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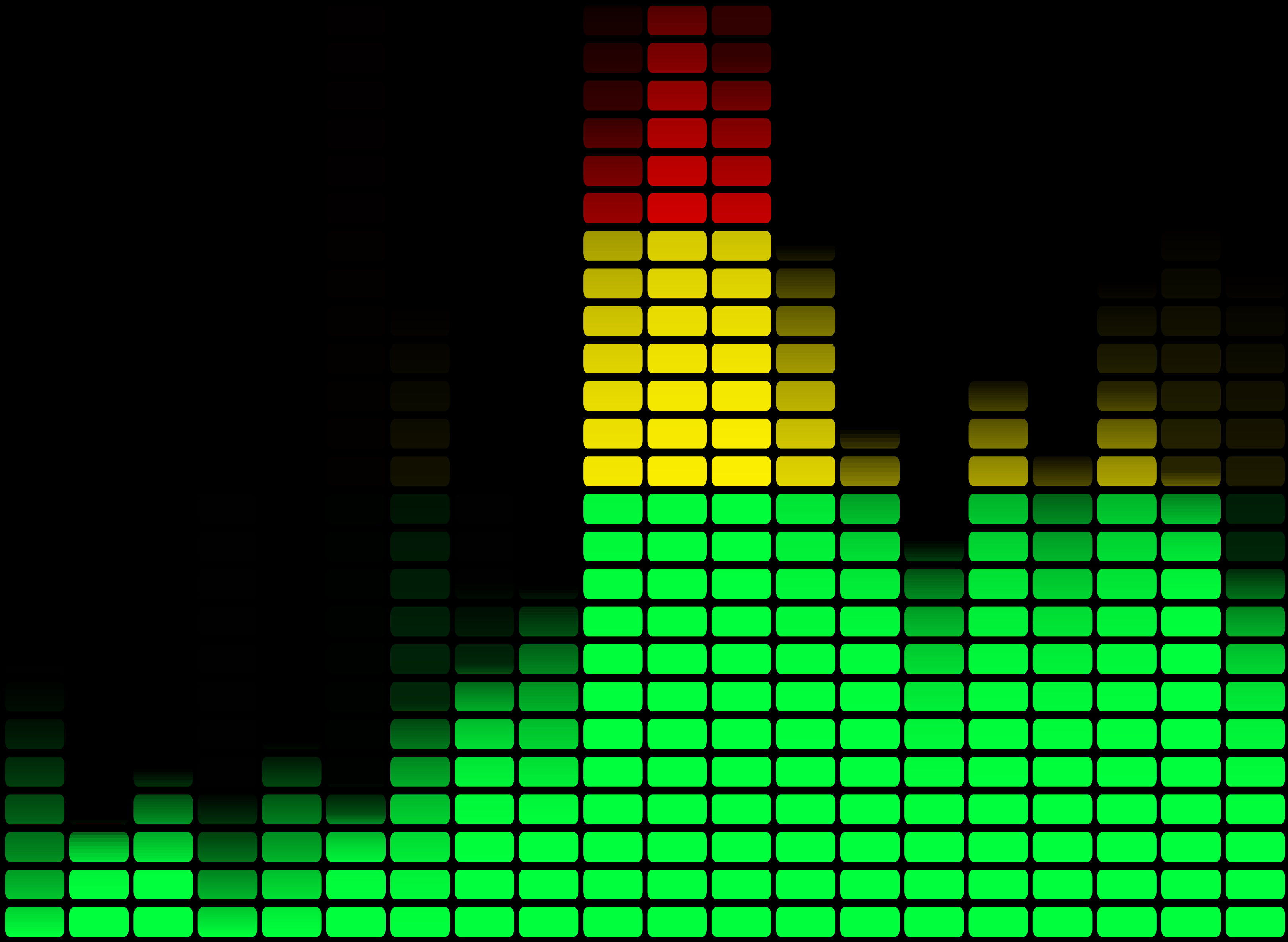

Quiet No Longer

Monthly Perspectives
August 19, 2024

15 minutes

Quiet No Longer

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In our most recent *Portfolio Strategy Quarterly (PSQ* Q3, "All Is Quiet"), we drew attention to the oddly calm environment we saw during the first half of 2024. We then explained this lack of volatility by pointing out a few of the peculiar things that characterized the markets in the first half of the year— like unusually high concentration, historically low correlations and expensive tech and credit, all amid simmering geopolitical risks in an election-filled 2024.

