Desjardins
Global Asset Management

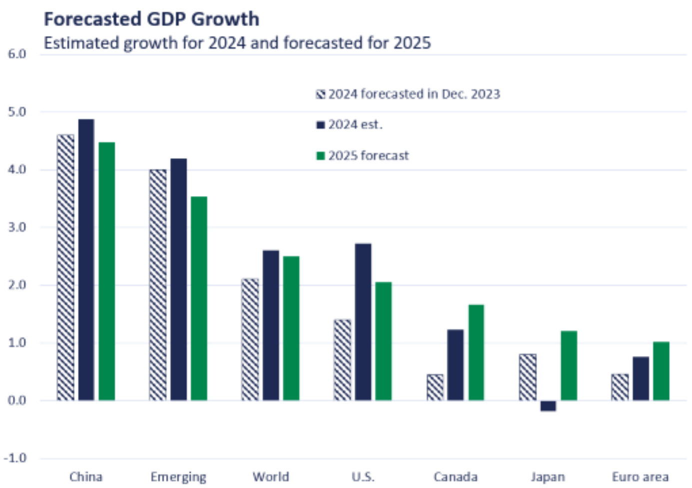
Market Review

DECEMBER 2024

Economic Review

What should we expect from the economic policies of the new US administration?

Forecasters agree that in 2025, the pace of global growth will be modest overall, although higher than expected at this time last year. They predict that global growth should be around 2.6%, which is comparable to what we saw in 2024.



Sources: DGAM, Consensus Economics, December 2024

For 2025, economists are in fact invoking "American exceptionalism" in predicting stronger growth in the United States (2.0%) than in Europe (1.0%), Canada (1.7%) and Japan (1.2%), while growth in emerging countries is expected to decline from 4.5% to 4.0%. With respect to inflation, some countries, including Canada, are doing well, as recent statistics are aligned with central bank targets. The situation is less clear in the US, where the risk of price acceleration persists due to the president-elect's potentially inflationary economic policies. This is one reason in particular why the Federal Reserve is being cautious about future rate cuts.

According to the International Monetary Fund (IMF), the US deficit could exceed 7% of GDP in 2025, more than 3 times the average of other developed countries. Deficits of this magnitude are usually seen during a recession, when tax revenues fall and social spending rises. This time, the government is simply borrowing on future growth to boost the economy in the short term. Even without considering the multiplier effect, the increase in government spending alone accounts for a quarter of GDP growth over the past 2 years. For how long can we continue to borrow on future growth? Will Donald Trump's return to the White House change anything? Small businesses are confident and have responded favourably to the deregulation and public sector downsizing promised by the Trump administration.

Meanwhile the Canadian economy will continue to face headwinds. Optimists are expecting growth of 2.2% and pessimists 0.4%, for an average of 1.6%. The US president-elect's threat to impose a 25% tariff on Canadian imports has certainly contributed to this uncertainty. With respect to domestic demand, weakness in residential real estate investment, which has been holding back economic growth for 3 and a half years now, seems to be coming to an end. While this partially justified the recession scenario expected in 2024, the rest of the economy held up better than predicted, particularly the consumer sector. It remains to be seen how consumers will respond to the wave of mortgage refinancing that will intensify in 2025 given that debt burden is already very high. Businesses whose revenue depends on consumer purchasing power still face significant challenges. In contrast, the energy transition and the advent of artificial intelligence remain favourable for the Canadian market, which is largely exposed to companies in the materials, energy and utilities sectors.

On the European side, Germany, the world's third-largest economy and second-largest exporter of manufactured goods, is suffering from a deep malaise. Sharply increasing energy prices since the start of the Ukraine war have undermined competitiveness. To this we can add competition from China, as well as weakness in the Chinese economy and decreased demand for German products. In 2025, US tariffs may well exacerbate the situation. The German central bank has in fact revised its growth forecast downward and warned that a trade war could push the country into recession. That said, neighbouring countries are experiencing more dynamic growth, and the Chinese stimulus measures directed at consumers are encouraging European exporters, especially luxury goods manufacturers. Finally, credit growth has picked up in recent months, reflecting improved confidence and the impact of interest rate cuts.

