RJL PCS: INSIGHTS & STRATEGIES

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July 2024 Insights & Strategies: "Let's Just Enjoy the Moment," But What Comes Next?

Neil Linsdell, CFA - Head of Investment Strategy; Eve Zhou, CFA - Senior Investment Strategy Analyst

On June 5 the Bank of Canada (BoC) lowered its policy interest rate for the first time in over four years, after holding its rate at 5.00% for the past 11 months. This was welcome news for an economy experiencing a slowdown in growth and rising unemployment. The start of the easing cycle offers the promise of some relief for mortgage holders, although renewals over the next couple of years will generally still be at higher rates than the ones expiring. When asked whether the June rate cut would be followed by another in July, BoC Governor Tiff Macklem responded, "Let's just enjoy the moment for a bit," which reminds us that while we are relieved to have entered this new phase, future rate cuts are not guaranteed and upcoming rate decisions will remain data-dependent and judged on a meeting-by-meeting basis.

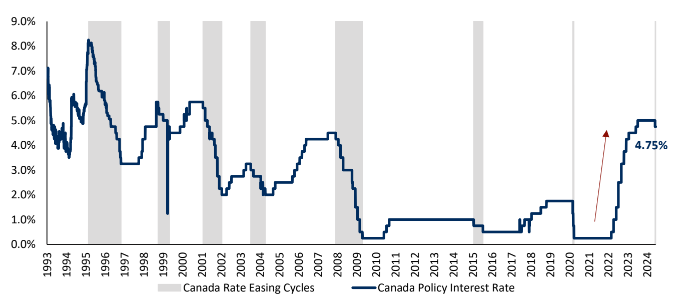
Nevertheless, this first rate cut signifies that the Canadian economy is transitioning into a rate easing cycle. While the BoC is not pre-committing to any particular path for lowering the policy interest rate, we anticipate three more cuts this year and another four next year, bringing the policy interest rate down to 3.00% by mid-2025. During rate easing cycles, economic trends can evolve quickly. Therefore, as investors, we can't enjoy the moment for too long; it's crucial to consider what might lie ahead. In this publication, we will examine past rate easing cycles to gain some insight into how major economic indicators and sector market performance might unfold in the current cycle.

A bit of history

When discussing BoC "rate hikes" and "rate cuts", the term "rate" refers to the policy interest rate, also known as the key interest rate. Historically, the BoC's policy interest rate alternated between floating and fixed arrangements. Since February 1996, it has been set at the upper bound of the BoC's overnight rate, providing a clearer indication of monetary policy intentions compared to the floating rate (based off the 3-month treasury yield), which the BoC had less influence over.

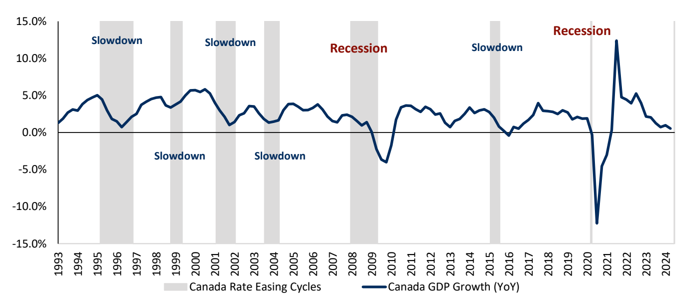
During periods of economic overheating, characterized by heightened inflation, the central bank may raise policy interest rates to curb excessive spending and borrowing, as has been the case over the past two years. Conversely, during economic slowdowns or when there is a risk of recession, the central bank may lower interest rates to ease financial pressures on households, stimulate spending, and encourage capital investments. Currently, Canada's economy is experiencing a slowdown, with confidence that inflation will gradually approach the 2% target. Consequently, the BoC's governing council decided that monetary policy no longer needed to be as restrictive, leading to a 25 basis point rate cut in their recent meeting on June 5. The cumulative rate hikes totaling 475 basis points since March 2022 have had an impact and continue to affect the economy. The current policy interest rate of 4.75%, which declined from 5%, is still considered quite elevated, especially when considering the era of ultra-low interest rates from around 2010 to 2021. Moreover, the overall tightening cycle has been notably aggressive compared to historical cycles (Chart 1).

Chart 1 - Bank of Canada Policy Interest Rate



Source: FactSet; Raymond James Ltd.; Data as of June 17, 2024.

Chart 2 - Canada GDP Growth During Rate Easing Cycles



Source: FactSet; Raymond James Ltd.; Data as of June 17, 2024.

There have been seven major rate easing cycles in Canada in the past thirty years, indicated by shaded areas in Charts 1 to 4. The magnitude and duration of these cycles varied, generally reflecting the severity of the economic deterioration. Typically, a more severe economic downturn results in larger, faster rate cuts and a lower terminal rate. During two of these easing cycles, the Canadian economy entered a recession: the global financial crisis of 2008-2009 and the COVID-19 pandemic in 2020.

