PICTON MAHONEY
Asset Management

Q3 2024

Investment Review & Outlook

The Fed is in a Sticky Situation:
Will it Cause the Bull Run to Come Unglued?

- The Soft-Landing Narrative Remains Dominant—For Now
- But Significant Divergences Are Emerging
- The Fed's Sticky Problem: Services Inflation Remains Too High
- Economic Data Around the World Are Signaling a Slowdown—Even in the U.S.
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Overview

Last quarter we discussed the over-extended nature of markets, and our inclination to buy on pullbacks so long as the soft-landing narrative held. Equities did pull back in mid-April by about 5%, but the retreat was short-lived, and U.S. markets quickly notched fresh all-time highs. Bears may not be officially extinct at this point, but their numbers have certainly thinned out as equities keep scaling new heights. Most investors now believe a recession in the next year is not in the cards.

Ironically, as fear of an economic slump has dissipated, signs are emerging that the U.S. economy is beginning to falter. While excessive fiscal spending, easing financial conditions, and the emergence of a powerful artificial intelligence ("AI") spending cycle have helped contribute to keeping the economy stronger for longer, the lagged impacts of aggressive tightening of monetary policy are starting to take hold. Leading indicators warn of rising risks, and the all-important U.S. labour market is showing signs of cracking.

Yet the U.S. Federal Reserve ("the Fed"), which began jawboning financial conditions easier last fall, is now committing to sitting on the sidelines, opting to keep policy rates unchanged for the time being. In their public comments, Fed officials point to the need for even more favourable data points confirming that inflation has been tamed before rate cuts become appropriate. It's reasonable to assume this U.S. central bank is wary of underestimating underlying inflationary forces, a mistake it already made as the global economy surged following the pandemic.

But the Fed is faced with a real problem. Even though goods are in outright price deflation, core services inflation is uncomfortably high, and seemingly staying there. Unless this stubbornly high services inflation rolls over, the central bank should be hesitant to cut rates. The longer it doesn't ease policy, though, the greater the odds that a recession develops. This is the Fed's sticky situation.

We see risks in equity markets and other risk assets, particularly if weakening economic data cause investors to abandon the soft-landing narrative and start focusing on an impending recession instead. After all, valuations are high, positioning is stretched on the long side, and various signs of late-cycle speculation have returned to the market. A recession that seems to come out of nowhere, coupled with a Fed that is slow to react, presents a key risk for investors. Against this backdrop, we remain cautious about equities at current levels, sensing that better entry points are likely to present themselves in the months ahead. A deeper sell-off can't be ruled out if recessionary forces are felt.

Picton Mahoney House Views July 2024

	PMAM vs. Consensus
Risk	
Macro risk rose in the second quarter of 2024 from low levels as investors' Goldilocks expectations became challenged by stickier than hoped inflation, negative economic surprises and the prospect of higher for longer rates. We expect that extreme investor sentiment and positioning will increasingly reflect this reality, and thus macro risk to continue to increase.	Higher +
Macroeconomic	
Global Real GDP Global growth is diverging as emerging economies face a milder monetary policy environment and are already showing signs of better growth, while developed markets face a very restrictive monetary policy environment where growth rates are slipping lower.	Same
U.S. Real GDP Signs of slowing growth and confidence are increasing in the U.S., as the U.S. Federal Reserve has pledged to keep rates higher for longer. The impact of high rates and sticky inflation will likely continue to wear away on the U.S. economy, where the cushion of pandemic era savings is no longer there.	Lower –
Canadian Real GDP GDP per capita continues to contract and is expected to do so next quarter as well even as the Bank of Canada (BoC) embarks on its first rate cut. The economic impulse from last year's population boom has faded while unemployment rises.	Lower –
U.S. Inflation Core services inflation remains sticky even as core goods becomes a negative contributor to inflation. Rising house prices and resilient wage growth continue to put upward pressure on inflation but a weakening economy may blunt this as the year progresses.	Same
Equity Returns	
U.S. Equities Election risk is coming into focus next quarter, with an out-of-control budget and the need for fiscal austerity likely a key focus. As rates stay higher for longer with inflation progress stalling, we believe there is little room for upside with sentiment and positioning already at extreme highs, while high real rates offer no valuation support.	Lower –
European Equities European Central Bank rate cuts and signs of improving economic sentiment are a hopeful combination for Europe which must be balanced by the political risk that the recent French elections brought to light.	Same
Canadian Equities We believe a weak Canadian economy will eventually be saved by the BoC, but there is still a long road of rate cuts ahead to do so and until then, the environment generally does not bode well for Canadian equities.	Lower –
Bond Yields	
Treasuries (U.S. 10-yr) While rate cuts in the U.S. have been pushed out by a quarter or two, other countries have begun to cut. We expect treasury demand imbalances will ultimately put a floor on treasury rates.	Lower –
Investment-Grade Corporate Bonds Falling government rates will likely offset any widening of spreads for Investment Grade yields in the event of rising risk aversion.	Same
High-Yield Corporate Bonds As bankruptcies rise, the higher risk segments of High Yield are showing signs of increasing risk aversion.	Higher +
Other	
WTI Crude Oil OPEC (Organization of the Petroleum Exporting Countries) continues to balance supply in the face of uncertain demand with the goal of keeping prices stable.	Same
EPS Growth (S&P 500) Earnings growth has been anemic outside of large cap technology.	Lower –
P/E (S&P 500) We expect extreme equity valuations to normalize over time.	Lower –

PMAM refers to Picton Mahoney Asset Management. PMAM view is relative to the Bloomberg Consensus Estimate for each category. As at June 2024.

The Soft-Landing Narrative Remains Dominant—For Now

Right now, the market still seems to be in a soft-landing mode, believing that the Fed has successfully tamed inflation without causing an economic contraction in the process. Indeed, according to Bank of America/Merrill Lynch's June fund manager survey, 73% of respondents do not expect a recession in the next 12 months—the most in nearly two years, and up from 64% in May.[1] Belief in this "Goldilocks" outcome seems to explain much of the relentless strength in equities and other risk assets. Continued embrace of the generative AI theme also accounts for a decent share of the strength.

Whether the market is priced for perfection is up for debate. However, it's notable that equity markets and high-yield spreads have mostly tracked the direction typical of the six months following a Fed pause that was followed by an economic re-acceleration *(see Figure 1)*. That said, interest rates have not adhered to the usual soft-landing script: they have risen as opposed to falling. What's more, the unemployment rate has gone up instead of down, perhaps a harbinger of impending economic weakness.

Figure 1:
Equities and High Yield Have Followed the Soft-Landing Script. But Interest Rates Suggest a Hard Landing.

	S&P 500 Equal Weighted Index	S&P 500 Index	S&P/TSX Composite Index	MSCI World Index	U.S. 10 Year Bond Yield	U.S. 2 Year Bond Yield	10/2 Year Yield Curve	High Yield Credit Spread	U.S. Unemployment Rate
Last 6 months	5.1%	15.3%	5.6%	12.6%	0.40%	0.38%	0.02%	-0.14%	0.3
Fed Pause (pre-recession)									
Prior 3 months	5.1%	3.1%	2.2%	1.0%	0.13%	0.39%	-0.26%	0.65%	-0.1
First 3 months	3.8%	8.3%	9.2%	2.4%	-0.58%	-0.55%	-0.03%	0.06%	0.0
Following 6 months	5.3%	-0.2%	-2.7%	1.4%	-0.53%	-0.98%	0.45%	0.10%	0.2
Fed Pause (re-acceleration)									
Prior 3 months	5.0%	7.9%	1.9%	4.2%	-0.24%	-0.10%	-0.14%	0.06%	0.0
First 3 months	8.4%	6.9%	5.0%	4.8%	-0.78%	-0.92%	0.14%	-0.04%	0.0
Following 6 months	8.9%	12.5%	9.1%	8.2%	-0.71%	-0.66%	-0.05%	-0.32%	-0.1

Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. June 1982 to June 2024. Last 6 months is as of June 26, 2024. **Fed pause** is defined as the last hike of a continuous hiking cycle. **Fed pause (pre-recession)** is a Fed pause that eventually led to recession and **Fed pause (re-acceleration)** is a Fed pause where the economy then avoided recession and accelerated.

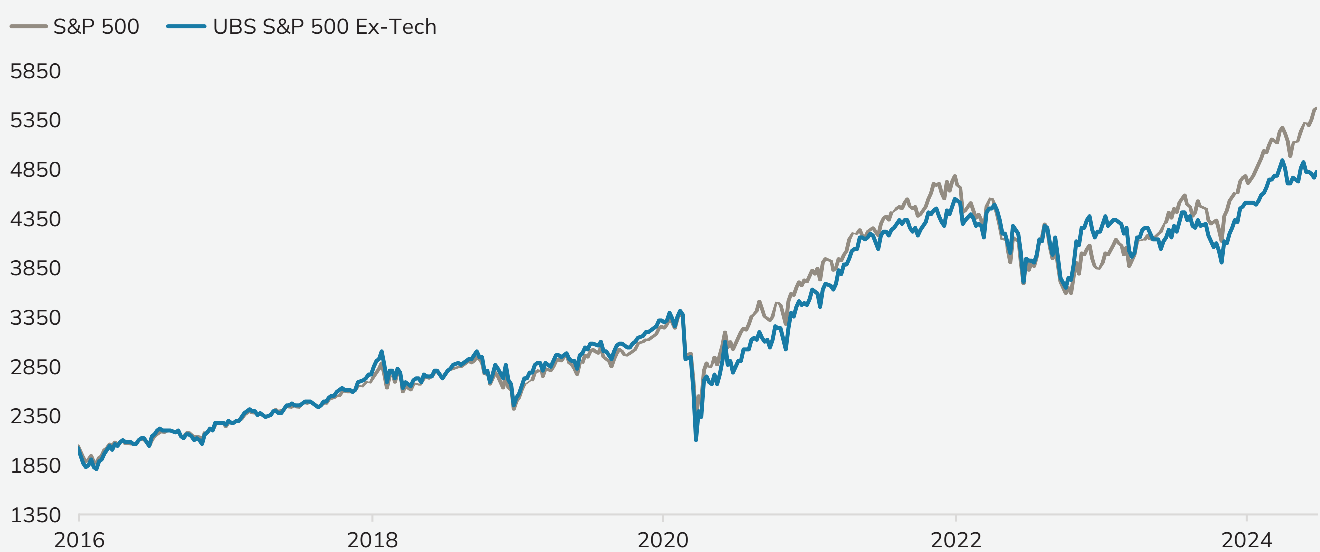
[1] BofA Global Research, Global Fund Manager Survey. June 18, 2024.

But Significant Divergences Are Emerging

If we just look at the overall performance of major equity indices, all appears calm. Beneath the surface, however, a different story is emerging. Significant divergences in stock and sector performance are developing, causing the market's breadth to deteriorate noticeably. For instance, although the capitalization-weighted S&P 500 Index has returned 12.0% for the last six months, the S&P Equal-Weight Index, which mutes the currently outsized impact of technology and AI, is only up 3.8% for the same period.

Large U.S. technology stocks have played a significant role in driving the strong performance of the S&P 500 Index. Nvidia Corporation alone was responsible for 34% of the performance of the index in the first five months of the year (as at June 3, 2024). Even within the more growth-oriented Nasdaq 100 Index, the famed "Magnificent 7" stocks are up 28% year-to-date, while the rest of the Nasdaq 100 Index is only up 3%.

Figure 2: If You Remove Large-Cap Tech Stocks from the Overall Market, the Rally is Much Less Buoyant



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2016 to June 2024.

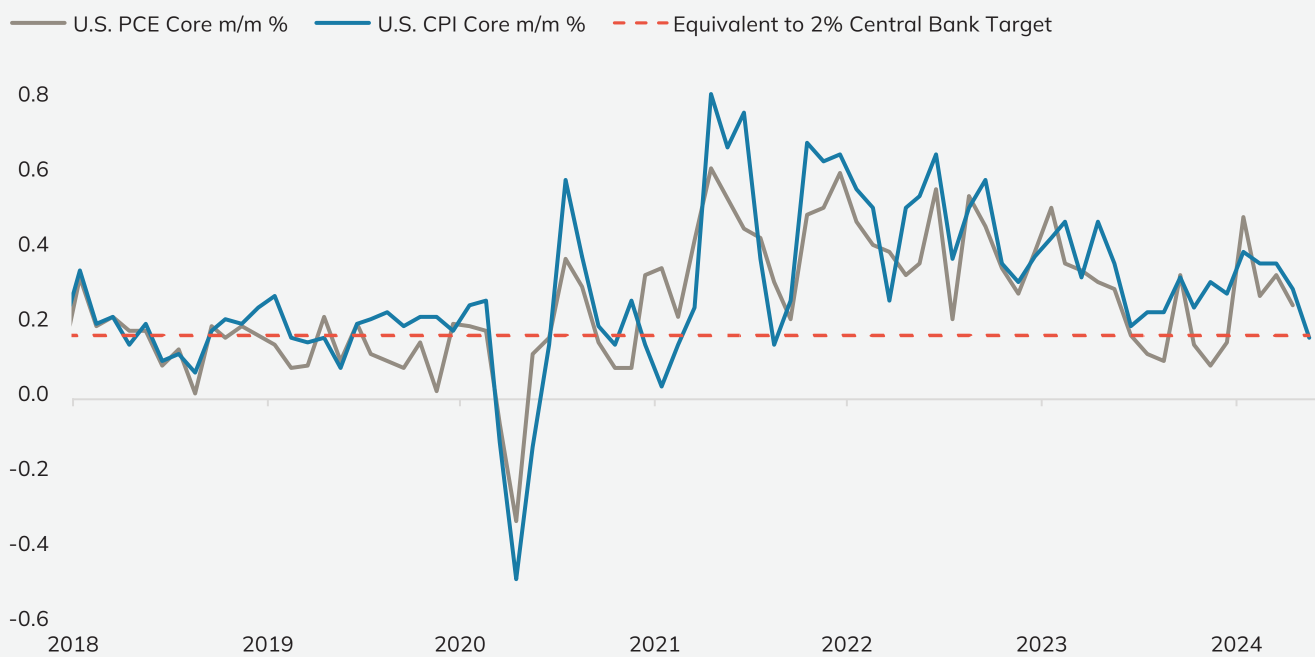
The divergence in performance between mega-cap technology stocks and other stocks can be at least partly explained by their relative earnings growth. In the first quarter, for example, the Magnificent 7 companies recorded year-over-year earnings growth of over 50%. By contrast, the remaining 493 stocks in the S&P 500 reported an aggregate profit increase of a mere 1% for the same period.

Referring to *Figure 1*, it is worth noting that the performance of the cap-weighted S&P 500 Index lines up quite closely with the soft-landing average of 12.8%. However, the equal-weight return resembles previous hard landings. Recent earnings growth in the equal-weighted index seems to confirm more of the latter as well.

Favourable Inflation Data Has Been a Tailwind for Equities

Recent inflation data have trended in the right direction, contributing to the rally in stocks. Both Core Consumer Price Index ("CPI") and Core Personal Consumption Expenditures ("PCE") inflation have decelerated on a month-over-month basis for the last two months, after trending higher to start the year. The latest Core CPI value came in right on target, with Core Services (ex-housing) surprising on the downside (although shelter costs did re-accelerate).

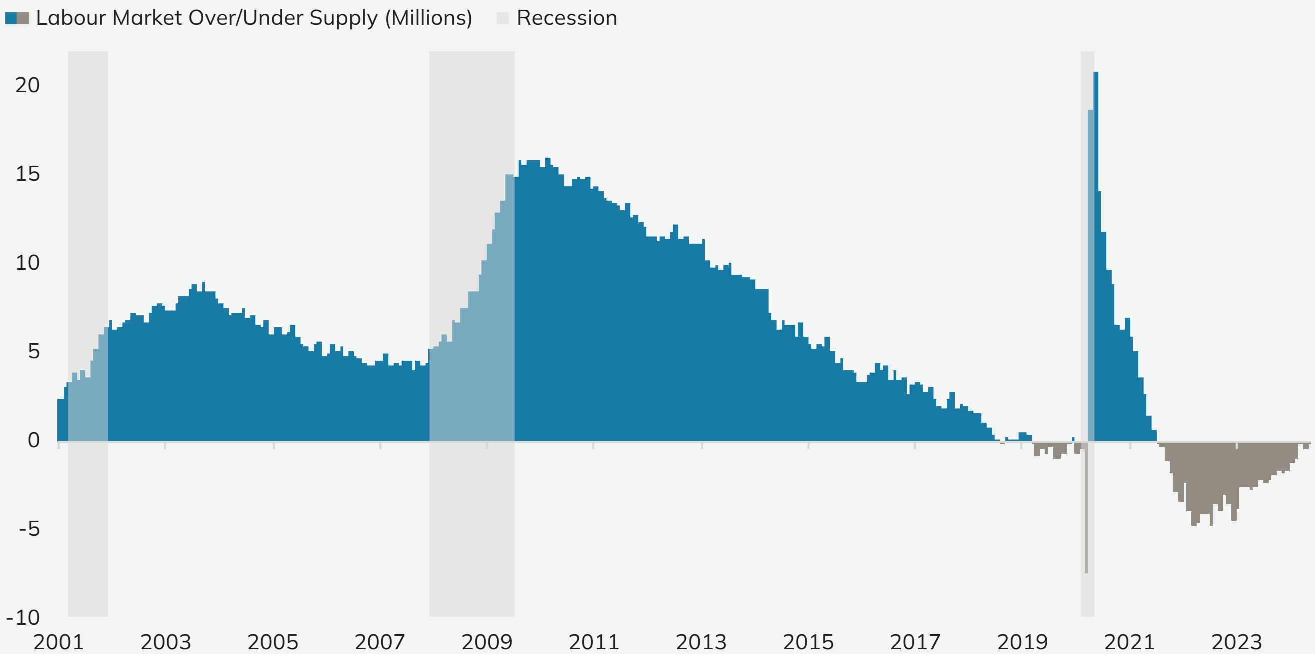
Figure 3: U.S. Core Inflation Month-Over-Month is Back to Target



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2018 to May 2024.

