OPTIMUM®
Global Asset Management

Financial Outlook

Second Quarter 2024

Summary

At a Glance

- The US economy is still strong after 2 years of FED tightening
- The market now expects about 75 basis points of rate cuts in 2024, in agreement with the FED
- Higher real interest rates have yet to impact the S&P 500 negatively
- The broader equity market offers better value than “The Magnificent 7” large Tech stocks
- The US equity market looks the least attractive relative to bonds since 2002

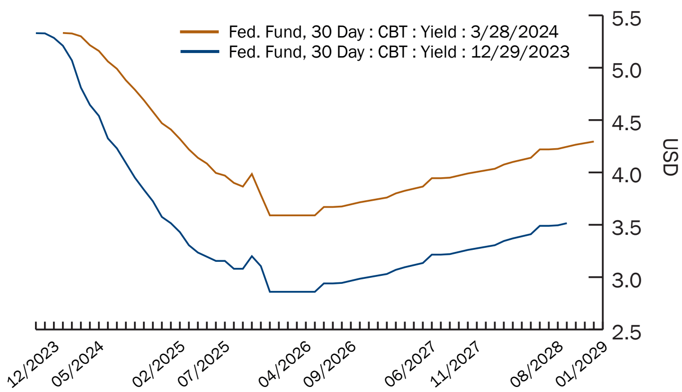
Point of View

Jan Erik Warneryd, Chief Investment Officer

Thus far, 2024 has offered a continuation of the seemingly unstoppable equity market rally seen last year. For the 1st quarter of 2024, the S&P 500 was up 10.56% after having been up 26% in 2023. Surprisingly, equities did well even in the face of rising Treasury yields, with the 10-year rising from 3.88% at the end of 2023 to 4.20% by the end of Q1.

While the market still expects rate cuts this year, the expected Fed (Federal Reserve) Funds rate at year-end 2024 has gone up from 3.745 % at the end of Q4 to 4.60% now. The market now expects about half the amount of Fed easing that it was expecting three months ago. In most circumstances, a less benign rate outlook would have a significant negative impact on the market, but not this time. Investors appear focused on the strength of the economy rather than worried about less monetary stimulus. The chart below shows the change in expectations regarding Fed Funds from Q4 2023 to Q1 2024.

Expected Path of Fed Funds at The End of Q4 2023 vs. Q1 2024



Source: Bloomberg

The bronze line is today's market (Fed Fund Futures) expectations, and the blue line shows expectations on December 29, 2023.

Analyzing market expectations is the first step in our investing process at Optimum Quantvest. We want to know what is "priced in." If the market is "right" and the priced-in scenario actually materializes, there is no added value to investors who positioned themselves according to the consensus. Only by taking a different view from the market's expectations can an investor add value. This is why we, after having established what the market expects (market expectations are actually the probability-weighted aggregations of many potential outcomes), contrast these expectations with our own. If there is a wide gap between our central outlook and market expectations, and we feel the risk is well compensated, we will consider taking a position against the consensus.

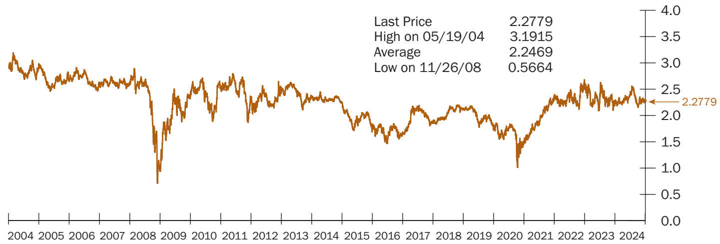
With this in mind, let's take a look at current market expectations:

As mentioned above, the market still expects **rate cuts by the FED this year**, although maybe only a total of about 75 basis points (which, coincidentally, is the FED's own consensus view according to the "Dot Plot"). A few months ago, the market was pricing in more than 150 basis points of rate cuts by the FED in 2024.

The slower pace of anticipated cuts is mainly due to inflation taking longer to approach the FED's 2% objective while the economy is strong.

