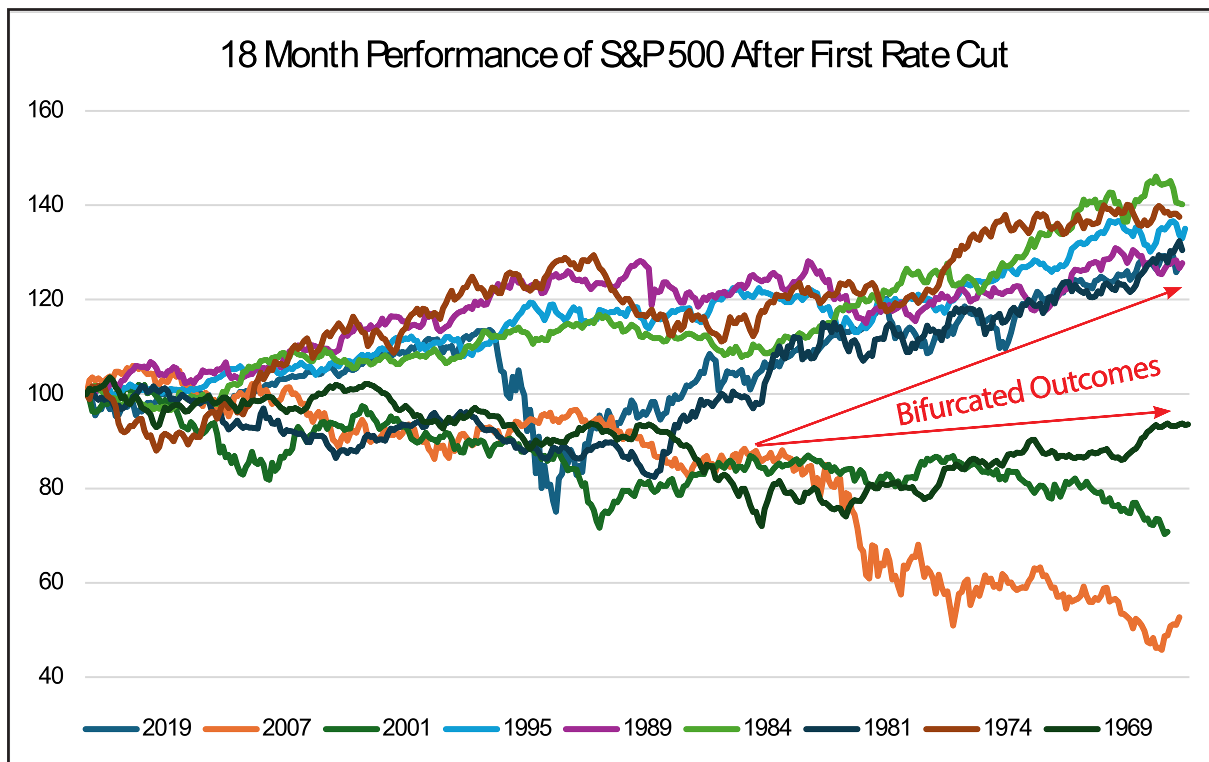
Going All-In On A Rate Cut?

"Rates are going to go down, buy equities". This simple concept has been said in many different forms by commentators across the financial world since December. The stock market has exploded higher on this narrative and the broad view is that a soft landing is the only landing in sight. This has resulted in the S&P 500 up ~23% from its low on October 27th (at time of writing) while the TSX is up 14% from its lows.

You can feel some of the excitement in the market, pre-empting the first rate cut by the U.S. Federal Reserve. For example, the U.S. 10-year bond saw its yield drop 1.2% from peak to trough but has reverted 0.5% since the trough.

We thought it would be useful to look back at the performance of the stock market 18 months after the first rate cut historically and its clear there is a bifurcated set of outcomes. 66% of the time, investors would make an average of 33% return. 33% of the time, investors would lose an average of 28%.

That is an average performance of ~13%, not a bad average, but as you can see below, there is no guarantee that being long at the start of rate cuts is 'easy money'.

