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Q1 2023 MARKET AND ECONOMIC REVIEW

PREPARED BYENCASA FINANCIAL

Capital Market Returns, Q1 2023

	Q1	YTD	1 Year	3 Year	5 Year	10 Year
FTSE CDN 91-Day T-Bill Index	1.1	1.1	2.8	1.1	1.3	1.0
FTSE CDN Short Term Index	1.8	1.8	0.7	0.0	1.3	1.4
FTSE CDN Universe Bond Index	3.2	3.2	(2.0)	(1.7)	0.9	1.9
S&P / TSX Composite Index	4.6	4.6	(5.2)	18.0	8.8	7.9
S&P 500 Index ($CAD)	7.4	7.4	(0.0)	16.6	12.3	15.5
S&P 500 Index ($USD)	7.5	7.5	(7.7)	18.6	11.2	12.2
MSCI World Index ($CAD)	7.6	7.6	0.7	14.5	9.0	12.0
MSCI World Index ($USD)	7.7	7.7	(7.0)	16.4	8.0	8.9
Russell 100 Growth Index ($CAD)	14.2	14.2	(3.5)	16.6	14.7	17.9
Russell 100 Value Index ($CAD)	0.9	0.9	1.9	16.0	8.5	12.3
MSCI EAFE Growth Index ($CAD)	11.1	11.1	5.7	9.4	6.3	9.5
MSCI EAFE Value Index ($CAD)	6.0	6.0	8.8	13.4	3.4	7.4

Introduction: The Quarter in Brief

The first quarter of 2023 was a good one for investors. Both stocks and bonds rose in major markets around the world. In many asset classes, one-year returns turned positive or at least got close, which was good to see after a tough 2022.

Equities delivered solid returns as investors became more confident about the ability of the economy to grow despite the challenges of higher inflation and interest rates.

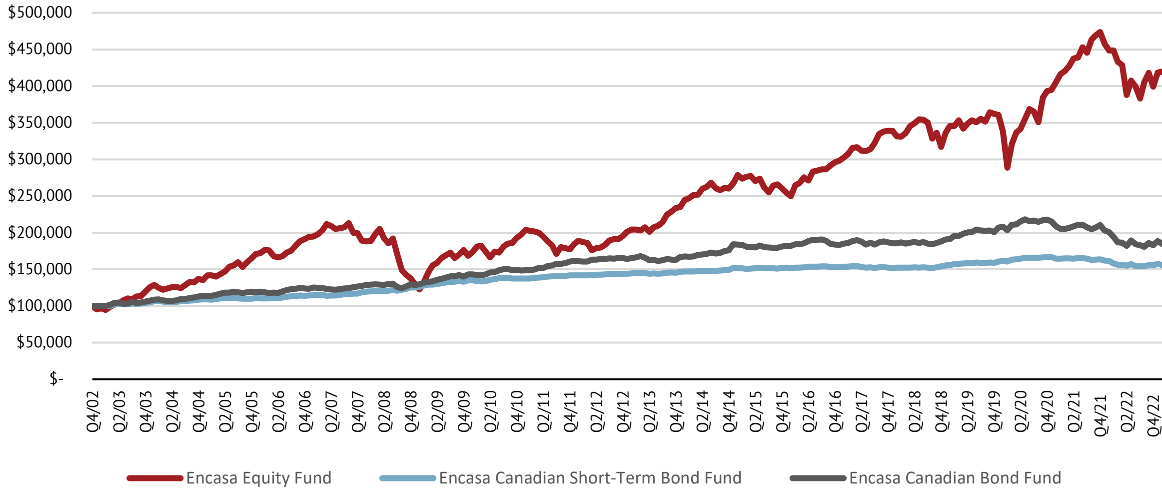
Interest rates declined in the quarter, which boosted bond returns. The decline in interest rates was partly due to signs that inflation stopped accelerating and may be starting to slow. Central banks in most major economies, including Canada, hinted that further interest rate increases are on hold for now.

