

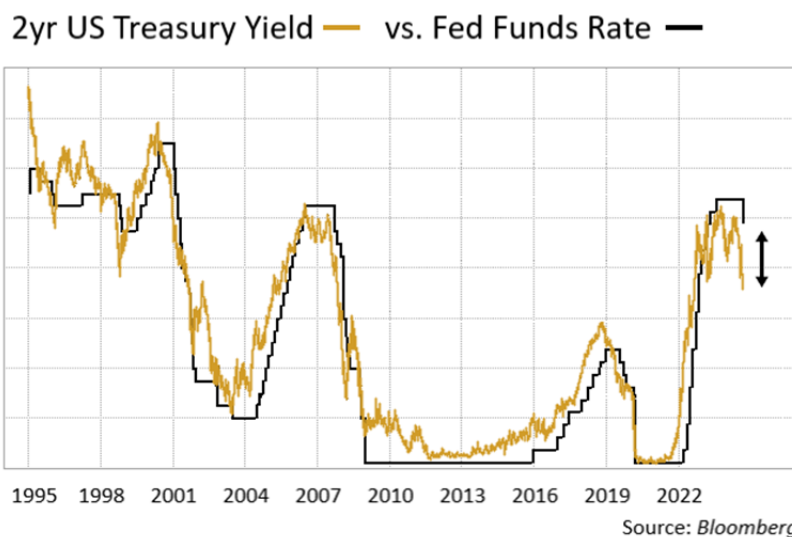
Regime Change

In the final paragraph of our first quarter letter, we wrote:

In the next issue of this commentary, we could very well be talking about a quarterly decline for your equity allocation, and it may be more than just a speed bump. History and the well-documented mistakes of others, however, tell us that our best course will be to stay put, regardless of how bleak things might seem in the moment or how tempted we are to try and out-smart the market.

While the three months immediately following that report passed without incident, it looked like our warning might be coming to fruition halfway through Q3. After reaching a new high in mid-July, the S&P 500 dropped by about 9% in a matter of days, with blame assigned to the rapidly unwinding “yen carry trade”. If this sounds like a bit of investment esoterica, that’s because it is. It’s the kind of thing that keeps traders and speculators up at night, but which should be of little concern to anyone taking positions in quality businesses with the goal of generating long-term compound growth. Regardless, just as quickly as the market got “carried” away, it forgot about this supposedly perilous development and resumed the ascent that began in the fall of 2022.

Around the same time, the Bank of Canada implemented its third consecutive interest rate cut, cementing its position as policy loosening leader amongst developed country central banks. When the US Federal Reserve subsequently met in late September, the question wasn’t “if” they’d ease, but rather by how much. Central bankers generally prefer to follow a measured path, with the vast majority of rate cuts and hikes coming in 25 basis point (or 0.25%) increments, and though a meaningful portion of observers thought that a 50 basis point reduction was possible, most predicted that the decrease would be meted out according to the usual dosage.



As it happened, the Fed did elect to chop half a percent off its policy rate, perhaps signaling that the governors felt they had ground to make up, or at least that the potential for adverse consequences was limited. To be sure, the two-year US bond yield - which often

leads the Fed funds rate - had opened up a wide spread against the monetary benchmark and, even at the end of the quarter, was still suggesting that the Fed had room to move (see first chart).

As many of you will know, interest rate changes can have a meaningful impact on asset valuations

and future performance. In the case of bonds, rising rates exert pressure on prices while falling yields do the opposite; and after having experienced the worst bond bear market in history from 2020 to 2023, holders of fixed income instruments will undoubtedly welcome the inflection in policy that arrived this summer.

If the connection between interest rates and bonds is mathematical, the linkage with stocks is less direct and often depends on what's driving

changes in central bank positioning.

When rates were slashed in 2008, for example, it was a four-alarm response to the near collapse of the global financial system and, not surprisingly, equity markets took their cue from the dire

economic backdrop rather than from the drop in yields. Today's cut, however, reflects a comparatively happy circumstance, with the slaying of the inflation dragon allowing bankers to put down their swords while most economic and financial variables remain in positive territory. In fact, US consumer sentiment rose to its highest level in five months in September, while economists boosted their aggregate 2024 GDP growth estimates for the second time since the beginning of August.