The U.S. labour market supply-demand situation has improved over time and is nearly back in balance. Although wage inflation remains elevated, it is expected to moderate as a result of the softening in labour market demand that is occurring.

Figure 4: The Labour Market is Nearly Back to Balance



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2001 to May 2024.

The Fed's Sticky Problem: Services Inflation Remains Too High

However, some inflation concerns remain, and are likely contributing to keeping the Fed on the sidelines for longer than anyone thought possible at the start of the year. For instance, while month-over-month inflation is back to target, both headline and Core CPI are now higher on a six-month basis than they were at the end of 2023: six-month CPI is at 4.1%, compared with 3.0% at the end of 2023, while 6-month Core CPI is at 3.7%, compared with 3.3% at the end of 2023.

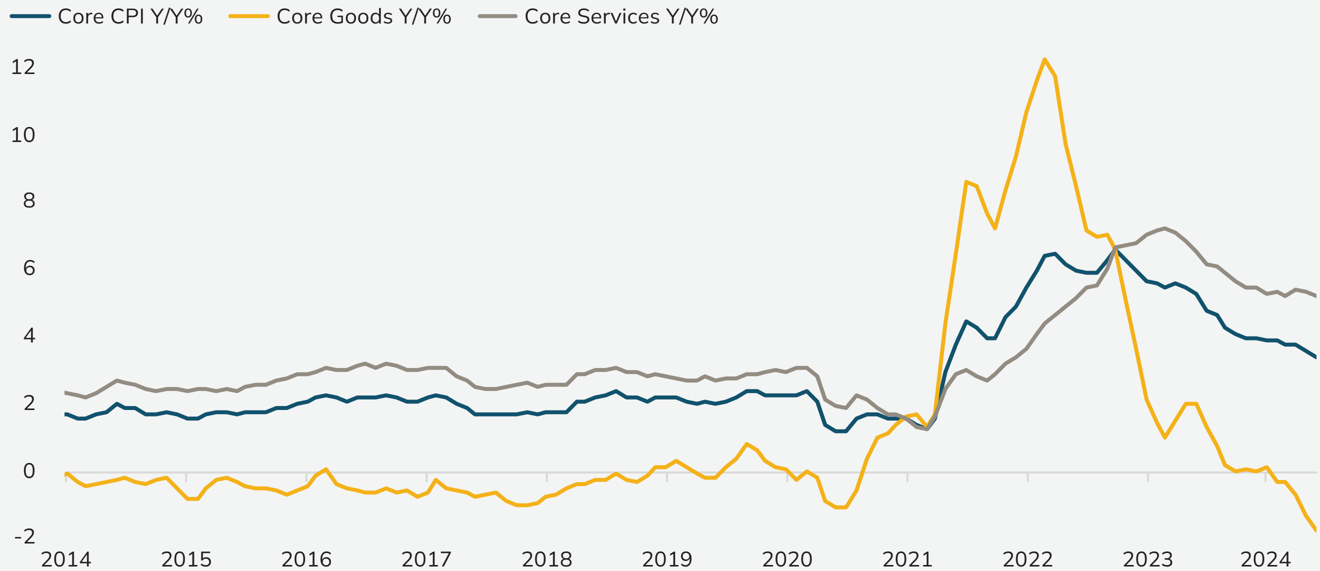
A Tale of Two Inflations

U.S. inflation has become decidedly bifurcated since 2022. Goods prices have been in outright deflation as of late, aiding the Fed's efforts to bring consumer prices back to target. However, services inflation has proven to be both elevated and sticky. In the words of National Bank economists:

> *...the real question going forward is whether the ongoing deflation in core goods will be enough to offset the persistent inflationary pressures in core services, where 12-month inflation has been above 5% for 24 consecutive months - the longest such streak since the early 1990s. Note that there is no precedent in modern U.S. history for core services inflation to be above 5% while core goods are deflating. As U.S. tariffs on Chinese goods ramp up, the possibility of disinflation stalling in the coming months remains. Keep in mind that the average base effect on core CPI from now to December will be only +0.17%, which means that, for the 12- month core rate to continue to fall, monthly results from now to the end of the year will have to be consistently below this figure. It's possible, but it's a tall order."*[2]

[2] National Bank of Canada, Core Services Inflation Remains Above 5% for 24th Consecutive Month, June 17, 2024.

Figure 5: Goods Prices are Deflating but Services Inflation Remains High

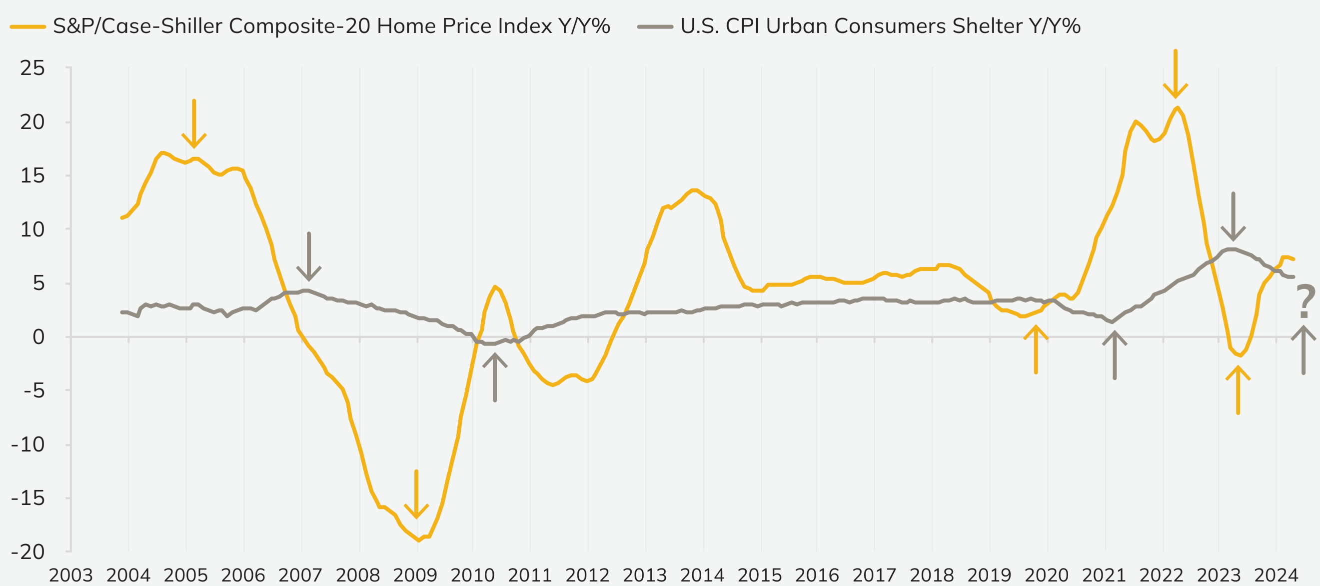


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to May 2024.

A Concerning Inflation Headwind for the Fed: Shelter CPI is Set to Bottom

Meanwhile, rising home prices suggest Shelter CPI will likely bottom at 2-3% year-over-year by around September 2024. This may add to the Fed's sticky inflation problem.

Figure 6: Rising Home Prices Suggest Shelter CPI Will Likely Bottom in September



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2003 to May 2024.

Longer Term Supply/Demand Imbalances Remain

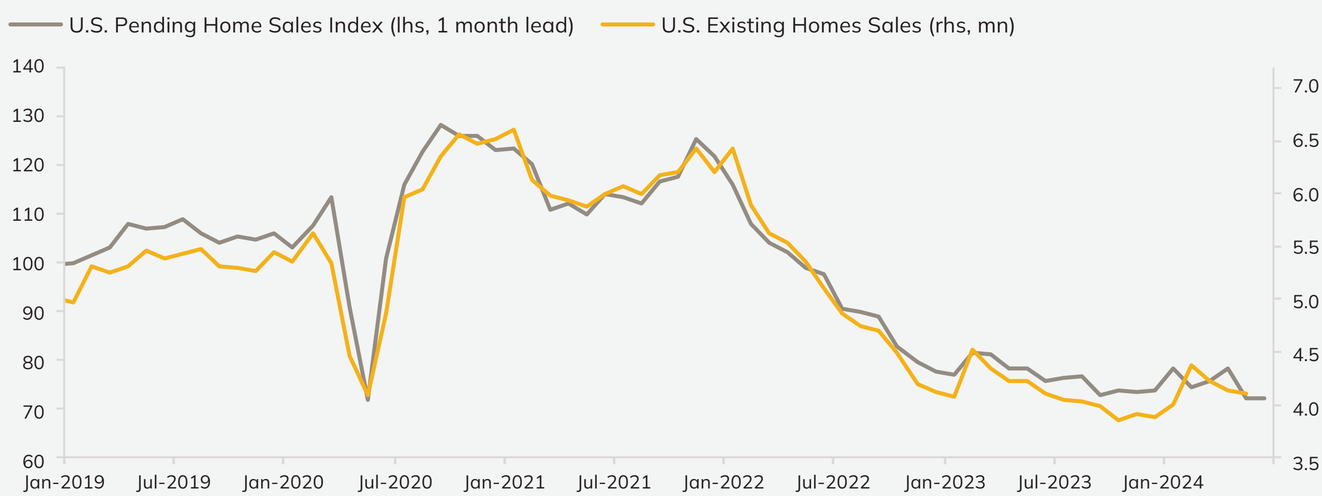
As we've previously written, there are some similarities between the inflation trends of the 1970s and what is occurring today. Just like in the 1970s, the U.S. faces structural shortages in key parts of the economy. There is nothing, for example, that Fed Chair Jerome Powell and his colleagues can do to produce more electricity, copper, or other commodities that are already in short supply, and that should become even more scarce when the economy reaccelerates and/or recovers in the next cycle.

A structural shortage of U.S. housing also poses challenges for the Fed. In spite of dramatically higher mortgage rates, U.S. home prices and rents continue to increase. Most existing homeowners locked in 30-year fixed mortgages when rates were much lower than they are today, and have not been significantly affected by rising interest rates. They have also generally benefited from rising home prices. But prospective homebuyers are faced with historic unaffordability, which has hurt new home sales.

Unfortunately, the Fed's tight monetary policy is likely exacerbating the supply shortage in housing. In the words of Joseph Wang (a former Fed trader):

> "*Higher interest rates appear to be negatively impacting the supply of housing and paradoxically pushing the achievement of the 2% inflation target further into the future. The last mile of above target inflation is largely due to elevated shelter inflation, which remains above its pre-pandemic pace. Higher interest rates may be decreasing the supply of housing even as the demand for housing is increasing from millennials and migrants.*"[3]

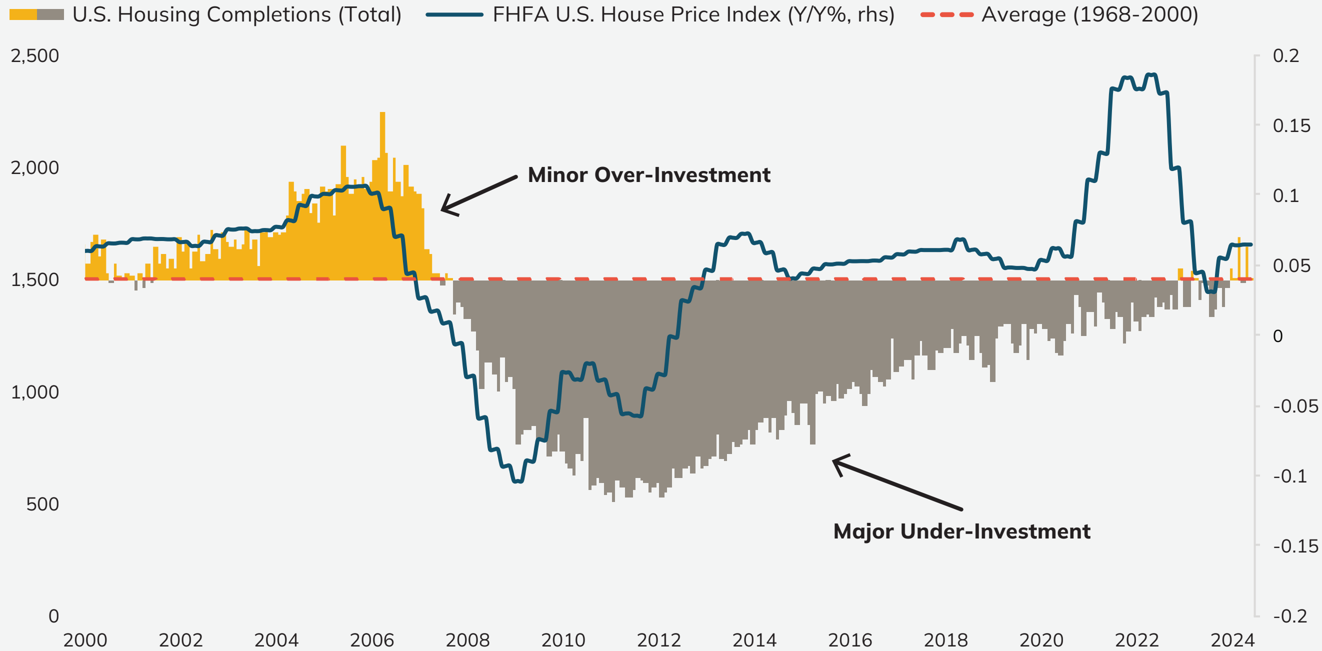
Figure 7: U.S. Home sales have plunged due to high rates



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2019 to May 2024.

[3] Joseph Wang, Creating Shortages, June 24, 2024.

Figure 8: The U.S. Housing market is Still Undersupplied



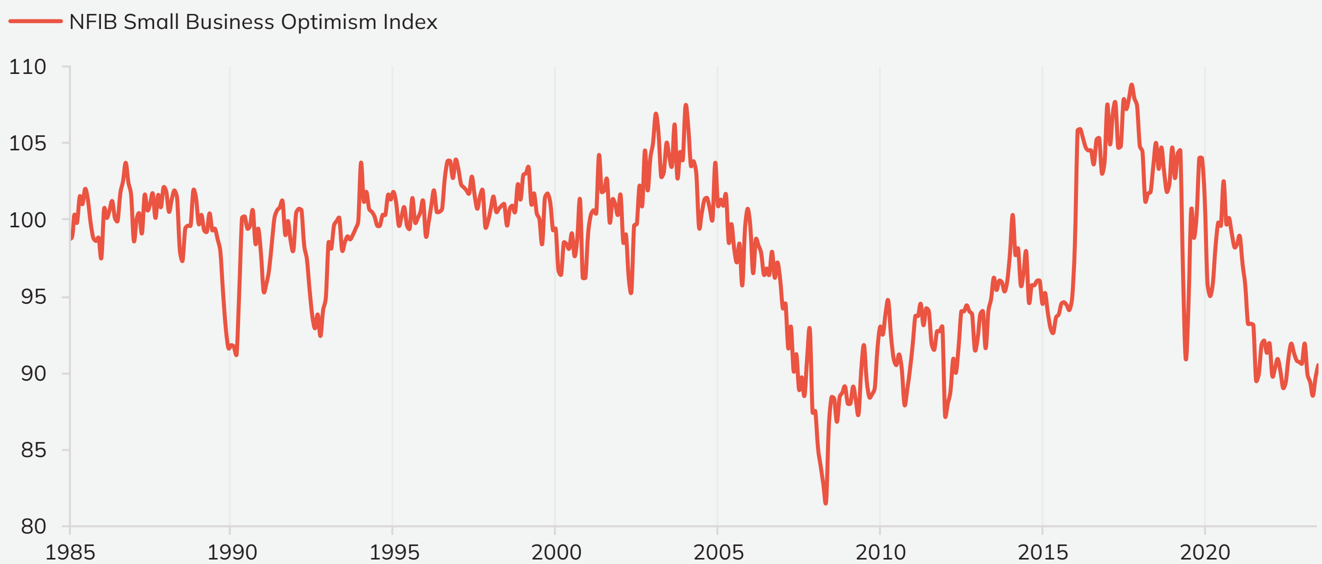
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to May 2024.

So perhaps the Fed is worried about what will happen to these imbalances when it takes its foot off the brakes. Will improving demand overwhelm current supply in housing, commodities or even skilled labour, which could reignite inflationary pressures much more quickly than in more recent cycles? Perhaps the Fed should be willing to create at least a mild recession to give supply forces more of a chance to catch up to potential demand growth down the road.

Economic Data Around the World Are Signaling a Slowdown—Even in the U.S.

Unfortunately, signs of an economic slowdown are building around the world. Even the U.S. economy seems to be faltering. From a weak April retail sales report to a significant drop in new home construction,[4] we may finally be seeing widespread evidence that the Fed's aggressive rate-hiking cycle is starting to take its toll. Consumer surveys show that employment expectations are deteriorating, while real income expectations have also plunged. To add to the malaise, small business confidence is near multi-year lows.

