After a strong start to the third quarter for markets, August's US Consumer Price Index reading disappointed investors, as it showed that despite a drop in energy prices, **inflation is becoming more widespread, with food, shelter, and medical costs all pushing higher**. Stocks sold off on concerns that a **more restrictive monetary policy** would likely be required going forward, potentially leading to a slowdown in global economic activity. Further unnerving investors was confirmation from the US Federal Reserve (the Fed) at its September meeting that a more hawkish approach might be required for the next two years in order to bring inflation back to its 2% annual target.

In Canada, the major sectors of the domestic stock market came under pressure in Q3. **Energy and materials were weighed down** by the possibility of falling demand. **The financial services sector was out of favour**, as its companies have had to pivot to adjust to a higher rate environment at a time when many consumers and businesses are overextended following a prolonged period of low borrowing costs. The Bank of Canada increased interest rates by a full point followed by a three-quarter point, bringing the effective lending rate to 3.25%. Canadian stocks as measured by the S&P/TSX Composite Index returned -1.4% this quarter, relatively outperforming other major financial markets so far this year.

The US dollar hit a multidecade high against major currencies, rising 8.6% relative to the Canadian dollar year to date. The S&P 500 Index, a broad measure of the 500 largest US companies, returned 1.6% (CAD), the only positive return among other major financial markets this quarter as a result of the currency effect. Of the 11 sectors, 10 had negative returns, with **technology and communication services being key underperformers**. During the quarter, the Fed announced two hikes of three-quarter points each, bringing the benchmark interest rate to the 3.00% to 3.25% range, the highest level since the 2008 financial crisis.

International equities continued to struggle through Q3 due to ongoing concerns regarding inflation, higher interest rates, and the Russia-Ukraine conflict as well as the **weakening of global currencies** relative to the Canadian dollar and even more so to the US dollar. China continues to face a housing crisis and is still dealing with a strict zero-COVID policy. International developed and emerging market stocks returned -3.2% and -4.1% respectively in Q3.

Bond yields continued to rise in the quarter, reflective of higher interest rates globally. The bond market has now reached a **record level of volatility** that has made it difficult for fixed income investors, who typically seek bonds for income and stability. Higher rates, however, will allow **investors buying new-issue bonds to lock in more attractive coupons going forward**. A basket of short-term Canadian bonds returned -0.3% for the quarter.

Following are the returns for major indices for the period ended Sept 30, 2022:

	Q3 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short-Term (FTSE 30-Day T-Bill)	0.5	0.8	0.8	0.6	0.9	0.8
Canadian Bonds (FTSE Short-Term Bond)	-0.3	-4.7	-5.2	-0.2	0.9	1.3
Canadian Stocks (S&P/TSX Composite)	-1.4	-11.1	-5.4	6.6	6.5	7.3
US Stocks (S&P 500)	1.6	-17.3	-8.3	9.5	11.3	15.5
Non-North American Dev. Stocks (EAFE)	-3.2	-20.8	-18.8	-0.6	1.1	7.2
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-4.1	-17.1	-17.8	1.1	1.5	4.5

* Q3, YTD, 1-year, 3-year, and 5-year returns are FTSE Emerging. 10-year returns are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard.

Outlook

Continued market volatility is expected as we enter the final quarter of what's been a challenging year for investors. Central banks have recently signaled that they will **act as aggressively as needed** in setting their monetary policies to combat persistent inflationary pressures caused by supply constraints exacerbated by the Russia-Ukraine war and a robust economy coming out of the COVID-19 pandemic. At the expense of the economy and the markets, the Fed is justifiably doing what it can to ensure that a detrimental wage/price spiral doesn't materialize. If higher wages are achieved due to labour shortages through collective bargaining and in inflation-adjusted employment contracts, stamping out price inflation would become an increasingly difficult task.

It typically **takes time for the impact of restrictive monetary policy** to be reflected in economic data. Consequently, with consumer and corporate debt at historically high levels, market participants are concerned that the Fed might "overshoot," resulting in a recession for the US economy in 2023. The inflation experienced in the US is very much a **global phenomenon** also being felt here in Canada and overseas. Accordingly, most global economies will be affected by it. Thankfully, one silver lining of central bank tightening is that, unlike this time a year ago, the world's central banks now have **significant room to adjust their policies to be more accommodative** if necessary.

Inflation is a major headwind for all markets, but the outlook for each geographic region varies due to market composition as well as geopolitical factors. For example, **higher interest rates will continue to pose a problem for the US market**, which is dominated by highly leveraged growth-oriented companies, such as those in the tech sector. The US midterm elections will also garner investor attention through November, as the outcome will impact investor sentiment. The Canadian equity index has a heavy concentration of energy and financial stocks, so the **S&P/TSX Composite Index will be relatively more sensitive to falling commodity prices** if demand wanes. For Canada's banks and other lenders, these rising rates could also contribute to both slower loan growth and a higher risk of nonperforming loans. **Europe's energy dependence on Russia may lead to an even more severe recession for the Continent**. **The surging US dollar will also negatively impact both Europe and emerging markets**. European nations will need to spend more to import US-dollar-denominated energy and goods, further stoking inflation. A higher US dollar is also detrimental for emerging market countries that borrow in, and need to service their debt in, US dollars.

The investing environment may be worrying in the near term, **but like all market cycles, this too shall pass**. As has been the case with past periods of volatility, our message is to remain disciplined in the interim. **Markets could snap back very quickly** if there is convincing evidence in upcoming data releases that inflation is coming under control and the labour market is normalizing.

Portfolio Strategy

It has been a very **weak year for almost all asset classes** as central banks struggle with higher inflation. While declines of 10% to 20% for equity markets are not unexpected and typically occur every few years, the **negative bond returns this year are unusual** and perhaps discomforting, particularly for more conservative investors.

Bond prices move inversely to interest rates, so when interest rates are rising, prices are falling. This year, **central banks are raising rates at a much faster pace than anticipated** to deal with inflation. For some context, one year ago they were not planning to raise interest rates at all this year, believing that the inflation was transitory. We have had numerous periods in the past when interest rates rose quickly, but never from the extremely low levels witnessed during the COVID-19 pandemic. In these previous periods, the much higher interest rates helped offset any price declines. With rates being so low following the pandemic, however, there has been very little in the way of an income return on bonds to offset the price decline. In our portfolios, we **focus on shorter-term bonds for more capital stability**, which has helped reduce the downside compared to longer-term bonds. As an example, the Vanguard Global Aggregate Bond ETF is down almost 15% in the past year.

While this may be small comfort currently, as previously noted, one positive development of a return to more normal interest rates is the opportunity to earn higher returns on fixed income investments in the future. From the index return chart on page 1, the annualized return of a short-term bond index over the past 10 years has been 1.3%. GIC rates are now in the 4.5% range, so we have been rebuilding a laddered maturity schedule to lock in these higher guaranteed returns. Funds will also be able to lock in more attractive yields as bonds mature, so we should start to see **higher fixed income returns than what we have seen in the past 10 years**. Bonds remain an important asset class in a well-diversified portfolio to moderate return variability, despite some of the near-term challenges, as we move back to more normal rates.

In the equity component, **uncertainty will remain elevated** until we have greater clarity on the inflation outlook. While equity prices may fall further in the near term, historically markets rebound and post positive returns following similar periods of weakness. Unfortunately, no one can predict with any accuracy when equity markets will hit bottom, but we do know it will typically be when the news is at its worst**.** For longer-term investors, a disciplined strategy of **adding to stocks on weakness** has always been a rewarding approach.