Monthly Market Commentary
February 2023

Investors deal with inflated expectations.

- Following strong performance to start the year, most global equity markets reversed direction in February. Developed markets outperformed emerging markets.
- Fixed-income asset classes posted losses in February as bond yields rose.
- At its early March meeting, the BoC paused its interest rate hikes and maintained its quantitative tightening (reducing its bond holdings) policies. Further Fed monetary-policy tightening is expected to continue in 2023 beyond the 0.25% interest-rate hike at the beginning of February.

Economic Backdrop

Following strong performance to start the year, most global equity markets reversed direction in February. Investors were concerned that ongoing inflationary pressures, including stronger-than-expected labour market data, would prompt the U.S. Federal Reserve (Fed) and other major central banks to extend their interest rate-hiking cycles. Developed-market equities saw less significant declines than their emerging-market counterparts during the month. Europe was the strongest performer within both the developed and emerging markets in February. Conversely, North America was the weakest-performing developed market, with Canada trailing the U.S. Among emerging markets, Asia was the primary laggard due mainly to weakness in China. Latin America stocks also recorded sizeable losses, most notably in Brazil.

U.S. fixed-income assets posted losses in February as bond yields rose across the U.S. Treasury yield curve (yields and prices have an inverse relationship). High-yield bonds saw the smallest declines and were the top performers for the month, followed by U.S. Treasurys and mortgage-backed securities (MBS). Corporate bonds were the primary fixed-income market laggards in February. The increase in Treasury yields during the month was most pronounced in the two-, three- and five-year segments of the curve. The spread between two- and ten-year notes increased 0.20% over the month, further inverting the yield curve.

Prices in the global commodities markets generally lost ground in February. The West Texas Intermediate crude-oil spot price decreased 2.3%, while Brent crude oil fell 2.4% amid concerns that additional interest-rate hikes from central banks will weigh on global economic growth and reduce demand. The NYMEX natural gas price climbed 6.7% during the month, bolstered by the U.S. Energy Information Administration’s report of a greater-than-expected decline in inventories during the week ending February 20. Natural gas prices had fallen steadily since mid-December of last year as an unusually mild winter in the U.S. continued to weigh on demand during the winter home-heating season. The gold spot price was down 5.6% in February amid investors’ worries that the Fed’s rate hikes may lead to a recession in the U.S., which would hamper demand for precious metals. Wheat prices fell 7.3% in February as Egypt made a large purchase tender for Russian wheat at a relatively low price. Russia reduced its prices in a bid to undercut those of other wheat-exporting countries.

In the U.S., all eyes (and ears) were on the Fed in February. During a discussion at the Economic Club of Washington, D.C., early in the month, Fed Chair Jerome Powell commented that the central bank’s efforts to cool inflation are “likely to take quite a bit of time. It's not going to be smooth. So we think we’re going to have to do further [rate] increases, and we think we’ll have to hold policy at a restrictive level for some time." Later in the month, Federal Reserve Bank of Cleveland President Loretta Meister stated her view that the federal funds rate must surpass 5% in order to bring inflation down to the central bank’s 2% target rate. In light of this assessment, she believed that there was “a compelling economic case” for a 50-basis-point (0.50%) increase at the Fed’s meeting on January 31-February 1. The Federal Open Market Committee (FOMC) approved a 25-basis-point rate hike during the meeting.

The U.S. dollar made a strong comeback in February following a four-month retreat. After reaching a bottom on February 1, the ICE U.S. Dollar Index (DXY), which measures the value of the greenback relative to a basket of foreign currencies, rose over 3%, benefiting mainly from expectations that the Fed will need to increase interest rates further to tame stubbornly high inflation. The DXY fell more than 11% between late September 2022 and late January of this year due to investors' worries about a possible recession in the U.S.

There were signs of a break in the ongoing labour tensions between U.K. public employees and the government. The administration of Prime Minister Rishi Sunak has been plagued by public-sector employee strikes and other job actions as pay increases have not kept up with the U.K.'s inflation rate, which rose 10.1% year over year in January. Sunak is considering pay increases of a maximum of 5% for public employees after the Office for National Statistics (ONS) reported that the public sector had a budget surplus of £5.4 billion (US$6.5 billion) in January. During the current financial year (which runs from April 6, 2022 to April 5, 2023) through January, the U.K. public sector borrowed £30.6 billion (US$36.7 billion) less than the Office for Financial Responsibility had projected in November 2022. The lower-than-expected credit costs resulted mainly from higher-than-expected tax revenues, reduced borrowing by local authorities and nationalized industries, and lower-than-anticipated government subsidies for household and company energy bills. U.K. Chancellor Jeremy Hunt will introduce the government's budget proposal for the 2023-2024 financial year in mid-March. In response to the news of a possible pay raise, the Royal College of Nursing canceled its plan for a 48-hour strike to restart labour negotiations with the U.K. National Health Service (NHS). In a related matter, the Financial Times reported that, according to an internal memo from the HM Treasury, the U.K.'s economic and finance ministry, there was minimal risk that public-sector pay hikes of up to 5% would establish a precedent for large pay increases for private-sector workers.

