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Q3 2023 MARKET AND ECONOMIC REVIEW

PREPARED BY ENCASA FINANCIAL

Executive Summary

- Q3 saw inflation reports come in slightly above expectations.
- Interest rates rose in response, leading to negative bond returns as bond prices fell.
- Equity markets sold off modestly in the quarter, partly in response to persistent inflation and higher interest rates.
- Economic growth in Canada remains modestly positive, although we may not yet be feeling the full impact of higher interest rates.
- Markets appear to be weighing positive news, such as continued economic growth, against potential negatives, such as stubborn inflation and interest rates. As a result, both stock and bond returns could fluctuate further in the coming months in response to economic data.

Capital Market Returns Q3 2023[1]

Product Name	Returns QTD	Returns YTD	Returns 1 Year	Returns 3 Years	Returns 5 Years	Returns 10 Years
Cash and Equivalents [2]	1.2	3.5	4.5	2.0	1.7	1.2
FTSE Canada Short Term Overall Bond Index	-0.1	0.9	1.6	-1.2	1.1	1.3
FTSE Canada Universe Bond Index	-3.9	-1.5	-1.4	-5.1	0.1	1.6
S&P/TSX Composite	-2.2	3.4	9.5	9.9	7.3	7.5
S&P 500	-1.2	12.8	19.7	10.6	10.9	15.0
MSCI World-GD	-1.3	11.3	20.6	9.0	8.8	11.9
Russell 1000 Growth	-1.0	24.7	25.7	8.4	13.4	17.7
Russell 1000 Value	-1.1	1.6	12.6	11.5	7.2	11.5
MSCI EAFE Growth-GD	-6.6	4.4	18.5	1.1	4.5	7.7
MSCI EAFE Value-GD	2.9	10.4	30.3	12.3	4.4	6.5

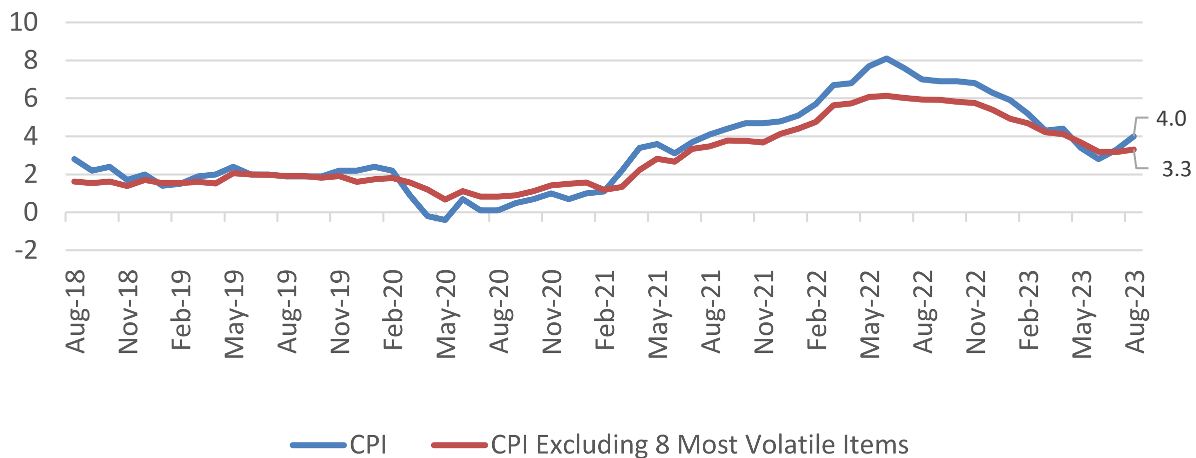
(1) All returns in Canadian dollars
(2) Bank of Canada 3-Month T-Bill

2023 has generally been good for equities, and not so good for bonds. For 2023 to date, stocks have been helped by economic growth and corporate earnings that have generally beaten expectations. Bonds have been hurt as inflation and interest rates have remained higher than many investors had hoped. Q3 saw stocks join in the bond markets' pain to some extent, as inflation and interest rates rose enough that the stock market took notice, leading to a modest sell-off in stocks in September that resulted in negative returns for the quarter from most major stock indices.

