

Market Commentary

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"Let's Just Enjoy the Moment," But What Comes Next?

On June 5 the Bank of Canada (BoC) lowered its policy interest rate for the first time in over four years, after holding its rate at 5.00% for the past 11 months. This was welcome news for an economy experiencing a slowdown in growth and rising unemployment. The start of the easing cycle offers the promise of some relief for mortgage holders, although renewals over the next couple of years will generally still be at higher rates than the ones expiring. When asked whether the June rate cut would be followed by another in July, BoC Governor Tiff Macklem responded, "Let's just enjoy the moment for a bit," which reminds us that while we are relieved to have entered this new phase, future rate cuts are not guaranteed and upcoming rate decisions will remain data-dependent and judged on a meeting-by-meeting basis.

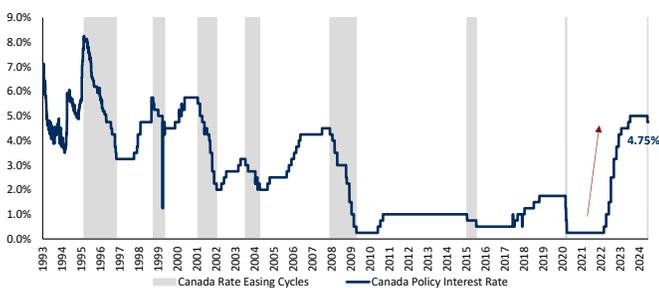
Nevertheless, this first rate cut signifies that the Canadian economy is transitioning into a rate easing cycle. While the BoC is not pre-committing to any particular path for lowering the policy interest rate, we anticipate three more cuts this year and another four next year, bringing the policy interest rate down to 3.00% by mid-2025. During rate easing cycles, economic trends can evolve quickly. Therefore, as investors, we can't enjoy the moment for too long; it's crucial to consider what might lie ahead. In this publication, we will examine past rate easing cycles to gain some insight into how major economic indicators and sector market performance might unfold in the current cycle.

A bit of history

When discussing BoC "rate hikes" and "rate cuts", the term "rate" refers to the policy interest rate, also known as the key interest rate. Historically, the BoC's policy interest rate alternated between floating and fixed arrangements. Since February 1996, it has been set at the upper bound of the BoC's overnight rate, providing a clearer indication of monetary policy intentions compared to the floating rate (based off the 3-month treasury yield), which the BoC had less influence over.

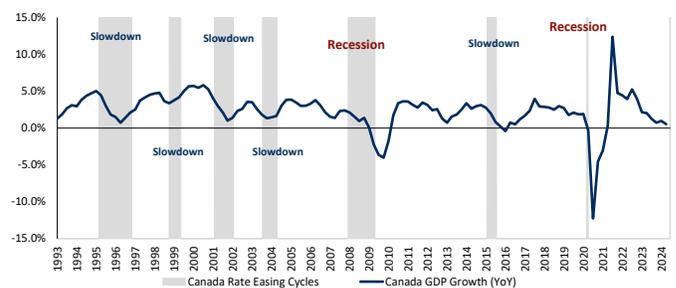
During periods of economic overheating, characterized by heightened inflation, the central bank may raise policy interest rates to curb excessive spending and borrowing, as has been the case over the past two years. Conversely, during economic slowdowns or when there is a risk of recession, the central bank may lower interest rates to ease financial pressures on households, stimulate spending, and encourage capital investments. Currently, Canada's economy is experiencing a slowdown, with confidence that inflation will gradually approach the 2% target. Consequently, the BoC's governing council decided that monetary policy no longer needed to be as restrictive, leading to a 25 basis point rate cut in their recent meeting on June 5. The cumulative rate hikes totaling 475 basis points since March 2022 have had an impact and continue to affect the economy. The current policy interest rate of 4.75%, which declined from 5%, is still considered quite elevated, especially when considering the era of ultra-low interest rates from around 2010 to 2021. Moreover, the overall tightening cycle has been notably aggressive compared to historical cycles (Chart 1).

Chart 1 - Bank of Canada Policy Interest Rate



Source: FactSet; Raymond James Ltd.; Data as of June 17, 2024.

Chart 2 - Canada GDP Growth During Rate Easing Cycles



Source: FactSet; Raymond James Ltd.; Data as of June 17, 2024.

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There have been seven major rate easing cycles in Canada in the past thirty years, indicated by shaded areas in Charts 1 to 4. The magnitude and duration of these cycles varied, generally reflecting the severity of the economic deterioration. Typically, a more severe economic downturn results in larger, faster rate cuts and a lower terminal rate. During two of these easing cycles, the Canadian economy entered a recession: the global financial crisis of 2008-2009 and the COVID-19 pandemic in 2020.

