CAIM | CROWN AGENTS INVESTMENT MANAGEMENT

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CAPITAL MARKETS MONTHLY

FIXED INCOME

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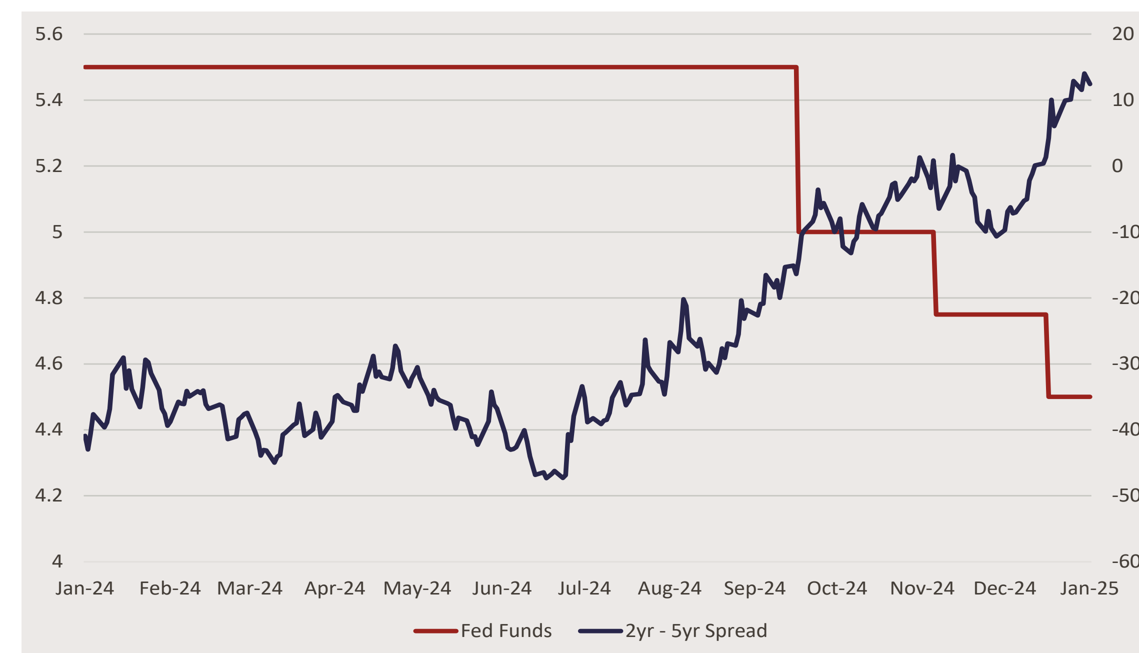
HEAD OF PORTFOLIO MANAGEMENT

Hawkish cut by the Federal Reserve causes yield curve to steepen further

The Federal Reserve lowered the Funds rate by 25 basis points at the Federal Open Markets Committee meeting on 18 December, taking the target range to 4.25% - 4.5%. We previously indicated that we thought this rate cut was likely although interest rate futures maintained a significant probability of a Fed policy hold throughout December. The FOMC statement was virtually unchanged from the November meeting save for the amended interest rate target. However, the forward guidance language was subtly extended, stating that the extent and timing of additional rate cuts would depend on incoming data. This would further reduce the probability of further reductions in the Fed Funds target rate in the first quarter of 2025.

Significantly, there was a material upward revision to the dot plots. The median projected Funds rate at the end of 2025 was increased from 3.375% to 3.875%, which is equivalent to just two 25 basis point cuts throughout 2025. The US budget deficit remains a key concern for the treasury market. This, together with an increasing inflation risk premium, explains why there has been a consistent steepening bias to the yield curve. The chart below shows the progression of the Fed funds rate (upper band) and the yield spread between 2-year and 5-year US treasuries. Over the fourth quarter of last year 5-year yields increased by around 100 basis points despite an equivalent amount of rate cuts by the Federal Reserve. Since the start of the rate cut cycle in September 2024, the yield spread between Fed funds rate and the 30-year long bond yield has moved from -157 basis points to +34 basis points.

