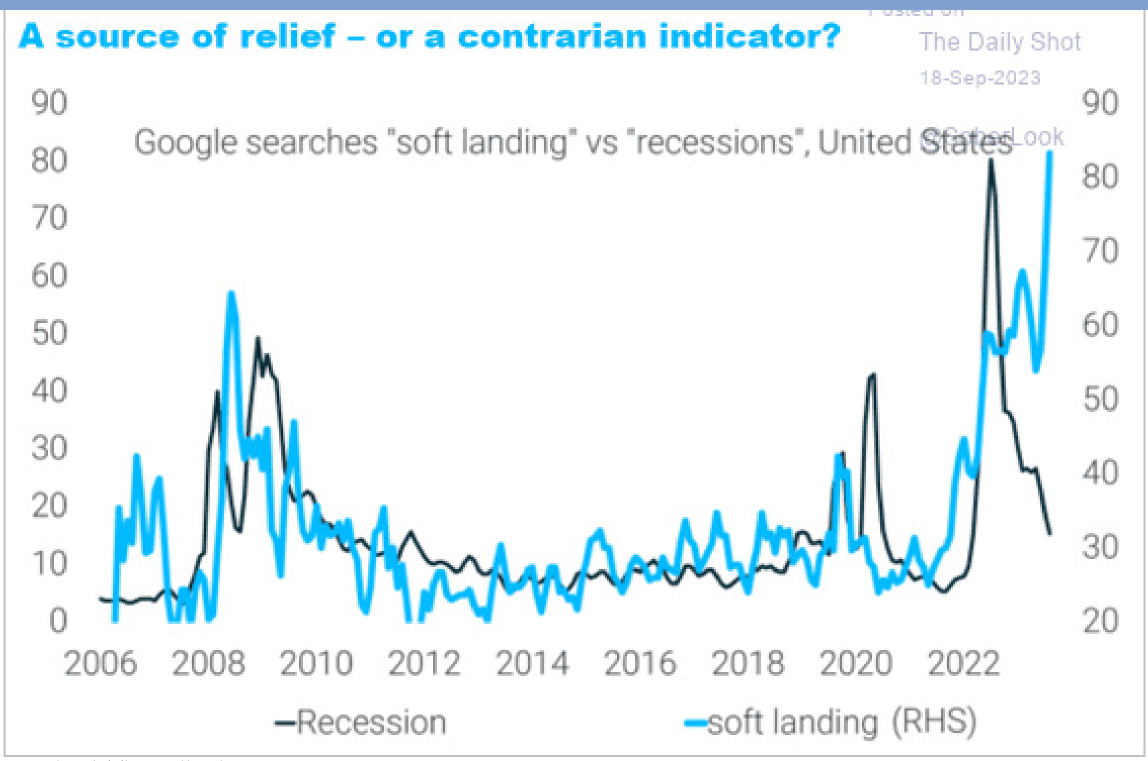
September 30, 2023

Third Quarter Review

NORTH AMERICAN EQUITY STRATEGY

Last quarter we discussed the likelihood of a soft economic landing given that economic growth was slowing but likely not turning negative, and the earnings outlook was improving in the back half of 2023 and 2024. Since then, a few positive data points on the inflation front have come in over the summer months to support that hypothesis, and these have been enough to shift market consensus to the soft-landing from recession camp as shown in **Exhibit 1**.

Exhibit 1: Google searches "soft landing" vs "recessions."



Source: TS Lombard, The Daily Shot

Time will tell as the title suggests, if this is "a source of relief or a contrarian indicator", however consider the following. **Exhibit 2** shows the Federal Reserve's Summary of Economic Projections (SEP) released on September 20th, 2023. Like in the June SEP, the Fed raised its economic forecast for real GDP growth for both 2023 and 2024, reduced their target unemployment rate for both years, and kept their PCE inflation forecast more or less flat at 3.3% with the expectation of it declining to 2.5% in 2024.

Effectively, it is forecasting higher economic growth, lower unemployment and elevated but improving inflation, which sounds a lot like the Fed is also moving toward the consensus soft landing camp. The trade-off appears to be a hawkish pause in that they did not raise rates in September but kept one more rate hike in the forecast for 2023 and lowered the number of future cuts in 2024 from 4 to 2 creating the expectation of higher rates for longer.

Exhibit 2: FOMC Summary of Economic Projections

Percent

Variable	Median[1]				
	2023	2024	2025	2026	Longer run
Change in real GDP	2.1	1.5	1.8	1.8	1.8
June projection	1.0	1.1	1.8		1.8
Unemployment rate	3.8	4.1	4.1	4.0	4.0
June projection	4.1	4.5	4.5		4.0
PCE inflation	3.3	2.5	2.2	2.0	2.0
June projection	3.2	2.5	2.1		2.0
Core PCE inflation[4]	3.7	2.6	2.3	2.0	
June projection	3.9	2.6	2.2		
Memo: Projected appropriate policy path					
Federal funds rate	5.6	5.1	3.9	2.9	2.5
June projection	5.6	4.6	3.4		2.5

Source: Federal Open Market Committee (FOMC), Summary of Economic Projections, September 20, 2023

Exhibit 3 shows the impact on the 10-year US Treasury bond yield increasing last week to as high as 4.61% on the Fed's hawkish tone, a level not seen since 2007. The S&P500 is also down -6.6% from its July 31st bull market high and we think this is mostly due to the competition with higher bond yields. Coincident with that, was the Fitch bond rating downgrade of US debt on August 1st, which has probably also contributed to the recent negative performance for both the bonds and stocks.

