Quarterly Market Commentary

Second Quarter 2024

Despite a mixed quarter, stocks maintain their lead at halftime.

- Major global equity market indexes saw mixed performance in the second quarter of 2024, but ended the first half of the year in positive territory. U.S. stocks were bolstered largely by a rally concentrated in shares of a select few companies—but namely Nvidia—benefiting from artificial intelligence (AI). Most developed equity markets outside of the U.S. lost ground over the quarter.
- Global fixed-income assets fell over the quarter. U.S. Treasury yields moved higher for all maturities, with the exception of 1-, 2-, and 6-month bills. (Bond prices move inversely to yields).
- We continue to view both concentration and valuation as concerning for U.S. equity investors. We believe the current size and future growth expectations of the top names set the bar exceedingly high even for the most stellar companies in the most transformative industries.

SEI's Domestic View

SEI has been cautioning investors that Canada's economy could be in for some tough sledding. Although growth hasn't been gangbusters, recession fears have so far proven unfounded. While both business and consumer sentiment remain depressed, neither has fed into actual economic behaviour to a degree sufficient to cause recession. We've also pointed out that, for a smaller, open economy such as Canada's, the domestic outlook often depends heavily on what's happening outside its borders. This is an observation that recent Bank of Canada research has confirmed in some interesting ways, and we'll take a brief look at some relevant data and research for investors.

Perhaps the most noteworthy news of the second quarter was the Bank of Canada's (BoC) decision to cut its target interest rate by 0.25% to an annualized rate of 4.75%. It was the first BoC rate cut since 2020, and the first among G7 central banks in this cycle. However, as has proven to be the case for multiple central banks, monetary policy easing has fallen far short of what markets expected coming into this year. The COVID and post-COVID eras have been challenging for central bankers. As higher inflation began to take hold a few years ago, we developed a tongue-in-cheek "central banker's misery index" to illustrate just how challenging those conditions were. While inflation has certainly improved over the last two years, the pressures faced by BoC Governor Tiff Macklem and his colleagues are still above historical norms.

We've also been pointing to poor productivity growth as an ongoing challenge for the BoC, and one of Governor Macklem's colleagues—Senior Deputy Carolyn Rogers—provided a stark warning on this issue in a March 2024 speech when she said, "Productivity is a way to inoculate the economy against inflation. An economy with low productivity can grow only so quickly before inflation sets in. But an economy with strong productivity can have faster growth, more jobs and higher wages with less risk of inflation. That's why I want to talk about Canada's long-standing, poor record on productivity and show you just how big the problem is." Inflation has eased, growth has held up better than expected, and consensus expectations are for an improvement in economic activity as we head into 2025. On the other hand, recent employment data have indicated that the labour market has continued to soften. And looser monetary policy in the context of poor productivity growth means a greater-than-usual risk of inflation reaccelerating, as we pointed out in our fourth quarter 2023 outlook. While markets expect further cuts from the BoC, these uncertainties were almost certainly behind Governor Macklem's press conference recommendation to "just enjoy the moment" as they'll be "taking it one meeting at a time."

Two recent staff working papers from the BoC provide interesting material for thinking about the economic and investment environments. As we have noted previously, for a smaller, open economy such as Canada's, it's important to take account of activity outside the country's borders. Recent surveys show that while sentiment among Canadian manufacturers has been weak and worse than in many other countries, it's still better than some.

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An April 2024 BoC working paper found that economic developments in the U.S. have an outsized impact on bond market behaviour in a selection of smaller, open economies (Canada, Sweden and the U.K.), inferring that "U.S. macroeconomic news…is even more important than the respective countries' domestic macroeconomic news" and "is particularly important to explain low-frequency changes in the expectation components of the nominal, real and break-even inflation rates." In March, another working paper proposed a recession-prediction model for Canada that, from a wide range of domestic and foreign variables, selected not only the behaviour of the domestic bond and equity markets, but also the Chicago Federal Reserve's National Activity Index (CFNAI) for the U.S. economy. Yield curve inversion in Canada has been indicating a higher-than-normal risk of recession since mid-2022. Despite a bit of a soft patch in mid-June, the S&P/TSX Index (Index) has been sending a more optimistic signal since last fall. And while the CFNAI diffusion index has been slightly negative for more than 18 months (an indicator that a greater number of components are falling), the overall Index remains in territory consistent with ongoing expansion. Obviously, it's important for anyone with an interest in the Canadian economic outlook to keep an eye on its southerly neighbour. SEI's view is that while we could see some continued softening in its economy, "the U.S. should continue to avoid sinking into recession."