This all pointed to one thing: the market setup seemed vulnerable and market sentiment far too complacent. When the market is this quiet, after all, a lot of things can become catalysts for a significant reversal — and when that reversal happens, as we wrote, it would be very fast.

Well, it didn't take long for just such a catalyst to materialize, starting with the failed assassination of the Republican presidential candidate, Donald Trump. This event helped Trump's popularity in the polls and resulted in a quick surge for U.S. small-caps, marking the beginning of a reversal from the large-cap-dominated first half of the year.

From that point, a series of seemingly unrelated headlines acted like falling dominoes on the market. There was a report on a possible U.S. export ban on advanced semiconductor technology to China. This resulted in a sell-off of a few chip manufacturers, which was only exacerbated when, soon thereafter, Trump again made the news, suggesting that Taiwan — the most important microchip exporter in the world — should pay the U.S. for its protection.

Finally, on July 31, the Bank of Japan dropped the biggest domino of them all, ambushing the market with a rate hike and a surprisingly hawkish pivot. Japanese equities sold off quickly, leading the Nikkei to suffer its worst drawdown since 1987 — 12% in a single day. The ripple effect continued to weigh on global equity markets. The CBOE Volatility Index (aka the "fear index") rose from 23 at close on Friday to 65 pre-market on Monday, August 5. The speed and wild range of this rollercoaster ride rivals the most volatile episodes of the global financial crisis or Covid breakout in 2020.

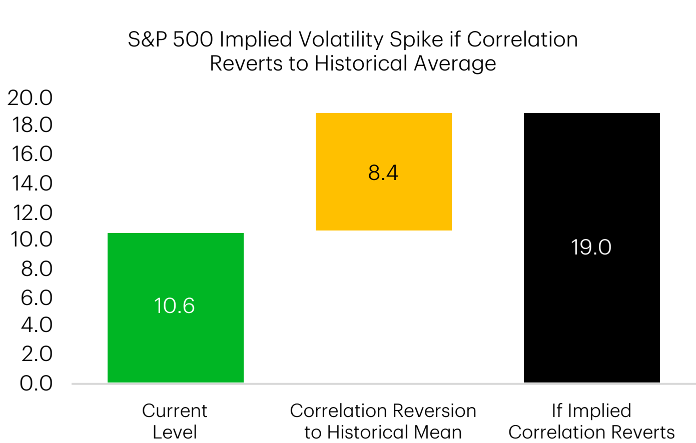
Not as bad as it seems

Normally such a sharp spike in the volatility index (VIX) would be a very bearish sign for investors. We are of the view, however, that the most recent spike is more likely a step towards normalization, given the low-volatility environment that prevailed at the end of Q2, and not a sign of deterioration in business fundamentals. In the *PSQ*, for instance, we noted that implied correlation among stocks within the S&P 500 had fallen to its lowest level since the inception of the VIX in 1993.

This low correlation was the result of a bifurcated market of extremes, where highly valued big tech names moved inversely to the rest of the market. In this sort of market — and particularly given the geopolitical situation — it was already likely that investors would eventually wake up to some macro driver that would bring correlations back to their historical norm. Doing so at the end of Q2 would have resulted in an 80% jump in the VIX, even without a spike in the implied volatility of individual stocks.

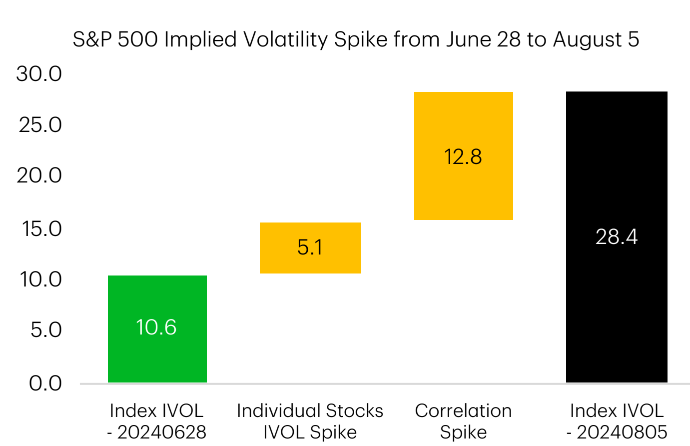
This is largely what occurred in early August. The one-month implied correlation coefficient (ranging from -1 to +1) of the largest 50 constituents of the S&P 500 index hit the historical low of 0.0293 before quickly rallying to 0.396 over three weeks, briefly surpassing the historical average of 0.394 — a truly remarkable pace. Figures 1 and 2 show two scenarios: (1) our analysis from the *PSQ* of the magnitude of a VIX spike assuming a return to the historical average; and (2) what actually occurred on that first weekend of August.