The 2008-2009 easing cycle had the largest magnitude since the policy interest rate returned to a fixed rate in 1996, lowering the rate by 425 basis points in just under 1.5 years. The second half of this cycle (from October 2008 to April 2009) was much more aggressive than the first half (December 2007 to September 2008), as evidenced by the GDP year-over-year growth during the same period (Chart 2). After a minor uptick to 1.4% in 3Q08 from 0.9% in 2Q08, GDP growth fell sharply, entering negative territory within two quarters and hitting -4% in 3Q09. The rapid economic deterioration necessitated aggressive rate cuts to fully accommodate the economy. The policy interest rate was lowered by 275 basis points to a historic low of 0.25% in just around seven months and remained there until May 2010, when GDP growth returned to normal levels.

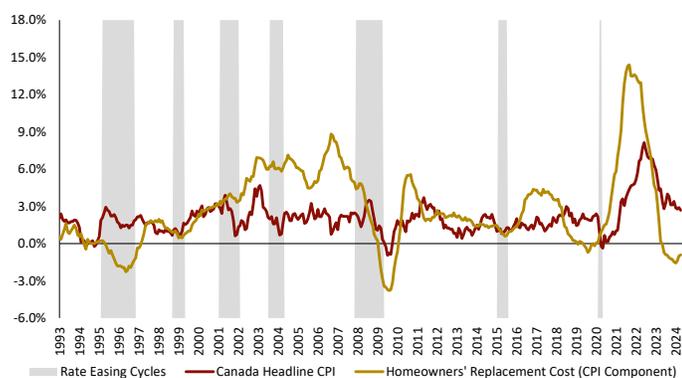
Similarly, when the COVID-19 pandemic sent shock waves through Canada's economy in 2020, the BoC lowered the policy interest rate from 1.75% to 0.25% within a month in March 2020, marking the fastest rate cut ever. The magnitude of this cut was not as large as previous ones because the starting rate was already relatively low, and 0.25% is essentially the "floor".

Soft landing ahead

However, the good news is that Canada's economy has held up relatively well and is likely to achieve a soft landing in this cycle. Therefore, we do not expect to see as aggressive rate cuts as seen during recessions, but rather a more measured approach similar to the five cycles experienced during economic slowdowns.

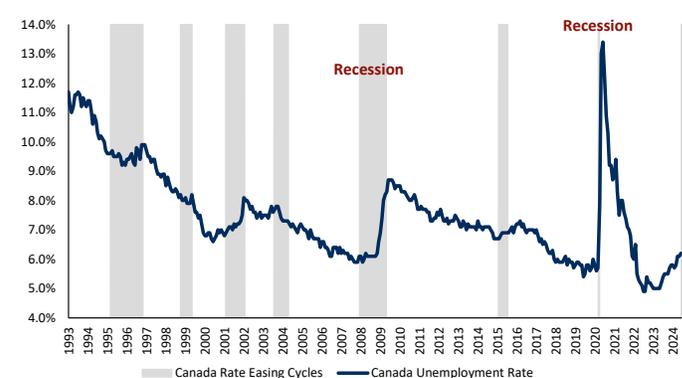
GDP in 1Q24 was up 0.5% from 1Q23, and the economy has been growing at a slower-than-average rate for three quarters now. With more households facing mortgage renewals in the coming months, softening consumer spending evidenced by a surging inventory-to-sales ratio, and rising consumer insolvencies, we do not anticipate a significant economic rebound this year. The BoC has forecasted that annual GDP growth for 2024 will be around 0.7%, indicating that GDP growth for the remaining three quarters of the year will remain modest compared to the first quarter. The BoC also predicts that annual GDP growth will return to the long-term average of 1.9% in 2025. This trend aligns with rate easing cycles where the economy slows down but does not enter a recession. Typically, GDP growth continues to decline after the initial rate cuts, with the turning point occurring around the middle of the easing cycle. As previously mentioned, we anticipate three more rate cuts this year and another four next year, potentially bringing the policy rate to 3.00% by mid-2025.

Chart 3 - Canada CPI During Rate Easing Cycles



Source: FactSet; Raymond James Ltd.; Data as of June 17, 2024.

Chart 4 - Canada Unemployment Rate During Rate Easing Cycles



Source: FactSet; Raymond James Ltd.; Data as of June 17, 2024.

