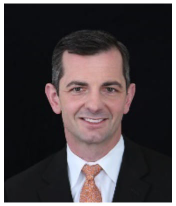


"We naturally fear the unknown, and the future is always unknown."

~ *Peter Bernstein*

2023 was full of noteworthy events: the discovery of a "spy balloon" over North America escalating US-China tensions, increasing conflicts with Russia-Ukraine and the Israel-Hamas war, new supply chain tensions and labor supply challenges, unprecedented and aggressive Fed rate increases reaching 5%, which then resulted in significant multiple bank failures requiring emergency government measures (SVB, Signature Bank, First Republic Bank, Credit Suisse), the unprecedented removal of the speaker of the House as a result of party in-fighting, the unexpected recovery of bitcoin on the heels of the FTX collapse, and the surprising impact of Artificial Intelligence on the "Magnificent 7" stocks. Given all these significant occurrences in 2023, who could have predicted that the market would end the year up 25%?

As we move into 2024 and reflect on the unpredictable nature of these events, we are reminded that the only constant in the world of investing is change. Our team is dedicated to the analysis of market trends and the identification of economic indicators that assess outcome probabilities in each scenario. We then work to position your portfolio accordingly, as we see change and economic surprises as a balanced combination of uncertainties and opportunities.

Our goal is always to provide you with innovative solutions adapted to the uncertainty of investing, guiding you through an optimal allocation according to your financial goals and risk tolerance. Now for my view on the topics affecting your investments.

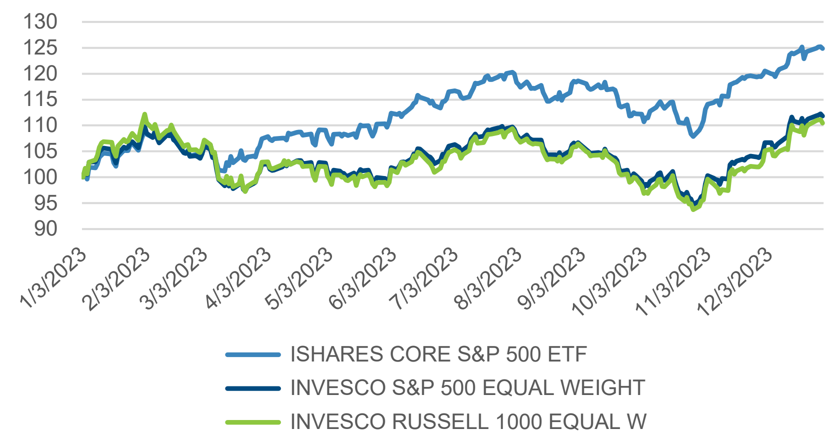
A CIO's View

These events are monitored daily by our models. We also regularly cover these topics in our monthly Navigator and quarterly Fixed Income Commentary.

Market Return: Historical Narrow Rally for Cap-Weighted Indices Only

We had mentioned in a previous newsletter the magnitude of the distortion of index returns caused by the run-up in the "Magnificent 7" stocks in the S&P 500 Index (the largest 500 companies in the U.S. weighted by market capitalization). These seven companies represent 26% of the weight in the S&P 500 and were on average up 111% in 2023. For 2023, the S&P 500 Net Total Return Index was up 25.7% while the S&P 500 Equal-weighted Index (an index representing the same 500 largest companies but allocating each of the 500 companies to an equal weight) was up 13.9% and the Russell 1000 Equal-weighted index was up 12.2% (Exhibit 1). Note that both equal-weighted indices were in negative territory two months before year-end. The median return in the S&P 500 in 2023 was 9.7%, with 34% of the stocks having a negative return and only 27% beating the S&P 500 Net Total Return Index. In other words, if you were a stock picker in 2023, you had a 75% chance of picking stocks that did not beat the S&P cap-weighted index.

