Brompton Insights

2024 Investment Outlook – Back to Normal

BROMPTON FUNDS

December 7, 2023

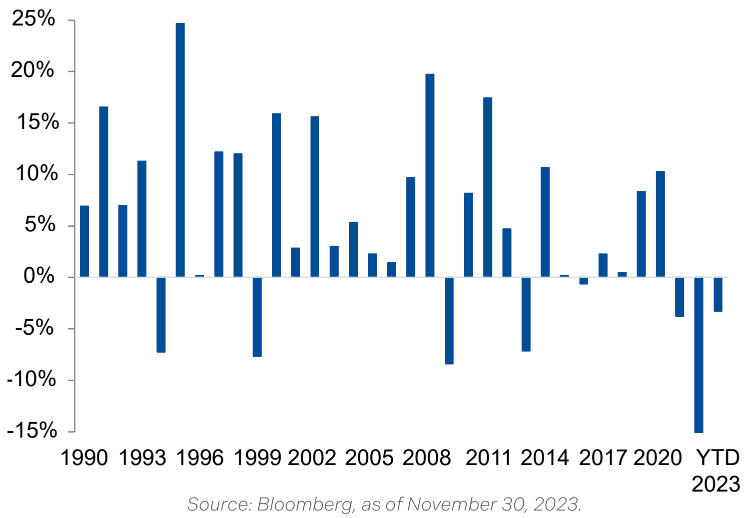
You may have heard the phrase "higher-for-longer" referring to the expectation that interest rates will remain higher for a longer period of time. We believe the phrase should actually be "back to normal". As you can see from the historical U.S. 10-year Treasury rate in the chart below, after nearly 40 years of declining rates, we have bounced off nearly zero yields back to the pre-Great Financial Crisis environment.

U.S. 10-Year Treasury Bond Yield

Source: Bloomberg, as of November 30, 2023.

Brompton expects interest rates to come down from the elevated post-COVID levels, but we do expect that the "last mile" to get closer to 2% inflation will be a slow grind. In the shorter term, we believe interest rates have peaked for this cycle and are poised to settle down, making fixed income look more attractive. U.S. 10-year Treasuries are on track for a third consecutive year of negative returns which, as you can see from the chart below, is highly unusual, so we do expect positive returns for fixed income in 2024.

U.S. 10-Year Treasury Bond Returns



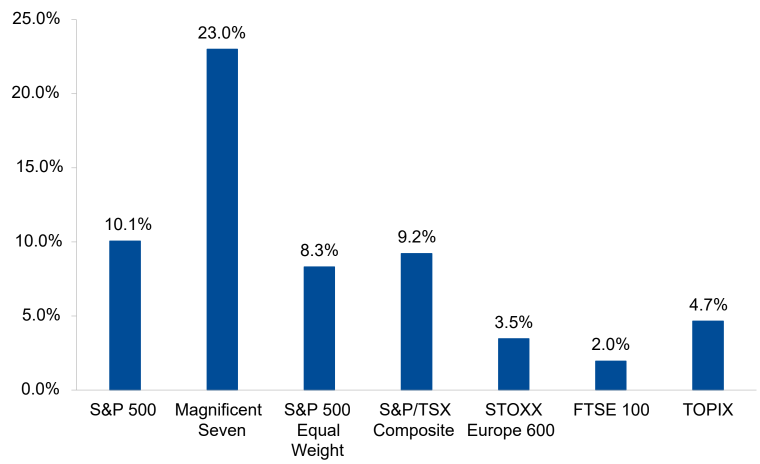
Source: Bloomberg, as of November 30, 2023.

We believe the U.S. Federal Reserve ("Fed") and other central banks will keep short-term interest rates higher to ensure inflation is under control. Even the U.S. Regional Banking Crisis in March 2023, which arguably was caused by the Fed rapidly increasing interest rates, did not deter the Fed from increasing interest rates. Short of another crisis, consensus expects the Fed to start easing rates mid-2024.

With higher-than-normal government deficit stimulus and 30-year term mortgages enabling consumer spending, Brompton expects the U.S. economy to slow, but still remain one of the strongest economies in the world. In Canada and Europe, leading economic indicators suggest weaker economies that may lead to a technical recession.

