Desjardins
Global Asset Management


# Market Outlook – Top Down Approach

September 2024

# Strong convictions despite an uncertain environment

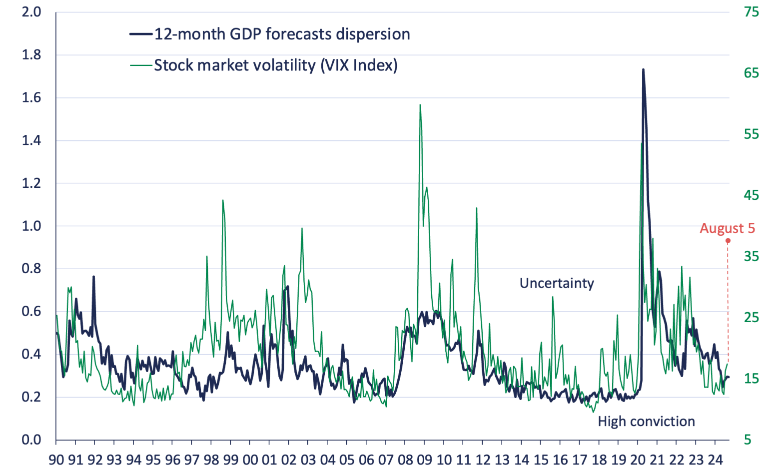
The consensus for the next 12 months is not only optimistic about the economy, inflation and corporate earnings but also very confident about its forecasts. The lack of disagreement among forecasters shows a high level of conviction. But when everyone embraces the same scenario, the potential for a surprise in the event of bad news is considerable.

Disappointing economic data on employment and the business climate in the United States cast doubt on U.S. growth during the summer. These figures, combined with an unexpected change of tone from Japan's central bank, roiled the financial markets. The turmoil was caused by a combination of factors that made for a very tense macro-financial environment: high growth expectations, very expensive equity markets and investors' extreme positioning in risky assets. The volatility confirmed that there's no room for bad news when the market is priced for perfection.

The degree of confidence in the consensus is surprising at a time when the macro-financial context is uncertain, owing to the slowdown in employment, the imminent U.S. election and the pace of monetary easing, which may or may not be adequate.

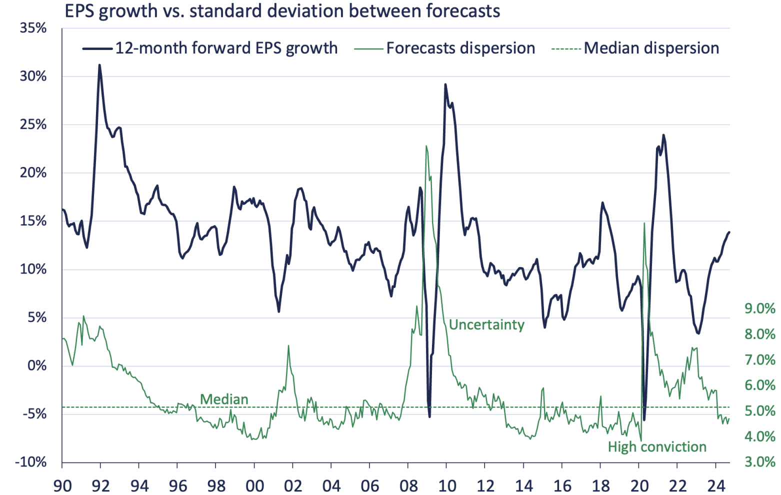
As a result, forecasters and investors may well have their high comfort level tested again in the coming months by further episodes of volatility, especially because the Federal Reserve's 50-basis-point cut in the key interest rate in September has injected an extra dose of optimism.

**Stock Market Volatility vs. GDP Forecasts Dispersion - United States**
VIX Index vs. standard deviation between GDP forecasts




Sources: DGAM, Consensus Economics, IBES, September 30, 2024

**12-month Forward Earnings & Forecasts Dispersion - S&P 500**
EPS growth vs. standard deviation between forecasts



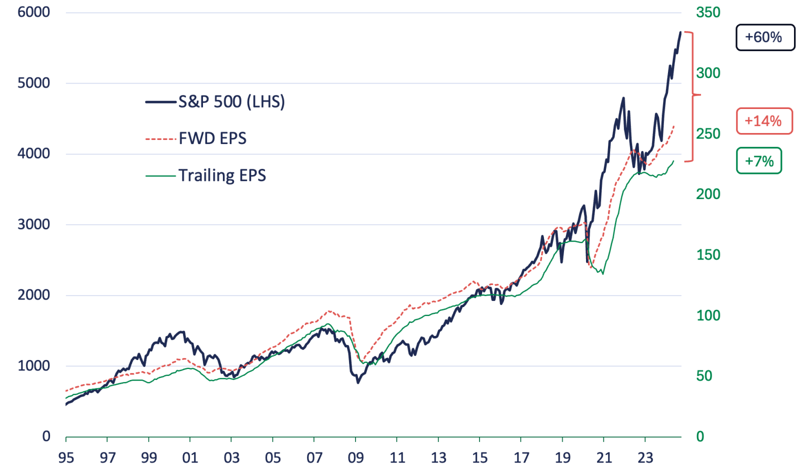

Sources: DGAM, IBES, September 2024

# The stock and bond markets are pricing in diametrically opposed scenarios

Economists and analysts are not the only ones with strong convictions. Equity investors expect an economic recovery with a significant acceleration of corporate earnings, especially in the United States. Over the past 24 months, the S&P 500 Index has advanced 60%, even though corporate earnings have been almost stagnant, rising only 7%. As for analysts' earnings forecasts, they are up only 14% over the same period. Investors have definitely gotten ahead of themselves. This is the second time in less than five years that such a disconnect has occurred between the stock market's valuation and its fundamentals. During the pandemic, earnings fell because of lockdowns, but the stock market soared with the massive influx of small investors trading on user-friendly platforms.

