September 30, 2024

Third Quarter Review

NORTH AMERICAN EQUITY STRATEGY

Yet another good quarter for both the S&P500 and TSX has come to a close. During the third quarter of 2024, the S&P500 total return was 5.89% in U.S. dollars. Adjusting for currency, the S&P500 returned +4.59% in Canadian dollars, as the Canadian dollar appreciated about +0.0084 cents, closing the quarter at US$0.7394. The TSX total return was +10.54% in the third quarter.

The much-anticipated monetary policy easing cycle started earlier this month when the Federal Open Market Committee (FOMC) cut interest rates by 50 basis points (bp) to 4.75%-5.0% as Chairman Powell signaled that he was shifting from being a so called an inflation 'hawk' to an employment 'dove'. That is, he now cares as much about maintaining employment as he does about reducing inflation with high interest rates. To quote the FOMC statement, "the committee has gained greater confidence that inflation is moving sustainably toward 2% (the committee's objective) and judges the risks to achieving its employment and inflation goals are roughly balanced". In the latest changes to the FOMC's Summary of Economic Projections (SEP) released on September 18th, 2024 **(Exhibit 1)**, the unemployment rate for the 2024-2026 period increased to a high of 4.4% while both Headline and Core PCE (the Fed's preferred inflation measure) moved lower toward its target of 2.0%. Real GDP was essentially held flat from its previous June projection over the next three years at about +2.0% annually.

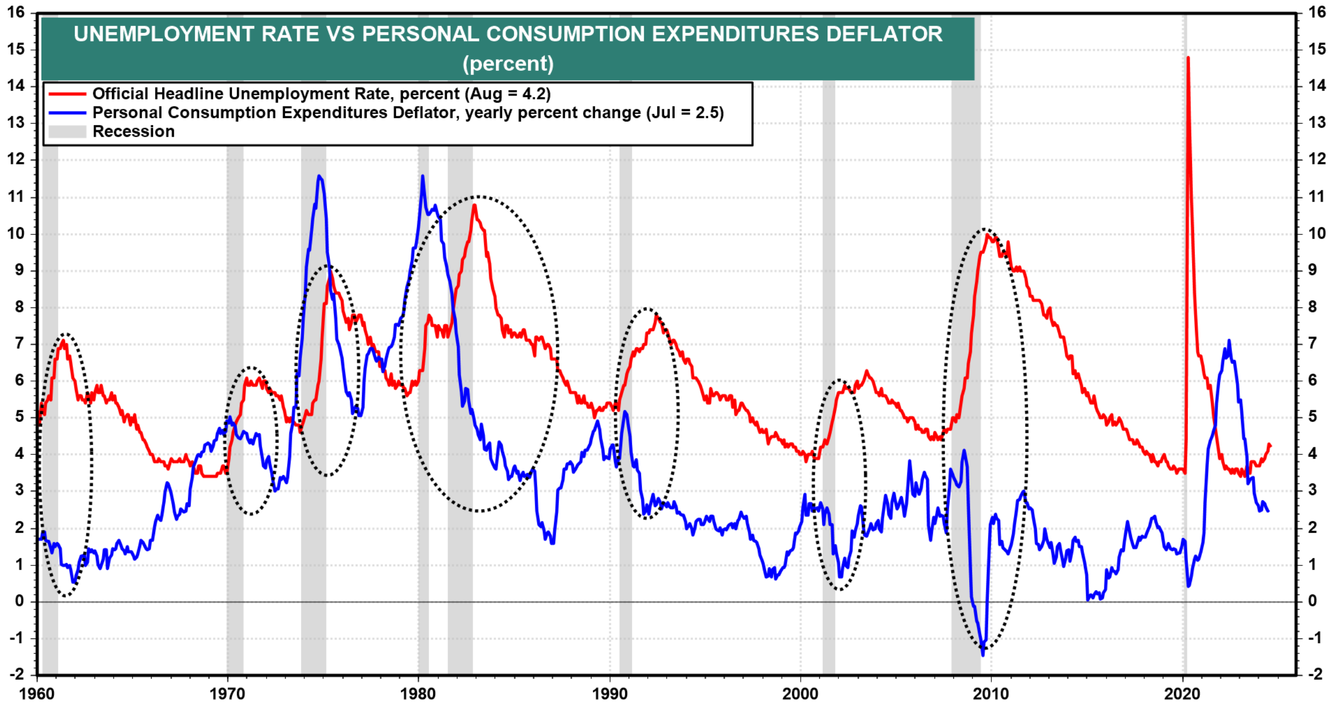
Exhibit 1: FOMC Projections

Variable [in %]	Median				
	2024	2025	2026	2027	Longer Run
Change in real GDP (June)	2.0	2.0	2.0	2.0	1.8
June projection	2.1	2.0	2.0		1.8
Unemployment rate (June)	4.4	4.4	4.3	4.2	4.2
June projection	4.0	4.2	4.1		4.2
PCE inflation (June)	2.3	2.1	2.0	2.0	2.0
June projection	2.6	2.3	2.0		2.0
Core PCE inflation	2.6	2.2	2.0	2.0	
June projection	2.8	2.3	2.0		
Memo: Projected appropriate policy path					
Federal funds rate	4.4	3.4	2.9	2.9	2.9
June projection	5.1	4.1	3.1		2.8