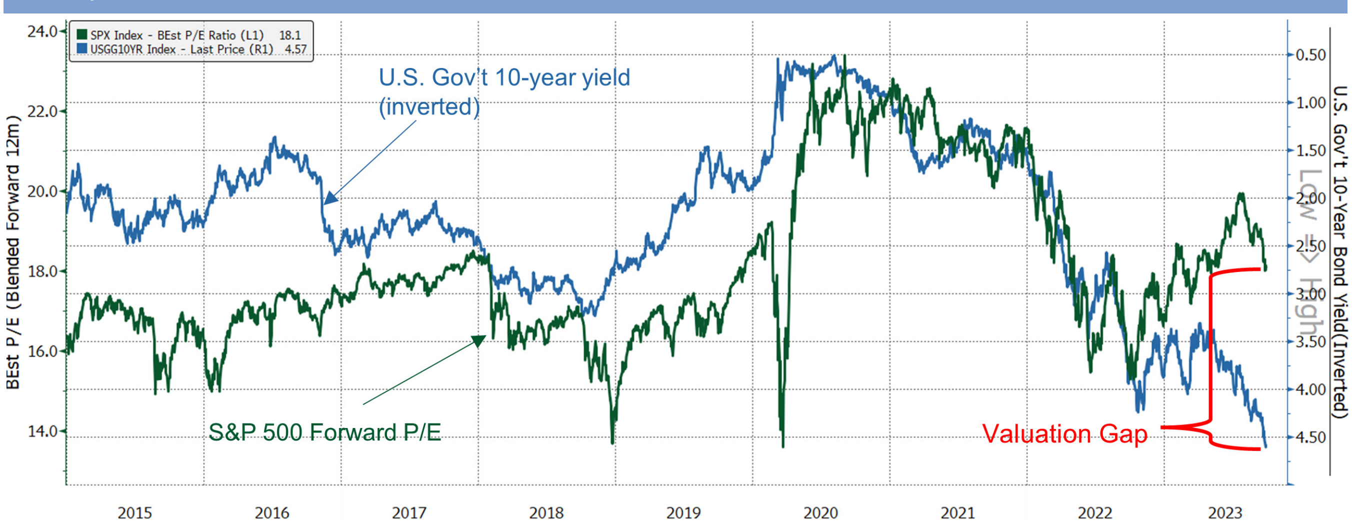
Exhibit 4 compares the relationship between S&P 500 forward price/earnings multiple (P/E in green) and the 10-year US Treasury yield (in blue). Typically, the correlation between the two lines is reasonably high but inverted, such that as the 10-year yield rises P/Es fall and vice-versa. In the chart, we have inverted the scale of the 10-year US Treasury yield to show the high correlation. However, as indicated in the chart the correlation has somewhat broken down and a valuation gap between the rising 10-year US Treasury yield and the S&P500 forward P/E has opened due to this recent rapid rise in interest rates.

The impact of competition from higher bond yields on stocks (or the gap between the blue and green lines in **Exhibit 4)** can typically resolve itself in a few ways: 1) yields can decline, which should happen if the Fed's projections for inflation are correct, 2) the 12M Forward Earnings growth can catch up, which effectively lowers the valuation of the market (lower the P/E by increasing the Earnings) or 3) the market pulls back, which is what has been happening the past two months.

Exhibit 3:US 10 Year Government Bond Yield

Source: Bloomberg 09/29/2023

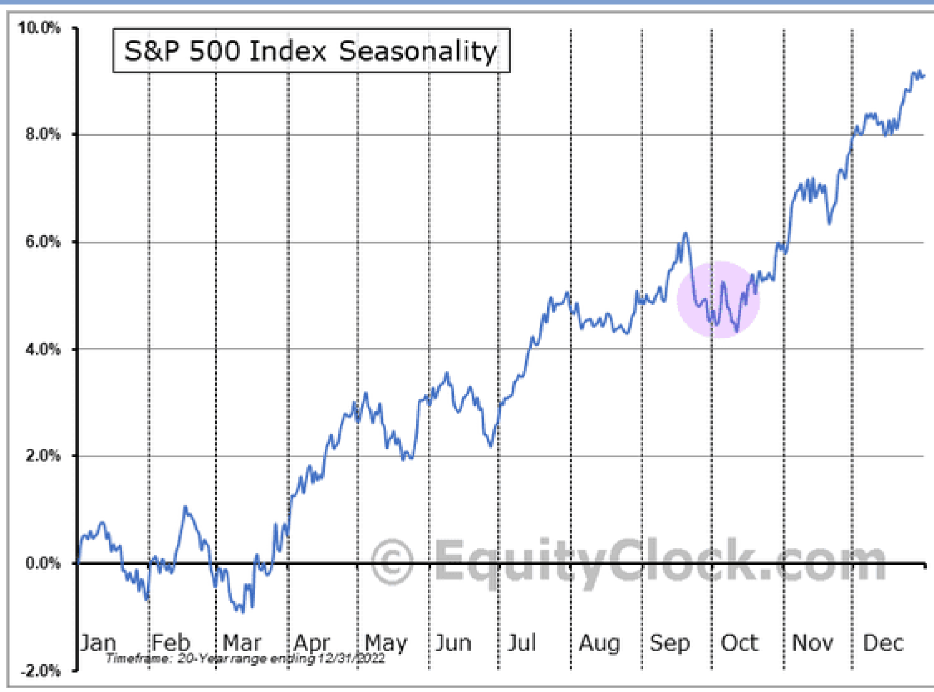
Exhibit 4: Relationship between S&P500 Price/Earnings ratio (P/E) and US 10-year Government bond yield