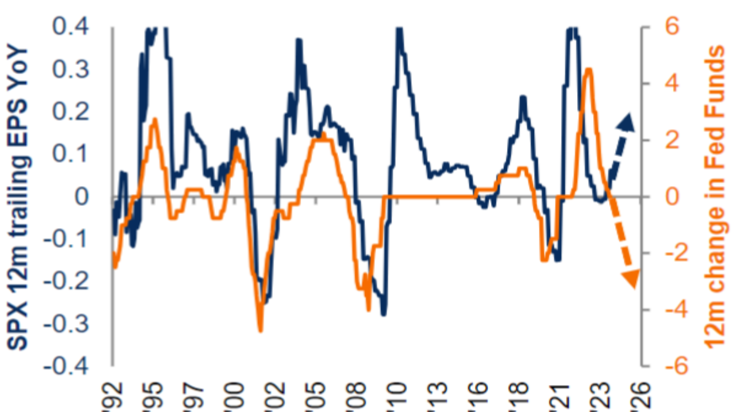
In contrast, the fixed income market is pricing in an economic slowdown or even a recession, which will require deep interest rate cuts in the United States, the euro zone and Canada. Such a scenario is obviously inconsistent with accelerating corporate earnings. One of the markets has to be wrong.

**S&P 500 vs. Forecasted and Realized Earnings**
Levels



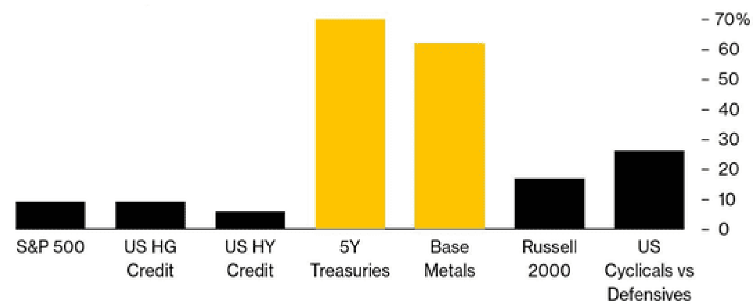

Sources: DGAM, IBES, Refinitiv, September 2024

**Forward EPS vs Interest Rate**
Realized and forecasted, United States




Source: State Street Global Markets, September 2024

**Recession Probabilities Across Asset Classes**




Probability of a recession currently priced in across assets

JPMorgan
The bank calculates the metrics by comparing the pre-recession peaks of various classes and their troughs during the economic contraction.

Source: JP Morgan, September 2024

## United States: Few excesses to purge from the real economy

From our perspective, there aren't many excesses that need to be purged from the real economy in the United States. Neither consumers nor businesses are drowning in debt. Barring an exogenous shock, our worst-case scenario is a short, shallow recession, like the one in 2001. Back then, the consumer was resilient, thanks in part to a very high savings rate before the recession, but that isn't the case today. As for businesses, investment had taken a temporary break amid a wave of major tech investment. This interruption, after the bursting of the speculative bubble, caused a shallow recession.

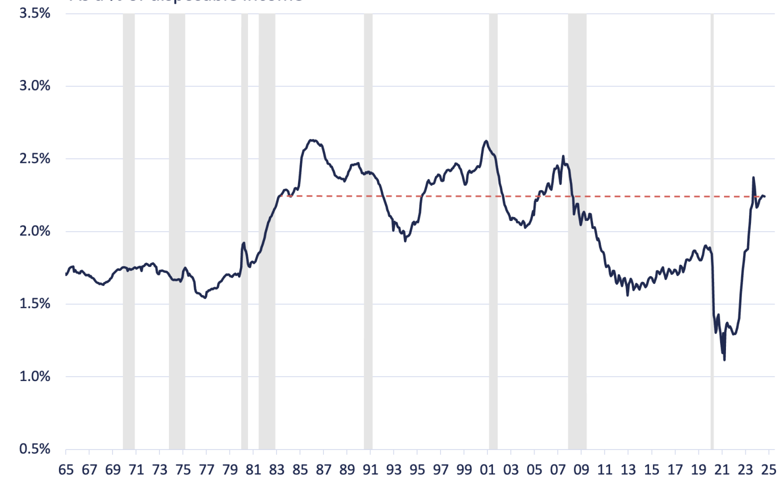
If there are excesses that need to be purged today, they tend much more to be in the financial markets than in the real economy, but they are not as great as they were in 2000.

The government's large deficits are definitely excesses that will have to be corrected one day. Federal debt service as a percentage of spending will soon reach the peaks of the 1990s, according to CBO projections. But neither political party seems to have an appetite for budgetary discipline.

In contrast to the excesses, a degree of pent-up demand for housing has built up since the rise in interest rates. When mortgage rates return to a more affordable level, activity could pick up to meet demand. Even though mortgage interest rates have fallen this year, the number of new mortgage applications is stagnant, suggesting that rates will have to fall much more to attract new buyers.

**Households Interest Payments - United States**

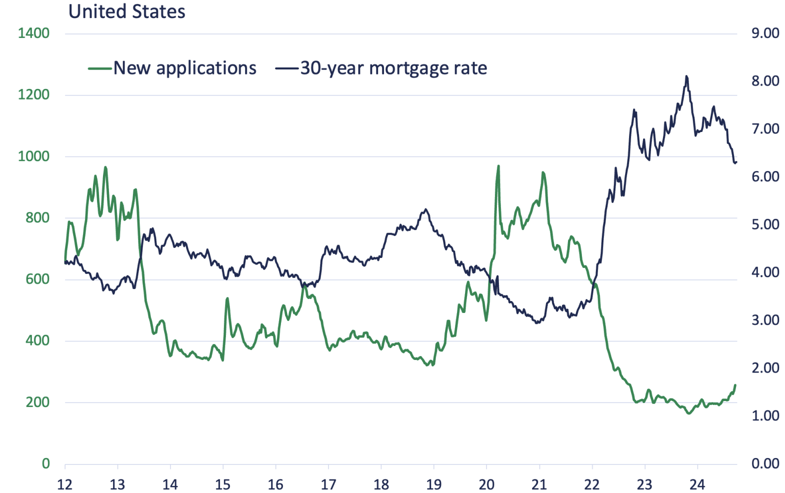
As a % of disposable income




Sources: DGAM, Refinitiv, September 2024

**New Mortgage Applications vs. Interest Rate**

United States




Sources: DGAM, Refinitiv, September 2024

[1] Congressional Budget Office, *An Update to the Budget and Economic Outlook: 2024 to 2034*, June 2024

