2023 Third Quarter Review

The third quarter of 2023 proved difficult for US stocks, as the likelihood of a **prolonged period of higher rates** due to stubborn inflation, the threat of a government shutdown, and the impact of the United Auto Workers union strike all dampened investor sentiment. The S&P 500 Index, a broad measure of the 500 largest US companies, declined 1.1% (CAD) this quarter. In August, year-over-year inflation increased to 3.7% from July's 3.2%, primarily due to **rising gasoline prices**. While core inflation has been trending downward in recent months, it remains far from the 2% target. After holding its overnight lending rate to the 5.25% to 5.50% range, the US Federal Reserve (the Fed) signaled that borrowing costs must remain higher for longer given the persistent strength of the economy, raising concerns over a higher probability of a recession.

In Canada, flat year-over-year GDP readings over the summer suggest that higher rates are starting to work to **slow economic growth**. However, inflation is still reading close to 4%. Similar to the Fed, our central bank communicated in September that it is committed to **maintaining a restrictive monetary policy** until prices fall, and this may take more time than initially expected. The nation's major financial institutions, which account for a significant weighting of the Canadian stock market, have set aside significant **provisions for potential loan-related losses** that may take place in the coming months with no near-term relief in sight for borrowers. While energy stocks have performed relatively well this year, helping to offset other challenged areas of the market, oil prices began to come under pressure late in the quarter, as demand was projected to drop. Canadian stocks, as measured by the S&P/TSX Composite Index, declined 2.2% this quarter.

International developed stocks also fell in Q3, declining 1.9%, while emerging markets posted positive returns of 0.7%. Like in North America, **prices in developed overseas countries have fallen** following aggressive tightening, but not to the desired degree. Hopes had been high that China would enjoy a robust recovery after it lifted COVID-19 lockdowns, but that prospect appears to have fizzled, as the country has seen its economy slow of late.

At the end of September, bond investors **extended losses as yields climbed higher**, nearing highs not seen since 2007. Short-term bonds in Canada and the US are yielding over 5%, and longer-term bonds now also sit close to that mark. The FTSE Short-Term Bond Index, comprising Canadian bonds with maturities of between one and five years, was flat for the quarter.

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

	Q3 actual	YTD actual	1-year actual	3-year annualized	5-year annualized	10-year annualized
Canadian Short Term (FTSE 30-Day T-Bill)	1.2	3.5	4.4	1.8	1.6	1.2
Canadian Bonds (FTSE Short-Term Bond)	-0.1	0.9	1.6	-1.2	1.1	1.3
Canadian Stocks (S&P/TSX Composite)	-2.2	3.4	9.5	9.9	7.3	7.5
US Stocks (S&P 500)	-1.1	13.1	19.7	10.7	10.9	15.0
Non-North American Dev. Stocks (EAFE)	-1.9	7.1	23.7	6.3	4.2	6.7
Emerging Market Stocks (FTSE)	0.7	2.4	9.2	0.7	3.2	5.5

All returns in Canadian dollars. Source: SS&C Technologies and Vanguard.

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Outlook

Navigating the markets over the next several months will continue to be challenging as investors contend with a **wide range of uncertainties**. Ongoing inflationary pressures and resulting tighter credit conditions are at the top of the list of headwinds in addition to the potential for a US government shutdown in the near term, important upcoming election outcomes, escalating geopolitical tensions and the wars in Ukraine and now Israel. To this point, major economies have defied expectations, plowing along despite the circumstances. However, inflation has remained stubbornly high as the **cost of food, shelter, energy, and travel remain elevated**. While signs of softening in prices have become evident, as consumers are spending selectively with borrowing costs up, central banks are expected to maintain a restrictive stance until their goal of 2% annual price growth is met.

Investors are concerned that keeping rates higher for longer to combat inflation could lead to a more severe economic downturn than initially anticipated. And while there is speculation that we may be nearing the end of rate hikes, policy makers are understandably unwilling to provide any guidance on the trajectory of interest rates, as this might have the effect of encouraging risk-taking behaviour and spending, which could impede the goal. Until widespread evidence exists that price growth is abating and the job market is loosening, we can **expect continued volatility** for both fixed income and equity markets.

