June 30, 2024

Second Quarter Review

NORTH AMERICAN EQUITY STRATEGY

Market performance for the second quarter of 2024 was mixed as the S&P500 experienced a small gain while the TSX was slightly negative. During the second quarter, the S&P500 total return was 4.28% in U.S. dollars. Adjusting for currency, the S&P500 returned +5.35% in Canadian dollars, as the Canadian dollar depreciated about -0.008 cents, closing the quarter at US$0.7310. The TSX total return was -0.53% in the second quarter.

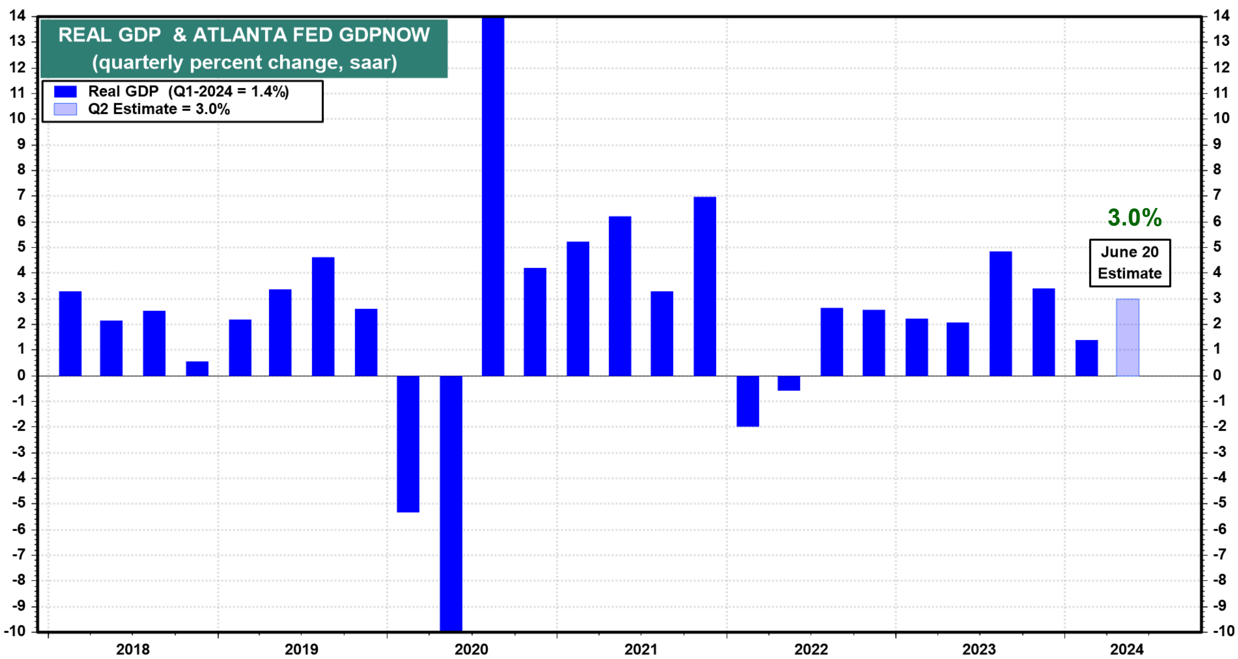
Is it possible that the Federal Open Market Committee (FOMC) June projections that reduced the number of rate cuts for 2024 from three to one are bullish for the stock market? Let's consider the FOMC's latest Summary of Economic Projections (SEP) released on June 12th, 2024 (**Exhibit 1**). Both Real GDP Growth and Unemployment expectations for year end 2024 were left unchanged at 2.1% and 4.0%, respectively, from the March projections (**Exhibit 1**, blue shaded highlight). This is not surprising given that the US unemployment rate is going into its third year at or below 4% and real GDP growth as forecasted by the Atlanta Fed GDPNOW is expected to be 3.0% for Q2 2024, up from 1.4% in Q1 2024 (**Exhibit 2**). The Fed did adjust its PCE inflation forecast up slightly from 2.4% to 2.6% by year end (**Exhibit 1**, yellow shaded highlight) but recent cooler than expected CPI data suggest that this may be somewhat backward looking.