# Canada: Depressed growth, but tentative signs of recovery

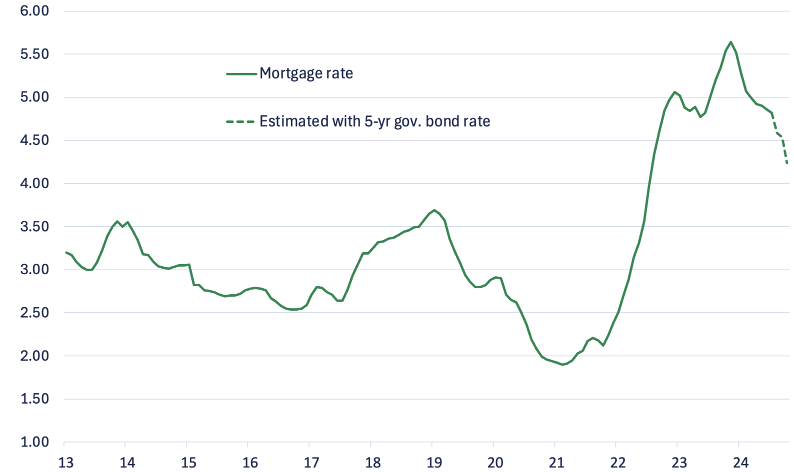
Canada's economic figures published this year have almost all fallen short of expectations, and September's figures were no exception. Fortunately, the inflation data were quite reassuring, and the Bank of Canada was confident enough to start its monetary easing cycle, with three consecutive 25-basis-point cuts. Further easing is expected in the near term, and we will be keeping an eye on the most interest-rate-sensitive sectors.

Mortgage rates have already fallen significantly since they peaked in 2023, with the 5-year mortgage rate down by almost 2%, and signs of improvement seem to be emerging in the real estate sector. Even so, the sector is struggling with a significant supply-demand imbalance. There is latent demand, but it isn't clear that the supply can meet it.

There seems to be no improvement in the labour market. It is struggling to keep pace with the country's population growth, which is pushing up the unemployment rate.

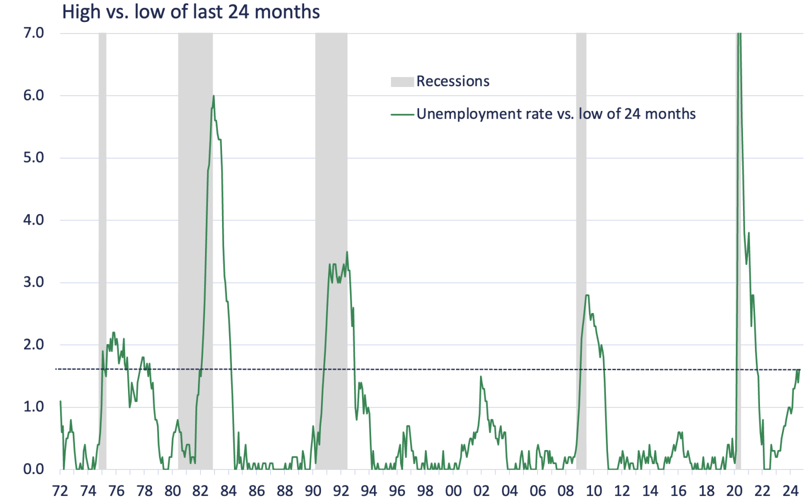
The outlook appears to be improving in the context of rapidly falling interest rates, which may further ease the pressure on households, many of which must renew their mortgages in the next 12 months. That being said, Canada isn't immune to a sharp slowdown south of the border, or to heightened trade tensions with China or the United States, and its economy could be at risk of a rough landing.

**Mortgage Rate - Canada**
5-year fixed rate, residential mortgage




Sources: DGAM, Bank of Canada, Refinitiv, September 2024

**Unemployment rate - Canada**
High vs. low of last 24 months




Sources: DGAM, Statistics Canada, September 2024

# Euro zone: An economy sensitive to global demand

The euro zone's economic growth slowed in the second quarter. Household spending and business investment contracted, and all indications are that the third quarter will also be disappointing, although growth expectations are already modest.

After an upturn in the services sector owing to tourism and the Summer Olympics, there has been little encouraging news: the job market has slowed, retail sales have deteriorated, and business climate surveys show declining confidence.

Europe is very sensitive to the strength of external demand but has been losing ground to the rest of the world in terms of competitiveness for a number of years. The recent reports by Mario Draghi and Enrico Letta propose solutions to reduce the gap, but there is a great deal to be done, and various detractors from economic activity are outside the European Union's control. Innovation is lagging, and tax rules and investors' tolerance for deficits are more constraining than in the United States.

But it's not all gloom in the euro zone. The recent news from China (next page) is encouraging for Europe's exports of consumer goods. And even though France, and especially Germany, are slowing, the so-called periphery is faring better, especially Spain. Finally, apart from temporary pressures on the price of services during the Olympics, the rate of inflation should allow the ECB to cut rates several times in the coming quarters, restoring household confidence somewhat.

[1] European Commission, *The Future of European Competitiveness*, September 2024

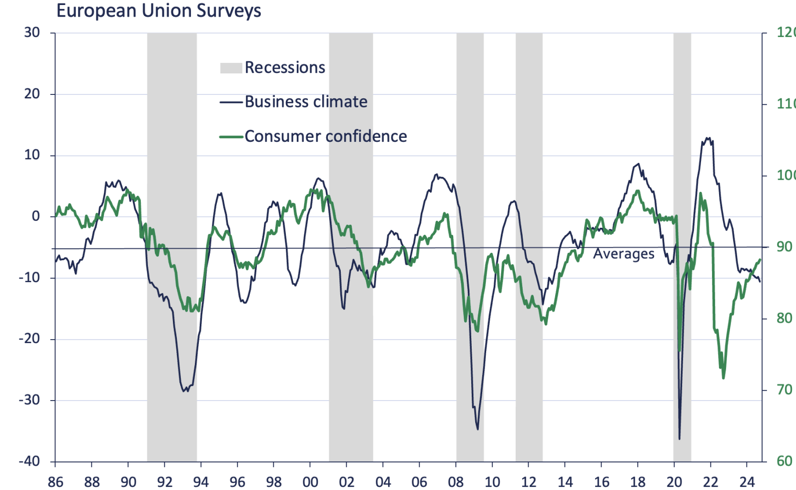
**Evolution of Forecasted Economic Growth, Euro Zone**

Real GDP growth for 2023 to 2025


Sources: DGAM, Consensus Economics, September 2024

**Consumer Confidence & Business Climate - Europe**

European Union Surveys




Sources: DGAM, Refinitiv, September 2024

# Asia: Difficult to get the Chinese to consume

For 20 years, the Chinese government had us accustomed to a knee-jerk response: as soon as external demand faltered, it would revive domestic demand with infrastructure programs and real estate developments. We saw it take such countercyclical measures during the financial crisis, the European recession in 2012 and the global manufacturing recession in 2016, but it had not done so in this cycle, at least until quite recently. With previous stimulus cycles having created significant excesses, especially in real estate, China has shifted its priority to long-term growth drivers, especially technology.