The fall in interest rates was also partly in response to bank failures in the US and Switzerland. However, it appears that the problems were specific to the banks that ran into trouble, and quick action by regulators and central banks restored investor confidence.

The economic outlook remains mixed. Inflation and interest rates remain high, which can squeeze consumer spending and corporate investment, hurting economic growth. Measures of economic activity, such as factory output and housing construction continue to send mixed signals. However, job markets remain strong, and business confidence appears to be holding up for now.

2023 is off to a solid start, but many investors are still recovering from the declines that we all experienced in 2022. The chart below shows that the quarter recovered some, but not all, of the pullback in 2022. We can see that each of the Encasa Funds resumed its upward path. More importantly, we can see the benefit of staying invested for the long term. Financial markets can be volatile in the short term, but they have rewarded patient investors over time.

Figure 1: Growth of $100,000 Invested in Encasa Funds



Source: Encasa Financial Inc.

Economic Commentary

The biggest economic news in the first quarter was a slowdown in inflation. We can see from the chart below that Canadian core inflation has slowed, falling from a peak of 5.6% in mid-2022 to 4.3% in March.

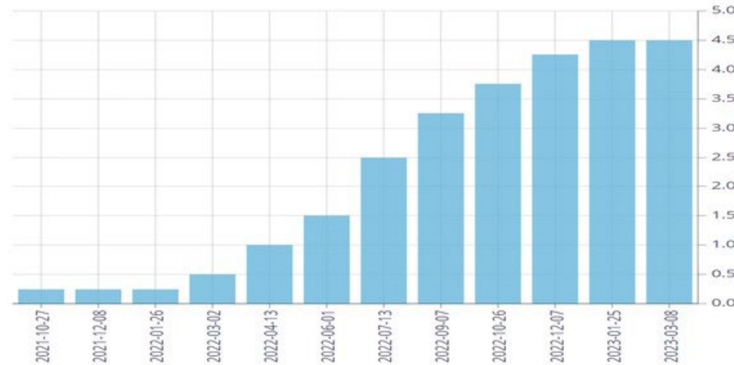
Figure 2: Core Inflation in Canada (%)

Source: Statistics Canada

Most other major economies have seen a similar slowdown in core inflation.

While inflation has slowed somewhat, many of us still experience sticker shock in our everyday lives, and from the Bank of Canada's perspective, inflation of 4.3% is still too high. As a result, the Bank raised its policy interest rate to 4.5% in January:

Figure 3: Bank of Canada Policy Interest Rate



Source: Bank of Canada

The Bank's policy rate is the foundation that many other interest rates, such as banks' prime rates and mortgage rates, are built on, so when the policy rate rises, other rates tend to move as well, affecting the broader economy.

However, the slowdown in inflation was enough that the Bank of Canada held off on raising rates again in March, and has hinted at keeping rate increases on hold for now.

Higher prices and higher interest rates have had an impact on consumer confidence, as we can see in the chart below:

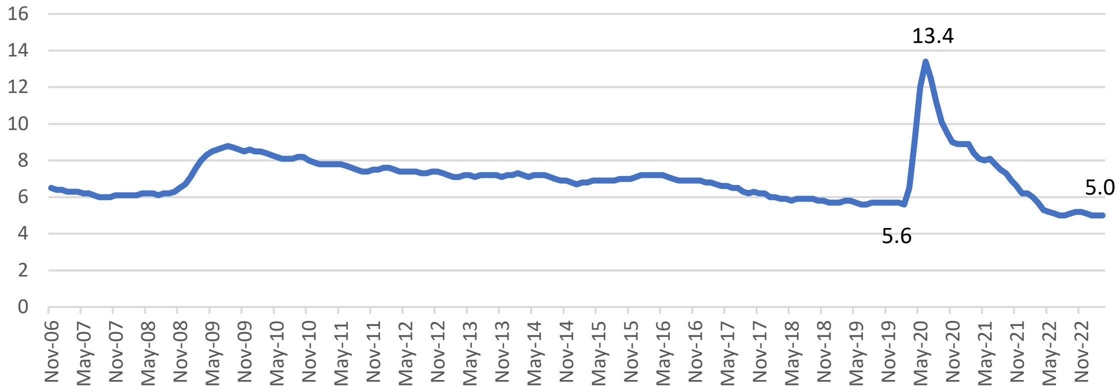
Figure 4: Canadian Consumer Confidence

Source: IPSOS

The decline in consumer confidence is a potential negative because it could mean that Canadians will cut back on spending, leading to a slowdown in economic growth. However, there are several factors that continue to support the economy for now.

The first is the strength of the labour market. Unemployment is near historic lows in Canada (and in the US), as we can see in the following chart:

Figure 5: Unemployment Rate in Canada

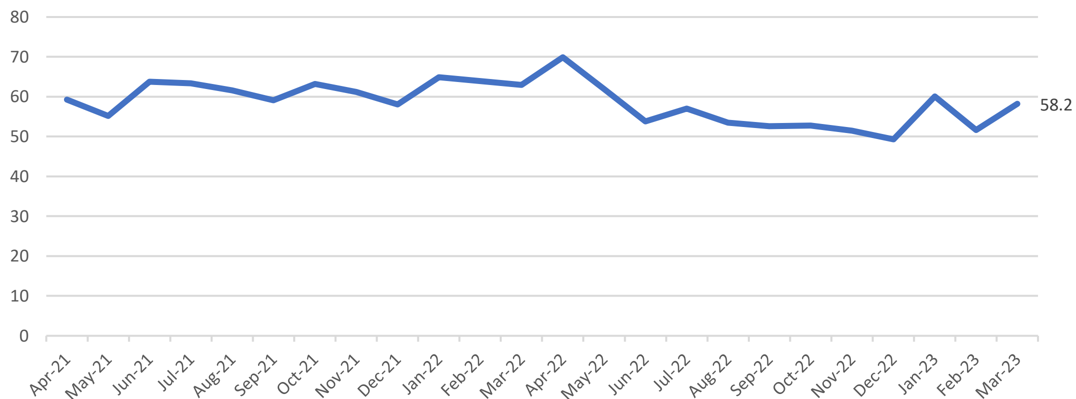


Source: Statistics Canada

A low unemployment rate is good for consumers and consumer spending, because it means that not only are a lot of people working and earning money, but also that they are in a good position to negotiate with employers. The Bank of Canada's quarterly survey of business conditions captured these dynamics from employers' point of view, with more businesses than usual reporting difficulty in filling vacant positions, and with expectations of having to pay higher wages in the coming year.

However, despite the headwinds of inflation, higher wages and higher borrowing costs, Canadian businesses remain optimistic. Business confidence in Canada is not at its highest levels ever, but it remains well above the low levels that signal a recession. The Ivey Purchasing Managers' Index, which measures how confident businesses are about the future, has risen since the start of the year, and its reading of 58.2 suggests that businesses expect growth to continue, as it sits well above 50, which is traditionally the level that signals concerns about a slowdown.