Inflation remains the main source of worry for bond markets. In most developed countries,

the third quarter saw inflation sitting well below year-ago levels, but still above typical levels from recent decades, and well above the levels that central banks are comfortable with. More problematically, in a number of countries, including Canada, inflation actually ticked back up a bit during the quarter. We can see Canadian inflation through August in the chart below:

Figure 1. Year-Over-Year Change in Canadian Consumer Price Index, Monthly to August 2023 (%)

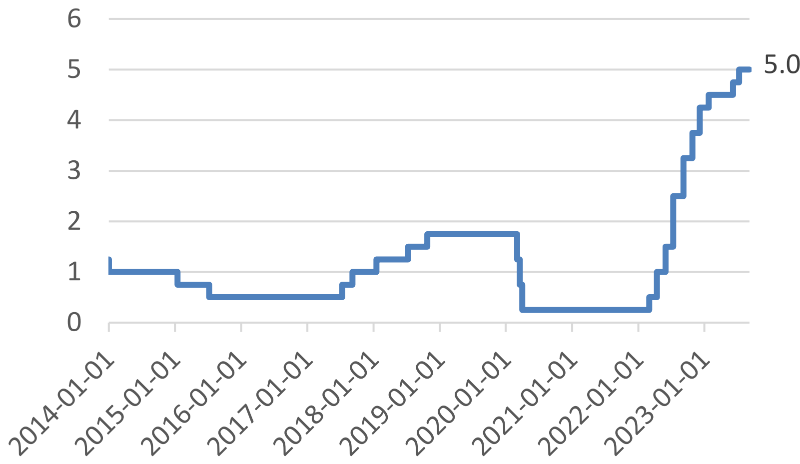


Source: Statistics Canada

Inflation in Canadian consumer prices started to pick up again during the quarter. This was partly the result of several items in the index, most notably energy prices, reversing declines that had helped bring down inflation in the first half of the year. More concerning for economists and bond markets was the role of housing, with shelter prices rising 5.5% year-over-year in July, and then 6.0% in August. The picture in the US was similar, with shelter costs contributing to inflation that came in slightly above market expectations. All that being said, following quarter end, Statistics Canada released inflation numbers for September that suggested inflation is slowing once again.

With inflation accelerating early in the quarter, or at least proving stickier than hoped, the Bank of Canada delivered a rate hike in July, bringing the target for its overnight lending rate to 5.0%.

Figure 2. Bank of Canada Target Rate (%)

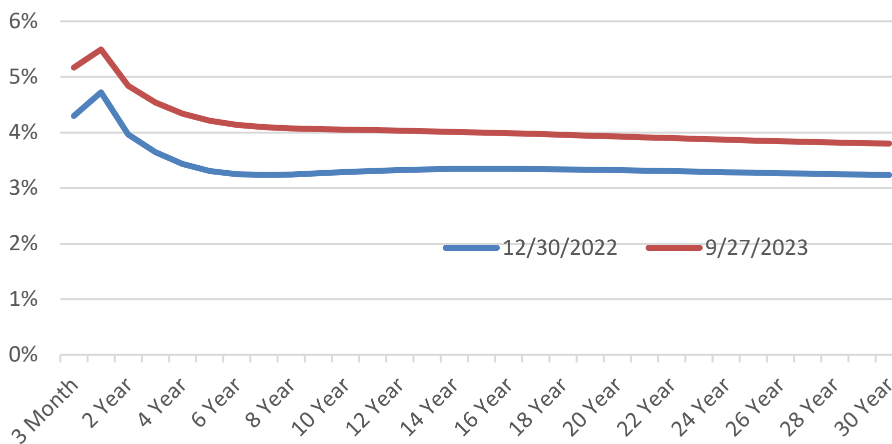


Source: Bank of Canada

The US Federal Reserve also hiked rates in July. 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.