In terms of the longer-term **inflation outlook**, according to the TIPS (Treasury Inflation Protected Securities) market, the rate over the next 30 years will be about 2.3%, which is fairly close to where it has been for the last 20 years (see chart below)

30-Year Inflation Expectations According to The TIPS Market



Source: Bloomberg

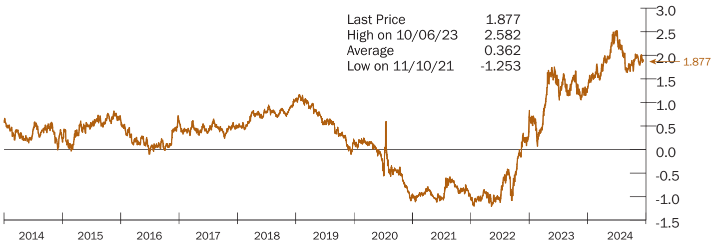
This outlook strikes us as too optimistic. We have just experienced a period of significant price rises that still hasn't ended but the market appears to consider a repeat of inflation running above 2% for any period in the next 30 years to be extremely unlikely. Potential disruptive factors such as de-globalization and geopolitical tension do not appear to concern the market regarding the inflation outlook.

The outlook for **real rates** is much less optimistic, in particular relative to recent years. Until the FED started raising rates in 2022, the market expected real rates (interest rates after deducting inflation) to be **negative** for the foreseeable future. The chart on the next page shows real rates (the forward-looking real yield on TIPS) over the last 10 years. Note that before the pandemic, real rates on TIPS had been trading in a range of about 0 to 1 percent. In 2021, during the pandemic, real rates fell as low as -1.25%. Now we are at almost 2%, which is the highest rate in 15 years. The real rate of interest is an important input into asset valuation, since it allows an investor to compare assets on a like-for-like basis whether their return streams are real (equities and real estate) or nominal (bonds).

Point of View (cont'd)

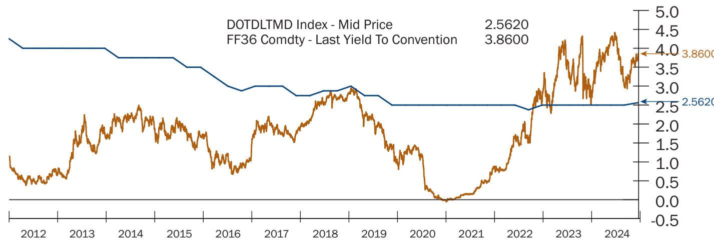
Jan Erik Warneryd, Chief Investment Officer

Real Yield on 10-Year TIPS



Source: Bloomberg

Market Expectations for Long-Term Fed Funds vs. FOMC Members' Expectations



Source: Bloomberg

The rise in real rates is good news for buyers of bonds since the forward-looking real return has increased significantly. The roughly 3% rise, from -1% to +2% between 2021 and 2023 was, however, a very difficult experience for bond holders. Most of the rise in nominal rates in the period was not due to rising inflation expectations, but rather rising real rates. As an example, the 30-year Treasury bond issued at par (100) in May 2020, is now worth about half of its issue price, while the yield has risen from 1.25% to 4.5%. Out of that 3.25% rise in yield, about 0.5% is rising inflation expectations and the rest is rising real yields. Mark-to-market losses in the fixed-income market as a result of rising rates is not surprising, but what is more puzzling is why the US equity market, which should have been impacted by the same rise in real rates, is close to all-time highs. Please see the equity section for a discussion of the relative valuation of equities vs. bonds.

Another perspective on the rise in yields is to see how the market's expectations have changed vis-à-vis the FED's expectations. I mentioned the FED's "Dot Plot" above: it's where the FOMC (Federal Reserve Open Market Committee) members anonymously share their forecasts for Fed Funds over the next few years. The median FOMC member forecast is very close to current market expectations: about 75 basis points of rate cuts in 2024. The FOMC members' forecast includes a "long-term" Fed Funds rate which is assumed to be the neutral rate beyond three years. The following chart shows how this rate was **above** the **market rate**, here represented by the Fed Funds Future contract 3 years out from any given point.

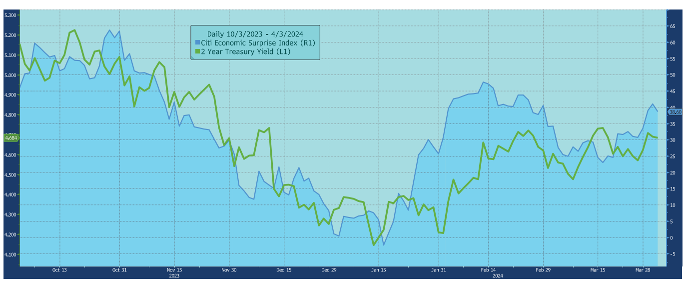
Since 2022, however, the FOMC estimate of long-term Fed Funds has been below the now, much higher, market estimate. The FED estimate has been stable over the last 5 years or so. It is currently just over 2.5%, but the market has changed its view significantly. When looked at in the context of roughly unchanged inflation expectations (about 2%) it is possible to say that the market believes that the FED will meet its 2% inflation target, but the "price" will be much higher for interest rates than previously thought. Reasons why real rates have shot up include market fears of unsustainable Government debt levels in the US and the seeming political unwillingness to address the issue. This is also consistent with the Corporate bond market, which is seeing spreads tighten versus Treasuries as the market sees a strong economy supporting business against a backdrop of massive budget deficits. The US Government is simply paying more relative to the corporate sector to finance its debt. If the market is correct, this change in real rate expectations is ushering in a very different market environment than investors have been used to since the 2008-9 financial crisis.