Exhibit 1: FOMC Summary of Economic Projections

Variable [in %]	**Median**			
	2024	**2025**	**2026**	**Longer Run**
Change in real GDP (June)	2.1	2.0	2.0	1.8
March projection	2.1	2.0	2.0	1.8
Unemployment rate (June)	4.0	4.2	4.1	4.2
March projection	4.0	4.1	4.0	4.1
PCE inflation (June)	2.6	2.3	2.0	2.0
March projection	2.4	2.2	2.0	2.0
Core PCE inflation	2.8	2.3	2.0	
March projection	2.6	2.2	2.0	
Memo: Projected appropriate policy path				
Federal funds rate	5.1	4.1	3.1	2.8
March projection	4.6	3.9	3.1	2.6

Source: Federal Reserve, Summary of Economic Projections, 06/12/2024

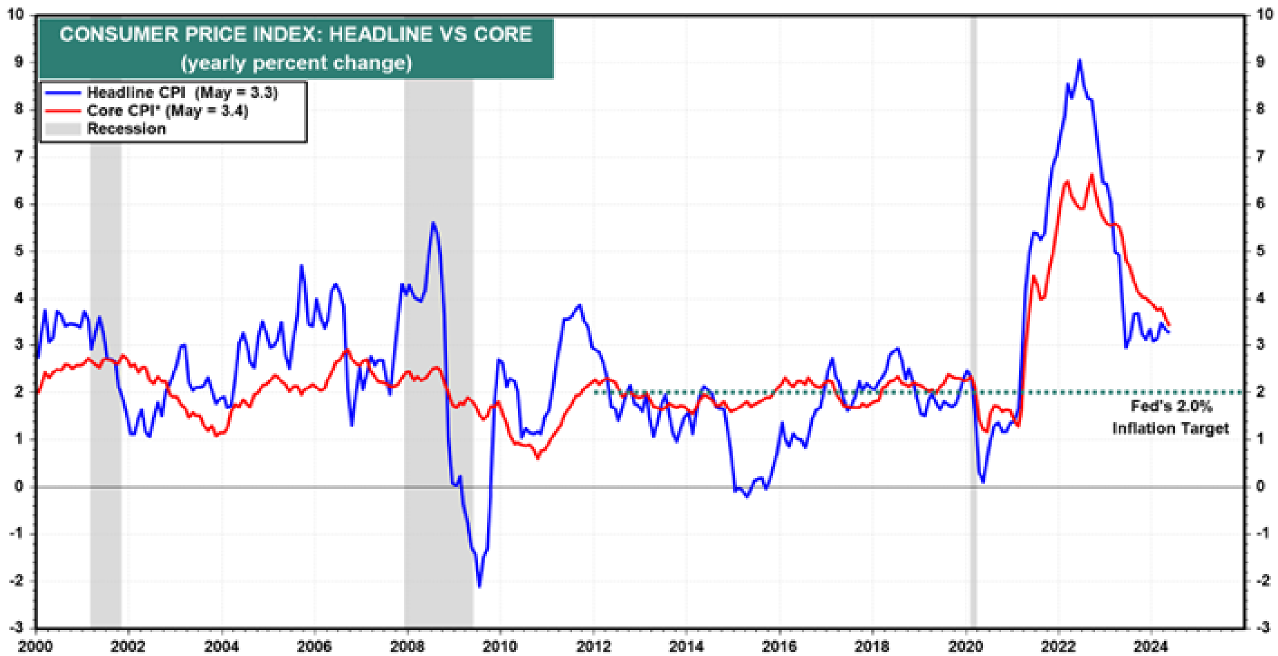
Exhibit 2: Real GDP and GDP Forecasts



Source: Yardeni Research, 06/20/24

The CPI data that came out the morning of the Federal Reserve statement was much lower than expected, inching closer to the FOMC target of 2% as shown in **Exhibit 3**. Even though Fed officials had the opportunity to adjust their PCE targets based on this data, it is questionable whether any would because of one data point. However, since then we have seen a weaker Producer Price Index or PPI report, which measures prices at the wholesale level, and import prices lower than expected. So, the disinflationary data points are piling up. Regardless, the Fed's projection for the Fed Funds interest rate for year end 2024 went from 4.6% to 5.1% (**Exhibit 1**, red dashed highlight) as compared to 5.25%-5.5% today, implying one rate cut this year versus three projected in March.