The BoC started hiking its policy interest rate in 2022 to combat surging inflation. Now, as the BoC has increased confidence that inflation is finally under control, the rate cuts make policy less restrictive and can allow the economy better room to grow. Easing can continue as long as the BoC does not see reaccelerating inflation pressures. For confidence, we can examine overall inflation changes during the past rate easing cycles and, because there is a structural housing shortage in Canada, we want to consider how lower rates impact housing prices.

Headline CPI can peak before or during the rate easing cycle, with the timing difference explained by varying lag effects of heightened policy interest rates moving through the economy each time (Chart 3). Over the past thirty years, despite fluctuations, headline inflation has typically stayed within the range of 0.5% to 3.0%. Even when it briefly breaks this range, it tends to revert relatively quickly. This stability occurs because

demand-driven inflation, without accommodative fiscal policies, can be effectively controlled by higher policy interest rates, which curb consumer spending and thus cool inflation.

However, the recent surge in inflation is largely due to supply shocks, compounded by record-high fiscal stimulus supporting consumers. These factors have kept inflation at a historically high level despite the most aggressive rate hike cycle. As supply chains normalized and savings from COVID-19 government stimulus finally depleted, we expect inflation to continue declining and return to its 2% target even as the BoC cuts rates. In fact, headline CPI excluding shelter has been below 2% since the beginning of the year.

Housing prices not likely to rebound quickly

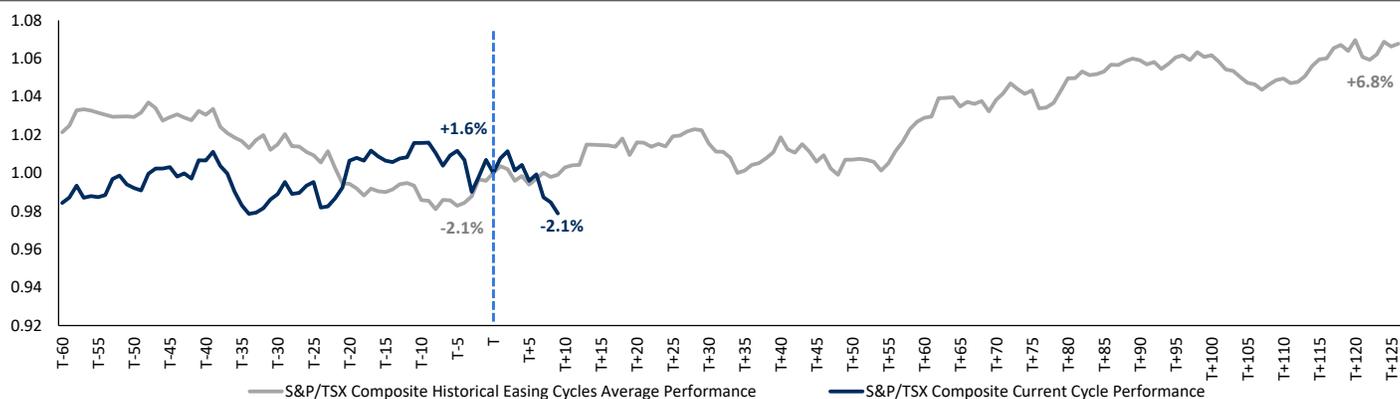
This prompts a revisit to another major factor keeping inflation elevated—the shelter component. In our April report, we discussed how rate cuts could potentially reduce shelter inflation. The main uncertainty then was whether lower rates would immediately lead to surging home prices, thereby increasing homeowners' replacement costs and driving inflation back up, making housing more unaffordable.

Looking at past rate easing cycles, homeowners' replacement cost inflation typically peaks before the cycle begins and does not rebound until the end or after it (Chart 3). For this cycle, we do not anticipate an immediate strong rebound in housing prices either. The year-over-year change in the New Home Price Index is flat, homeowners' replacement cost inflation remain in negative territory. Despite structural supply shortages, household finances remain under stress, and current high mortgage rates continue to pose challenges for homeownership.

Labour market likely to weaken more before it gets better

Regarding the labour market, during most rate easing cycles, the unemployment rate tends to increase. If the economy enters a recession, the unemployment rate is likely to increase further (Chart 4). Following a historically tight labour market from mid-2022 to mid-2023, Canada's unemployment rate gradually rose to 6.2% in May 2024, returning to pre-COVID levels. Based on our forecast of a soft landing for the Canadian economy and recent positive job creation figures, we anticipate the unemployment rate will follow a pattern similar to past rate easing cycles during economic slowdowns. While an influx of workers, driven by surging immigration, may exert some upward pressure on the unemployment rate, the risk of significant layoffs remains low at this time.