The 2008-2009 easing cycle had the largest magnitude since the policy interest rate returned to a fixed rate in 1996, lowering the rate by 425 basis points in just under 1.5 years. The second half of this cycle (from October 2008 to April 2009) was much more aggressive than the first half (December 2007 to September 2008), as evidenced by the GDP year-over-year growth during the same period (Chart 2). After a minor uptick to 1.4% in 3Q08 from 0.9% in 2Q08, GDP growth fell sharply, entering negative territory within two quarters and hitting -4% in 3Q09. The rapid economic deterioration necessitated aggressive rate cuts to fully accommodate the economy. The policy interest rate was lowered by 275 basis points to a historic low of 0.25% in just around seven months and remained there until May 2010, when GDP growth returned to normal levels.

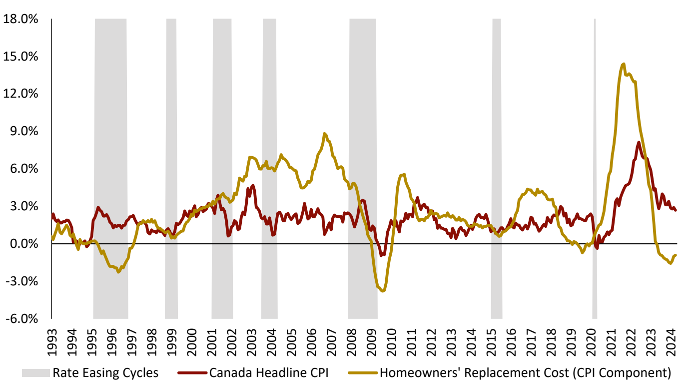
Similarly, when the COVID-19 pandemic sent shock waves through Canada's economy in 2020, the BoC lowered the policy interest rate from 1.75% to 0.25% within a month in March 2020, marking the fastest rate cut ever. The magnitude of this cut was not as large as previous ones because the starting rate was already relatively low, and 0.25% is essentially the "floor".

Soft landing ahead

However, the good news is that Canada's economy has held up relatively well and is likely to achieve a soft landing in this cycle. Therefore, we do not expect to see as aggressive rate cuts as seen during recessions, but rather a more measured approach similar to the five cycles experienced during economic slowdowns.

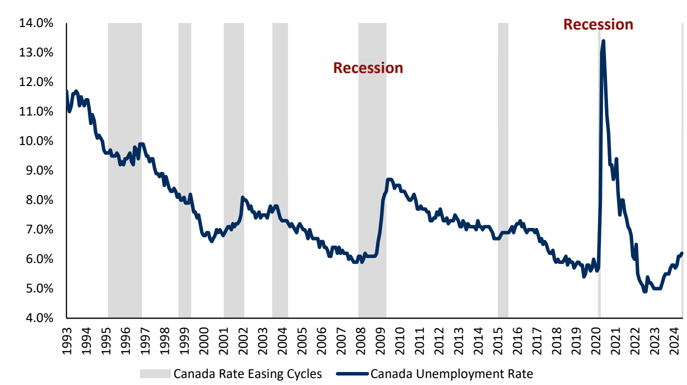
GDP in 1Q24 was up 0.5% from 1Q23, and the economy has been growing at a slower-than-average rate for three quarters now. With more households facing mortgage renewals in the coming months, softening consumer spending evidenced by a surging inventory-to-sales ratio, and rising consumer insolvencies, we do not anticipate a significant economic rebound this year. The BoC has forecasted that annual GDP growth for 2024 will be around 0.7%, indicating that GDP growth for the remaining three quarters of the year will remain modest compared to the first quarter. The BoC also predicts that annual GDP growth will return to the long-term average of 1.9% in 2025. This trend aligns with rate easing cycles where the economy slows down but does not enter a recession. Typically, GDP growth continues to decline after the initial rate cuts, with the turning point occurring around the middle of the easing cycle. As previously mentioned, we anticipate three more rate cuts this year and another four next year, potentially bringing the policy rate to 3.00% by mid-2025.

Chart 3 - Canada CPI During Rate Easing Cycles



Source: FactSet; Raymond James Ltd.; Data as of June 17, 2024.

Chart 4 - Canada Unemployment Rate During Rate Easing Cycles



Source: FactSet; Raymond James Ltd.; Data as of June 17, 2024.

The BoC started hiking its policy interest rate in 2022 to combat surging inflation. Now, as the BoC has increased confidence that inflation is finally under control, the rate cuts make policy less restrictive and can allow the economy better room to grow. Easing can continue as long as the BoC does not see reaccelerating inflation pressures. For confidence, we can examine overall inflation changes during the past rate easing cycles and, because there is a structural housing shortage in Canada, we want to consider how lower rates impact housing prices.