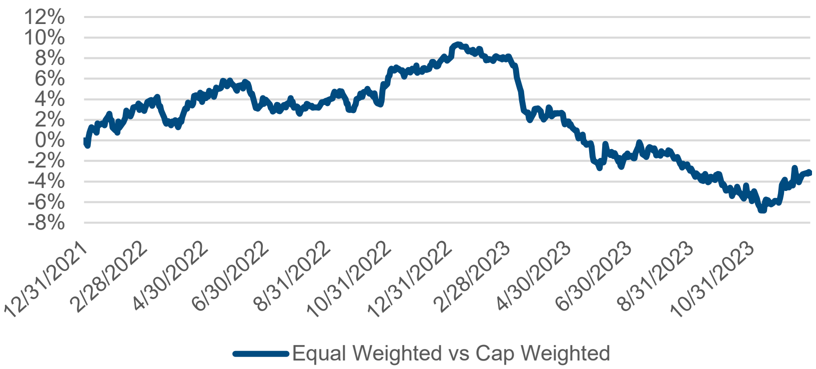
Exhibit 1: Cap-Weighted vs. Equal-Weighted Indices



Source: Bloomberg

Fortunately, this trend has started to reverse, with a broadening of the rally and a softening of these seven stocks. (Exhibit 2)

Exhibit 2: S&P500 Cap-Weighted vs. Equal-Weighted Performance



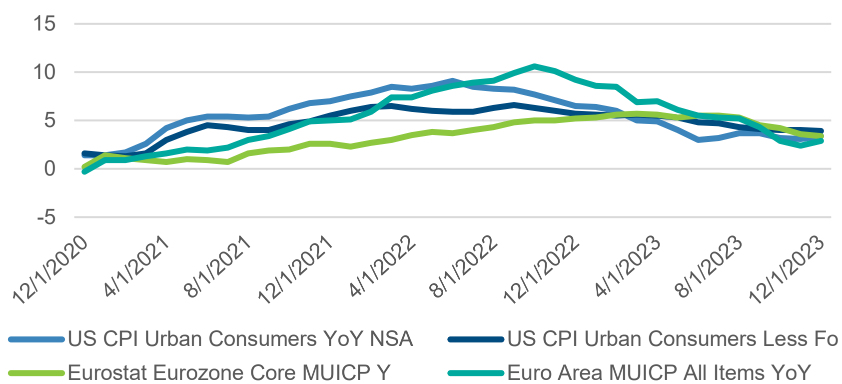
Source: Bloomberg.

Inflation: Improvements so far with some resilience

Core inflation has continued to abate but is now doing so slower. Core inflation today stands at 3.4%, while headline inflation barely inched down to 3.9%. While the trend is in the right direction, the pace is slower than the market anticipated, and this last data point created a negative surprise as consensus was 3.2% and 3.8% respectively. The food CPI measures were reasonable between 0.2% and 0.3%, while other metrics were up 0.4%: vehicles, services, tenants' rent. Medical care service prices ticked higher with a 0.7% increase last month.

Core inflation above 3% for the remainder of 2024 is a scenario which would trigger hawkish actions from the Federal Reserve such as a delay in interest rate cuts as inflation could be more persistent than predicted.

Exhibit 3: US/Europe Core Inflation Rates

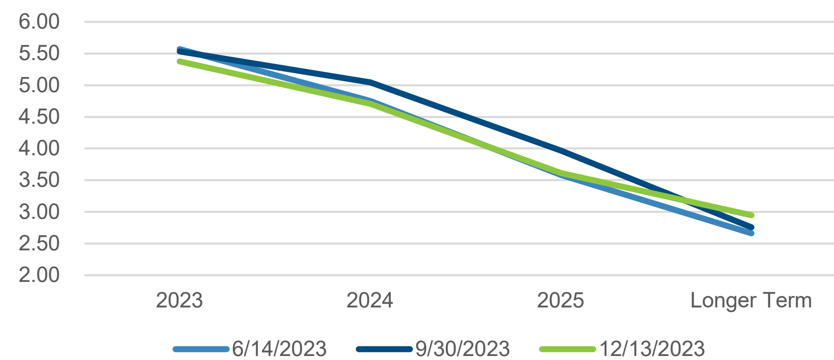


Source: Bloomberg.

Federal Reserve actions: Pause with some cuts signaled.

In December, the FOMC continued to pause and maintain its policy rate within 5.25% and 5.5%. The tone was more dovish, with the consideration of 75 bps of interest rate cuts in 2024, and the acknowledgement of an economic slowdown and inflation easing. The dot plot is now lower, at a similar level as June 2023.