Figure 1: Theoretical VIX Normalization



Source: Macrobond, WIO as of June 28, 2024

Figure 2: Actual VIX Spike on August 5



Source: Macrobond, WIO as of August 5, 2024

The takeaway here is that, while the VIX has spiked almost 170%, the primary reason is the impact of a broad macroeconomic driver that forced divergent stocks to move together again, not the deterioration of fundamentals. Now, absent future negative surprises, the VIX could reverse again to trend lower slowly in the short run, but we believe the low is already in.

Will the Sahm Rule work this time?

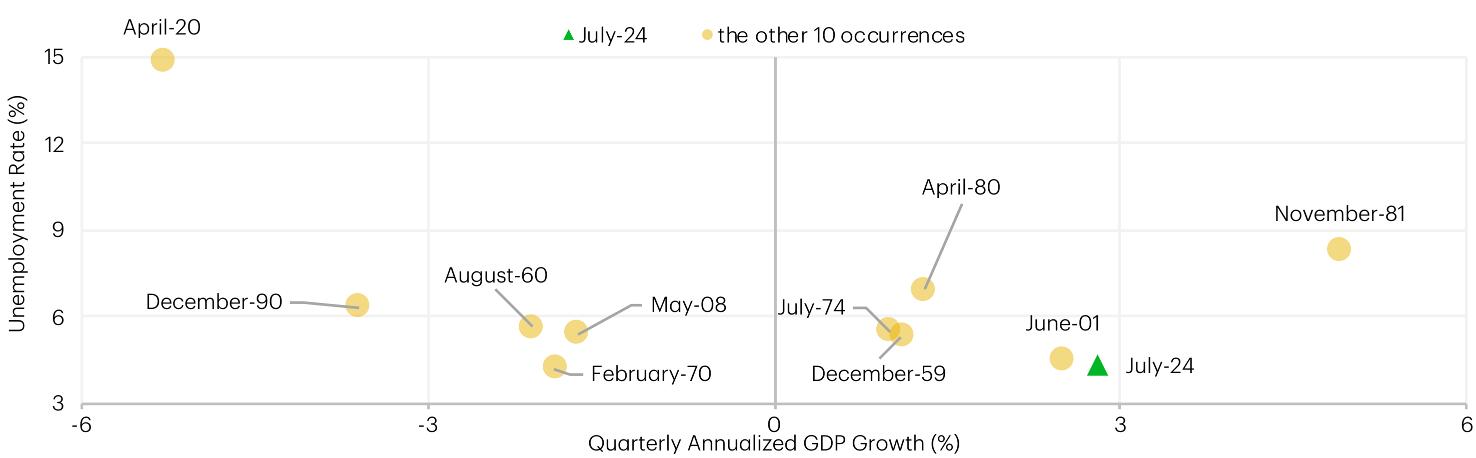
Besides the technical nuances associated with the spike in the fear gauge, a natural question is whether the economy is still on a path to a soft landing. In previous publications, we've often pointed out that the U.S. economy is so resilient because of robust employment. Going forward the health of its labour market will indeed be the main determinant of whether the Fed's landing will be soft or hard.

In early August, figures came in showing that unemployment had jumped 0.2 points, to 4.3%. We quickly realized that this data triggered the so-called "Sahm Rule," which links the start of a recession to when the three-month moving average of the jobless rate rises at least half a percentage point above its low over the past 12 months.

Apparently, we weren't the only ones to notice that a recession signal had blipped into existence. This unwelcome surprise sent the market-implied policy rate and bond yields downwards, and caused a sell-off and defensive rotation in the equities market, as well as a spike in the VIX.

To put this into a historical context, however, the Sahm Rule may not prove accurate this time around. Why? Because the Sahm Rule has been triggered 11 times, and this time, although the economy is slowing, it is actually in much better shape. As shown in Figures 3 and 4, the current economy is growing at a much faster pace, creating a lot more jobs and has much lower unemployment. In fact, Dr. Claudia Sahm herself stated in a recent interview on CNBC that it's unlikely the U.S. economy is currently in recession. We agree with her.