Headline CPI can peak before or during the rate easing cycle, with the timing difference explained by varying lag effects of heightened policy interest rates moving through the economy each time (Chart 3). Over the past thirty years, despite fluctuations, headline inflation has typically stayed within the range of 0.5% to 3.0%. Even when it briefly breaks this range, it tends to revert relatively quickly. This stability occurs because demand-driven inflation, without accommodative fiscal policies, can be effectively controlled by higher policy interest rates, which curb consumer spending and thus cool inflation.

However, the recent surge in inflation is largely due to supply shocks, compounded by record-high fiscal stimulus supporting consumers. These factors have kept inflation at a historically high level despite the most aggressive rate hike cycle. As supply chains normalized and savings from COVID-19 government stimulus finally depleted, we expect inflation to continue declining and return to its 2% target even as the BoC cuts rates. In fact, headline CPI excluding shelter has been below 2% since the beginning of the year.

Housing prices not likely to rebound quickly

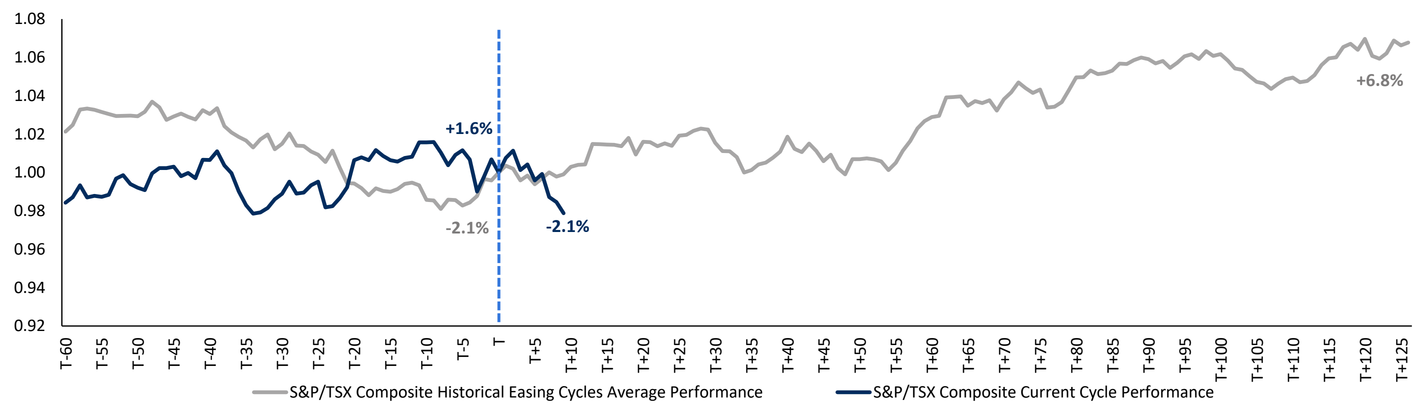
This prompts a revisit to another major factor keeping inflation elevated—the shelter component. In our April report, we discussed how rate cuts could potentially reduce shelter inflation. The main uncertainty then was whether lower rates would immediately lead to surging home prices, thereby increasing homeowners' replacement costs and driving inflation back up, making housing more unaffordable.

Looking at past rate easing cycles, homeowners' replacement cost inflation typically peaks before the cycle begins and does not rebound until the end or after it (Chart 3). For this cycle, we do not anticipate an immediate strong rebound in housing prices either. The year-over-year change in the New Home Price Index is flat, homeowners' replacement cost inflation remain in negative territory. Despite structural supply shortages, household finances remain under stress, and current high mortgage rates continue to pose challenges for homeownership.

Labour market likely to weaken more before it gets better

Regarding the labour market, during most rate easing cycles, the unemployment rate tends to increase. If the economy enters a recession, the unemployment rate is likely to increase further (Chart 4). Following a historically tight labour market from mid-2022 to mid-2023, Canada's unemployment rate gradually rose to 6.2% in May 2024, returning to pre-COVID levels. Based on our forecast of a soft landing for the Canadian economy and recent positive job creation figures, we anticipate the unemployment rate will follow a pattern similar to past rate easing cycles during economic slowdowns. While an influx of workers, driven by surging immigration, may exert some upward pressure on the unemployment rate, the risk of significant layoffs remains low at this time.

Chart 5 - S&P/TSX Composite Performance (Indexed, Day Prior to First Rate Cut = 1)



Source: FactSet; Raymond James Ltd. Data as of June 18, 2024. T: day prior to first rate cut; T +/- number of trading day(s). The March 2020 rate easing cycle is excluded due to its short duration of only one month.

The market is not the economy

While Canada's economy is likely to continue slowing down during the rate easing cycle, the market usually looks ahead, gradually pricing in future rate cuts and becoming optimistic about the new market cycle. In Chart 5, we compared the average daily return of the S&P/TSX Composite from three months before the first rate cut to six months after, across past rate easing cycles, with the current cycle starting on June 5. For easier comparison, both the historical average and the current cycle performance are indexed, with the day before the first rate cut equal to one, referred to as time "T."

