# 2023 Second Quarter Review

US equities posted the **strongest returns** of the major equity markets during the first half of the year as **growth-oriented tech stocks recovered**. Other sectors had trouble keeping pace due to concerns over banking-sector turmoil, the threat of government debt default, and a potential economic slowdown due to high interest rates. Since early last year, the policy rate of the US Federal Reserve (the Fed) has **increased by 5%** and currently stands at the 5.00%–5.25% range. The Fed's messaging is that any additional hikes will be data dependent but that further increases may very well be needed to bring inflation down to the 2% target. The S&P 500 Index, a broad measure of the 500 largest US companies, returned 14.3% (CAD) year to date, while the tech-heavy NASDAQ closed its **best first half in 40 years**, returning 31.7% (CAD) over the same period (following a 33% drop in 2022).

Canadian stocks, as measured by the S&P/TSX Composite Index, returned 1.1% this quarter. Investors are uneasy over **falling demand for energy and higher credit provisions for potential loan losses** set aside by the banks. After a pause since January, the Bank of Canada raised its benchmark interest rate to 4.75% in June following an unexpectedly hot inflation reading for April. In May, inflation fell to a two-year low of 3.4%, mainly due to shrinking demand for energy. However, this is unlikely to dissuade the Bank of Canada from another hike this summer, as consumption growth was strong and broad based, with the costs of food, shelter, and services continuing to go up.

Momentum slowed in the second quarter for international developed and emerging market stocks, which returned 0.8% (CAD) and -1.2% (CAD), respectively. Ongoing geopolitical tensions, talk of deglobalization, and inflation remain key issues as central banks overseas continue to tighten policy. China's post pandemic **recovery has also waned** due to weak investor confidence and low consumer demand, which has hurt emerging market stocks.

Rising interest rates weighed on global bond prices in the second quarter, but demand for bonds has been increasing, with **yields becoming more attractive**. A basket of short-term Canadian bonds returned -0.8% in Q2. GIC rates in Canada have also moved higher across one- to five-year maturities.

Following are the returns for major indices for the period ended June 30, 2023:

| | Q2 actual | YTD actual | 1-year actual | 3-year annualized | 5-year annualized | 10-year annualized |
|---|---|---|---|---|---|---|
| Canadian Short Term (FTSE 30-Day T-Bill) | 1.1 | 2.2 | 3.7 | 1.4 | 1.4 | 1.1 |
| Canadian Bonds (FTSE Short-Term Bond) | -0.8 | 1.0 | 1.4 | -1.0 | 1.1 | 1.4 |
| Canadian Stocks (S&P/TSX Composite) | 1.1 | 5.7 | 10.4 | 12.4 | 7.6 | 8.4 |
| US Stocks (S&P 500) | 6.4 | 14.3 | 23.0 | 13.5 | 12.5 | 15.5 |
| Non-North American Dev. Stocks (EAFE) | 0.8 | 9.2 | 22.1 | 7.9 | 4.5 | 7.9 |
| Emerging Market Stocks (FTSE*/MSCI) | -1.2 | 1.7 | 4.1 | 2.7 | 2.3 | 5.4 |

* Q2, 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

To this point in the year, equities, particularly in the US, have **performed better than expected** despite sticky inflation, high interest rates, and the possibility of a recession on the near horizon. US inflation has dropped by more than half from where it was last summer, but there is still a ways to go to bring it back down to the 2% target. Policy makers are encouraged at the lower demand for commodities, supply chains coming back into line, producer prices falling, and wage growth slowing. However, the **hot services sector and rising costs related to shelter** are currently the most significant roadblocks to lowering inflation. A slowdown in economic activity is likely needed for the final stretch. And so, while interest rates are probably close to their peak, central banks are committed to keeping them elevated until inflationary pressures have fully abated.

So why all the market enthusiasm if the outlook for economic growth is cloudy? When you distill the performance for US stocks year to date, it's apparent that the positive returns have not come from broad-based optimism. In fact, a small number of the country's largest companies are responsible for the rise of the S&P 500 Index in the first half of 2023. The **rapid emergence of the artificial intelligence (AI) boom** has sent valuations of a handful of tech-oriented companies skyrocketing. The top 10 companies by market capitalization are trading at almost **twice the valuations** of the remaining stocks in the index, which are closer to historical averages. This suggests that outside the latest tech-driven boom, investors remain cautious. US stocks might do well in the back half of 2023 with AI in the driver's seat, but we've learned from history to be skeptical of any trend where investor behavior seems overly exuberant.

Without a meaningful tech-sector weighting to buoy performance, the Canadian equity market outlook is more challenging. At home, natural resources (including oil and gas) and financial services companies make up the majority of our index. **Falling demand for commodities** in a recessionary environment will impact materials and energy stocks, and **deteriorating credit conditions** as Canadians have more difficulty servicing their debt will impact our banks. These factors may act as headwinds in the near term for Canadian stocks.

Over the last year, overseas stocks have posted returns almost as high as the S&P 500 Index in Canadian dollars. However, the landscape in the Eurozone and the UK has become less favourable for equities. In Europe, GDP growth was negative in both Q4 2022 and Q1 2023, as the economy there is showing **signs of weakness** due to ongoing monetary tightening. GDP has been flat over the past year in the UK and is still lower than it was prepandemic. Yet Britain is now the **only major economy with rising inflation**, meaning that the Bank of England will likely bring rates even higher. For emerging market stocks, persistent inflation, a high US dollar, and slowing demand for goods will continue to pose problems for the asset class, which has underperformed of late.

We know that inflation will eventually come down, and so will interest rates, and we assume that lower rates and prices would significantly benefit the world's equity markets. A drop in interest rates would also be a welcome development for the bond market, as prices of existing issues would rise. However, until the path to a more accommodating environment for stocks and bonds becomes clearer, investors should expect continued volatility.

## Portfolio Strategy

With the possibility that we are in the final chapters of this rate cycle, we are **opportunistically enhancing income streams** across client portfolios. On the fixed income side, rates on cash-equivalent high-interest savings funds are attractive, as they are currently paying **close to 5%**. As of early July, yields of 5% were also available across all GIC maturities. With the expectation that rates will come down, we believe a strategy to buy **GICs at longer-dated maturities**, forgoing some liquidity, will be beneficial to clients. Canadian dividend-paying stocks, which have a track record of increasing their dividends over time even through difficult periods, are also poised to do well as rates fall. We are selectively taking advantage of lower valuations for these companies, as there are opportunities to **lock in growing income streams at a preferred rate** by historical standards, thereby being "paid to wait" until a price recovery happens.

Both near- and long-term performance for US stocks has been strong, and this has pushed the geographic weighting higher in many client portfolios. Therefore, where rebalancing is required, we would use this **strength to reallocate into other regions**. This includes the Canadian dividend stocks already mentioned but also international and emerging market stocks. These regions have both underperformed over the last several years, and we believe this leaves room for relatively more upside going forward.

While we may make minor adjustments to portfolios where appropriate, we believe that maintaining a **diversified and disciplined** approach to portfolio construction continues to be the strategy that will win out in the long term.