U.S. earnings appear to have bottomed in Q2/2023, with analysts estimating S&P 500 earnings to grow at 10.1% in 2024[1] which we believe is optimistic given the consensus 1.2% GDP growth rate.[2] Earnings growth estimates for the Magnificent Seven (Meta, Nvidia, Amazon, Apple, Alphabet, Microsoft, Tesla), which comprise more than 25% of the market value of the S&P 500,[3] are pulling up the growth of the overall S&P 500 earnings. If you remove the effect of these large weights by using the Equal Weighted S&P 500 Index, growth is about 18% lower.

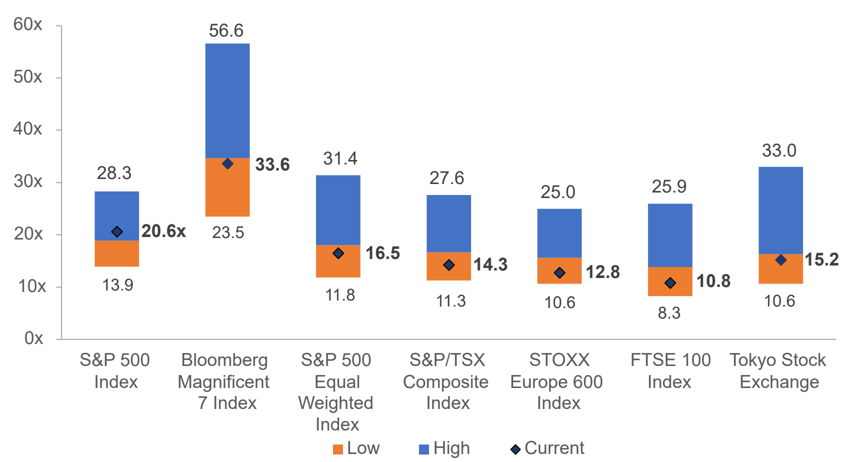
2024 Earnings Growth Estimates for Select Indices



Source: Bloomberg as of November 30, 2023. Reflects consensus earnings estimates for fiscal year 2024.

In terms of valuations, the U.S. market is the most expensive of the major global equity markets reflecting stronger growth, particularly of the Magnificent Seven as shown in the chart below.

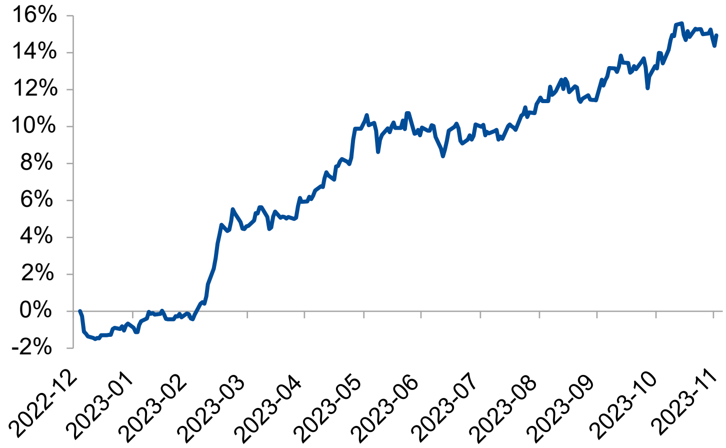
Headline Price-to-Earnings (P/E) vs. 10-year History



Source: Bloomberg as of November 30, 2023

On an equal-weighted basis, U.S. stocks trade at a much more reasonable P/E of 16.5x.[4] In 2023, the Magnificent Seven outperformed since that was where the majority of the earnings growth and Artificial Intelligence ("AI") hype was concentrated. In 2024, earnings in the rest of the S&P 500 are poised to recover, so Brompton believes the performance gap should narrow. We expect more broad-based gains in 2024 based on broadening earnings growth.

Year-to-Date Outperformance of S&P 500 vs Equal Weight S&P 500 Driven by the Magnificent Seven



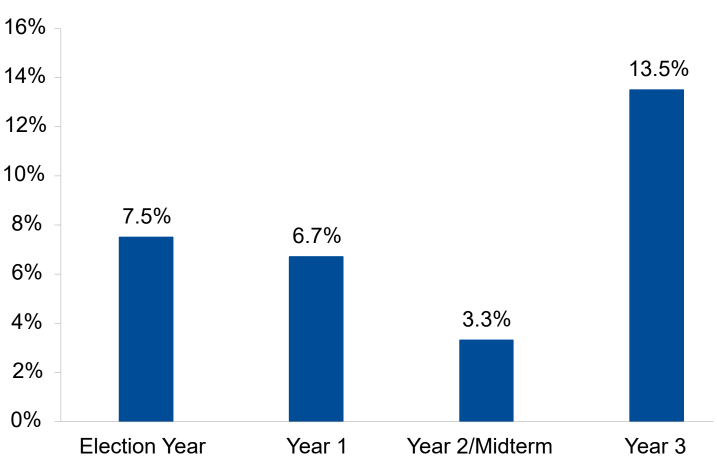
Source: Bloomberg as of November 30, 2023.