On the Asian side, tariffs and export restrictions in an increasingly integrated global economy will be neither one-way nor without consequences for the global supply chain. Will Asian allies of the US, including South Korea and Japan, be able to benefit from the reorganization of the supply chain outside of China? Nothing is less certain. At the end of 2024, president-elect Trump had still not met with elected officials from South Korea and Japan, leading them to fear high tariffs. In January 2017, during his first term, Donald Trump had accused Japan of manipulating its currency. However, the yen has since depreciated by 25% against the dollar, a further irritant for the new US administration.

Canadian Fixed Income

In the fourth quarter, the 10-year yield on Canadian bonds went from 2.96% to 3.23%. For the same period, the total return of the FTSE Canada Universe Bond Index stood at -0.04%, for a year-to-date total of 4.23%. Meanwhile, the corporate bonds in this index returned 1.03% in the fourth quarter and 6.97% over the year. This performance resulted from a combination of current yield, tighter credit spreads and higher interest rates.

Provincial Credit

The widespread absence of risk aversion, combined with demand driven by December coupon payments in a quarter marked by a domestic supply at half its usual level, led to tighter credit spreads for provincial bonds. Compared to the Ontario benchmark bonds, credit spreads for 5-year bonds tightened by 4.5 basis points (bps) to 22.5 bps, while 10-year bonds tightened from 68 bps to 59 bps. For their part, long-term bonds tightened by about 9 bps to 85.5 bps at year-end, after hitting a low of 81 bps in December.

The announcement of an agreement in principle between Quebec and Newfoundland and Labrador for the purchase and development of hydroelectric energy was a landmark event. Some see the agreement as having a short-term negative impact for Quebec, but one that is consistent with the strategic plan to ensure access to clean and inexpensive energy for many years to come. It is quite beneficial for Newfoundland and Labrador, given the considerable amounts involved and its small population. Following the announcement, credit spreads for Quebec and Hydro-Québec bonds widened by 1 to 2 bps, while for Newfoundland and Labrador they tightened by about 7 bps, reaching 24 bps above the Ontario benchmark for 30-year bonds, although on very low volumes.

Spreads on British Columbia bonds also widened by 2 basis points relative to Ontario's, primarily due to a lack of improvement in the province's balance sheet, as its financing needs remain high. As for Alberta bonds, they recovered some of the previous quarter's loss to close the year at 1.5 bps above Ontario for long-term bonds.

We believe that the recent performance of provincial bonds could be short-lived. Although borrowing programs for the current fiscal year are generally well advanced, supply will continue to be an issue in 2025. The risks of a downturn in the Canadian economy, given potential tariffs, weaker population growth and higher mortgage rates, call for caution. We will therefore wait before we significantly increase our exposure to provincial bonds.

Corporate Credit

Corporate credit spreads tightened by about 20 bps in the fourth quarter. The 2 sectors that performed best were real estate, which views the lower key rate favourably, and energy, which should be minimally affected by threatened tariffs while benefiting from a potential wave of deregulation.

In 2024, credit spreads tightened by about 50 bps to reach 99 bps, their lowest level since 2018. This spectacular tightening can be explained by a combination of several factors: the solid economic fundamentals of Canadian companies, strong demand for corporate credit, and the lower key rate, which reduces the risk of a recession. Despite historically favourable spreads for Canadian issuers, the US primary market remains a more attractive option for many Canadian businesses that are able to raise funds in US dollars. In 2024, however, Canadian businesses were very active, with nearly $140 billion in financing, which is close to the record of $145 billion set in 2021.

Against this backdrop, we're maintaining a defensive position. Corporate balance sheets and investor demand remain strong, but macroeconomic and geopolitical risks, as well as valuations, are prompting us to start the year with caution.

Fixed Income Strategy

In the fourth quarter, our baseline scenario for the evolving Canadian economy and inflation unfolded as anticipated, given the key and market rate decreases as well as a further steepening of the yield curve. The Bank of Canada should continue its monetary easing to avoid a tightening of real credit conditions. At the end of the quarter, markets were anticipating an administered rate slightly below 2.70%, close to the midpoint of the range the Bank describes as neutral, between 2.25% and 3.25%. Since we expect the Bank of Canada will need to reach the lower bound of its range, given the trajectory of the Canadian economy and inflation, not to mention the threat of tariffs, we are maintaining a slightly long duration bias in our portfolios.

