ROUNDTABLE

meritage PORTFOLIOS®

Spring 2024

Is a soft landing realistic amid potential rate cuts?

CONTENT

NATIONAL BANK INVESTMENTS

Fixed Income

John Shaw, CFA

Vice-President, Portfolio Management and Portfolio Manager
CI Global Asset Management

CI Canadian Bond Fund
[Held within 13 Meritage Portfolios: get more information]

Challenges

The Canadian economy is heading towards a soft landing/recession as growth has slowed except with exports; moreover, the unemployment rate is rising, and more consumers are feeling the stress of higher mortgages and housing costs.

So far, the Bank of Canada (BoC) has not moved to lower interest rates as the strong U.S. economy has pushed out the timing of the first cuts by the U.S. Federal Reserve (Fed). If the BoC lowers rates (as they should) too soon before the Fed, the Canadian dollar risks falling, causing import goods inflation. In addition, house prices would likely get a boost. Both would send inflation higher.

What is the BoC to do? They will likely wait until the summer before cutting rates. By then, the economy may be weaker than it is today, so the cuts may have to be steeper than the bond market is forecasting.

The U.S. economy is doing much better than what market participants believed was going to be the case at the beginning of the year. U.S. gross domestic product (GDP) is strong, employment growth has beat expectations and inflation has remained too high for the Fed to begin cutting interest rates anytime soon. This is hardly a soft landing; it is a no-landing scenario so far. With that backdrop, the U.S. Treasury market has moved from pricing 6 cuts in 2024 to only 3 cuts.

Opportunities

Canadian fixed income offers a very good opportunity at these attractive yields. Investors are paid to wait for the BoC to begin cutting rates. However, when it does begin to lower rates, returns should be very good in the middle of the curve.

Fund strategy

The CI Canadian Bond Fund is long duration, but we are leaning to take duration longer as the Canadian economy slows further and the BoC begins cutting rates. The corporate bond overweight has been steady to start the year but will likely be reduced later in the year should the U.S. credit market begin to show signs of weakness.

The market reached its peak in yields last October and this current backup represents another very good opportunity to increase your exposure to fixed income, especially for those investors who have been underweight over the past number of years.

Fixed Income

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RBC Global Bond Fund
[Held within 5 Meritage Portfolios: get more information]

Challenges

Following the exceptional rally of bond markets at end 2023, investor expectations for early and frequent interest rate cuts have proven to be somewhat overenthusiastic. We agree that central bank policy rates are likely to fall this year, and the pace and magnitude of the adjustment will continue to be a key determinant of bond market volatility.

We believe that the slowdown in inflation will likely continue, and the high interest rate burden should weigh on household finances, allowing central banks to ease rates from current restrictive levels. These expectations are likely to protect bond markets from a sustained sell-off, while at the same time presenting us with an opening to opportunistically accumulate duration should yields spike suddenly.

Regionally, we believe that U.S. economic exceptionalism will most likely result in Treasuries underperforming peers in Canada, Europe, the U.K., Mexico, Brazil and South Africa. Japan is finally beginning to tighten monetary policy and we continue to be positioned underweight in Japan, preferring to allocate the portfolio towards other markets where we believe yields are likely to fall. We also remain underweight in China, seeing limited requirement for easing from policymakers going forward, given the potential positive turnaround in the global economy.

Opportunities

Our economic outlook across several major regions has been cautiously improving. However, given we believe valuations in riskier areas of credit markets don't accurately reflect unresolved risks, we continue to prefer high-quality bonds, primarily via short-dated investment-grade corporates and short maturity emerging-market sovereigns.

With limited upside in currencies, in our view, we expect to continue to run limited exposure in the near term. We believe the Canadian dollar will keep pace with major developed market currencies such as the euro and Japanese yen but may underperform next to cyclical and high-beta currencies that would benefit from improving global economic activity, interest rate cuts and continued fiscal stimulus spending by governments during a busy year for elections around the globe.

Fund strategy

In the present environment, the potential returns from bonds remain compelling, partly owing to the attractive jumping-off point provided by elevated yields. While the outcome for the year ahead is unforeseeable at this stage, we would suggest mid single-digit returns for global government bonds is a reasonable base case scenario. The biggest risk to this outlook comes from a re-acceleration of the economy, which has the potential to push inflation higher and force central banks to maintain their restrictive policy rates.

Canadian Equity

Pat Palozzi, CFA

Vice-President, Canadian Equities
Beutel, Goodman & Company Ltd.