Historically, pessimism about the future economy and uncertainties around the BoC's rate decisions result in a ~2% decrease in total return during the three months leading up to the initial rate cut. However, as certainty about easing policy interest rates and economic conditions increases, the market becomes more optimistic, generating around a 6% increase in total return during the first six months after the initial rate cut.

For this cycle, the market largely anticipated the first rate cut would occur in the summer, so the good news of the long-awaited cut may have been priced in well before it happened. Additionally, the recent surge in gold prices has boosted the S&P/TSX Composite's performance before the first rate cut, given its ~7% exposure to precious metals. As of the writing of this report, ten trading days after the first rate cut, we are seeing some weakness in the index performance. There are still many concerns about future economic conditions and whether the BoC will lower the rate again in its July meeting. More volatility is also expected for the rest of this year. Nonetheless, if a soft landing is achieved as expected, with inflation on track to reach its 2% target, the S&P/TSX Composite could potentially finish 2024 with a high single-digit total return.

Chart 6 - Sector Performance During the First Six Months of Past Rate Easing Cycles (Ranked by Average Total Return)

Rate Easing Cycle Start Date / 6M from Start Date	Average	02/1995 08/1995	09/1998 03/1999	01/2001 07/2001	07/2003 01/2004	12/2007 06/2008	01/2015 07/2015
S&P/TSX COMPOSITE	6.7%	12.6%	15.4%	-17.1%	19.1%	10.6%	-0.5%
CONS STAPLES	12.9%	19.5%	16.4%	22.3%	7.8%	-1.8%	13.5%
INFO TECH	12.2%	6.5%	55.9%	-70.4%	54.7%	21.3%	5.0%
ENERGY	9.8%	11.0%	-7.1%	9.1%	24.6%	31.2%	-9.8%
MATERIALS	9.5%	19.4%	-4.1%	9.0%	35.4%	22.4%	-24.9%
CONS DISCRET	8.4%	8.9%	32.9%	-0.4%	14.0%	-15.5%	10.7%
FINANCIALS	6.5%	7.5%	15.7%	3.6%	15.3%	-6.5%	3.4%
INDUSTRIALS	6.3%	12.4%	1.4%	5.4%	14.4%	9.7%	-5.4%
REAL ESTATE	6.0%	3.1%	-5.2%	14.3%	23.7%	-0.5%	0.6%
COMM SVC	3.0%	-2.0%	38.6%	-15.8%	2.4%	-3.7%	-1.7%
UTILITIES	2.3%	-0.2%	-4.8%	12.0%	8.5%	5.1%	-6.6%

Return >= 15%
15% > Return >= 10%
10% > Return >= 5%
5% > Return >= 0%
0% > Return >= -5%
-5% > Return >= -10%
-10% > Return >= -15%
-15% > Return

Source: FactSet; Raymond James Ltd. Total returns; the March 2020 rate easing cycle is excluded due to its short duration of only one month.

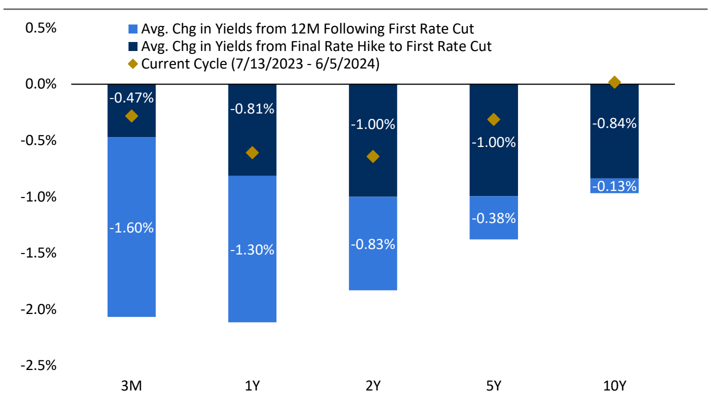
Consumer Staples and Info Tech typically lead during easing

In terms of sector-level performance (Chart 6), consumer staples typically have the highest average total return during the first six months after the initial rate cut and experience the smallest drawdowns across different periods. The consumer staples sector in the S&P/TSX Composite is mainly composed of food retailers. As mentioned earlier, the economy tends to continue to deteriorate after the initial rate cut, but groceries are considered essential spending, so food retailers' earnings are less impacted compared to more cyclical sectors.

Information technology also performs well, though it is more volatile, especially during events like the tech bubble burst in 2001. Most companies in the information technology sector are growth-oriented. A lower rate environment favours growth stocks because their projected cash flows are weighted further in the future, and a lower discount rate results in their higher present value. Additionally, as confidence in economic recovery grows, there is more enthusiasm for investing in technological innovation, similar to the current excitement around A.I. However, the sustainability of this enthusiasm depends on meaningful applications of A.I.

