Quarterly Commentary

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The U.S. Election: Predicting the Unpredictable

Over the past several years, financial and business media have been dominated by two things: inflation and interest rates. As the U.S. Federal Reserve and central banks around the world have grappled with inflation, pundits have been focused on foretelling the future of markets one-quarter-percentage-point at a time. But as Jerome Powell and the yield curve have stolen the highlight reel of late, nothing can compete with the blinding lights of the quadrennial circus that is the U.S. election. This version of the circus has been particularly spectacular — complete with not two but three primary candidates! And so the punditry have dutifully followed the spotlights away from the boring, measured tones of Jerome Powell, and shifted their focus to foretelling the market's destiny according to which ringleader is set to head the circus for the next four years.

We need only go back to the election of 2016 to reveal the folly of predicting the unpredictable. At that time, Hillary Clinton was all but certain to win, and markets would surely crater if Donald Trump somehow proved victorious with his unusual campaign. When the 2016 Presidential race was nearing its final days, pollsters showed an 80% chance of Hillary winning. On election day, November 8th, 2016, all three major U.S. Indexes posted their largest one-day gain since March of that year, while volatility recorded its biggest drop since June. The FBI had just cleared Clinton of any wrongdoing associated with her e-mail practices during her time as Secretary of State. Her chances of winning jumped to 90% based on the final Reuters/Ipsos poll. As the election results trickled in and the scales gradually tilted towards a Donald Trump victory, the S&P futures market began to plummet. And yet, by the closing bell the next day, all three major U.S. stock indexes were up by approximately 0.5%. Come December of 2017, the U.S. stock market had risen by more than 30%, leaving no shortage of whiplash among the punditry.

A Lookback on Recent History: Expectations versus Reality

- President Obama was viewed by the Republicans as an enemy of the markets and free enterprise — The stock market was up all eight of his eight years in Office.
- President Trump was viewed by Democrats as an enemy of norms and institutions; his erratic ways, coupled with tariff threats, would surely have drastic impacts on the economy — The S&P 500 was up 50% from November 2016 to the end of October 2020, despite the COVID-19 pandemic that rocked markets.
- President Trump was viewed as a pro-energy President (recall him signing the Executive Order approving TC Energy's Keystone XL Pipeline) — Energy was the worst-performing sector during his administration, while technology surged 150%, despite him spending much of his time fighting with the leaders of Big Tech.
- President Biden 'declared war' on energy, cancelling the same Keystone XL Pipeline via Executive Order on his first day in office, while also denying new permits on federal lands, and eventually halting new opportunities for LNG export — Energy was the best-performing sector during his term in office.

Indeed, a lookback through more Presidencies of the past shows that, while it is important to understand and navigate a U.S. President's economic policies, those policies require the support of both the House of Representatives and the Senate to pass into legislation, and seldom does that occur without significant amendments. Even then, a study conducted by US Bank looking back 75 years shows that Presidencies defined by one-party control of both the White House and Congress showed no statistical relationship to market performance. That same study concluded market returns are typically more dependent on economic and inflation trends of the time, rather than who the sitting President is and which party they align with.

With economics and inflation in mind, in our opinion, the elephant in today's U.S. election room is that neither Presidential hopeful is feigning any interest in dealing with ballooning fiscal deficits. Annual budget deficits in the U.S. have been steadily on the rise since 2015. In the last year of Obama's Presidency, the budget deficit totaled $440 billion; 2023's deficit totaled $1.7 trillion. When President Trump took office in 2016, U.S. debt totaled $18 trillion; it was $27 trillion when he left office in 2020. On President Biden's watch, the debt level has risen a further $7 trillion. We would be remiss not to acknowledge the significant impact of the COVID-19 pandemic on the acceleration of debt in the U.S., and the world over. However, several years removed, current budget deficits remain inflated, and neither party seems too interested in austerity. This reality reflects a combination of increasing political polarization, entitlement-demographics, rising interest expense on accumulated debts, and, of course, the usual challenges associated with healthcare inefficiencies and decades of foreign adventurism.

We had previously pondered about governments potentially being biased towards letting inflation run at moderately higher levels as a means of managing the real cost of their debt (i.e. 'inflating debt away').