In the eurozone, there were fears of recession in Germany as the nation's economy contracted by a greater-than-expected annual rate of 0.4% in the fourth quarter of 2022. High inflation weighed on consumer spending and investments in buildings and machinery during the quarter.

Nearly a year after the beginning of Russia's invasion of Ukraine, U.S. President Joe Biden made an unannounced visit to Ukraine to meet with his counterpart, Volodymyr Zelenskyy, and to encourage ongoing support from U.S. allies. The visit occurred as Russian President Vladimir Putin increased military activity in eastern Ukraine. Biden's trip was particularly risky as there was no protection from U.S. military personnel on the ground in Ukraine.

According to The Wall Street Journal, a classified intelligence report recently provided to the White House and several members of the U.S. Congress revealed that the U.S. Department of Energy agreed with the Federal Bureau of Investigation's (FBI) determination that the COVID-19 pandemic began with a leak in a lab in China; four other U.S. agencies still believe that the virus likely originated from natural transmission. The Energy Department reached this conclusion based on new intelligence information. However, the agency noted that it made its judgment with "low confidence." China's government vehemently disputed the determination of the Department of Energy. A spokesperson for the National Security Council said that the Biden Administration still has not come to a conclusion regarding the origin of COVID.

Central Banks

- The Bank of Canada (BoC) paused its interest rate hiking cycle following its meeting on March 8. The overnight rate was held steady at 4.50%, while the Bank continued reducing the amount of bonds it holds on its balance sheet—a policy known as quantitative tightening. This broke a string of eight consecutive rate hikes totaling 4.25% over the course of 2022 and early 2023. The BoC indicated that expectations are for continued moderation of consumer price inflation to about 3% by mid-2023. It also noted that a 3% level of inflation was still too high and would need to continue receding—further rate hikes may be justified based on economic conditions. The next scheduled meeting is on April 12.

- It appears that the Fed believes that it will need to raise the federal funds rate above the previously expected year-end 2023 median of 5.1%, as noted in its "dot plot" of economic projections published in December of last year. In the minutes of its meeting concluded on February 1, the FOMC observed that "a policy stance that proved to be insufficiently restrictive could halt recent progress in moderating inflationary pressures, leading inflation to remain above the Committee's 2 percent objective for a longer period, and pose a risk of inflation expectations becoming unanchored."

- The Bank of England (BOE) released its monthly monetary policy survey of 59 financial market participants. The survey participants anticipate that the BOE will raise the Bank Rate by 0.25% at its next meeting in late March, then leave it unchanged for the remainder of the year. The central bank conducted the survey from January 18-20, so the participants may not express as much optimism in the next monthly survey, as the U.K.'s year-over-year inflation rate remains in double digits. The BOE increased its benchmark rate by 0.5% to 4.0% in early February.

- The respondents to the European Central Bank's Survey of Professional Forecasters for the first quarter of 2023 increased their projections for eurozone inflation to annual rates of 5.9% for 2023 and 2.7% in 2024—up from their estimates of 5.8% and 2.4%, respectively, noted in the fourth-quarter 2022 survey released in late October. The participants also forecasted eurozone GDP to increase by 0.2% in 2023 and 1.4% in 2024 compared to their previous estimates of 0.1% and 1.6% for the corresponding calendar years.

- In an address to the National Diet, Japan's legislative body, Kazuo Ueda, the nominee for governor of the Bank of Japan (BOJ), signaled that he will maintain the central bank's loose monetary policy even though annual inflation of 4.3% in January is well above the BOJ's 2% target. Ueda commented: "I believe it is appropriate to continue monetary easing measures while being creative in line with the situation." He cautioned that raising interest rates in the near term could slow the economy, as strong demand is not driving the current rise in inflation. Both Ueda and the two nominees for deputy governor are expected to be confirmed by the Diet in March.

Economic Data (unless otherwise noted, data sourced to Bloomberg)

- According to Statistics Canada, the rate of inflation rose (as measured by the change in the Consumer Price Index (CPI)) 0.5% for January, but moderated to a 5.9% increase for the one-year period. Prices remain broadly elevated however, food, energy, and mortgage interest costs have all outstripped the one-year increase in prices. Producer prices were mixed in January, but cost pressures continued to ease from a year ago. The Industrial Product Price Index (IPPI) was up 0.4% in January, while the Raw Materials Price Index (RMPI) fell a modest 0.1%. On a year-over-year basis, the IPPI climbed 5.4% and the RMPI increased 1.2%. While there is still considerable work to be done on the inflation front, it is encouraging that year-over-year figures continue to trend towards the BoC target zone, with at least the RMPI no longer above target. As of this writing, the most recent employment report is from January and reveals the economy added 150,000 jobs in the month, with the bulk of the increase in full-time employment. The unemployment rate was steady at 5.0%, which is just above the all-time low of 4.9% registered in July 2022.