Chart 5 - S&P/TSX Composite Performance (Indexed, Day Prior to First Rate Cut = 1)



Source: FactSet; Raymond James Ltd. Data as of June 18, 2024. T: day prior to first rate cut; T +/- number of trading day(s). The March 2020 rate easing cycle is excluded due to its short duration of only one month.

The market is not the economy

While Canada's economy is likely to continue slowing down during the rate easing cycle, the market usually looks ahead, gradually pricing in future rate cuts and becoming optimistic about the new market cycle. In Chart 5, we compared the average daily return of the S&P/TSX Composite from three months before the first rate cut to six months after, across past rate easing cycles, with the current cycle starting on June 5. For easier comparison, both the historical average and the current cycle performance are indexed, with the day before the first rate cut equal to one, referred to as time "T."

Historically, pessimism about the future economy and uncertainties around the BoC's rate decisions result in a ~2% decrease in total return during the three months leading up to the initial rate cut. However, as certainty about easing policy interest rates and economic conditions increases, the market becomes more optimistic, generating around a 6% increase in total return during the first six months after the initial rate cut.

For this cycle, the market largely anticipated the first rate cut would occur in the summer, so the good news of the long-awaited cut may have

been priced in well before it happened. Additionally, the recent surge in gold prices has boosted the S&P/TSX Composite's performance before the first rate cut, given its ~7% exposure to precious metals. As of the writing of this report, ten trading days after the first rate cut, we are seeing some weakness in the index performance. There are still many concerns about future economic conditions and whether the BoC will lower the rate again in its July meeting. More volatility is also expected for the rest of this year. Nonetheless, if a soft landing is achieved as expected, with inflation on track to reach its 2% target, the S&P/TSX Composite could potentially finish 2024 with a high single-digit total return.

Chart 6 - Sector Performance During the First Six Months of Past Rate Easing Cycles (Ranked by Average Total Return)

Rate Easing Cycle Start Date 6M from Start Date	Average	02/1995 08/1995	09/1998 03/1999	01/2001 07/2001	07/2003 01/2004	12/2007 06/2008	01/2015 07/2015
S&P/TSX COMPOSITE	6.7%	12.6%	15.4%	-17.1%	19.1%	10.6%	-0.5%
CONS STAPLES	12.9%	19.5%	16.4%	22.3%	7.8%	-1.8%	13.5%
INFO TECH	12.2%	6.5%	55.9%	-70.4%	54.7%	21.3%	5.0%
ENERGY	9.8%	11.0%	-7.1%	9.1%	24.6%	31.2%	-9.8%
MATERIALS	9.5%	19.4%	-4.1%	9.0%	35.4%	22.4%	-24.9%
CONS DISCRET	8.4%	8.9%	32.9%	-0.4%	14.0%	-15.5%	10.7%
FINANCIALS	6.5%	7.5%	15.7%	3.6%	15.3%	-6.5%	3.4%
INDUSTRIALS	6.3%	12.4%	1.4%	5.4%	14.4%	9.7%	-5.4%
REAL ESTATE	6.0%	3.1%	-5.2%	14.3%	23.7%	-0.5%	0.6%
COMM SVC	3.0%	-2.0%	38.6%	-15.8%	2.4%	-3.7%	-1.7%
UTILITIES	2.3%	-0.2%	-4.8%	12.0%	8.5%	5.1%	-6.6%

- Return >= 15%
- 15% > Return >= 10%
- 10% > Return >= 5%
- 5% > Return >= 0%
- 0% > Return >= -5%
- 5% > Return >= -10%
- 10% > Return >= -15%
- 15% > Return

Source: FactSet; Raymond James Ltd. Total returns; the March 2020 rate easing cycle is excluded due to its short duration of only one month.