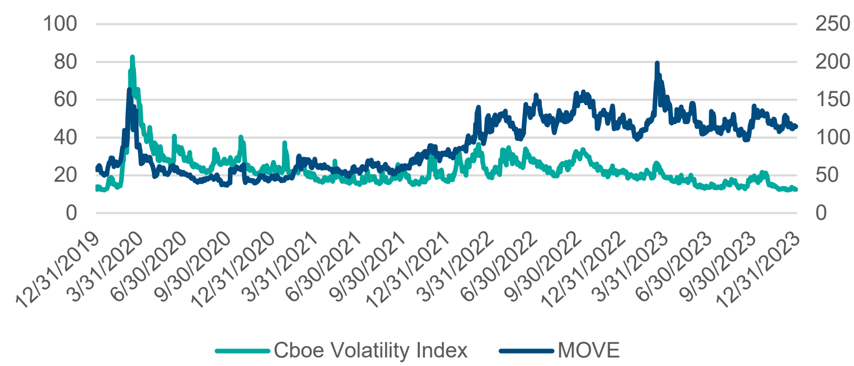
Exhibit 4: FOMC Dot Plots continue to signal high rates for longer



Source: Bloomberg.

The interest rate uncertainty is still high, as can be seen in Exhibit 5: the MOVE Index (implied volatility of a basket of OTC options on US interest rate swaps) illustrates the uncertain environment we are in, while the VIX Index is at a new low along with tight credit spreads, reflecting the optimism on the economic situation.

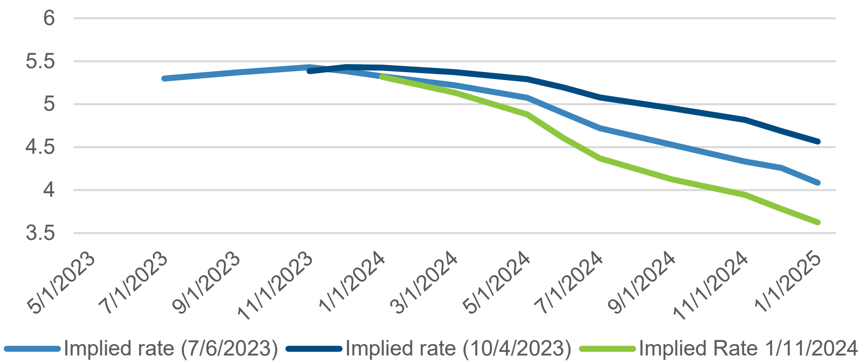
Exhibit 5: The VIX Volatility Index reflects a more benign environment while the MOVE Index indicates greater uncertainty in fixed income



Source: Bloomberg.

The market has reacted to this information and incorporated most but not all the data (Exhibit 6). During Q4, the prevailing thesis of a perfect soft landing, allowing central banks to cut rates toward the neutral stance fueled risk appetites, with implied rates reverting the increase of Q3 and more. The recent CPI data point might be challenging to that thesis, making risk assets seem overbought and exposing vulnerabilities in equities especially at multiples of 22x-23x. Rate cuts can be expected in June, with the possibility of them coming earlier: March or May. However Fed Presidents' recent language indicated that there is not yet a compelling case for earlier cuts and significant developments would be needed to make such a case.

Exhibit 6: Implied Rates have significantly decreased in Q4

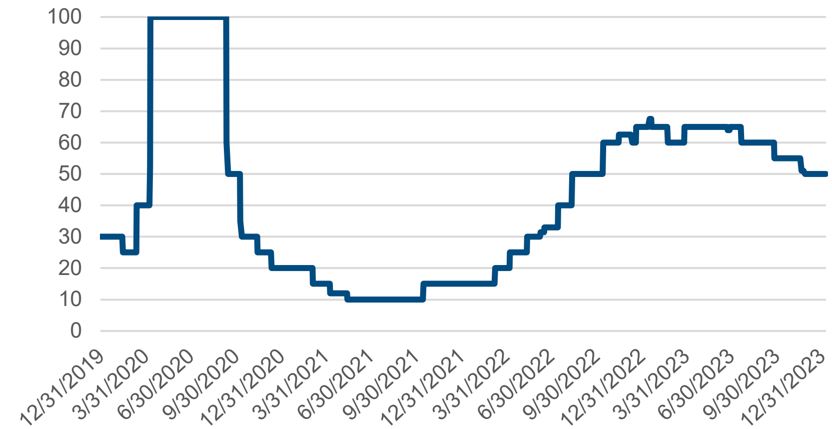


Source: Bloomberg.