- Inflation data for January sent mixed signals. The U.S. Department of Labor's consumer-price index (CPI) accelerated on a monthly basis (rising by 0.5% compared to 0.1% in December). However, the index recorded its smallest annual gain since October 2021, as it slowed to 6.4% year over year from 6.5% in December. Housing costs contributed significantly to inflation both for the month and for the 2022 calendar year. Food and energy prices (particularly gasoline) rose sharply in January. Core inflation, as measured by the CPI for all items less food and energy, rose 0.4% for the month and 5.6% year over year. According to the U.S. Department of Commerce, the personal-consumption-expenditures (PCE) price index posted greater-than-expected increases of 0.6% in January and 5.4% over the previous 12-month period. The PCE price index tracks the change in prices paid by or on behalf of consumers for a more comprehensive set of goods and services than the consumer-price index (CPI). Consequently, the PCE price index is the Fed's preferred gauge of inflation. Energy goods and services comprised the bulk of the upturn in the PCE price index in January, climbing 2.0%. Prices for nondurable goods rose 0.8% for the month after falling 0.7% in December. Food and energy goods and services costs recorded year-over-year increases of 11.1% and 9.6%, respectively. The Census Bureau reported that U.S. retail sales–a gauge of consumer spending that comprises more than two-thirds of gross domestic product (GDP) increased 3.0% in January and 6.4% year over year. All 13 retail categories achieved sales growth for the month, with the largest gains in food services and drinking places, motor vehicle and parts dealers, and furniture and home furnishings stores. Annual growth was strongest in food services and drinking places, while sporting goods, hobby, musical instrument, and book stores also performed well. Conversely, sales for electronics and appliance stores declined over the previous 12-month period. According to the Department of Commerce, U.S. GDP grew at an annual rate of 2.7% in the fourth quarter of 2022, marking a slowdown from the third quarter's increase of 3.2%. The reading is also down slightly from the government's initial fourth-quarter estimate of 2.9%. The government attributed the revised estimate to a downward revision to consumer spending and an increase in imports (which are subtracted from the calculation of GDP). The U.S. economy expanded by 2.1% for the 2022 calendar year.

- According to the Officer for National Statistics (ONS), consumer prices in the U.K. fell 0.4% month over month in January—a reversal of the 0.4% increase in December 2022. The inflation rate dipped to 10.1% over the previous 12-month period compared to the 10.5% year-over-year rise in December. Housing and household services (mainly from electricity, gas, and other fuels), as well as food and non-alcoholic beverages, were the primary contributors to the annual increase in prices. The ONS also reported that U.K. GDP fell by 0.5% in December 2022, following marginal growth of 0.1% in November, and was flat for the three-month period ending in December. The economy expanded by 4.1% for the 2022 calendar year. Production output increased 0.3% in December, led by electricity, gas, steam and air conditioning supply. Conversely, the services sector declined 0.8% for the month due mainly to downturns in human health and social work activity, and education. The S&P Global/CIPS Flash UK Manufacturing Output Index rose 4.6 to a nine-month high of 51.6 in January—the first increase in activity in seven months. A reading above 50 indicates expansion. The S&P Global/CIPS Flash UK Services PMI Business Activity Index was up 4.6 to 53.3 in January. There was particular strength in the services sector following four consecutive months of modest declines in activity.

- Inflation in the eurozone slowed by 0.6% to 8.6% in the 12-month period ending in January. Prices for energy and food, alcohol and tobacco saw double-digit gains for the year. Eurozone manufacturing activity expanded in February, with the S&P Global Flash Eurozone Manufacturing Purchasing Managers Index (PMI) rising 1.5 points to 50.4. Services activity in the eurozone reached an eight-month high in February, with the S&P Global Flash Eurozone Services PMI increasing 2.2 points to 53.0. According to Eurostat's revised estimate issued in mid-February, the eurozone's economy grew by 0.1% in the fourth quarter of 2022, unchanged from the initial growth estimate released in January. GDP rose by 1.9% year over year in the fourth quarter and increased by 3.5% for the 2022 calendar year.

Index Data (February 2023)

- The S&P/TSX Composite Index slid 2.45%.
- The FTSE Canada Universe Bond Index returned -1.99%.
- The S&P 500 Index, which measures U.S. equities, fell 0.46%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, declined 0.89%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned -1.33% (currency hedged) and 0.72% (unhedged).
- The Chicago Board Options Exchange Volatility Index—a measure of implied volatility in the S&P 500 Index that is also known as the "fear index"—rose modestly from 19.40 to 20.70.
- WTI Cushing crude oil prices—a key indicator of movements in the oil market—moved lower from US$78.87 to US$77.05 a barrel to end January.
- The Canadian dollar weakened to C$1.36 per U.S. dollar. The U.S. dollar was generally stronger versus the world's other major currencies; it ended February at US$1.06 versus the euro, US$1.21 against sterling and at 136.22 yen.

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