Figure 9: **U.S. Small Business Optimism is Near Multi-Year Lows**

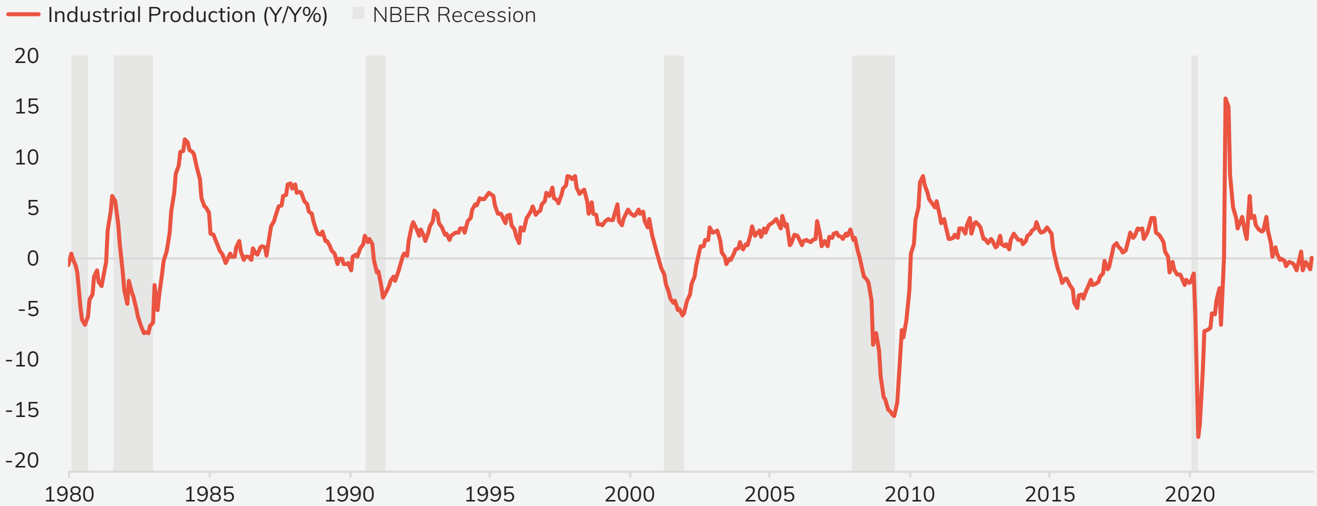


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1985 to May 2024.

High interest rates are weighing on investment in machinery and equipment spending. Real capital goods orders (a proxy for business investment in machinery and equipment) have fallen 3.4% from early 2022 peaks and continue to trend lower. Industrial production, meanwhile, has flatlined at zero, underscoring the current lack of demand growth.

[4] Bloomberg, From US Stores to Factor Floors, Second Quarter Starts Out Slow, May 16, 2024.

Figure 10: Industrial Production Growth is Non-Existent

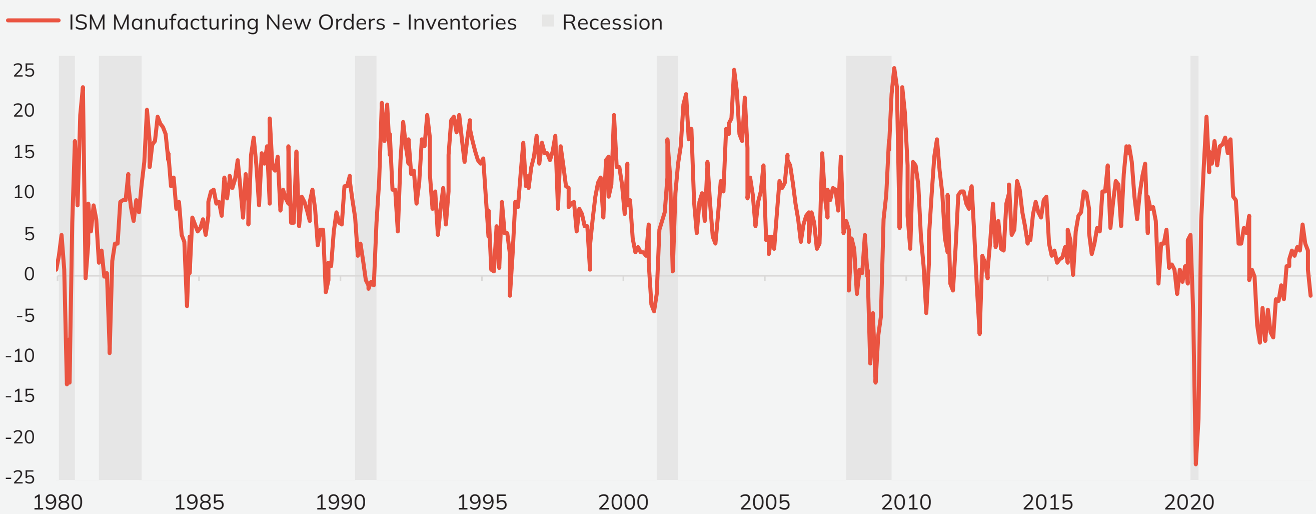


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1980 to May 2024.

May's ISM Manufacturing New Orders fell by the most they have in nearly two years, pushing the forward-looking New Orders-to-Inventories ratio back into negative territory. According to Timothy Fiore, chair of the ISM Manufacturing Business Survey Committee:

> *"Demand remains elusive as companies demonstrate an unwillingness to invest due to current monetary policy and other conditions. These investments include supplier order commitments, inventory building and capital expenditures."*[5]

Figure 11: ISM Manufacturing New Orders Minus Inventories Suggest a Downturn is Ahead

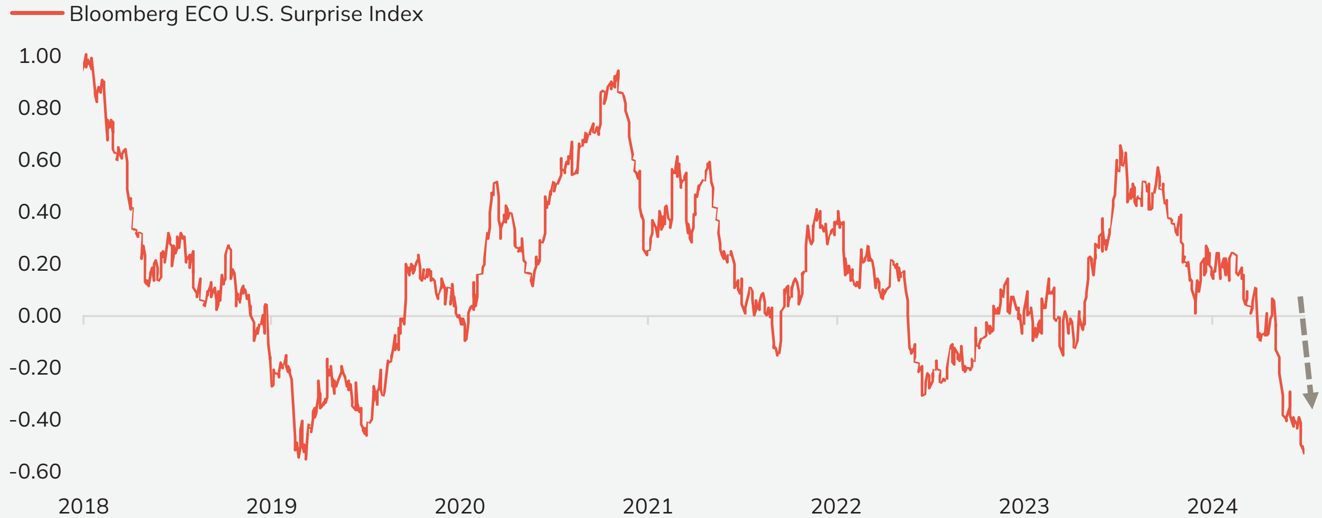


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1980 to May 2024.

[5] ISM, May 2024 Manufacturing ISM Report on Business, May 2024.

In addition, the Bloomberg U.S. Economic Surprise Index is at five-year lows.

Figure 12: U.S. Economic Data are Surprising on the Downside

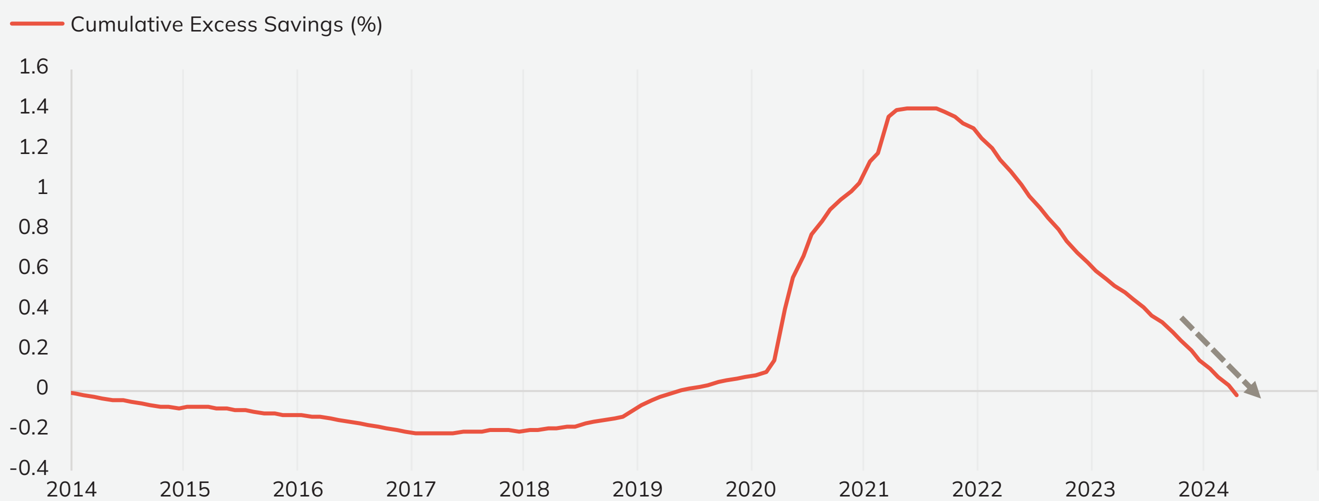


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2018 to June 2024.

Excess Savings are Gone, While Credit Availability is Tightening

Excess savings, the result of massive government stimulus during the pandemic, have supported the U.S. consumer for quite some time. But all good things must come to an end, and these excess balances are finally depleted.

Figure 13: And…They're Gone. Pandemic-Era Excess Savings Have Been Depleted.

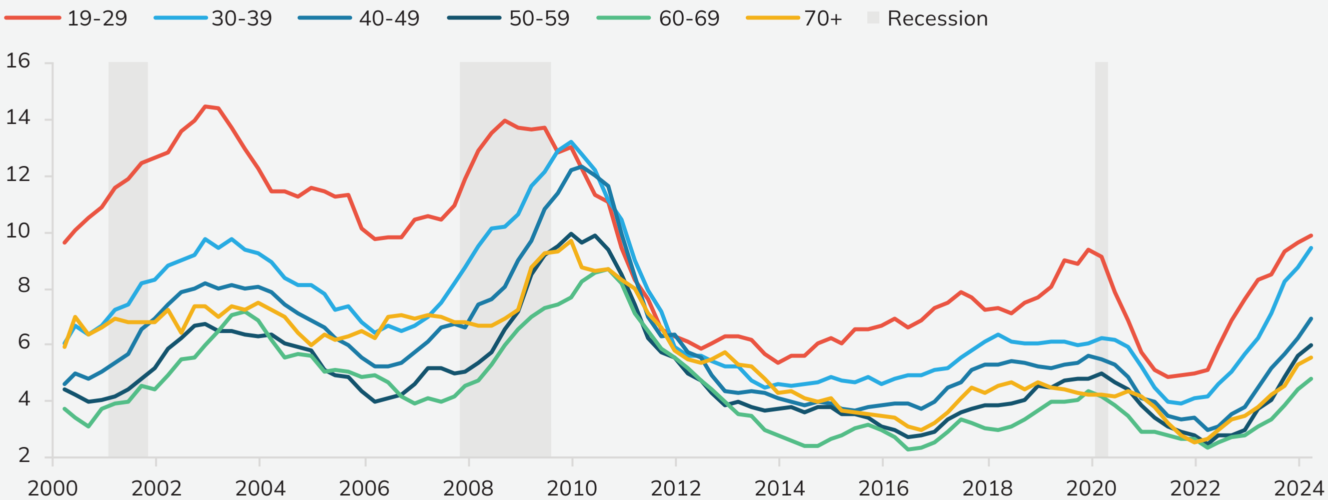


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to May 2024.
Cumulative excess savings calculated as the difference between the savings rate and its 5-year average.

As pent-up savings have run out, consumer credit pressures are rising (although the rate of change is improving), especially for younger cohorts who benefit less from the wealth effect created by increasing equity and housing prices. While the wealthiest classes are more likely to be winning, due to the higher interest rates on their savings, the middle and working classes who need to do more borrowing are losing.

Figure 14: U.S. Credit Card Delinquencies on the Rise

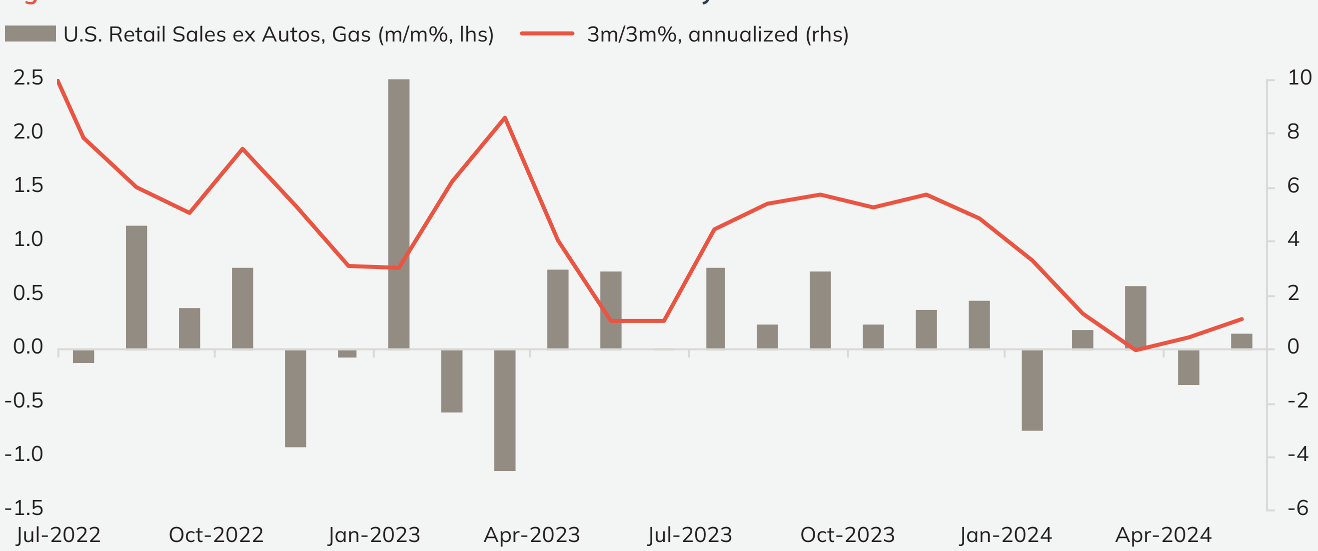
U.S. Credit Card 90+ Days Delinquent (%, By Age)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 2000 to Q1 2024.

The consumer represents the lion's share of the U.S. economy—around 70%. Accordingly, it's worrisome that core retail sales growth has slowed dramatically.

Figure 15: U.S. Retail Sales Growth Has Slowed Considerably

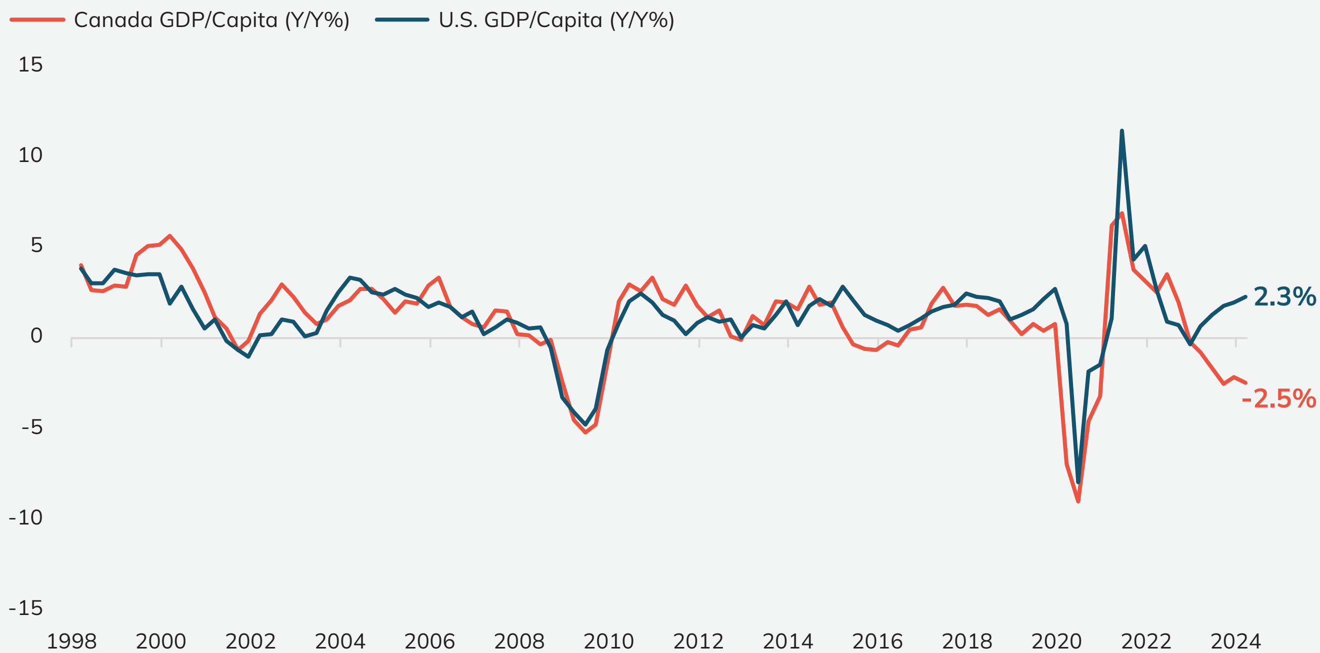


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. July 2022 to May 2024.