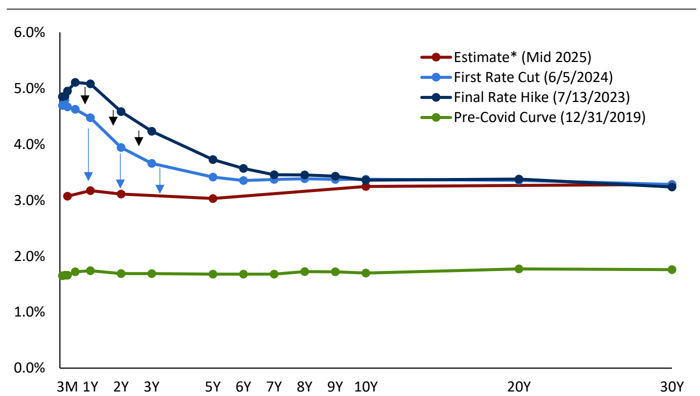
Energy and materials sectors are highly integrated with the global economy and geopolitics, making them harder to predict, especially given that major economies are currently in different business cycles. However, the containers and packaging subindustry within the materials sector has significantly outperformed the S&P/TSX Composite during most of the listed periods. Additionally, the construction and engineering subindustry within the industrials sector consistently generates solid returns during these periods.

Chart 7 - Yield Moves Leading Into and Following 1st Rate Cut



Source: FactSet; Raymond James Ltd. Data as of June 5, 2024.

Chart 8 - Canada Yield Curve Estimate One Year From Now



Source: FactSet; Raymond James Ltd.; Data as of June 5, 2024.
*Estimate derived by June 5, 2024 yields minus the average change in yields from 12 months following first rate cut.

Fixed Income opportunities remain

As for bonds, there is still time to take advantage of the current elevated rate levels. Given the inverse relationship between bond yields and bond prices, a decrease in yield implies an increase in price. Chart 7 illustrates the average change in yields from the final rate hike to the first rate cut (dark blue bars) and the average change in yields 12 months following the first rate cut (light blue bars) across different maturities for government bonds. The yellow diamonds indicate the change in yields for the current cycle, from the last rate hike on July 13, 2023, to June 5, 2024.

We observe that the magnitude of yield changes in this cycle is smaller compared to historical averages (dark blue bars). As we are now a few weeks past the first rate cut, the question remains whether yields will change by the same magnitude as historical averages (light blue bars) over the next 12 months or if there will be further catchup to offset the smaller yield changes leading into the first rate cut. Nonetheless, there is still some room for yields to come down and bond prices to rise. If the yield changes over the next 12 months follow historical averages, the yield curve in mid-2025 will resemble the red line in Chart 8. This estimated yield curve aligns with our expectation of eight rate cuts of 25 basis points each, leaving the policy interest rate at 3% into the second half of 2025.

Final thoughts

In summary, we believe Canada’s economy is very likely to achieve a soft landing with inflation under control. During this rate easing cycle, even though GDP growth may continue to slow and the unemployment rate may continue to rise, we do not anticipate drastic changes. The Canadian equity market is likely to become more optimistic about the new market cycle, especially when there is more certainty about future rate decisions and economic recovery. Finally, there is still room for bond yields, particularly at the front end, to come down, presenting investment opportunities in fixed income.

With the Fed Front & Center, It's All About the Cuts

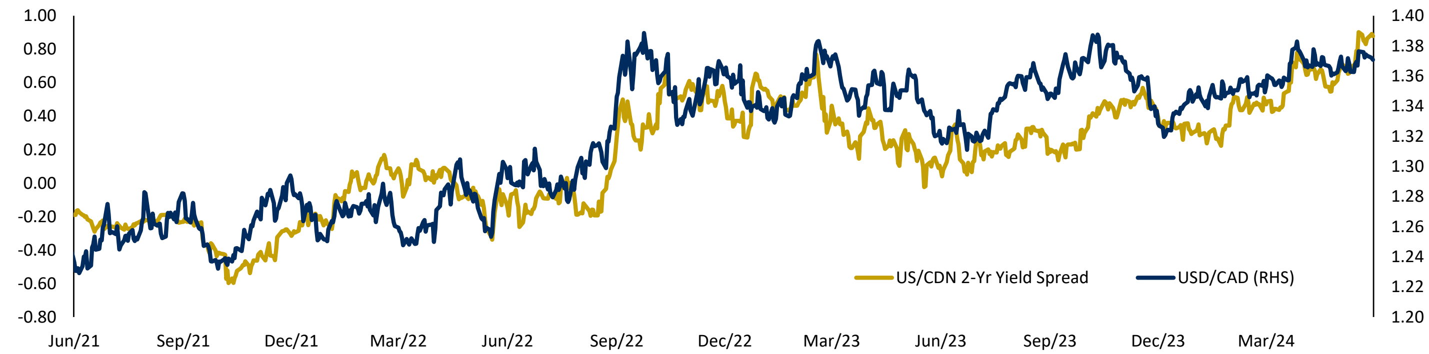
Ajay Virk, CFA, CMT - Head Trader, Currencies

The BoC kicked things off with the first rate cut amongst the G7 bloc in four years, a move which was swiftly followed by the ECB. As confidence continues to grow that policymakers have a handle on steering inflation towards its 2% target, BoC Governor Macklem stated that it's "reasonable to expect further cuts" should progress continue to move in the right direction.

