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Q2 2023 MARKET AND ECONOMIC REVIEW

PREPARED BY ENCASA FINANCIAL

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Capital Market Returns, Q2 2023 (%, in CAD)

Index	Returns QTD	Returns YTD	Returns 1 Year	Returns 3 Years	Returns 5 Years	Returns 10 Years
Cash and Equivalents (1)	1.2	2.4	4.0	1.5	1.5	1.1
FTSE Canada Short Term Overall Bond Index	-0.8	1.0	1.4	-0.9	1.1	1.4
FTSE Canada Universe Bond Index	-0.7	2.5	3.1	-3.7	0.7	2.1
S&P/TSX Composite	1.1	5.7	10.4	12.4	7.6	8.4
S&P 500	6.3	14.2	22.7	13.5	12.4	15.4
MSCI World	4.6	12.7	22.2	11.6	9.8	12.6
Russell 1000 Growth	10.3	26.0	30.4	12.6	15.3	18.4
Russell 1000 Value	1.8	2.7	14.4	13.2	8.2	11.7
MSCI EAFE Growth	0.6	11.8	23.7	5.6	5.9	9.3
MSCI EAFE Value	1.2	7.3	21.3	11.0	3.7	7.2

1. CIBC World Markets 91-Day T-Bill Index to August 2021, 3-Month CDOR thereafter

Executive Summary

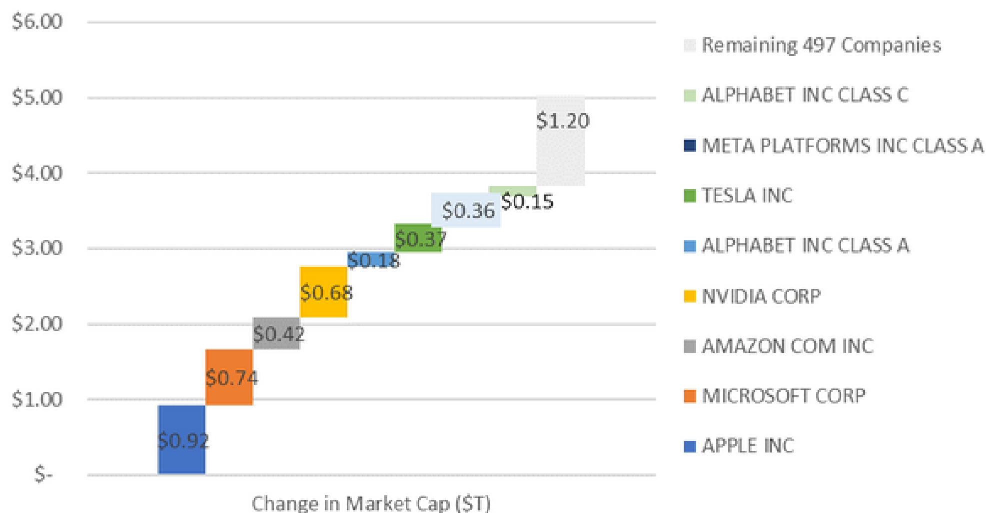
- In the second quarter of 2023, artificial intelligence-related tech stocks in the United States (US) rose dramatically, with the rest of the stock market rising very modestly on average.
- Stocks around the world generally followed the US pattern. In Canada, Europe and Asia, a handful technology-related companies did well, while most other companies delivered middling performance.
- Inflation in goods prices generally decreased in both Canada and the US.
- However, inflation in the services sector remained high due to strong demand in sectors such as travel and hospitality, as well as elevated housing and shelter costs.
- In both Canada and the US, the central banks noted the decline in core inflation, but raised interest rates modestly as inflation remained above their target ranges.
- In fixed income markets, rates were volatile but generally moved upwards. Inflation and interest rate hikes put upward pressure on shorter and medium-term durations, resulting in small losses for many government bonds. Yields for bonds with long maturities (e.g., greater than 15 years) hardly moved as these tend to be less affected by short-term interest rates.
- Corporate credit spreads narrowed during the quarter due to an improved outlook for corporate profits, which allowed corporate bonds to deliver small gains in the quarter.
- As we move into the second half of 2023, economic growth is expected to remain positive, and markets remain focused on many of the same factors and risks that we saw playing out in the first half: economic growth, inflation, and interest rates.
- Ultimately, for investors, the most important thing is to make sure that portfolios are diversified and allocated to investments that match their time horizon and risk tolerance. If you have questions about your organization's portfolio, contact us!

