Quarterly Commentary October | 2024

Volatility returns to the markets

While there had been a relatively uninterrupted rise in global equity markets for much of the first half of 2024, volatility returned in the third quarter, prompted by a Bank of Japan (BoJ) rate hike that led to a messy unwind in Japan's yen carry trade and a rapid selloff in stock markets throughout the world. Investors such as hedge funds utilize carry trades to earn leveraged investment returns by borrowing in a low-interest rate currency such as the Japanese yen and use the borrowed monies to invest in stocks or other assets with the potential to earn higher returns. The yen's strengthening after the BoJ's hike forced borrowers to sell their stock positions to close out their more costly yen denominated borrowings. In early August, VIX (chart 1), the S&P 100 volatility index (frequently referred to as the fear gauge) hit elevated levels that are only seen in times of great market stress and usually associated with rapid panicked declines in the stock market. As has been the case for all this year, the weakness in stocks was fleeting. Both the S&P 500 and the S&P/TSX Composite Index have since rebounded to all-time highs.

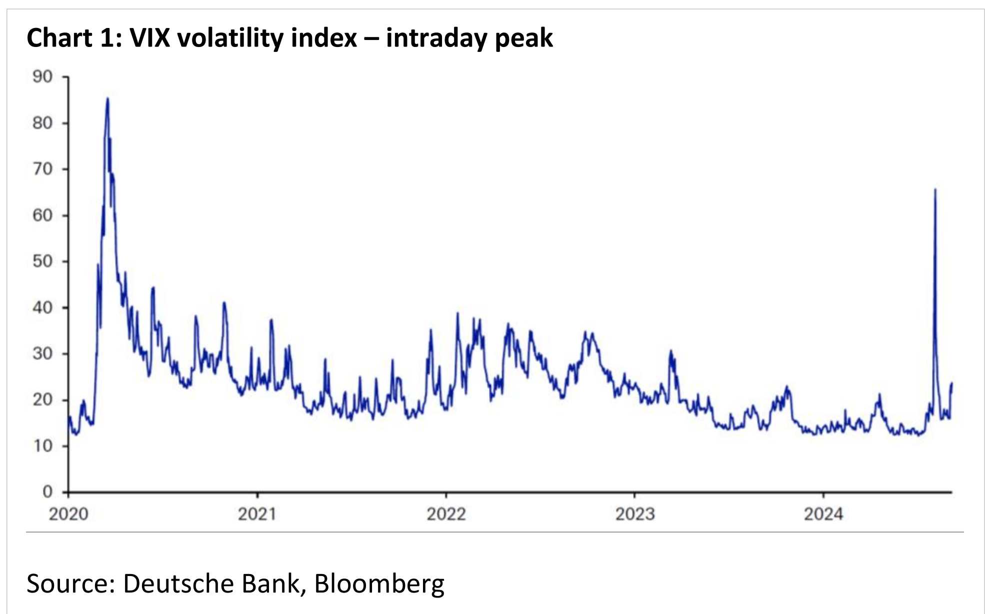


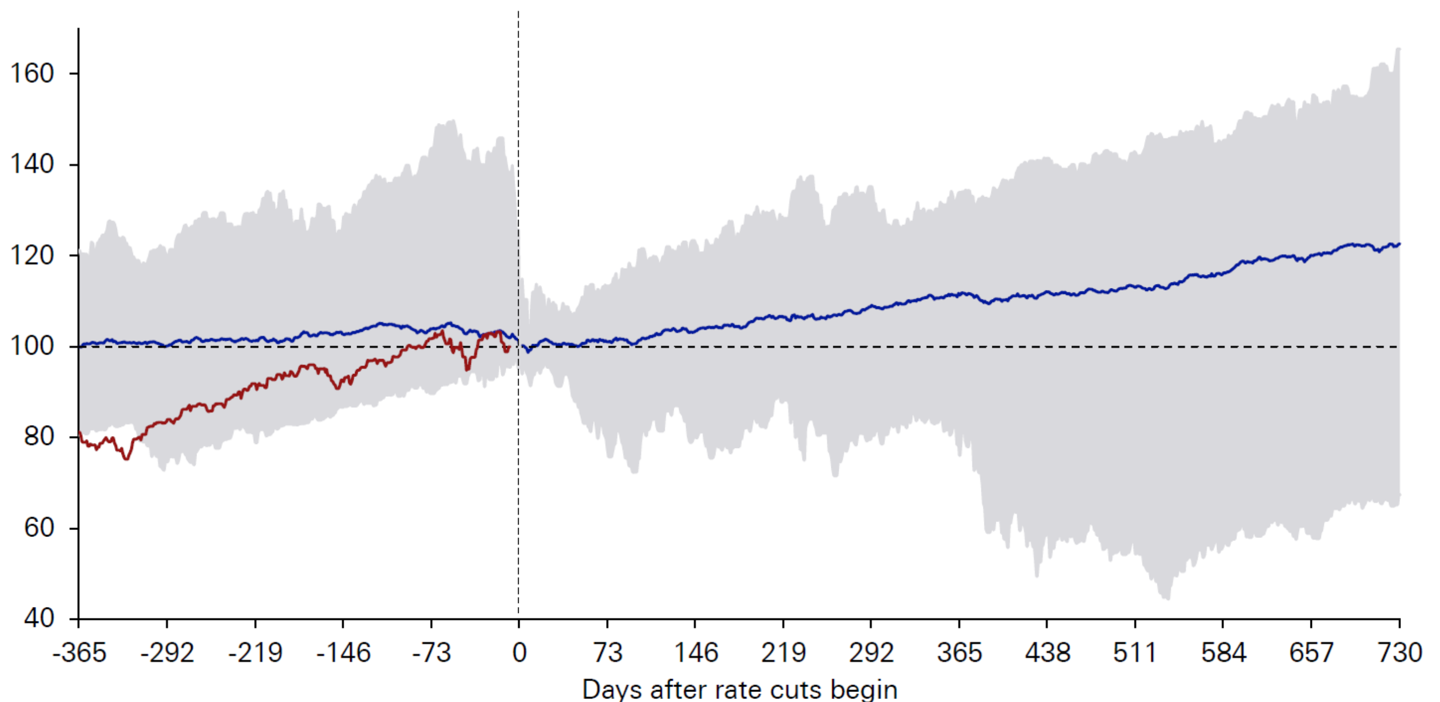
Chart 1: VIX volatility index – intraday peak