Bond markets responded to higher inflation and central banks' comments with higher yields across all maturities, as we can see in the yield curve chart below:

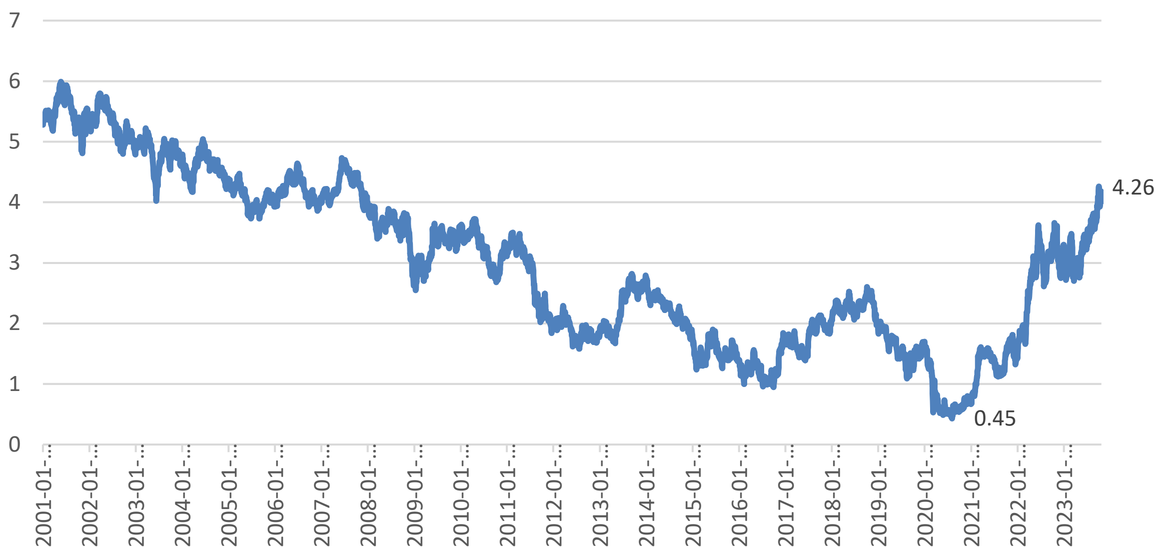
Figure 3. Government of Canada Yield Curve



Source: Bank of Canada

To put the magnitude of the increase in perspective, we can look at the history of the Government of Canada 10-year bond yield. As we can see in the chart below, the recent move up returned yields to levels not seen since before the Global Financial Crisis in 2008. The size of the move up since the lows of 2020 has reached almost 4 percentage points, which is a truly dramatic move for fixed income markets, especially over such a relatively short period.

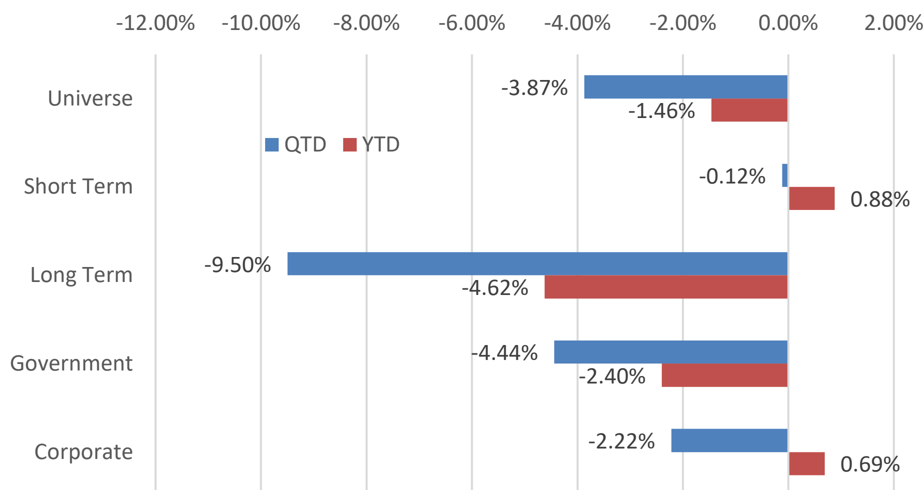
Figure 4. Government of Canada 10-Year Bond Yield (%)