Source: Federal Reserve, Summary of Economic Projections, 09/18/2024

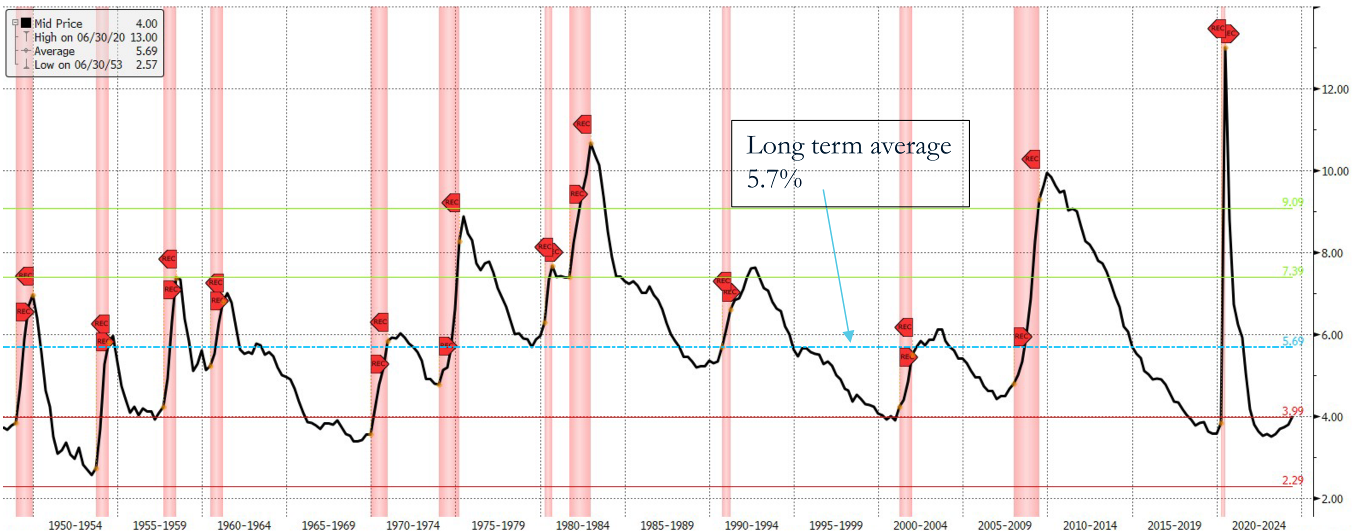
Exhibit 2 shows the historical inverse relationship between the US unemployment rate (red line) and headline PCE inflation (blue line) going back to the 1960's, where the grey shaded areas represent recessions. As suggested by the chart, there is nothing like a recession to stop inflation. Unfortunately, recessions are also associated with higher unemployment, so clearly a recession is something the Fed is trying to avoid by not waiting for inflation to get to 2% before starting to cut interest rates, and by initiating a larger 50bp cut right out of the gate. Time will tell whether the FOMC can pull off the soft landing. However, the 4.4% target unemployment rate, which the Fed is currently projecting, while off the historic pre-covid lows of 3.5%, would not be considered a recessionary level by historical standards, and is still well below the long-term average unemployment rate as shown in **Exhibit 3** of 5.69%.

Exhibit 2: Unemployment and Inflation



Source: Yardeni Research, 09/25/2024

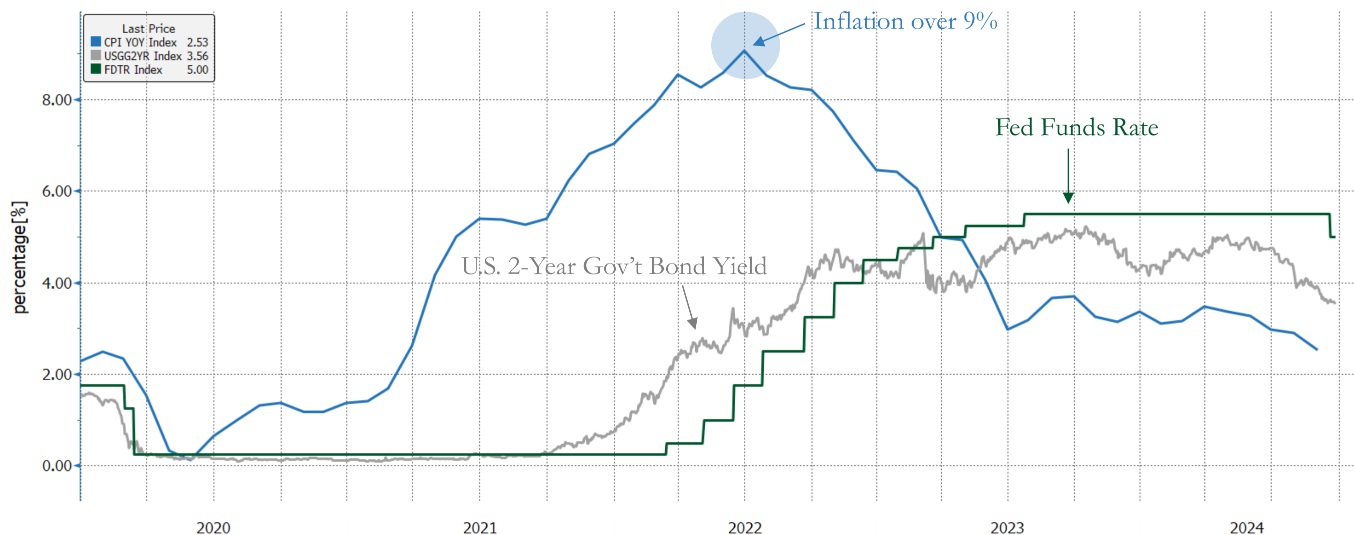
Exhibit 3: Historical Unemployment Rate (Line) & Recessions (Red Bars)



Source: Bloomberg, EHUPUS Index

Exhibit 4 is a familiar chart, which we have referenced before that compares year over year CPI inflation data, 2-year US treasury bond yields and the Federal Funds rate from January 2020. Recall in 2022, central banks were way behind the curve in raising rates while inflation spiked, and they then had 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 to cool inflation and priced that into the 2-year yield in advance of the Fed actually raising rates. In general, the 2-year yield is a decent proxy for the future Federal Funds rate. With the CPI (blue line) now trending below 3% from over 9% in June 2022, 2-year Treasury yields had leveled off for the better part of the past year and are now declining materially below the Fed Funds rate suggesting the market is now pricing in a series of rate cuts well beyond the 50bp cut we just saw in September.