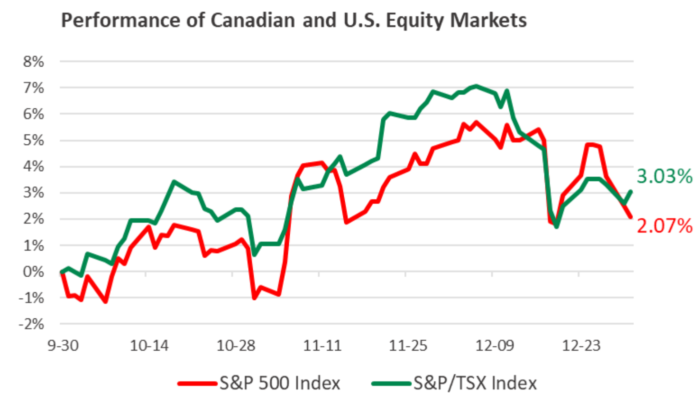
We again reduced our exposure to corporate and provincial securities at the end of the quarter, focusing primarily on corporate bonds with maturities over 10 years and provincial bonds with maturities over 30 years. This approach is an intensification of a position held for several months, except in the case of provincial securities, where it involves a reduction in long positions. Considering historical trends, several risky assets point to a perfect soft landing, which we doubt will happen, especially on the Canadian side.

Over the past few months, we've seen that the US economic situation is very different from the one in Canada. As previously mentioned, the Federal Reserve is being cautious about future rate cuts. What's most interesting is that since the Federal Reserve began its cycle of monetary easing, 10-year yields to maturity have risen by nearly 90 bps! The president-elect's inflationary policies, combined with a fiscal situation that's concerning, to say the least, surely had something to do with this. With 10-year yields 130 bps higher than Canadian rates, we can see a strong divergence between the 2 economies.

Stock Markets

Canadian and US Equities

In the fourth quarter of 2024, North American stock markets posted lower returns than in the previous quarter but remained in positive territory. The outcome of the US election in particular had a positive effect, given investor optimism over the president-elect's policies, which are likely to benefit businesses. Most indexes thus hit new highs in early December. However, uncertainty caused by the US Federal Reserve's mid-December statement led to a significant downturn. For the quarter overall, the S&P/TSX Index gained 3.03%, while the S&P 500 Index in the US closed with a 2.07% return. In 2024 overall, they posted returns of 18.0% and 23.3%, respectively, compared to 8.1% and 24.2% as at December 31, 2023.



Sources: DGAM, Bloomberg, December 31, 2024

In Canada, lower interest rates remain a key factor affecting market developments. However, the US president-elect's statements about potential tariffs on Canadian imports are creating uncertainty. At the same time, the Chinese government's economic recovery plan has proved less favourable than anticipated and negatively impacted the raw materials sector, with declines in copper, iron ore and oil prices. However, the tech sector had a great quarter, with companies announcing better-than-expected results and positive growth prospects for 2025.

In the fourth quarter, the Canadian stock market once again showed significant dispersion in sector performance, unlike the third quarter, when all sectors ended in positive territory. Half of the sectors posted gains, and the technology sector in particular stood out with a 24.2% increase in its index.

Celestica, up 98.1%, posted the quarter's best performance. As one of the few Canadian companies exposed to the rise of artificial intelligence, it is expected to benefit greatly from investments in data centre equipment. Some industrial sector companies also had a strong quarter due to a solid order backlog, efficient execution and sound margins. This was the case with MDA Space, which benefited from generally positive sentiment toward the aerospace industry to post a return of 69.7% in the fourth quarter. Meanwhile AtkinsRéalis has benefited from increased investor interest due to its work in the nuclear energy sector, leading to a 36.9% appreciation in its share value.

Companies in the communications sector are among those that underperformed during the quarter, including Bell and Rogers, which posted declines of 29.1% and 16.9% respectively. Increased competition, questionable acquisition strategies and high debt rates have added to constant pressure, particularly regarding the growth outlook for 2025.

