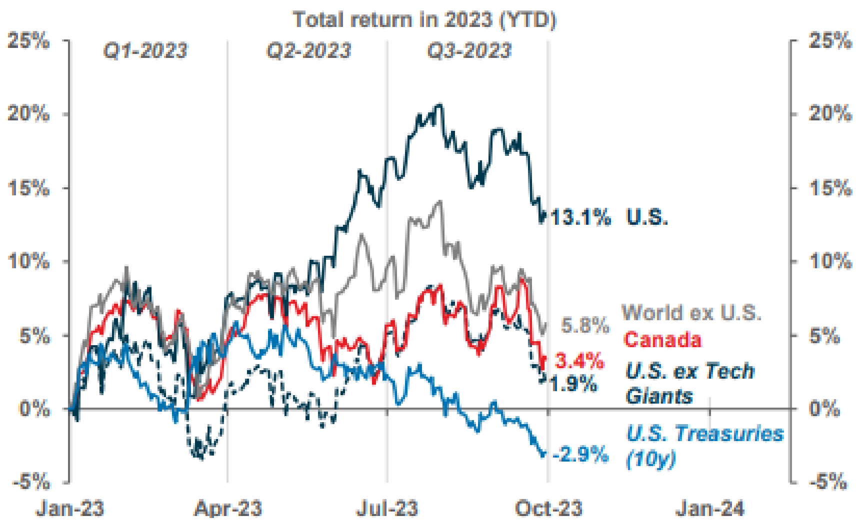
Third quarter 2023 market update

The 2023 Seesaw Market

2023 Year to date performance:



Source: National Bank Financial - CIO Office (data via Refinitiv)

After an optimistic start to the quarter, stock markets reversed course in September, giving up the whole three months of gains, after a shock upwards in interest rates in the last weeks of the month. The S&P 500 is still the winning index this year, up 13%, owing to a handful of mega-cap technology stocks. However, if you strip out the top 7 companies (Google, Microsoft, Apple, etc.), the S&P 500 is only marginally positive, by 1.8% this year. Throughout 2023, the ups-and-downs of the bond and stock markets have been tightly reactive to changes in interest rates, inflation, employment data, and their perceived future impact on corporate earnings. All of these factors have been very dynamic, and inflation is not yet tamed to the levels central banks want to achieve. Until inflation is definitively tamed, down to a target of 2.5% or lower, interest rates are likely to stay where they are. Today, inflation is sitting at an estimated 3.8% year over year, in Canada and the US, down from over 8% in June of 2022. Central banks estimate that inflation will reach the target late 2024.

Asset Classes	Sept	Q3	YTD
Cash	0.4%	1.2%	3.4%
Canadian Equities (TSX)	-3.3%	-2.2%	3.4%
US Equities (S&P 500)	-4.8%	-3.3%	13.1%
WTI Oil	8.6%	28.5%	13.2%
FTSE Canadian Bonds	-2.6%	-3.9%	-1.5%

Bond prices dipped again this quarter, with 10-year yields in Canada and the US hitting their highest levels in 16 years.

10-year yields and borrowing costs are back to pre-financial crisis levels:

Source: National Bank Financial - CIO Office (data via Refinitiv)

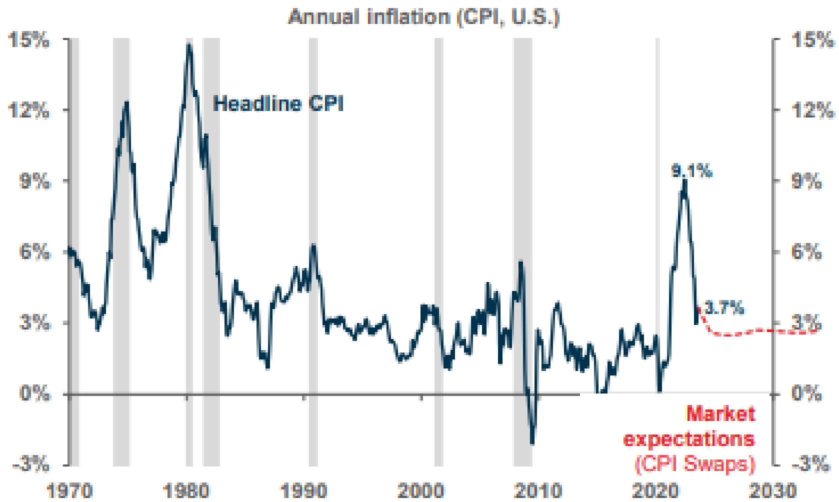
The dramatic spike upwards in 10-year interest rates at the end of September spooked the market, as 10-year yields determine the price of consumer and business credit in the form of mortgages, lines of credit, car loans and credit cards. A big increase in yields should spell a slowdown in the economy if borrowing costs and defaults dramatically change. Discretionary spending goes down when household costs go up.