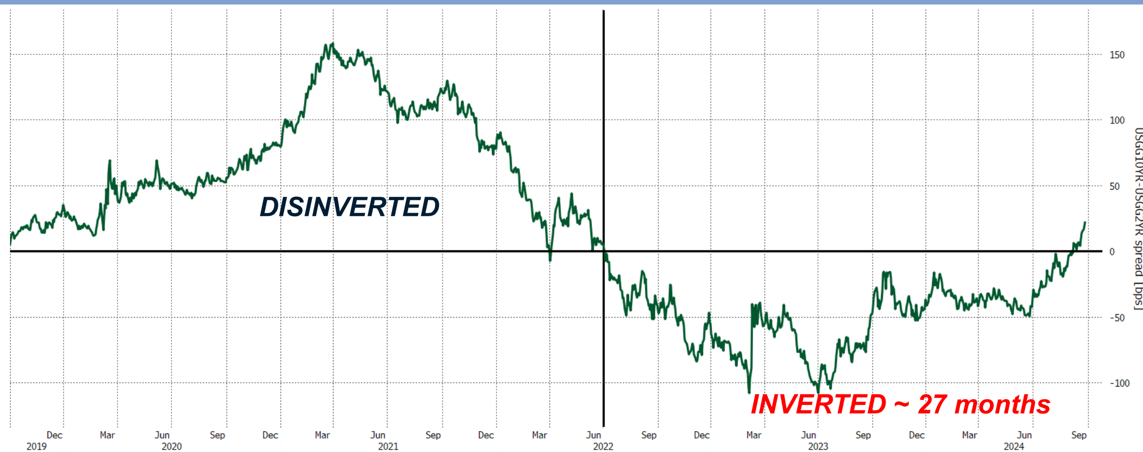
Exhibit 4: CPI YoY vs Fed Funds Rate vs US Government 2-Year Yield



Source: Bloomberg, 9/25/2024

The recent decline in 2-year yields relative to 10-year yields has also led to the dis-inverting (or steepening) of the yield curve. **Exhibit 5** shows the spread (or difference between) the 10-year yield and the 2-year yield and that the yield curve has been inverted for the past 27 months (i.e.: short-term higher than long term ones). We view this dis-inverting (short-term rates now lower than long term ones) as good news as inverted yield curves are often, but not always, historically associated with recessions.

Exhibit 5: US 10-Year & US 2-Year Government Spread:
Dis-inverted vs Inverted Yield Curve (in bps)