Source: Bloomberg

The fact that we are in the weakest period of the year for the stock market from a seasonality perspective **(Exhibit 5)** also does not help, but the bottom line is that until we get more data confirming that inflation is coming down, allowing policy rates to adjust lower and/or allowing earnings to continue their positive momentum higher, we expect some level of volatility. The good news is that we think the outlook for inflation is improving as policy rates are likely tight enough and the direction of earnings for the S&P500 is indeed moving higher, which should be positive for the equity markets moving forward. Also, it's probably worth noting from a seasonal perspective, that by the time most clients read this report, seasonality is expected to have a positive effect on equities from about mid-October onward.

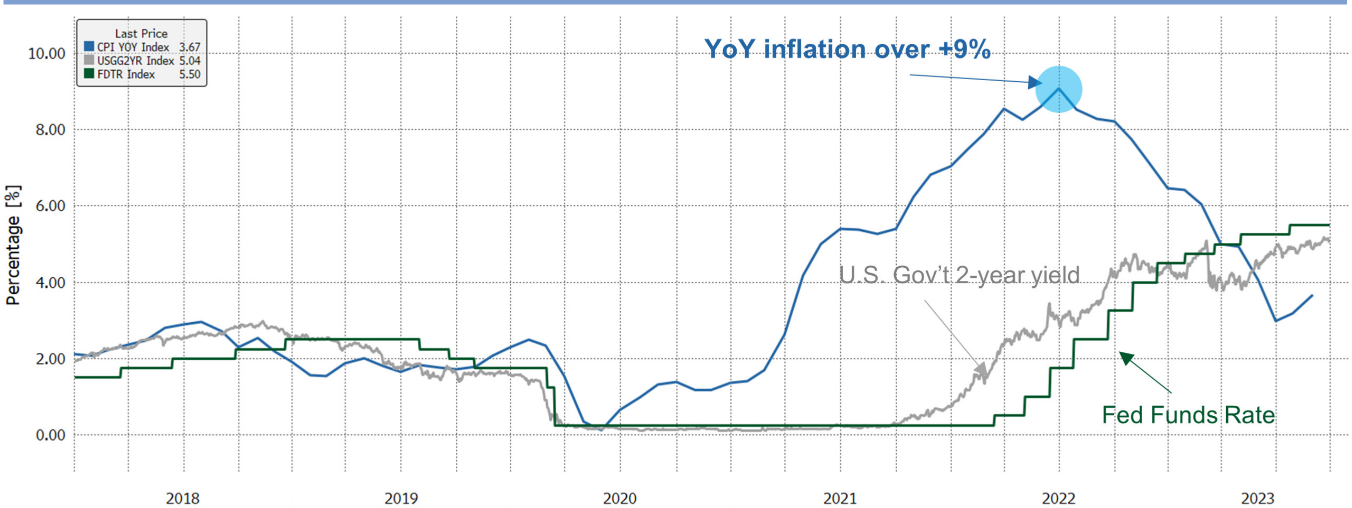
Exhibit 5: S&P500 20-Year Seasonality



Source: Equity Clock, The Daily Shot

Exhibit 6 compares year over year CPI inflation data, 2-year US Treasury bond yields and the Federal Funds rate from December 2020. Last year, central banks were way behind the curve in raising rates while inflation spiked causing them to hike rates at one of the most aggressive paces in history (11 hikes in 18 months or 5.25%), which sent both stock and bond prices down double digits. The market rates, or the 2-year US Treasury yield (grey line) moved higher well in advance of the actual Fed Funds rate (green line), which is a reminder that the markets are forward looking. That is, the market expected that the Fed would have to raise rates and priced that in advance and in general, the 2-year yield is a decent proxy for the future Federal Funds rate. With the CPI (blue line) now down closer to 3% from over 9% 15 months ago, 2-year treasury yields have leveled off and now sit slightly lower than the Fed Funds rate suggesting the market is now expecting we are at the end of rate hikes and that policy rates are "restrictive enough" to lower inflation.