Source: Bank of Canada

The rise in rates resulted in negative quarterly returns from all major sectors of the Canadian bond market, as bond prices fell in response to rising yields. As we can see below, all sectors of the Canadian bond market were negative in Q3, and only two, Short-Term Bonds and Corporate Bonds, remained positive for the year. The decline in Short-Term Bonds was less pronounced due to their lower sensitivity to interest rates; we can see the opposite in the case of Long-Term Bonds, which fell nearly 10%. The decline in Corporate Bonds was mitigated by their interest rate sensitivity, which, while not as low as that of Short-Term Bonds, is still lower than that of the bond market as a whole. Also helping Corporate Bonds was investors' continued confidence in the ability of corporate issuers to repay their bonds, which allowed credit spreads (the additional yield that bond buyers demand to compensate for the risk of non-payment by corporate issuers) to remain steady, or even to improve slightly for some bonds, over the quarter.

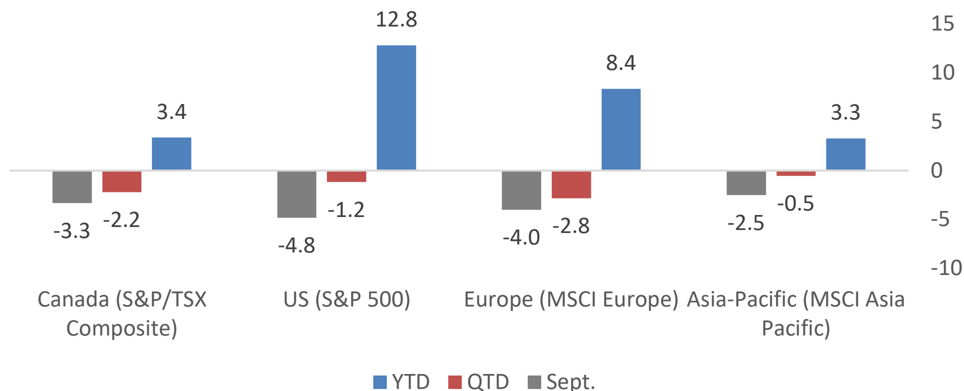
Figure 5. Q3 and Year-to-Date Canadian Fixed Income Sector Returns



Source: BlackRock

Stock markets took note of the move up in rates, with major markets around the world declining in September.

Figure 6. Stock Market Index Returns for September, Q3 and YTD 2023 (%)