Bond Markets

Mark McDonnell, Senior Portfolio Manager

The economy continues to surprise to the upside. We have ways of tracking that, one of which is the Citi Economic Surprise Index. Citi and other banks look at average forecasts for various economic indicators and compare those to the actual results. As you can see in the following graph, the surprises were less and less positive until the start of this year. That encouraged the markets to price in an aggressive series of Federal Funds cuts, starting in March. Indeed, at the end of September the markets priced in a bit over three cuts through the end of 2024 with Fed Funds ending the year at 4.50%. As the fourth quarter unfolded the upside surprises, which is still a good thing for the economy, were more and more muted. This encouraged the markets to price in an additional four cuts with the expectation that we would see Fed Funds at a bit over 3.50% at the end of 2024. The new year brought a host of economic indicators that surprised to the upside. This has led to a reevaluation of the potential for cuts. As the chart shows, we saw a continued series of stronger and stronger upside surprises, leading to the unwinding of expectations for an aggressive easing cycle. By the close of this quarter, we were pricing in less cuts than in September 2023. The chart illustrates in part the impact on the 2-year treasury note as those expectations were unwound.

Fundamentals Driving Yields



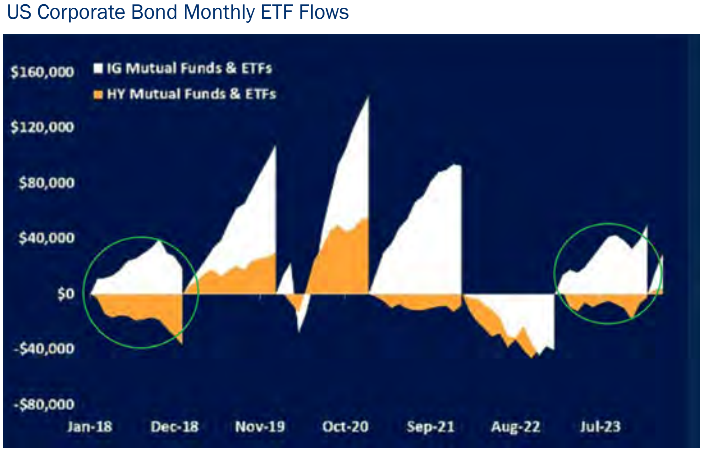
Source: Courtesy Bloomberg LLC

This unwinding of expectations for aggressive cuts from the Fed resulted in a rise in treasury yields across the entire yield curve with 2-year notes rising 37 basis points and the 10-year rising 32 in what is called a Bear Flattener. Since the total return of a bond is composed of both income and price change, this resulted in the shorter maturities out to two years actually having a very modest positive return while the 10-year, being longer and more sensitive to changes in interest rates, lost 1.5% over the quarter. The Bloomberg Aggregate Index lost a little more than three quarters of a percent -0.776% while the underlying treasury backbone of the Bloomberg Aggregate lost just under 1% at (-0.956%). Rounding out the other two thirds of the index, Securitzed which is mainly mortgage debt lost a bit less than the Treasury component at -0.909% and the clear winner was the corporate debt component. It lost -0.399%. This makes sense as credit spreads tightened to levels not seen since treasury yields were around 1.5%. That tightening in spreads resulted in a higher total return for a corporate bond than for a matched treasury. That tightening in spreads makes some sense in light of economic conditions coming in better than expected. It also makes sense in terms of what market participants have experienced over the last few decades.

The Great Financial Crisis saw the Fed drive interest rates below 1% and as they were normalizing rates a decade later Covid hit, driving rates to even lower yields with the 5-year note yielding less than a quarter of a percent at one point. In September of 2023, professional investors could buy a 5-year note at 4.50%, a rate they hadn't seen in 16 years. Add in 100 basis points or 1% additional yield which one could get for credit risk and investors bought that 5.50% yield time and time again over the last several quarters. As rates rose, spreads tightened. The question we ask ourselves is have spreads tightened too much.

