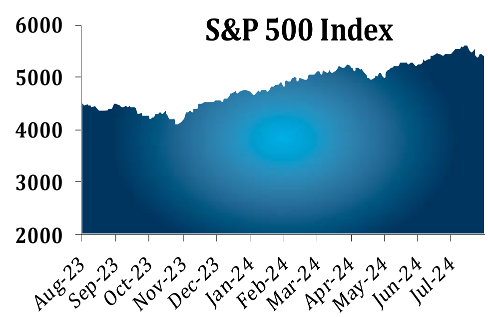
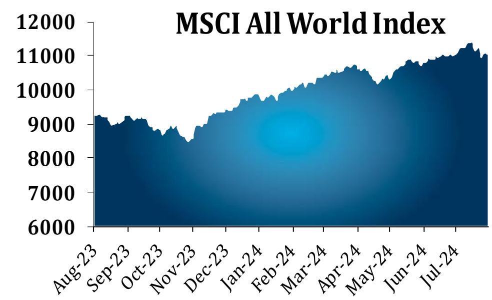
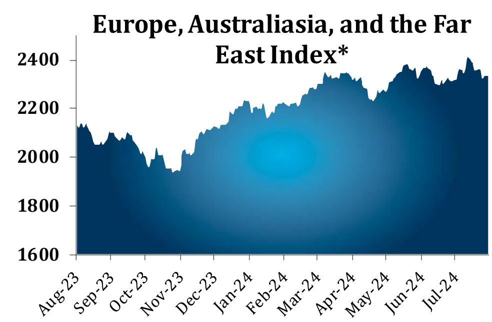
This Month in the Markets

July 2024

Equity Commentary: Crop Rotation







*MSCI EAFE Index

July was volatile for equities as the economic reports led to a rotation amongst sub-sectors of equity classes, and a resurgence in small caps and other more interest rate-sensitive sectors was observed. As a result, the MSCI ACWI Index was up 1.6%. The MSCI Emerging Markets Index had a small gain of 0.4%. International shares led the gains, with the S&P 500 Index rising 1.2% compared to the increase of 3.0% for the MSCI EAFE Index. Value significantly outperformed growth in terms of investment styles, with the MSCI All Country World Growth Index falling 0.9% while the MSCI ACWI Value Index was up 4.4%. The MSCI ACWI Utilities Sector was the biggest gainer, with a rally of 6.4%, driven mainly on the back of the narrative for increasing power demand to fuel the AI data center expansion. Conversely, the MSCI ACWI Communications Sector Index declined by 2.8%, primarily due to the retreat in large benchmark names such as Alphabet and Meta.

In farming, there is a concept called crop rotation. Essentially, this refers to the practice in which different crops are planted sequentially on the same plot of land to improve soil health, optimize nutrients, and control pests and weed infestation. In the equity market, rotation can happen along similar veins. Some sectors (crops) deplete future yields mainly due to stretches in excess valuation. They grow to the point that even exciting narratives cannot overcome the weight of high valuations. As a result, it is healthy to see a rotation of leadership or returns into other factors or industries (crops) that have better potential. This can be healthy, especially for equal-weight portfolios in a market dominated by a rather concentrated series of stocks in an over-weight sector of the market. REITS and Utilities, interest rate-sensitive sectors, jumped in July on the shift in interest rate expectations. Small caps, a crop that has been left fallow for years, rallied nearly 7.0%. The weather shifted in favor of these crops.

Meanwhile, the market became more skeptical about the potential returns in AI – the soil was becoming exhausted with this narrative. We, of course, do not know how long this rotation will continue but we do welcome a broadening of the equity market and are happy to have a more diverse crop planted at this stage.

We had three sales in the month, including CrowdStrike (“CRWD”), as it rallied up to our target price zone, and we were uncomfortable with its stretched valuation. We also sold Royalty Pharma PLC (“RPRX”) as we were concerned that the insider buying stopped in July despite continued weakness in the shares and concerns of potential pharma drug pricing pressures. These reductions could accelerate with Inflation Reduction Act of 2022 provisions to lower prescription drug costs for people with Medicare and lower drug spending by the federal government. Finally, we sold Diageo PLC (“DEO”), as we lost confidence that there would be a rebound in the spirit maker’s volumes in the next 12-18 months following disappointing six months results.

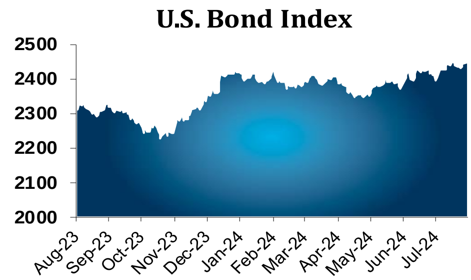
Micron Technology Inc. (“MU”) experienced the largest underperformance in July, with its stock falling 16.4%. Concerns over AI related stocks and the extent to which the picks and shovels companies like Micron will benefit plagued the semiconductor sector. In contrast, Match Group was the top performer, with its stock rising 25.5%. The leading online dating service reported better than expected second quarter results and Starboard became the third activist investor in Match shares (along with Elliott & Anson. We raised the cash position in the equity portfolio in July to take advantage of market dislocation during the earnings reporting season.