In light of the uncertain environment, we increased ownership of dividend-paying stocks in the early part of 2023 as a component of our strategy to defensively position portfolios, and increase income generated by investments. Yet, as interest rates continued to increase this summer and fall, the stocks that are steady income-payers, but are low-growth “bond-proxy” stocks suffered, alongside the price of bonds. Investors have been selling telecoms, pipelines, and utilities that are higher debt and lower growth companies, down to near 52-week lows, in favour of holding cash. No-risk cash investments (like GICs) currently yield nearly 5%.

There are some signals that an economic “soft-landing” from covid-era government spending largesse and resultant hikes in interest rates and quantitative tightening may perhaps be achieved:

Inflation is coming down and is expected to reach 2.5% later in 2024. Moderate and lowering inflation would spell the end of increasing interest rates, which would be a boost to consumer confidence.

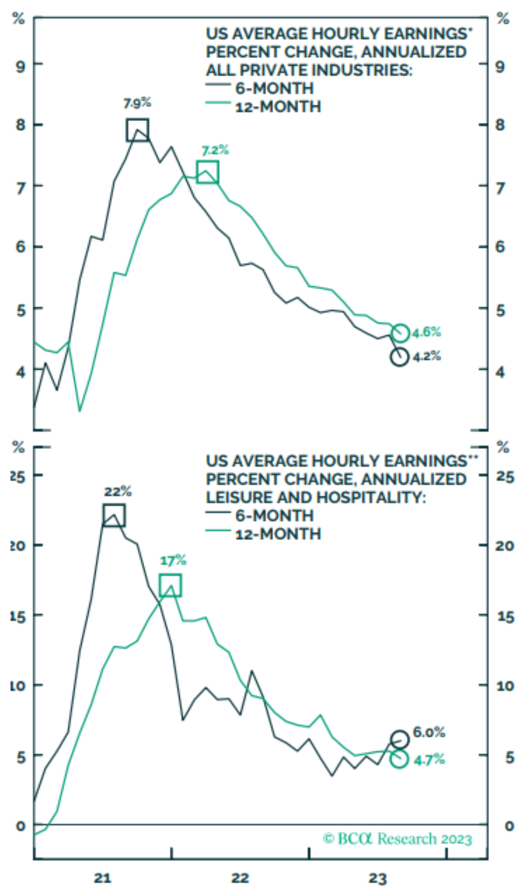
Inflation has slowed and is expected to land:



Source: National Bank Financial - CIO Office (data via Refinitiv)

Wage growth is slowing, which is also a positive for inflation.

Wage Growth:



Source: BCA Research

Further, consumption has been resilient. Consumer spending is keeping the economy going, especially in travel and hospitality. The “Taylor Swift effect” is a great example of this. The Washington Post reports that fans have been spending around $92 million per concert on tickets, travel, merchandise, and outfits, leading to a possible $5.7 billion boost to the US economy this year.

Excess savings and wage increases have cushioned the effects of higher inflation, for now. Outside of discretionary travel and leisure spending, households are still buying roughly the same basket of goods that they were pre-pandemic. However, risks are rising to the consumer, as data shows that the ability to keep up old spending patterns may end in 2024. If consumer spending does pull back, this could be what tips the economy into recession. As mortgages and business loans are reset to higher interest rates, discretionary spending needs to be curbed. Further, tighter bank standards will lead to less economic activity for businesses and home buyers. A higher price of credit and lower volume of borrowing will cool economic growth.

Excess savings were accumulated during the pandemic, and are now close to being spent:

Source: National Bank Financial - CIO Office (data via Refinitiv)

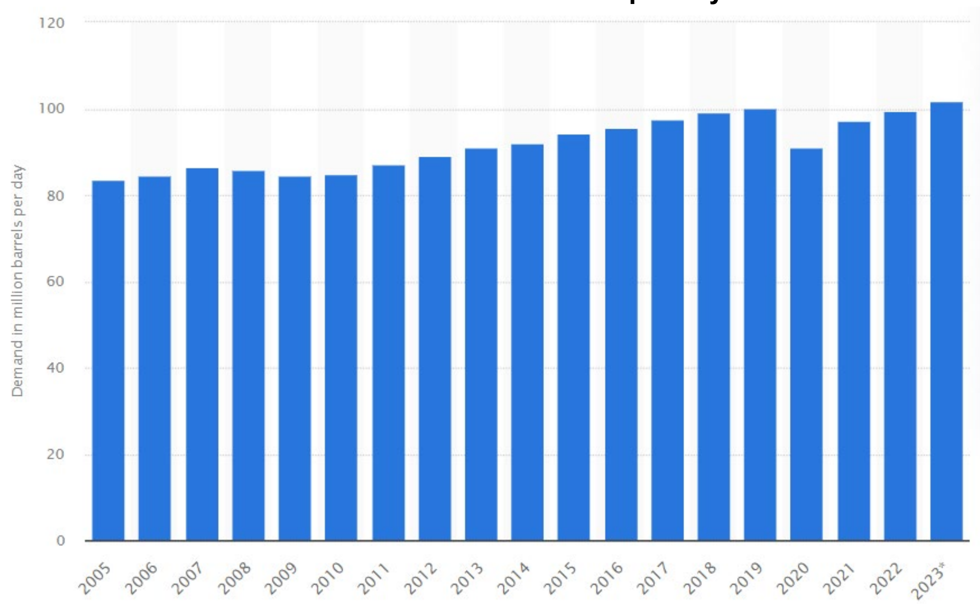
We are not positioning portfolios hoping the “soft-landing” thesis is correct.