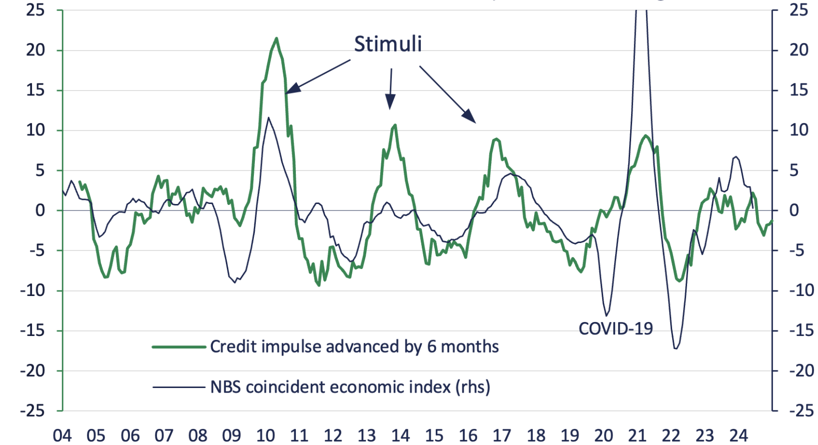
In the eyes of the government, the economy's deterioration had clearly gone too far in recent months. This observation is shared by multinationals operating in China: consumer demand is sluggish, particularly in consumer discretionary and the luxury goods segment. Capital goods manufacturers have also seen more weakness recently.

At the end of September, the government unexpectedly announced a new round of monetary and fiscal stimulus. New interest rate cuts have been added to those that began in 2019 but failed to revive consumer spending. Even so, the fact that the government has added fiscal stimulus and is targeting the real estate sector, which is the backbone of household confidence, could make a difference.

Elsewhere in Asia, the climate is more positive. Taiwan and South Korea continue to benefit from tailwinds, such as supply chain reorganization and global demand for semiconductors.

**Credit and Economic Activity - China**

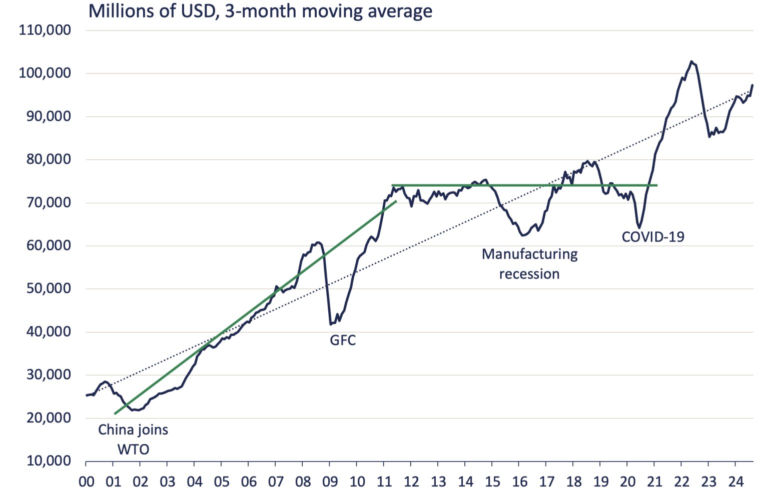
NBS coincident economic indicator vs. credit impulse, annual change




Sources: DGAM, National Bureau of Statistics of China, Refinitiv, September 2024

**Sum of Exports From Korea and Taiwan**

Millions of USD, 3-month moving average




Sources: DGAM, Refinitiv, September 2024

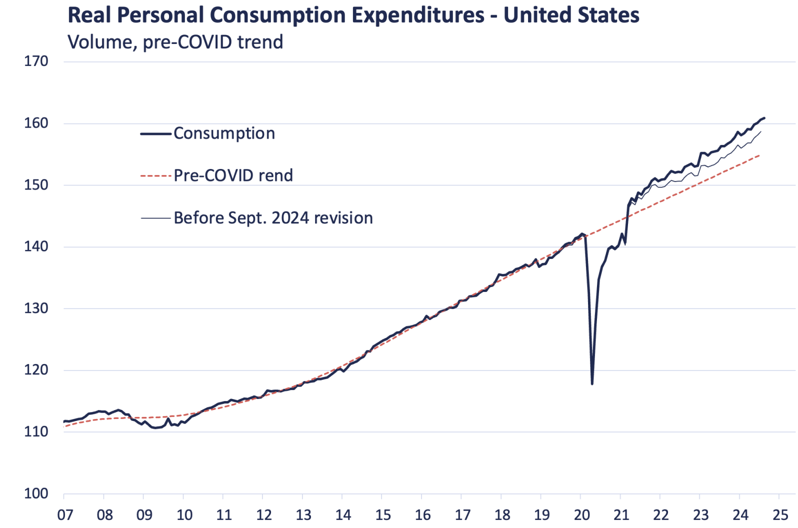
## Inflation falls, but some risks are slow to fade

In the previous quarter, we pointed out that the main obstacle to further disinflation was resilient, above-potential economic growth. This has definitely been the case so far this year in the United States, where GDP grew by 3% in the second quarter, a rate well above potential, and all indications are that growth will be close to 2% in the third quarter.

