



QUARTERLY MARKET COMMENTARY

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**“Ultimately nothing should be more important
to investors than the ability to sleep at night.”**

Seth Klarman, billionaire investor, hedge fund manager, author

Thanksgiving

Investors have much to be thankful for in the last year. Inflation has subsided, interest rates have come down and the markets ended September on a high note. Over the last 100 years September has had the worst results of any month and, on average, is negative. Fortunately, that was not the case this year. Below are the performance numbers for the Moderate Risk Equity and Balanced portfolios in which many of you invest. Keep in mind the below model portfolios are designed to carry less risk than the market in general but provide similar or better returns over the long-term.

Moderate Risk Equity Portfolio vs. Canadian and U.S. markets over the last five years:

	Three Month	One Year	Three Year	Five Year
TSX	+9.7%	+22.8%	+19.6% (6.1%/yr)	+44.1% (+7.6%/yr)
Dow Jones (in CDN\$)	+7.0%	+25.7%	+31.1% (9.4%/yr)	+60.5% (+9.9%/yr)
Moderate Risk Equity Portfolio	+6.0%	+18.1%	+34.2% (+10.3%/yr)	+72.5% (+11.5%/yr)

Balanced Portfolio Returns vs. Benchmark over last three years:

	Three Month	One Year	Three Year	Five Year
Benchmark*	+7.2%	+17.8%	+9.5% (3.0%/yr)	+23.4% (+4.1%/yr)
Balanced Portfolio	+6.6%	+19.1%	+18.1% (+5.7%/yr)	+45.3% (+7.8%/yr)

**50% TSX/50% Canadian Bond Universe Index ETF (XBB)*

Changing Tide

In the first half of this year, the top seven stocks in the S&P 500 were responsible for all of the returns, as the rest of the stocks in the index had negative or neutral returns. This concentration was a concern, as it is often seen at or near market tops, however, there was a complete turnaround in market leadership in the last three months and a much more balanced return profile in the

market. The top seven stocks only produced about 3% of the gains this quarter. The other 97% of the return was provided by other sectors. That is a healthy sign, which shows there is strength in other parts of the economy, which often leads to a sustainable bull market.

There was also a change in tone from the Federal Reserve. They care about two things: keeping inflation under control and keeping employment strong. Since 2021, the Fed’s main focus has been on inflation, but now that this is near their 2% target, their focus has shifted to employment. In early August, there was a jobs report that was weaker than expected, which seemed to push the Fed to start cutting interest rates at their September meeting. The market expected a 0.25% cut but they actually cut rates by 0.5%. This was their first interest rate cut since March 2020. The Bank of Canada also cut their rates by 0.5% in the quarter, for a total of 0.75% this year so far. By the end of 2024, both the U.S. and Canada are expected to cut rates by an additional 0.5% or more and another 1.0% in 2025. This year’s rate cuts and the expected further rate cuts provided some welcome relief to investors. Many of whom had worried that rates had gone too high too quickly and were starting to create a recession. Their concern is warranted as this has been the case many times in the past. For now, it appears rates were increased just enough to slow down inflation without causing a recession.

Dividends Back in Style

Since the end of 2021, as interest rates were rising quickly, it has been very difficult to make money with stable dividend-paying stocks such as utilities, real estate investment trusts, telecom companies and pipelines. This is because an investor could earn interest with very little risk with a short-term bond or a cash fund. Buying a utility exposed them to a bit more risk than a bond but didn’t give them much added return potential, especially if rates were expected to rise further. This has been changing over the last year and especially over the last three months. It appears there has been a rotation out of technology stocks and into dividend-paying companies. This rotation is quite clear looking at the table below:

Key Sector ETF Performance (US Market)¹

ETF Symbol	Sector	First Half 2024	Last Three Months
XLK	Technology	+17.9%	-1.0%
SMH	Semi-conductors	+49.1%	-5.7%
XLU	Utilities	+9.3%	+19.0%
XLRE	Real Estate	-2.5%	+13.2%
XLC	Telecom	+18.5%	+5.3%
DVY	Dividend Payers	+4.9%	+11.6%

1. Data from Bespoke Investment Group, “The Bespoke Report: Equity Market Pros and Cons”, October 4, 2024

Despite the good returns in equities so far this year, it is likely that more upside is in the future. Usually, when interest rates are cut for the first time, stocks rise 12% on average over the next year as long as we avoid a recession. The utility sector in the six-month period after a rate cut tends to be the best performing sector with telecom a close second. They tend to outperform the rest of the market by 5% and 4% respectively, six months after the first rate cut². I have added utilities, telecom and short-term bonds to most of your portfolios in the last year and a half. Short-term high-quality government bonds have already risen in price with the rate cuts, and they should continue to do so with more cuts, so there is a good chance the nice returns we have experienced in recent years will last at least a little longer. Also, in the less likely case of a recession, these sectors will also hold up much better than the overall market. You should sleep well at night knowing this.