One interesting feature of the U.S. economy—one that it shares with Canada—is that consumer sentiment has been surprisingly weak in the post-pandemic era despite falling inflation and a strong labour market. We can see this if we look at the traditional "misery index" alongside the University of Michigan's consumer confidence index. The misery index fell sharply thanks to lower (but still too high!) inflation and a still-low unemployment rate, but there's a notable gap between this index and the latest University of Michigan sentiment measure.

One obvious possibility is that political affiliation might be playing a role, but it's unlikely that this can explain much of the gap as more partisan views tend to flip depending upon which party holds the executive branch. This avenue of inquiry also gets more complicated when you consider that the U.S. Congress has as much influence on the economy as (if not more than) the President. One group of economists revisited U.S. inflation measures in an attempt to analyze the sentiment-misery paradox and found that incorporating interest expense (or consumer financing costs for mortgages and automobiles) into their model could explain a majority of the gap in sentiment. The paper was not a criticism of how various consumer price indexes have changed over time—current methods still tend to do a better job than older ones of separating the inflation signal from price level noise. However, when contemplating consumer sentiment measures, it's important to note that financing expenses may be playing as significant a role as employment and inflation. That's undoubtedly true for Canadian consumers as well.

This leads to a key question that market observers have been asking themselves in recent months: If and when the U.S. Federal Reserve (Fed) finally does follow the BoC's lead on lowering its policy interest-rate target, what effects might that have on consumer sentiment, credit, and activity? And what impacts might the BoC's rate-cutting decisions have on domestic activity? It's anyone's guess at this point. The Fed, the BoC, and their counterparts elsewhere have to thread a needle between continued progress on inflation and preventing unnecessary harm to the economy. In other words, while central bankers' misery indexes have retreated somewhat, they're still facing significant uncertainty in the economic outlook and setting appropriate policy. For investors, the best response to this uncertainty is to stay diversified, no matter how much "correlation anxiety" they might feel.

SEI's Global View

Today's equity market dynamics remind us that diversifying exposures across geographies, sectors, factors and individual companies are as important as ever for investors, and we remain committed to this foundational principle. This is particularly acute for passive investors who, at this stage of the cycle (concentrated and expensive), may want to begin diversifying into actively managed strategies. We continue to view both concentration and valuation as concerning for U.S. equity investors. We believe the current size and future growth expectations of the top names set the bar exceedingly high even for the most stellar companies in the most transformative industries.

While we have been highlighting the relatively low level of broad equity volatility for the better part of year, we are also focusing on the high level of volatility present specifically in the market's biggest names. The Cboe Volatility Index or VIX is a forward-looking view of volatility derived from 30-day S&P 500 Index options. The VIX closed the quarter at roughly 12.50%, which is significantly below the longer-term average of about 16%. The same measure of implied volatility for U.S.-based, artificial intelligence (AI)-focused chip-maker Nvidia Corp. is roughly 4 times the VIX level, at over 50%. Certainly it makes sense for single-name volatility to be higher than the market level; however, when one of the biggest companies in the world is

trading with such high levels of volatility, this suggests to us that a bumpier ride may be in store for equity investor in the second half of 2024.

Our outlook for interest rates in the U.S. is decidedly bearish. The yield on the U.S. 10-year Treasury note began the second quarter with upward pressure from consecutive hot inflation prints and stronger-than-expected employment data. A slight softening in the inflation trend and a more dovish tone from the Fed allowed the 10-year Treasury to end the quarter at 4.36%, down roughly 30 basis points from the quarter's high point. We are leaning against this more recent rally and continue to position for higher longer-term U.S. interest rates. We expect that a still-stubborn inflationary picture in the near term and a resilient job market will keep the Fed on hold until at least after the U.S. presidential election in November.

While we acknowledge that the Fed is desperate to join the central banks of Canada, Europe, Switzerland and Sweden (which have already begun reducing rates), we continue to suspect that the specter of a reacceleration of inflation will keep any U.S. monetary policy easing cycle relatively shallow. In addition to a higher-than-expected terminal federal-funds rate—the ultimate interest-rate level that the Fed sets as its target for a cycle of rate hikes or cuts—we continue to see a resilient U.S. economy despite some early warning signs of economic weakness, a return of term premium (with investors earning higher yields on long-term debt) into the U.S. yield curve, and the basics of supply and demand keeping upward pressure on longer-term rates into the end of this year.