Historically, the Fed and the BoC typically act in tandem with respect to interest rates cycles. However, with the BoC now pulling the trigger before the Fed, there are currency concerns that naturally come into play. Namely, lower rates act as a headwind to the domestic currency, and in this case, a weaker CAD may imply higher import costs, which poses unwanted risks to the BoC's progress on the inflationary front.

As for the monetary policy divergence consequences between the Fed and the BoC, Macklem appeared to be unbothered by the fact that the BoC/Fed policy spread has now reached levels not seen since 2017-2019 at 75bps. While he did capitulate that there are limits to this divergence, we have apparently not yet crossed that line, which may indicate a willingness for the BoC to move on cuts a bit more aggressively. It is also important to note that historically, U.S./Canadian interest rate spreads have been a key driver of USD/CAD performance.

Chart 9 - USD/CAD Moving in Sync with US/CDN 2-Yr Yield Spreads



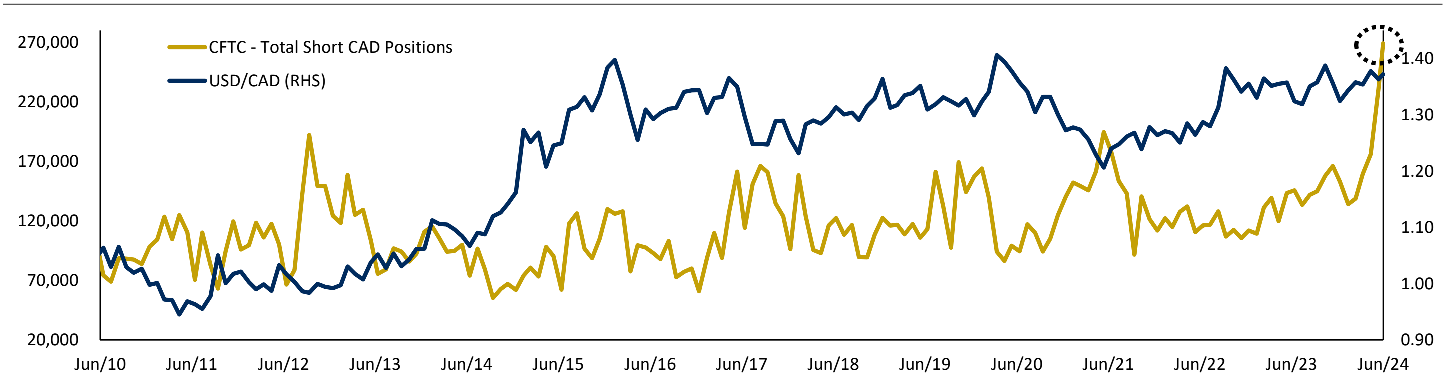
Source: FactSet; Raymond James, Ltd.; Data as of June 18, 2024.

Bearish Bets on the Loonie Hit Historic Levels

According to the latest report from the U.S. Commodity Futures Trading Commission (CFTC), speculators have now raised their bearish bets on the loonie to the highest level on record. This level of negative sentiment underscores rising fears of a global economic slowdown as higher interest rates continue to impact the broader real economy, which puts the Canadian economy in a difficult position given its relatively high leverage and housing exposure. However, given the sheer extent of how markets have been so bearishly positioned on the CAD may imply that most of the negative news and economic outlook may already be factored in to some extent.

Given the extent of how stretched these short-CAD positions appear to be, one cannot dismiss the risks of a potential short squeeze on CAD-positive developments. This suggests that any material upside gains in USD/CAD (CAD-negative) may be difficult to achieve without some sort of additional catalyst.

Chart 10 - SHORT CAD Speculative Positions Skyrocket To Historic Highs



Source: FactSet; Raymond James, Ltd.; Data as of June 18, 2024.

Outlook for the Greenback & Loonie

At the time of writing, the market is currently pricing in just 1-2 quarter-point cuts for the Fed this year, versus another 2-3 for the BoC. However, given some of the upside surprises we have seen in economic data out of the U.S., it is conceivable to believe that this has lowered the Fed's confidence surrounding rate cuts this year to some degree.

Nonetheless, we continue to anticipate a rather lethargic move for USD/CAD to the ~1.38-1.39 range by year end as the market continues to position itself for a potentially wider policy stance between the Fed and BoC, coupled with escalating geopolitical risks and the upcoming U.S. Presidential election.

Surging Debt Issuance in Canada

Charlotte Jakubowicz, CMT, CIM - Vice President, Fixed Income and Currencies; Joshua Lucchetto - Fixed Income Associate

Corporations and governments routinely issue debt when they are looking to raise capital. Despite this being common overall, there are periods of higher or lower activity, based frequently on broader market trends.

