Q4 2022 MARKET AND ECONOMIC REVIEW

PREPARED BY ENCASA FINANCIAL

INTRODUCTION

Capital Market Returns Q4 2022 (%)

	Q4	1 Year	3 Year	5 Year	10 Year
FTSE CDN 91 Day T-Bill Index	1.0	1.8	0.9	1.2	0.9
FTSE CDN Short Term Index	0.7	(4.0)	0.0	1.0	1.4
FTSE CDN Universe Bond Index	0.1	(11.7)	(2.2)	0.3	1.6
S&P/TSX Index	6.0	(5.8)	7.5	6.8	7.7
S&P 500 Index ($CAD)	6.1	(12.2)	9.2	11.2	16.1
S&P 500 Index ($USD)	7.6	(18.1)	7.7	9.4	12.6
MSCI World Index ($CAD)	8.2	(12.2)	6.5	7.8	12.3
MSCI EAFE Index ($CAD)	15.7	(8.2)	2.4	3.2	8.0
Russell 1000 Growth Index ($CAD)	0.8	(24.0)	9.4	12.7	17.7
Russell 1000 Value Index ($CAD)	10.9	(0.8)	7.5	8.4	13.8
MSCI EAFE Growth Index ($CAD)	13.5	(17.1)	2.3	4.5	9.3
MSCI EAFE Value Index ($CAD)	18.1	2.0	2.8	2.4	7.4

The Quarter in Review

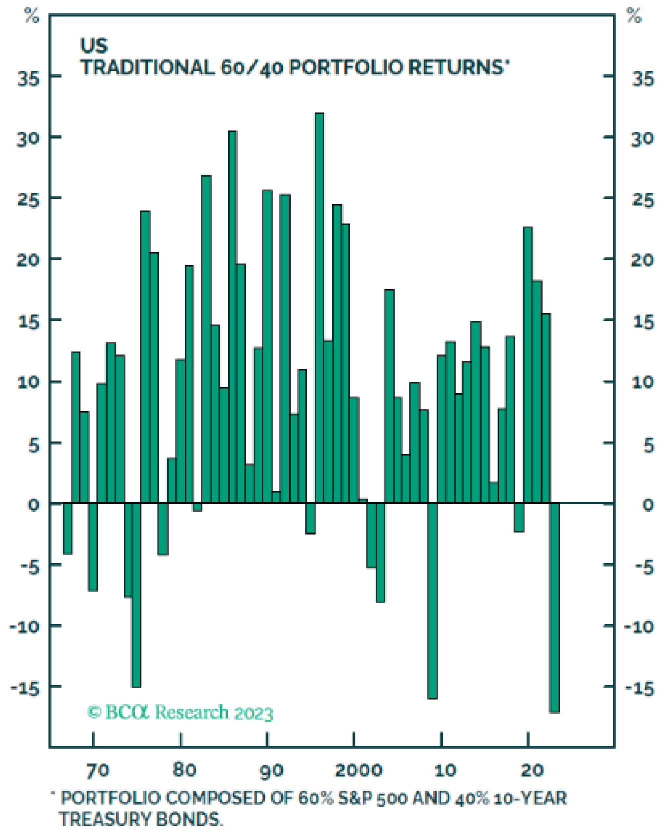
Positive returns for stocks and bonds in the fourth quarter of 2022 gave investors a reprieve after three difficult quarters.

Stocks and bonds both rose in Q4. Although the gains were not enough to turn 2022 results from negative to positive, they kept most investors out of “bear market” territory (-20% or below).

For 2022 as a whole, stocks and bonds fell in tandem for the first time in 40 years as inflation, interest rate hikes and concerns about a possible recession weighed on investor sentiment.

We can see the effect of this in the chart below, which shows the return for a balanced portfolio that includes both stocks and bonds.