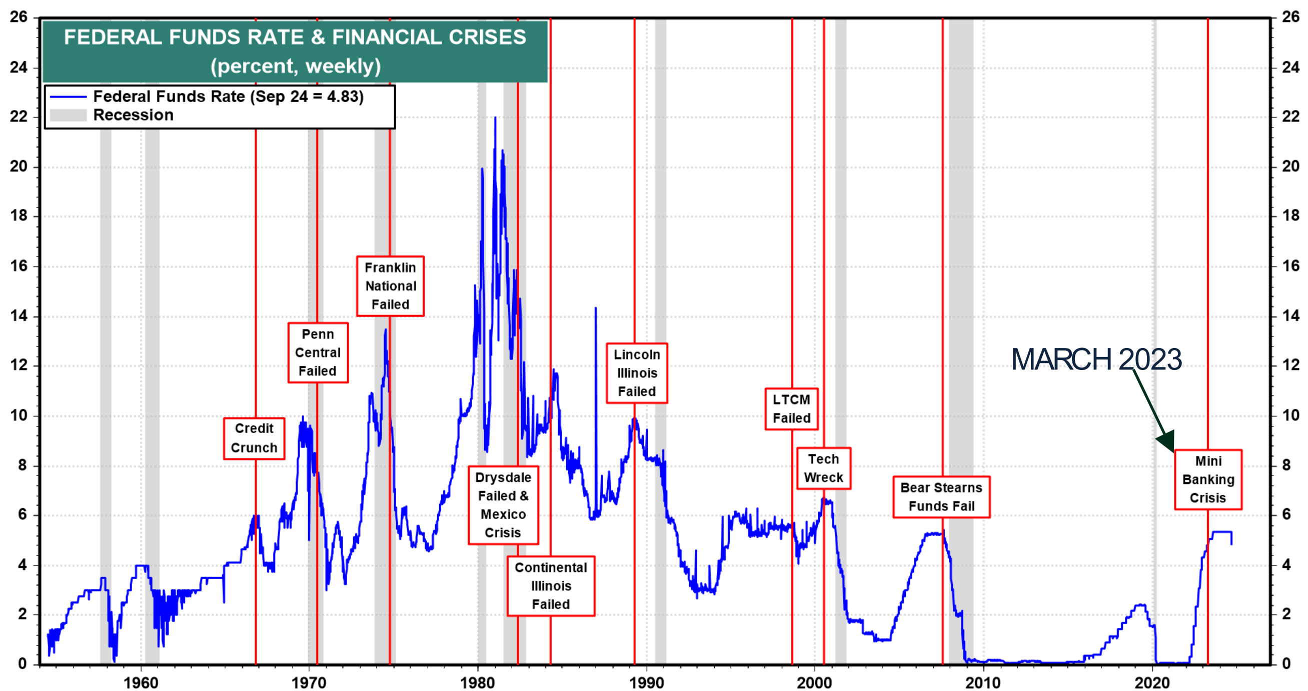


Source: Bloomberg, 9/25/2024

CUMBERLAND
Private Wealth

According to Ed Yardeni, a strategist we follow, recessions don't happen very often, and they don't last very long; however, of the nine recessions since 1960, most were caused by the tightening of monetary policy. This led to yield curve inversion (due to rising short-term interest rates) and tightening credit conditions which triggered a financial crisis and an economywide credit crunch that caused a recession. **Exhibit 6** shows these financial crises going back to the 1960's, most preceded by tightening monetary policy, and the subsequent recessions that followed. Past federal fund rate hiking cycles tended to peak when the financial crisis hit. The Fed almost always responded immediately to previous financial crises by lowering the Federal Funds rate significantly. That helped to mitigate the credit crunch and shorten the recession. The one exception shown in **Exhibit 6**, is the recent mini-banking crisis, which occurred in March 2023, when Silicon Valley bank, Signature Bank and First Republic banks failed. The collapse of these banks once again highlighted the financial system's vulnerability during periods of rising interest rates. However, the Fed averted a credit crunch by rapidly providing liquidity through a new emergency lending facility called the "Bank Term Funding Program". The Fed did not have to lower rates rapidly at that point, as happened in every other credit crisis, as this potential credit crisis was averted.

Exhibit 6: Fed Funds Rate & Financial Crises (Mini Banking Crisis)

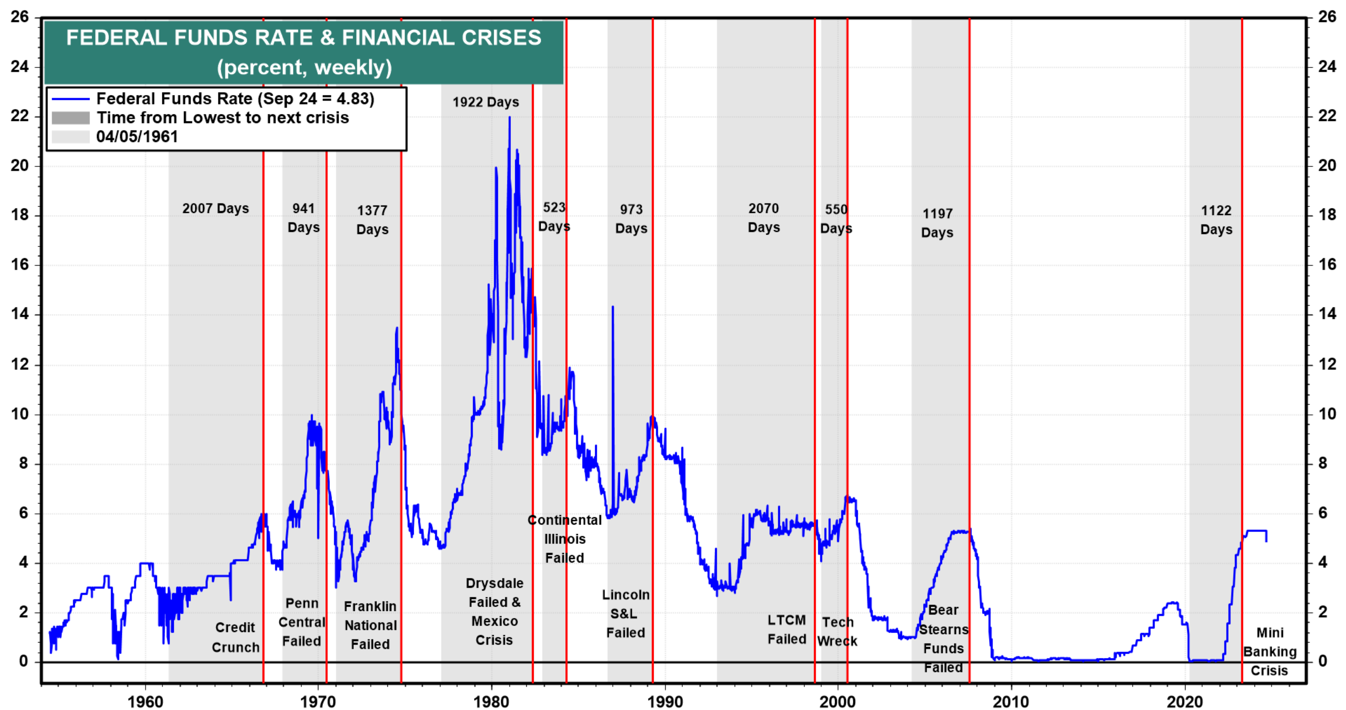


Source: Yardeni Research, 9/25/2024

Other proponents of an upcoming recession theory believe that even as the yield curve dis-inverts (short-term rates coming down resulting in yield curve steepening), the lag effect of higher interest rates continues, and the economy will further deteriorate. This long and variable lag theory can't be ruled out; however, consider that 30-year fixed rate borrowing for mortgages and long-term corporate borrowing have somewhat sheltered the private sector from higher rates and interest rates are now heading lower.

Exhibit 7 looks at the historical period from when the Fed Funds rate bottomed, until the financial crisis/ credit crunch began (grey shaded areas) that ultimately led to recession, going back to the 1960's. The timeline of this current cycle does not look much different from the rest, the exception being there has been no major financial crisis / credit crunch. One could also argue that since most monetary tightening cycles ended with a financial crisis and credit crunch, the long and variable lag period was the period heading up to the mini-banking crisis, which we passed 18 months ago! It remains to be seen if enough borrowers will have to refinance their debt at higher rates causing further financial stress, but the fact that the Fed is now lowering rates should provide some cushion to this possible outcome.