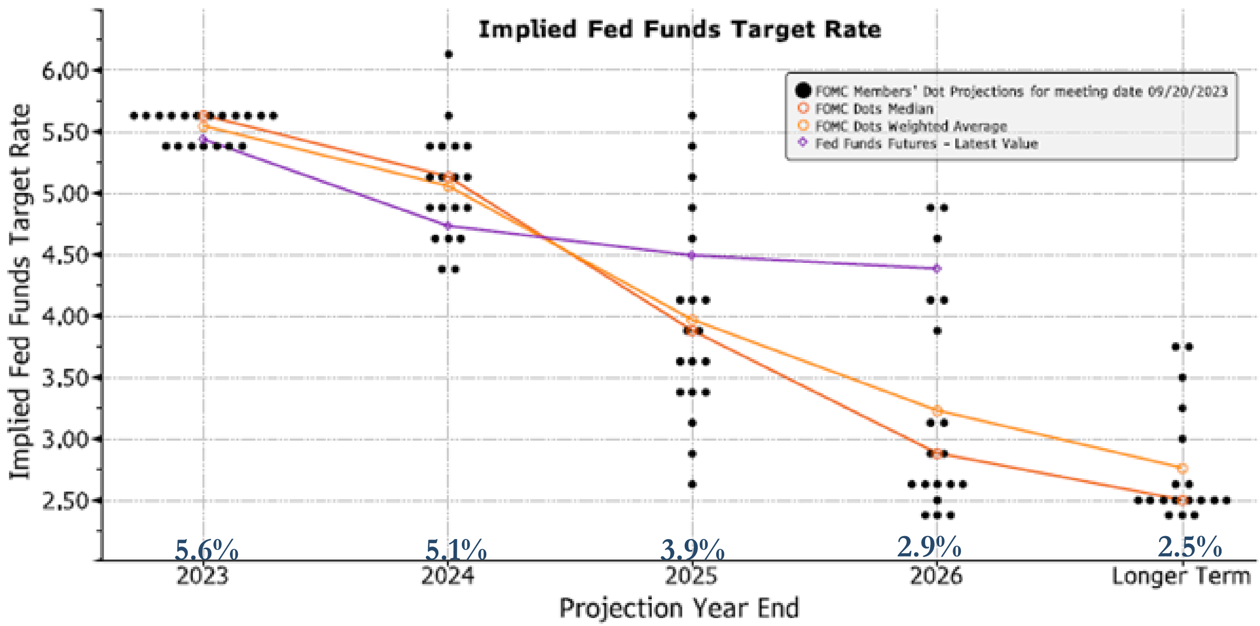
Exhibit 6: US Inflation and Interest Rates



Source: Bloomberg, CPWM

Exhibit 7 looks at the September FOMC dot plot. This shows what individual FOMC participants believe is the appropriate level of monetary policy as represented by the target Fed Funds rate for each Calendar year end. While the majority or 12 of FOMC participants see another rate hike by the end of 2023, 7 are predicting rates unchanged. However, in 2024, 17 of the 19 Fed participants see rates flat or lower than current levels and 13 of the 17 expect cuts, which implies that some Fed officials forecasting hikes into year-end also see cuts in 2024. We have learned to take these Fed predictions with a "grain of salt". However, the one take-away here is that the Fed is in sync with the bond market in expecting lower rates in 2024.

Exhibit 7: Implied Fed Funds Target Rate (Median Dot Plot)



Source: Bloomberg

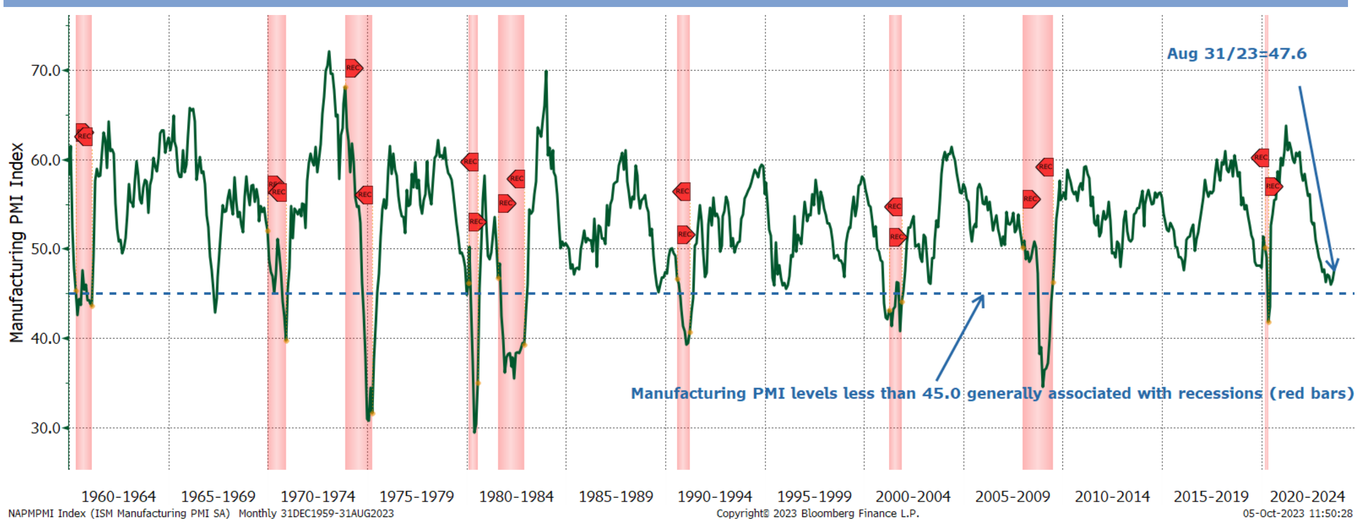
The other topic we want to review is where we are in the economic cycle and how that may impact forward earnings. **Exhibit 8** shows the latest ISM Manufacturing PMI for August (green line). When the PMI is below 50, the manufacturing segment of the economy is contracting. Recessions are shown on the chart by the vertical pink bars. The dividing line for entering recessionary territory or not has historically been 45, according to the National Bureau of Economic Research.