Figure 1: Returns from a 60% Equity, 40% Bond Balanced Portfolio



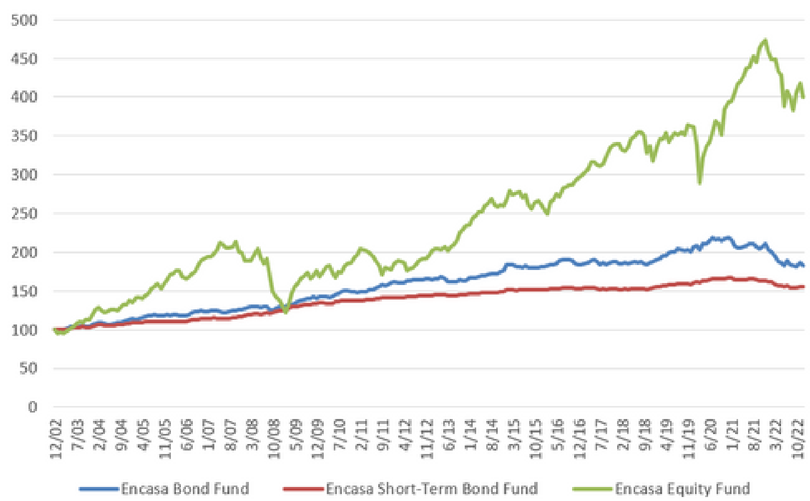
Source: BCA Research

2022 was the worst year for the traditional balanced investment portfolio in modern market history (the chart shows the history of US returns, but experience in Canada has been similar). Canadian investors certainly had good reasons to feel that 2022 was a challenging year.

The economic picture included some positives in Q4, as inflation measures in Canada and most major economies showed signs that price increases were slowing. On the negative side, measures of growth showed softening economic activity in many countries, leaving many investors concerned about a possible recession in 2023.

However, forecasting recessions is difficult, and investments like stocks and bonds don't always respond to economic news in the ways that we might expect. At Encasa, we believe that over the long run, success in investing is about focusing on long-term goals, making sure that investments are aligned with time horizon and risk tolerance, and not trying to respond to the markets' short-term ups and downs. As we can see from the chart below, the Encasa funds have seen periods of volatility in the past, but investors who have stayed invested have come out ahead over time.

Figure 2: Growth of $100 Invested in Encasa Funds, Since Inception



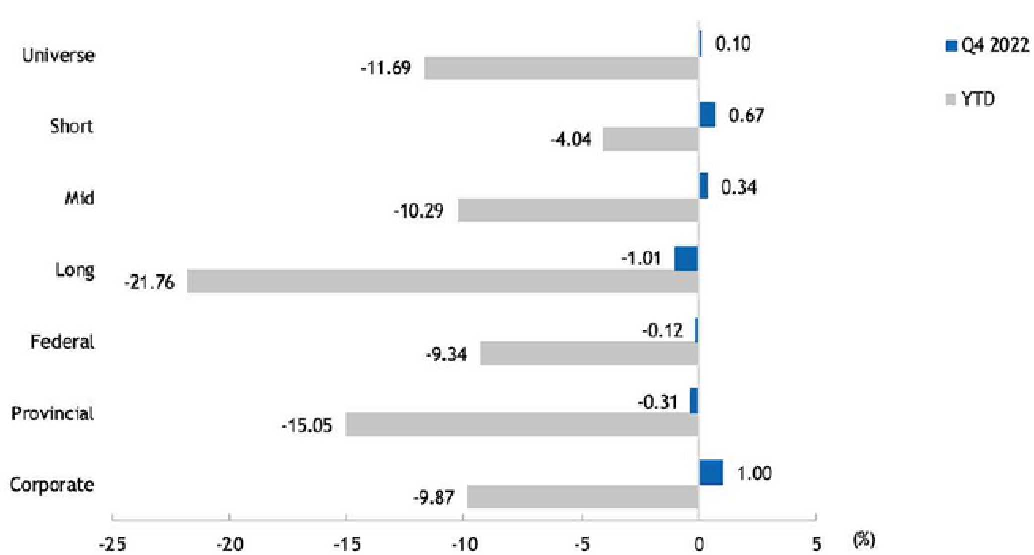
Bond Market Commentary

In 2022, the Canadian bond market was adversely impacted by two main drivers: stubbornly high inflation, and aggressive interest rate increases by the Bank of Canada.

Short-term bonds returned 0.7% in the fourth quarter reducing the annual losses to 4.0%. Medium-term bonds also had positive returns in the quarter, rising by 0.3% over the last three months.

Unfortunately, these positive returns were largely offset by negative returns for long-term bonds in the fourth quarter as bonds with 10-years or longer until maturity declined by 1.0%. The broader bond market, as measured by the FTSE Canada Universe Bond Index [1], which includes short, medium, and long-term bonds, rose 0.1% in the fourth quarter. Canadian universe bonds have declined 11.7% year-to-date, giving up all their gains over the past three years and offering up a paltry 1.6% return over 10 years.