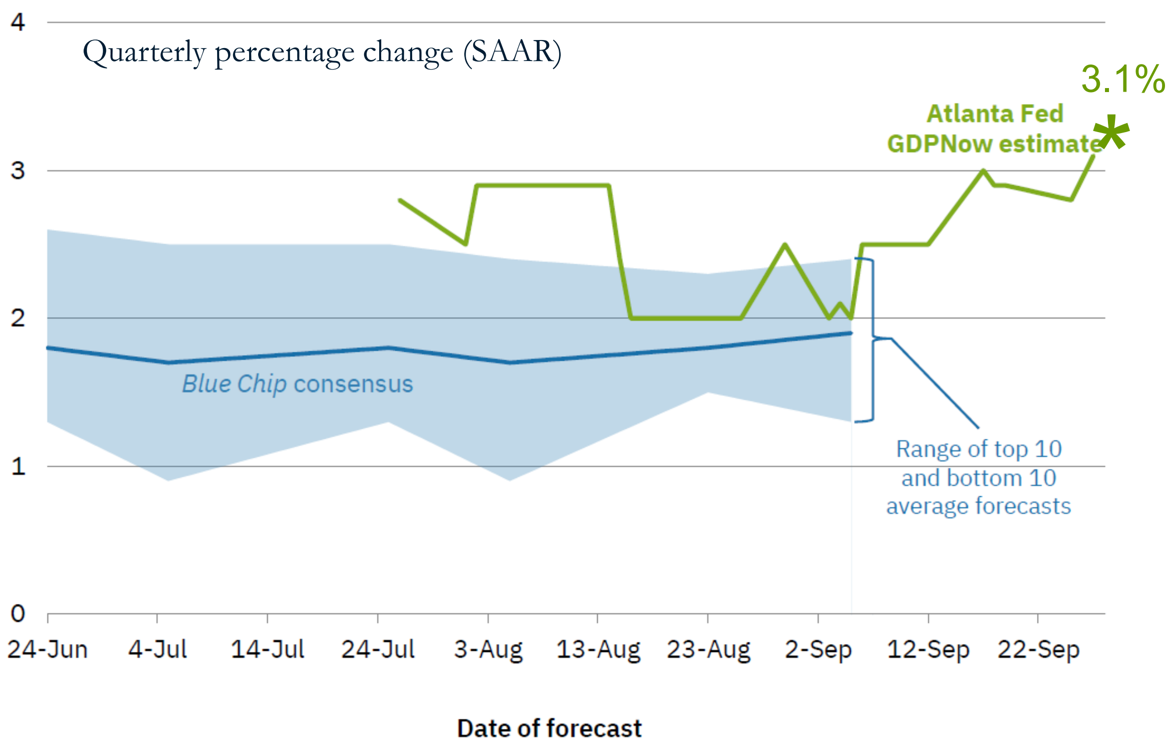
Exhibit 7: Fed Funds Rate & Financial Crises



Source: Yardeni Research, 9/25/2024

Turning to the most recent estimates of economic growth, the GDPNow model prepared by the Atlanta Fed is an estimate of real gross domestic product (GDP) growth. **Exhibit 8** shows the GDPNow estimate for the third quarter of 2024. It currently sits at +3.1% as of September 27th. That compares to about +2.2% during the first half of 2024. The growth rate of GDP is a key indicator of economic activity. While this is not an official forecast of the Atlanta Fed, it is best viewed as a running estimate of real GDP growth based on all available economic data for the current measured quarter, and again it is a long way from the two consecutive quarters of negative growth that defines a recession, and even well above the Fed's own target of 2% for 2024 GDP shown in **Exhibit 1**.

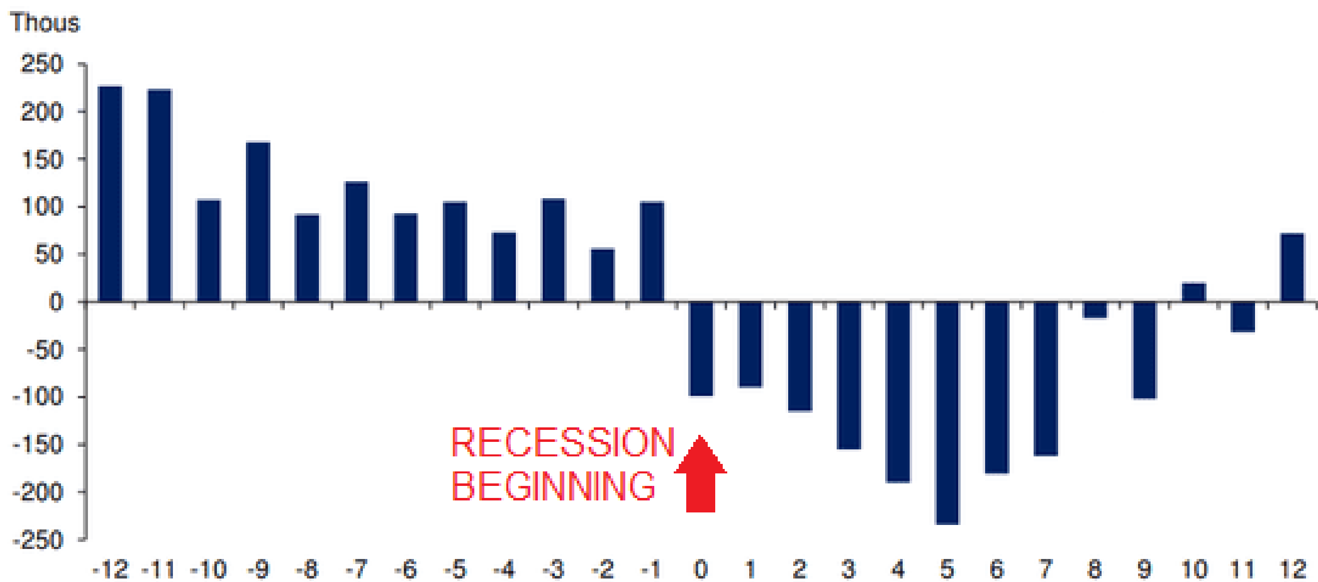
Exhibit 8: Atlanta Fed GDPNow Real GDP Forecast for 2024: Q3



Source: Federal Reserve Bank of Atlanta, 9/27/2024

Exhibit 9 looks at the median path for the Non-farm Payroll's growth in the 12 months around US recessions going back to 1945, where "zero" in the chart represents the first month of the recession. As indicated in the chart, the start of a recession is heavily aligned with the first month that payrolls turn negative.