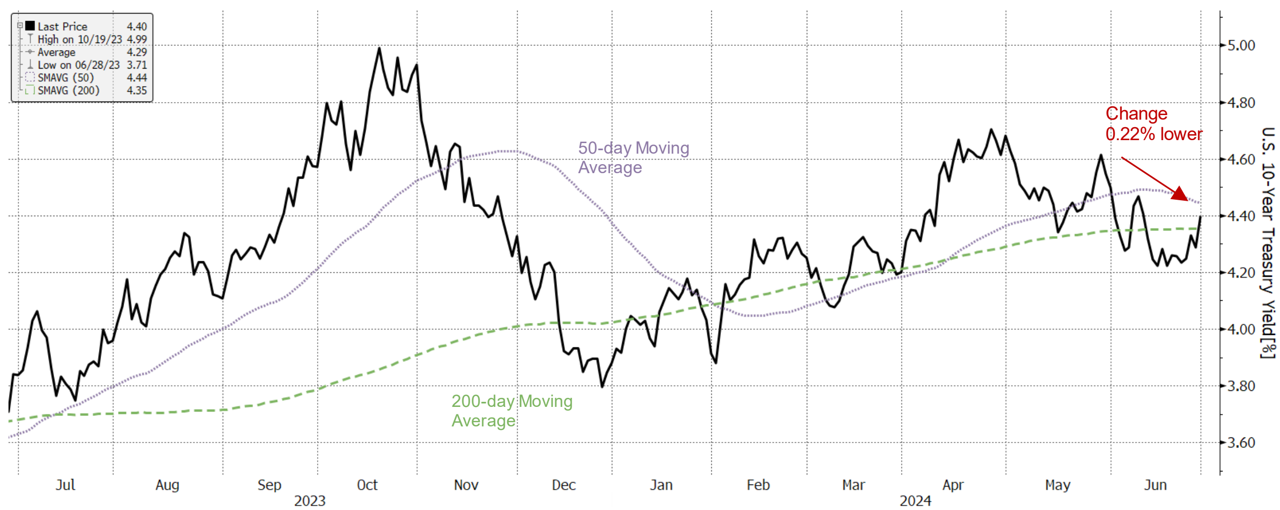
Exhibit 3: Headline CPI vs Core CPI



Source: Yardeni Research, 06/28/24

The good news is that the bond market has interpreted the softer inflationary data favourably, as 10-Year Treasury yields have fallen from about 4.6% at the end of May to the current level around 4.4% (**Exhibit 4**). Lower Treasury yields support the idea that inflationary conditions are improving notwithstanding the economy's resilience and strong labor market. However, the reduction in inflation is happening more slowly than anticipated by the Fed earlier in 2024.

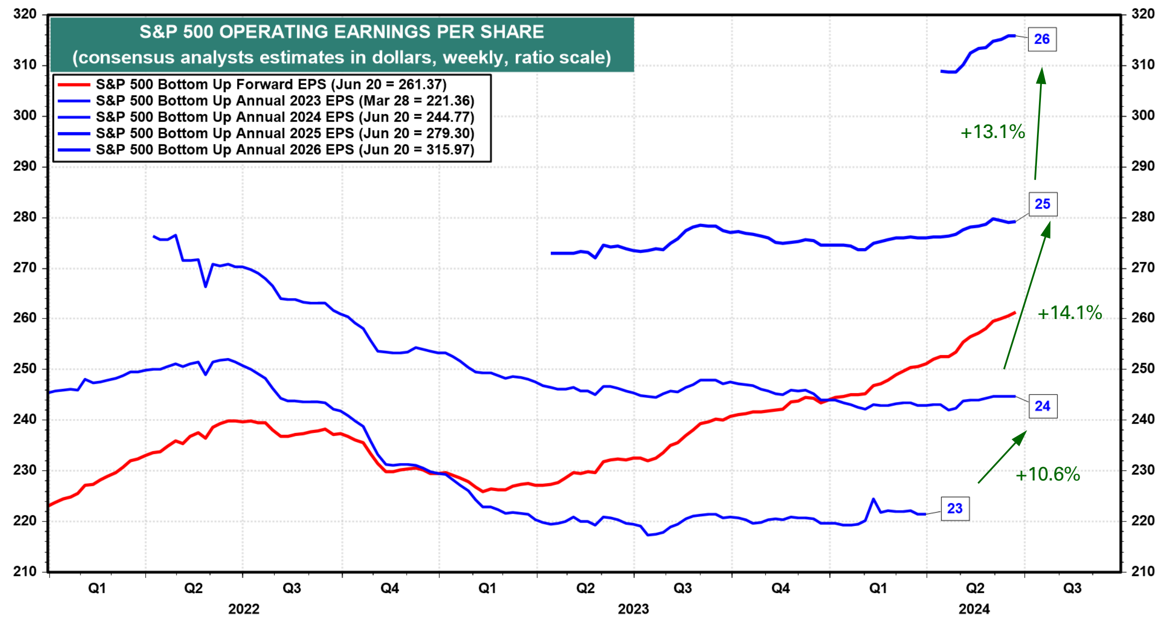
Exhibit 4: U.S. 10-Year Treasury Yield and its Moving Averages