Recent data from Statistics Canada reveals a significant surge in net Canadian dollar borrowing by corporations and governments during the first quarter of 2024 versus prior periods. This substantial increase in debt issuance warrants closer examination, especially given the current economic landscape characterized by high interest rates and an inverted yield curve.

Key Findings

Magnitude of Debt Issuances: In Q1 2024, net borrowing reached an impressive $106.3 billion, marking a staggering 300% surge compared to the same period last year (1Q23) which recorded a total of $26.4 billion in new debt (Table 1).

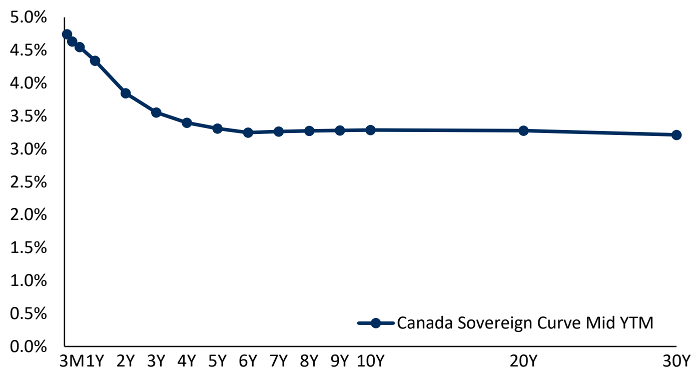
Table 1 - Bond Issuance Sees Huge Jump Year-over-year

Debt and equity securities issues, net issuances (billions of dollars)

	Q1 2023	Q1 2024
Total debt securities	26.4	106.3
By sector		
Non-financial corporations	15.3	22.9
Financial corporations	36.1	28.5
General government	-24.9	54.9
By currency		
Canadian dollars	22.1	95.1
Foreign currencies	4.3	11.3
By original maturity		
Short term (money market instruments)	-20	-10.5
Long term (bonds)	46.4	116.8
One to two years	11.1	-4.9
Two to five years	0.1	23.8
Five to ten years	12.5	41.2
More than ten years	22.6	56.8

Source: Statistics Canada, Raymond James Ltd.

Chart 11 - Inverted Yield Curve Still Persists



Source: FactSet, Raymond James Ltd.; Data as of June 19, 2024.

Interest Rates and Yield Curve: The economy currently faces unusual circumstances, including elevated interest rates and an inverted yield curve (Chart 11). Notably, the majority of newly issued bonds fall within the mid-term and long-term categories. Why? Debt issuers find it more cost-effective to borrow for extended periods (10 years and beyond) due to lower lending rates. Long-term borrowing can be over 100 basis points cheaper than short-term issuance and reduces reinvestment needs.

Interest Rate Outlook: The general consensus is that interest rates will continue to decline in the coming years. Canada's recent rate cut on June 5th, the first since March 2020, marks the beginning of an anticipated period of easing. Armed with this information, debt issuers may anticipate the eventual ability to issue short-term debt at significantly reduced costs.

Government Debt Issuance: Of the new debt issued in 1Q24, more than half of the $106.3 billion comes from provincial and federal governments. Despite the high interest rates compared to three years ago, the increase in debt issuance is not surprising given the projected cash needs in the future. The Government of Canada has projected a principal borrowing amount of $508 billion for the 2024-25 fiscal year. Bonds will account for $228 billion of this debt, with 83% allocated for refinancing maturing debt. Additionally, a $30 billion plan aims to fund purchases of Canadian mortgage bonds.

As interest rates remain elevated and the yield curve exhibits inversion, both investors and policymakers must closely monitor these developments. For investors, this unique situation presents an opportunity to secure elevated yields for an extended time to maturity. To illustrate, in March 2022 (before rate hikes began), the 10-year GoC yield stood at 1.71%. Currently, investors can acquire a 10-year security from the government yielding 3.27%. With rates expected to fall from this point onward, we encourage clients to evaluate their needs and if possible, extend term to capitalize on the opportunity.

Revisiting the S&P 500 Equal Weight Index ETF

Luke Kahnert, MBA, CIM - Mutual Fund & ETF Specialist

An index weighting methodology determines how much each security is included in an index ETF and can have a substantial impact on overall performance. For instance, the industry standard S&P 500 is a market cap weighted index in which the weight of each constituent is determined by dividing its market capitalization by the total market capitalization of all 500 companies in the index. Another index weighting methodology is the equal weight approach where each security is assigned an equal weight, regardless of its market capitalization. A more in-depth explanation of the S&P 500 equal-weight index methodology can be found in the March 2023 Insights & Strategies publication titled "Equal Weight Index ETFs".