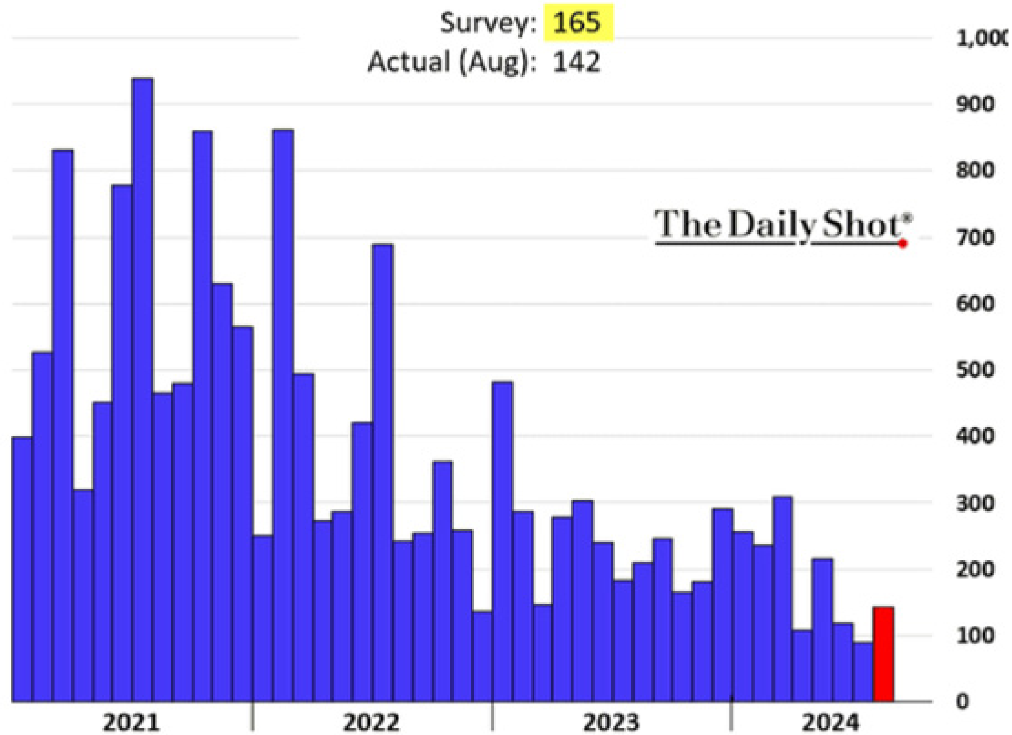
Exhibit 9: Median Path for Non-farm Payrolls in the 12 months around U.S. Recessions since 1945



Source: Daily Shot, Deutsche Bank

Exhibit 10 shows the recent trend in the US Non-farm Payrolls which, on a three-month basis, is running slightly higher than 100,000 per month, and is close to the breakeven rate for job creation, or the number of new jobs the economy needs to create each month to keep the unemployment rate stable. And so far, in this cycle we have not seen a print lower than this and certainly not a negative one as is typically associated with recessions.

Exhibit 10: US Nonfarm Payrolls MoM in '000



Source: Daily Shot

Exhibit 11, the black line, shows high yield credit spreads (yield on high yield bonds relative to US Treasuries) going back to the 1990's where the blue horizontal line represents the average spread over time and the shaded red vertical areas represent recessions. As indicated in the chart, during periods of economic stress (i.e. recessions), historically, credit spreads widen considerably as bond holders demand a higher premium for taking on more risk. Even with the recent volatility experienced in the stock market through August and September, it has not been enough to cause credit spreads to blow out, suggesting that the market is not worried about elevated risk of default. In fact, the current credit spread level is significantly below the average by almost one standard deviation (red horizontal line).

Exhibit 11: US Corporate High Yield Spread vs U.S. Treasuries (Red Vertical Bars=Recession)

Source:Bloomberg, ICE BofA H0A0 Index, 9/5/2024

Exhibit 12 looks at the performance of the S&P500 Regional Bank Index (blue line) for the past 20 years with recessions again represented by the grey vertical shaded areas in the chart. If we were in a period of economic stress where banks were tightening credit, and loan growth was shrinking, regional banks would likely not be performing positively as they are, let alone trading above their 200-day moving average (red line).

Exhibit 12: S&P 500 Regional Bank Performance

Source:Yardeni Research, 9/25/2024

Putting this all together, the latest GDPNow forecast, the payrolls data, the current level of credit spreads and the performance of regional bank stocks, does not suggest that we are even close to a recession. The fact that the Fed has so far successfully engineered bringing inflation down without causing a credit crunch would seem to continue to support the soft-landing outcome that we've been a proponent of for some time.

Asset Mix and Investments

Asset Allocation for our North American Equity Strategy As of September 30, 2024

Equities	97%
Fixed Income	0%
Cash	3%

Our overall equity exposure increased by 1% to 97% and cash decreased from 4% to 3% since June 30th, 2024. Our U.S. equity exposure is 55% while our Canadian equity exposure is currently 42%. Compared to a year ago our exposure in Canada has declined by 10%, while our US exposure has increased by 13%. 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.

Over the past 12 months, we continued to shift our allocation in favour of US equities (+13%) over Canadian equities (-10%) with cash declining from 6% to 3%. US earnings growth continues to outpace Canadian earnings growth so far in 2024, and this is estimated to continue in 2025 and 2026. While we are not calling for a recession in Canada, we do believe the risk of one is higher, with economic growth slower and unemployment higher here than in the US. That said, so far, we have been seeing interest rates decline faster here in Canada than in the US, which may mitigate that risk. It is worth noting that our Canadian companies have growing earnings, and many are globally diversified in terms of revenue sources despite having Canadian headquarters.