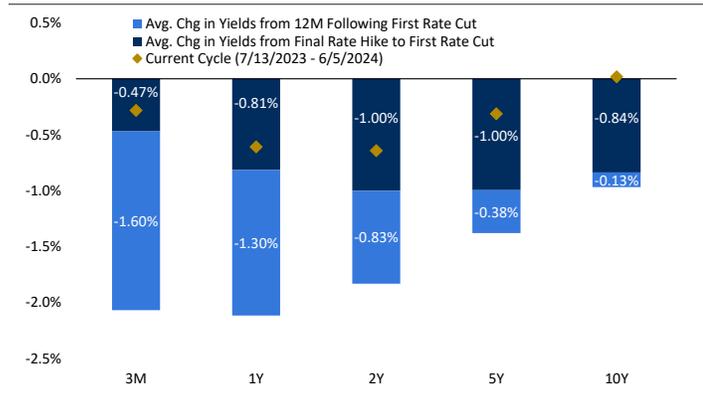
Consumer Staples and Info Tech typically lead during easing

In terms of sector-level performance (Chart 6), consumer staples typically have the highest average total return during the first six months after the initial rate cut and experience the smallest drawdowns across different periods. The consumer staples sector in the S&P/TSX Composite is mainly composed of food retailers. As mentioned earlier, the economy tends to continue to deteriorate after the initial rate cut, but groceries are considered essential spending, so food retailers' earnings are less impacted compared to more cyclical sectors.

Information technology also performs well, though it is more volatile, especially during events like the tech bubble burst in 2001. Most companies in the information technology sector are growth-oriented. A lower rate environment favours growth stocks because their projected cash flows are weighted further in the future, and a lower discount rate results in their higher present value. Additionally, as confidence in economic recovery grows, there is more enthusiasm for investing in technological innovation, similar to the current excitement around A.I. However, the sustainability of this enthusiasm depends on meaningful applications of A.I.

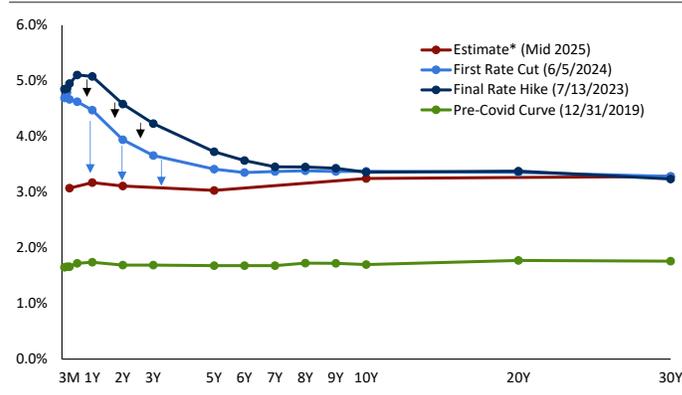
Energy and materials sectors are highly integrated with the global economy and geopolitics, making them harder to predict, especially given that major economies are currently in different business cycles. However, the containers and packaging subindustry within the materials sector has significantly outperformed the S&P/TSX Composite during most of the listed periods. Additionally, the construction and engineering subindustry within the industrials sector consistently generates solid returns during these periods.

Chart 7 - Yield Moves Leading Into and Following 1st Rate Cut



Source: FactSet; Raymond James Ltd. Data as of June 5, 2024.

Chart 8 - Canada Yield Curve Estimate One Year From Now



Source: FactSet; Raymond James Ltd.; Data as of June 5, 2024. *Estimate derived by June 5, 2024 yields minus the average change in yields from 12 months following first rate cut.

Fixed Income opportunities remain

As for bonds, there is still time to take advantage of the current elevated rate levels. Given the inverse relationship between bond yields and bond prices, a decrease in yield implies an increase in price. Chart 7 illustrates the average change in yields from the final rate hike to the first rate cut (dark blue bars) and the average change in yields 12 months following the first rate cut (light blue bars) across different maturities for government bonds. The yellow diamonds indicate the change in yields for the current cycle, from the last rate hike on July 13, 2023, to June 5, 2024.

We observe that the magnitude of yield changes in this cycle is smaller compared to historical averages (dark blue bars). As we are now a few weeks past the first rate cut, the question remains whether yields will change by the same magnitude as historical averages (light blue bars) over the next 12 months or if there will be further catchup to offset the smaller yield changes leading into the first rate cut. Nonetheless, there is still some room for yields to come down and bond prices to rise. If the yield changes over the next 12 months follow historical averages, the yield curve in mid-2025 will resemble the red line in Chart 8. This estimated yield curve aligns with our expectation of eight rate cuts of 25 basis points each, leaving the policy interest rate at 3% into the second half of 2025.

Final thoughts

In summary, we believe Canada's economy is very likely to achieve a soft landing with inflation under control. During this rate easing cycle, even though GDP growth may continue to slow and the unemployment rate may continue to rise, we do not anticipate drastic changes. The Canadian equity market is likely to become more optimistic about the new market cycle, especially when there is more certainty about future rate decisions and economic recovery. Finally, there is still room for bond yields, particularly at the front end, to come down, presenting investment opportunities in fixed income.

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