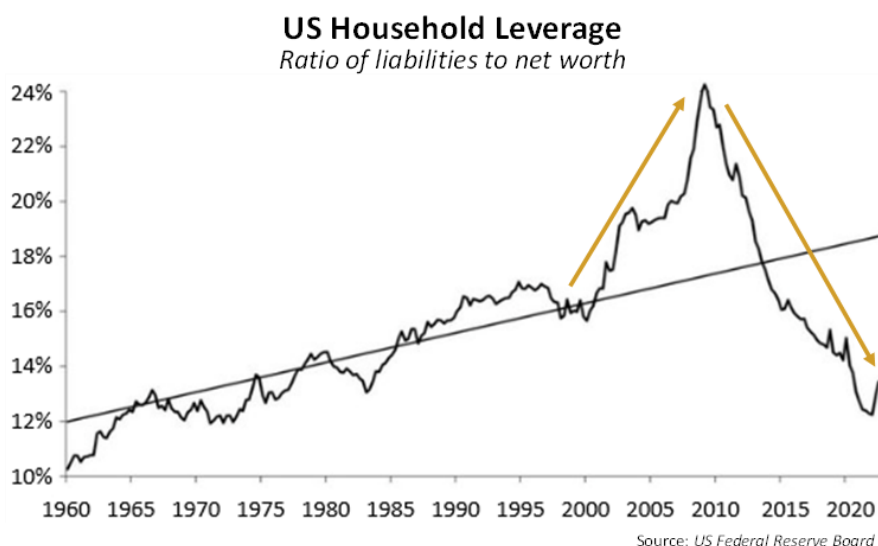
Continuing with the financial crisis analogue, that was a period when individuals had binged on debt in pursuit of real estate riches and so when things turned down, a negative feedback loop developed, where stretched household finances blunted consumer activity, which undermined

the economy, which put more pressure on private sector balance sheets, and so on. Today, however, households are wealthier than they've ever been and much less levered than they were at any point since the mid-80s (see second chart). On top of that, deposits in money market funds, which had surged to \$5 trillion in the first quarter of 2023, are now approaching \$6.5 trillion. As short-term yields fall, it wouldn't be unreasonable to imagine that some of this liquidity

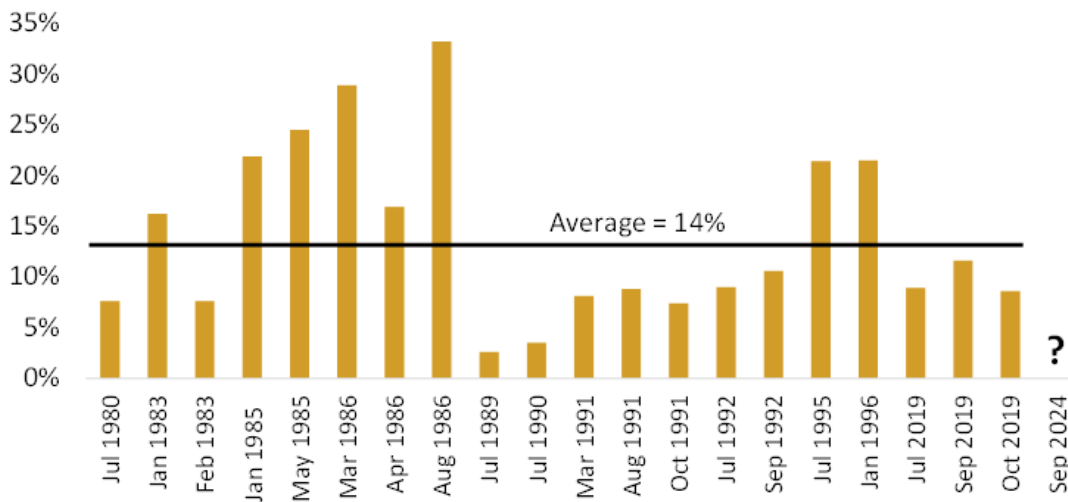
will find its way to consumption or investment, a wave which could be doubly amplified if those same lower rates also encourage households to re-lever. These characteristics are almost the mirror image of those prevailing in 2007/08 and could provide

a persistent bid beneath both the economy and asset markets.

When rates are falling and the economy is in reasonably good shape, it makes sense that lower yields would be supportive of stock prices, as the competition for capital is diminished (i.e. bond and money market yields become less attractive) and the present value of future cash flows is boosted. As the graph on the next page depicts, this relationship seems to have played out in the past, in that every time since 1980 that the Fed has cut rates when the S&P 500 is within 2% of its all-time high, stocks have gained over the following 12 months (*note that when the Fed reduced its policy rate in September, the S&P was just 0.58% below its record level and reached another new high just days later*).



1yr S&P 500 returns when Fed cuts within 2% of all-time high



Source: Bloomberg

Of course, as Warren Buffett once remarked, “if history was all there was to investing, the richest people would be librarians.” Similarly, we’re not about to rest on the likelihood that the past will be repeated and will instead maintain our ongoing hunt for unique opportunities within the

broad market and our commitment to managing risk within each of our mandates. That said, in an environment of low unemployment, strong corporate earnings, and robust innovation, we’ll always choose falling over rising interest rates!