Figure 3: Far from a Recession



Source: Macrobond, as of August 2, 2024

Figure 4: Sahm Rule May Not Apply

	U-3 Employment Rate (%)	GDP QoQ SAAR	Payroll Change ('000)
December-59	5.3	1.1	540
August-60	5.6	-2.1	-34
February-70	4.2	-1.9	129
July-74	5.5	1	32
April-80	6.9	1.3	-145
November-81	8.3	4.9	-209
December-90	6.3	-3.6	-52
June-01	4.5	2.5	-115
May-08	5.4	-1.7	-190
April-20	14.8	-5.3	-20477
July-24	4.3	2.8	114
Median	**5.5**	**1.0**	**-52**
Average	**6.5**	**-0.1**	**-1855**

Source: Macrobond, WIO as of July 31, 2024

BoJ's move unwinds the yen carry trade

As mentioned, the Bank of Japan's hawkish tilt proved to be the biggest catalyst for the recent spike in volatility. On July 31, the BoJ — after years of steadfast dovishness — hiked its policy rate and announced a plan to wind down its asset-purchase program (aka, "quantitative easing").

This sent the markets into a veritable panic, impacting both the yen and Japanese equities. First, it set off a rewind of the yen "carry trade," where the depreciating and cheap-to-borrow yen is sold to fund the purchase of higher-interest currencies across the globe. This winning trade has been doing very well. For example, the S&P Risk Premia FX Carry G10 Index returned 13% over the first half of 2024, probably attracting significant amounts of flow along the way.

The big risk of this consensus trade is exactly the scenario that played out. When the BoJ pivoted hawkish, levered investors were caught by surprise. They had to buy back the yen in a hurry in order to close out their positions, leading the beaten-down yen to appreciate quickly. This put enormous pressure on Japanese exporters, whose yen-denominated revenues would sink on the stronger currency.

The collapse of Nikkei then triggered a circuit-breaker to halt trading at the Tokyo Stock Exchange — but this only made things worse. Even though equity trading had been halted, investors were still able to buy yen on the currency markets as a way of hedging their equities. This dynamic created a vicious cycle that led the yen to rise ever higher while the Nikkei braced for a steeper fall once the circuit breaker lifted. By close on August 5, the Nikkei had plummeted 12.4%, its worst day since 1987.

What should we make of this historical bout of volatility? Although the BoJ stated that the rate hike was meant to address the risk of inflation, we believe the unspoken objective here was to backstop the falling yen. Although the weakening currency had helped the economy attract visitors and buyers of Japanese exports, it was also threatening to add to the inflation problem over the long run, since Japan imports a lot of goods as well. Indeed, over the first half of 2024, there were a few instances where the Japanese finance ministry had to prop up the currency by purchasing yen in the foreign-exchange market.

At the root of it, the depreciating yen was the result of dramatically diverging monetary policies, with the Fed and many other major central banks tightening to combat inflation, whereas Japan's low-inflation economy allowed the BoJ, until recently at least, to maintain an ultra-accommodative stance.

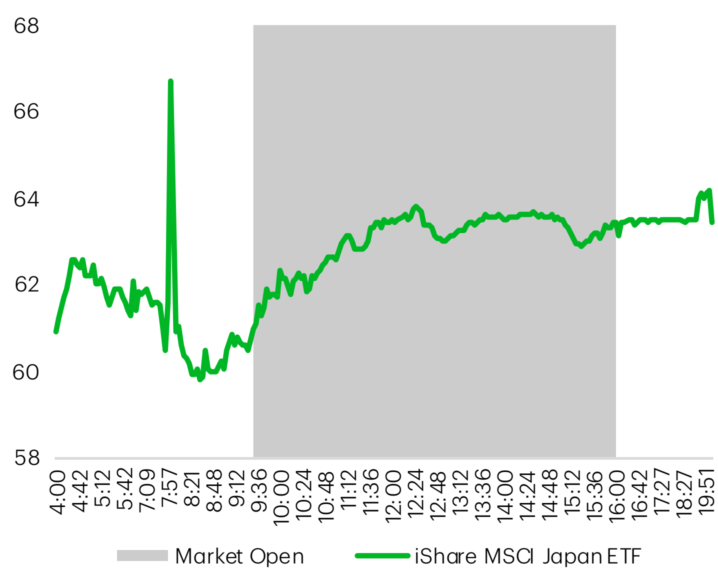
One thing to note during the sell-off is that, even as the central bank hiked its rate, the yield on Japanese bonds and the implied policy rate both fell. One explanation for this counterintuitive reaction is that such a huge equity sell-off would generate demand for Japanese government bonds as a safe haven. Our belief is that the market was merely expressing its forward-looking view — that the need for future hikes, given a 10% jump in the yen vis-à-vis the U.S. dollar, had already started to wane. This view was then affirmed on August 7 when the BoJ's deputy governor sought to reassure investors, saying that the BoJ would not hike rates so long as markets remained unstable.