Uh, Oh, Canada: Economic Weakness in the Great White North

A warning sign of slowing global growth can be found here at home. Canadian GDP per capita shows a significant 3% contraction from the peak (for context, that's around half of the decline seen in 2008). On a year-over-year basis, per capita GDP is down 2.5%, while U.S. per capita GDP is up 2.3%—talk about a divergence. For its part, the Bank of Canada continues to project a *further* contraction in real GDP per capita growth in 2024.

Figure 16: Canadian GDP Per Capita is Going South



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 1998 to Q1 2024.

Canada would be in a deep official recession were it not for record population growth in 2023 and the first quarter of 2024, which effectively masked underlying economic weaknesses. A lack of productivity growth, combined with higher interest rates, means there are no real intrinsic drivers of economic expansion at this time.

Unfortunately, serious cracks have also developed in Canada's labour market, which bodes ill for consumption in coming quarters:

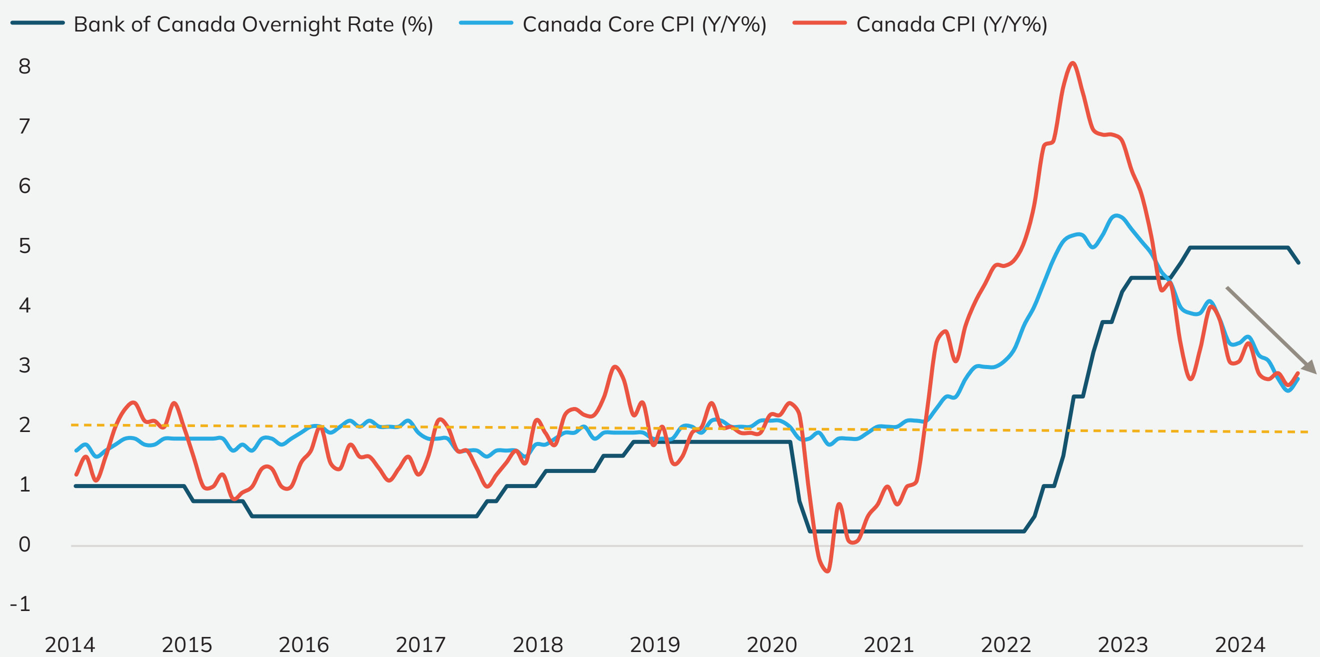
- Hiring is no longer keeping pace with population growth.
- The unemployment rate is now 6.2%, with young people and immigrants hardest hit by this deterioration.
- A slowdown in construction activity also affects the job market outlook for this demographic.

Canadian Households Face an Interest Rate Shock

While the majority of mortgages in the U.S. have terms of 30 years, in Canada almost all mortgages have terms of five years or fewer. Thus, mortgage debt servicing has risen sharply in Canada and is set to continue climbing. This year, an estimated CAD 251 billion in mortgages face renewal, with a further CAD 352 billion in 2025.[6]

There is some consolation to be had at this time. By some measures, Canadian inflation may already be under target. Without the rise in mortgage interest costs, which is mainly attributable to the central bank's own intervention, Canada's inflation rate stands at 1.9%. If we also subtract rents, whose increase coincides with the large increase in Canada's population, annual inflation is just 1.4%.

Figure 17: Canada is Experiencing Core Disinflation

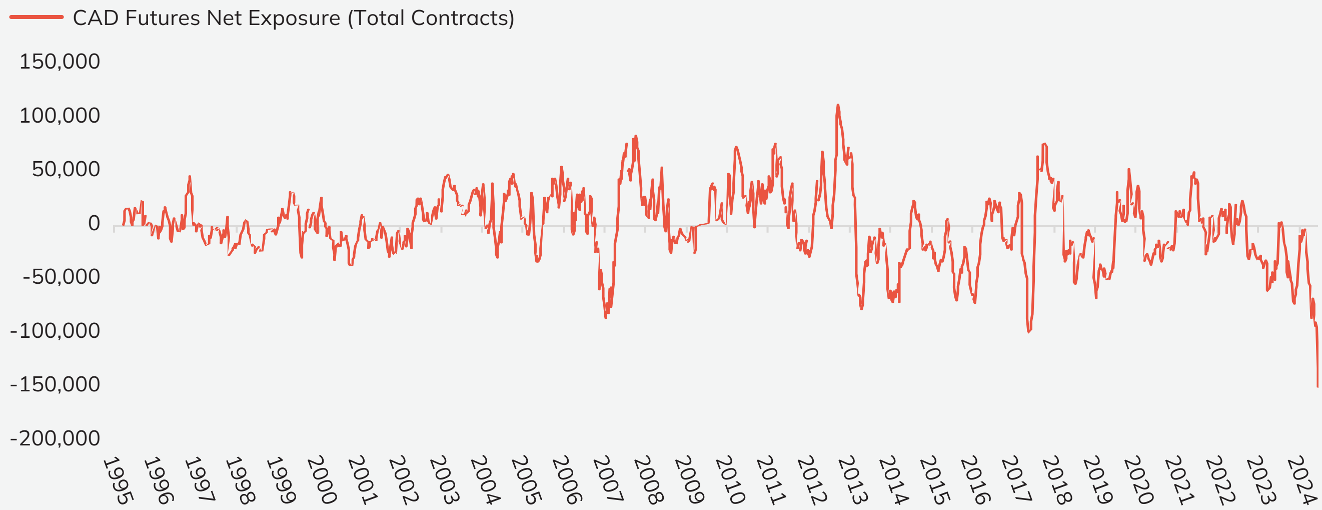


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to June 2024.

This has given the Bank of Canada cover to jump ahead of the U.S. and start the easing process with a 25-basis-point cut to its key interest rate in June. A weaker Canadian dollar is an expected outcome of the divergence between the economy and interest rate policy in Canada and in the U.S. Not surprisingly, currency speculators are already betting big on this outcome and are shorting futures on the Canadian dollar.

[6] Canadian Mortgage Trends, Lower Interest Rates to Mitigate Mortgage Payment Shock Says RBCs Dave McKay, January 11, 2024.

Figure 18: Speculators are Betting on a Weaker Canadian Dollar in a Big Way

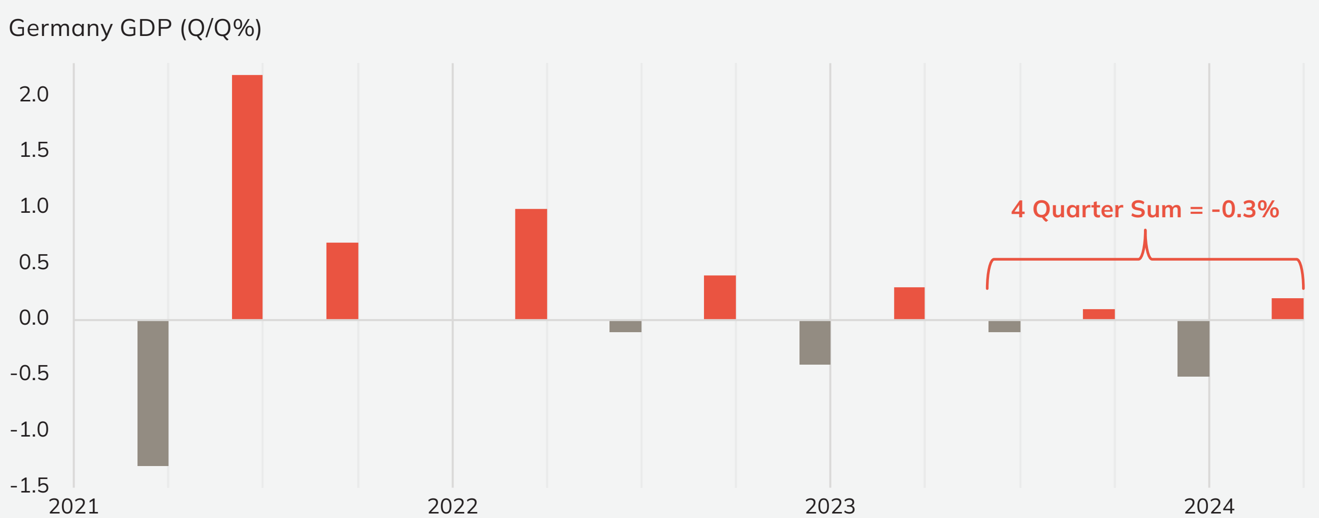


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1995 to June 2024.

European Data Have Also Been Weak

Economic data outside of North America are also experiencing a considerable slowdown in activity. In Germany, industrial production fell in April for a second straight month.[7] Adding to the disappointing data, German retail sales for April declined 1.2% month-over-month (vs. expectations of only a 0.1% decrease).[8] In real terms, sales are down 0.6% on a year-over-year basis. In total, the German economy has barely grown over the last 12 months.

Figure 19: German GDP Growth is Flat Over the Last Year

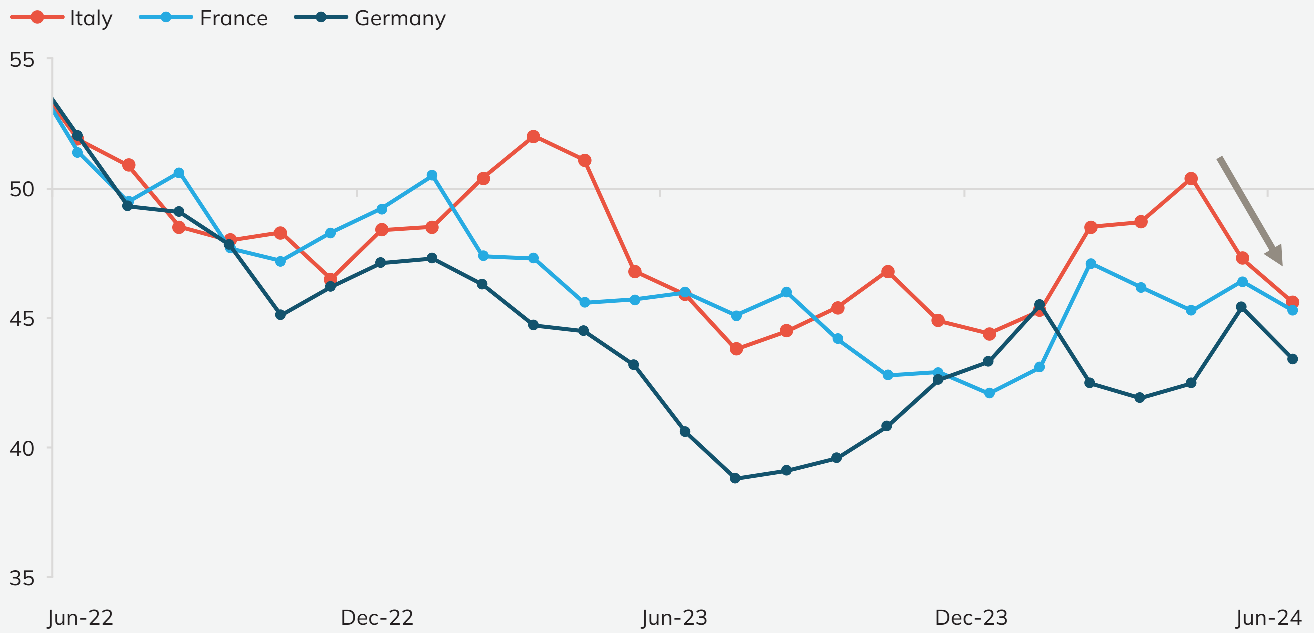


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 2021 to Q1 2024.

[7] Bloomberg, German Industrial Production Fell Again in Poor Start to Quarter, June 7, 2024.
[8] Reuters, German retail sales fall more than expected in April, May 31, 2024.

France's economy also seems to be faltering, with more weakness expected, due to heightened political uncertainty in the wake of President Macron's party losing in the European Union (E.U.) parliamentary elections and his subsequent call for a snap domestic election. Data released in mid-June showed that the French Composite Purchasing Managers' Index ("PMI") fell from 49.8 to 48.2, dragging the overall Europe PMI down to 50.8, which is just above a contraction reading.[9] Meanwhile, based on the most recent data, the three largest eurozone economies (Germany, France and Italy) seem to be in a manufacturing recession.

Figure 20: Europe May be in a Manufacturing Recession
Manufacturing Purchasing Managers' Index (PMI)



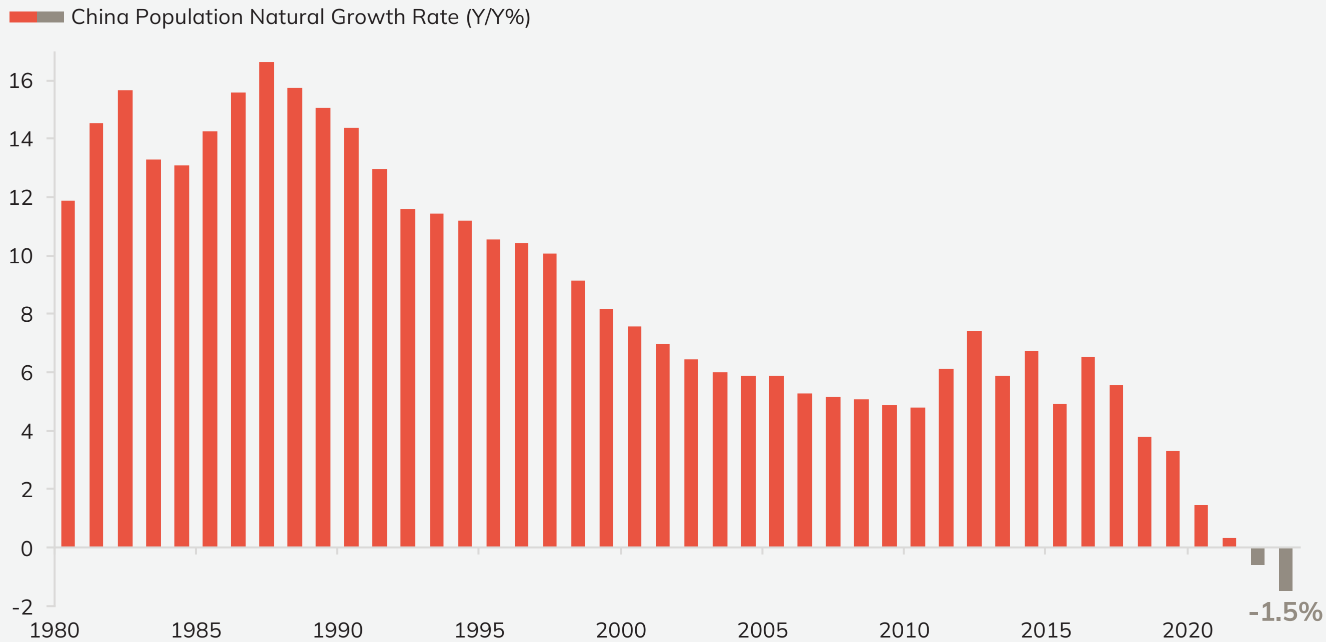
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. June 2022 to June 2024.

China: Facing Both a Property Crisis and a Demographic One

Chinese economic data have also disappointed as of late. The country reported weak May industrial output figures, as well as continued declines for both property investment and new home sales.[10] The problem for policy makers is that they previously relied on the property market to stimulate the domestic economy, but previous overinvestment, combined with deteriorating demographic trends, is making the old strategy much more difficult. China's population growth continues to surprise on the downside, with the latest revision to 2023's estimate being -1.5%. So there's a large excess inventory of unsold homes and fewer new buyers to purchase them.

[9] MarketWatch Inc, PMI data show Europe is losing momentum, says Goldman Sachs, June 21, 2024.
[10] Asia Financial, Weak Factory, Property Data Highlights China's Uneven Recovery, June 17, 2024.