Source: Bloomberg, 06/28/24

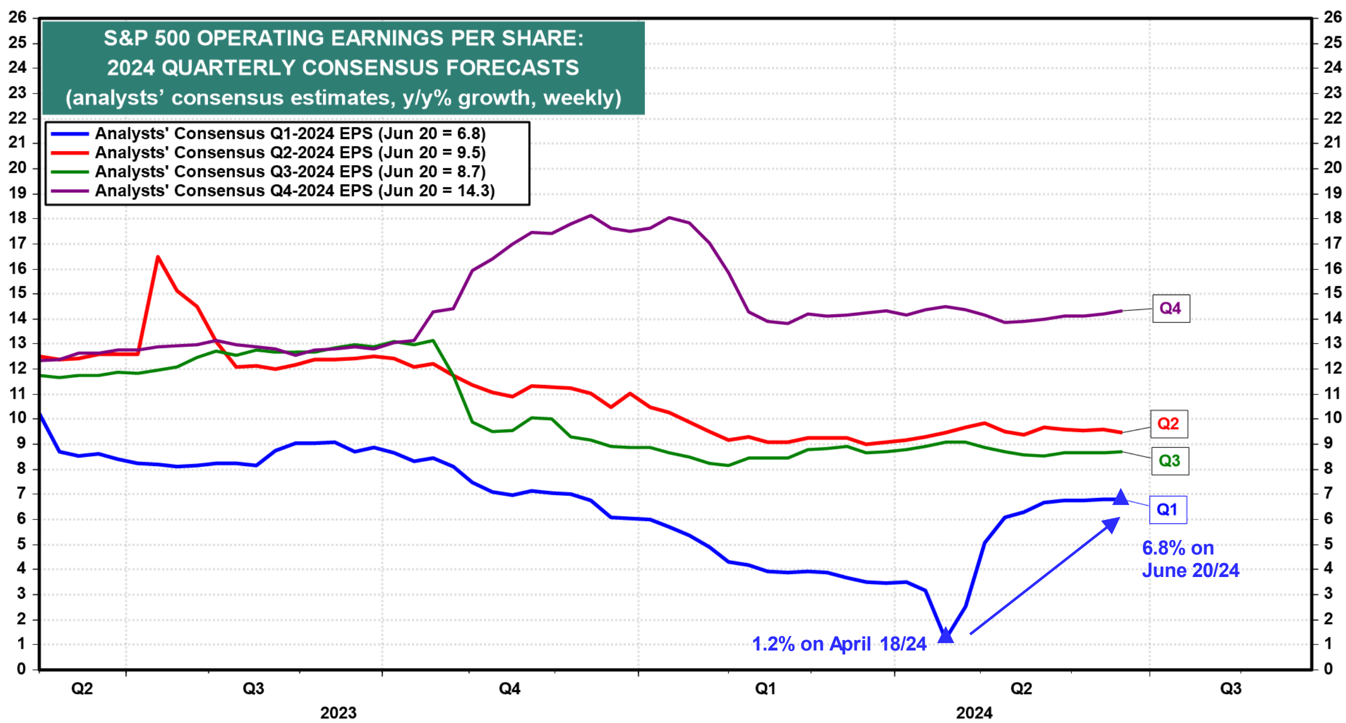
While lowering rates might incite further stock market gains in the near term, with the S&P500 trading at 21.2x forward 12-month (F12M) earnings, it could also lead to excessive valuation. We prefer to see market gains going forward supported by stronger earnings growth. The good news is that positive earnings surprises during Q1 2024 and higher forward guidance have led to higher consensus calendar year revisions for 2024, 2025 and 2026 (**Exhibit 5**) over the past month. In April, near the start of the earnings season, analysts were expecting Q1 earnings to be up 1.2% year over year. Instead, the growth rate was 6.8% (**Exhibit 6**).