While US manufacturing activity has continued to decline, the pace of contraction seems to be slowing with the line turning up a little on the right of the chart. While this was the tenth month of consecutive contraction (below 50), the index rose for the second month in a row to 47.6 from a three-year low in June of 46. And importantly, it did not fall below 45, indicating recession.

Indeed, there are several past examples when mid-cycle slowdowns (soft landings) subdued inflation without recessions. These occurred during the mid-1980s and mid-2010s. One issue with the mid-80's, while perhaps there was no recession, there was a serious stock market correction (October 87). While we can't rule out a market pullback beyond the one we have been experiencing, 1987 was extreme and driven more by technical issues than systemic economic issues and even then, the market recouped all its losses in about 20 months.

So again, it's possible that the current inflation dynamic gets resolved without a recession or serious long-term implications.

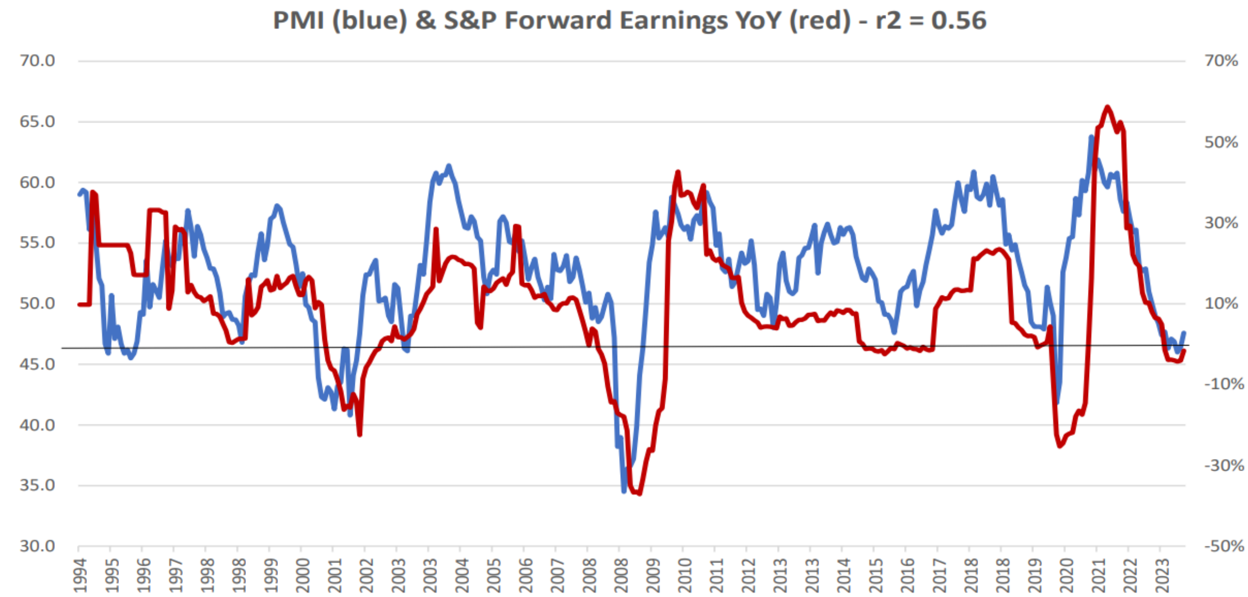
Exhibit 8: Manufacturing PMI and Recessions



Source: Bloomberg

Exhibit 9 shows the relationship between the ISM PMI manufacturing data and 12M forward earnings. As indicated in the chart, the correlation is strong and while we did experience a mild earnings recession during the latter part of 2022 and first part of 2023, consensus forward 12m earnings revision momentum has now turned positive on a 1-, 3- and 12-month basis.