The general idea being, governments issue debt today that is due some time in the future, while in the interim, inflation reduces the real cost of that debt by eroding the value of future dollars used to pay for it when it comes due. However, with real interest rates hitting historical highs (that is, nominal interest minus inflation), the current environment has increasingly poured cold water on this concept. We have also pondered whether yield-curve-control ('YCC') may be forced back into fashion as a means of managing the cost of debt. This involves central banks attempting to control yields on longer-term bonds, as opposed to the current approach where they set only the overnight benchmark rate and let market dynamics price yields across the curve from there. Japan provides a real-world example of this, having practiced YCC in some form since the collapse of their real estate balloon in the early 1990s. Thirty years on, there is no shortage of distortion in the Japanese bond market.

While current governments and policy platforms point to continued deficit expansion, such policies will ultimately have consequences for future generations, and will force circus candidates of the future to address such consequences. In the meantime, from a market perspective, the historical data show markets and politics mix a lot less than we think — inflation, corporate earnings, and economic trends prevalent at the time tend to be much more important than the political ringleaders who happen to be in power. That said, in the short-term, markets can move on emotions, and as the November 5th election approaches, the pundits will continue to foretell the future, and volatility is more than likely to rise.

Borger Griffiths Wealth Management Portfolio Positioning

At Borger Griffiths Wealth Management, we track, monitor, and gauge the potential impact political events, including elections, may have on the economy, especially where abrupt policy changes are possible. However, it is impossible to predict the unpredictable, and we therefore manage portfolios based on our clients' investment objectives, risk tolerances, family dynamics, and goals, with a bias towards mitigating downside risk. The data show global economies are slowing, and our current outlook is that, regardless of who takes office as President, that trend is likely to continue, and we are positioning portfolios accordingly. We have taken profits in areas that have performed exceedingly well (including large-cap technology) and reduced exposure to economically sensitive sectors. We have increased exposure to fixed income assets that should continue to benefit from falling interest rates, and are also carrying higher levels of cash to take advantage of opportunities that may arise with enhanced volatility.

Market Commentary

The ongoing equity bull market flies in the face of one of the steepest and quickest rate-hiking cycles in modern times. There have been periods of time characterized by narrow market leadership — recent Magnificent Seven outperformance being a prime example — but Q3 brought about a healthy sector rotation and broad participation within the S&P 500. This was illustrated by the equal-weight S&P 500 index significantly outperforming the market-cap-weighted index during the quarter, up 9.6% compared to 5.9%, respectively. Ten of the 11 sectors in the S&P 500 posted positive performance, with Utilities and Real Estate leading the way at 19.4% and 17.2%, respectively. These two sectors were playing a bit of catch-up following the pummeling they took during the aggressive rate-hiking cycle of the past two years. Energy was the worst-performing sector over the quarter, falling 2.3%, followed by Technology, rising just 1.6%.

The U.S. Federal Reserve (the 'Fed') was fully expected to reduce interest rates by 0.25% in September, however, to the surprise of many economists and market participants, they instead delivered a 0.50% cut on September 18th. The decision for the 'oversized' cut was largely predicated on weakening employment data, which, you may recall, represents the other half of the Fed's dual mandate. Up until recently, this half of the equation had been drastically overshadowed by the inflation picture. However, with August inflation coming in at 2.5% (from 3.3% in May), the Fed's focus seems to have resolutely shifted to the jobs picture. The Fed's own forecast (as indicated by the so-called 'dot plot') shows they expect to cut rates by a further 0.5% this year. While markets were quick to price-in an additional 1.25% in cuts before year-end, recent jobs numbers have demonstrated some resilience, and so expectations for more accelerated cuts have been quelled somewhat. That said, regardless of the exact pace, investors should expect rates to drop through year-end and in 2025.

Canadian equity markets followed the U.S. higher in the quarter, with the S&P/TSX Composite gaining 10.5%. All eleven sectors posted positive returns. Real Estate jumped off its lows with a index-leading 23% gain, while Energy was the laggard, rising just 2.0% over the quarter. Although Canadian banks as a group reported significantly higher loan-loss provisions during the quarter, investors shook-off the news and lifted the sector by 17%, second only to Real Estate.