We do believe the disruptive potential of AI is real. To use a baseball analogy, we are only in the first inning of the next Industrial Revolution, but it will take time for companies to implement AI to realize efficiencies and cost savings. The initial winners will be the technology companies that can sell the tools and services to enable AI. The next winners will be the companies that can deploy AI to reduce costs, analyze data, and gain customers. That is why we still believe every portfolio should have at least a market weight or an overweight in Technology.

Looking at valuations of other markets, Brompton believes there is value in the Canadian and Japanese markets.

2024 will be a U.S. election year and as shown in the chart below, election years typically have good returns, but not as good as the third year of the Presidential Cycle in 2023. Election years typically have weak starts with defensive stocks outperforming and then rallying around election time.

Average S&P 500 Performance During Election Cycles Since 1928

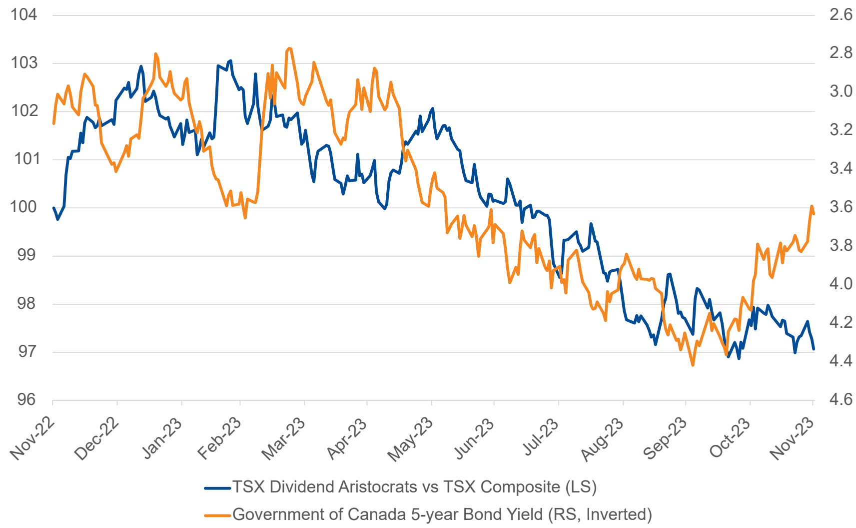


Source: RBC Strategy Spotlight, November 22, 2023.

Aligning with our view, we expect long-term rates to come down in 2024, benefiting those companies with long duration assets such as Telecommunications, Utilities, and Real Estate. As the year progresses and it becomes more obvious that a soft landing is within reach, and as U.S. election noise subsides, Brompton expects deep value cyclicals such as banks and energy to outperform. We also expect continued strong performance from companies with exposure to key themes, such as AI and obesity drugs.

It has been a difficult year for dividend growth stocks to compete with the higher yields in fixed income. As shown in the chart below, dividend growth stocks have underperformed the market over the past year as bond yields have risen (shown on an inverted scale). We believe as interest rates decline, dividend growth stocks should start outperforming again.

TSX Dividend Aristocrats Relative Performance vs. 5-year Canada Bond Yield



Source: Bloomberg, Brompton, December 5, 2023

We believe that investors will need to be nimble in 2024 and that stock picking will remain an important driver of alpha. We also expect volatility to remain elevated and believe that investors will be well-served by strategies that have historically demonstrated lower volatility than the market, such as dividend growth and covered call strategies.

(1) Source: Bloomberg, as of November 30, 2023.

(2) Source: Bloomberg, as of December 1, 2023. Consensus estimate year-over-year U.S. real GDP growth.

(3) Source: Bloomberg, as of November 29, 2023. Based on SPDR S&P 500 ETF Trust portfolio weightings.

(4) Source: Bloomberg as of November 30, 2023. Based on S&P 500 Equal Weighted Index.

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