US Treasury Yield Curve Slope and the Fed Funds Rate



Source: Bloomberg Finance L.P., December 2024.

During December 2024 there were no Sovereign, Supranational and Agency borrowers in USD with amount outstanding of at least USD 500m, credit rating at least A- and maturity between 1 and 10 years. We anticipate a significant amount of issuance in the SSA sector in January 2025. We will continue to monitor these primary market transactions closely with the expectation that we may participate by selecting those securities that offer good value, in terms of yield spread relative to government bonds, on a risk adjusted basis.

We anticipate large new benchmark issues throughout January from World Bank, EIB, Asian Development Bank, KFW, AIIB, African Development Bank and Inter-American Development Bank. Additionally, it is likely that the large Canadian Pension plans, including CPPIB, will be coming to the market this month. We also expect upcoming primary market transactions from Canadian Provinces, including Alberta, and financials such as L-Bank, BNG and Landesbank Baden-Weurttemberg.

FOREIGN EXCHANGE

SLAWOMIR SOROCZYNSKI

HEAD OF FIXED INCOME

The exceptionally strong US Dollar and US exceptionalism

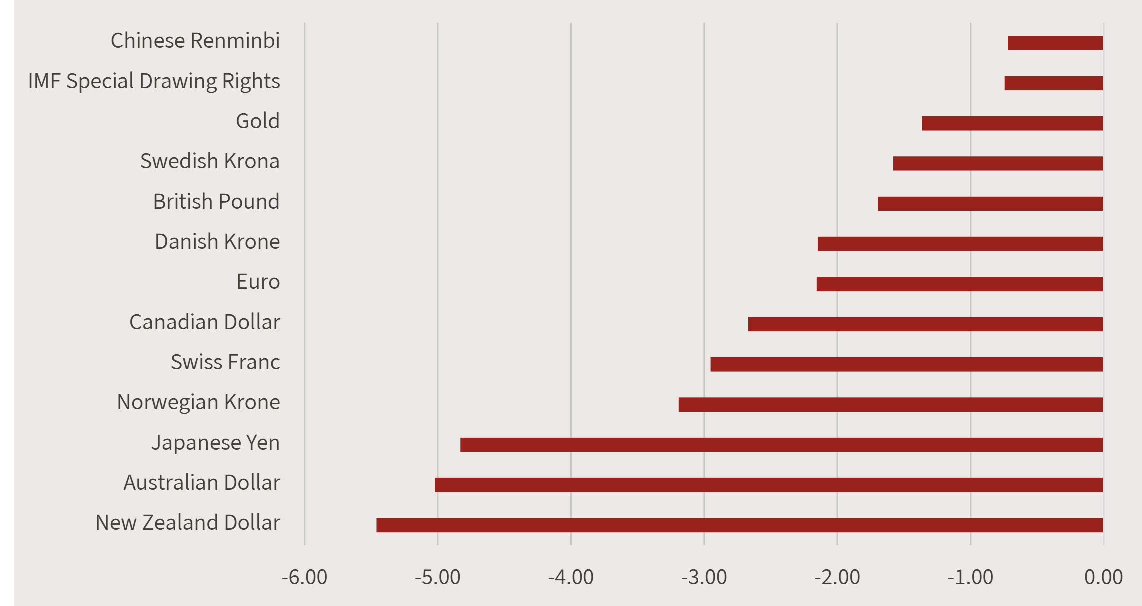
The final days of 2024 surprised many foreign exchange forecasters, including ourselves, as the US Dollar continued to strengthen, with many currency pairs closing the year at new record highs. It's fair to say that across various financial assets, contrarian investment strategies delivered strong positive returns throughout 2024. The last few weeks of the year were characterized by deteriorating liquidity and heightened volatility. Some market participants chose to step back and reassess the investment landscape, while others looked boldly at the set of "known unknowns" for 2025, aiming to build risk exposures. These themes were fully reflected in the foreign exchange market.