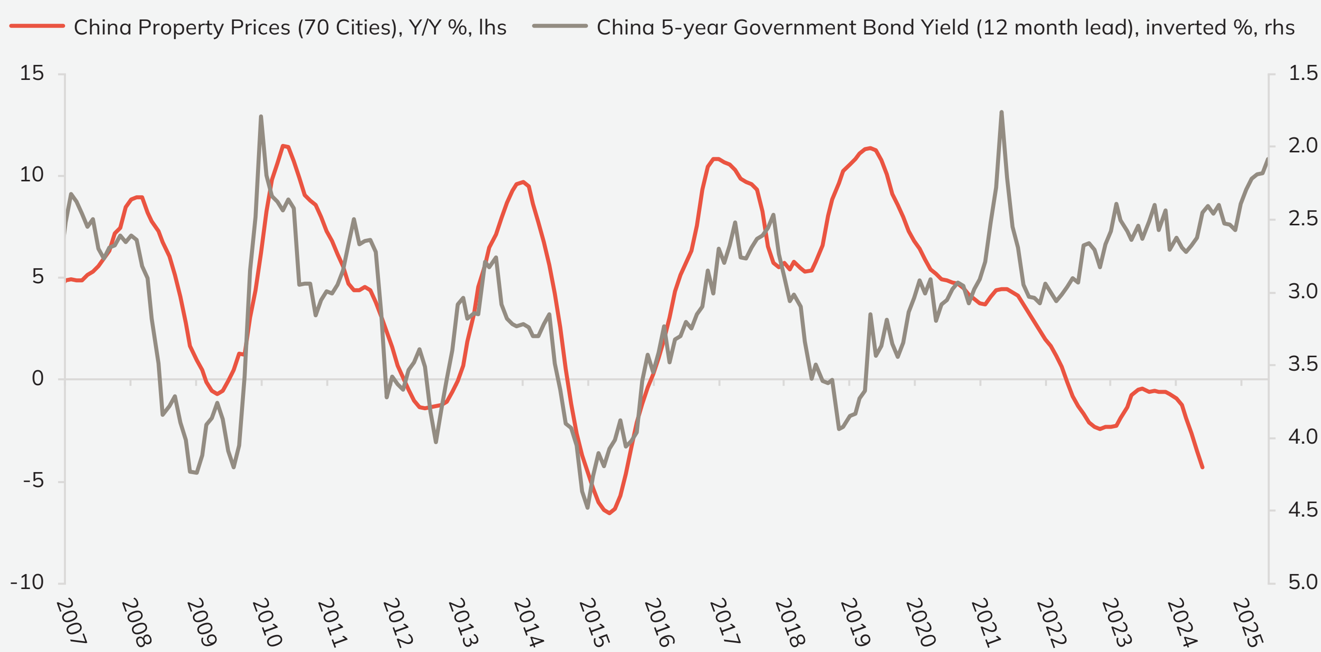
Figure 21: **China's Population is Shrinking**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. 1980 to 2023.

The property overhang is reflected in prices that are accelerating on the downside. Tellingly, this is happening despite China having some of the lowest bond yields in the world.

Figure 22: **Chinese Property Prices Keep Falling Despite Falling Yields**



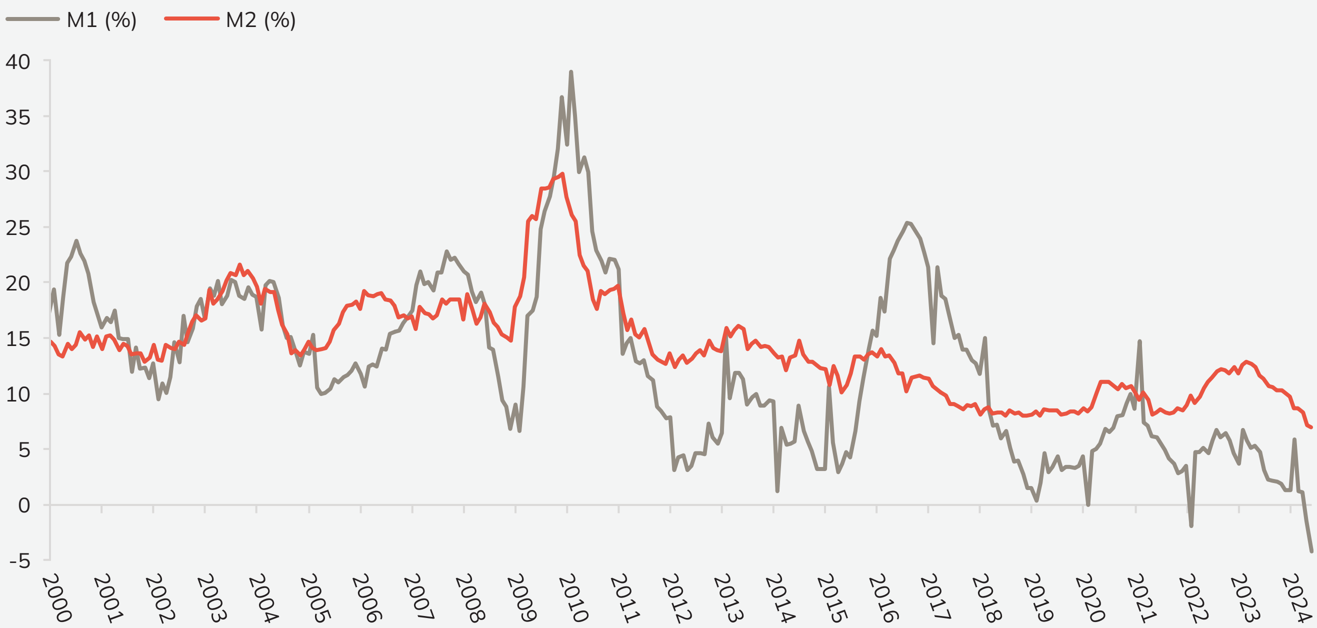
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2007 to June 2024.

Are Chinese Economic Policy Makers out of Bullets?

Despite some very small tweaks around the edges, there is no new Chinese stimulus in sight, and traditional measures of stimulus such as money supply growth and total social financing growth are at multi-decade lows.

Figure 23: Chinese Money Supply Growth is at Multi-Decade Lows

China Money Supply Growth



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to May 2024.

Markets Seem to Be Reflecting Concerns About a Slowdown

The relative performance of different sectors and countries suggests that stock markets are starting to be concerned about the risk of an economic slowdown. While large-cap technology, artificial intelligence and infrastructure themes continue to work, small caps, cyclicals and the equal-weight S&P 500 are fading. The following year-to-date performance figures from early June illustrate this pronounced divergence in performance:

- **Large Cap (S&P 500 Index) vs. Small Cap (Russell 2000 Index):** +15.04% vs. -0.9%
- **S&P Growth vs. Value:** +24.19% vs. +4.57%
- **MSCI USA Quality Factor vs. Goldman Sachs U.S. Cyclicals:** +17.90% vs. +7.97%

Credit markets are finally starting to reflect at least some chance of a slowdown and the deterioration in credit that would ensue. The spreads of the lowest-quality segment of the junk bond market (those rated CCC) are starting to rise as investors demand higher yields – an early sign of risk aversion.

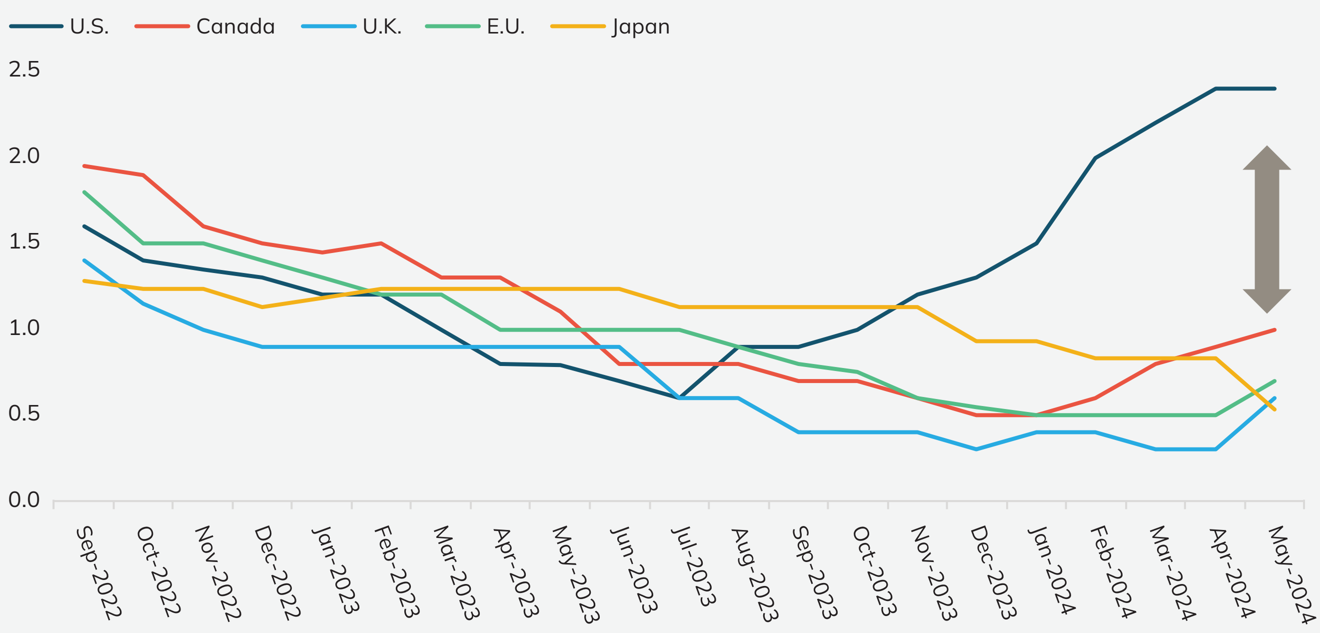
Figure 24: Taking Back Credit Where It May Not Be Due: U.S. Junk Bond Yields are Rising
U.S. Corporate Credit Ex Energy Yield

Bloomberg, L.P., Picton Mahoney Asset Management Research. June 2015 to June 2024.

Other Risks to Consider: The Dollar, the Election, Sentiment and Positioning

We see other risks looming on the horizon, each of which could have a negative impact on both the economy and equity prices. For starters, the U.S. dollar may strengthen due to differences in growth, inflation and monetary policy between the U.S. and the rest of the world—plus the fact we're in a U.S. presidential election year.

Figure 25: Among the G7 Countries, U.S. GDP Growth is King
GDP Forecast 2024 (%)



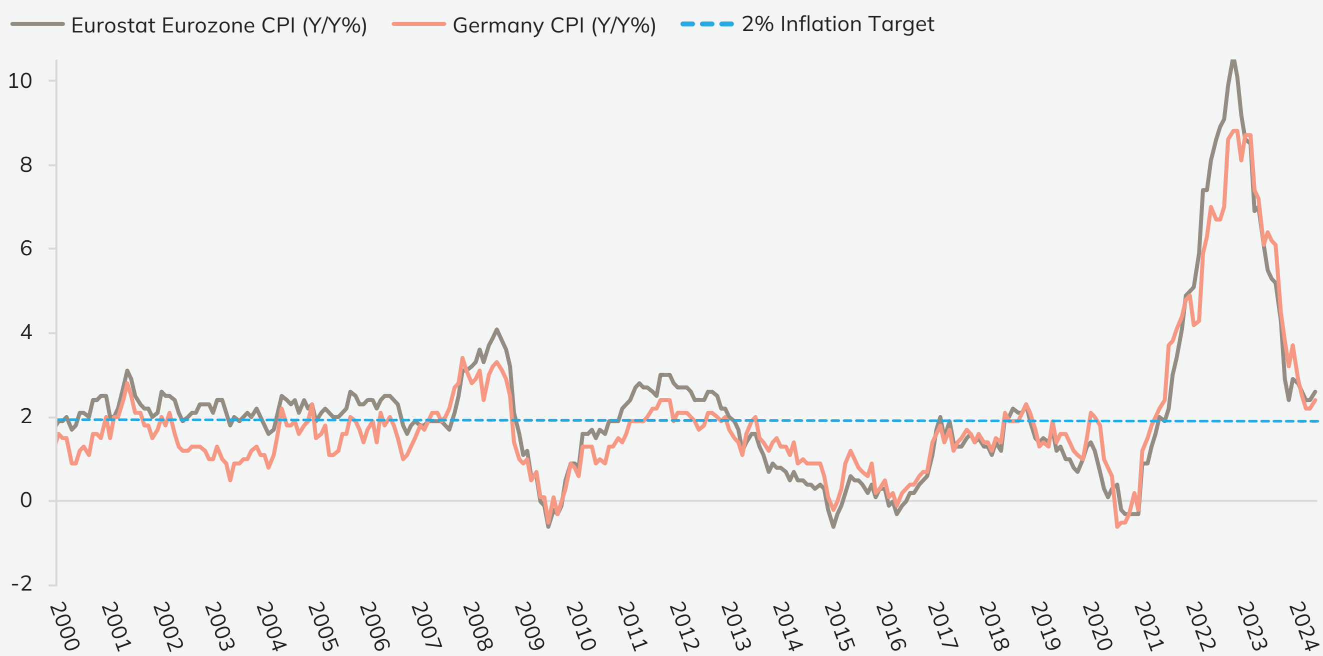
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Sept 2022 to May 2024.

Other Central Banks are Cutting Rates—But Not the Fed

The list of central banks cutting rates is growing. Brazil started an easing cycle in July 2023 and has cut seven times since. The Bank of Switzerland slashed its policy rate by 25 basis points in March, and Sweden's Riksbank did the same in May.

The Bank of Canada recently became the first G7 country to ease policy, cutting the benchmark rate by 25 basis points at its June meeting. Meanwhile, in Europe, the European Central Bank ("ECB") is also starting to ease. This makes sense. The labour outlook in the E.U. is much weaker than in the U.S., and there is no comparable shelter cost problem in Europe. These two factors explain why E.U. inflation is nearly at target and not as sticky.

Figure 26: Eurozone Inflation is Nearly Back to Target, Allowing the ECB to Ease



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to May 2024.

At the same time, Fed officials have made it clear that they are not satisfied with current U.S. inflation progress, and that they don't expect rate cuts in the near term. Some even hint at further tightening. For example, consider these headlines following the release of the Federal Open Market Committee ("FOMC") minutes on May 22:

- *Some Officials Worry Financial Conditions Not Sufficiently Restrictive*
- *Officials Discuss Holding Rates Steady for Longer if Inflation Doesn't Fall*
- *'Various' Fed Officials Mention Raising Rates if Inflation Warrants It*

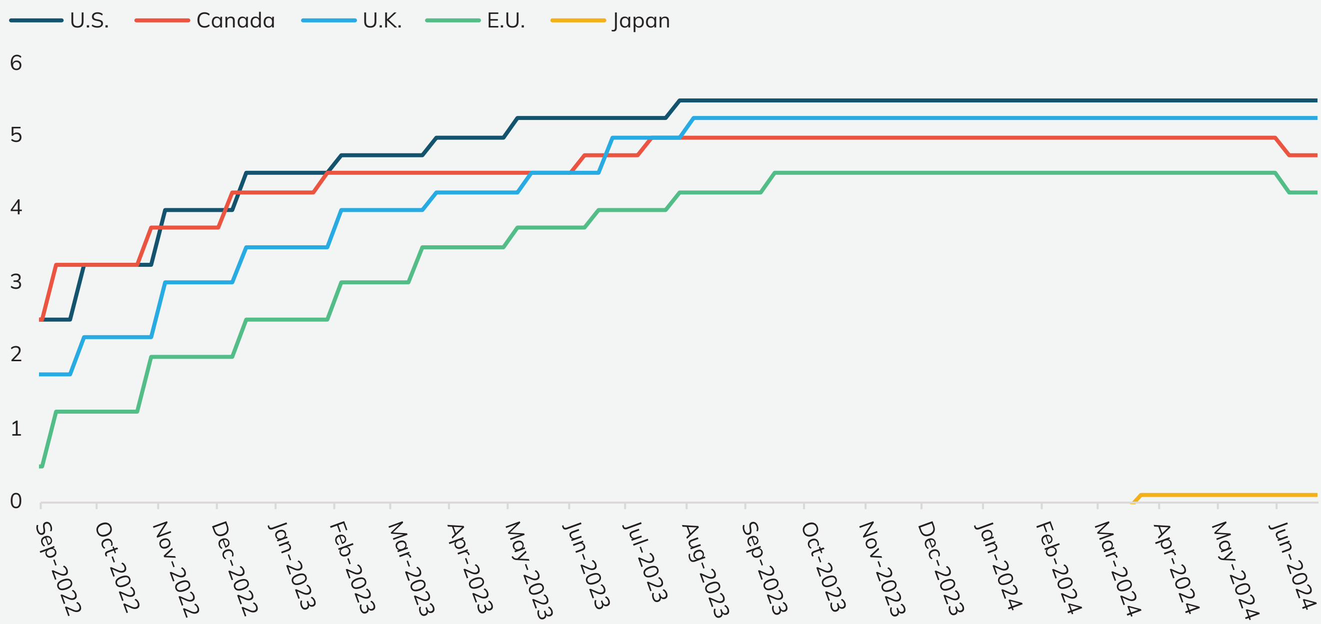
Cleveland Fed President Mester seems to reflect this thinking. In mid-June, she said:

> *Given all the progress we've made on inflation, I think we do need to see* ***a few more data points*** *that really tell us, 'OK, we now can be pretty confident inflation is on that downward path, and therefore we can start reducing the restrictiveness,'."*[11]

This puts the first cut closer to the end of this year (which, incidentally, is what the Fed's updated "dot plot" also suggests).