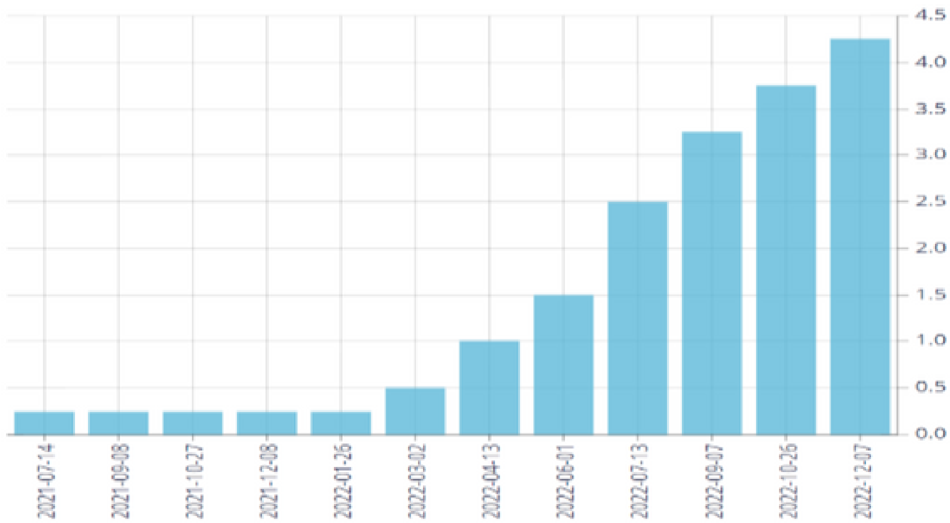
Figure 3: Canadian Bond Market Returns



Source: Addenda Capital

The Bank of Canada was the most hawkish[2] central bank in the developed world during 2022, as it raised interest rates 7 times to curb inflation. The Bank of Canada policy interest rate[3] started the year at only 0.25% and reached 4.25% by the end of the year.

Figure 4: Bank of Canada Policy Interest Rate

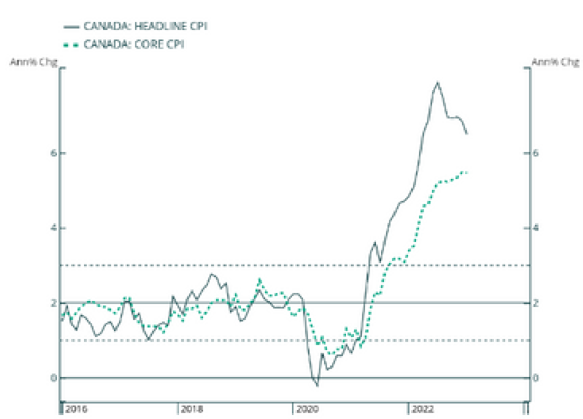


Source: Bank of Canada

This series of back-to-back interest rates is unprecedented in Canada (even looking back to the inflationary period of the 1970s and early ‘80s) and it delivered a strong headwind to bond markets. Bond returns tend to be weak when interest rates are rising, as higher interest rates translate into lower bond prices[4].

The good news is that **the interest rate hikes seem to be working, as inflation is easing. Canada's inflation rate declined** over the quarter, as the Consumer Price Index rose 6.3% in December year-over-year, down from a 6.8% year-over-year pace in November. We can see this slowdown in inflation in the chart below, which shows Canadian headline inflation peaking early in 2022 and then declining over the course of the year.

Figure 5: Canadian Inflation



Source: BCA Research

This slowdown in inflation is good news and shows that rate hikes are having an effect. However, **the risk of interest rate hikes is that if they are too aggressive, they can lead to a recession by slowing down economic growth**. For example, in the early 1990s, the Bank of Canada raised interest rates several times to curb inflation, which contributed to a two-year recession that lasted from April 1990 to April 1992

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Higher interest rates can raise the risk of a recession in several ways:

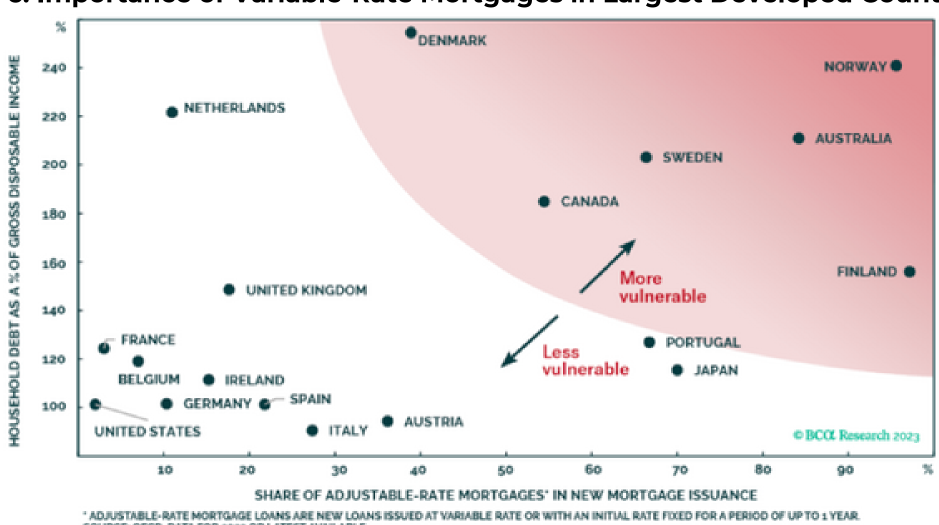
- First, higher interest rates make borrowing money more expensive, which can discourage investment and consumption, leading to a slowdown in business activity and, importantly, job growth.
- Second, higher interest rates can also lead to a fall in housing prices, leading to weaker consumer confidence and decreased consumer spending.
- Third, higher interest rates can lead to a stronger Canadian dollar, leading to a decrease in exports which are an important component of the Canadian economy.

That said, interest rates are just one of the factors that can contribute to an economic downturn. Other factors such as the strength of the labour market, consumer and government spending, exports and the health of the real estate markets can all play a role. Several of these areas, such as the labour market, continue to look strong in Canada. This allows for the possibility of a "soft landing," in which economic growth slows but does not turn negative, while inflation falls to a level that the Bank of Canada considers acceptable.

However, the health of the residential real estate market and its potential effect on consumer spending raise some concerns. In particular, **the Canadian economy is especially vulnerable to rising interest rates due to its heavy reliance on variable rate mortgages** and above-average levels of household debt.

The chart below shows why Canada is more vulnerable than many other developed nations to rising interest rates. Almost 60% of Canada's mortgages are variable rate with Canadians carrying debt at over 180% of income. In contrast, a country like the Netherlands has greater personal debt to income (approximately 220%) but only 10% of mortgages are variable rate. Canada is also quite different from the US, where US citizens are in better financial shape (with less debt compared to income) and with more fixed-rate long-term mortgages - meaning they are more sheltered personally from interest rate increases.

Figure 6: Importance of Variable-Rate Mortgages in Largest Developed Countries



Source: BCA Research

The impacts of higher interest rates are felt sooner by borrowers with variable rate mortgages or other forms of floating rate debt, as the interest portion of their monthly payment rises immediately rather than at renewal. So compared to a country with a lower percentage of variable-rate mortgages (eg, the Netherlands), Canadian consumers might feel pinched sooner, even though their debt level is not necessarily higher.

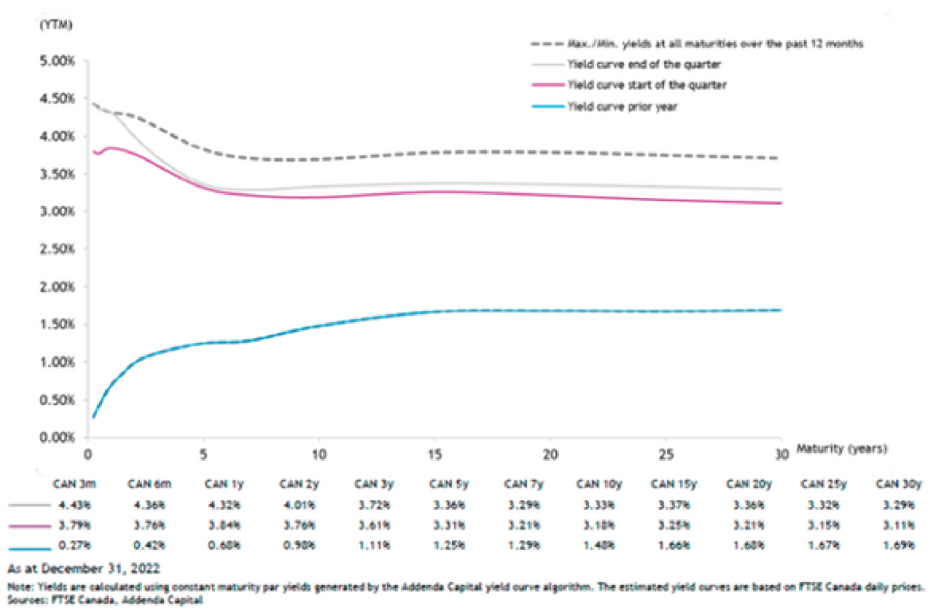
In other words, as interest rates rise, Canadian spend more on their mortgage payments, leaving them less to spend on other things, which could result in lower economic growth.