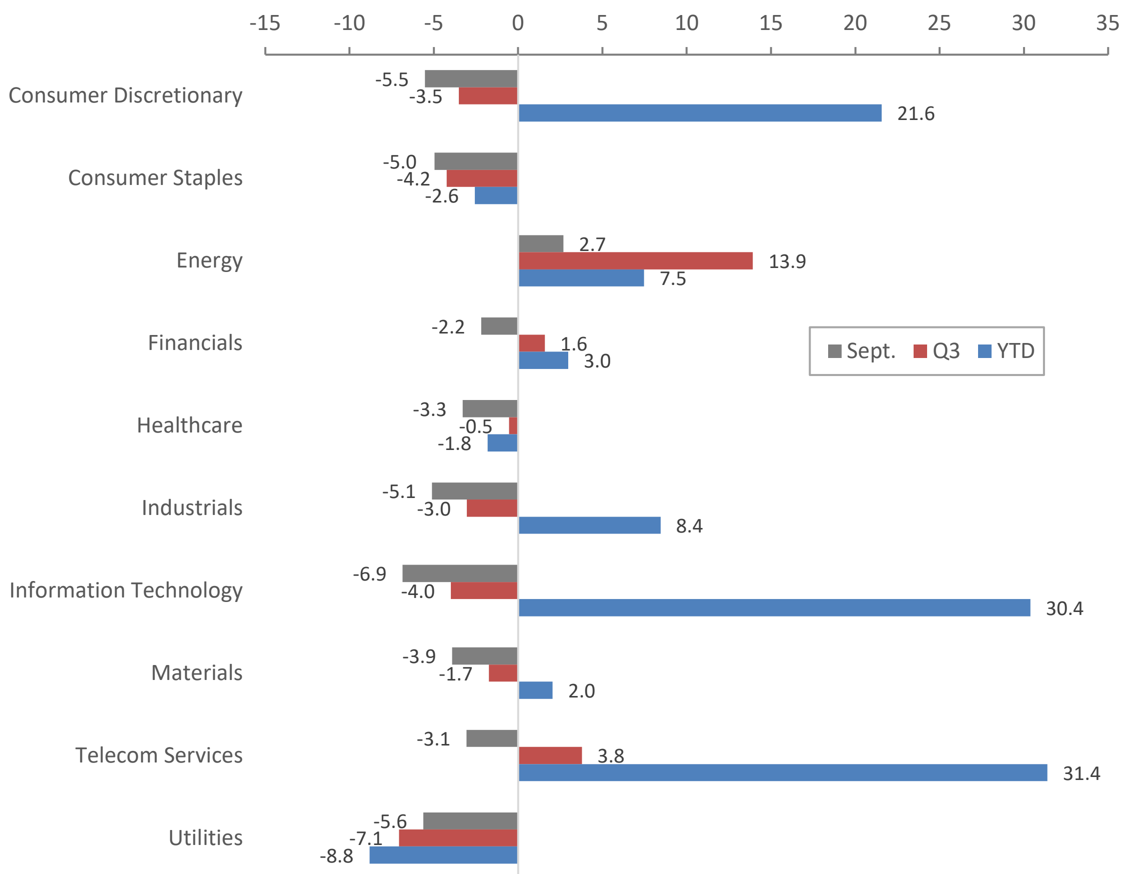
Source: *eVestment*

We can see the same pattern in each region in the chart above: in each case, September's declines (the grey column) resulted in negative returns for Q3 as a whole (red). In each case, equity returns remained positive overall for year (blue), but only by a small amount in the case of Canada and the Asia Pacific region. The US and Europe continued to show relatively solid gains.

As we've seen in past quarters, much of the gains that stock markets have made to date in 2023 have come from 3 sectors, Information Technology, Consumer Discretionary and

Telecom Services, in which large, US-based technology companies, such as Apple, Meta, Nvidia and Tesla, have been the biggest drivers. The growth prospects of large technology companies convinced investors to pay higher and higher prices for these stocks during the first half of the year. However, in September, this trend reversed itself, with declines in the Consumer Discretionary, Information Technology, and, to a lesser extent, the Telecom Services sector.

Figure 7. MSCI World Index Sector Returns for September, Q3 and YTD 2023 (%)