Beutel Goodman Canadian Equity Fund
[Held within 9 Meritage Portfolios: get more information]

Challenges

Soft or hard landings are always difficult to predict, and we do not factor specific macro forecasts into our investment decisions. Should the Bank of Canada be slow to lower interest rates, we could see some short-term pressure on our bank holdings or more interest-sensitive names like Brookfield Corporation and Fortis. A faster reduction in rates should be beneficial to most names in our fund due to lower interest cost assumptions and capitalization rates.

Opportunities

In the current environment, we are finding good value in individual names in the Consumer Discretionary asset class, which sold off due to macro concerns. The amount of pessimism priced into these stocks does not reflect the long-term earnings power of the companies, in our view. We also see good value in several investments that generate high levels of sustainable free cash flow where either temporary disruption in earnings growth (such as with Metro Inc.) or overblown sectoral concerns (such as Rogers Communications Inc.) have resulted in these names being oversold.

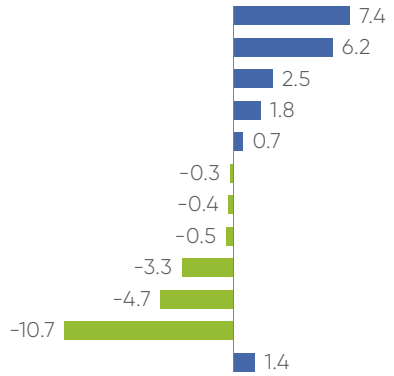
Fund strategy

We are overweight in sectors where significant value opportunities exist in individual names, such as financials, communication services and consumer discretionary. We are underweight in sectors where the market currently relies on momentum rather than valuation measures to assign price (information technology) or where commodity price assumptions are the key drivers of value and internally generated cashflow does not compound returns, such as energy and materials.

Betel Goodman Canadian Equity Fund

Sector	Portfolio (%)	Benchmark (%)
Consumer Staples	11.4	4.1
Consumer Discretionary	9.8	3.5
Financials	33.4	30.9
Communication Services	4.9	3.2
Industrials	15.1	14.4
Health Care	0.0	0.3
Real Estate	1.9	2.3
Utilities	3.2	3.7
Materials	7.8	11.0
Information Technology	3.9	8.6
Energy	7.3	18.0
Cash and Cash Equivalents	1.4	0.0

Underweight/Overweight (%)



Sector Overview as at March 31, 2024.
86 weights are combined to include a 8.1% small cap component.

Source: Beutel, Goodman & Company Ltd. Benchmark: S&P/TSX Composite Index. Numbers may not add up to 100% due to rounding.

Past performance does not guarantee future results. Invested capital is at risk of loss. Any securities, sector, or allocations listed should not be perceived as investment recommendations and may no longer be held in an account's investment portfolio.

Global Equity

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Emme Kozloff
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Capital Group Global Equity Fund
[Held within 16 Meritage Portfolios: get more information]

Challenges

The biggest challenge related to the current market consensus view of upcoming rate cuts and soft landings stems from the fact that these anticipated events are largely reflected in today's market pricing, particularly in the U.S. That leaves little room for error at a time when economic momentum is uneven across geographies and inflation may remain sticky and above target in some countries.

Opportunities

With the cost of capital elevated and inflation still a factor, we are looking for companies able to thrive under various circumstances. This includes companies with strong competitive positions in industries experiencing structural growth, such as pharmaceuticals, semiconductors and defence. Other opportunities include companies that may benefit from recovery in industry-specific cycles (travel/aerospace), or those able to boost operating performance through initiatives such as better cost management. Geographically, equities are, on average, priced more attractively outside the U.S., but a company's country of domicile matters less to us compared to where it generates revenue.

Fund strategy

The Fund is built from high-conviction, bottom-up investment ideas, as it seeks to deliver long-term growth of capital. In many cases, these ideas combine opportunities for structural or cyclical growth, as well as resilience supported by market structure, pricing power, balance sheets and capital allocation.

Some notable examples in industrials include select airlines as well as companies in commercial aerospace, which, following a sharp cyclical downturn during the pandemic, are seeing a strong recovery in demand.

Other examples include leading providers in defence, earth-moving equipment and transportation industries. In pharma and biotech, we've been finding opportunities across companies, including those offering new treatment options for diabetes, obesity and related health concerns. We're also investing in select companies positioned to benefit from the ongoing build-out of artificial intelligence computing infrastructure, such as in cloud computing, the semiconductor supply chain and power/electricity.

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Summary table

Brochure

NATIONAL BANK INVESTMENTS

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(2024/04)