In the US, stock performance has been heavily skewed upward by the largest seven companies in the S&P 500 Index. Near the end of September, Apple, Amazon, Microsoft, Google, Tesla, and Meta were up 50% while the rest of the market gained only 4%. The **rapid emergence of AI technology** is behind this disparity and has been a welcome positive catalyst for markets during an otherwise challenging time. Like the evolution and adoption of the internet, AI has the potential to dramatically impact our daily lives and the way we do business, and investors will be paying close attention to this trend to see how it plays out in the future.

Canada's market is **heavily concentrated** in two main sectors: energy and financials. Higher oil and gas prices have benefited energy stocks, and this has helped to partially offset the decline in financial services and other **interest rate–sensitive equities**. The country's banks have experienced lower profits as they set aside provisions for the possibility of losses on their outstanding loans. Notably, though, banks tend to overstate these provisions and have historically clawed them back as conditions improve. They also have a track record of maintaining and even growing dividend payments through difficult periods.

Overseas developed economies have proven resilient despite their proximity to the Russia-Ukraine conflict and their reliance on gas supply from Russia, recovering well from the initial shock of the invasion. However, without a heavy tech weighting, these markets are susceptible to recessionary pressures should rates stay higher for longer. China's sputtering economy and issues with its **heavily leveraged property developers** will continue to be a drag for emerging market stocks.

As reflected in the index return table on page one, US equities, as represented by the S&P 500 Index, have been the best-performing asset class by a wide margin over the past 10 years. This is largely due to the **technology weighting in the S&P 500 Index**, which is far higher than other global equity indices—including Canada, which has a very low weighting. Much has been written about the top stocks in the S&P 500 Index dominating returns so far this year and how concentrated the index is, with the **top 10 stocks representing approximately 30% of the holdings**. While it is true that the index has become more top heavy lately, it is not uncommon for the top companies to represent an outsized weighting in the index.

For example, in 1980 almost 26% of the index was represented by the top 10 companies, and since then the weighting is usually around 20%. This year has been somewhat different, as the heavily weighted companies are also the best-performing ones. This leadership changes from year to year, which is one of the reasons the index is so difficult to outperform over time through active stock picking. By owning the index, investors are assured of having **exposure to the best-performing companies**. While it is very difficult to envision a future where Apple, Amazon, Microsoft, and other leading companies don't continue to dominate, new leadership will likely emerge. IBM and General Electric were two of the largest companies for decades, and they now are both outside the top 50. Just as evolving technology has created today's big winners, AI will likely create the big winners in coming decades. Trying to predict these companies in advance given how quickly technology changes will be exceptionally difficult.

Here in Canada, we have an index that is very underweight on technology and tilted toward financials, resources, and regulated industries like telecom and utilities. Many of these companies pay above-average dividends, and over time investors have been rewarded by owning dividend-paying stocks. Although the current rising-interest-rate environment has resulted in weaker returns recently for dividend-paying stocks, we continue to believe this is an **attractive asset class to provide a tax-efficient rising income stream** over time. Many companies now have dividend yields in the 5% to 7% range given the recent increase in rates.

Fixed income investing has been challenging in the past couple of years as we move through the first rising-interest-rate environment in a long time. When **interest rates increase, bond prices fall**, so returns have been lackluster of late, particularly impacting more conservative investors. The higher-rate environment presents an opportunity, though, to create a **laddered maturity schedule**, as interest rates are now at levels that are closer to historical averages. The past 10 to 15 years have been an anomaly, and with rates now over 5% for maturities of one to five years, we are using this opportunity to lock in these rates, primarily with GICs. These rates are higher than comparable government bonds, with the only drawback being liquidity, so we want to be mindful of ensuring enough liquidity in client portfolios to meet cash flow needs.

As always, there are uncertainties ahead. Eternal blue skies would be wonderful, but that never happens in markets, and now is no different. From rising rates, inflation, political dysfunction in the US, rising geopolitical concerns, and wars in Ukraine and Israel, there is no shortage of clouds on the horizon. We do expect to see added volatility in the near term as we navigate these challenges, but maintaining well-diversified portfolios that are tailored to client circumstances within acceptable risk tolerance levels is the key to longer-term success.