MAKING THE CUT

"The time has come for policy to adjust." Fed Chairman Powell's message at the recent Jackson Hole Economic Symposium required little in the way of interpretation:US policy interest rates are headed lower. While the writing has been on the wall for some time now, the headline debate is shifting from "when?" to "how many?" and whether the central bank waited too long to cut rates. Below, we opine on these questions and dig into the broader implications for global financial markets.

To start, soft US labour market data over the summer has once again ignited recession fears. Per the chart below, the Sahm rule (an early recession indicator) was triggered, whereby the 3-month moving average unemployment rate rises by more than half a percentage point above its 12-month low. This has come amidst a weak patch in payrolls data, with downward revisions to previous estimates further compounding concerns. However, the narrative that the Fed kept interest rates too high for too long is wide of the mark in our view. The rising unemployment rate has coincided with a rising labour force participation rate, meaning the supply of labour is growing as opposed to a faltering demand for workers (Claudia Sahm, the creator of the Sahm rule, has also downplayed imminent recession risk and advocated this interpretation). As for the payroll figures, job growth remains within the range characteristic of a "healthy" economy. While the recent softening in data warrants attention, it currently appears to be a temporary lull in an otherwise resilient US economy.

The conclusions drawn from the recession question above directly impact rate cut projections. Put simply, a relatively strong economy does not need significantly lower interest rates, and aggressive rate cuts could risk overheating and renewed inflationary pressure. However, in central banking, things are seldom straightforward. Historical precedent shows that once the Fed starts cutting, interest rates are usually lowered meaningfully thereafter. Additionally, there is a tendency to overshoot on the upside and downside as policymakers react to changes in the economy with a considerable lag. Our take is that a number of "sticky" inflationary pressures remain, and absent an expedient return to target inflation (headline and core CPI are currently at 2.9% and 3.2% year-on-year respectively), the Fed may cut somewhat less aggressively than past cycles.

The prospect of rate cuts has clearly emboldened bond investors, as fund flows and investor survey data indicate concentrated positioning. While lower policy rates should pull down short-term bond yields, we are less convinced about the direction of longer-term bond yields. The starting point is an inverted US yield curve, with the 10 year and 1 year treasury yields at 3.8% and 4.4% respectively at the time of writing. With rate cuts likely to support domestic demand and investment, coupled with our view that the US economy is already on solid footing, we see little reason for the yield curve to remain inverted (which generally signals an impending recession). That means that longer-term yields would either fall less than short-term yields, stay relatively unchanged, or perhaps even increase from current levels.

As for the almighty US dollar, rate cuts may remove a short-term interest rate differential advantage versus other central banks that have already begun easing, but there is little reason to expect that the Fed will now "outpace" its peers. However, if lower interest rates help reinvigorate

risk appetite in financial markets and the global trade cycle continues to firm, money is likely to venture further afield in search of growth and income opportunities. This would put downwards pressure on the greenback against major international currencies and be a boon for asset classes such as commodities and emerging markets stocks and bonds.

GLOBAL STRATEGY OVERVIEW

CASH

The US dollar continues to look vulnerable from a medium to longer-term perspective given its rich valuation and counter-cyclicality to global growth. However, on a shorter time horizon, the US dollar should be supported by a widening interest rate differential versus the Canadian dollar, as the Bank of Canada has more imperative to cut interest rates. We have decreased the hedged proportion of US dollar asset exposures this quarter.

BONDS

A “high-pressure economy” is not an ideal macro backdrop for fixed income, as sticky inflation and above-trend growth are likely to keep long-term bond yields elevated. This limits the potential for capital gains, as we expect yield curves to re-steepen as most major global central banks cut interest rates. Fixed income remains underweight in client portfolios.

EQUITIES

Europe has struggled in recent years with natural gas shortage fears pressuring up energy costs and a German industrial slump. A more constructive outlook beckons, as credit growth appears to have bottomed, manufacturing PMIs have turned positive and the European Central Bank has started cutting interest rates. We have increased exposure to European equities this quarter.

OPPORTUNITIES

US senior leveraged loans were a standout in our analysis, as credit spreads were very tight in virtually every other speculative fixed income asset class we surveyed. Loan issuer fundamentals modestly deteriorated during the Federal Reserve’s rate hiking cycle, but should remain well-supported by US economic resilience and easing refinancing risk. US senior leveraged loan exposure has been added to the High Income Opportunities strategy this quarter.

FORSTRONG GLOBAL ASSET MANAGEMENT INC.

STRATEGY DASHBOARD: Q3 - SEPTEMBER 2024

FORSTRONG STRATEGIES	INCEPTION DATE	1 MONTH	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEARS	SINCE INCEPTION
BALANCED								
Global Income	30/06/08	0.04%	6.97%	10.36%	2.62%	4.09%	5.53%	7.15%
Global Balanced	30/06/03	-0.13%	8.04%	11.05%	2.47%	6.24%	6.87%	6.96%
Global Growth	30/06/03	-0.12%	11.08%	15.09%	3.71%	8.58%	8.42%	8.21%
Canadian Income	30/06/08	0.55%	6.10%	9.96%	2.45%	4.14%	4.71%	6.14%
Canadian Balanced	30/06/03	0.23%	7.35%	10.84%	3.28%	6.44%	6.25%	7.01%
Canadian Growth	30/06/03	0.39%	10.22%	14.32%	4.16%	8.35%	7.38%	8.04%
GLOBAL EQUITY								
Emerging Markets Equity Focus	31/01/19	-1.24%	6.14%	6.21%	-1.32%	3.50%	-	2.62%
Global Ex-North America Equity Focus	31/12/19	0.17%	9.95%	13.37%	2.61%	-	-	5.43%
ALTERNATIVE INCOME								
High Income Opportunities	30/06/22	-0.17%	5.23%	8.73%	-	-	-	11.38%

* Performance as of August 31st, 2024
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