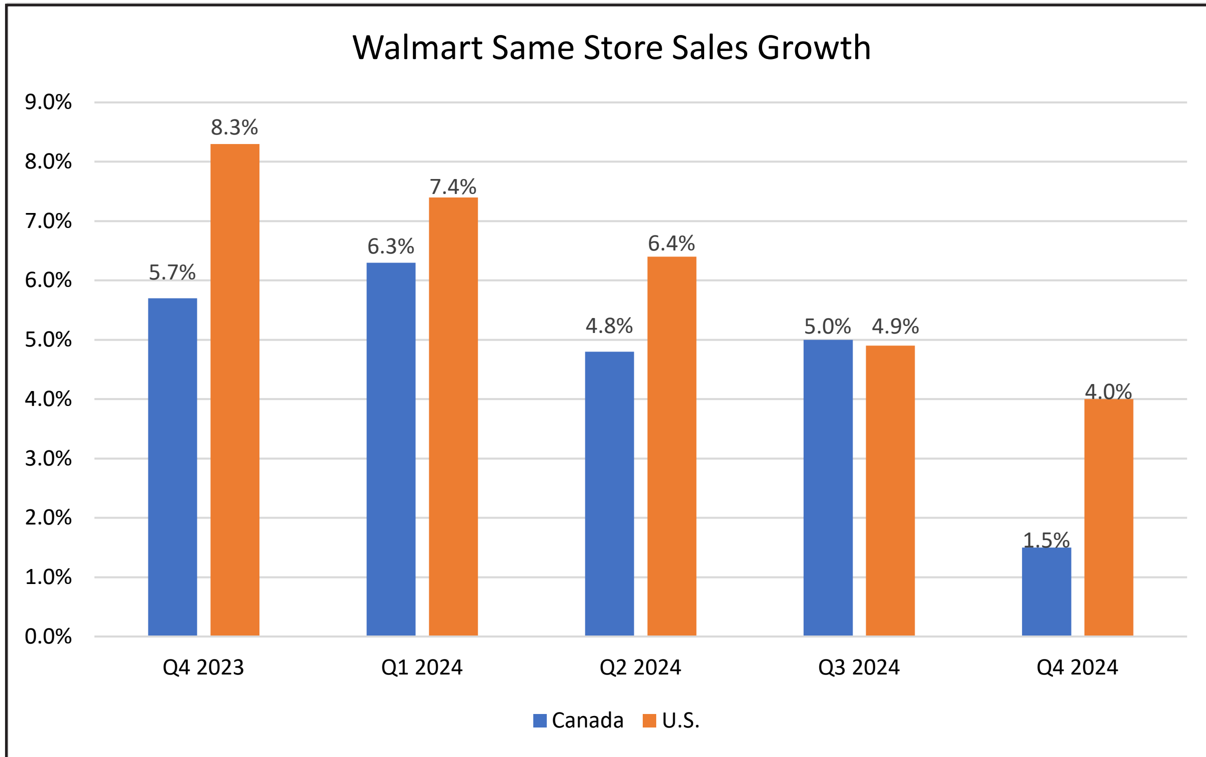


Source: FRED

The market has gone from expecting almost 6 rate cuts through 2024 to now just under 4, but equity markets have continued to grind higher, making it seem to us that rate cuts are already priced as we sit here at the all-time highs. This also makes us believe that the path of the market after the first rate cut may not be a guaranteed upside scenario.

Canada Divergence Continuing

Last month we talked about the weakness in Canada and how it is diverging with the United States. We saw further evidence most recently with Walmart's results. Walmart USA comparable sales were +4% in Q4, Canada's were +1.5%. However, Canada population was up almost 3.2% YoY which suggests the per capita comp sales was negative 1.7%. This contrasts USA population being up 0.5% YoY, which implies per capita comps sales being positive 3.5%. That's a 5.2% spread between Canada and USA.



Source: Walmart

Quebec's November also showed terribly, with GDP down 0.4% in the month, which is shocking considering the population of Quebec was up 0.8% in Q4 vs. Q3. This implies per capita GDP was down almost 8% annualized in November. Some of this was the strikes during the month, but we can't help but see these kinds of events and ask how bad is Canada really doing.