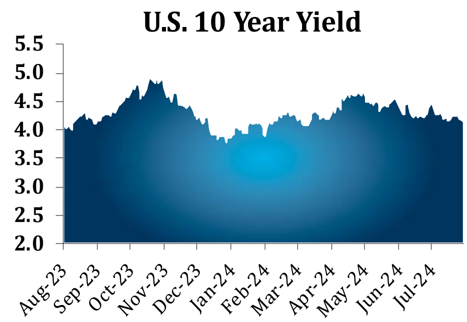
Fixed Income Commentary: The Great Bond Rally

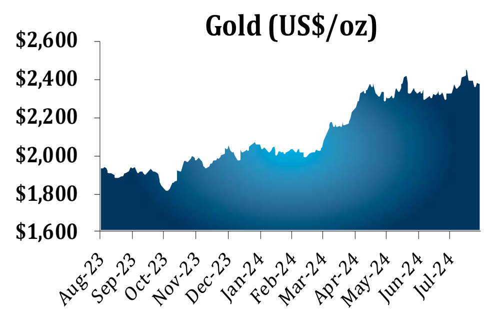
Bonds rallied in July due to continuing disinflation and a labour market closer to a supply/demand balance. Consequently, calls for the Federal Open Market Committee to cut interest rates have grown. Former president of the Federal Reserve Bank of New York, Bill Dudley, published an article in Bloomberg arguing for just this. Dudley had been an outspoken advocate for the "higher for longer" camp for the Fed's policy rate. The Federal Open Market Committee (FOMC) met on July 31st, leaving the Fed funds rate unchanged at 5.25%-5.50%. However, in the press conference, Chair Powell suggested that a rate cut would be forthcoming in the September (next) FOMC meeting. The market is pricing in a 0.5% interest rate cut in the meeting, after a weak jobs report on August 2nd. If the Fed cuts in September, they will be joining other major central banks that have cut their policy rates this year, such as the Bank of Canada (2 cuts), European Central Bank (1 cut), Swiss National Bank (2 cuts), and Riksbank (1 cut).

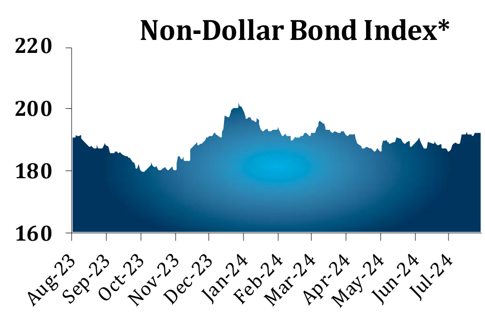
A corporate bond yield comprises the risk-free rate component (treasury yield) and compensation for credit and liquidity risks (credit spread). Credit spreads are currently very "tight" (or narrow). Using data since the beginning of 1997, investment-grade credit spreads are in the 13th percentile, while high-yield credit spreads are in the 12th percentile. Thus, since the beginning of 1997, credit spreads have only been tighter 13% of the time for investment grade and 12% of the time for high yield. This measure is useful; however, it does not consider the asset's potential volatility. We calculated the long-term z-scores (using data since 1997) of corporate bond yields, treasury yields, and corporate credit spreads. The z-score is a statistical measure that compares the latest value to its long-term average, then dividing by its standard deviation. As such, it gives a value adjusted for its standard deviation (a proxy for volatility). For our purposes, a positive z-score suggests an attractive valuation, while a negative z-score suggests an unattractive valuation. Looking at absolute 5- and 10-year yields, treasury yields screen as attractive, followed by investment grade debt, while high yields screen as over-valued. When looking at the z-score of high yield and investment grade credit spreads, they screen profoundly negative. These z-scores suggest that investors aren't adequately compensated for the volatility that corporate bonds can exhibit (global financial crisis, European debt crisis, COVID-19).

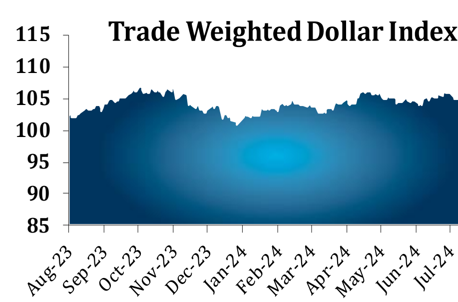
Given how tight credit spreads are, we continue to focus our corporate credit exposure on those companies with solid credit profiles and cash-generating ability. This is especially true for lower-rated companies, where a sudden or prolonged risk-off sentiment shift would have a greater impact. To be clear, we aren't suggesting this is imminent or likely, but things can change quickly. We wouldn't want to be reaching for yield in high beta names when the compensation for doing so is minimal. As Warren Buffett said, "Only when the tide goes out do you learn who has been swimming naked."











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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