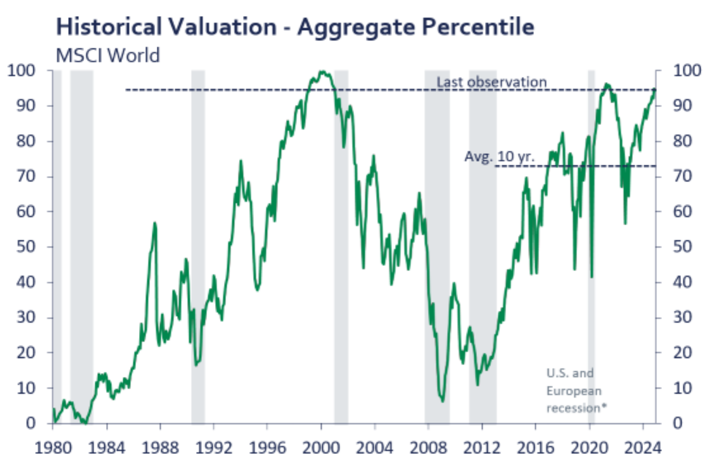
International Equity

In the fourth quarter, global equity values again hit new highs, with the MSCI World Index up 1.9% despite a difficult December. The optimism that followed the US election faded late in the year due to concerns about a potential slowdown in the economy and an interest rate hike. This led to a nearly 2% drop in the value of global equities. For 2024 as a whole, however, global equities posted a gain of 21%, making it the second consecutive year with a return of over 20%.

While economic growth remained strong, it was slightly below expectations. The US economic surprise index peaked in mid-November before weakening. Forecasts by the Atlanta Federal Reserve for fourth-quarter GDP were volatile, with a downward revision in the GDPNow model estimate, from 3.5% to 2.5%. Investors are also increasingly concerned about the potential impact of higher tariffs on US inflation as well as economic growth in the rest of the world.

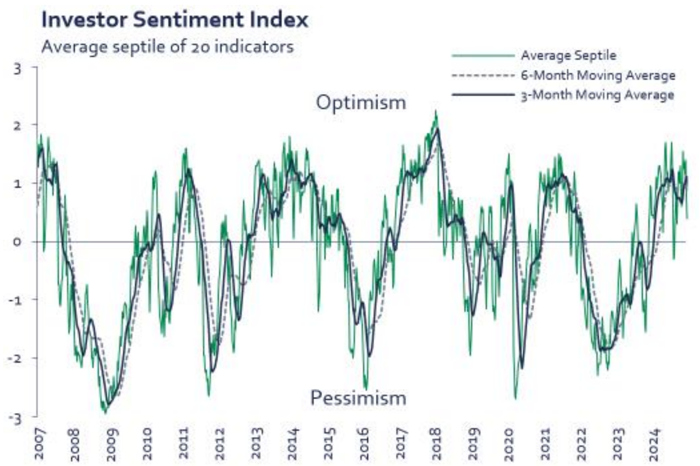
Rising interest rates also weighed on equities at the end of the year. Yields on 10-year US Treasury bills hit a 6-month high, while market expectations for the Federal Reserve rate target for December 2025 stood at 3.9%, up from 3% at the end of the third quarter.

The rise in interest rates had very little impact on valuation multiples, with the aggregate valuation index of the MSCI World Index remaining unchanged at the 94th percentile of its historical distribution, its highest level since late 2021. According to our aggregate valuation index, the US equity market remains the most expensive, while those in Europe, developed Asian countries and emerging markets are all close to the 70th percentile.



Sources: DGAM, LSEG, MSCI, IBES, NBER, *ECRI, Bloomberg, December 2024

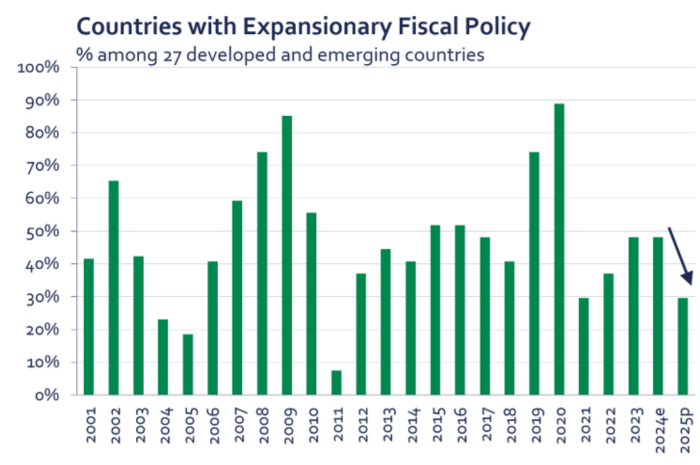
Our internal sentiment index remains high, although the biweekly readings have recently become more volatile. As for the 20 indicators that make up the index, the distribution is relatively neutral: Financial and technical data show a negative bias, while investor surveys and positions show a strong positive bias. Investor optimism increased after the US election, but not enough to raise moving averages, which could have improved sentiment in the coming months. If moving averages have already peaked, a change in overall investor optimism could lead to a reduction in risk exposure.