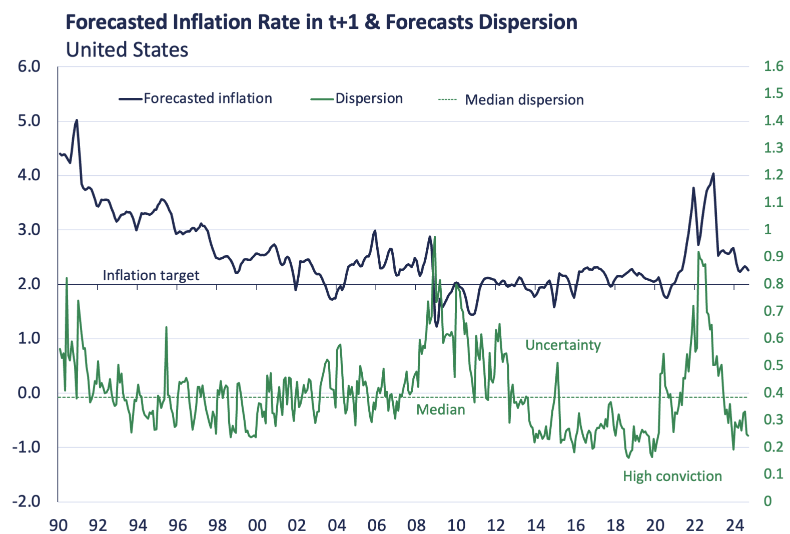
Last summer, U.S. household spending was still growing at a fast pace exceeding its long-term trend and was, therefore, potentially inflationary. When announcing their quarterly results, however, consumer companies were more lukewarm about the outlook. But the official economic data indicated no sign that the interest rate hikes or the cooling of employment was affecting household spending – quite the contrary. This sort of context gives central bankers headaches.

Forecasters are unconcerned, however. The consensus of economists is that in 2025 inflation will decline in the United States and Canada to 2%, a rate in the middle of the central banks' target range. This scenario is widely shared: the standard deviation between the different forecasts is negligible, at 0.2% in the U.S. and Canada. The level of conviction is very high. In Europe, a return to the 2% target is also forecast for 2025.

The most recent inflation data are fairly consistent with the consensus scenario. But, in the United States, without a cooling of household demand, the risk that inflation will be unexpectedly persistent cannot be ignored.




Sources: DGAM, Refinitiv, September 2024




Sources: DGAM, Refinitiv, September 2024

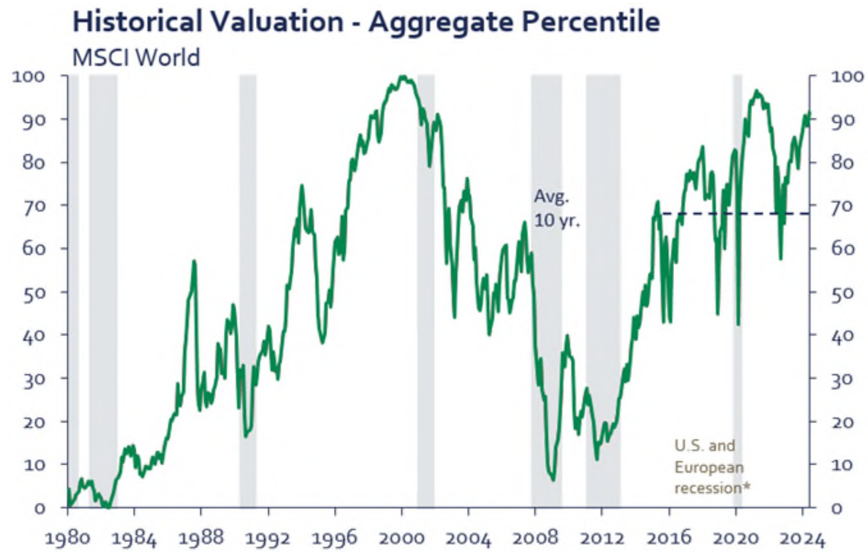
# Valuation rises again in the third quarter

The MSCI World Index's aggregate valuation was in the 93rd percentile of its historical distribution as at September 30, the highest level since 2001 if we exclude the distortions caused by the pandemic.

In the 97th percentile, the United States was still the most expensive stock market by far. The rest of the global stock market was in the 63rd percentile, slightly above its historical median.

The Canadian stock market jumped by 10% in the third quarter and leapt from the 65th percentile to the 87th. Europe's valuation was stable during the quarter in the 79th percentile, while Asia-Pacific's plunged from the 83rd percentile to the 69th after the selloff in Japan.

Finally, the valuation of emerging markets rose from the 77th percentile to the 81st in the third quarter, mainly on the back of the Chinese stock market rally after the government announced its stimulus package. Even though China's valuation jumped 18 percentiles to the 56th as at September 30, it is still at an appealing level.




Sources: DGAM, Refinitiv, MSCI, IBES, NBER, *ECRI, Bloomberg, September 30, 2024

**MSCI World excl. U.S. Valuation**

| Metric | Sept. 2024 | Percentile |
|---|---|---|
| Price / forward earnings | 13.9 | 32 |
| Price / trailing earnings | 15.8 | 40 |
| Price-to-Book | 1.9 | 61 |
| Price-to-cash flow | 10.1 | 87 |
| EV / EBITDA (Ex-financials) | 9.9 | 76 |
| Price / trailing sales | 1.5 | 93 |
| Cyclically adjusted P/E (CAPE) | 13.1 | 45 |
| Aggregate percentile† | | 63 |

Sources: DGAM, Refinitiv, MSCI, IBES, Bloomberg, September 30, 2024

†Average percentiles for the seven valuation indicators

**MSCI World Valuation**

| Metric | Sept. 2024 | Percentile |
|---|---|---|
| Price / forward earnings | 18.6 | 80 |
| Price / trailing earnings | 22.7 | 81 |
| Price-to-Book | 3.5 | 96 |
| Price-to-cash flow | 15.7 | 97 |
| EV / EBITDA (Ex-financials) | 13.8 | 95 |
| Price / trailing sales | 2.4 | 98 |
| Cyclically adjusted P/E (CAPE) | 26.5 | 89 |
| Aggregate percentile | | 93 |