We expect a positive cyclical and structural macroeconomic environment to prompt a strong recovery in commodities for the second half of 2024. The asset class peaked in mid-2022 along with global inflation rates and has suffered as the disinflation trend took hold around the globe. More recently, we have seen surprising production discipline from OPEC+, AI-influenced demand, and central bank gold purchases influencing year-to-date returns. We believe that seasonality factors will add to the positive momentum in this space as summer travel demands remain robust and weather related volatility provides asymmetric upside pressures. In addition, July also marks the start of China's Third Plenum of the China's Central Committee, which is the top governing body of the Communist Party. Expectations for this gathering include infrastructure reforms and stimulus projects focused on power grid improvements. We view this as another potential boost to demand in the short term, which further enhances our longer-term views of global chronic underinvestment in the commodity space, which we believe will continue to act as a structural tailwind.

Economic Backdrop

Major global equity market indexes saw mixed performance in the second quarter of 2024, but ended the first half of the year in positive territory. In the U.S., the broad-market S&P 500 Index and the tech-heavy Nasdaq Composite Index garnered positive returns, bolstered largely by a rally concentrated in shares of a select few companies—but namely Nvidia—benefiting from AI. Most developed equity markets outside of the U.S. lost ground over the quarter amid investors' concerns that sticky inflation would cause many global central banks to delay pivoting to a rate-cutting regime.

The Nordic countries were the strongest performers among developed equity markets for the quarter, led by Norway and Finland. North America also posted a notable gain attributable mainly to an upturn in the U.S. The Far East recorded a negative return for the quarter and was the primary developed-market laggard due to weakness in Japan. Africa was the top performer within emerging markets for the quarter, attributable primarily to strength in South Africa. Conversely, the Latin American market declined sharply over the quarter and was the most notable underperformer due to significant downturns in Mexico and Brazil.

Global fixed-income assets, as measured by the Bloomberg Global Aggregate Bond Index, declined 1.1% in the second quarter. High-yield bonds posted modest gains and were the strongest performers within the U.S. fixed-income market, followed by U.S. Treasury securities, mortgage-backed securities (MBS), and corporate bonds. Treasury yields moved higher for all maturities, with the exception of 1-, 2-, and 6-month bills. Yields on 2-, 3-, 5-year Treasury notes each rose 0.12% over the quarter, while the 10-year was up 0.16%. The spread between 10- and 2-year notes narrowed from –0.39% to –0.35% over the quarter, and the yield curve remained inverted.

Global commodity prices, as measured by the Bloomberg Commodity Total Return Index, rose 2.9% during the quarter. The West Texas Intermediate (WTI) and Brent crude oil prices declined 2.0% and 2.4%, respectively, amid concerns about softening demand for gasoline. The New York Mercantile Exchange (NYMEX) natural gas price surged 47.4% over the quarter due to strong demand and a decline in production in the U.S., along with expectations that advances in AI will increase consumption

of natural gas-generated electricity. The gold spot price rose 4.5% over the quarter as the ongoing Israel-Hamas conflict prompted investors to seek “safe-haven” investments. Despite a slump in June due to a significant increase in production, wheat prices ended the quarter up 2.4% on earlier speculation that below-average rainfall in Russia and the Southern Plains in the U.S. could lead to supply constraints.

As widely anticipated, the Federal Open Market Committee (FOMC) left the federal-funds rate unchanged in a range of 5.25% to 5.50% following its meeting on June 11-12. In a statement announcing the rate decision, the FOMC noted, “Inflation has eased over the past year but remains elevated. In recent months, there has been modest further progress toward the Committee’s 2 percent inflation objective.” The FOMC’s acknowledgement of “further progress” in achieving the inflation target came in contrast to the statement following its previous meeting on May 1, in which the Committee cited the “lack of progress” toward its objective.

The Fed’s so-called dot plot of economic projections indicated a median federal-funds rate of 5.1% at the end of 2024, up from its previous estimate of 4.6% issued in March, signaling that the central bank anticipates just one federal-funds rate cut of roughly 25 basis points (0.25%) by the end of this year. The Fed estimated that core inflation, as measured by the core personal-consumption-expenditures (PCE) price index, will end the year at an annual rate of 2.6%—modestly higher than the central bank’s 2.4% projection in March. The PCE price index is the Fed’s preferred gauge of inflation, as it tracks the change in prices that consumers pay for a more comprehensive set of goods and services than that of the consumer-price index (CPI).