What is an Inverted Yield Curve and Why Does It Matter?

The yield curve is another source of concern for Canadian economists, as the yield curve today looks similar to how it has looked before some recessions in the past. A yield curve is simply a line plotting the interest rates offered on fixed income securities (such as treasury bills or bonds) of different maturities.

The chart below shows the Canada yield curve at different moments in time. The blue line in the chart below shows the yield curve at the end of 2021. That yield curve is "normal" or upwardly sloped, as short-term securities offer low interest rates, while longer-dated securities offer higher rates. The typical explanation for this is that investors demand higher yields to compensate for the greater risk that they take with longer term bonds.

Figure 7: Government of Canada Yield Curve, Q4 2022 - Q4 2023

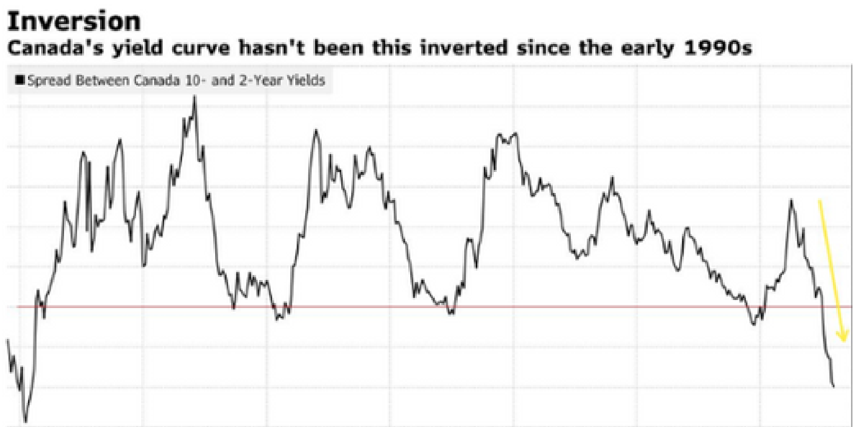


Source: Addenda Capital

The lines at the top of the chart above show yield curves at the beginning and end of Q4, as well as the highest yields for 2022. These curves are "inverted," with near-term interest rates higher than those of longer-dated bonds, leading the curves to slope downwards. The yield curve first started to invert in the third quarter of 2022 and by the end of the year, it remained inverted with two-year government bonds yielding 0.7% more than ten-year government bonds (two-year bonds yielded 4.0% and ten-year bonds yielded 3.3%).

One measure of the shape of the yield curve is the difference between longer-term and shorter-term bond yields; the difference between 10-year and 2-year bonds is often used. Bond traders, who love to invent terminology, sometimes call this the "10s-2s spread". With a normal yield curve, the "10s-2s spread" will be positive (ie, 10-year bonds will offer a higher interest rate than 2-year bonds), but as we can see from the chart below, when the yield curve inverts, the spread becomes negative:

Figure 8: "10s-2s Spread": Canada 10 Year vs 2 Year Bond Yield Difference



Source: Bloomberg

As shown in the chart above, the yield curve is quite a bit more inverted now (ie, the black line is further into negative territory) than at any time since 1990. As noted above, Canada underwent a 2-year recession from April 1990 to April 1992, when the yield curve inverted in response to Bank of Canada rate hikes.

