Monday, June 10, 2024

SUMMARY-

I. Stocks hit fresh record highs on normalizing data.

II. Labor market remains strong but hints at upcoming softening.

III. Economic projections still show positive GDP ahead.

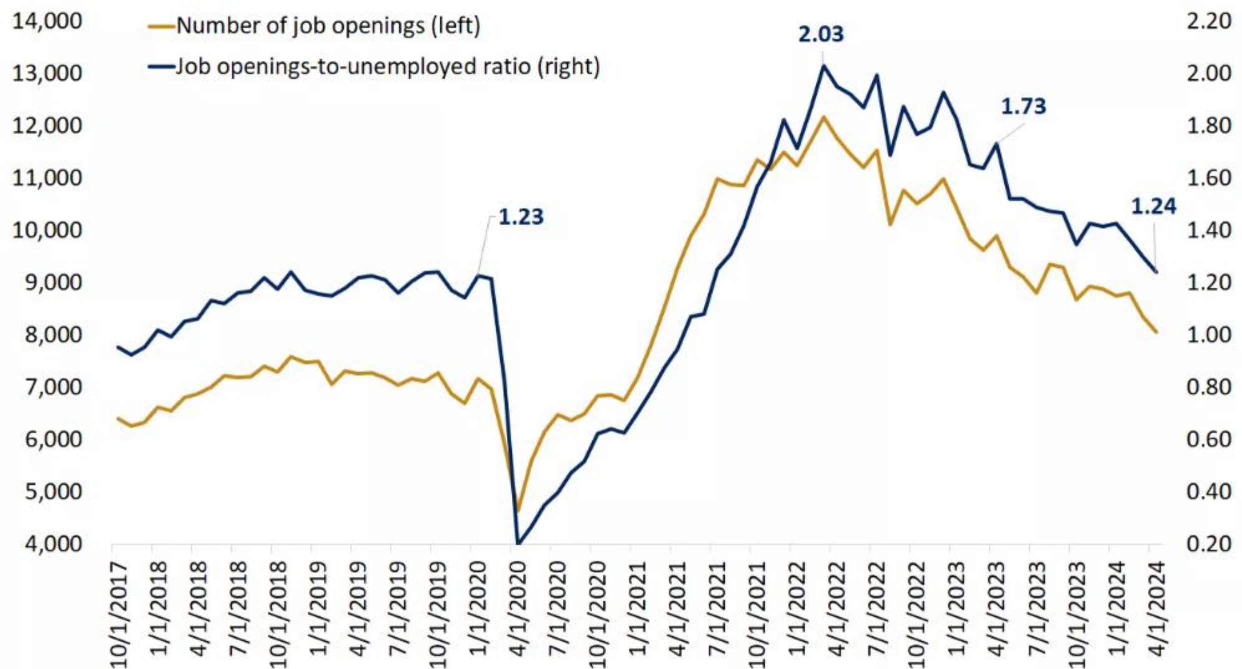
IV. Canada and Europe cut rates as Fed remains on hold.

Good morning:

U.S. stock indices rebounded from a modest setback the previous week as the NASDAQ and the S&P 500 eclipsed record highs set last month. Renewed enthusiasm over artificial intelligence lifted technology stocks, helping the NASDAQ's 2.4% weekly advance which outpaced more modest gains for the S&P 500 and Dow. Equity markets were also encouraged by signs that the labor market, economy, and central bank policy are all normalizing. Even the report released last week showing a much stronger than expected 272,000 new jobs created last month revealed other aspects of a slowly softening, but normalizing labor market.

The unemployment rate ticked up to 4%, the highest in 2½ years. Back in March 2022, there were two unfilled jobs for every unemployed worker. That ratio is now down to the pre-pandemic ratio of 1.2 to 1 as is the rate of people quitting their jobs voluntarily. Some economists see softer hiring ahead and slower wage growth, both of which are disinflationary.