Exhibit 5: S&P 500 Earnings per Share Estimates by Year



Source: Yardeni Research, 06/28/24

Exhibit 6: S&P 500 Earnings per Share Estimates by Quarter in 2024



Source: Yardeni Research, 06/28/24

Putting all this together, we continue to see an economy that can sustain moderate economic growth, with lower inflation, which should eventually allow for market friendly monetary policy. Furthermore, stronger earnings growth should be supportive of valuations.

Exhibit 7 compares price, earnings and valuations at the time of the prior peak in the S&P500 in January 2022 to the trough in October 2022 and to today. We are not suggesting that the market is cheap at 21.2x F12M earnings, however as shown in blue, despite the fact that market prices have risen by 13.8% since the prior peak, the market is actually cheaper today than at the previous peak, given that the forward P/E multiple has fallen 1.8% over that time frame. The entire increase in the price of the market therefore is due to higher earnings, which have risen 16.0%, and not due to multiple expansion. It is also worth considering that the headwind created by the Federal Reserve, which increased the Fed Funds rate by 4.25% from January 2022 to December 2022, was likely the main cause of the -25.4% bear market correction. Looking ahead, interest rates are more likely a potential tailwind (or positive) with future rate cuts likely at some point.

Exhibit 7: S&P 500 Peak-to-Trough Price, EPS, and Valuation (Price/Forward Earnings)

Source: Bloomberg, Forward EPS (blended forward 12 months), 06/28/24

Asset Allocation for our North American Equity Strategy As of June 30, 2024	
Equities	96%
Fixed Income	0%
Cash	4%

Our overall equity exposure remains high having increased by 1% to 96% with cash decreasing to 4% Our U.S. equity exposure increased from 52% to 56% while our Canadian exposure decreased from 43% to 40%. For portfolios invested in our North American plus International Equity strategy, the US and Canada weights will be proportionately less than this given the current 20% allocation to international companies.

During the quarter, we continued to shift our allocation in favour of US equities (+4%) over Canadian equities (-3%). US earnings growth continues to outpace Canadian earnings growth where recent F12M earnings for the TSX turned negative. This was largely driven by energy resource sector downgrades, which is a sector in which we maintain minimal exposure. Our Canadian companies have growing earnings, and many are globally diversified in terms of revenue sources despite their Canadian headquarters.