During the quarter, we added three new investments in NVIDIA Corporation, Eli Lilly and Company and Stantec Inc. Nvidia needs no introduction being the leader in the production of graphics processing units (GPU's) that power Artificial Intelligence (AI). It is a much-transformed company from the former gaming focus it once had. We took advantage of the macro-pullback in the market this summer to initiate a position at a now reasonable valuation as earnings continue to grow. The market was also concerned about supply issues with its new Blackwell chip, which is immaterial to the long-term supply/demand outlook for the company. Furthermore, many other Tech companies had recently reported higher capital expenditure forecasts, with much of that spending likely headed to Nvidia's products as companies race to better incorporate AI into their offerings. In healthcare, we decided to switch into Eli Lilly from a similar company, Novo Nordisk, in which we had over a 50% gain. While both Novo and Lilly are strong players

in the growing diabetes and obesity markets, several factors suggest that Lilly might offer a more attractive investment opportunity at this time. Its diversified portfolio, superior drug efficacy, deeper drug pipeline and longer patent protection contribute to a compelling case for the switch. In the industrials sector, we added Stantec, which is a global leader in engineering consultancy with a focus on water and infrastructure. With a strong 5-year compound annual EBITDA growth rate of over 20% and record current backlog, Stantec is positioned to continue to deliver strong operating results.

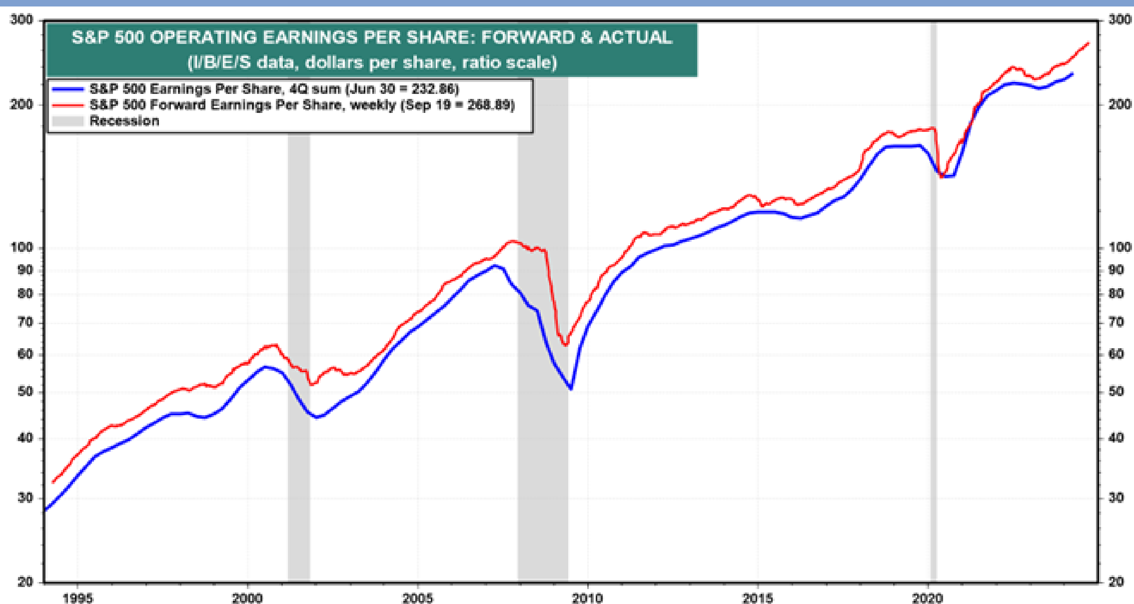
A complete review of the business and fundamental outlook for these companies can be found in **Appendix 1.**

Closing Comments and Outlook

The much-anticipated monetary easing cycle has begun against a backdrop, according to the Fed, of inflation moving sustainably toward 2%, an unemployment level that by historical standards would still be considered low and a stable real GDP growth outlook of about +2%. Our economic checklist including the latest GDPNow forecast for Q3, the payrolls data, the current level of credit spreads and the performance of regional bank stocks does not suggest any economic stress at this time.

S&P500's actual earnings growth of +11.9% bested the estimated earnings growth of +8.9% during the second quarter 2024, according to FactSet Earnings Insight. **Exhibit 13** compares S&P500 weekly forward earnings estimates (red line) to the trailing four quarter earnings (blue line). As indicated in the chart, forward estimates are a pretty good proxy for actual trailing estimates and forward estimates are hitting all-time highs with an earnings growth outlook for 2025 and 2026 of up 15.1% and 12.4% respectively.

Exhibit 13: S&P 500 Operating EPS - Forward (red) & Actual (blue)