Markets remained focused on two broad themes in the second quarter. One was very specific: the potential for artificial intelligence (AI) to transform how we live and work, and to deliver earnings for a handful of technology companies. The other was general and carried over from recent quarters: the ongoing debate about the path of economic growth, inflation, and interest rates.

The AI theme played out mainly in equity markets, and most dramatically in the United States, where the companies expected to benefit from the roll-out of Large Language Models (LLMs), such as ChatGPT, are headquartered. The narrow focus on AI created a tale of two stock markets, with AI-related tech stocks rising dramatically, and the rest of the stock market rising very modestly on average.

We can see this dynamic in Figure 1 below. The chart shows the change in market value of the S&P 500 overall in the first half of 2023, broken down by source. The companies in the S&P 500 gained over $5 trillion in market value (in USD) in the first half of the year. Of that, the 7 companies identified accounted for nearly four fifths, or just under $4 trillion in gains. The remaining 497 companies in the index gained just over $1 trillion between them.

Figure 1: Change in Market Value, Dec. 30, 2022 to June 30, 2023 (Trillions of US Dollars)

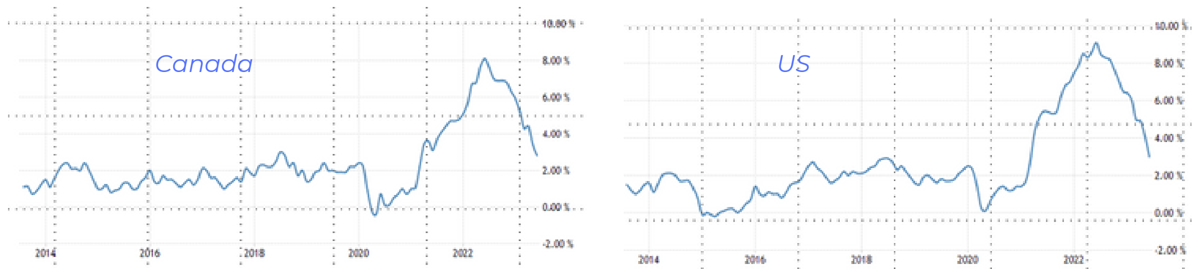


Source: BlackRock

Stocks around the world generally followed the US pattern. In Canada, Europe and Asia, a handful technology-related companies did well, while most other companies delivered middling performance. For example, in the Eurozone, IT stocks did well, led by semiconductor stocks. In Canada, the IT sector led with gains of 17% in the quarter, while the S&P/TSX Composite Index overall rose only 1%.

On the second theme, markets remained focused on inflation data and central banks' responses to it. During the quarter, inflation continued to decrease gradually. Some of the issues that had contributed to inflation in goods prices, such as supply chain disruptions, have started to normalize, and energy prices have come down considerably compared to the prior year. As a result, inflation in the prices of goods has generally decreased in both Canada and the US. However, inflation in the services sector remained high due to ongoing labor market disruptions, even with full employment, and housing and shelter costs continued to pressure inflation upwards.

Figure 2: Core Inflation in Canada and the United States, June 30, 2023 (%)



Sources: Statistics Canada, US Bureau of Labor Statistics

In both Canada and the US, the central banks noted the decline in core inflation, but commented that inflation remains above their target ranges. Both central banks raised interest rates in the quarter, though at a slower pace, to manage the high inflation levels. The Bank of Canada had paused raising interest rates earlier in the year but resumed raising rates later in the quarter due to persistent inflationary pressures. The Federal Reserve had been consistently raising interest rates for ten consecutive meetings, but in June, they finally decided to pause their rate hikes.