Figure 27: The Fed Stays Tight While Other Central Banks Start to Cut

Central Bank Rate (%)



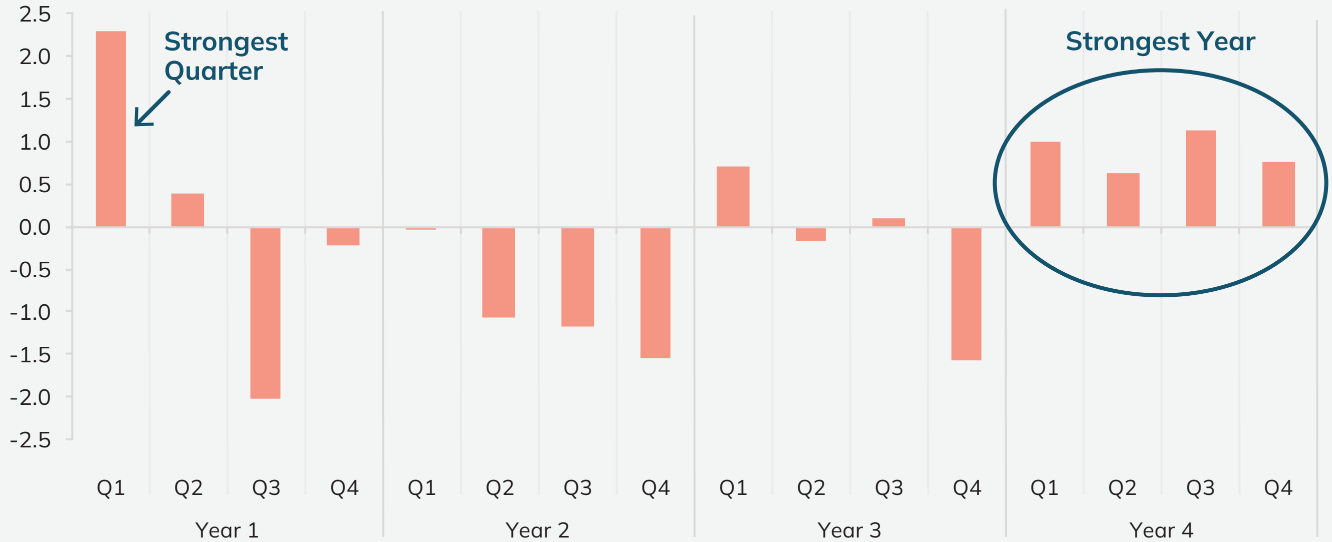
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Sept 2022 to June 2024.

U.S. election years tend to have the strongest U.S. dollar returns, with the first quarter of the year following the election having the strongest quarterly returns of all.

[11] BNN Bloomberg, Fed's Mester Wants Few More Months of Good Inflation Before Cuts, June 14, 2024.

Figure 28: Historically, the Greenback is Strong in Election Years

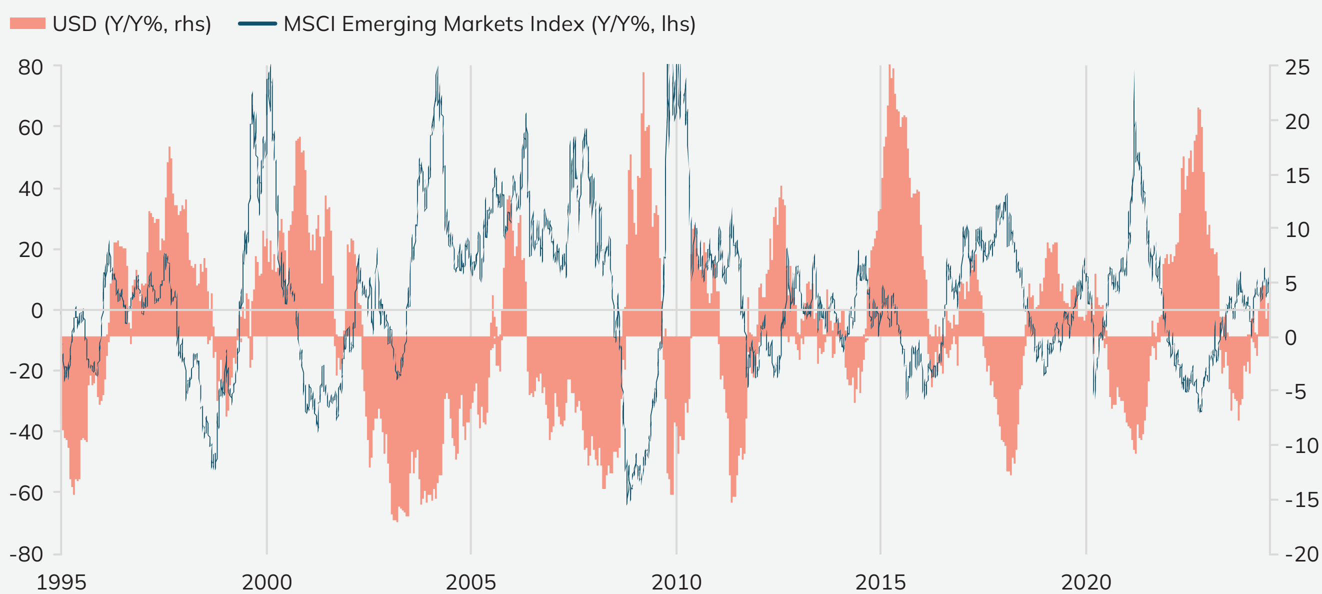
Quarterly Average U.S. Dollar Returns By Presidential Cycle (1967 - 2020) (%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 1967 to Q4 2020.

If we look at historical precedents, a rallying U.S. dollar, combined with tighter Fed monetary policy, is typically a negative double whammy for many countries around the world. Many emerging market economies suffer disproportionately, having borrowed in U.S. dollars. Furthermore, as the following chart illustrates, there's a clear inverse relationship between the U.S. dollar and emerging market equities.

Figure 29: Emerging Market Equities Suffer When the Dollar Rises

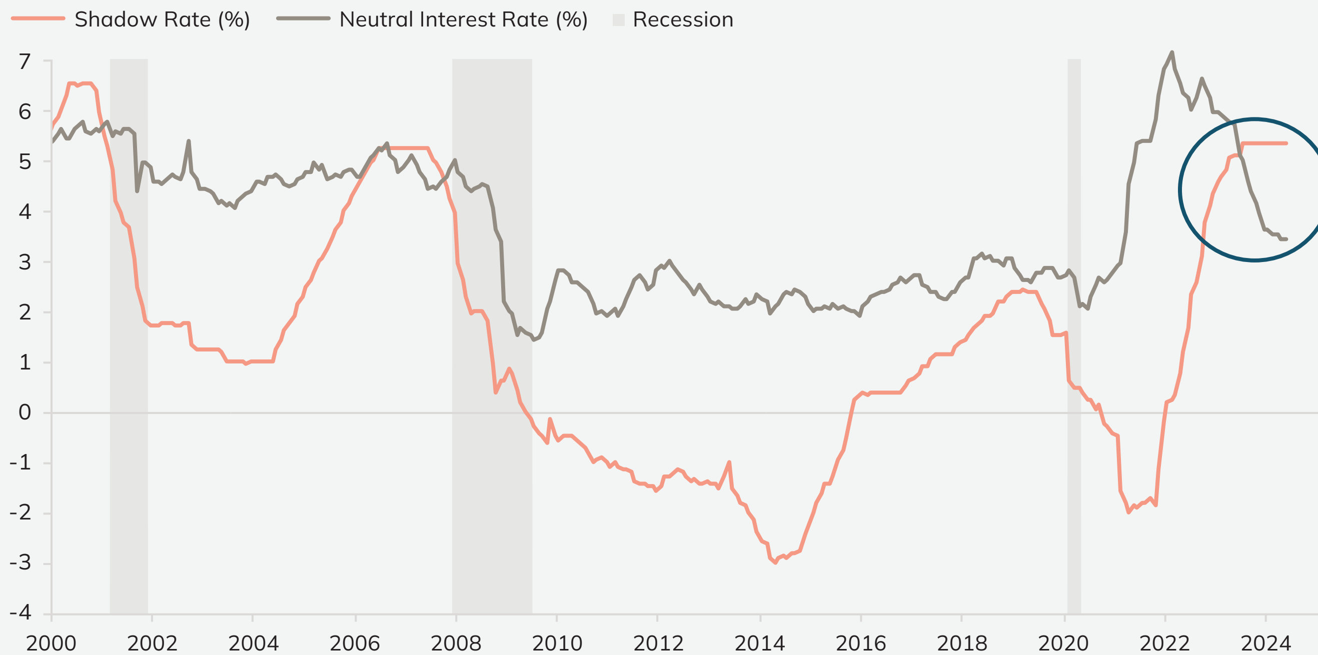


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1995 to June 2024.

Risks of a Policy Mistake are Building

If the Fed is indeed willing to keep interest rates higher for longer and risk a recession in order to curb longer-term inflationary pressures, then it may be on the right path. However, if its goal is to engineer a soft landing while guiding down near-term inflation rates, then it may be waiting too long to ease policy. After all, U.S. inflation has fallen considerably from its highs. Therefore, the stationary Fed funds rate acts in an increasingly restrictive manner as real interest rates rise.

Figure 30: The Fed is Being Passive-Aggressive: Real Rates are Rising

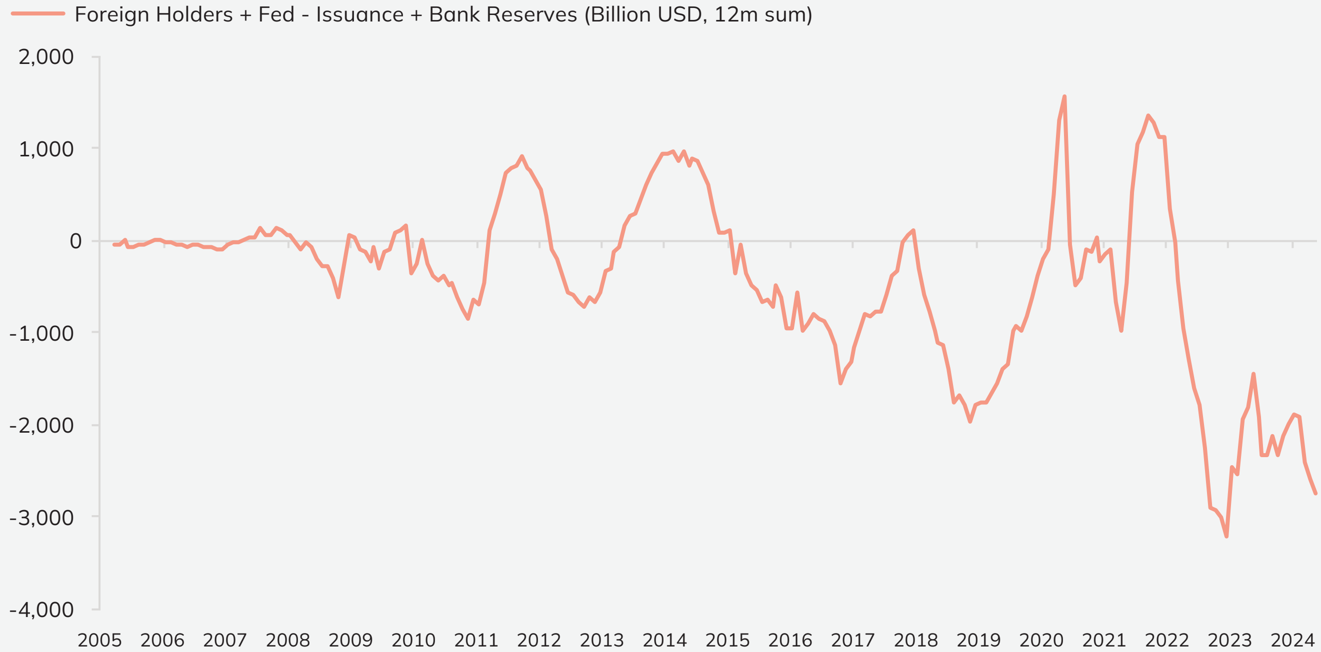


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to June 2024.

Treasury Supply/Demand Further Out of Balance

We are also concerned that longer-term real rates may also increase due to significant imbalances in the Treasury market that keep yields elevated, all else being equal. Excessive deficit spending is driving the supply of U.S. bonds higher as more bonds are issued to pay for government programs. However, this is occurring when traditional foreign holders of U.S. bonds are now sellers, along with the U.S. Fed, which is also a seller due to quantitative tightening.

Figure 31: Household Purchases are Key to Demand for Treasuries



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2005 to May 2024.

The household sector has been the saving grace for U.S. bonds up until now, absorbing most of the massive issuance and bridging the gap. But for this demand from households to continue, longer-term yields will have to stay high enough to attract new savings or inflows from other investments.

The U.S. Election Poses Policy Risks

U.S. elections pose additional policy risks. For starters, if Trump wins, his promised tariffs on Chinese goods could result in materially higher U.S. inflation. And if Biden wins, some of his party's more left-leaning policies may start to imperil U.S. competitiveness.

Regardless of who wins, the U.S. economy faces a significant post-election fiscal cliff. In 2017, Congress and the president enacted the Tax Cuts and Jobs Act (TCJA), which made significant changes to the tax code for individuals and corporations. Most of the changes to the corporate tax code were legislated as permanent law, but many of the individual income tax provisions, as well as certain other provisions, are slated to expire at the end of December 2025. That deadline sets up a significant decision point for policy makers, with major implications for the country's fiscal outlook.

The following represent the largest components of the fiscal cliff:[12]

- Standard deduction cut in half
- Child tax credit cut in half, lower income limits
- Income tax rates increase with the top rate at 39.6%
- Lower alternative minimum tax exemption
- Estate tax exemption cut in half
- Qualified business tax income deduction increases from 21 to 39.6%
- ACA COVID subsidies Expire

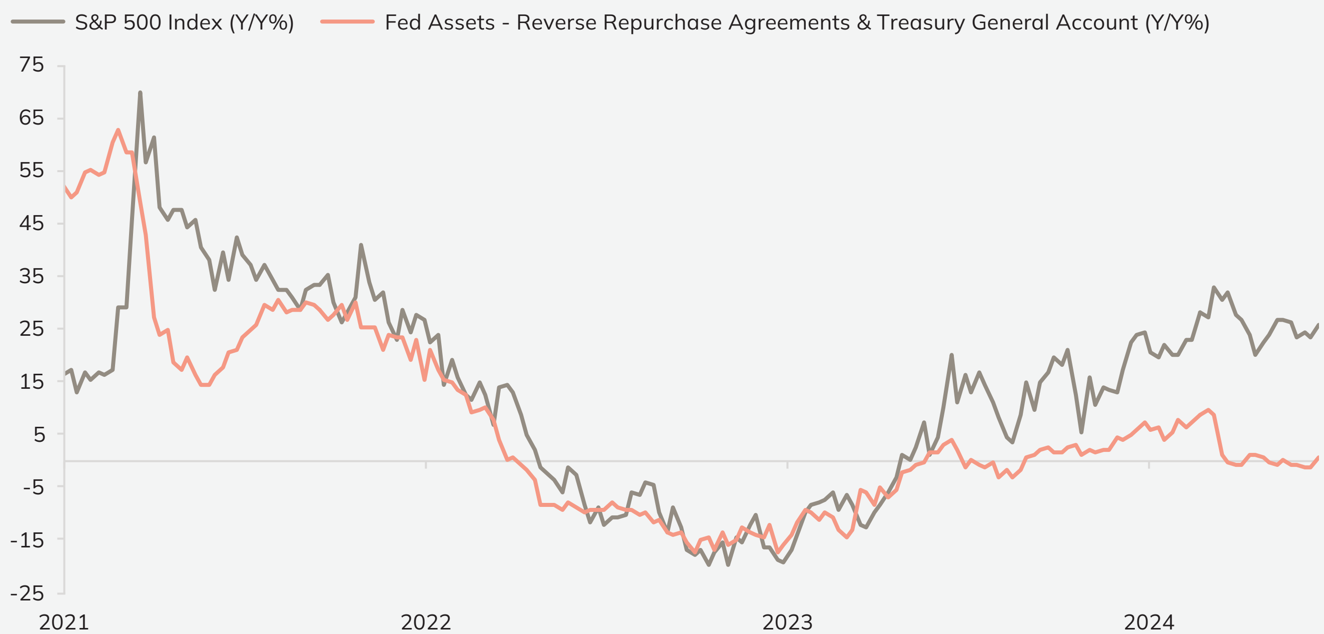
According to TD Cowen,

> *The looming tax hike at the end of 2025 would likely result in the largest nominal tax hike in U.S. history with an impact of ~$3.5T [USD] over 10 years."*[13]

Liquidity is Waning in the U.S. and Abroad

Another risk is that liquidity is drying up, which could cause distress in the economic system or in the prices for risk assets.

Figure 32: U.S. Liquidity is Receding—a Warning Sign for Equities

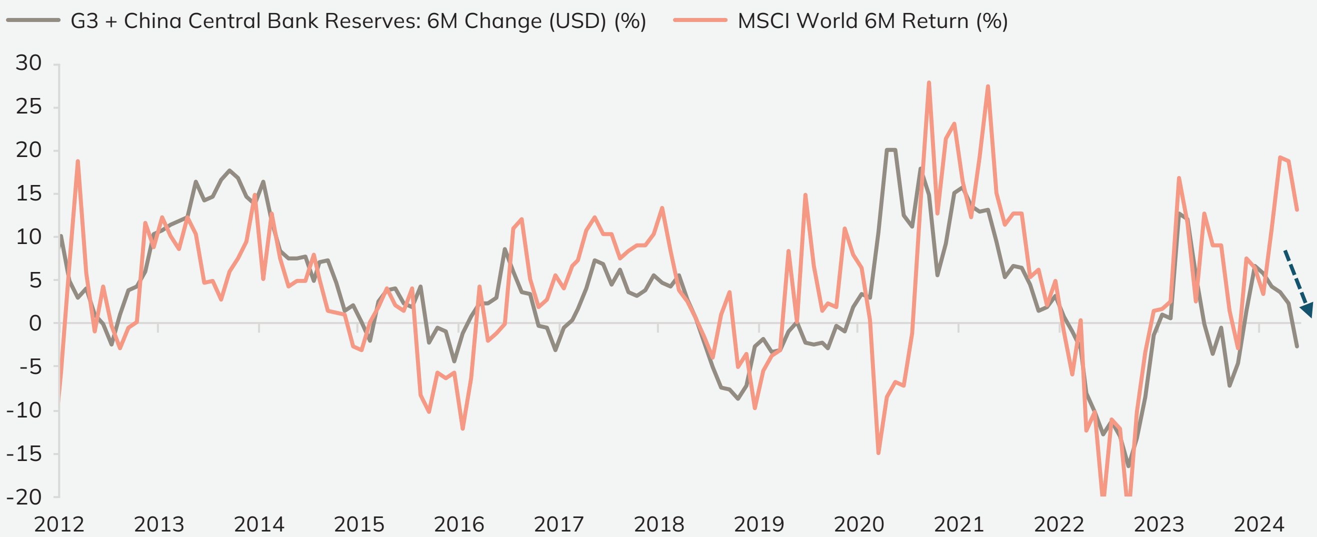


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2021 to June 2024.