The yield curve can invert for a variety of reasons. However, in general, **an inverted yield curve indicates that investors are expecting lower future economic growth and inflation**, which leads them to demand higher yields on shorter-term bonds. Another way to look at this is to say that they are willing to accept lower yields on longer-term bonds, since they expect interest rates to fall in the future in response to weaker economic conditions and lower inflation. The most likely reasons that the yield curve inverted in 2022 are a combination of the aggressive interest rate increases by the Bank of Canada, global economic uncertainty, and the rising risk of recession.

It is important to note that an inverted yield curve is not always a reliable indicator of a recession, it's just one of many indicators that investors and analysts use to gauge the health of the economy.

Notably, the Canadian yield curve temporarily inverted in December 2005. At the time, some experts predicted that this was a sign of an impending recession. However, a recession did not follow, and the Canadian economy continued to grow.
n down to their 2% target.

How Might a Recession in 2023 Impact the Bond Market?

Recessions can have a significant impact on the bond market, and that impact can be positive. Bonds are generally considered to be less risky investments than stocks, and they are often used as a haven during times of economic uncertainty. As investors become more risk-averse during a recession, they may shift their money from stocks to bonds. This can bid up the price of bonds, which translates to positive returns for bond investors on the bonds that they hold.

In addition, slowing economic growth increases the likelihood that central banks will pivot and start cutting rates. Because consumers and businesses cut back spending on real goods and services in a recession, inflation tends to fall. This gives central banks room to cut their policy interest rates. In addition, many central banks try to avoid causing serious recessions and the unemployment that often comes with them, which gives them a further incentive to lower their policy rates to boost economic activity. As a result of these dynamics, central bank policy can benefit bond investors when a recession seems likely.

Stock Market Commentary

Stocks reversed their downward trend in the fourth quarter of 2022 as inflation fears started to wane, leading to an improvement in investor sentiment.

The S&P/TSX Index increased 6.0% in Q4, reducing the decline on the year to 5.8%. However, on a 10-year basis, returns on the S&P/TSX Index are still a respectable 7.7%.

For Canadian investors in U.S. markets, results also recovered as the S&P 500 Index increased by 6.1% in Canadian dollar terms during the fourth quarter, reducing annual losses to 12.2%. Long-term Canadian investors in the S&P 500 have been handsomely rewarded, experiencing double digit positive returns of 16.1% in Canadian dollar terms over the last ten years.

The MSCI World Index5, which is comprised of about 70% US stocks, increased by 8.2% in the fourth quarter, reducing the year's losses to 12.2% in Canadian dollars. On a 10-year basis, returns on the index are 12.3% in Canadian dollars.

International stocks (as measured by the MSCI EAFE Index6) increased 15.7% in the fourth quarter, reducing the year's losses to 8.2% in Canadian dollar terms. On a 10-year basis, returns on the MSCI EAFE Index now stand at a respectable 8.0% in Canadian dollars.

The returns on US and international stocks are important for Canadian investors because many of us have exposure to stocks outside Canada through our investments, pensions and, for Encasa investors, through the Encasa Equity Fund. Investing abroad gives Canadians exposure to a more diverse range of economies, companies, and currencies than we can find in Canada's markets alone.

How Might a Recession in 2023 Impact the Stock Market?

Recessions are periods of economic slowdown, and this often translates into weaker corporate earnings. Since stocks represent ownership in companies and rights to a share of a company's earnings, falling earnings can contribute to lower share prices, as investors will pay less for a company that is expected to earn less.

Inflation and interest rates can also play a role, as higher interest rates can reduce company earnings, and make future earnings less valuable in comparison to the yields available on short-term investments.

There is an adage in investing that markets lead economies, so the stock market will often decline before a recession is actually declared, and it's common for stock markets to rally before a recession is officially over. January of 2023 has seen a surge in equity markets that suggests that at least some stock market investors are already looking past any economic slowdown in 2023, anticipating a return to earnings growth, and possibly a "soft landing" that avoids a recession.

As this shows, it is difficult to use economic analysis to predict what markets will do. Although there is a risk that stock markets will decline in 2023 if the outlook for economic growth worsens, we would advise investors to maintain their allocations to equities, focusing as always on long-term objectives, time horizon and ability to bear market risk.