Sources: DGAM, Refinitiv, MSCI, IBES, Bloomberg, September 30, 2024

VALUATION

# In absolute terms, several regions have become more expensive

### S&P 500 Valuation

| Metric | Sept. 2024 | Per centile |
|---|---|---|
| Price / forward earnings | 21.1 | 88 |
| Price / trailing earnings | 28.4 | 95 |
| Price-to-Book | 5.0 | 99 |
| Price-to-cash flow | 19.4 | 99 |
| EV / EBITDA (Ex-financials) | 16.1 | 98 |
| Price / trailing sales | 3.1 | 98 |
| Cyclically adjusted P/E (CAPE) | 35.0 | 93 |
| **Aggregate percentile** | | **97** |

### MSCI Europe Valuation

| Metric | Sept. 2024 | Per centile |
|---|---|---|
| Price / forward earnings | 13.6 | 49 |
| Price / trailing earnings | 15.2 | 55 |
| Price-to-Book | 2.1 | 78 |
| Price-to-cash flow | 10.1 | 87 |
| EV / EBITDA (Ex-financials) | 10.2 | 78 |
| Price / trailing sales | 1.5 | 92 |
| Cyclically adjusted P/E (CAPE) | 18.7 | 68 |
| **Aggregate percentile** | | **79** |

### MSCI Europe Valuation

| Metric | Sept. 2024 | Per centile |
|---|---|---|
| Price / forward earnings | 13.6 | 49 |
| Price / trailing earnings | 15.2 | 55 |
| Price-to-Book | 2.1 | 78 |
| Price-to-cash flow | 10.1 | 87 |
| EV / EBITDA (Ex-financials) | 10.2 | 78 |
| Price / trailing sales | 1.5 | 92 |
| Cyclically adjusted P/E (CAPE) | 18.7 | 68 |
| **Aggregate percentile** | | **79** |

### MSCI Emerging Markets Valuation

| Metric | Sept. 2024 | Per centile |
|---|---|---|
| Price / forward earnings | 11.7 | 41 |
| Price / trailing earnings | 16.3 | 77 |
| Price-to-Book | 1.9 | 72 |
| Price-to-cash flow | 11.0 | 93 |
| EV / EBITDA (Ex-financials) | 10.6 | 90 |
| Price / trailing sales | 1.1 | 78 |
| Cyclically adjusted P/E (CAPE) | 14.5 | 51 |
| **Aggregate percentile** | | **81** |

### MSCI Canada Valuation

| Metric | Sept. 2024 | Per centile |
|---|---|---|
| Price / forward earnings | 14.8 | 57 |
| Price / trailing earnings | 18.5 | 59 |
| Price-to-Book | 2.1 | 81 |
| Price-to-cash flow | 11.2 | 86 |
| EV / EBITDA (Ex-financials) | 9.9 | 80 |
| Price / trailing sales | 2.2 | 99 |
| Cyclically adjusted P/E (CAPE) | 21.4 | 66 |
| **Aggregate percentile** | | **87** |

Sources: DGAM, Refinitiv, MSCI, IBES, Bloomberg, September 30, 2024

†Average percentiles for the seven valuation indicators

# Where are the opportunities in the stock market?

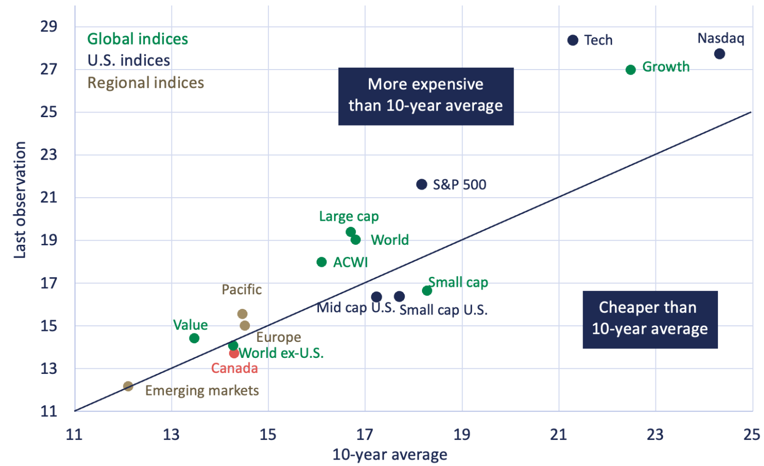
Even though the overall valuation of the stock market is expensive, some segments are still attractive. As we have just seen, few regions are inexpensive. However, some countries, sectors and styles offer bargains. The chart on the right compares the most recent forward price-to-earnings ratios with their averages over the past 10 years.

Small caps and mid-caps have valuations comparable to the long-term norm and below the average of the past 10 years. In relative terms, they are even more attractive: rarely have they been so cheap in relation to large caps.

Opportunities can even be found in the very expensive S&P 500, as evidenced by its rather normal valuation when all the companies in it are given the same weight. In contrast, NASDAQ and growth stocks are extremely expensive.