[12] Ericksen Krentel, Tax Changes Coming After 2025, October 19, 2023.
[13] TD Cowen, TAXMAN: $3.5T TAX CLIFF ON 1/1/26 FOR INDIVIDUAL RATES, MORTGAGE, ESTATE & SALT, April 30, 2024.

Global liquidity is also drying up and has not supported the recent global equity run-up. Recently, the Bank of Japan's balance sheet has started to contract, adding to draining global liquidity pressures at the margin.

Figure 33: Global Liquidity Has Gone Negative

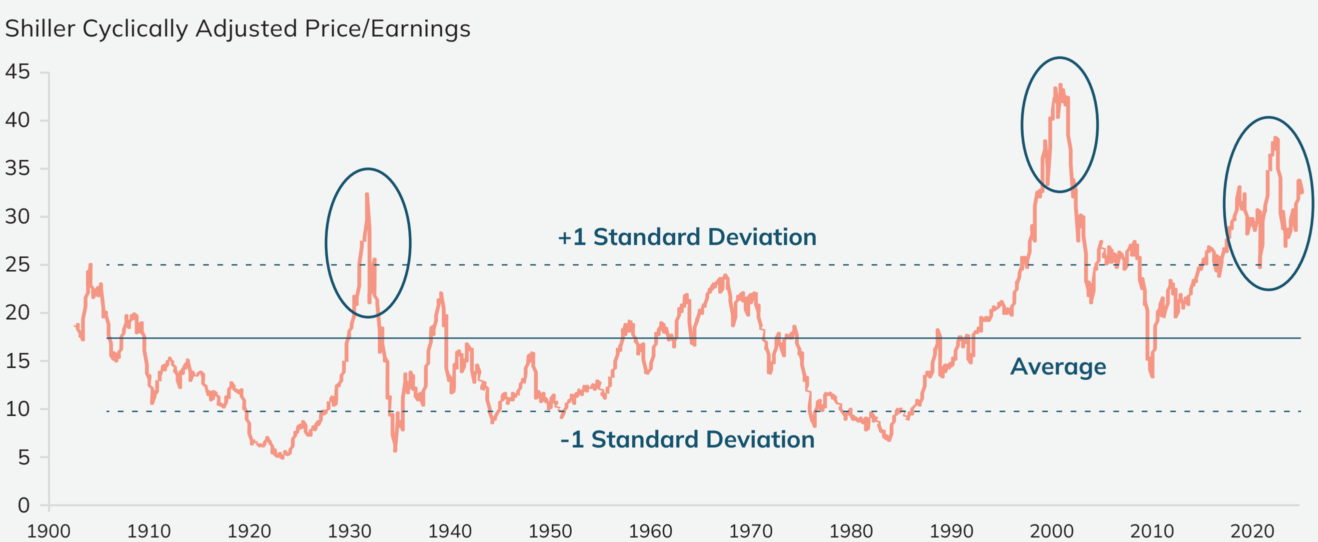


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2012 to June 2024.

Valuations are Pricey

The blistering rally in U.S. equities has sent valuations, as measured by the Shiller Cyclically Adjusted Price/Earnings ("CAPE") ratio, back to levels seen only a few times in U.S. economic history (none of which ended well for investors!).

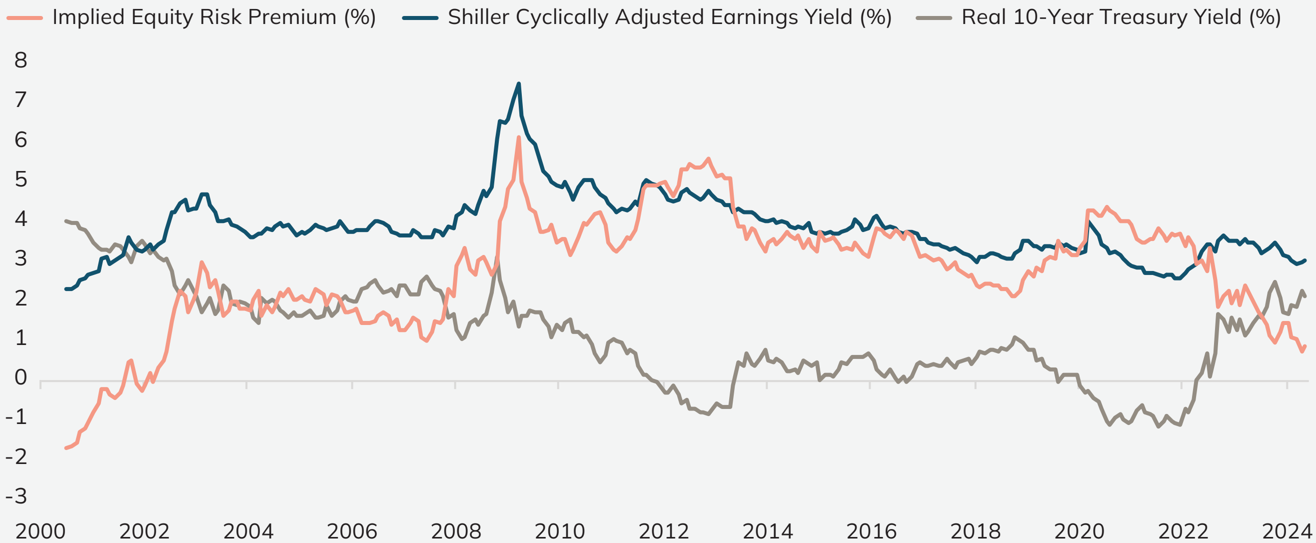
Figure 34: The Shiller CAPE Ratio is Back in Rarefied Air



Source: Robert Shiller, Picton Mahoney Asset Management Research. Jan 1900 to May 2024.

As price-earnings ratios soar, the implied equity risk premium has fallen to levels not seen in over 20 years.

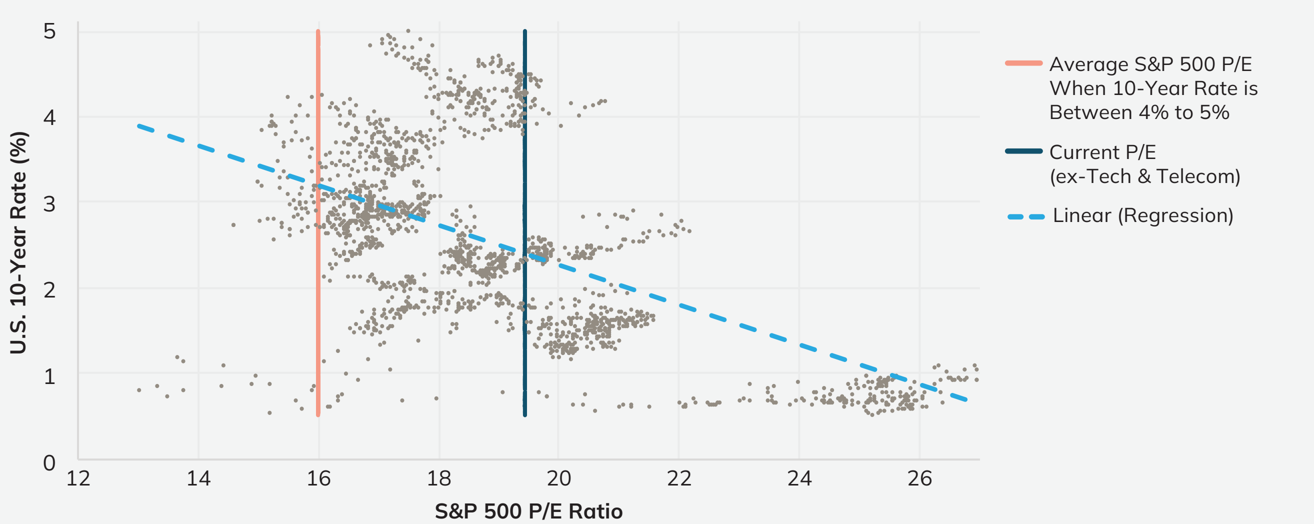
Figure 35: Equity Risk Premium Plumbs the Depths



Source: Robert Shiller, Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to May 2024.

Even if we exclude the impact of highly priced technology and telecommunication stocks, the market still seems very overvalued. Historical relationships would suggest that with current 10-year bond yields at 4.2%, P/E ratios for the entire stock market should be around 16x forward earnings. However, the current P/E ratio is over 19x, even excluding the high-priced tech and telecom sectors.

Figure 36: The Stock Market is Pricey Even if We Exclude Tech and Telecom
S&P 500 ex-Tech & Telecom, Forward P/E Ratio vs. U.S. 10-Year Rate (2016-2024)



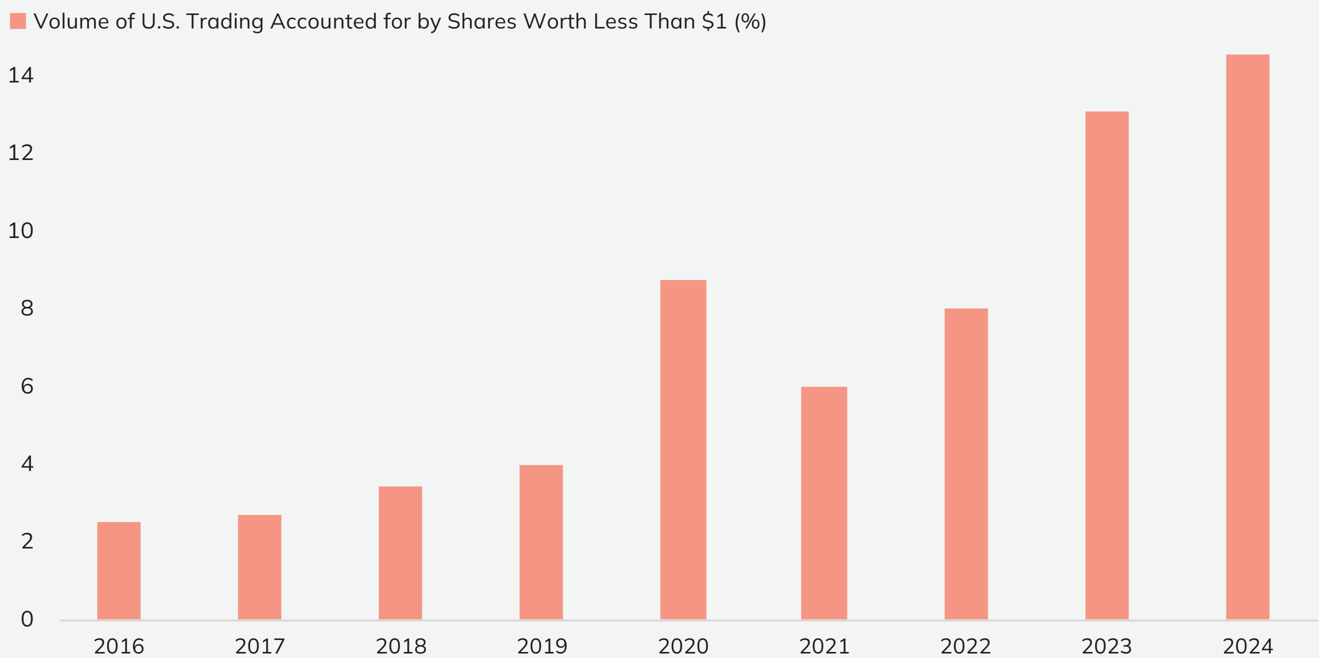
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2016 to June 2024.

Sentiment is Bullish

We are concerned by evidence of overwhelming bullish sentiment among investors, which often serves as a precursor to a correction. Whether it's extreme readings from the American Association of Individual Investors ("AAII") readings, the low CBOE Volatility Index ("VIX") or the "vol of vol", complacency and even exuberance abound. In addition, penny stock trading is on the rise, which tends to be a warning sign:

> *When markets get frothy, the speculative froth often hits penny stocks as well—this is a classic sign of market peaks,"* said James Angel, a finance professor at Georgetown University. *"Penny stocks tend to be extremely volatile, so you can make or lose a ton of money very quickly. That appeals to the speculative urge."*[14]

Figure 37: Trading of Penny Stocks is Elevated



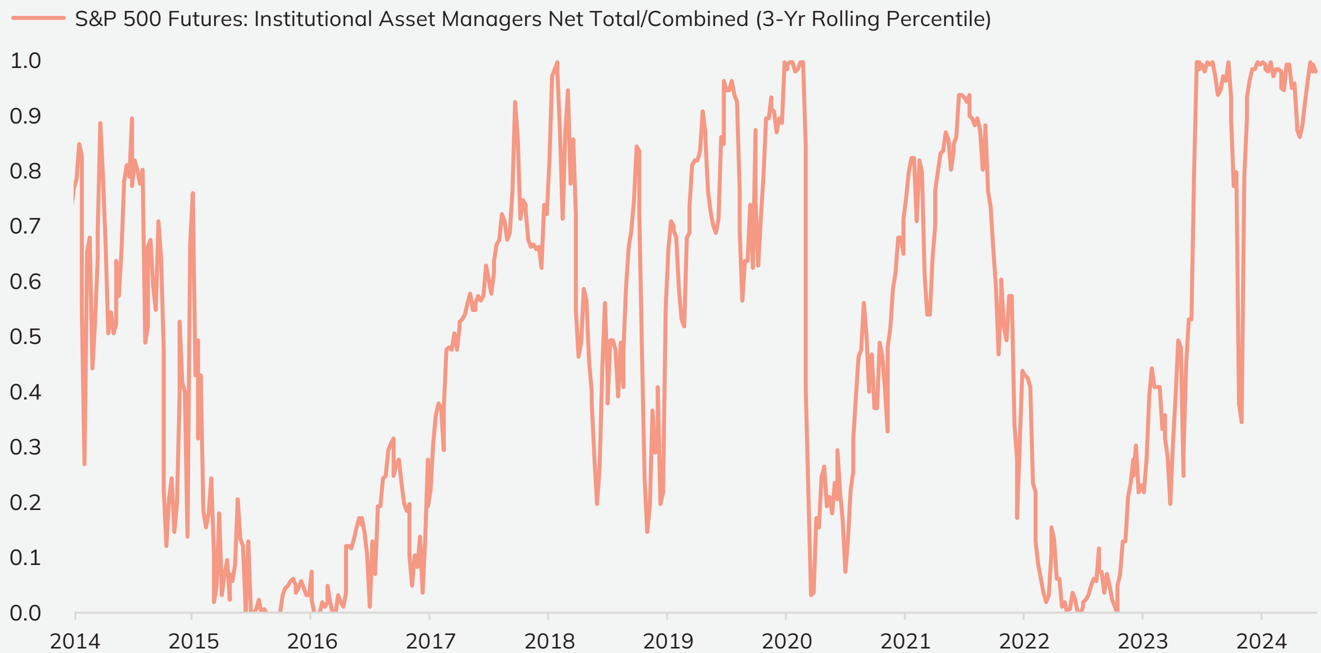
Source: CBOE, Picton Mahoney Asset Management Research. Jan 2016 to June 2024.

[14] Financial Times, Boom in US penny stock trading prompts warnings of frothy markets, June 1, 2024.

Positioning is Stretched

A whole range of data reveals that investors are basically fully committed to the long side of the market. First, institutional investors are close to maximum-bullish S&P 500 futures.

Figure 38: Institutional Investors Are Close to Max-Long S&P 500 Futures



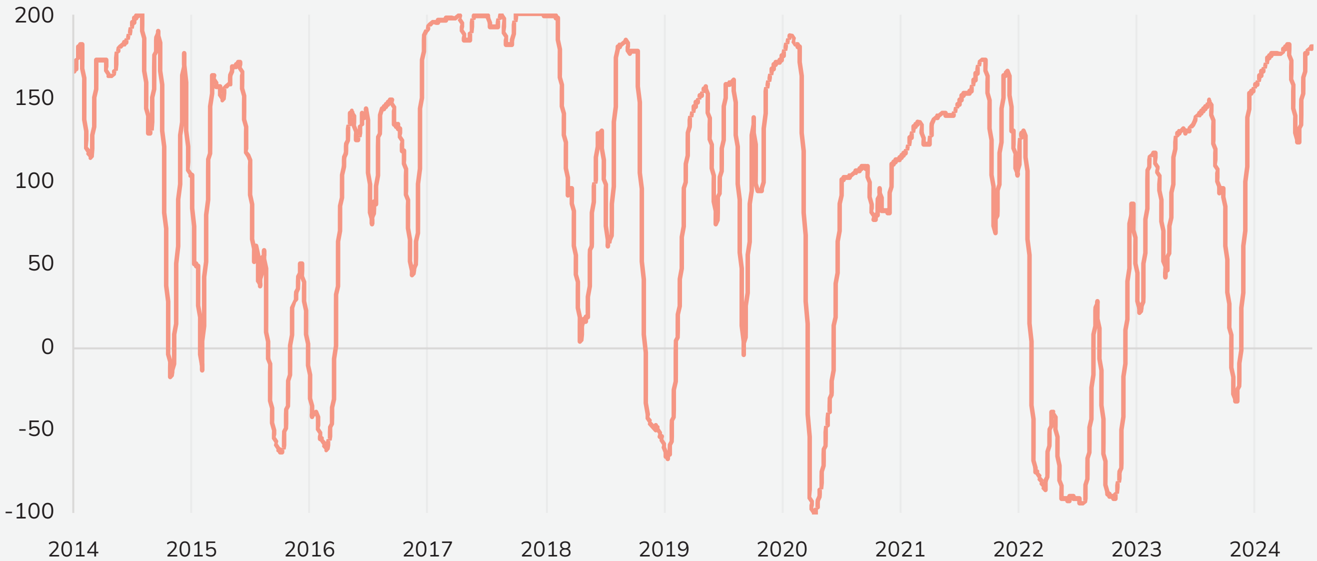
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to June 2024.