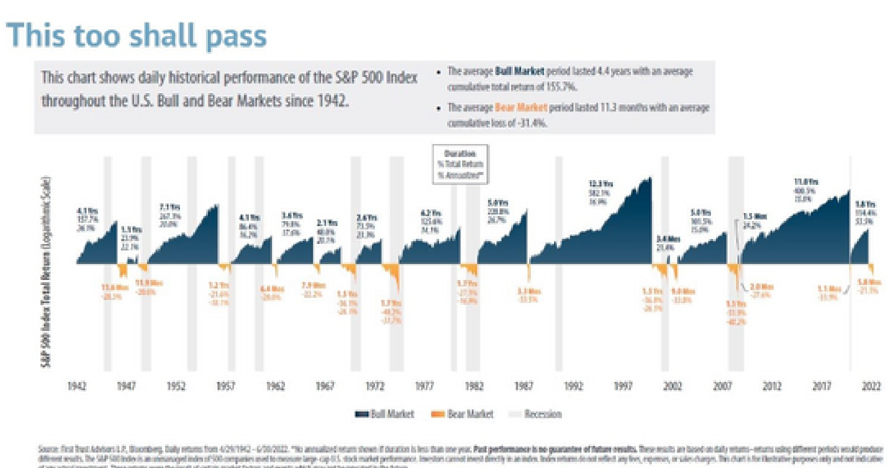
Conclusion

There's no question that 2022 was a tough year for investors in both stocks and bonds. Q4 was a positive one and allowed investors to recover some of their losses from earlier in the year. 2023 has started out strong, but markets rarely continue in a straight line for long, and it's almost certain that the new year will deliver surprises along the way.

The most important thing to keep in mind is that over the long run, markets reward investors who stay the course. It's the nature of markets to deliver returns in an uneven way – some years are good, some great, and some difficult. However, over time, investors who stick to their plans with a focus on the long term generally do well.

The chart below highlights how this plays out for investors in US stocks, but the dynamics are similar in other countries. Although the negative periods (shown in orange) feel painful and never-ending at the time, in hindsight, they are brief and not that large in comparison to the positive periods.

Figure 9: Historical US Stock Market Returns in "Bull" and "Bear" Periods



Source: John Authers, Bloomberg Opinion

With that in mind, the fourth quarter of 2022 left us with reasons for both optimism and caution.

On the positive side, the interest rate hikes by the Bank of Canada and other central banks around the world seem to be working, as inflation has been easing. Central banks are signalling that they are near or at the end of their cycles of interest rate increases, at least for now. The Bank of Canada's January interest rate policy announcement confirmed this, indicating that they will be pausing on further increases, as they wait to see if inflation comes down in response to 2022's rate increases.

On the down side, we still face the possibility of a recession in Canada and other developed countries in 2023. This could have a mixed impact on portfolios. As noted above, a recession can bring about a rise in bond prices as investors become more risk averse and look for safer assets. Slowing economic growth could also increase the likelihood that central banks will pivot and start cutting rates in response. This would provide a further tailwind for bond investors.

Stocks may react negatively to a recession, as a downturn in the economy can lead to lower corporate profits and increased uncertainty. However, the timing of declines and rises in share prices can be very difficult to predict.

Most importantly, given the difficulty of forecasting recessions or markets' reaction to them, we recommend that investors maintain their bond and equity fund investments and keep a diversified portfolio that aligns with their investment objectives, time horizon, and risk tolerance. It is important for investors to consider not only their emotional comfort with risk but also their financial capacity to take on risk, such as the size of their investment pool and their need for the capital.

As always, we encourage you to contact your advisor if you have any questions or would like to discuss your organization's investment portfolio.

Endnotes

1. The FTSE Canada Universe Bond Index measures the performance of the Canadian Dollar denominated investment-grade fixed income market. It includes Canadian government, quasi-government, and corporate bonds across short, medium, and long-term maturities.
2. A hawkish central bank refers to a central bank that takes a more aggressive stance on monetary policy and is more likely to raise interest rates to combat inflation. This contrasts with a dovish central bank, which takes a more accommodative stance on monetary policy and is more likely to lower interest rates to stimulate economic growth.
3. The policy interest rate is the interest rate that is referenced in the media and by the Bank of Canada itself. It anchors the interest rates that are charged to consumers for mortgages, lines of credit etc. as well as the interest rates paid
4. Bond yields and bond prices have an inverse relationship, so when bond yields fall, bond prices rise, and when bond yields rise, bond prices fall

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