6%
U.S. equities (S&P 500 Index)	+23.2%	+13.3%
International equities (MSCI EAFE Index)	+15.4%	+8.5%
Canadian fixed income (FTSE Canada Universe Bond Index)	+6.7%	-1.2%

Source: Bloomberg and FTSE

Q1 2024

The first quarter of 2024 saw bond yields rise, partially reversing the decrease experienced near the end of 2023. This slight uptick in yields resulted in negative performance for the broad Canadian fixed income market (bond prices decrease when yields increase). Bond yields appear to be hyper-sensitive to shifting expectations around central bank policy rate cuts – most notably with respect to the U.S. Federal Reserve. Expectations changed during the quarter from 3-4 anticipated rate cuts in 2024 to 2-3 anticipated cuts (assuming each cut is 0.25%).

Equity markets continued to rise during the first quarter of 2024. All major developed market indices ended the quarter near or at new all-time highs for the first time in roughly two years. Economic data has been generally positive and supportive – inflation appears to have stabilized and economic growth has so far been resilient despite higher interest rates.

The U.S. equity market was again a notable standout, returning 13.3% in Canadian dollar terms and exceeding its prior 2022 peak by approximately 10%. The Magnificent 7 continued to have an outsized impact on index performance, although to a much lesser extent than 2023. Additionally, the first quarter of 2024 saw some divergence within the group compared to 2023. While all components of the Magnificent 7 posted strong and correlated returns in 2023, there were clear winners and losers in the first quarter of 2024. Leading the group was NVIDIA by far, which has benefitted from a massive increase in demand for its products that are currently integral to the rapidly growing AI sector. Tesla was the largest drag on the group as it experienced sluggish growth and increased competition combined with a sky-high starting valuation relative to automaker peers. Apple also posted a negative return and dragged down the group average.

Magnificent 7	Weight in S&P 500 (Dec. 31, 2023)	2023 Total Return % (in CAD)	Q1 2024 Total Return % (in CAD)
Microsoft	6.70%	54.4%	14.9%
Apple	7.17%	45.4%	-8.6%
Nvidia	2.93%	230.9%	87.0%
Alphabet (Google)	4.21%	54.5%	10.7%
Amazon	3.76%	76.6%	21.7%
Meta	2.18%	187.1%	40.8%
Tesla	1.89%	96.9%	-27.5%
Magnificent 7	**28.8%**	**65.9%**	**24.7%**
S&P493	**71.2%**	**8.3%**	**8.7%**
S&P500		**23.2%**	**13.3%**

Source: Bloomberg

Shifting to Canadian equity markets, performance was relatively broad based during the first quarter, with 9 out of 11 sectors posting positive returns. The energy sector was one of the strongest performers, returning over 13% and supported by an 18% increase in the price of oil over the same time period. The energy, financials, and industrials sectors contributed the majority of index performance due to their combined weight of approximately 62%. The communication services and utilities sectors both posted negative returns, influenced by higher interest rates and lower than expected earnings from the big telecom players (Rogers, BCE, and Telus).

International equity market performance was similarly broad based, with 10 out of 11 sectors posting positive returns. The information technology and consumer discretionary sectors had the highest absolute returns. Financials ultimately contributed the most to overall performance due to the notable sector weight in the index. The defensive consumer staples sector posted slightly negative returns as value style companies broadly underperformed growth style companies.

Looking Ahead

Below are some observations and key themes to keep in mind for the remainder of 2024.

<u>Valuations</u>

Recent market returns have been primarily fueled by valuation multiple expansion as opposed to fundamental earnings growth. Valuations are notably higher across developed market indices compared to the beginning of 2023. The U.S. equity market in particular is at historically high valuation levels on a price-to-earnings basis. The tech-bubble period of the late 1990s and the 2020-21 pandemic period are the only times the S&P 500 Index has been this “expensive”. Canadian and international equity market valuations, despite rising over the past year, remain significantly below U.S. levels and more in line with historical averages.

Price-to-Earnings (trailing 12 mo.)	Q1 2024	20-Year Avg.
Canadian equities (S&P/TSX Composite Index)	18.5x	18.2x
U.S. equities (S&P 500 Index)	25.2x	18.8x
International equities (MSCI EAFE Index)	15.2x	18.7x