Source: *eVestment*

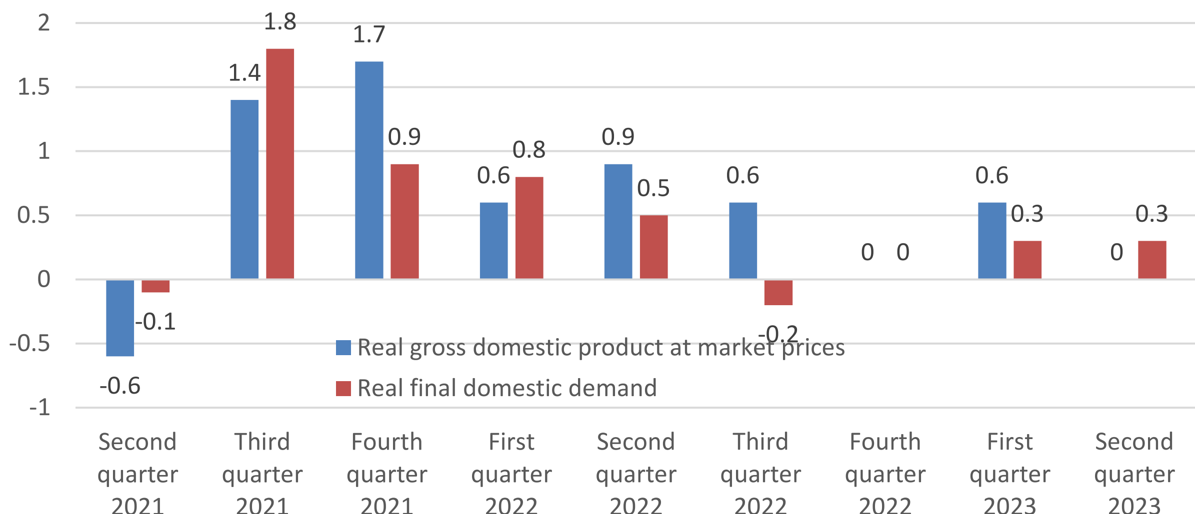
The only sector that experienced gains in September was Energy, helped by a rise in the price of oil as Russia and Saudi Arabia cut production. Oil prices briefly rose above $90 (USD) per barrel before giving back some ground in the final days of the month.
The rise in energy stocks, and the simultaneous fall in the sectors that the markets have viewed as promising long-term growth plays, suggests that some stock market investors may be coming to believe that inflation and higher interest rates may be with us for longer than originally hoped. The future profits of high-growth companies seem less attractive when high short-term interest rates offer attractive, low-risk returns. Conversely, energy stocks, which are currently generating strong profits and can help protect against future inflation, seem

more attractive to investors who believe that inflation will persist for some time.

Markets seem to be weighing potential scenarios while hoping for a "soft landing" from inflation. A "soft landing" scenario would involve economic growth and consumer demand easing just enough for inflation to come down, without the pain of a recession. The two major alternative scenarios would be 1) a "higher for longer" situation, in which economic growth and employment remain strong, resulting in continued inflation and the need for higher interest rates, or 2) a recession scenario, in which slowing economic growth and rising unemployment lead to lower demand, bringing down inflation and interest rates, but at some cost to the economy and to Canadian households.

For now, Canada seems to be leaning more towards scenarios of softer growth. Overall economic growth has slowed, as we can see in the chart below:

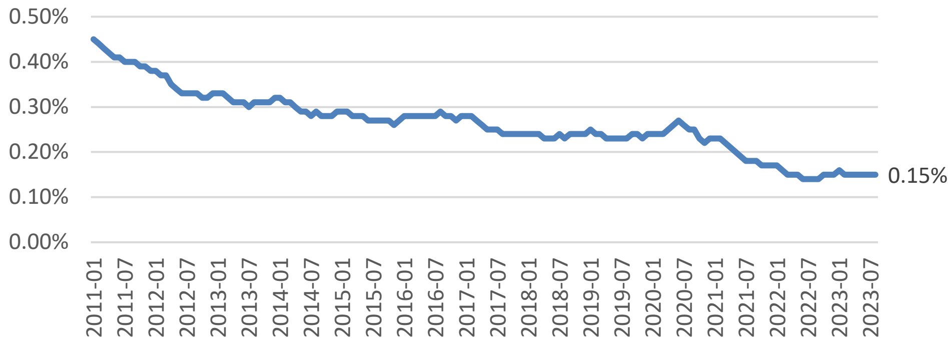
Figure 8. Measures of Gross Domestic Product Growth in Canada, to end of Q2 2023 (%)



Source: *Statistics Canada*

As we can see, two different measures of economic growth suggest that the Canadian economy was still growing coming into Q3, but only just. Nonetheless, Canadian consumer spending remains reasonably stable. We can get some sense of the health of household finances by considering the mortgage default rate. As we can see, it remains historically low, suggesting that Canadian households are still managing to pay their bills.