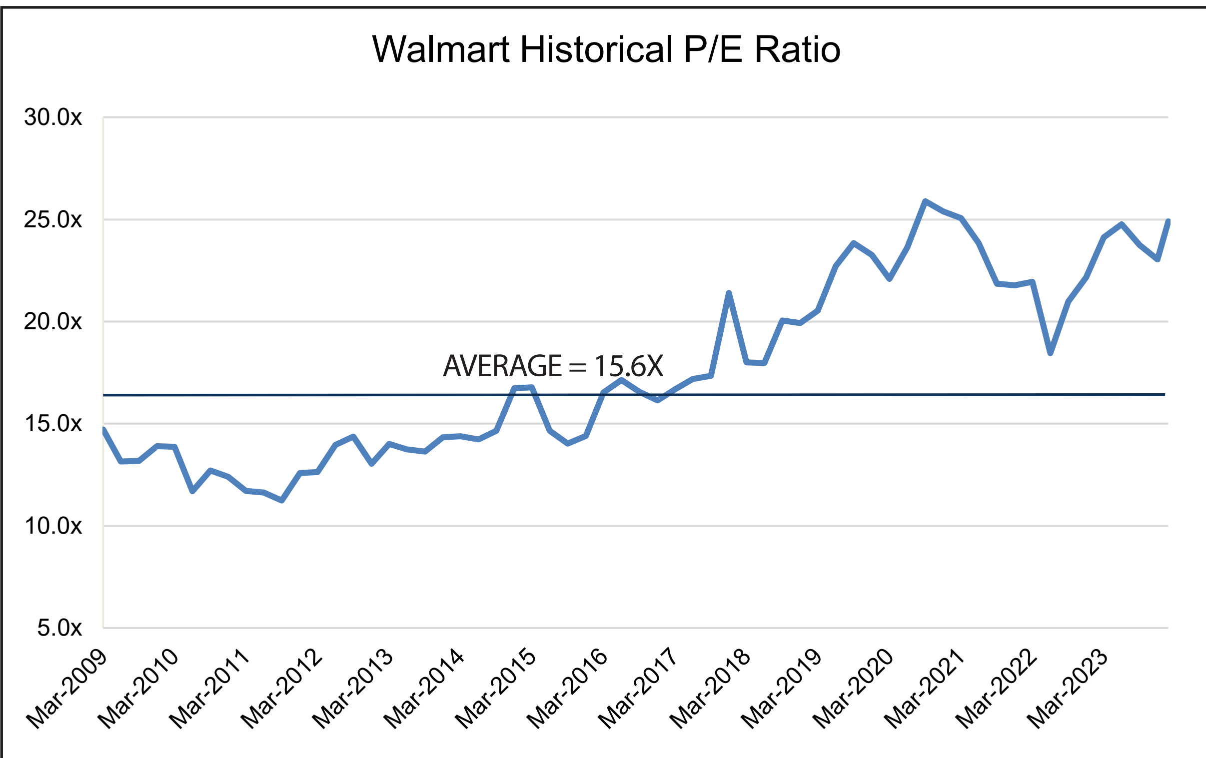
Portfolio Positioning

We remain relatively conservative in our positioning, though we have taken slightly more risk as we've seen opportunities show themselves in various forms. We remain focused on finding names where we see good risk reward, real free cash flow and where we are able to get conviction. In fact, we see lots of cheap stocks out there, but no one seems to care, the top of the market is clearly seeing the majority of the fund flows.

This divergence feels extreme and companies which are 'high quality', 'long term compounders' or in 'mini oligopolies' buckets generally look expensive compared to pre-pandemic.

We'll use Walmart as an example (charts on next page). The point is that 10 years prior to Covid, the average multiple was 15.6x P/E and has now expanded to 25.0x P/E today. The stock is at its peak and has seen significant multiple expansion despite ticket vs inflation trends being bad. Most of these stocks (top large cap + long term compounders and high market share) trade at a multiple much higher than pre-covid despite rates being higher (higher discount rate should actually lower valuation). This makes no sense to us. We believe the main cause is the substantial flow of money toward passive investing along with momentum. We believe this is not sustainable although we admit we have no idea when this is going to reverse.

Source: Bloomberg



Source: Bloomberg

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