U.S. Election

The U.S. election is less than a month away and, if I were to guess, I would pick Kamala Harris as the winner. This would just be a guess, however, as the polls have her with only a 2.7% lead over Donald Trump. She has a similar lead over Trump in the swing states but the number one issue for swing state voters (and also nationally) is the economy. In the swing states, only 45% of voters think Harris can better handle the economy vs. 49% for Trump. Given that Democrats require a pretty big win in the popular vote to win the election, this race is too close to call with any degree of confidence. It should be noted that Hillary Clinton won the popular vote in 2016 by 2.9 million votes but still lost the election. For more insight on who might win, we could look to historian Allan Lichtman for an answer. He has correctly predicted nine of the last ten U.S. elections and he has a 13-point system that he uses to pick a winner based on the following criteria:

Allan Lichtman's 13 Keys. The keys include whether:

- The White House party gained seats in the midterms: False, favours Trump
- The sitting president is running for election: False, favours Trump
- The White House Party is avoiding a primary contest: True, favours Harris
- There is a third-party challenger: False, favours Harris since RFK Jr. stopped running
- The short-term economy is strong: True, favours Harris
- The long-term economic growth has been as good as the last two terms: True, favours Harris
- The White House Party has made major changes to national policy: True, favours Harris
- There is sustained social unrest during the term: False, favours Harris
- The White House is untainted by scandal: True, favours Harris

² From Finimize Podcast on Spotify, September 24, 2024, with special guest Stephen You of Blue Whale Growth Fund, "Three Investments That Thrive After The Fed's First Rate Cut", Source of data was Goldman Sachs Investment Research. Podcast was summarized by Russel Burns

- The challenger is uncharismatic: False, favours Harris. Trump is only considered charismatic to his small base and had horrible approval ratings while President.
- The incumbent is charismatic: False, favours Trump. Lichtman only considers a candidate to be charismatic if they have very broad appeal. Examples are: JFK, Roosevelt, Obama and Reagan
- The White House party has a major failure in foreign policy: True, favours Trump. Lichtman considers the Gaza response to be a failure.
- The White House party has a foreign policy success: True, favours Harris. Lichtman considers the Ukraine policy a success so far.

Lichtman would only predict the challenger, in this case being Trump, to win the election if he had six or more of the above 13 points in his favour. In this case, Trump only has four, so Lichtman is predicting a win for Harris. Given neither of the two candidates is likely to win in a landslide and their policies are not radically different, the markets likely will not be too concerned about which candidate wins. Likely, the markets will rise after the election is over, no matter who wins, like it did after Trump won in 2016 and after Biden was officially declared the winner in 2020. Markets hate uncertainty and, when a winner is declared, some uncertainty will be removed. This doesn't mean it is irrelevant who wins. Some say Trump will try and hold on to power as long as he can, if he wins and put an end to democracy as we know it. Whether or not this will happen is beyond the scope of this newsletter.

Not All Roses

The markets are having a stellar year so far and we are only just beginning the fourth quarter, which historically outperforms all the other quarters. Economic news has been improving and the lower interest rates are supportive to stock and bond prices. Most economists now agree that we have avoided recession but there are still a few items that concern me.

1. Japanese yen carry trade: The market plummeted in the first week of August this year and the carry trade was blamed for it. Many large investors borrow yen, which typically carries a lower interest rate than other currencies, and they use this money to buy other investments that have more potential upside. The popular trade in recent years has been borrowing yen to buy U.S. large cap technology stocks. In August, the Japanese government announced they would raise interest rates, and this caused an increase in the yen relative to the US\$ and induced lots of investors to sell their U.S. tech stocks and buy back the yen they borrowed. Since August, the yen has dropped back down, allowing this trade to continue but the yen is very under-valued compared to the US\$. This could easily happen again, especially as U.S. interest rates fall quickly.
2. U.S. stock valuations: Total U.S. stock market value compared to U.S. gross domestic product is a measure used by Warren Buffett to measure how expensive the market is in general. Currently, this ratio is almost 2:1. Buffett considers a ratio of 1.2:1 as fairly valued. The 2:1 ratio is considered to be extremely over-valued and is well above its peak value in 2000 (near the tech crash) and right where it was at the previous market peak in 2021 before the 2022 market drop. Investors would be well served to avoid some of the more expensive parts of the U.S. market at this time.
3. Leading indicators: These include things like housing starts, purchase managers indicators and consumer confidence surveys, which can be used to predict future moves in the economy. Leading indicators are down significantly in the last six months, which typically only happens preceding recessions.
4. Yield curve: Approximately 85% of the time, an investor can get a better interest rate for a longer-term bond than a shorter-term one. Up until just recently, the opposite was true. A three-month U.S. bond paid much more than a 10-year bond. That is considered to be an inverted yield curve and is one of the most consistent recession predictors. This situation has corrected in recent months but recessions, if they occur, usually happen shortly after an inverted yield curve corrects. This is an ominous sign.

Given these items, some caution is still warranted, so I will invest accordingly.

Final Thoughts

My goal is to protect your capital from permanent loss and to grow that capital as much as possible without taking on too much risk. I want you to be able to sleep well at night. This requires a conservative stance and some periods of underperformance when the markets are hot but in the inevitable market downturns, I want you to know that the investments you have will weather any storm. Over the years, many of you have invested with me through the Great Financial Crisis of 2008, the oil crash in 2015, the pandemic in 2020 and the inflation/interest rate spike in 2022 and 2023. You have seen major ups and downs and continued to trust me to protect and grow your hard-earned money. For that, I am incredibly thankful. I hope all of you have a fantastic Thanksgiving weekend and holiday season.

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