Last but not least, we have to put the magnitude of the Nikkei sell-off in context. Markets, after all, do not go down 12% every day. When this sort of thing happens, it normally reflects extreme positioning and leverage as a result of crowding. And when a reversal happens, it happens quickly and violently, with the crowded positions squeezed. Excessive leverage and risk-taking are flushed out of the market.

All this is to say that, as the dust settles, rational buyers and sellers who were scared away from a volatile market will return. Investment teams will go back to discuss company fundamentals rather than how much exposure they should retain. The data-driven portfolio managers will turn on their algorithms again to find new investment opportunities in a calmer environment. The disruptive catalyst, in a sense, helps the market to restore balance.

One final observation we'd like to point out is the intra-day performance of the iShare MSCI Japan ETF on August 5 at the New York Stock Exchange (Figure 5). After the Nikkei's worst day since 1987, during North American trading hours, the most liquid ETF tracking the Japanese equity was actually stable and consistently trending higher. This reflects the market's expectation that the Nikkei was oversold, with North American buyers jumping in after what appeared to be a calamity.

Figure 5: Calm after the Storm



Source: Macrobond, WIO as of August 5, 2024

We remain constructive on bonds

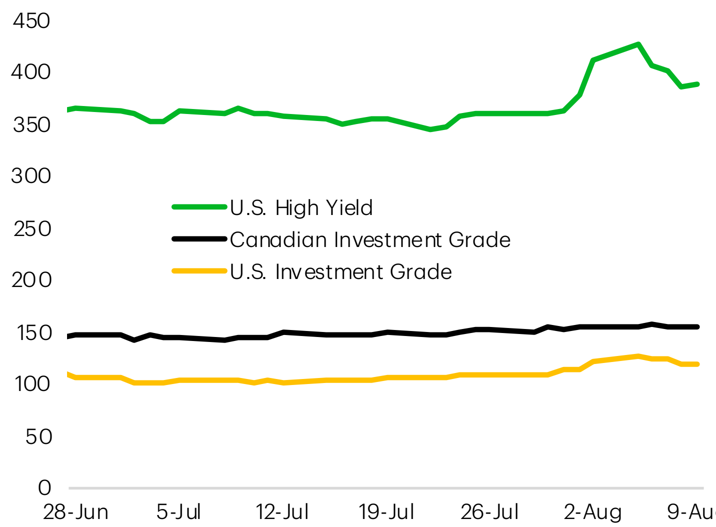
Turning away from all the drama of equities, a look at the bond market offers a refreshingly contrary perspective. First, while U.S. equities were sold off on August 2, bonds had their best day of 2024 so far (Figure 6). That may not seem like much of a surprise, but remember that over the past two years bond/stock correlations have remained unusually positive for most part. During this time, traditional diversification failed and so the balanced portfolio had a tough time. The performance of bonds during the equity sell-off suggests that the value of bonds as a diversifier has finally recovered.

The second thing to note is that the negative surprise from non-farm payrolls data quickly accelerated the pace of expected rate cuts. Although there will still be a few important data releases on employment and inflation between now and the next Fed meeting on September 17 and 18, we are no doubt one step closer to the beginning of the rate-cut cycle because the risk of the Fed falling behind the curve is increasing.

Last but not least, we note the remarkable stability in the corporate credit markets. Figure 7 shows the spread over government bonds for U.S. high-yield, investment-grade and Canadian investment-grade credit. At the end of Q2, the spreads for all U.S. high-yield and investment-grade credit were at the lower end of their historical range, making them expensive and vulnerable to negative shocks. We saw better relative value in Canadian investment-grade credit.