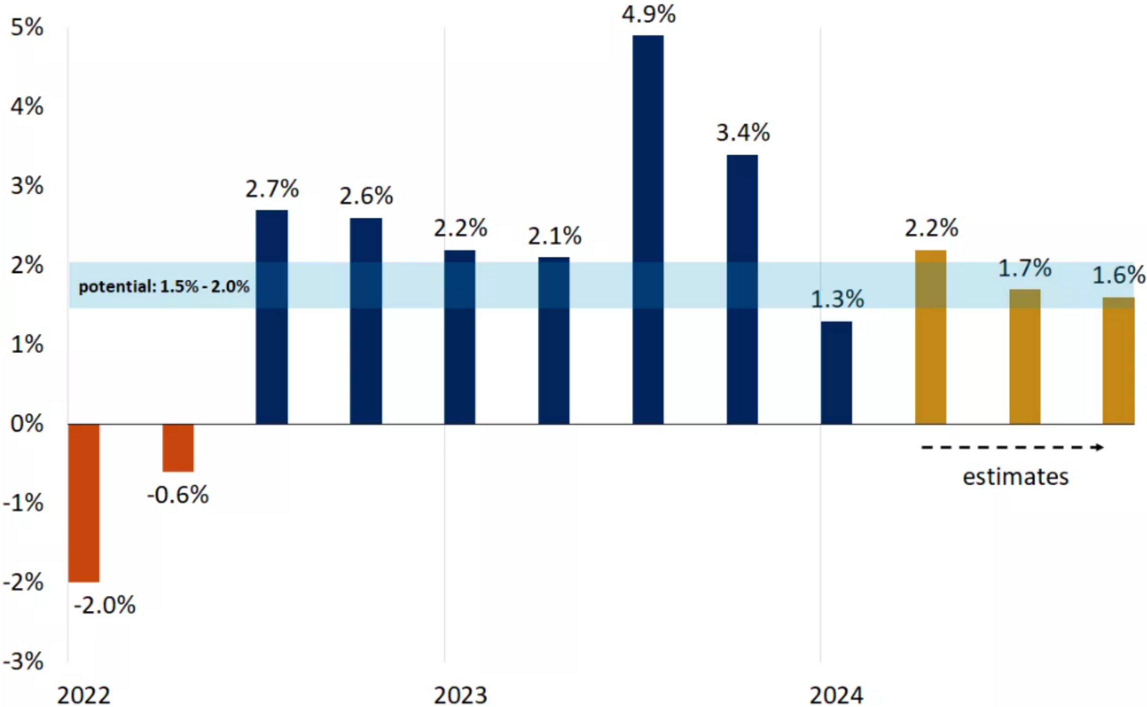
Demand for labor is gradually cooling, consistent with a healthy but looser labor market



Source: Bloomberg

Despite high inflation and the Fed's aggressive tightening campaign, the economy has been able to grow above 2% in the previous six quarters up until the start of this year. Excess savings accumulated in the early days of the pandemic, generous fiscal spending, and mortgages with low fixed rates have helped make the economy less sensitive to the sharp rise in interest rates. However, growing evidence suggests that high borrowing costs are slowly filtering through the economy. Low- and middle-income consumers suffer the most due to higher costs for virtually everything and are now pushing back against rising prices, as noted in management commentary from several retailers. Unlike 2021 and 2022,