As we wrote in our Q2 letter, the Canadian economy continues to slow faster than our southern neighbor. Second-quarter GDP came in at 2.1%, driven predominantly by higher government wages and business spending, while consumer spending and net exports weakened. Jobs numbers have also deteriorated much more quickly than the U.S., with unemployment coming in at 6.6% in August. The Bank of Canada (the BoC) reduced its benchmark rate from 4.75% to 4.25%, driven primarily by slowing inflation, which hit the BoC's 2% target in August. The BoC is expected to continue to cut interest rates through year-end and through 2025, although the pace is likely to be faster than that of the U.S. Falling rates will no doubt be a welcome relief for heavily indebted Canadian households.

The Eurozone also had a positive quarter, up 3.7%, with real estate, utilities, and healthcare leading the way. Economically, however, this region continues to struggle as a deepening downturn in the manufacturing sector weighs on overall activity.

Japanese stocks had a very volatile quarter, reaching new highs in July, only to correct sharply towards the end of the month on the heals of the Bank of Japan's surprise move to raise interest rates. The Nikkei 225 Stock Average fell 5.8% on August 2nd, and by a dizzying 12.4% on August 5th, representing the worst one-day decline since Black

Monday in 1987. The surprise rate-hike was juxtaposed sharply against expectations for rate cuts in the U.S., which prompted a rapid unwinding of the so-called 'Yen carry trade'. (Put simply, the Yen carry trade has been a long-standing foreign-exchange trade in which investors borrowed at cheap Yen interest rates and invested in other foreign currencies — primarily USD — paying higher rates.) Although Japanese markets recovered over the quarter, the shockwave felt across markets served, if nothing else, as a reminder to investors how quickly markets and narratives can change.

Finally, Chinese stocks continued their seemingly never-ending downward march through much of the quarter. That is until the People's Bank of China finally stepped in with a 0.5% interest-rate cut on September 23rd, which allowed the SSE Composite index to post a 12.4% gain on the quarter. Despite the enthusiasm, we remain warry of Chinese stocks amidst rising political tensions with the developed world, and an economy that continues to struggle to move beyond its dependence on massive, government-led infrastructure projects.

Fixed Income

The third quarter ushered in the start of the rate-cutting cycle in most major economies. In the U.S. bond market, 10-year Treasury yields moved into the 3.6% range on softer economic data and inflation, which made further progress towards the Fed's target range. This quickly reversed course following the most recent jobs report, which once again prompted 10-year yields to jump above the 4% mark. With the anticipation rates would begin to fall, our team continued to take advantage of higher rates offered in fixed-income assets over the prior year. However, the window of opportunity to lock-in decade-high yields looks to be closing rapidly in Canada, as data continue to point to further rate cuts. That said, although rates have retreated from their peaks, yields on fixed-income assets remain attractive, particularly on a risk-adjusted basis. With the outlook for continued interest rate cuts globally, our team has diversified into strategies that offer compelling opportunities to take advantage of this trend. We also continue to monitor key economic data points that will influence the future path of interest rates, including: GDP, job and wage growth, inflation, growing fiscal deficits, and the potential for punitive tariffs.

Borger Griffiths Wealth Management Team Update

We would like to extend a warm welcome back to Maddie MacDiarmid (née Mailey) as she returns to the team from her recent maternity leave. We would also like to take this opportunity to thank Aehwa Mun for the tremendous support and commitment she provided to our team, and the very high level of service she provided to our clients while covering for Maddie. We are very pleased to announce that Aehwa will be continuing her career within TD Wealth Private Investment Advice in Calgary.

The Borger Griffiths Wealth Management team thanks you for your business and continued trust in us. We look forward to continuing to work with you and your family as we help navigate your financial journey with deep knowledge, diverse experience, and commitment on your side. If you have any questions or issues you would like to discuss, we would be happy to receive your call.

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Sources: Nasdaq Market Review, Bloomberg, JP Morgan Asset Management, US Bank, Reuters, FiscalData.Treasury.Gov, Oaktree Capital Management, Mauldin Economics, BCA Research, TD Wealth Investment Office, TD Economics, FactSet