At the end of June, the CME Group’s FedWatch Tool implied a 56% chance that the central bank will implement a rate cut of 25 basis points (0.25%) following its meeting on September 17-18. The FedWatch Tool provides a gauge of the markets' expectations of potential changes to the federal-funds target rate while assessing potential Fed monetary policy actions at Federal Open Market Committee (FOMC) meetings.

Central Banks

- Nearly eleven months after its last rate hike, the Bank of Canada (BoC) became the first notable developed market central bank to ease its policy rate with a 0.25% cut to 4.75% following its June 5 meeting. Additionally, the BoC will continue to normalize its balance sheet via quantitative tightening. In its press release, the BoC noted that global growth was solid—around 3%—even as growth moderated in North America. It also noted that inflation, while still elevated in many developed economies, continues to make progress towards the BoC’s target. With this in mind, the BoC decided that monetary policy could be less restrictive going forward, this despite continued concerns that the risk of reacceleration in the inflation rate remains. The next BoC meeting is scheduled for July 24.

- At a news conference following the FOMC meeting on June 12, Fed Chair Jerome Powell commented that, while the central bank has not pivoted to rate cuts, no FOMC member anticipates the need for a rate hike. Powell said, “We've always been pointing to cuts at a certain point. Not to eliminate the possibility of hikes, but no one has that as their base case.” The Fed chair acknowledged progress in slowing inflation, “a good level” of economic growth, and a robust labor market. “Now, ultimately, we think rates will have to come down to continue to support that,” Powell noted. “But so far, they haven't had to. And that's why we're watching so carefully for signs of weakness.”

- The Bank of England (BOE) left the Bank Rate unchanged at a 15-year high of 5.25% following its meeting on June 19. The decision was not unanimous; two BOE Monetary Policy Committee (MPC) members voted for a rate cut of 25 basis points (0.25%) to 5.00%. In its announcement of the rate decision, the MPC commented, “The restrictive stance of monetary policy is weighing on activity in the real economy, is leading to a looser labour market and is bearing down on inflationary pressures. Key indicators of inflation persistence have continued to moderate, although they remain elevated.” The MPC also reiterated its commitment to “adjust monetary policy as warranted by economic data to return inflation to the 2% target sustainably.”

- The European Central Bank (ECB) became the largest and most notable central bank to loosen monetary policy, reducing its benchmark interest rate by 25 basis points to 4.25% following its meeting on June 6—its first rate cut since September 19. In a statement announcing the rate decision, the ECB’s Governing Council commented, “Based on an updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, it is now appropriate to moderate the degree of monetary policy restriction after nine months of holding rates steady.” However, the Governing Council cautioned that it is “not pre-committing to a particular rate path.”

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- The Bank of Japan (BOJ) maintained its benchmark interest rate in a range of 0.0% to 0.1% after its meeting on June 13-14. However, the central bank did not provide information regarding the timeline to reduce its bond purchase program, which led to a sharp decline in the yen versus the U.S. dollar. In its "Summary of Opinions at the Monetary Policy Meeting," the BOJ noted, "While price developments have been in line with the Bank's outlook, there is a possibility that prices will deviate upward from the baseline scenario if another pass-through of recent cost increases to consumer prices happens. It is therefore necessary for the Bank to consider whether further adjustments to monetary accommodation are needed from the perspective of risk management."

Economic Data (unless otherwise noted, data sourced to Bloomberg)

- According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) was up 0.6% in May and rose 2.9% for the year ending in May. This modest reacceleration in price increases was led by higher costs for cellular services, travel tours, rent, and air travel. Producer prices were mixed as the Industrial Product Price Index (IPPI) was flat and the Raw Materials Price Index (RMPI) declined 1.0% in May. Over the year ending in May, the IPPI and RMPI increased 1.8% and 7.6%, respectively. Recent weakness in fuel and lumber costs resulted in more muted price increases in May. Meanwhile, fuel costs and metal prices were higher than a year ago. The Labour Force Survey indicated that employment was essentially unchanged in June as the economy shed 1,400 jobs, while the unemployment rate rose 0.2% to 6.4%. Unemployment has continued to trend higher, rising 1.3% since April 2023.

