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Quarterly Market Commentary

Third Quarter 2023

Stocks retreat on higher-for-longer interest-rate fears.

- Global equity markets experienced a downturn during the third quarter of 2023. There were numerous periods of volatility amid investors' uncertainty regarding the implications of a higher-for-longer interest-rate environment, as well as worries about China's weakening economy. These offset a market rally in July prompted by optimism that the U.S. Federal Reserve (Fed) might be able to curb inflation while piloting the economy to a "soft landing."
- Most global fixed-income assets lost ground over the quarter. U.S. Treasury yields moved higher across all segments of the yield curve, particularly one- and two-month bills (bond prices move inversely to yields).
- While predictions of a downturn in business activity during 2023 have been widely held since the end of last year, the U.S. economy has mostly surprised to the upside. Recession calls are now in the minority, with the latest plane analogy going from "hard landing" to "soft landing," and even to "no landing."

SEI's Domestic View

After a respite in the second quarter, the bond market (like those in many advanced economies) was challenged once again. The Canadian yield curve remained deeply inverted. While the degree of inversion eased somewhat, the difference between 10- and two-year yields is still well below historical norms. And while data limitations don't allow us to infer much about a potential recession from this curve inversion, evidence from the U.S. indicates that a long period of inversion could correspond to a longer period of slow growth or recession. That being said, SEI expects any downturn to be relatively mild barring any negative surprises. A likely scenario in the coming year or two could be a so-called rolling recession that meaningfully impacts certain sectors and industries at any given time without dragging the overall economy into a ditch.

Interestingly, the bond market selloff this quarter involved a "bear steepening," where the yield curve shifts upwards and longer-term yields rise more than shorter-term yields. This reflected markets and central banks coming around to our view that inflation would likely prove more stubborn than expected and, therefore, interest rates would need to stay higher for longer. Another notable feature of third-quarter bond market performance was the continued rise in real yields, which reflect the expected after-inflation yield demanded by investors. The 10-year Canadian real yield has now returned to levels that haven't been seen since the global financial crisis of 2008-2009.

With bond yields rising globally (and by definition, valuations falling), many observers are concerned about the return of "bond vigilantes" disciplining profligate central governments by demanding higher and higher yields. We've certainly seen increasing strike activity by workers in many countries and sectors; why not a buyers' strike in bond markets? Canada certainly isn't immune to worries about government deficits and debt levels. While the Trudeau government is now seeking to reduce government spending by just over $14 billion in the next five years, the bulk of those cuts are likely to take effect in the later years. This, along with challenging demographics and global supply-chain reconfiguration, could keep inflation from returning to the BoC's longstanding target of 2% any time soon, barring a more-severe-than-expected recession.

Despite these worries, it's interesting to note that on both the fiscal and monetary fronts, Canada appears to have made more progress than many of its fellow G7 members. The BoC has retreated from its initial foray (spurred by COVID-19) into quantitative easing (the purchasing of government bonds by a central bank in an effort to lower interest rates), while Canada's central government budget position is actually much closer to balance than many of its G7 counterparts.

Whether these trends can continue remains to be seen. Housing and manufacturing activity is still in the doldrums, leading economic indicators remain depressed, and there appear to be some early signs of labour-market deterioration. Depending on the depth and duration of any economic slowdown or downturn, both the BoC and the Canadian government might need to pause or even reverse course.

However, if the rebound in commodity prices causes inflation to reaccelerate, or if the labour market manages to remain tight, that could constrain the BoC's ability to cut interest rates. And with household balance sheets still extended, there is not a lot of room for private sector credit expansion to support the economy. Therefore, any downturn could bring central government finances under pressure once again.

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With this outlook, some of the strongest cross-currents in the quarters ahead might relate to the Canadian dollar. For example, tighter fiscal and monetary policies, as well as close ties to a still-strong U.S. economy, should be supportive, while a deeper-than-expected downturn and/or renewed deterioration of the government's finances (holding all else outside the country equal) could pressure the loonie. At the same time, if energy commodity prices remain elevated, that could be favourable for the currency given Canada's position as a net exporter of such goods.

For investors, SEI believes that diversification remains key. Although nothing is guaranteed in financial markets, in an environment of higher interest rates and bond yields, long-term returns on riskier assets *should* be higher as well; and hopefully this will prove true for inflation-adjusted returns on diversified portfolios. It's why investors assume the risk of investing after all.

SEI's Global View

While predictions of a downturn in business activity during 2023 have been widely held since the end of last year, the U.S. economy has mostly surprised to the upside. Recession calls are now in the minority, with the latest plane analogy going from "hard landing" to "soft landing," and even to "no landing." Strong July results for retail sales, services consumption, industrial production, and housing starts resulted in the inflation-adjusted gross domestic product reaching an annualized 5.9% rate of gain in August. We do not believe this trend is sustainable. Although the consensus has swung away from this view, there is a reasonable probability of a recession in 2024.

Other major economies outside the U.S. are showing signs of weakness, despite advances during the first half of this year. Germany is already in recession and the U.K. may not be far behind. In these developed economies, businesses and consumers alike are feeling pressure from rising interest rates and persistent core inflation.

Hopes that China, the world's second-largest economy after the U.S., would offset slowing growth elsewhere have proven to be elusive. Although Chinese domestic travel and services consumption experienced a post-COVID-19 bounce, the economic data have been mostly disappointing. Consumer sentiment remains extremely depressed, with the latest quarterly reading showing a partial reversal of the early 2023 post-lockdown bounce. Chinese consumers and financial market participants appear largely unimpressed with the government's efforts, both fiscal and monetary, to turn the economy around.

