2024 First Quarter Review

US stocks had their best start to the year since 2019, with the S&P 500 Index gaining 13.4% (CAD) in Q1. Continued enthusiasm over the emergence of AI technology, the expectation of rate cuts as early as June as inflation abates, and a potential soft landing for the US economy are the main factors contributing to market optimism. The **“Magnificent Seven” stocks**—Apple, Amazon, Alphabet (Google), Microsoft, Meta (Facebook), Nvidia, and Tesla—accounted for about **40% of the S&P 500’s gains in the quarter**. However, Tesla, Apple, and Alphabet have deviated from the pack recently, as demand weakens for core products of the first two while the latter has struggled with AI-related decision-making. Similar to the final quarter of 2023, Q1 2024 saw an **“everything rally”** that extended beyond the United States to other major markets.

While Canada lagged US markets due to its relatively small exposure to the AI trend, performance was still notably positive, with the S&P/TSX Composite Index **hitting an all-time high** and adding 6.6% year to date. The financial, energy, and material (e.g., gold and base metals) sectors make up 60% of Canada’s stock market. Two consecutive inflation readings below 3% have helped to prop up the interest-rate-sensitive financial sector, as rate cuts appear close on the horizon. With prospects for the global economy beginning to improve, a **renewed interest in Canada’s energy and materials** sectors has been evident.

International stocks also posted solid returns, up 8.4% (CAD) in Q1. Inflation data in the region continues to show **reduced price pressure**, and both the European Central Bank and the Bank of England have suggested that they may be able to cut rates soon. European stocks hit all-time highs in March, and Japan’s market finally surpassed the bubble-era high of 1989. Emerging markets lagged all others, increasing only 4.7% (CAD), held back by continued **debt and growth-related challenges** in China.

Heading into this year there was speculation that rates could begin to fall as early as March. Hotter-than-anticipated inflation in the United States **pushed rate-cut forecasts to the latter half of the year**, and bond markets declined in Q1 as a result. After dropping below 4.00% late in Q4 2023, the five-year US treasury yield finished the first quarter at 4.21%. Short-term bonds were flat, posting 0.3% returns in the quarter.

Following are the returns for major indices for the period ended March 31, 2024:

	Q1 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short Term (FTSE 30-Day T-Bill)	1.2	1.2	4.9	2.6	1.9	1.4
Canadian Bonds (FTSE Short-Term Bond)	0.3	0.3	3.5	0.3	1.3	1.6
Canadian Stocks (S&P/TSX Composite)	6.6	6.6	14.0	9.1	10.0	7.7
US Stocks (S&P 500)	13.4	13.4	30.0	14.3	15.4	15.3
Non-North American Dev. Stocks (EAFE)	8.4	8.4	15.4	7.4	7.6	6.9
Emerging Market Stocks (FTSE)	4.7	4.7	8.5	-0.8	3.4	5.5

All returns in Canadian dollars. Source: SS&C Technologies and Vanguard.

Outlook

Markets have surged to all-time highs across the globe on hopes that we will soon be leaving inflation behind us without having to sacrifice economic growth. That said, there is no shortage of risks investors will need to monitor this year that could stall or even reverse the current rally. These include ongoing wars overseas, the outcome of upcoming elections with over two billion voters set to go to the polls across 50 different countries, and upcoming data releases that will inform the timing and direction of monetary policy decisions.

US stocks have surpassed most other major equity markets to start the year. The **US market is also heavily concentrated**, with the Magnificent Seven representing approximately 29% of the S&P 500 Index at the end of February. These seven companies are so large that their aggregate market capitalization of 16.9% (as at the end of 2023) was almost the size of the stock markets of Japan, the United Kingdom, France, Canada, and China combined (17.5%). Lofty valuations and the concentrated nature of the US market has many commentators suggesting that the recent strong performance of US stocks might be unlikely to continue at the pace it has. It is noteworthy that from 1927 to 2022, US companies that grew large enough to break the top 10 in market capitalization ended up **trailing the broad US equity market by 1.5% per year over the subsequent 10 year period**. All this said, 493 other stocks remain in the index, and these names might be positioned to play some catch-up if economic conditions become more favourable, even if the AI theme takes a breather. Investors will no doubt also be paying attention to the US presidential election race and its ultimate outcome over the course of the year. While major political events have been found to have little long-term impact on equity markets, they can cause short-term volatility as investors digest potential policy changes.

The situation in Canada is more challenging than in the United States. Our economy here is suffering from a productivity slowdown as measured by GDP per capita, and the average consumer is contending with an **increasing cost of living while having to service record debt levels at elevated rates**. Our central bank often follows in lockstep with the US Federal Reserve's rate decisions. However, given the fragility of the Canadian economy relative to that of the United States, we may possibly see rate cuts here in advance of our neighbours to the south. Market forecasts are anticipating lower rates as early as June, and such a move would **benefit dividend-paying equities**, particularly in the country's financial sector, which is dominated by the large banks. Canada's more cyclical sectors such as energy and materials would be poised to benefit from increased demand if a soft landing for the US economy ends up being the case.

Similar to Canada, **Eurozone markets lack the AI exposure** that has benefited US stocks. Stocks in this area are currently cheap compared to those in the United States and could see some upside if they surpass lacklustre earnings expectations for the region in the upcoming period. After an impressive run over the last six months, Japanese stocks might be **due for a correction** based on current valuations. For emerging markets, Chinese equities remain out of favour. Trading at 9.5 times earnings versus their long-term average of 11, they appear undervalued, which could gain the attention of bargain hunters.

Portfolio Strategy

In managing risk, prudent investors know the importance of flagging heavily concentrated positions in their portfolios. Concentration risk is very present now with the **dominance of technology stocks in the US market**, as previously highlighted. Some commentators are comparing this current situation to the tech bubble of 2000, and while this time around the companies involved have real earnings, we know that trees don't grow to the sky, and cracks are starting to show. With three of the Magnificent Seven having lagged of late, this could be a sign of an impending change in sentiment.

The approach to mitigate concentration risk when building portfolios is through **broad-based diversification**, which is something we do and have always done for our clients. Such a strategy allows for participation in what is doing well but can also provide a layer of protection through volatile periods. For equities, diversification by style, sector, and region is particularly important. If a sell-off in growth-oriented tech ends up playing out, holding value stocks could help to insulate returns in a manner similar to events in 2022, when the tech-focused NASDAQ dropped 33%. If the economy stalls and interest rates decline in response, Canadian dividend stocks would likely do well as their yields become more attractive to other income-generating options. With all this in mind, in our view the outperformance of the S&P 500 Index in the United States is an **opportunity to rebalance to other complementary asset classes**.

On the fixed income side, yields continue to hold strong despite the expectation of lower rates in the back half of the year. As a result, we continue to take advantage of locking in yield where we can, either via GICs (being mindful of liquidity constraints for clients) and bond funds where appropriate. If rates do come down, high-credit-quality bond funds might also see some capital appreciation. We are also using high-interest savings funds that pay close to 5% to park cash where a near-term need for it exists.

Our clients have been well served over the years by staying disciplined through market cycles, this latest being no exception. In our experience, this is best achieved by constructing a diversified portfolio designed to meet financial goals while also reflecting each client's risk profile.