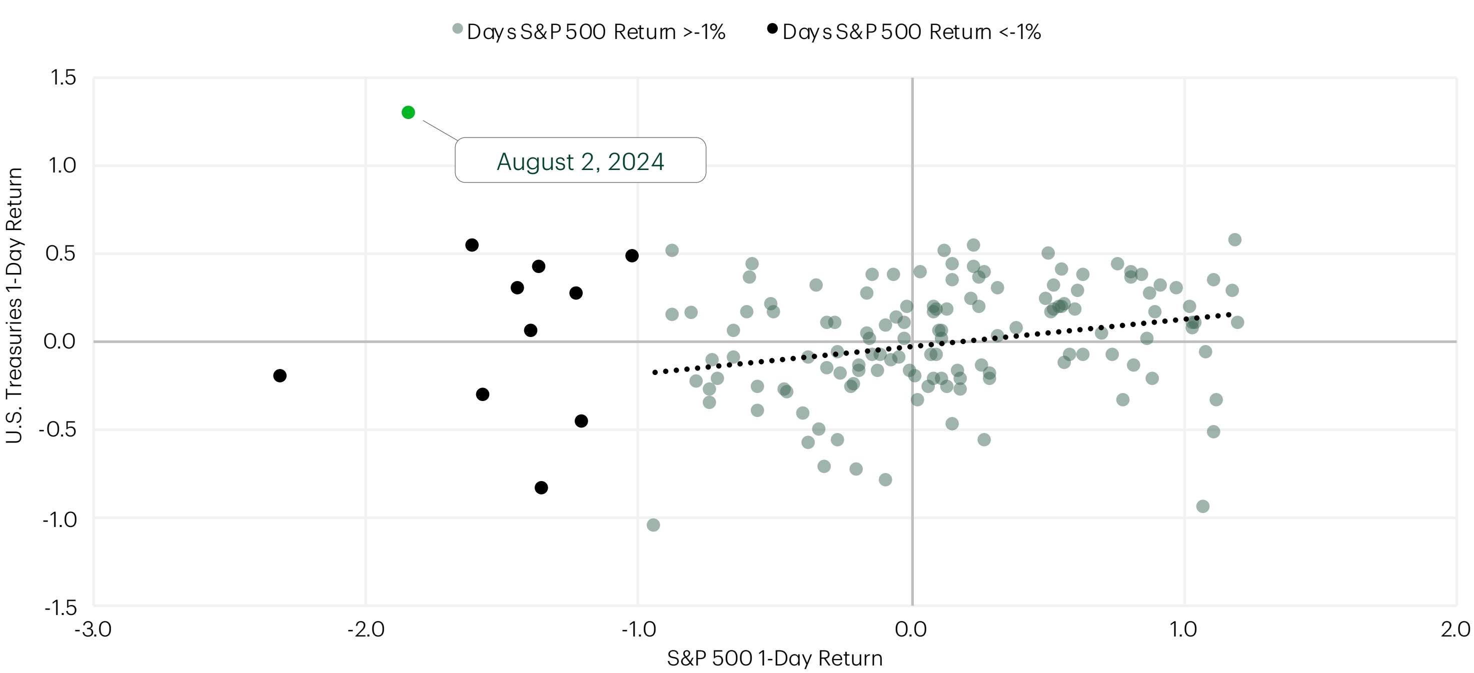
So far this quarter, credit has held up relatively well and continues to be aligned with the soft-landing narrative. We saw a modest spike in the U.S. high-yield spread and a small uptick in the U.S. investment-grade spread. Meanwhile, Canadian investment-grade credit seemed largely unfazed by the goings-on in Japan. Overall, this stability in credit has led us to maintain our constructive view on bonds, especially Canadian bonds.

Figure 7: Credit Spread over Government for U.S. High Yield, Investment Grade and Canadian Investment Grade bonds



Source: Macrobond, WIO as of August 9, 2024

Figure 6: Bonds Provide Valuable Hedge



Source: Macrobond, WIO as of August 2, 2024

Volatility could make stock-picking great again

The broad market sell-off at the beginning of the quarter also led to a significant style rotation. If the first half was a challenging environment for stock-pickers, where missing a few AI-related names could mean underperformance, the volatility in the third quarter not only reversed the dominance of the first-half winners, it suggested that cyclical names, smaller companies and defensive stocks could outperform in the coming months, depending on how market sentiment shifts.

Within the tech sector, we expect stocks with a more defensive posture to outperform their peers, especially if the threat of recession intensifies or if downstream AI application fail to gain traction despite the persistent rise in capital expenditures from the cloud providers.

Even in a sector as cyclical as semiconductors, where the recessionary impact is hard to deflect, some companies will benefit from the cycle-agnostic support to their earnings. For example, the suppliers of fabrication equipment are set to benefit from government subsidies aimed at supporting the onshoring of semiconductor production. Also, the U.S. governments' export controls target mainly advanced technologies, leaving a path for consistent revenue streams from the demand in China for legacy tools.

Thus, we prefer the cohort with secular tailwinds, instead of betting on the continued multiple expansion of big AI names, most of which are now priced for perfection. Figure 8 shows that, although the overall semiconductor index is priced at a sizeable premium against the S&P 500 after a significant drawdown, the non-AI semiconductor names are now trading at a discount to the broad index, offering a great value.