Exhibit 9 Earnings Growth Tracks PMI Closely



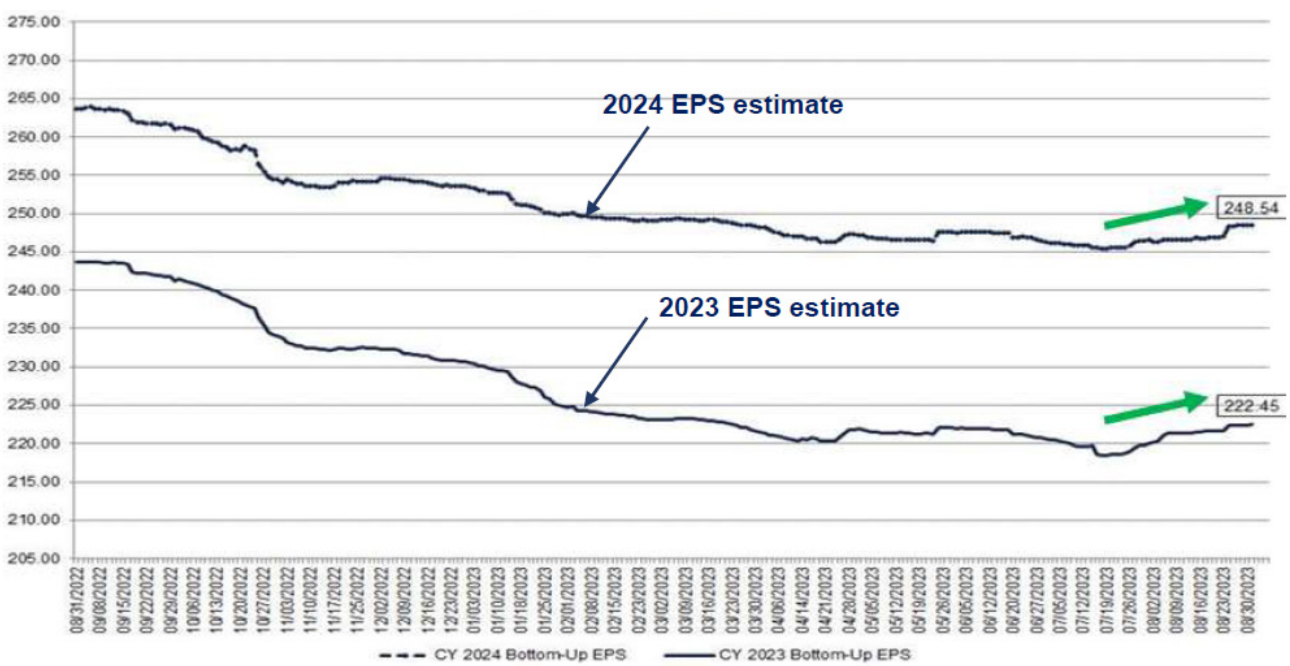
Source: Cormark Securities

Further confirmation can be seen in **Exhibit 10**, which shows the ISM Manufacturing Index in blue and the number of companies beating analyst earnings estimates in beige. As shown, companies have started to do quite well in relation to market expectations. **Exhibit 11** takes a closer look at calendar earnings over the past year. It shows earnings for companies in the S&P 500 have inflected higher in both 2023 shown by the bottom line, and 2024 shown by the top line.

Exhibit 10 : ISM PMI Manufacturing vs % of Companies Beating Estimates

Source: Credit Suisse

Exhibit 11: Bottom-up S&P500 2023 and 2024 Calendar Year Earnings



Source: FactSet

Asset Allocation for our North American Equity Strategy As of September 30, 2023	
Equities	94%
Fixed Income	0%
Cash	6 %

During the third quarter, the S&P500 total return was -3.27% in US dollars. Adjusting for currency, the S&P500 returned -1.22% in Canadian dollars, as the Canadian dollar depreciated about -1.6 cents, closing the quarter at US$0.7396. The TSX total return was -2.20% in the second quarter.

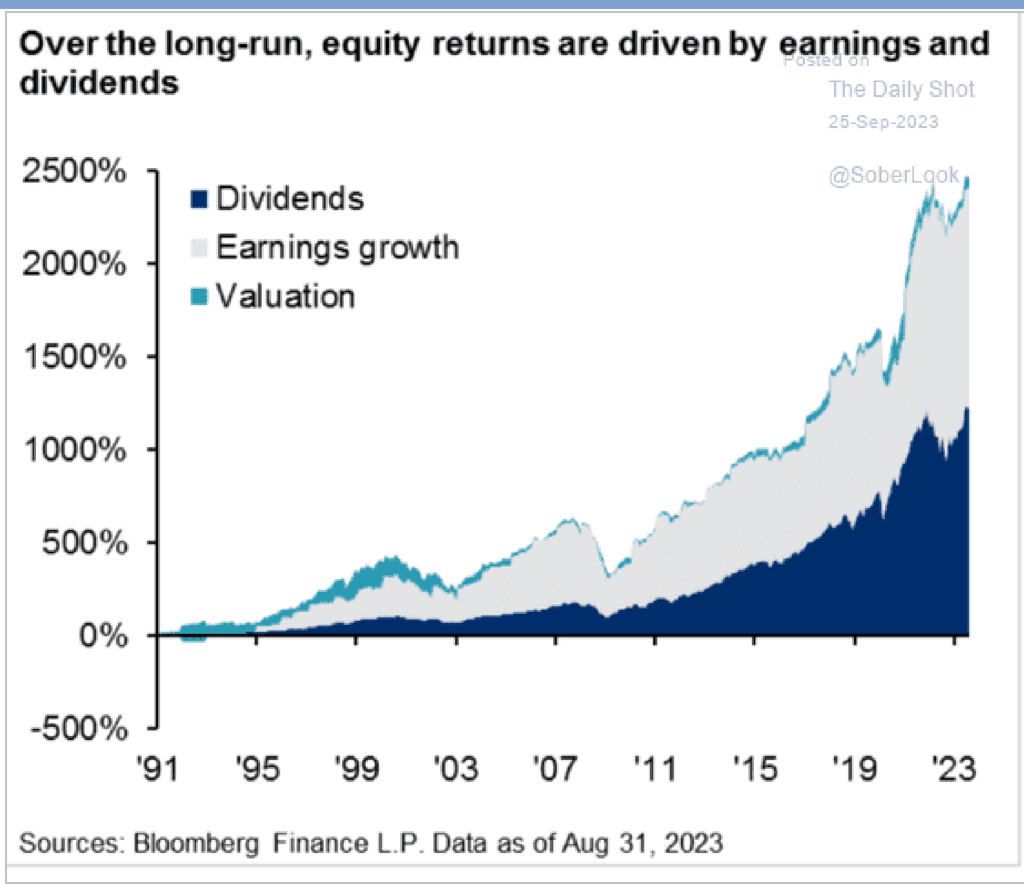
During the quarter, our overall equity exposure was unchanged at 94% with cash making up the balance at 6%. Our split between US/Canadian equity exposure also remained unchanged at 42% and 52%, respectively. It is important to note that many of our clients' portfolios are invested in our North American plus International Equity strategy, meaning that the actual weights of US and Canada within their equity holdings will be proportionately less than this given the allocation to international companies.