**Price-to-Forward Earnings**

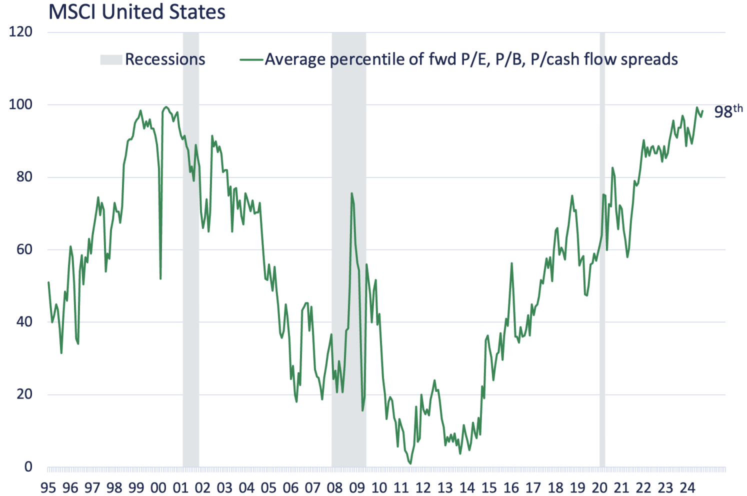
Last observation vs. 10-year averages




Sources: DGAM, IBES, MSCI, September 30, 2024

**Relative Valuation of Large Cap vs. Mid Cap Stocks**

MSCI United States




Sources: DGAM, MSCI, Refinitiv, September 2024

**S&P 500 Equally Weighted Valuation**

Price-to-forward earnings ratio

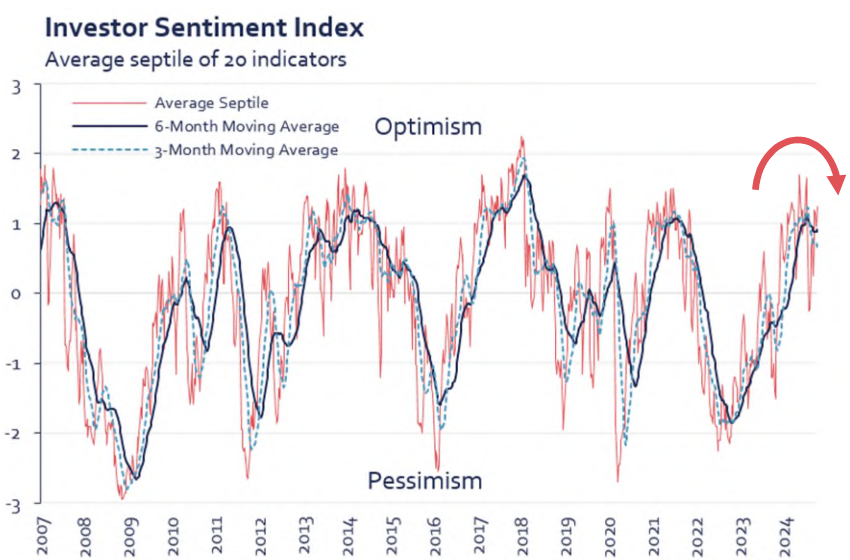

Source: The Daily Shot, September 2024

# Our sentiment index is changing direction

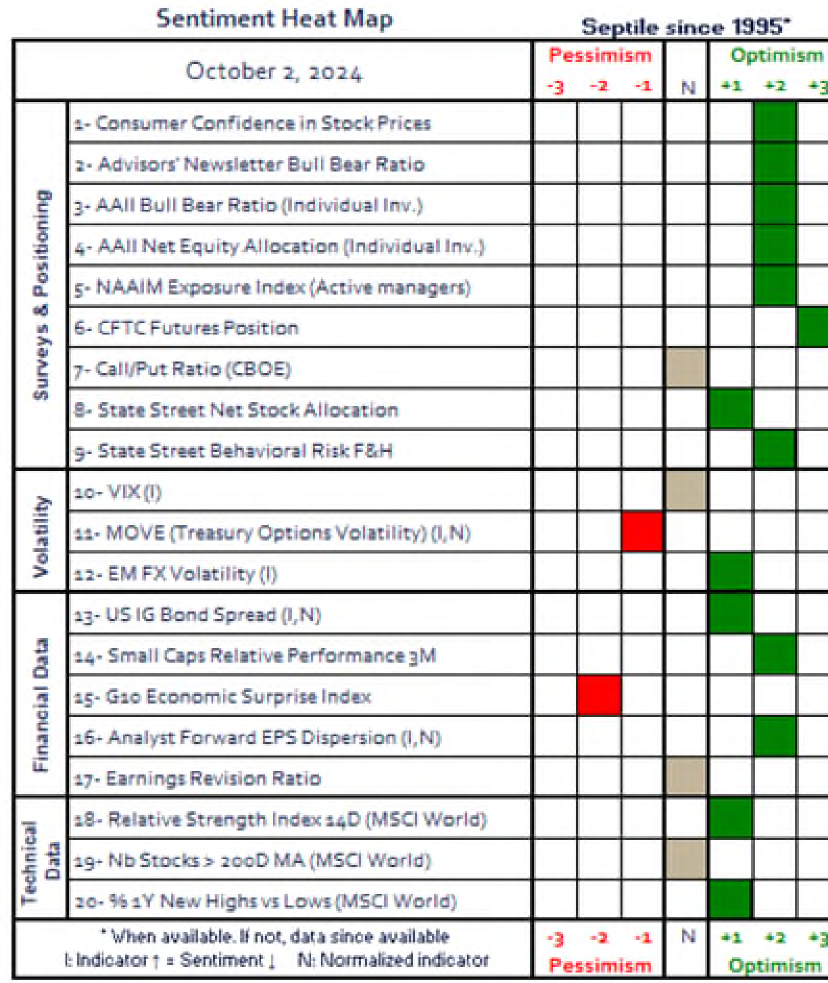
The MSCI World's total return over the past two years was 57% as at September 30. The rally was driven mainly by investors' risk appetite. Two-thirds of the return is due to the expansion of valuation multiples. The starting point of the rally, however, corresponds to the very depressed level of investor sentiment observed in September 2022. The ensuing comeback was spectacular.

But the tone changed in the third quarter of 2024. Risk appetite seemingly peaked in July and then began to fall, although the stock market continued to rise and reached new highs in September.

Even so, the direction of our investor sentiment index is as important as its level in our analysis. A high but falling level usually bodes ill for returns in subsequent months.




Sources: DGAM, Refinitiv, Bloomberg, State Street Global Markets, September 2024




Sources: DGAM, Refinitiv, Bloomberg, State Street Global Markets, September 2024

# Investors unshaken by the summer's market turmoil

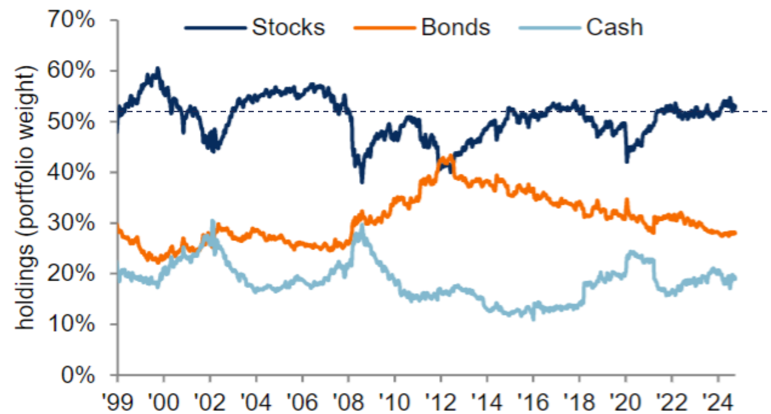
Financial markets experienced a spike in volatility at the beginning of August. However, it was so brief that their sense of invincibility was unaffected. At the end of the third quarter, there was a very modest decline in the equity allocation of institutional managers and retail investors alike. In both cases, the reallocated funds went into cash while interest in bonds remained tepid.