...And Global Equities, Too

U.S. equities may be the top performers, but investors are also very bullish on global equities. The following chart shows that Commodity Trading Advisors (CTAs) are close to their maximum long position when it comes to international stocks.

Figure 39: CTAs are Nearly Max-Long Global Equities

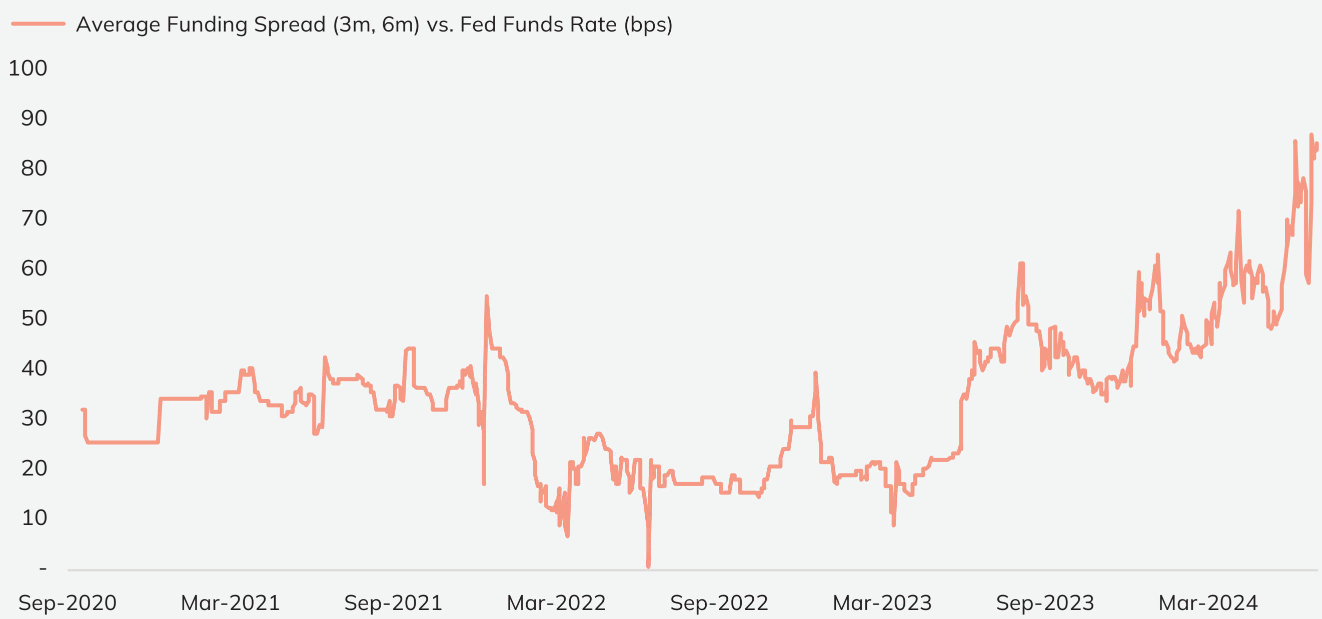
CTA & Risk Parity - MSCI World Index (%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to June 2024.

As positioning is stretched, demand for fresh long positions is quite elevated, with S&P futures funding spreads near record highs. These spreads represent the implied cost above the Fed funds rate that dealers are charging their clients to add S&P futures exposure. A higher rate implies extended demand for or positioning to own S&P futures.

Figure 40: Funding Spreads Show Investors are Clamouring to Add Exposure



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Sept 2020 to June 2024.

Conclusion

As we see it, the Fed is in a sticky situation. Core services inflation remains well above target, and the last thing the central bank wants to do is pronounce inflation conquered, only to see it surge again. The longer the Fed waits to ease, however, the greater the likelihood that a slowdown will morph into a recession.

The central bank's sticky situation is a predicament for investors too. Stocks don't appear cheap, sentiment is very bullish, and positioning is very long. At the very least, we would wait for better entry points to add to risk positions. However, if the soft-landing narrative begins to crack under the weight of deteriorating economic data, equities (and other risk assets) could be in for more than just a typical annual pullback.

Sector Outlooks

Industrials

More recently, we've seen industrial names across the board retrench on a weaker-than-anticipated back half of 2024. Erring on the side of conservatism, we've increased our short exposure to more expensive multi-industrial/staffing names, while also hedging cyclical long positions in broader secular themes. We are confident that the businesses we like – including those with cyclical exposure – will continue to meet our long-term return thresholds.

We continue to look for out-of-favour companies with a history of outsized growth, catalyst-driven idiosyncratic rerating angles and/or opportunities to improve structural returns on invested capital. Lately, we have been focusing on hazardous waste names exposed to growing infrastructure spending and onshoring. We also remain bullish on the industrial leasing complex over the long term. We have hedged the cyclicality of rentals with less attractive names that have similar exposures. We have been looking into certain airlines, but are not buying aggressively quite yet, despite their cheap valuations. The merger and acquisition environment for serial acquirers seems quite favourable. Accordingly, we have shored up weightings in companies with a strong track record of acquisition and ample cash on hand.

Materials

Gold Market Dynamics

Gold prices continued their bullish momentum in the second quarter, driven by a combination of economic uncertainties, safe-haven demand and a weakening U.S. dollar. The spot gold price reached a new all-time high during the quarter. Additionally, central banks, particularly in emerging markets, have continued to accumulate gold as a reserve asset, contributing to upward price pressure.

Gold equities rallied alongside higher commodity prices. Although gold equities have faced margin compression over the past few years due to operating cost inflation, the recent surge in gold prices should provide an opportunity for margins to inflect and then expand if prices remain high. Our preference within the gold sector remains tilted toward companies that demonstrate strong operational execution.

Copper Market Trends

Copper prices reached record highs in the second quarter, with the COMEX copper price climbing to an unprecedented USD 5.20 per pound (USD 11,464 per metric ton) on May 20. This remarkable surge has been driven by the outlook for long-term demand from the energy transition and artificial intelligence ("AI") data centres, along with current supply constraints that are creating a tight market environment. However, the rally was followed by a pullback due to concerns about an economic slowdown and elevated speculative selling by traders seeking to capitalize on the rally.

We continue to believe we have entered a new bull cycle for copper. While there will likely be short-term volatility and pullbacks, the lack of investment over the past decade has led to supply constraints that are expected to result in deficits into 2030, with further upside risk if central banks lower interest rates and fuel demand. Maintaining a favourable view of copper, we have adopted a diversified approach within our portfolio, holding multiple copper names to capitalize on the anticipated upswing in copper prices.

Information Technology

MSCI World Information Technology Index increased by 11.5% for the second quarter of 2024, while the Information Technology sector in the S&P/TSX Composite Index declined by 5.6%. Sector performance compounded on first-quarter strength. The best-performing subsector was semiconductors, led by AI winners such as Nvidia Corporation (NASDAQ: NVDA) and Micron Inc. (NASDAQ: MU), while firms with less AI exposure, such as Intel Corp and Lattice Semiconductor Corp were the top underperformers. Internet stocks performed well, with the Nasdaq CTA Internet Index up 2.9%. Software sector gains were weaker in the second quarter of 2024, with the iShares Expanded Tech-Software Sector ETF up on the quarter only 1.9%, while Salesforce Inc. (NYSE: CRM), Workday Inc. (NASDAQ: WDAY) and MongoDB, Inc. (NASDAQ: MDB) all saw earning per share-related pressure in a demand environment in which AI crowded out other software spending. In hardware and networking, results mirrored semiconductors performance, with the top performers (Dell Technologies Inc. and Pure Storage, Inc.) being those most exposed to generative AI.

Our outlook for Information Technology in the third quarter of 2024 remains cautiously optimistic: falling inflation could lead to lower rates and more consumer spending and capital investment, as well as ongoing multiple expansion. In semiconductors, we expect the AI bifurcation to continue, and are increasingly focused on companies that will likely be beneficiaries as this theme moves beyond the data centre. On the analog front, fundamentals and performance improved, but we remain cautious here, as high valuations and expectations, as well as uncertain end-market demand, could create some risks for future returns. Within software, we expect a similar split in which those proving they can generate AI-associated revenue pickups will see investor demand, while others suffering from a shift in budget share will lose sponsorship. Among internet stocks, we prefer staple-like share gainers in a muted consumer spending environment and remain keenly attuned to rates and employment to predict the next leg in consumer spending.

We expect performance in hardware to continue to be varied, with demand remaining muted and the economics of AI-based products continuing to be a point of focus for investors.

Health Care

Through the second quarter, Health Care continued to underperform the S&P 500 Index. Despite robust activity in the biotechnology capital markets, increasing uncertainty about the macro environment and the forward path for interest rates has reduced investor appetite for risk. This has pressured unprofitable biotechnology companies, as well as the companies that serve this end market, including life science tools and clinical research organizations. On the other hand, strong medical utilization and procedure volumes have continued to be a tailwind for hospital providers and medical devices, but a headwind for managed care organizations.

The relative performance of the broader index notwithstanding, we continue to see a wide dispersion in performance in subsectors in Health Care that has rewarded prudent stock selection. The dynamic that is driving this limited breadth is expected to persist into the third quarter, especially as U.S. election rhetoric starts to become more prominent and headline risk rises. Generally, we continue to favour names with quality growth and positive estimate revisions driven by innovative product cycles and strong base businesses with defensible moats, as well as opportunity for margin expansion. We remain highly selective among catalyst-driven names in biotechnology that offer favourable risk/reward.

Consumer Discretionary

We saw very little change in discretionary spending trends in the second quarter relative to the first, along with further evidence of a more selective and value-seeking consumer across the board. This showed up in quarterly results as well as management commentary; a wide range of companies, from Starbucks Corporation (NASDAQ: SBUX), to McDonald's Corporation (NYSE: MCD), to Walmart Inc. (NYSE: WMT), to The Coca-Cola Company (NYSE: KO), all referred to an increasingly value-conscious and price-sensitive consumer. The dispersion in earnings was clear, with "trade down" winners such as Domino's Pizza, Inc. (NYSE: DPZ) and The TJX Companies, Inc. (NYSE: TJX) delivering better-than-expected results, while companies without a sharp value proposition, such as SBUX and Papa John's International, Inc. (NASDAQ: PZZA) struggled to drive traffic through their stores.

We expect these trends to continue in the near to medium term, even as inflationary pressures ease. We believe the middle- to higher-income cohort will continue to see a greater normalization of spending from this point forward – leading to further down trading – after the strong "revenge spending" seen in the years of reopening following COVID, combined with depleted savings and the end of the moratorium on student loan payments. Accordingly, we continue to favour stocks with positive momentum and meaningful top-line drivers. We continue to monitor high-quality cyclical stocks trading at attractive multiples ahead of rate cuts later this year in the U.S., while shying away from companies relying on continued strength from middle-income consumers to drive growth.

Consumer Staples

In the second quarter of 2024, we saw the sector outperform the broader market in Canada, while modestly underperforming in the U.S.

In Canada, we continue to see a flight to safety due to a slowing economy and rising unemployment, with Loblaw Companies Ltd. (TSX: L) leading the outperformance. We believe George Weston Ltd. (TSX: WN) provides quality exposure to Loblaw Companies Ltd. (TSX: L); through its REIT exposure, it should also benefit as the Bank of Canada reduces interest rates.

In the U.S., we are seeing a wide dispersion in performance in the sector. Quality retailers such as Walmart Inc. (NYSE: WMT) have significantly outperformed this year. Walmart has consistently gained share, insulated from recent consumer weakness and being an idiosyncratic profit inflection story as the company pivots to higher-growth, higher-margin verticals such as advertising.

On the other hand, packaged food and beverages remain beaten down within the sector. There remains little appetite, especially for packaged food, with a potentially structural GLP-1 headwind. Volumes for the group remain negative after increasing the prices on their products about 30% since 2021. Low- and middle-income consumers have started to react negatively to these higher prices and are consistently shopping around more in the discount and club channels as they look for deals. Any volume inflection for the group has remained elusive so far.

However, names such as BellRing Brands Inc. (NYSE: BRBR) are more immune from GLP-1 headwinds for packaged food. The company is gaining notable shelf space with its protein shake offering and remains on trend with, and may benefit from, GLP-1 users who need more protein in their diets. We believe the company is an attractive takeout target.

Financials

Financials lagged the broader market both in Canada and the U.S. in the second quarter. In the sector, capital-markets beneficiaries have shown relative outperformance, while the more credit-sensitive regional banks have lagged. We continue to be a little more cautious about banks, especially in Canada, because revenues are slowing, and credit losses are trending higher. In Canada, we believe we are headed for a period of more rapid deleveraging that will likely hold back growth and profitability for the banks' domestic banking businesses. Among financials, we favour less credit-sensitive companies with good idiosyncratic growth tailwinds, irrespective of the macroeconomic backdrop. We remain very bullish on life insurance: we believe a structural re-rating opportunity could be provided by a higher rate regime compared with the zero-interest-rate policy that followed the global financial crisis. Additionally, many of the life insurance companies we like have built large capital-light wealth/asset management businesses that will likely continue to benefit from numerous secular tailwinds and strong growth.

Communication Services

The second quarter was marked by micro over macro. Notwithstanding a decline in the Canadian ten-year bond yield, an equal-weighted portfolio of BCE Inc. (TSX: BCE), Rogers Communications Inc. (TSX: RCI/B), Telus Corp. (TSX: T), Quebecor Inc. (TSX: QBR/B) and Cogeco Communications Inc. (TSX: CCA) declined 5.4%, lagging the S&P/TSX Composite Index by about 484 basis points (bps).

We have noted in our previous outlooks that we were expecting average revenue per user (ARPU) for 2024 to be "flattish to down modestly." Pricing promotion trends in the second quarter make us feel comfortable with that forecast. Broadly speaking, the stock price performance of the group this quarter makes us believe that the market has come to discount service revenue growth driven primarily by growth in subscribers, and we would want to see growth in ARPU before becoming more positive about the sector. The attractiveness of the group is also dampened by idiosyncratic headwinds for each of the constituent companies.

There is no change to our lukewarm view of the sector. If we were to see pricing actions – price increases like the ones we are seeing at U.S. telecommunication companies, we would become more positive regarding the group, as stock valuations are at reasonable levels.

Utilities

Utilities was an interesting sector in the second quarter. At the headline level, it was a rather pedestrian quarter with the group registering modest outperformance compared to the S&P TSX Composite (approximately 65 bps). However, there were some very interesting dispersions within the sector.

Independent power producers found a new lease on life, driven by optimism about the need for power to meet the growing demand for AI. We have previously mentioned that we prefer companies that have no large project risk and that can self-fund growth. Intra-sector performance was consistent with our preference, because growth stories with better balance sheets handily outperformed names with questionable balance sheet and outstanding large-project risks.

The balance sheet-driven dispersion was also seen in the regulated utility group, where growth stories with better balance sheets outperformed companies with higher leverage and/or weaker growth.

Looking ahead, we see no reason to change our preference for growth, backed by a strong balance sheet.

Real Estate

Like other defensive sectors, real estate investment trusts ("REITs") were unable to ride a decline in bond yields and notch up any outperformance; real estate lagged the S&P/TSX Composite Index by about 550 bps. Broadly speaking, REITs are struggling to find much traction with investors, because the combination of low growth (partly a function of refinancing headwinds) and a merely reasonable dividend yield is less attractive than higher-yield options available elsewhere. Relatively speaking, our preferred names in the sector are those that have good balance sheets and stronger internal growth that can more than offset higher interest rates, as well as those which continue to outperform companies that don't have much growth and/or need to fix their balance sheets. Looking ahead, we believe that REITs need a soft landing, backed by rate cuts, to renew investors' interest in the space.

Energy

Oil prices experienced significant volatility in the second quarter. Brent crude reached a peak of USD 92 per barrel in late April before retreating to a low of approximately USD 77 per barrel in June. The initial surge in prices was driven by supply concerns due to OPEC+ production cuts and geopolitical tensions. However, prices have moderated recently due to several factors, including an easing of geopolitical risks, rising U.S. crude oil inventories, a stronger U.S. dollar and fears of an economic slowdown. On the demand side, growth from non-OPEC countries continues, yet OPEC remains restrained, extending its output cuts of around 1.6 million barrels per day through 2024 to support prices.

Natural gas prices surged in the second quarter, primarily due to a decline in U.S. production. Producers reduced output earlier this year due to lower prices, leading to upward pressure on current prices. Additionally, natural gas has seen increased attention from AI demand over time, as it remains a key power supplier for data centres. Natural gas offers reliable, low-cost energy and can be developed quickly to meet power demands, unlike wind and solar energy, which face intermittent supply challenges that do not align with the consistent energy needs of data centres.

In the portfolio, a prominent theme is investing in oil and gas equities with large, long-life resources, while avoiding equities with short reserve life indexes. Companies with short reserve lives, typically mid-cap and oil-weighted equities, have underinvested in exploration in recent years, and are often forced to engage in dilutive mergers and acquisitions to expand their reserves.

We generally favour companies that have substantial and sustainable resource bases, which provide a more stable and positive outlook compared with companies with shorter reserve lives.

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