Conclusion

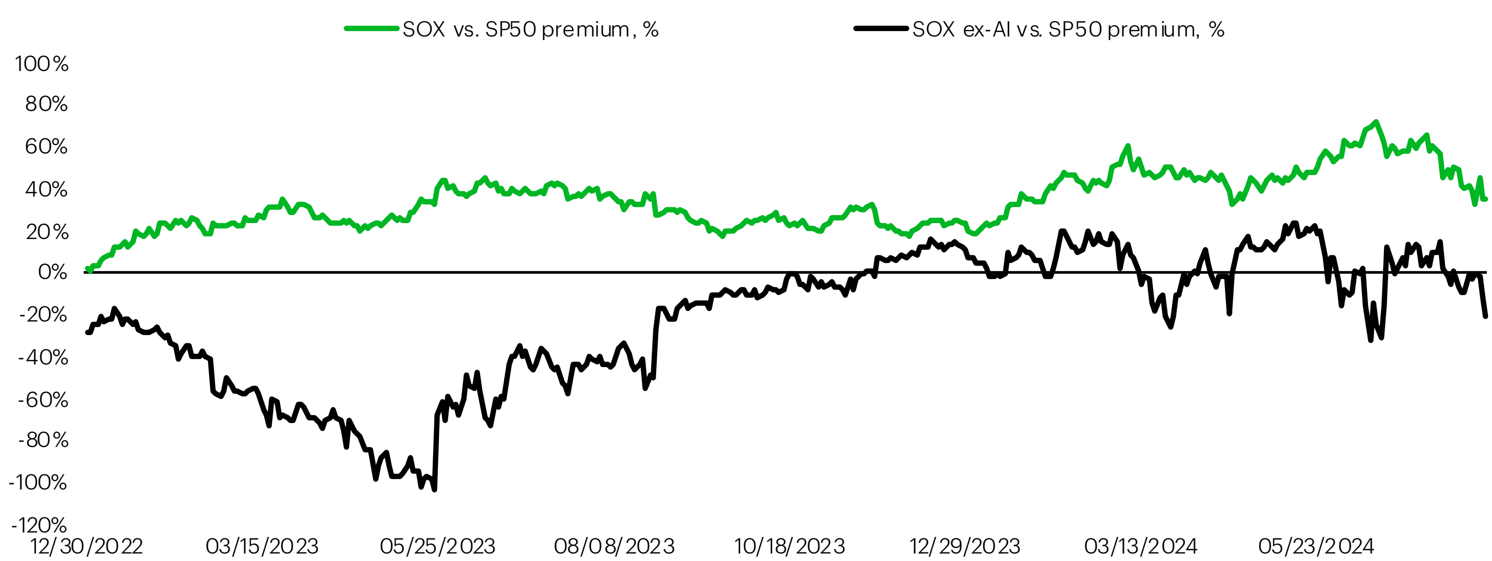
The turbulence of the last few weeks highlights the importance of sticking to an investment process that aligns with your individual goals and constraints. The recent volatility has not changed our overall outlook. A soft landing remains the most likely outcome for the U.S. economy and our asset-class recommendations remain unchanged, with a neutral view across the board. We expected to see a spike in volatility, and we were positioned for it.

Fixed Income: Overall, we remain constructive on bonds, particularly in the shorter-duration end of the universe, and we believe they will generate attractive returns for investors over the next 12 months. However, we also expect to see ongoing volatility in fixed income given the continued uncertainty related to fiscal policy and the timing of rate cuts. Bonds still provide diversification benefits, reduce overall portfolio volatility and preserve capital, all of which were highlighted during the market disturbance of early August.

Equities: We maintain a neutral outlook for equities. We also continue to prefer U.S. equities given the more resilient and attractive earnings outlook for U.S. companies. However, as noted, it's important to be selective in this market. We continue to believe that a barbell approach makes a lot of sense, with exposure to growth names as well as defensive and value names. In addition, as highlighted in the recent market swings, we believe it's important to also have some exposure to the small-cap segments of the equity market.

As noted in our recent *PSQ*, extended periods of market calm often end with a reality check. Peace time doesn't last forever. Being mindful of that, sticking to your process, staying diversified and adapting to the environment around you is always the best course of action.