Analyzing this data, we see that there is more useful information when the equity allocation is at a low than when it is high. Sentiment can remain optimistic for a very long time, but episodes where it is depressed tend to be temporary, even during major crises.

The high allocation to equities is consistent with the optimism and high degree of conviction evidenced by the consensus of economists and financial analysts discussed in the introduction. But surprises always happen. And when everyone shares the same scenario, it can lead to a return of volatility.

**Asset Class Weights**

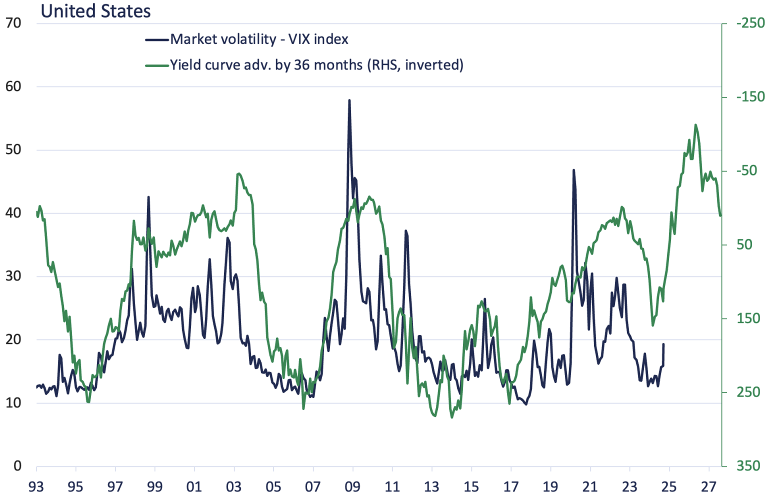
Institutional investors, normalized




Source: State Street Global Markets, October 2, 2024

**Yield Curve vs. Equity Market Volatility**

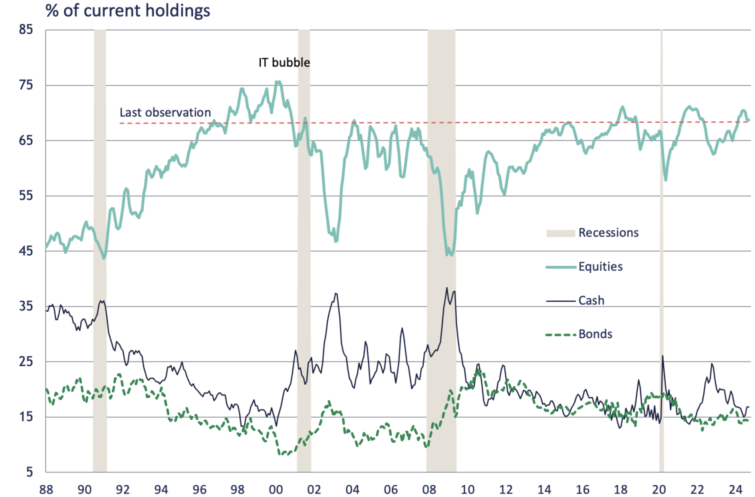
United States




Sources: DGAM, CBOE, Refinitiv, September 2024

**AAII Survey on Asset Allocation**

% of current holdings




Sources: DGAM, American Association of Individual Investors, September 2024

# Global Outlook

### MACROECONOMIC ENVIRONMENT: RATE CUTS IN THE U.S. AND EUROPE WITH STIMULUS IN CHINA

The restrictive effect of interest rate hikes over the past two years will continue to dampen growth in the near term. It is clearly seen in household confidence and business climate surveys around the world. Over the medium term, however, falling inflation, interest rate cuts and Chinese stimulus will help support growth. The success of these measures will depend on the job market and the speed at which monetary and fiscal stimulus are deployed. For the time being, monetary policies remain very restrictive and, as we know, their full effect on economic activity takes 18 to 24 months to become apparent. We should therefore not expect the monetary easing that has just begun to have a significant positive impact as early as 2025. That said, the decline in inflation has a fundamentally positive effect on households' purchasing power and central banks' leeway. For that reason, we are raising our macroeconomic environment vector to “single negative”.

### MARKET VALUATION: A FEW OPPORTUNITIES IN AN EXTREMELY EXPENSIVE MARKET

Global equities were very expensive at the end of the third quarter, when the MSCI World's valuation reached the 93rd percentile of its historical distribution, the highest level since 2001 if we exclude the distortions of the pandemic in 2021. The S&P 500's valuation was in the 97th percentile. Despite these unusual, if not extremely rare, conditions, there were still a few market segments that were attractively valued or in sync with the economic context or the historical norm. These included small and mid- caps, some cyclical sectors of the traditional economy and some defensive sectors. In contrast, the technology sector and industries benefiting from artificial intelligence were the most expensive. Finally, there were no longer any bargain regions, but all looked cheap in relation to the United States. In this context, we are maintaining a “triple negative” valuation rating.

### INVESTOR SENTIMENT: OUR SENTIMENT INDEX UNDERGOES A REGIME SHIFT

The impressive stock market surge over the past two years is due mainly to the expansion of valuation multiples, and therefore to investor optimism about earnings growth. Sentiment is particularly euphoric in the U.S. market: as at September 30, the S&P 500 index was showing its best year-to-date performance since 1997, despite all the political and economic uncertainty. But the tone changed in the third quarter after risk appetite seemingly peaked in July and then began to fall, even though the stock market continued to advance, reaching new highs in September. That being said, we consider the direction of our investor sentiment index as important as its level. A high but falling level usually bodes ill for returns in subsequent months. This change has prompted us to lower our investor sentiment rating to “double negative.”

**Our analysis of the three vectors has prompted us to maintain a defensive bias. We are concerned about the deteriorating economic growth outlook and its impact on corporate earnings at a time when market valuations and investor positioning reflect no indication of a slowdown.**

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