During the quarter, we continued to position our portfolio toward value-oriented stocks (including financials, consumer discretionary, industrials, energy and materials) making up 58% of the portfolio; however, this has declined from 63% on December 31st while exposure to growth stocks (including healthcare, information technology and communication services) increased to 34% up from 29% on December 31st. Staples, which we don't classify as either growth or value make up the difference at 2%. During the quarter, we added new positions in Oracle Corporation and TFI International (TFII). Oracle's business is very defensive, providing the most critical software to Fortune 500 businesses. Oracle has also improved its business mix over the past few years and now has accelerating organic growth due to 1) increasing cloud application revenue, and 2) increasing cloud infrastructure revenue. Oracle's business has analogies to Microsoft Azure's cloud business as it is using its strength in software applications to drive its database and cloud infrastructure businesses, yet it trades at a significantly lower valuation premium than Microsoft. TFI International provides freight transportation and logistics services with about a 70%/30% split between US and Canadian revenues. While the industry has experienced a freight recession so far in 2023, the recent bankruptcy of Yellow Corporation, a TFII competitor, has resulted in a significant pick-up in freight shipments for TFII. Also, the freight market should normalize in 2024. Management has a history of making large accretive acquisitions, and with its balance sheet now deleveraged from its last acquisition, it is well positioned to acquire going into 2024. A complete review of the business and fundamental outlook for new companies purchased during the quarter can be found in Appendix 1.

Closing Comments and Outlook

The S&P500 is down -6.6% from its July 31st bull market high, likely resulting from the increase in bond yields following the Fitch downgrade August 1st and more hawkish Fed chatter coming out of the September FOMC meeting. The rise in bond yields has put upward pressure on valuation risk in the short term. However, over the long-term, valuation is a small component of equity returns, which historically have been driven by earnings growth and dividends as illustrated in **Exhibit 12.** Given there is evidence that economic conditions are reaccelerating, we believe earnings growth should be a tailwind for the markets going forward.

Exhibit 12: Contribution to Cumulative total S&P500 equity returns %



Source: Bloomberg Finance L.P. Data as of Aug 31, 2023

Exhibit 13 compares historical market bottoms going back to the 1940's for the S&P500 and the US Manufacturing PMI, which is proxy for the US economy. Historically, the S&P500 has bottomed 5 months before the low in the PMI in 17 of 21 observations, or 81% of the time and on average the S&P500 has risen +17.7% from its low by the time the PMI bottoms. As shown in the chart, if October 2022 was in fact the low for the S&P500 and June 2023 was the low for the PMI, this would represent a +24.1% move for the S&P500 from S&P500 October low to the June PMI low over 9 months, once again supporting the historical pattern of the market bottoming well ahead of the economy and earnings.

Exhibit 13: S&P 500 vs. PMI Market Bottoms

Date of PMI Low	Date of S&P Low	S&P Bottom Relative to PMI Bottom	S&P Perf at PMI Bottom (rel. to bottom)
28-Feb-49	29-Feb-48	-12	4.4%
31-Dec-53	29-Aug-53	-4	4.5%
31-Jan-58	31-Dec-57	-1	4.3%
31-May-60	31-Oct-60	5	
31-Aug-62	30-Jun-62	-2	8.0%
30-Apr-67	30-Sep-66	-7	22.8%
30-Nov-70	30-Jun-70	-5	19.9%
31-Jan-75	30-Sep-74	-4	21.2%
31-May-80	31-Mar-80	-2	9.0%
31-May-82	31-Jul-82	2	
31-May-85	31-Jul-84	-10	25.8%
31-Aug-89	30-Nov-87	-21	52.6%
31-Jan-91	31-Oct-90	-3	13.1%
31-Jan-96	30-Nov-94	-14	40.2%
31-Dec-98	31-Oct-98	-2	11.9%
31-Oct-01	30-Sep-02	11	
31-Dec-08	28-Feb-09	2	
30-Nov-12	30-Sep-11	-14	25.2%
31-Jan-16	30-Sep-15	-4	1.1%
30-Apr-20	31-Mar-20	-1	12.7%
30-Jun-23	30-Sep-22	-9	24.1%
Average		-5	17.7%
Median		-4	13.1%
Hit Rate		81%	

S&P bottoms on avg. 5 months before the low of the PMI and is up 17.5% when the PMI bottoms. Just 4 of 21 times the S&P lagged the PMI bottom, most notably 2001/2002 after the tech bubble burst lagged by 11 months

Source: Cormark Securities

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Exhibit 14 looks at the performance of the S&P500 from 1 month to 24 months after the PMI bottom for the same 21 observations shown in Exhibit 13. In each time period measured, the performance for the S&P500 is positive in more than 65% of the observations. Also, the S&P500 1-year average return is +21.2% following the PMI bottom and the S&P500 has been positive in 19 out of 21 observations since the 1940's for a 90% hit rate.