As value driven investors, we see spreads on corporate debt at levels that compensate the investor for the credit risk incurred over the next several quarters. Tight? Yes, but with low unemployment and most aspects of the economy not dramatically out of balance, the prospect for risk assets over the next several quarters looks fair. Yet we run a modest underweight in credit exposure. Why? Because we believe we will be afforded the opportunity to cover that underweight at modestly more attractive levels. Professional investors bought corporate bonds as they hit their yield targets or bogies as we call them. However, as the chart below shows at the two points circled in green money flowed into investment grade ETFs *while money flowed out of high yield ETFs*. *Both* periods saw rising treasury yields. *Both* times saw the opportunity to invest in higher yields in investment grade debt and no longer needed to reach for yield by investing in junk bonds. The Treasury auction calendar continues to build as we auction off more and more treasury debt. Should we get a modest rise in interest rates during the even larger quarterly refundings market, participants may view the smaller yield offered by corporate credit as inadequate and invest in the underlying treasuries instead. We call this "crowding out". It would afford us the opportunity to purchase corporate debt as a well needed discussion on Federal deficit spending starts to occur.

US Corporate Bond Monthly ETF Flows



Source: Bloomberg Intelligence

Bond Markets (cont'd)

Mark McDonnell, Senior Portfolio Manager

We may get an opportunity before several quarterly refundings pass. Markets are fickle. We are also aware that at these tight spreads the margin for error is somewhat slim. The following is a chart that calculates the Breakeven Spread. In this example, the Breakeven spread is the spread widening needed to negate the increased yield one gets for investing in the corporate component of the Bloomberg aggregate Index. Should spreads widen by 12 basis points, one would have been better off investing in treasuries.

Timing Allocations Becomes Very Important

Source: Courtesy Bloomberg LLC

STRATEGY

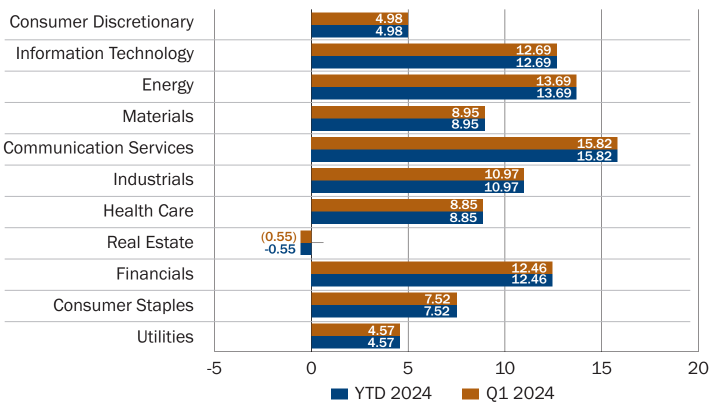
We are positioned very modestly longer than the index in duration as we see rates at the upper end of the near-term range. We are at index weight in Mortgage securities and hold a very modest underweight in Credit.

U.S. Equities

Jan Erik Warneryd, Chief Investment Officer

The first quarter of 2024 saw continued strength in the US equity market. The total return for the S&P 500 was 10.56% and the rally was led by Communication Services, Energy, IT and Financials. All sectors were up except Real Estate. See below for sector returns.

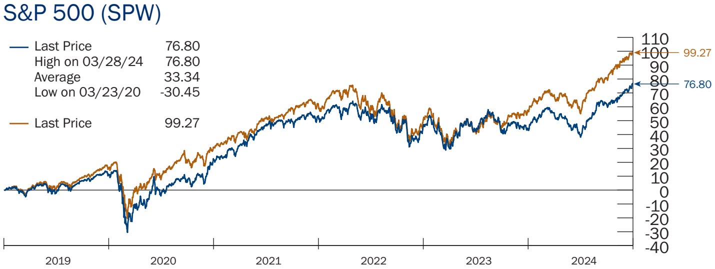
S&P 500 Index
Total Return (%) by Sector - Quarter End March 2024



Source: Optimum Quantvest and S&P Global

Although there has been a recent tendency for the rally to broaden beyond "The Magnificent 7" stocks (Meta, Alphabet, Nvidia, Tesla, Amazon, Microsoft and Apple), one way to illustrate the continued dominance of a few, mostly large-cap technology stocks, is to compare the equal-weighted S&P 500 (SPW) with the broad capitalisation-weighted S&P 500 (SPX) Index. The chart below shows the respective total return of the two indices over the last 5 years.