December's flows favoured the US Dollar, making it the best-performing currency in the G10 bloc. The scale of its performance is particularly notable. The US Dollar saw significant gains against traditionally high-beta currencies. The antipodean currencies depreciated by around 5%, with the New Zealand Dollar closing the G10 ranking at -5.46%, while the Australian Dollar fell by 5.02%. Even traditionally risk-averse currencies disappointed, with the Japanese Yen resuming its downward trend and losing 4.83% against the greenback, while the Swiss Franc dropped 2.95%. These declines can be partially attributed to the dovish central bank policy shifts observed in December, with the Swiss National Bank delivering a larger-than-expected 50 basis point rate cut and the Bank of Japan keeping interest rates unchanged, signalling a more cautious stance. (Please see the chart overleaf for detailed December performance of the G10 foreign exchange crosses, along with gold, the Renminbi, and the SDR.)

As for the Renminbi (CNY), its depreciation placed it among the top performers, with its value dropping by just 0.72%. However, the spread between the CNY and CNH widened to levels not seen in months, signalling a shift toward market pessimism. Additionally, the technical outlook, with the cross reaching a two-year low, suggests further weakness. Two main factors contribute to the Renminbi's decline: first, the drop in Chinese interest rates to record lows, and second, market disappointment regarding the economic stimulus measures announced. Looking ahead, we remain sceptical about further strengthening of the US Dollar. We believe that most of the positive factors driving US Dollar exceptionalism have already played out. Specifically, the current trajectory of the Federal Reserve's interest rate path appears too shallow, and we anticipate at least three 25 basis point rate cuts this year, which should weaken the US Dollar. Moreover, a potential resolution to the Ukraine conflict could support the Eurozone economy. Finally, we expect rising demand in China, which should bolster investment optimism and drive demand for high-beta currencies.

Regarding tariff risks, we view them as equally detrimental to the US as they are to the rest of the world. However, it is important to acknowledge that at this stage, there are plenty of "unknown unknowns" that could derail any long-term forecasts for financial assets this year.

December performance vs. USD (%)



Source: CAIM, December 2024.

EQUITIES

SIMON PRICE

SENIOR EQUITY FUND MANAGER

United States

Questions over Fed future policy and profit-taking in a strong Year for equities

US equity markets reached new highs in 2024, advancing by 25%. However, they stumbled in December after the Federal Reserve pivoted in what many suggested was a more hawkish direction. Profit-taking following November's post-election surge also increased volatility in December, bucking the trend of historically strong returns for the last month of the year. In a defensive swing, mega-cap tech stocks managed to squeeze out gains, but these were not enough to offset losses in cyclicals as concerns about the duration of the Fed's rate cut cycle negatively impacted equities.

Regarding monetary policy, the Federal Reserve delivered a widely expected 25 basis point cut, taking the fed funds rate down to the 4.25-4.50% range. Aside from the decision itself, other aspects leaned in a more hawkish direction. The latest dot plot pencilled in only 50 basis points of cuts for 2025, down from 100 basis points in September and less than the 75 basis points expected by consensus. Similarly, the long-run median dot moved up to 3.0%, while inflation projections saw a visible upgrade, with 2025 PCE inflation now seen at 2.5%, up from 2.1%. Most FOMC members now see the risks to core PCE as tilted to the upside, and Cleveland Fed President Hammack voted against the rate cut altogether. Chair Powell echoed this hawkish tone in the press conference, stating that the latest rate cut "was a closer call" and that it would be appropriate to slow the pace of rate cuts.

While the macroeconomic picture remained solid, the labour market presented a mixed picture. The headline gain for non-farm payrolls was broadly as expected, with positive revisions to the previous months. However, the unemployment rate ticked up to 4.246%, and the latest JOLTS report showed a tighter labour market than expected. Although inflation was still running a bit too fast for the Fed to be comfortable, markets were relieved that it wasn't higher, which would have prevented the Fed from cutting rates in December.

Corporate earnings have supported equities, with Q4 2024 expectations currently at a 3.3% increase over Q3 2024, setting an earnings record with a 13.4% increase over Q4 2023. For 2024, earnings are expected to increase by 9.2%, and for 2025, by approximately 15%.