As we look towards the end of 2023 and into 2024, we appreciate how resilient the economy has been, yet increasingly feel that defensive positioning in portfolios is warranted. There is no certainty in economics, but history shows that landing only a modest uptick in unemployment, while dramatically increasing the cost of borrowing, but not pushing the economy into a recession, has never before been achieved by central banks.

Our defensive portfolio positioning includes higher balances of cash/short-term corporate bonds that earn 4.5%-5.5%, and corporate bond funds that today have yields between 6% and 7%. Depending on the specific growth orientation of a portfolio, we also have moderate to meaningful exposure to the high-margin, strong balance sheet, growing big-tech stocks of the US. Many of our portfolios would have an upwards to 10% weighting to this group. Alternative fund strategies (such as long/short funds) have been challenged this year by the whipsaws of the market, but are largely holding their ground. We will maintain our “bond-proxy” stocks and get paid handsome and tax-efficient dividends from banks, life-insurers, pipelines that are in excess of 5% today.

For long term growth, owning oil and gas producers, industrial metals companies is worthwhile. The 8-year under-investment in oil and gas development has led to tight markets in an environment where demand is still steadily growing. Oil demand was for 100 million barrels a day and projected to increase to 102 million barrels in 2023, the highest ever annual level, and to 105.7MM barrels per day in 2028 (IEA).

Oil demand in million barrels per day

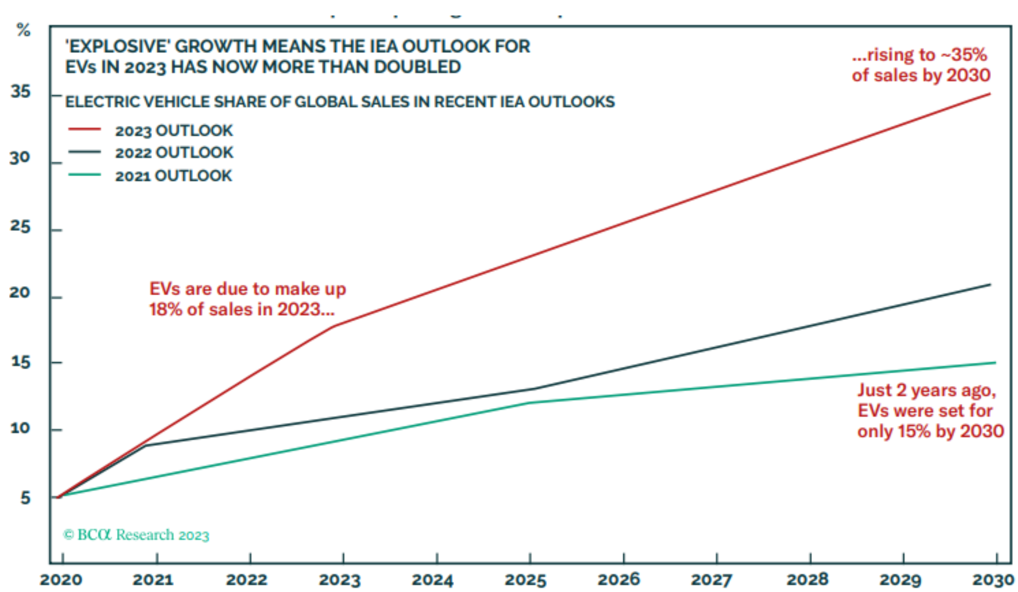


***2023 Estimate**

Source: Statista

On the industrial metals front, EV proliferation will keep demand for metals like copper and nickel high, while mining capex has been weak for the last 10 years. Inventories for industrial metals are universally at historically low levels.

The proliferation of EVS keeps surprising on the upside:



Source: BCA Research

Cash allows portfolios to stay nimble to changing data, yet we recognize there is “no free lunch” in portfolios investing in cash over the long run. Short term cash positions are intended to be tactical, while we continue to observe the “seesaws” of the changing economy.

We look forward to furthering this conversation with you in the weeks ahead.

Best regards,

Tricia Leadbeater CFA

Portfolio Manager, Investment Advisor

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