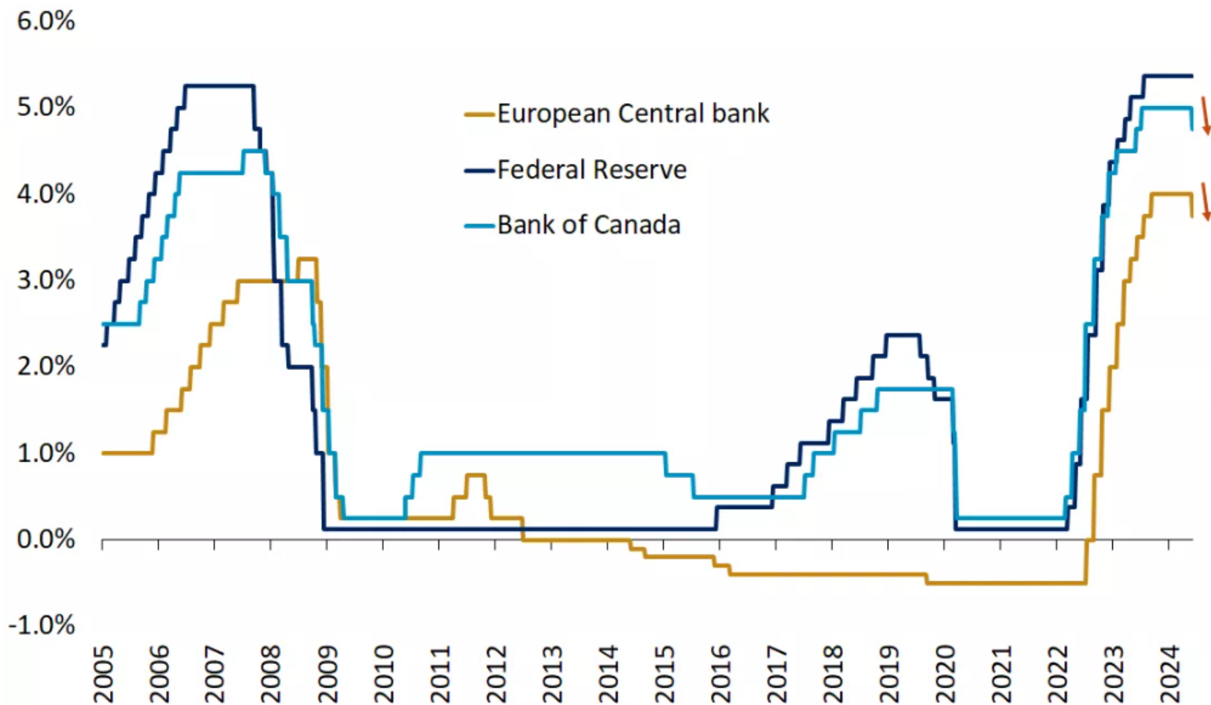
wage growth has been outpacing the rate of inflation over the past year, bolstering consumer spending. But with the labor market cooling and the progress on inflation stalling in the first quarter of 2024, real wage growth (adjusted for inflation) has slowed, affecting discretionary spending. Additionally, the recovery in housing and manufacturing activity is wobbly as of late, though the outlook for improvement remains. Based on estimates for population and productivity growth, the U.S. economy's potential growth rate is still currently positive at around 1.5% - 2% over the medium to long term. In other words, the "soft landing" scenario, that seemed so improbable not that long ago, now remains the most likely outcome of our current economic trajectory.



Source: Bloomberg

As a precursor to upcoming Fed easing, the Bank of Canada (BoC) and European Central Bank (ECB) both cut their interest rates by ¼% last week. Assuming inflation remains under control and on a downward path, this will be viewed as a measured first step in a multiyear rate-cutting cycle among G7 central banks. And while the Fed is not expected to follow suit when they meet this week, holding Fed Funds rate at a 23 year high of 5.5%, the focus will be on their new projections. The Fed's "dot plot" of expected upcoming moves will likely change from three cuts this year in March to only one or two by year end. With the economy showing growth, but inflation still stubbornly in the mid-3% range, markets have had to adjust expectations to their "higher for longer" message for the past quarter. Under the assumption that rates have peaked in this cycle, even *delayed* rate cuts have kept an underlying level of optimism to both equity and fixed income markets as hopes shift to a potential initial Fed rate cut in September.

The BoC and ECB cut rates for the first time in this cycle, Fed is next



Source: Bloomberg.

We remain cautiously optimistic that the U.S. economy will remain resilient and rate cuts will eventually come. During this upcoming period, we think chances are good for the many undervalued and lagging areas of the equity market to see renewed interest from investors. However, a declining interest rate environment, particularly among short-term instruments like CDs and money market funds, presents a level of reinvestment risk not seen in quite some time. There is still time to lock in higher rates for longer time periods or reallocate to a historically better performing asset class with a portion of sidelined cash that may not be needed for upcoming purchases or liquidity.

Reinvestment Risk

- When interest rates fall, the coupon payments on the bond are reinvested at lower rates

Have a great week!

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