Source: Deutsche Bank, Bloomberg

While the top performers were dominated by technology companies, viewed as the big winners in artificial intelligence, pushing the tech-heavy Nasdaq Composite index to record highs in July, there has since been a big change in market leadership. Technology stocks have pulled back, and the Nasdaq Composite remains below its previous highs. Prior stock market laggards have garnered renewed investor interest and are now leading the broader market to new highs. Consumer staples, utilities, and dividend-yielding stocks have benefited from this rotation. Dividend stocks have re-rated as bond yields have declined on softer inflation data and in anticipation of more central bank rate cuts. The Bank of Canada has cut rates at three consecutive meetings, and the U.S. Federal Reserve commenced their rate cut cycle with a jumbo half-point cut in September. The challenge for central banks has shifted from a goal of getting inflation under control to now providing relief to households that have to contend with much higher debt servicing payments. High interest rates have hurt lower income and less wealthy families, as more of their cash flow is eaten up by a rise in their cost of living. Wealthy families, however, can benefit since their savings are earning higher rates of interest. The U.S. Fed is most concerned about the health of the jobs market that has shown some signs of weakening, albeit from a strong starting point. With the U.S. economy still growing at a healthy three per cent clip, and consumer spending continuing to

show resilience, the risks of a recession in the near term for the U.S. has diminished with this aggressive reduction in policy rates. It is interesting to note that the performance of the S&P 500 index after the initial rate cut depends on whether there is a recession around the corner or not (Chart 2). If rate cuts occur and a soft-landing (no recession) is the result, the stock market historically has done very well. However, if the cuts are not enough to prevent a recession, the stock market struggles in the immediate period afterwards. Given that this time around we have already seen strong gains in the S&P 500 before the first cut, any gains in a soft-landing scenario might be quite modest in comparison with what we have seen in the past.

Chart 2: S&P 500 performance before and after the first Fed cut in each cycle since the 1950s (current cycle in red)



Source: Deutsche Bank, Bloomberg

Investment Outlook

The U.S. election on November 5 could be a catalyst for a bout of market volatility in the coming months. The two candidates have polarizing perspectives on policy, though market reaction, particularly from a sector-performance basis to the eventual outcome could be short lived, as any change in policy could be difficult to pass unless the incoming President's party controls both chambers of Congress. Regardless of who wins, we can expect a tough stance on trade with China and continued regulatory scrutiny on big tech, particularly when it comes to mergers and acquisitions.
While the stock markets have performed well this year, stocks (particularly in the U.S.) are expensive by most valuation measures. Global economic growth has been disappointing, but the U.S. economy continues to be the standout, which is largely the reason why U.S. equities have outperformed their global counterparts, including here in Canada. The higher weighting in technology stocks in the U.S. versus other stock markets in the world can also explain the performance differential, although it will become more challenging for tech companies to maintain that growth trajectory in the coming

year. Most importantly, we continue to closely monitor the state of the economy and corporate earnings growth, given that a recession or soft-landing outcome would have massive implications for investment returns in the coming year.

Worth Allaye-Chan Investment Counsel | www.worthallayechan.com | worthallayechan@raymondjames.ca
Suite 2100-925 West Georgia Street, Vancouver, B.C., Canada V6C 3L2
T: 604.659.8066 TF: 1.855.659.8066 F: 604.659.8449

This newsletter has been prepared by Worth Allaye-Chan Investment Counsel, and expresses the opinions of the authors and not necessarily those of Raymond James Ltd. (RJL). Statistics, factual data and other information are from sources believed to be reliable but accuracy cannot be guaranteed. It is furnished on the basis and understanding that RJL is to be under no liability whatsoever in respect thereof. It is for information purposes only and is not to be construed as an offer or solicitation for the sale or purchase of securities. RJL, its officers, directors, employees and their families may from time to time invest in the securities discussed in this newsletter. It is intended for distribution only in those jurisdictions where RJL is registered as a dealer in securities. Distribution or dissemination of this newsletter in any other jurisdiction is strictly prohibited. This newsletter is not intended for nor should it be distributed to any person residing in the USA. Raymond James Ltd. is a Member Canadian Investor Protection Fund.