Figure 3: Bank of Canada and US Federal Reserve Policy Rates

Sources: Statistics Canada, US Federal Reserve

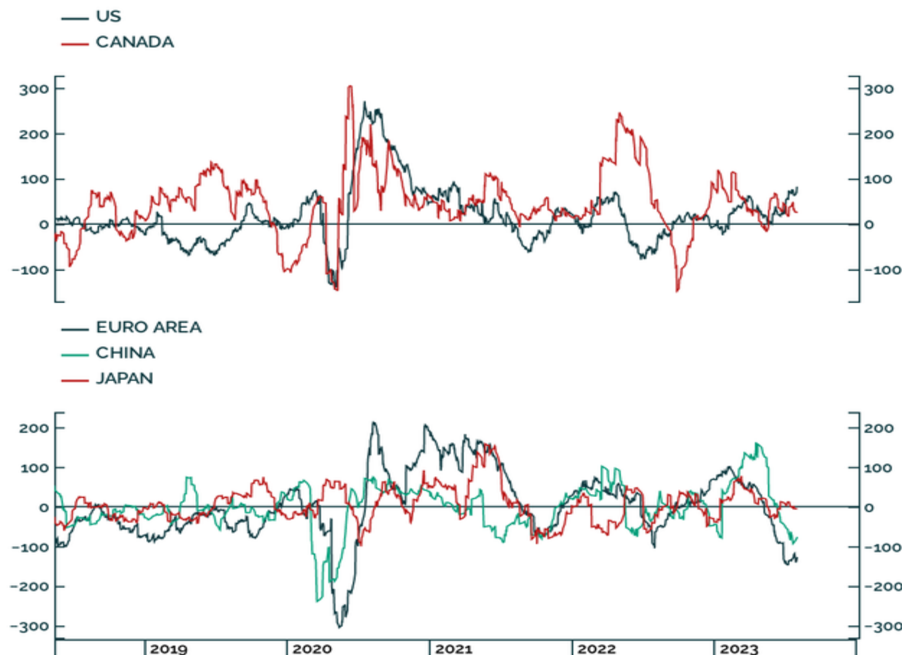
Both the Bank of Canada and the Federal Reserve commented that future rate hikes might be necessary, and that future interest rate decisions would be based on inflation and other economic data.

Markets seemed to shrug off other potentially significant developments, as the US debt ceiling standoff was resolved and the banking crisis from earlier in the year was quickly addressed by U.S. regulators and the Federal Reserve, who acted promptly to handle the situation. This quick response prevented any further problems, and there was no widespread negative impact from the bank failures and forced merger of Credit Suisse.

In terms of economic growth, Canada experienced what the Bank of Canada called "surprisingly strong demand". Real (ie, inflation-adjusted) consumption grew at an annualized rate of nearly 3.5%, with strength in all categories of spending that the Bank tracks. The United States saw a rise in household consumption spending and continued job gains, but there were signs of weakness in exports. Demand for services, such as travel, hospitality and housing, was notably strong. Globally, the Organization for Economic Cooperation and Development (OECD) expects moderate growth for the remainder of 2023 and into 2024.

We can see this dynamic in Figure 4 below. The Citi Economic Surprise Index looks at how countries have performed versus analyst expectations on key economic indicators. A positive value means that the country has been beating expectations on measures of economic activity. As we can see in the charts below, Canada and the US have generally exceeded expectations in 2023, whereas data in Europe and Asia have lagged.

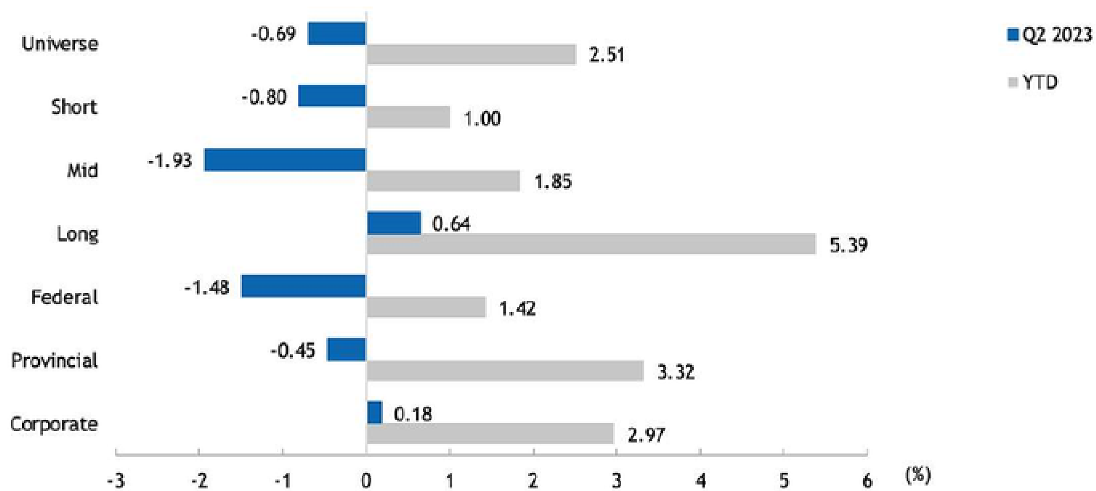
Figure 4: Citi Economic Surprise Index



In the fixed income markets, rates were volatile but generally moved upwards, as inflation and interest rate hikes put upward pressure on shorter and medium-term durations. This resulted in small losses for government bonds of most durations. The exception was long-term bonds, as yields for longer-dated bonds did not rise by as much. Corporate credit spreads, which measure how much additional yield investors demand to compensate for bond issuers' credit risk, narrowed during the quarter due to strong investor demand and an improved outlook for corporate profits. Narrowing spreads allowed corporate bonds to deliver small gains in the quarter.