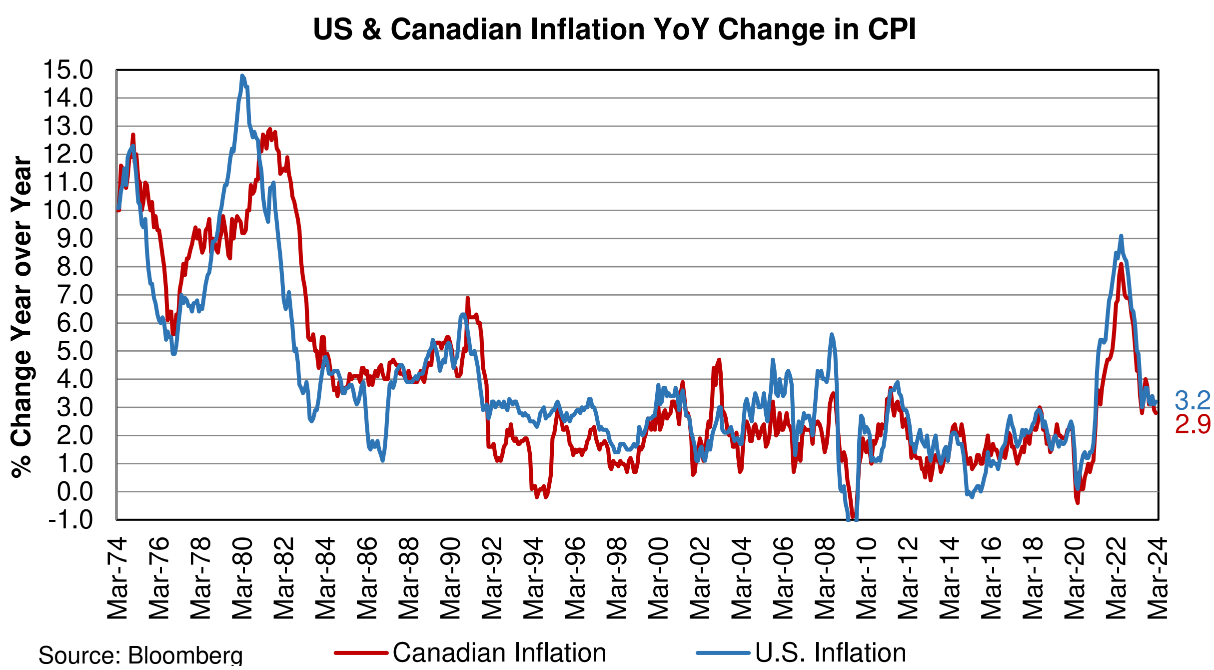
Source: Bloomberg

While elevated valuation levels do not necessarily imply a market correction is imminent, it does represent a higher level of downside risk and the potential for lower returns going forward.

Interest Rates

Following a period of rapid central bank policy rate increases over the past two years, it is likely that policy rates will begin to decrease in 2024. How soon and how much are the key questions that will be a focus this year. Current expectations are for 2-3 policy rate cuts of 0.25% each in 2024 for both Canada and the U.S., with the first decline expected to occur in June.

The pace and magnitude of policy rate changes will be heavily influenced by incoming inflation and economic data. Current inflation levels are in the 3% range for both Canada and the U.S., above the target level of 2% but down significantly from peak levels of 8-9%. Unexpectedly high inflation data and/or unexpectedly strong economic data may result in a delay to interest rate decreases or a fewer number of cuts than currently expected.



Will U.S. Equity Continue to be the Winner?

Historically, the U.S. equity market has moved in a cycle of outperformance / underperformance relative to international equity markets. The U.S. has been a clear outperformer over the past 15 years or so – one of the longest stretches of outperformance versus international equities.

It is possible that U.S. equities continue to outperform international equities for some time, but it would not be surprising to see a period of underperformance, especially given the noted valuation multiple differences between the two markets. The most recent cycle of U.S. equity market underperformance occurred from roughly 2001-2008.

U.S. Election Year

Americans will head to the polls in November in a presidential election that might feel like déjà vu. In a repeat of the 2020 election, President Joe Biden and former President Donald Trump will be running against each other again in 2024. The election will be unique in that one of the candidates has 88 criminal charges outstanding across four separate legal cases, two of which are related to efforts to overturn the results of the 2020 election.

The campaign will likely dominate the news cycle in the months leading up to the election and may result in heightened market volatility. As always, it is best to ignore the noise and leave politics out of portfolio decisions.

Quadrant Philosophy

At Quadrant, our goal is to build portfolios that are durable and able to withstand inevitable but unpredictable market events and volatility. We do not attempt to time the market, predict interest rates, or bet on which asset class will be the top performer next year. Instead, we are mindful of risks and maintain a long-term perspective.

Our philosophy is straightforward – we build well-diversified portfolios and partner with best-in-class institutional managers within each asset class. As experts in their respective asset class domains, our managers are attuned to the ever-changing risks in the financial markets and how these risks may impact portfolio holdings. As such, our managers are best positioned to manage risks at the individual holding level and make adjustments over time as needed.

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