In terms of performance, major indices declined in December, with small caps underperforming large caps. Growth stocks suffered less than their value counterparts as 10-year Treasury yields rose. Breadth for December decreased and turned strongly negative, with only three sectors—communications, discretionary, and technology—in positive territory. Every other sector fell more than the index, led by materials, energy, and real estate.

Europe

ECB language and geopolitical concerns as headwinds

European equity markets saw mild losses in December, driven by investor disappointment that the ECB did not adopt a more dovish tone after President Lagarde stated that inflation risks were "two-sided." Geopolitical risks remained high, with the French government losing a no-confidence vote for the first time since 1962, and the German government also losing a no-confidence vote, leading to an election in February 2025.

The ECB, as expected, cut rates by 25 basis points, taking the deposit rate down to 3%. The statement had some dovish shifts, dropping the language about keeping rates "sufficiently restrictive" to get inflation back to target. However, with the latest economic forecasts indicating both growth and inflation downgrades over the years ahead, many expected a more dovish tone.

In corporate earnings news, European earnings have been less supportive for equities, with some sectors, namely autos and luxury goods, experiencing rolling EPS recessions. Consensus forecasts suggest EPS improvement into 2025 of 8%, with growth across most sectors. Despite concerns over potential trade tariffs by US President-elect Donald Trump and China growth concerns, there was a slight rebound for cyclical names, including autos and luxury, while defensive names, including real estate and utilities, underperformed.

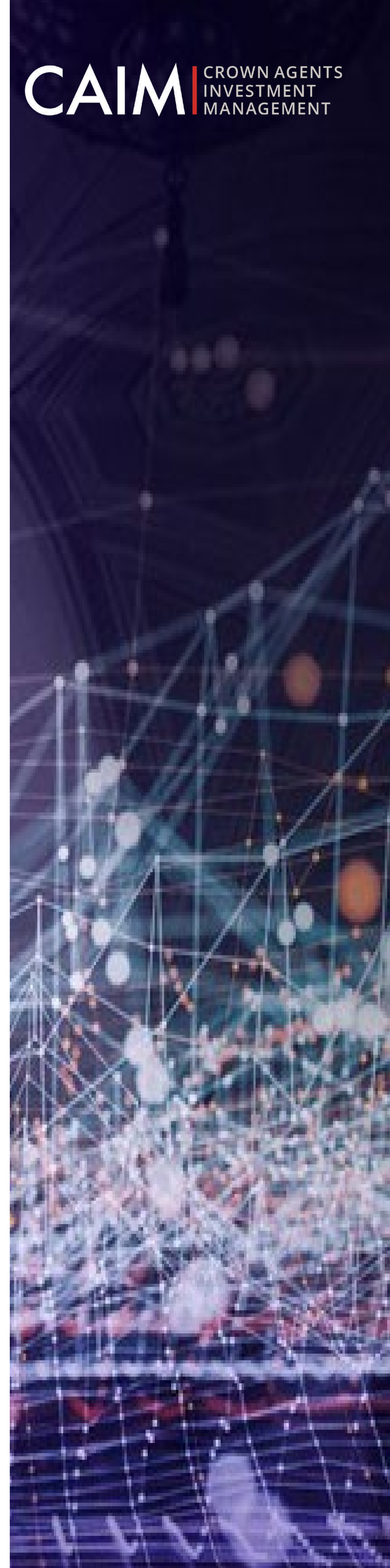
Developed Asia

Positive reversal in Hong Kong and optimistic Japanese sentiment aid gains

Developed Asian equity markets performed stronger, with Hong Kong rebounding from two negative months. Japanese equities saw continued support from corporate earnings, yen weakness, strong macro indicators, and news that the BOJ was leaving rates unchanged, which was deemed positive for sentiment.

Emerging markets

Emerging market equities traded sideways, slightly outperforming their developed market counterparts despite global issues, including a strong dollar and trade war concerns, along with domestic concerns that intensified after the Trump victory. CEEMEA and EM Asia posted muted gains, while LatAm recorded a relatively large underperformance. Brazil was the worst-performing EM, with the currency declining due to worsening fiscal dynamics. The fiscal package announced in November was much less than market expectations, intensifying currency pressures and leading to the central bank delivering a more hawkish rate hike than expected.



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