Source:Yardeni Research, 9/25/2024

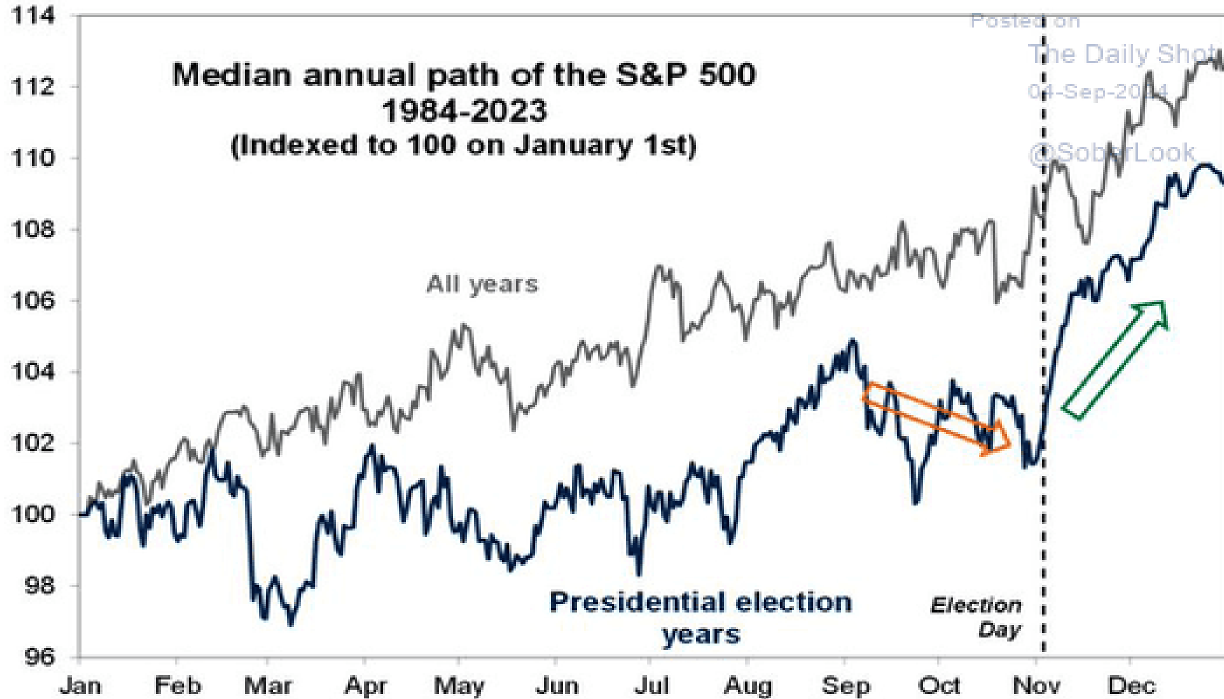
Exhibit 14 compares eight easing cycles going back to 1982 and measures the performance in both 12 months and 2 years following the initial rate cut. While the overall performance on average for all cycles was positive +11.3% after 12 months and +21.0% after 2 years, it did vary considerably. Years where the economic back drop remained positive and forward earnings were rising (6 of the 8 periods), which is where we think we are today, stocks performed quite well. If these trends continue, we think the current easing cycle should be a tailwind for stock price performance.

Exhibit 14: S&P 500 Price Performance Around Initial Fed Rate Cuts

	Performance Period in Relation to Initial Fed Rate Cut			
Date of Initial Fed Cut	**-12 Months**	**+3 Months**	**+12 Months**	**2 Year Total***
10/1/1982	4.2%	15.1%	36.2%	41.8%
9/20/1984	-0.6%	-0.2%	8.7%	8.1%
4/25/1985	15.6%	4.4%	32.1%	52.7%
7/7/1989	19.5%	9.9%	10.3%	31.9%
4/6/1995	13.0%	8.1%	29.6%	46.4%
1/3/2001	-3.7%	-17.9%	-13.5%	-16.7%
9/18/2007	15.0%	-4.9%	-23.9%	-12.5%
8/1/2019	5.0%	3.2%	10.8%	16.3%
Average	**8.5%**	**2.2%**	**11.3%**	**21.0%**
Excluding Tech Bubble and GFC	**9.5%**	**6.7%**	**21.3%**	**32.9%**
Latest	**25.4%**			

Source:BMO Capital Markets, Belski et al., 09/13/2024 [Total price return for the period 12 months prior and following the initial Fed rate cut]

Exhibit 15: Seasonality of the S&P 500



Source: Daily Shot, Goldman Sachs

In conclusion, we think a robust earnings outlook, solid economic growth and lower interest rates is a positive backdrop for further share price appreciation. That said, we could see some near-term volatility leading into the U.S. election. **Exhibit 15** looks at seasonality of the S&P500 over the past 40 years (grey line) and compares this to election year periods (blue line). As indicated in the chart by the orange arrow, we are in this period of increased volatility during an election year. However, beyond the election, if history repeats itself, market performance usually improves and within that framework we just described, we remain constructive on the market outlook from here.

Peter Jackson
Chief Investment Officer

September 30, 2024

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

UNITED STATES

Eli Lilly and Company

Eli Lilly is the largest pharmaceutical company in the United States, with leading positions addressing diabetes, obesity, and recently Alzheimer's disease. With Mounjaro for diabetes and the recent approval of Zepbound for obesity, Lilly is set up for substantial growth over the next 5 years. The immense market potential for weight-loss treatment is underscored by the fact that over 40% of Americans are considered obese. Coupled with the urgent need for Alzheimer's therapies for an aging population, we believe its innovative therapies have the potential to improve millions of lives while also driving significant value for investors in the years to come.

NVIDIA Corporation

Nvidia is a leading designer and manufacturer of graphics processing units (GPUs), accelerated computing platforms, and AI software. The company's products are essential for powering AI and datacenter deployments, and demand for these solutions is surging due to the rapid growth of AI. Nvidia's leadership in accelerated computing has positioned it at the forefront of technological innovation, driving robust revenue and earnings growth. We purchased the stock opportunistically, following a pullback in the market, which brought the stock's valuation to reasonable levels as earnings continue to grow strong.

CANADA

Stantec Inc.

Stantec is a 30,000-person engineering consultancy with a focus on projects in water management (21% of revenue) and public transportation systems (27% of revenue). The business enjoys an excellent organic growth rate of 7% a year and this is supplemented by acquisitions funded by the strong free cashflow the business generates. Major US legislation like the Inflation Reduction Act and corporations' reshoring operations closer to home markets have recently provided additional tailwinds.

*Cumberland and Cumberland Private Wealth refer to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). CIC acts as sub-advisor to certain CPWM investment mandates.

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