Figure 6. Ivey Purchasing Managers' Index



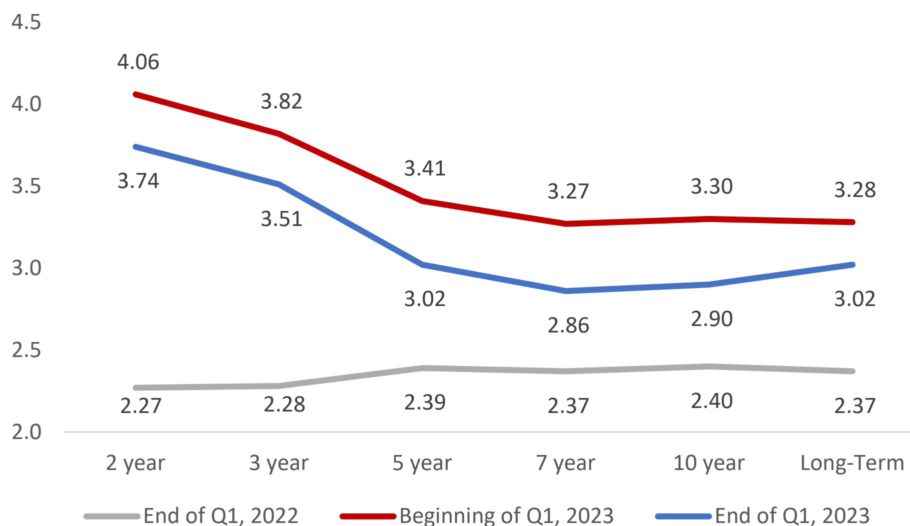
Source: Ivey School of Business, Western University

In brief, the economic picture remains mixed. Inflation and high interest rates present headwinds, but for now, the strength of the labour market and business confidence are supporting continued economic growth.

Bond Market Commentary

Bond investors welcomed the slowdown in inflation by lowering the interest rates that they demanded for holding bonds of all maturities. In bond market terminology, this meant that the yield curve moved down, as we can see in the chart below:

Figure 7: Yield Curve for Government of Canada Bonds



Source: Bank of Canada

The yield curve has a few features that are worth noting. The grey curve shows interest rates as they stood a year ago, on March 31, 2022. At that point, the yield curve was still sloping upward to a very small extent, with longer-dated bonds offering about 0.1% more in yield than short-term, 2- and 3-year bonds. That upward slope is often called a "normal" slope, as it fits with economic theory that suggests that investors should demand higher yields from investments that tie up their money for longer.

The yield curves for both the beginning and end of Q1 are both downward-sloping, or "inverted", which runs against that theory. The usual explanation for an inverted yield curve is that it represents bond investors' expectation that interest rates will decline in the future. That explanation certainly lines up with many forecasts from economists and bond strategists, which predict that inflation will come down during 2023, allowing interest rates to decline as well.

Another factor that contributed to the decline in interest rates was the brief period of concern about the health of banks in the US and Europe. Several regional banks in the US ran into trouble as they faced losses on long-dated bonds due to the rise in interest rates in 2022. When depositors grew worried and demanded their cash back, the banks were forced to sell bonds and realized some losses. This increased concern among depositors and led to runs on several regional banks. Depositors wanted more cash than the banks had on hand. However, regulators and the US Federal Reserve quickly stepped in with a plan that protected deposits and halted the panic. Similarly, in Switzerland, concerns about the outlook for Credit Suisse led the Swiss government to force it into a merger with its Swiss sibling, UBS. Quick action by governments and regulators appears to have confined the crisis for now, but the brief panic did show that the rise in interest rates in 2022 may have ripple effects that have yet to play out.

For bond markets overall, the decline in interest rates was a positive, with the broad FTSE Canadian Universe Index delivering a return of 3.2% in the quarter, and the FTSE Canadian Short-Term Index returning 1.8%.