Exhibit 14: Historical Returns for S&P500 after PMI Bottoms

	S&P Return					
Date of PMI Low	**+1m**	**+3m**	**+6m**	**+12m**	**+18m**	**+24m**
28-Feb-49	3.0%	-2.9%	4.1%	17.8%	26.0%	49.1%
31-Dec-53	5.1%	8.6%	17.7%	45.0%	65.4%	83.3%
31-Jan-58	-2.1%	4.2%	13.2%	32.9%	45.1%	33.4%
31-May-60	2.0%	2.0%	-0.5%	19.2%	27.7%	6.8%
31-Aug-62	-4.8%	5.3%	8.7%	22.6%	31.6%	38.4%
30-Apr-67	-5.2%	0.8%	-0.1%	3.8%	10.0%	10.3%
30-Nov-70	5.7%	11.0%	14.3%	7.8%	25.6%	33.8%
31-Jan-75	6.0%	13.4%	15.3%	31.0%	34.4%	32.5%
31-May-80	2.7%	10.0%	26.3%	19.2%	13.6%	0.6%
31-May-82	-2.0%	6.8%	23.8%	45.1%	48.7%	34.6%
31-May-85	1.2%	-0.5%	6.7%	30.5%	31.5%	53.0%
31-Aug-89	-0.7%	-1.6%	-5.6%	-8.2%	4.4%	12.5%
31-Jan-91	6.7%	9.1%	12.8%	18.9%	23.3%	27.6%
31-Jan-96	0.7%	2.9%	0.6%	23.6%	50.0%	54.1%
31-Dec-98	4.1%	4.6%	11.7%	19.5%	18.3%	7.4%
31-Oct-01	7.5%	6.6%	1.6%	-16.4%	-13.5%	-0.9%
31-Dec-08	-8.6%	-11.7%	1.8%	23.5%	14.1%	39.2%
30-Nov-12	0.7%	7.0%	15.2%	27.5%	35.8%	46.0%
31-Jan-16	-0.4%	6.4%	12.0%	17.5%	27.3%	45.5%
30-Apr-20	4.5%	12.3%	12.3%	43.6%	58.1%	41.9%
30-Jun-23	3.1%					
Average	1.3%	4.7%	9.6%	21.2%	28.9%	32.5%
Median	1.6%	5.9%	11.8%	21.1%	27.5%	34.2%
Hit Rate	65%	80%	85%	90%	95%	95%
S&P Average	0.7%	2.2%	4.4%	9.0%	13.8%	18.9%

Source: Cormark Securities

After the bottom in the PMI, the S&P continues to do well, average 12-month return 21.2%, up 90% of the time.

The market often bottoms well ahead of the economy and earnings, and it would appear this time is no exception. As we have discussed in the past, some of the best times to invest in equities are when it's most uncomfortable to do so, as there is never an all-clear signal and if there is, it often comes much too late to benefit. So, as difficult as investing may feel at times, our advice is to remain fully invested in accordance with risk tolerance to ensure you're there when the markets are going up.

In closing, we remain cautiously optimistic on the equity market given that we think interest rates have peaked or are close to it and the outlook for earnings has turned positive. While we can't rule out a further market pullback during this seasonally weak period, periods of increased volatility are common amid an ongoing bull market. We believe the underlying economic fundamentals are improving and this combined with lower interest rates as we look out into 2024 should limit the downside.

Peter Jackson
Chief Investment Officer
September 30, 2023

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

CANADA

TFI International

TFII International, Inc. provides freight transportation and logistics services. It operates through 4 segments: Package & Courier, Less-than-Truckload ("LTL"), Truckload, and Logistics. Since the acquisition of UPS Freight (now T-Force Freight), the LTL segment is roughly 40% of EBITDA and is their fastest growing segment. LTL is less competitive than general trucking, which requires a large real estate footprint with distribution facilities to compete well. And the market has just become less competitive with the recent dissolution of Yellow – a large competitor that was trying to take share with disruptive pricing. With Yellow gone, TFII should gain volume and be able to increase prices. Further, we've bought TFII while the shipping industry is weak. Any recovery in general volumes will also be accretive to earnings.

UNITED STATES

Oracle Corporation

Oracle is a technology company that provides database management, enterprise resource planning (ERP) and human capital management (HCM) applications targeting various industries such as healthcare, communications, utilities, financial services, etc., and cloud infrastructure like Microsoft's Azure or Amazon Web Service (compute, networking, storage, database, AI services…). Oracle's business has analogies to Microsoft as it is using its strength in software applications to drive its database and cloud infrastructure businesses. The company has improved its business mix over the past few years and now has accelerating organic growth due to 1) increasing cloud application revenue, and 2) increasing cloud infrastructure revenue. Earnings growth is accelerating as it continues to gain market share over competitors in ERP and gain scale in its cloud infrastructure business. We like Oracle's defensive business. Its software solutions are the operating systems to Fortune 500 businesses. We think it has reasonable valuation with earnings expected to grow in low double digits over the next couple of years, faster than the market overall, but it trades at market PE multiple.