Recession: Slightly lower likelihood, with clouds on the horizon

Recession risks have continued to inch lower however more recently recession probability has improved slightly to an elevated 50% (Exhibit 7). Since the economy has shown some resilience with some softening, this may embolden the FOMC to continue its restrictive actions and stay higher for longer.

Exhibit 7: Probability of a U.S. Recession (remains at 50%)



Source: Bloomberg.

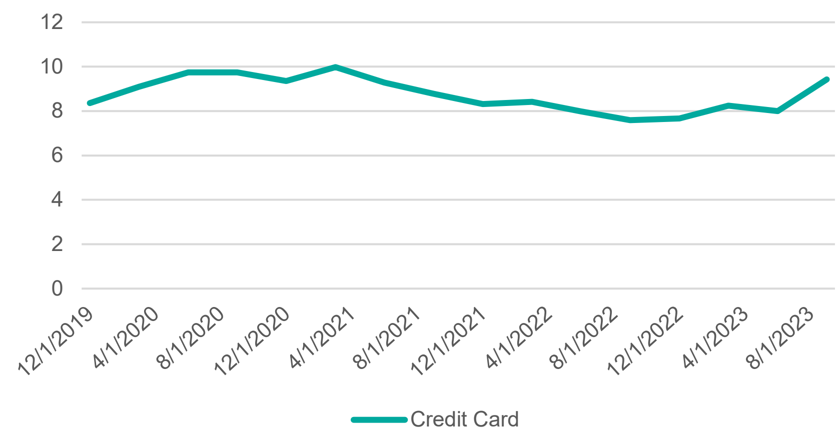
Economy: Resilient with some cracks

The economy in 2023 proved surprisingly resilient despite "bank-rupcies," geopolitical turmoil and unprecedented, restrictive monetary policy. This resiliency can be explained by quick government intervention to avoid systematic financial contagion, corporate margins continuing their trend on the back of past inflation, and labor supply increasing while the unemployment rate stayed exceptionally low. The soft-landing scenario has prevailed and has become the overwhelming consensus for Q4 2023.

For 2024, we see some further signs of slowdown which could grow more substantial: personal savings buffers are lower than post-pandemic which could diminish consumer strength, fiscal policy is looking contractionary with the lapsing of past policies, the additional labor participation rate looks more challenging, the delayed impact of variable rate debt is likely to be seen in more corners of the economy, US election uncertainty, and geopolitical tensions in the Middle East could create additional headwinds.

Looking at the data, we see some evidence of this slowdown, first with credit card delinquencies rising to levels equivalent to the 2020 recession. This can be seen as a sign of normalization from the past low levels of previous years and a digestion of the riskier lending. Corporate bankruptcies have also been rising while they are still below pre-pandemic levels. Commercial real estate does look problematic, but accounts for only 2-3% of bank loan portfolios, which should avoid a repeat of the 2008 episode.

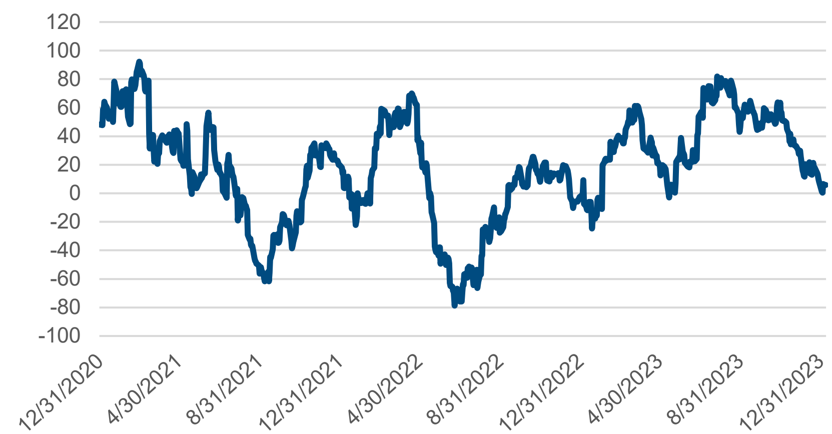
Exhibit 8: Credit Card Delinquencies starting to rise (% of balance delinquent 30+ days)



Source: Bloomberg

Next, the Citigroup Economic Surprise Index has declined over the past quarter, indicating that while still resilient, the US economy is no longer posting as many positive surprises as the majority of 2023. While the indicator is in neutral territory, it is not displaying a sharply negative trend like the one of 2022. (Exhibit 9).