Equity Market Commentary

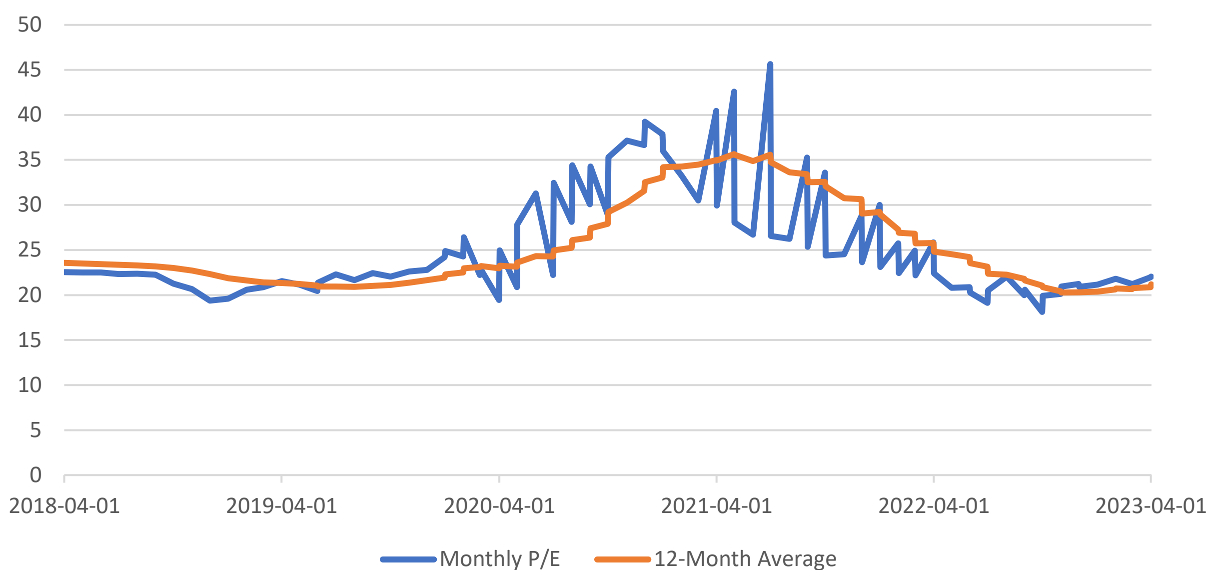
Equity markets started 2023 strongly, with world stocks rising nearly 9% in Canadian dollar terms before giving up a bit of ground in the face of mixed economic news and headlines about bank troubles.

The S&P 500, the main US index of large company stocks, rose by 7.4% in the quarter, led by Technology and Communication Services companies. Health Care, Financial Services and Energy companies did not do as well. In Canada, the S&P/TSX Composite Index rose by 4.6%. Technology and Consumer companies led the Canadian market, and as in the US, Health Care, Financials and Energy did not do as well.

As with the economic news overall, corporate earnings for the first quarter have been mixed. According to FactSet, which tracks financial results for US companies (which tend to report earlier than Canadian companies), revenues were up 2.1% on average year-over-year. 76% of companies that have reported to date for the first quarter beat analysts' expectations, which is roughly in line with an average quarter. In absolute terms, earnings are down about 6.2% year-over-year, but remain at relatively high levels compared to the long term. Higher input costs, in terms of both materials and labour, are clearly having an impact on earnings, but most companies remain upbeat on the outlook for their businesses.

Overall, due to the decline in share prices in 2022, stocks are slightly cheaper than they were at this time last year, when comparing share prices to earnings:

Figure 8. Price-to-Earnings Ratio for S&P 500 Companies



Source: NASDAQ DataLink

As we can see from the chart, in mid-2021, it cost approximately $35 to buy shares of S&P 500 companies that earned $1 in annual earnings in the prior year. At the end of the first quarter, that dollar of earnings cost just over $20, which is around the level that stocks have traded in recent decades.

As always, we would emphasize that the short-term direction of the stock market is almost impossible to predict, but from a long-term perspective, we continue to believe that equities are likely to deliver better returns than bonds, for investors who have the risk tolerance and time horizon to live with their ups and downs.

Conclusion

In short, the economic picture continues to be mixed. The slowdown in inflation is clearly a positive for both stock and bond investors, not to mention consumers. The outlook for economic and earnings growth remains mixed, as inflation and higher interest rates present headwinds, while the strong labour market and measures of current economic activity, business confidence and earnings suggest that companies and the economy more broadly are adapting and growing.

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

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Learn more at www.encasa.ca.

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