- The U.S. Department of Labor reported that the consumer-price index (CPI) was flat in May, declining from the 0.3% increase in April. The 3.3% year-over-year advance in the index, down from the 3.4% annual rise in April, was slightly below expectations. Housing costs rose 0.4% and 5.4% in May and over the previous 12 months, respectively, while food prices posted corresponding increases of 0.1% and 2.1%. Energy prices declined 2.0% in May, but were up 3.7% year-over-year. The 3.4% rolling 12-month rise in core inflation in May, as measured by the CPI for all items less food and energy, was down 0.2 percentage point from the year-over-year upturn for the previous month, and represented the smallest annual increase since April 2021. According to the third estimate from the Department of Commerce, U.S. gross domestic product (GDP) grew at an annualized rate of 1.4% in the first quarter of 2024—down sharply from the 3.4% rise in the fourth quarter of 2023. The latest figure represents an uptick from the second estimate of 1.3% for first-quarter GDP growth. The change was attributed to a downward revision to imports (which are subtracted in the calculation of GDP), as well as upward revisions to non-residential fixed investment (purchases of both nonresidential structures and equipment and software), and government spending. These were partly offset by a downward revision to consumer spending.

- The Office for National Statistics (ONS) reported that inflation in the U.K., as measured by the CPI, rose 0.3% in May, matching the increase in April. The CPI's 2.0% year-over-year advance was lower than the 2.3% annual upturn for the previous month. The largest contributors to the 12-month rise in inflation included alcohol and tobacco, as well as health care. These more than offset declines in costs for housing and household services, and furniture and household goods. Core inflation, which excludes volatile food prices, rose at an annual rate of 3.5% in May, down from the 3.9% year-over-year increase in April. According to the second estimate of the ONS, U.K. GDP grew 0.7% in the first quarter of 2024 (the most recent reporting period), an uptick from the initial estimate of a 0.6% increase, and significantly outpacing the 0.6% decline in the last three months of 2023. Output in the services and production sectors rose 0.8% and 0.6%, respectively, for the first quarter, while construction output fell 0.6%.

- Eurostat pegged the inflation rate for the eurozone at 2.6% for the 12-month period ending in May, up modestly from the 2.4% annual increase in April. Costs in the services sector rose 4.1% for the period. Prices for food, alcohol and tobacco were up 2.6% year-over-year in April, slightly lower than the 2.8% annual rate for the previous month. Energy prices rose 0.3% over the previous 12 months following a 0.6% annual decline in April. Core inflation, which excludes volatile energy and food prices, rose at an annual rate of 2.9% in April, up 0.2 percentage point from the 2.7% year-over-year increase in April. Eurostat also reported that eurozone GDP edged up 0.3% in the first quarter of 2024, following a 0.1% dip for the fourth quarter of 2023, and was up 0.4% year-over-year. The economies of Malta, Cyprus, and Croatia were the strongest performers for the first quarter, expanding 1.3%, 1.2%, and 1.0%, respectively. Conversely, GDP in Denmark and Estonia declined by corresponding margins of 1.8% and 0.5% during the quarter.

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Index Data (Q2 2024)

- The S&P/TSX Composite Index slipped 0.53%.
- The FTSE Canada Universe Bond Index gained 0.86%.
- The S&P 500 Index, which measures U.S. equities, jumped 5.45%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, was up 4.02%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 0.91% (currency hedged) and 2.22% (unhedged).
- The Chicago Board Options Exchange Volatility Index, also known as the "fear index," a measure of implied volatility in the S&P 500 Index, peaked at 19.23 during the quarter, but ultimately moved lower from 13.01 to 12.44.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, declined from US$83.17 to US$81.54 a barrel to end the quarter.
- The Canadian dollar weakened to C$1.37 per U.S. dollar. The U.S. dollar was generally stronger versus the world's other major currencies, ending June at US$1.07 versus the euro, US$1.26 against sterling, and at 160.86 yen.

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Indexes definitions

The **personal-consumption expenditures (PCE) Price Index** measures the prices that consumers pay for goods and services to reveal underlying inflation trends. The Core PCE Price Index excludes volatile food and energy prices.

The traditional "**misery index**" was created by economist Arthur Okun. It added the unemployment and inflation rates to assess how consumers were faring economically. For the central banker's misery index, we subtract the unemployment rate from the inflation rate, using the (sometimes controversial) rule of thumb that tight labour markets tend to foster higher inflation.

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