Sources: DGAM, LSEG, Bloomberg, State Street Global Markets, December 2024

Emerging Markets Equity

As already mentioned, economists are expecting less economic growth in emerging countries in 2025 compared to 2024. In Asia, the strong export performance of 2024 will be very difficult to repeat. The easy gains made in the tech sector recovery are now behind us, and the arrival of Donald Trump as US president raises the risk of tariffs.



Sources: DGAM, LSEG, IMF, December 31, 2024

The IMF estimates that only 30% of countries worldwide will implement an expansionary fiscal policy in 2025, one of the lowest proportions since 2011. China should be one of these few countries and it will try to boost domestic demand to offset trade tensions on the horizon. Nevertheless, keep in mind that China is now less dependent on the US than it was during Donald Trump's first mandate.

That said, since late September 2024, the Chinese authorities' desire to boost household confidence has been increasingly pronounced. The trade-in program for replacing and upgrading durable consumer goods is expanding, and voucher distribution rounds have been announced in various cities.

As for the valuation of emerging market equities, our normalized model shows a slight improvement over the fourth quarter, from the 83rd to the 74th percentile of its historical distribution. However, we still don't find the valuation of emerging market equities attractive in absolute terms. That said, they remain highly attractive compared to US securities, comparable to European securities, but increasingly less attractive relative to Asia-Pacific securities.

Despite significant stock market fluctuations and the investor sentiment seen throughout 2024, the emerging markets sentiment index closed the year in neutral territory. This contrasts with the optimistic data on developed markets. The gap between these 2 indexes is the widest it has been in 6 years.

Asset Allocation

Dual stimulus from fiscal and monetary policies

Consistent with our past observations, the North American government yield curves have rebounded following the Federal Reserve's first key rate cut. A soft landing for the North American economy appears to be taking shape, supported by fiscal stimulus measures and key rate cuts on a nearly worldwide scale. This scenario seems more credible in the US, where the continuing strong economy and the president-elect's election promises have led the Federal Reserve to slow its monetary easing. This stronger-than-expected growth and the stalling of disinflation are keeping long-term interest rates high, which could pose a threat to equity valuations.

As noted, the key rate in Canada is now at the upper end of the Bank of Canada's estimated neutral rate range. Although interest rate-sensitive economic sectors (real estate, retail sales) have strengthened, further cuts will likely still be needed, potentially down to the lower end of the range. The wave of mortgage renewals, slowing population growth and potential new US tariff barriers could well affect economic growth. The Bank of Canada is aiming for the economy to operate above its potential for a certain time to reduce unused capacity, but growth remains below its projections and below long-term potential. The S&P/TSX Index, which is more sensitive to interest rates due to its industrial composition, could benefit from a steepening of the yield curve. The new federal objective to limit net immigration should begin to curb revenue growth among businesses in several industries at a time of moderate inflation, creating downward pressure on profitability.

In the US, earnings per share (EPS) growth forecasts for S&P 500 companies stand at 14%, exceeding historical averages and the 6% revenue growth anticipated for the next 12 months. This suggests that profit margins, already at record highs, are likely to expand further. As indicated at the outset, the US deficit remains highly expansionary. Investors are largely underestimating the impact of significant US fiscal stimulus measures. If the EPS growth of US companies is based on fiscal stimulus rather than technological exceptionalism, it is crucial to understand this dynamic to assess the sustainability of stock market performance. However, the combination of a strong dollar, fewer key rate cuts and an increase in long-term interest rates should soon hinder EPS growth. A price-to-earnings ratio of 22x combined with a 10-year interest rate of approximately 4.5% means there is no risk premium. Investors also appear indifferent about holding US equities and government bonds due to concerns about a second wave of inflation and fiscal indiscipline on the part of the government.