S&P 500 Market Cap ETF vs. S&P 500 Equal Weight ETF

Currently, the S&P 500 market cap weighted index is heavily concentrated with 34% of its overall allocation in its top 10 constituents as shown in Table 2 using the **Vanguard S&P 500 Index ETF (VFV.TO)**. Conversely, the **Invesco S&P 500 Equal Weighted Index ETF (EQL.TO)**, which has the same constituents as VFV.TO but at a fixed weight of 0.20% at each quarterly rebalancing of the index, is equally diversified across its 500 holdings. With the exception of 2022, a market cap weighted approach has clearly provided superior returns to the equal weighted approach and illustrates the dominant growth found in U.S. mega-cap companies in recent years (Table 3).

Table 2 - Vanguard S&P 500 (VFV): Top 10 Constituents

Constituent	Allocation
Microsoft Corp.	6.95%
Apple Inc.	6.29%
NVIDIA Corp.	6.10%
Amazon.com Inc.	3.64%
Meta Platforms Inc.	2.31%
Alphabet Inc. Class A	2.29%
Alphabet Inc. Class C	1.93%
Berkshire Hathaway Inc. Class B	1.70%
Eli Lilly & Co.	1.47%
JPMorgan Chase & Co.	1.32%
	34.00%

Source: Vanguard S&P 500 (VFV.TO), directly from ETF Provider, data as of May 31, 2024.

Table 3 - Annual Returns of VFV vs. EQL

ETF Name	Ticker	YTD	2023	2022	2021	2020	2019
Vanguard S&P 500 ETF	VFV	19.73%	23.25%	-12.69%	27.64%	15.58%	24.49%
Invesco S&P 500 Equal Weight Index ETF	EQL	9.21%	10.27%	-5.57%	27.96%	10.41%	21.97%
VFV Excess Return		10.52%	12.98%	-7.12%	-0.32%	5.17%	2.52%

Source: Raymond James Ltd., Capintel. Data as of June 19, 2024.

Evolving Benchmark

An interesting byproduct of the higher concentration development in the S&P 500 is found in mutual funds as the majority of actively managed funds in the U.S. Equity category use the S&P 500 Total Return Index as their prospectus benchmark. As opposed to the current composition of the S&P 500 Index, actively managed mutual funds will typically avoid constructing a portfolio that is so heavily reliant on the performance of a few companies. As these mega cap companies continue to lead the index, combined with an active manager's focus on overall risk management, it has created a challenging environment for active U.S. Equity fund managers to keep up with their benchmark. **According to a recent report from Invesco Canada, 36% of the S&P 500 Index's YTD return as of May 31st, 2024 is attributed to a single company, Nvidia.** Given the lack of breadth of returns in the S&P 500, a U.S. Equity fund manager's recent short term relative performance may very well be distilled down to their allocation to the largest companies in the index. As the S&P 500 continues to hit new highs in concentration levels with performance being led by only a few companies, it begs the question whether the S&P 500 market cap index currently acts as a suitable measure to assess a U.S. Equity fund manager's performance in this current environment. In addition, when evaluating a fund manager's performance, it may be prudent to evaluate how the market capitalization weighted benchmark (such as the S&P 500 Index) is performing next to its equal weight alternative. If a market cap weighted index is producing superior returns to its equally weighted counterpart, this may indicate that the largest companies in the market are outperforming and therefore the opportunity set for active mutual funds may be leaner.

Final Thoughts

As of May 2024, the S&P 500 Index ETF reached its highest concentration level with a total allocation of 34.03% in its top 10 holdings (Table 4). The last time the S&P 500 achieved a new record concentration level were in the years 2021, 2020 and 2003. In each of those years, the S&P 500 Equal Weight Index ETF outperformed the S&P 500 market cap index in the following 12 months as shown below. If we begin to see a slowdown across the top 10 names in the S&P 500 compared to the other 490 companies in the index, the equal-weighted index methodology will likely outperform the market capitalization methodology. In addition, if this should occur, this may create a more favourable environment for active management in the U.S. Equity category which may lead to better relative benchmark performance for mutual fund managers. When exploring and comparing a market cap weighted index ETF, an equal weighted index ETF, or an active mutual fund, a personalized approach is recommended as every investor will have different risk tolerances, objectives and preferences. A blend of different strategies may also work as an optimal solution.

Table 4 - S&P 500 Market Cap Weighted Index vs. S&P 500 Equal Weighted Index 12-mth Returns Post All-Time High Concentration Levels

Highest Concentration Level of Top 10	Next 12-Month S&P 500 Equal Weight Return	Next 12-Month S&P 500 Market Cap Return	Excess Return of Equal Weight Methodology
2003: **23.0%**	16.95%	10.88%	6.07%
2020: **28.6%**	29.63%	28.71%	0.92%
2021: **30.5%**	-11.45%	-18.11%	6.66%
May 2024: **34.03%**	*TBD*	*TBD*	*TBD*

Source: Invesco Canada, Morningstar Direct. Performance is based on the S&P 500 and S&P 500 EW TR Indices. Concentration level is reported as of the end of each year. Performance data in USD.

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