Figure 8: Relative Valuation of Semiconductor Names



Source: FactSet, WIO as of August 14, 2024

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	94,359	5.87	7.26	12.28	15.73	7.72	10.46	7.41	8.21
S&P/TSX Composite (PR)	23,111	5.65	6.43	10.27	12.04	4.44	7.09	4.19	5.15
S&P/TSX 60 (TR)	4,606	6.10	7.00	11.30	15.49	7.78	10.65	7.91	8.60
S&P/TSX SmallCap (TR)	1,458	5.81	6.52	15.15	14.12	4.14	8.62	3.96	4.62
S&P/TSX Preferred Share(TR)	1974	2.25	5.23	16.76	21.70	1.62	5.76	2.47	2.83
U.S. Indices ($US) Return									
S&P 500 (TR)	12,052	1.22	10.05	16.70	22.15	9.60	15.00	13.15	10.54
S&P 500 (PR)	5,522	1.13	9.66	15.78	20.34	7.91	13.13	11.08	8.39
Dow Jones Industrial (PR)	40,843	4.41	8.00	8.37	14.86	5.35	8.74	9.45	7.21
NASDAQ Composite (PR)	17,599	-0.75	12.40	17.24	22.68	6.25	16.57	14.95	11.81
Russell 2000 (TR)	12,117	10.16	14.62	12.07	14.25	1.85	8.91	8.72	8.75
U.S. Indices ($CA) Return									
S&P 500 (TR)	16,642	2.20	10.47	22.01	28.11	13.37	16.13	15.87	10.76
S&P 500 (PR)	7,625	2.12	10.09	21.04	26.22	11.62	14.24	13.75	8.60
Dow Jones Industrial (PR)	56,396	5.42	8.42	13.30	20.47	8.97	9.81	12.07	7.42
NASDAQ Composite (PR)	24,301	0.21	12.83	22.58	28.67	9.91	17.72	17.71	12.03
Russell 2000 (TR)	16,732	11.23	15.06	17.17	19.83	5.36	9.98	11.33	8.96
MSCI Indices ($US) Total Return									
World	16,601	1.78	8.60	14.03	18.89	7.37	12.60	10.10	9.06
EAFE (Europe, Australasia, Far East)	11,640	2.95	5.36	8.86	11.76	4.17	7.88	5.35	6.45
EM (Emerging Markets)	2,854	0.37	5.01	8.08	6.68	-2.34	3.80	3.01	7.76
MSCI Indices ($CA) Total Return									
World	22,923	2.77	9.02	19.22	24.69	11.06	13.71	12.74	9.27
EAFE (Europe, Australasia, Far East)	16,073	3.95	5.77	13.82	17.22	7.76	8.94	7.88	6.66
EM (Emerging Markets)	3,941	1.34	5.41	12.99	11.89	1.02	4.82	5.48	7.97

Currency									
Canadian Dollar ($US/$CA)	1.38	0.94	0.22	4.27	4.69	3.44	0.92	2.39	0.18
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	8,368	2.50	2.75	8.21	8.68	5.97	1.98	2.20	3.25
Hang Seng (Hong Kong)	17,345	-2.11	-2.36	1.74	-13.62	-12.58	-8.99	-3.50	1.76
Nikkei 225 (Japan)	39,102	-1.22	1.81	16.85	17.88	12.75	12.68	9.61	6.39

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	4.42	3.09	3.16	3.21
US Treasury Yields	5.29	3.91	4.03	4.31

Bond Indices ($CA Hedged) Total Return	Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)
FTSE TMX Canada 91-day Treasury Bill Index	463	0.47	1.30	3.03	5.21	3.21	2.24	1.56
FTSE TMX Canada Universe Bond Index	1,144	2.37	5.36	1.99	7.34	-1.34	0.39	2.07
FTSE TMX Canada All Government Bond Index	1,075	2.42	5.59	1.50	6.69	-1.93	-0.10	1.78
FTSE TMX Canada All Corporate Bond Index	1,392	2.23	4.64	3.41	9.23	0.34	1.77	2.91
U.S. Corporate High Yield Bond Index	294	1.89	3.87	4.20	10.16	1.52	3.47	4.04
Global Aggregate Bond Index	257	1.88	3.56	1.67	5.34	-1.83	0.09	1.90
JPM EMBI Global Core Bond Index	522	1.87	4.39	3.69	7.98	-3.22	-0.84	1.97
S&P/TSX Preferred Total Return Index	1,974	2.25	5.23	16.76	21.70	1.62	5.76	2.47

Source: TD Securities Inc., Morningstar®, TR: total return, PR: price return, as of July 31, 2024

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