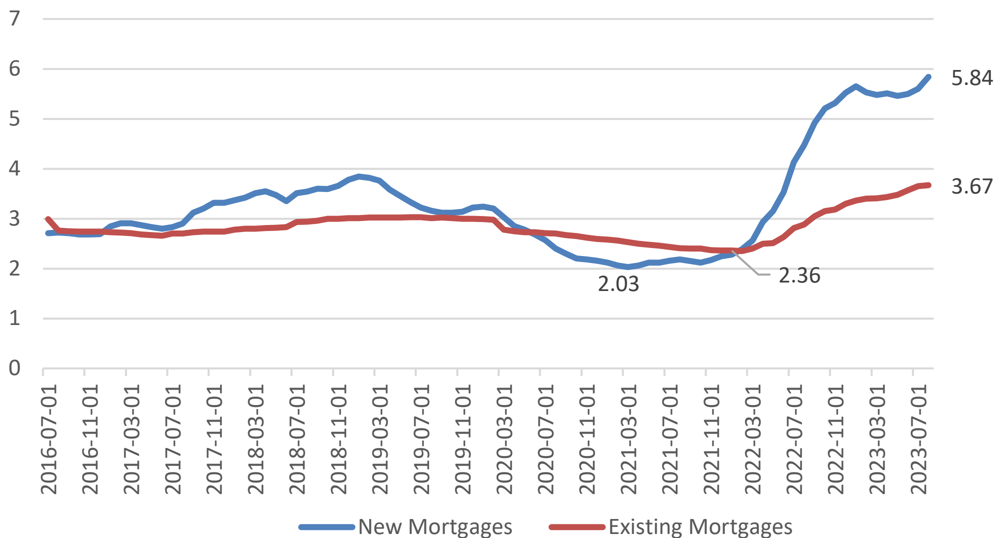
Figure 9. Canadian Mortgages in Arrears, as % of Total Mortgage Balances Outstanding



Source: *Canadian Bankers' Association*

Part of the explanation for this may have to do with the fact that mortgages don't all reset to higher interest rates at once, which means that the impact of higher rates might not be felt for some time. Fixed-rate mortgages will stay at "old" interest rates until their term ends. This can result in a lag of up to 5 years (or even longer in some cases) until a household has to renew its mortgage at a higher rate, leading to a delay between an increase in published interest rates and when those rates actually affect households. We can see this in the chart below, which shows the published 5-year mortgage rate compared to the average rate that households are currently paying on all outstanding mortgages:

Figure 10. Rates on New Mortgages vs Rates on Outstanding Mortgages



Source: *Bank of Canada*

We can see from the chart that through the end of August, 2023, the average rate on existing mortgages (the red line) has risen about 1.3% from its low in 2022, but that is far from the 3.6% increase in new mortgage rates (the blue line). This suggests that if inflation and interest rates remain high, mortgage costs could reduce consumer spending and put downward pressure on Canadian economic growth.

The delayed action of higher interest rates illustrates why it's often said that monetary policy operates with "long and variable lags". These lags make it difficult for market participants to assess what the ultimate effect of higher rates will be, or when they will be fully felt. We could remain in a seesaw market environment for a while as markets try to figure this out, with good news for growth being interpreted as bad news for inflation, and vice versa, with markets trading up or down based on individual data points without a clear trend.

Notably, stock and bond markets have reacted only in muted ways to geopolitical events in recent months. Headlines about a potential US government shutdown, the ongoing war in Ukraine and now Hamas' attack on Israel have caused only small and quickly reversed market moves. Markets seem determined to focus on inflation, interest rates and the economic factors that affect central bank decision-making most directly. That could of course change over time, but for now, inflation seems to be the focus.

As always, the most important thing for investors is to make sure that their investments line up with when they will need cash from their portfolio and with their ability to live through market fluctuations along the way. If you have questions or concerns, your Encasa advisor is available to review your organization's portfolio with you to ensure that it is aligned with your time horizon, risk tolerance and income needs.

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