2023 First Quarter Review

Stocks started the year on a turbulent ride. Equities surged in January on hopes that upward price pressure was easing. However, the script quickly flipped in February with the US Federal Reserve (the Fed) reacting to a **hotter-than-expected US inflation** reading by communicating that an even more aggressive policy stance might be needed to cool prices. On top of this development, investors then had to contend with **turmoil in the banking sector** caused by capital mismanagement at financial institutions that were not adequately positioned to deal with rapidly rising interest rates. Contagion spread from the US regional banking system to Europe, with the Swiss government facilitating the snap takeover of embattled Credit Suisse by UBS. As it became apparent that the fallout from these events would be contained with the help of central banks and governments, **stocks mostly recovered** by the end of the quarter with positive returns across indices.

The Bank of Canada became the first major central bank to **pause interest rate hikes** in March. After eight consecutive increases, the target overnight rate was held at 4.5% as policy makers stopped to assess the impact of tightening. Like other central banks, though, it is prepared to resume rate hikes if inflationary pressures do not subside. Inflation in Canada eased to 5.2% in February, but **rising prices for food and shelter** continue to weigh on consumers while energy costs are expected to increase again. Canada's well-regulated banking system has thus far helped to protect our banks from the recent crisis. Canadian stocks, as measured by the S&P/TSX Composite Index, returned 4.6% this quarter.

In the United States, the possibility of a forthcoming recession is becoming a reality as **credit conditions continue to tighten**, with banks likely to adopt more conservative lending standards while the Fed maintains its focus on combatting inflation. The Fed announced another 0.25% rate bump, increasing the overnight lending rate range to 4.75%–5.00%. Despite the recent banking shock waves, the S&P 500 Index, a broad measure of the 500 largest US companies, returned 7.4% (CAD) this quarter as investors raised their expectations for rate cuts later this year.

International developed and emerging market **stocks proved resilient** to the banking issues and weaker economic forecasts with returns of 8.4% and 3.0% (CAD), respectively. The reopening of China's economy has helped ease supply chain woes. A **falling US dollar** also improved international trade conditions as import costs for the region were reduced. Not all is rosy, however, as overseas economies are still dealing with high inflation and geopolitical headwinds.

Bonds rallied in the quarter as the unfolding banking crisis resulted in investors seeking safety in high-quality bonds, driving yields lower and prices higher. Canada's "pause" and the quarter-point hike by the Fed versus the initial expectation of a half-point hike also supported bond prices. A basket of short-term Canadian bonds returned 1.8% in Q1.

Following are the returns for major indices for the period ended March 31, 2023:

	Q1 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	1.1	2.8	1.0	1.2	1.0
Canadian Bonds (FTSE Short-Term Bond)	1.8	1.8	0.7	0.0	1.3	1.5
Canadian Stocks (S&P/TSX Composite)	4.6	4.6	-5.2	18.0	8.8	7.9
US Stocks (S&P 500)	7.4	7.4	0.0	16.9	12.2	15.5
Non-North American Dev. Stocks (EAFE)	8.4	8.4	6.8	11.4	4.5	8.1
Emerging Markets Stocks (FTSE / MSCI Emerging)*	3.0	3.0	-2.6	7.7	1.2	5.0

* Q1, 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

While recent data readings have shown that **inflation is slowing**, price pressure in the United States remains elevated, and annual CPI growth is still far above the Fed's 2% target. Despite cracks starting to form in the system, with Q1's banking crisis being a prime example of the **toll exacted by aggressive policy tightening**, the Fed has communicated that it intends to keep rates high to tackle inflation until at least the end of 2023. However, market expectations differ, with investors fearing a recession is on the horizon and accordingly pricing in some potential cuts this year.

Investors have many reasons to feel uneasy about the near-term prospects for the economy. The unexpected rapid rise of interest rates from near zero has put stress on consumers and corporations. Higher costs of borrowing and servicing existing debt, shrinking household wealth, and higher costs of living have resulted in **lower discretionary spending and reduced consumption**. Corporations are dealing with higher costs of capital, higher production inputs, and a shortage of labour at a time of falling demand for goods and services. Credit conditions have become even more challenging due to the recent strains on the banking system. The **crisis appears to be contained**, with governments stepping in to provide a backstop, but banks are expected to reform their lending practices, and the result of this has been likened to an additional 1.0%–1.5% increase in interest rates. There is also a slew of geopolitical issues to contend with—notably, the ongoing conflict between Russia and Ukraine along with cooling relations between China and rest of the Western world—which will likely **add to the cost of production** given the integration of supply chains and ultimately lower GDP going forward. Also, oil output controls initiated by OPEC in April will further stoke inflation.