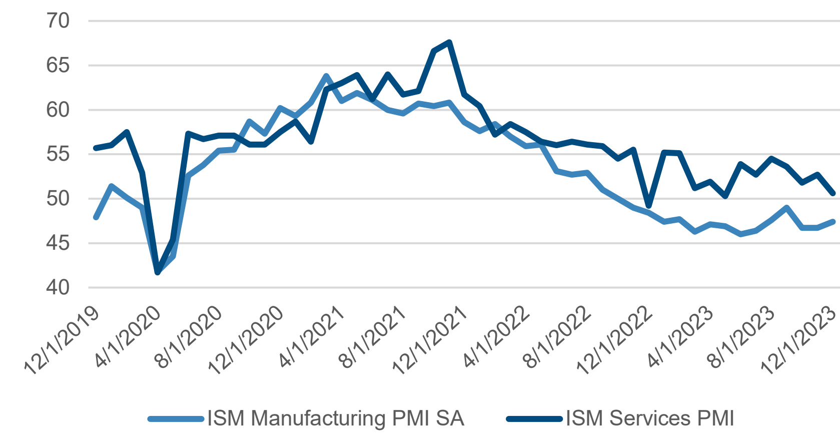
Exhibit 9: The Citigroup Economic Surprise Index indicates how economic data compares with consensus estimates



Source: Bloomberg, Citigroup.

Further signs of slowdown can be seen in the leading indicators of the PMI ISM surveys. Both indices are close to or below the neutral 50 level. While the declines seem to have stabilized, they have not yet shown any clear signs of improvement over the past six months.

Exhibit 10: ISM Manufacturing and Services Indices are still at a low



Source: Bloomberg.

Geopolitical risks: The Red Sea situation could trigger supply chain disruptions.

The Middle East conflict is starting to have supply chain ramifications as some shipping companies have started re-routing via the Cape of Good Hope, creating delays and additional costs which could increase inflation or make it more resilient. These risks could be exacerbated by the closure of some factories for the Chinese New Year.

US-China relationships and competition are likely to intensify, in particular with the strategic interest in Artificial Intelligence and associated enabling technologies. US restrictions have started to be enacted, likely to trigger more reactions from China and the increasing de-globalization trend which is inflationary.

US Elections: More uncertainty later in the year

While this aspect is dominating the news, it has not yet seemed to impact the markets. We anticipate some volatility as the year progresses and the agendas become more clearly defined between the candidates on fiscal, trade and regulatory policies.

Investment Implications

Looking forward, we cannot help but notice that the markets have anticipated a perfectly soft landing scenario: lower inflation and resilient economic growth and profits, leading to equity multiples appearing overbought. Any evidence of a less than perfect scenario can create vulnerabilities and some pull back. While we do not see any major risks to the upside or the downside, the current return/risk environment does not appear the most favorable, thus our cautious stance and willingness to embrace any trading weaknesses to capitalize on future opportunities.

In summary, I have a few considerations for your portfolio given market conditions:

- Remain cautious and opportunistic in the current environment with active and tactical strategies.
- Diversify your investments: not only per asset class (bonds, equities, alternatives, options), but also per investment approach (long, tactical, defined outcome, premium income).
- Consider active risk management and equal-weighted approaches to differentiate from the current consensus and embrace other scenarios.
- Allocate to fixed income which is looking increasingly attractive with higher yields in quality fixed income while the yield curve is normalizing.

Remember that forecasting is a very uncertain exercise and positioning for several alternative scenarios will more likely result in a positive long-term outcome. If you have any questions about your portfolio or would like to discuss your current positioning, please contact your advisor at any time. Our team always has your interest at heart and stands ready to help meet your goals with the proper allocations and financial planning.

I hope this letter finds you and your family happy and healthy in the new year. As always, we thank you for your business.

Happy New Year and wishing you a healthy and prosperous 2024!

Warm regards,

Patrick Jamin
President & CIO

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