The table below presents our positioning recommendations as at December 31, 2024, based on our analysis of the economic context. We're lowering our recommendation on emerging market equities. To balance our position, we're increasing our recommendation on long-term Canadian bonds following the recent increase in rates.

POSITIONING					
	- -	-	0	+	++
CANADIAN EQUITY	☐	☐	☑	☐	☐
US EQUITY	☐	☑	☐	☐	☐
EMERGING MARKET EQUITY	☐	☐	☑	☐	☐
EAFE EQUITY	☐	☑	☐	☐	☐
WORLD EQUITY	☐	☐	☑	☐	☐
US 10Y BONDS	☐	☐	☑	☐	☐
CANADIAN 10Y BONDS	☐	☐	☐	☑	☐
CAN. CORPORATE BONDS	☐	☑	☐	☐	☐
PREFERRED SHARES	☐	☐	☑	☐	☐
CASH	☐	☐	☑	☐	☐

■ Fixed Income

Yields to maturity - Canada	Current level	1 month	3 months	6 months	1 year
Bank of Canada overnight rate	3.25%	3.75%	4.25%	4.75%	5.00%
2 years	2.93%	3.04%	2.91%	4.00%	3.89%
10 years	3.23%	3.09%	2.96%	3.50%	3.11%
30 years	3.33%	3.14%	3.14%	3.39%	3.03%
Credit market	**Current level**	**1 month**	**3 months**	**6 months**	**1 year**
Mortgage rate (prime rate)	5.5%	6.0%	6.5%	7.0%	7.2%
5-yr credit spreads (CDX.IG)	50	48	53	53	57
5-yr High yield credit spreads (CDX.HY)	311	295	329	344	356
5-yr Emerging debt credit spreads	297	303	323	344	319

■ Fixed Income

Yields to maturity - United States	Current level	1 month	3 months	6 months	1 year
Fed rate	4.50%	4.75%	5.00%	5.50%	5.50%
2 years	4.24%	4.15%	3.64%	4.75%	4.25%
10 years	4.57%	4.17%	3.78%	4.40%	3.88%
30 years	4.78%	4.36%	4.12%	4.56%	4.03%
Credit Market	**Current spread**	**1 month**	**3 months**	**6 months**	**1 year**
Spreads Ontario - 10 years	57	62	66	64	64
Spreads utilities - 10 years	95	101	115	116	128
Spreads communications - 10 years (BBB)	132	140	147	156	158
Spreads banks - 10 years	30	34	44	50	88

■ Fixed Income indices

	Current level	Total return 1 month	3 months	6 months	5 years (ann.)
FTSE Provinces index	1343	-1.4%	-0.4%	3.1%	0.0%
FTSE Municipal index	1458	-1.0%	-0.1%	3.9%	0.6%
FTSE Corporate index	1440	-0.1%	1.0%	7.0%	2.3%
FTSE Overall	1169	-0.7%	0.0%	4.2%	0.8%

■ Equities

	Current level	Total return in CAD 1 month	3 months	6 months	5 years (ann.)
S&P/TSX Composite	24728	-3.3%	3.8%	21.7%	11.1%
S&P 500	5882	0.3%	9.1%	36.2%	16.9%
MSCI World	3708	0.1%	6.5%	29.9%	14.0%
MSCI Emerging Markets	1075	2.7%	-1.8%	17.6%	4.2%
MSCI Global Small Cap.	563	-3.3%	3.9%	18.4%	9.1%

■ Currencies

	Current level	Variation 1 month	3 months	6 months	5 years (ann.)
CAD/USD	0.70	-2.6%	-6.0%	-7.9%	-9.7%
CAD/EUR	0.67	-0.5%	1.1%	-1.8%	-2.2%
CAD/GBP	0.56	-0.9%	0.5%	-6.3%	-4.3%

■ Misc.

	Current level	Yield / return 1 month	3 months	6 months	5 years (ann.)
VIX (level)	17%	14%	17%	12%	14%
Bloomberg Commodity Index	99	3.4%	4.9%	9.1%	6.2%
Gold	2625	-0.7%	-0.4%	27.2%	11.6%
WTI crude oil	72	5.9%	6.5%	3.0%	6.7%

Legal notes