We can see this reflected in fixed income sector performance in Figure 5:

Figure 5: Canadian Fixed Income Sector Performance, Q2, 2023

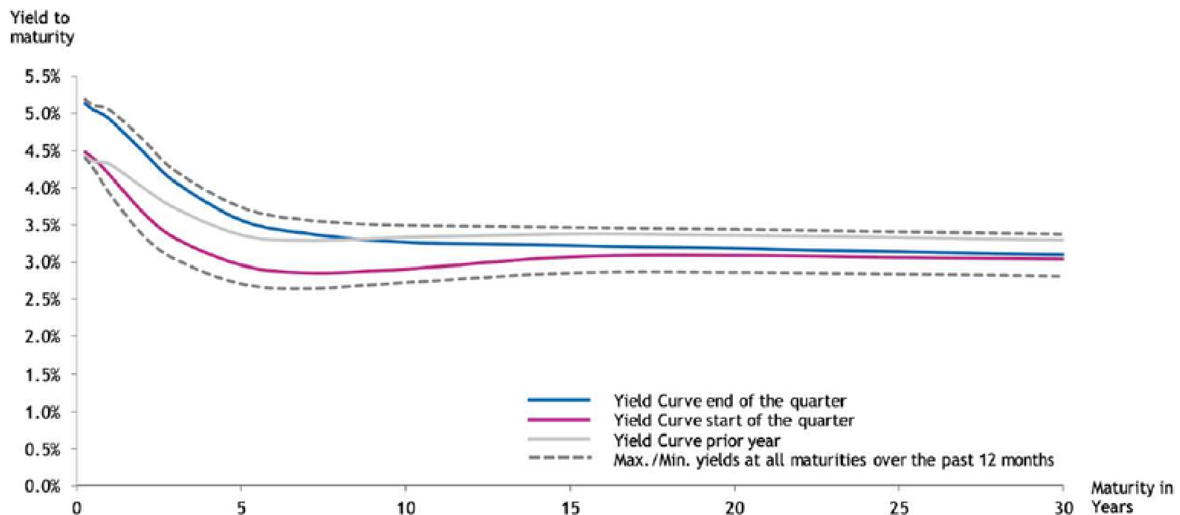


Source: Addenda Capital

The stronger rise in short-term yields compared to longer-term yields meant that the yield curve became even more inverted. Short-term yields are likely to stay high until central banks start cutting interest rates, which means that the yield curve is likely to stay inverted until signs of an economic slowdown become evident.

We can see all these changes illustrated in the yield curve in Figure 6:

Figure 6: Canada Yield Curve



Source: Addenda Capital

As we can see, yields for bonds with long maturities (e.g., greater than 15 years) hardly moved, while short-term rates rose roughly half a percentage point in response to strong economic growth and central banks' rate increases and comments.
As we move into the second half of 2023, markets remain focused on many of the same factors and risks that we saw playing out in the first half: economic growth, inflation, and interest rates.

As always, it's difficult to predict the direction of economies and markets. The inverted yield curve has historically been a sign that economic growth will slow, but economic growth, employment and consumption continued to be strong during the first half of the year. Many economists expect some kind of slowdown later in 2023 or in 2024, but even if they are right, the timing is proving very difficult to call.

Ultimately, for investors, the most important thing is to make sure that portfolios are diversified and allocated to investments that match their time horizon and risk tolerance. It can be tempting to respond to uncertainty by reducing market risk and moving to cash, but this can have long-term costs. For example, $100,000 invested in a balanced portfolio with 50% in bonds, 33% in global equities and 17% in Canadian equities, would have grown to $358,977 from January 2003 to June 2023. If the portfolio was left in cash for the best month in that period, the returns would be reduced by over $20,000. Being out of the market for the best 6 months would reduce returns by nearly $72,000, and missing the best 12 months would reduce returns to only $217,114, or over $120,000 less than if the portfolio had stayed invested.

Overall, it's important to remember that markets have their ups and downs, but that despite the short-term fluctuations, they have delivered solid returns over time. If you have questions or concerns, speak with your Encasa advisor to ensure that your organization's portfolio is properly aligned with your time horizon, risk tolerance and income needs.

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