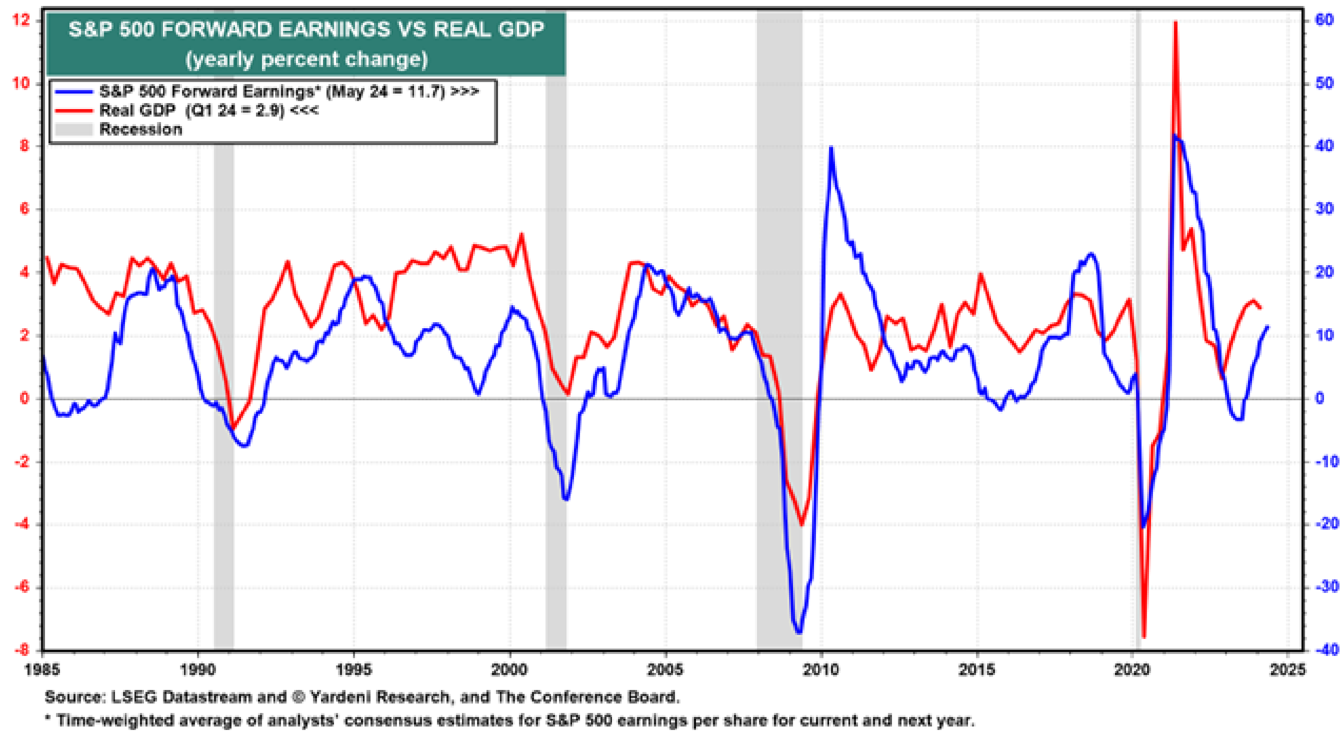
During the quarter, we added one new position in Cadence Designs Systems, which is often referred to as one of the most important companies you have never heard of. It is a leader in Electronic Design Automation (EDA) software, a critical tool that turns complex chip designs into manufacturing blueprints. The EDA market has a near-duopoly structure dominated by Cadence and one other player ensuring stability and pricing power. This specialized software commands high returns on invested capital and less cyclicality than the semiconductor industry overall, and Cadence is poised to benefit from the growing trend of companies designing their own chips. See Appendix 1.

Closing Comments and Outlook

As we discussed above, the upcoming monetary easing cycle is likely to take place against a backdrop where economic/GDP growth is solid, the unemployment rate is low, and inflation continues to move toward target levels. At the June FOMC meeting, the Fed has taken the stance that they “will need to see more good data to bolster confidence that inflation is moving sustainably toward 2 percent”. Positive earnings surprises during Q1 and higher forward guidance have led to higher consensus Calendar earnings revisions for 2024, 2025 and 2026, which from our perspective is supportive of current market valuations. **Exhibit 8** shows the strong correlation between forward twelve month earnings and year-over-year real GDP growth. Clearly the

Q1 strong earnings report would imply a continuation of at least moderate economic growth. And if the labor market were to weaken unexpectedly, or inflation were to fall more quickly than anticipated, knowing the Fed is prepared to respond with lower interest rates, does provides some dry powder, so to speak.