Return on Capitalization-Weighted S&P 500 (SPX) vs. Equal-Weighted S&P 500 (SPW)



Source: Bloomberg

As we can see, the capitalisation-weighted S&P 500 has outperformed the equal-weighted version of the same index by a significant margin. The total return for SPX was 99.27% versus 76.8% for SPW over the 5-year period. The indices consist of the exact same companies but rather than weigh them by market capitalisation as the SPX does, the equal-weight index, as the name implies, gives each company the same weight. This results in an index that currently exhibits factor tilts such as Value (cheaper), Size (smaller), Beta (lower) and Momentum (lower). These factor exposures are mostly the result of the equal-weight index having lower weightings in the above-mentioned "Magnificent 7" and similar stocks. The Price/Earnings Ratio (P/E) of SPW is about 17.5 times estimated 2024 earnings and the dividend yield is 2.05% versus 21.5 and 1.44%, respectively, for the SPX.

It is interesting to note that, apart from the Momentum factor, the factor tilts in the equal-weight S&P 500 have historically led to outperformance rather than, as has been the case in the last several years, lagging performance. In essence, investors who prefer SPX over SPW are expressing the view that the higher the market capitalisation of a company is, the higher its expected return will be. Investors who are agnostic about the link between market cap and future returns should consider the cheaper SPW rather than SPX, especially in light of the latter's recent outperformance.

It is of course impossible to say exactly when the performance gap between the two versions of the S&P 500 will start to narrow, but a prudent investor would likely be well served by starting to re-allocate away from the cap-weighted S&P 500 into a more balanced portfolio.

Another measure we follow is the valuation of the S&P 500 relative to the US Treasury Bond market. The Equity Risk Premium can be defined as the yield differential, in real terms, between stocks and bonds. The chart below shows the history of the spread between the CAPE (Cyclically Adjusted Price/Earnings ratio, also known as the Shiller P/E) yield of the S&P 500 and the real yield on 10-year TIPS (Treasury Inflation Protected Securities).

Equity Risk Premium (S&P 500 vs. 10-year TIPS)

Source: Bloomberg

As can be seen above, at a yield advantage of 1.12%, the US equity market now offers the lowest risk premium over TIPS since 2002. The average yield advantage for equities over TIPS has been about 4% since 2008, but as discussed in "Our Point of View," the rise in real interest rates has ushered in a new era that may have changed the valuation framework that has been in place since the Financial Crisis of 2008-9.

It remains to be seen whether we will return to valuations seen in the late 1990's and early 2000's, where equities were even more expensive relative to the real yield on bonds than they are today. If the post-Financial Crisis framework still holds, US equities are very expensive.

U.S. Equities (cont'd)

Jan Erik Warneryd, Chief Investment Officer

STRATEGY

The US economy is still strong even after two years of tighter monetary policy aimed at bringing inflation down to 2%. Significant progress on inflation has been made, and the FED should be in a position to lower rates later in 2024, matching current market expectations. This creates a positive backdrop for financial assets, including equities. However, as noted above, overall valuations in the US equity market are stretched as a result of a rally led by large-cap tech stocks (The Magnificent 7). We believe better value can be found in the broader market and therefore prefer to have more exposure to the cheaper sectors in the S&P 500 such as Financials, Health Care, Utilities and the Telecom sub-sector.

Overall, with a Price/Earnings ratio of about 21.5 times estimated 2024 earnings, the S&P 500 Index is expensive but not in a bubble.

We think the best-performing sectors of late may ultimately underperform the broader market. Contrary to the historical record, Growth has outperformed Value as a return factor for a long time. While the timing is difficult to master, we believe there will come a time of outperformance by sectors such as Health Care and Financials and other sub-sectors with low valuations and stable cash flows.

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OPTIMUM QUANTVEST CORPORATION

We take a different approach to traditional US fixed income and equity investing by using a combination of macroeconomic and fundamentally based analysis. With a track record of over 30 years, we have assisted pensions, insurance companies, corporations, endowments, foundations and high-net worth individuals with their investment needs. Our approach to investing combines a macroeconomic perspective with an inherent value bias. We collaborate with our sister companies in Montréal and Paris to enhance our analysis of the markets. While our expertise is investment management, becoming a trusted partner and advisor defines our purpose.

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