Stocks will likely continue to **experience volatility** this year due to the great degree of uncertainty. That said, during times like these we like to remind our clients that historically, **stocks climb a wall of worry**. There has been no shortage of headwinds over decades of investing (e.g., the credit crisis of 2008–2009, the tech wreck of 2000–2001, Black Monday in 1987, to name just a few), but the long-term trend for equities has been to the upside if your time horizon allows for it. In our view, this time is no different. The challenges for financial markets since the start of 2022 have been interest rate driven, and there is wide speculation that **rates have peaked**, as the recent banking issues and the possibility for instabilities in other areas of the market have tied the Fed's hands from making further material increases. So, if we're nearing the end of Fed tightening and the prospect for lower rates begins to materialize, be it later this year or next year, markets should benefit as they have in past cycles when credit conditions ease. It is also reassuring to know that in the meantime, central banks and governments appear ready to intervene if needed.

The **tech-heavy US market** has benefited from falling yields of late, and the price-to-earnings ratio for the S&P 500 Index suggests that US stocks are now overvalued vis-à-vis historical averages. The US market has become heavily concentrated, with the top five members of the S&P 500 (all tech related) accounting for a **whopping 23%** of the index, which is a recent record. It is notable, though, that if you strip out these biggest names, the broader US market appears more attractive from a valuation standpoint.

In Canada, the past year has emphasized the pitfalls of the narrow composition of our country's market, which is dominated by two sectors—financials and resources. **Falling demand for energy and contagion across financial services holdings** weighed on the S&P/TSX Composite Index. Canadian investors tend to have a home bias, and periods like this are helpful to highlight the benefits of diversification across geographies.

Overseas economies and their markets have proven resilient. On a relative basis, analysts have suggested that after a long period of being out of favour with investors, international stocks might be poised to outperform other regions going forward. The more **balanced composition** of international equity markets (much less technology than the US and lower in resources than Canada) is also an appealing characteristic for Canadian investors looking to diversify their portfolios.

Portfolio Strategy

With interest rates still well above where they were through the height of the COVID-19 pandemic and into the beginning of 2022, we continue to **take advantage of higher yields** for fixed income investments via a combination of GICs and bonds. Longer-dated GICs (in the three- to five-year maturity range) currently offer rates that exceed similar-term Government of Canada bonds by almost 1.5%. As a result of this spread, we believe it is an ideal time to rebuild GIC ladders, forfeiting some liquidity where it makes sense depending on portfolio circumstances. Bonds are also offering relatively attractive yields. Unlike GICs, bonds have the benefit of daily liquidity; consequently, their **prices are sensitive to movements in rates**. We cannot predict if rates will go up or down, but we do know that if rates fall, bond values should appreciate and today's GIC rates will no longer be available to investors. On the other hand, if rates stay high or even rise, there will be more chances to enhance portfolio income as cash is deployed at higher yields.

For equities, in line with our investment philosophy we continue to maintain **diversified portfolios by geography and style**. US stocks have enjoyed a prolonged period of outperformance, contributing to expensive valuations and relatively higher US weightings in portfolios. The top end of the US market is not well diversified in that it is heavily concentrated in the world's largest tech-oriented companies. For example, in Q1 the S&P 500 Index was up 3% in USD terms. A closer look into performance attribution for the index shows that Facebook, Amazon, Apple, Microsoft, and Google posted a 19% quarterly return, recouping some of their 2022 losses, while the remaining 495 companies in the index were flat for the same period. In rebalancing, we look to **international and Canadian markets to broaden exposure**. By purchasing international stocks, investors can benefit from relatively cheaper valuations, higher dividends, and less-concentrated sector composition. Our domestic stock market also offers well-protected oligopolies, with cash-rich businesses that have historically increased dividend payments.

Q1 offered yet another lesson in the **importance of maintaining discipline**, which is also a main tenet of our investment philosophy. It was certainly a volatile quarter for stocks, but equity valuations still managed to end March at meaningfully higher levels than at year-end, showing again that keeping an even keel during times of stress is often a winning strategy for portfolios—and one that Milestone will continue to follow.