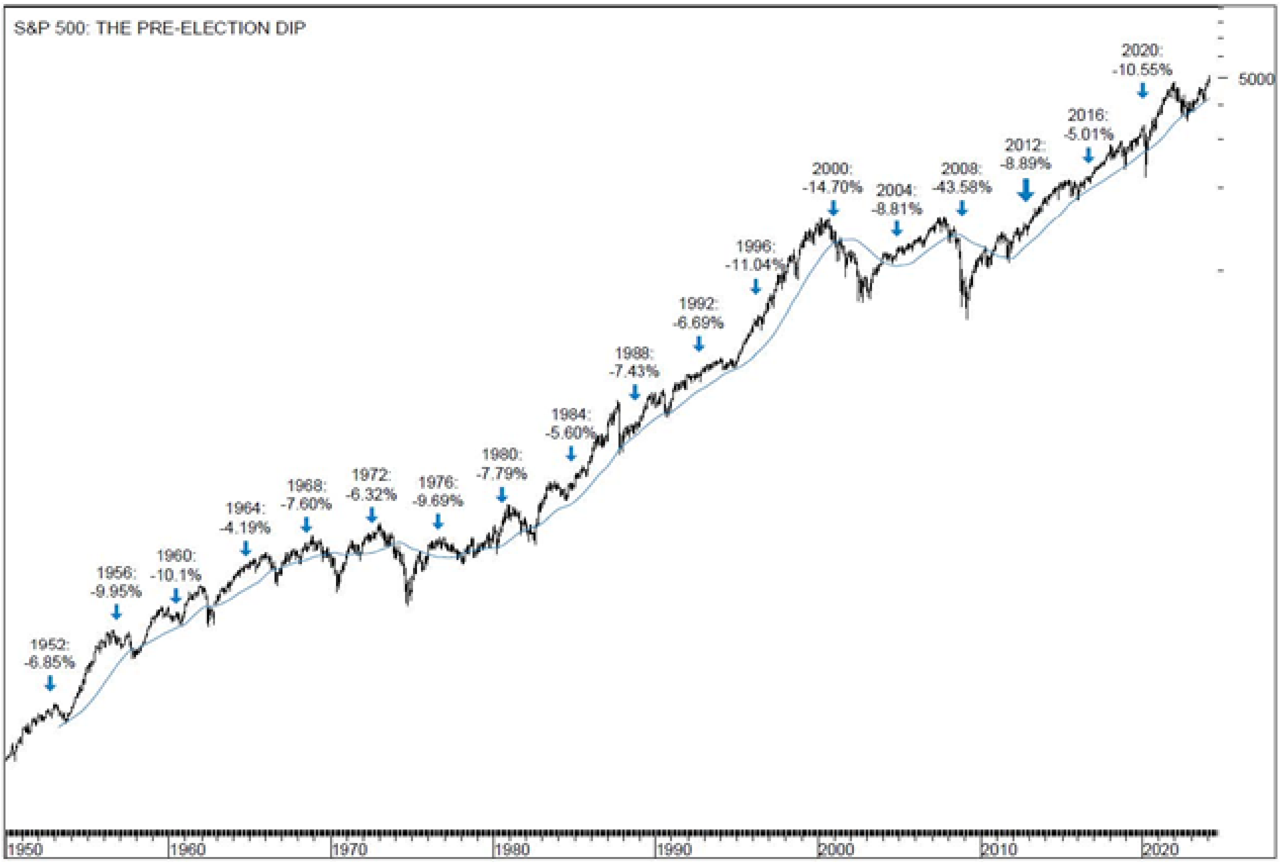
Exhibit 8: Strong historical correlation between S&P 500 Forward EPS & Real GDP



Source: Yardeni Research, 06/28/24

Despite that generally positive outlook, we can't forget that we are in an election year and broader market pullbacks of 5%-10% in the third quarter of U.S. presidential election years have been the historical norm for the past 75 years. **Exhibit 9** shows the pre-election dip in the S&P500 dating back to 1952. Taking the averages and ignoring the significant outlier in 2008, the average Q3 pullback since 1952 has been about -8.5%. So, if history repeats itself, we can't rule out some market turbulence in the July through September period, which has historically been a more volatile seasonal period anyway. And as we've pointed out in prior commentaries, every year has some type of pullback, so one would not be surprising regardless.

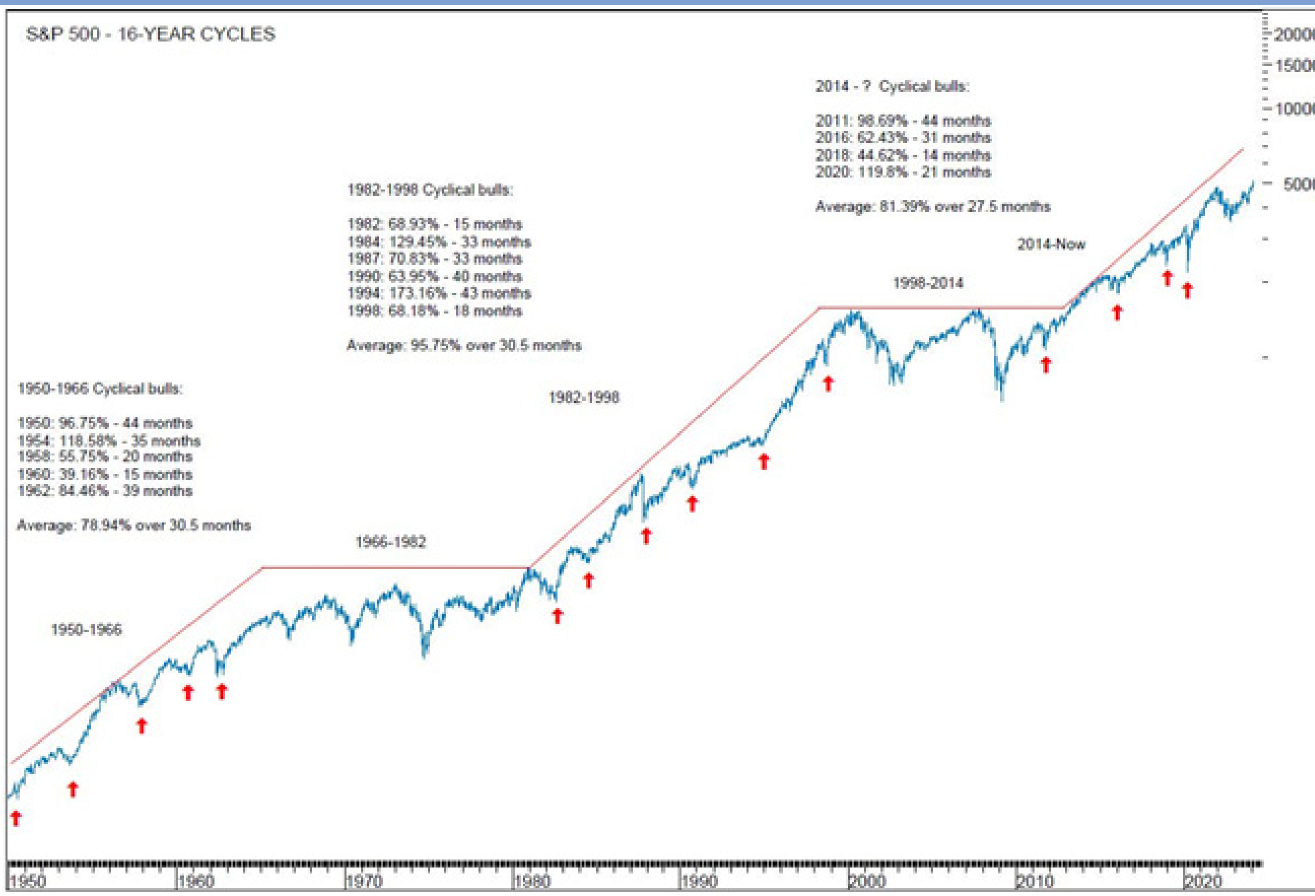
Exhibit 9: S&P500 The Pre-Election Dip



Source: BMO Nesbitt Burns, March 2024

Taking a longer-term technical perspective however, **Exhibit 10** suggests we are only part way through a cyclical bull market within an average 16-year secular bull-market cycle. As indicated in the chart below, cyclical bulls last on average about 30 months (2.5 years) with an average historical gain of 86%. From the October 2022 cyclical bear market low (about 20 months ago), the S&P500 is up about 53% suggesting, at least from a historical perspective, any short-term pull-back would likely be temporary.

Exhibit 10: The S&P500 16 – Year Cycles



Source: BMO Nesbitt Burns, March 2024

To conclude, while we can't rule out a pullback heading into the fall election, we think the solid earnings progression and positive earnings guidance in Q1 supported by lower interest rates in the second half of 2024 provide a constructive backdrop for the markets going forward.

Peter Jackson
Chief Investment Officer
June 30, 2024

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

UNITED STATES

Cadence Design Systems Inc.

Cadence Design Systems (CDNS) is a leading provider of Electronic Design Automation (EDA) software, a critical tool used to design a range of chips, from analog sensors to high-end logic chips used in artificial intelligence. Its dominant market position, a duopoly alongside Synopsys, offers stability and pricing power. The growing trend of custom chip design, particularly in AI and ARM-based chips, is increasing demand for its software. Cadence has a history of strong return on invested capital as well as organic revenue growth, driven by its essential role in the chip design process and overall industry expansion.