Inflation continues to fall as COVID-19-era supply-chain disruptions abate. However, it is SEI's strong conviction that there has been a regime change when it comes to long-run inflation, and that it will run sustainably higher in the U.S. than the Federal Reserve's (Fed) 2% target. Structurally tight labour markets, the shifting of global supply chains away from China, higher financing costs, the disruptions caused by the transition to a carbon-neutral regime, and a likely boost in corporate tax rates in the years ahead suggest to us that an inflation rate over 3% is more likely than one under 2%.

The Fed's rate-hiking cycle is nearing an end, but this does not mean that the federal-funds rate will be moving lower anytime soon. We believe there could be one more interest-rate increase from the Fed, but as labour-market pressures ease, even this appears increasingly unlikely. The latest Federal Open Market Committee projections indicate an intention to keep the federal-funds rate higher for longer. In our view, it is unlikely the central bank will begin cutting rates before the second half of 2024.

Other major central banks are in similar positions. Given Europe's stubborn inflation and lower policy-rate stance, the European Central Bank may raise its key interest rate once or twice more this cycle. The U.K. is closest to a wage-price spiral, which may force the Bank of England to implement a monetary policy that is tighter than it would prefer. Meanwhile, the Bank of Japan is under increasing pressure to start raising its policy interest rate in order to firm up the yen.

Bond yields have risen despite lower inflation rates. We believe markets are responding to the increase in government debt issuance at a time when central banks are adding to supply pressures via quantitative tightening (i.e., selling bonds out of their portfolios).

SEI expects bond yields to remain elevated as investors adjust their expectations regarding the probability of higher-for-longer central bank interest-rate policy. We also believe that the term premium (the excess yield required to offset the additional risk in longer-dated bonds) will turn positive as investors demand compensation for taking on a greater level of uncertainty around future interest-rate risk.

Equity markets have entered a corrective phase. U.S. large-capitalization stocks are expected to trade in a broad range, with the S&P 500 Index currently closer to the upper end of this range. Growth companies with high price-to-earnings ratios are vulnerable to rising bond yields, and more cyclical and economically sensitive names within this cohort could face pressure from declining profit margins.

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Economic Backdrop

Global equity markets experienced a downturn during the third quarter of 2023. There were numerous periods of volatility amid investors' uncertainty regarding the implications of a higher-for-longer interest-rate environment, as well as worries about China's weakening economy. These offset a market rally in July prompted by optimism that the Fed might be able to curb inflation while piloting the economy to a soft landing. Emerging markets modestly outperformed their developed-market counterparts for the period. The Nordic countries recorded comparatively smaller losses and were the top performers among developed markets for the quarter, benefiting mainly from strength in Norway and Denmark. Europe was the weakest-performing developed market over the period attributable largely to notable losses in the Netherlands and Portugal. In contrast, within the emerging markets, Europe garnered a positive return and was the top performer during the month, bolstered mainly by a double-digit gain in Turkey. Conversely, the Eastern Europe ex. Russia region was the primary laggard among emerging markets due to weak performance in Poland.

As widely expected, the Fed increased the federal-funds rate by 25 basis points (0.25%) to a range of 5.25%-5.50% at its meeting in late July, and subsequently left its benchmark interest rate in a range unchanged following its meeting in September. In a statement announcing the pause in September, the Federal Open Market Committee (FOMC) reiterated its commitment to bringing inflation down to its 2% target rate and cautioned that "tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain." The central bank also commented that it "would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals."

China, the world's second-largest economy, recently has experienced relatively weak credit growth, a downturn in exports, and a year-over-year decline in consumer prices. Lower demand for goods and services from Chinese consumers could have a negative impact on other countries' exports of iron ore, crude oil, factory equipment, and luxury goods into the country. U.S.-based manufacturers of chemicals and heavy machinery have cautioned that they may experience a slowdown of sales in China. Additionally, a large property developer filed for protection under Chapter 15 of the U.S. bankruptcy code, which safeguards non-U.S. companies that are undergoing debt restructurings from creditors seeking to sue the firms or to freeze their assets in the U.S.

Most global fixed-income asset classes lost ground in the third quarter. However, U.S. high-yield bonds registered positive returns and were the top performers within the U.S. market for the period. U.S. corporate bonds, U.S. Treasurys, and mortgage-backed securities (MBS) declined. Treasury yields moved higher across all segments of the yield curve, particularly one- and two-month bills (bond prices move inversely to yields). The yields on the 2-, 3-, 5- and 10-year Treasury notes rose 0.16%, 0.31%, and 0.47%, respectively, over the quarter. The spread between 10- and 2-year notes moved from -1.06% to -0.62% during the period, and the yield curve remained inverted.

Global commodity prices generally moved higher during the quarter. The West Texas Intermediate (WTI) crude-oil spot price and the Brent crude oil price climbed 28.5% and 23.7%, respectively, in U.S. dollar terms, on expectations that production output cuts from the Organization of the Petroleum Exporting Countries (OPEC) and Russia would continue through the end of 2023. The New York Mercantile Exchange (NYMEX) natural gas price rose 5.6% over the period, benefiting from strong demand due to record-high temperatures in the U.S., particularly in the southwestern region of the country. Conversely, the 3.3% decline in the gold spot price for the quarter was attributable to strength in the U.S. dollar. Wheat prices fell 16.8% over the period, hampered by Russia's shipments of large quantities of cheaply priced grain.

Central Banks

- The Bank of Canada (BoC) held its overnight interest rate steady at 5.00% and continued its policy of quantitative tightening following its September 6 meeting. BoC Governor Tiff Macklem noted that higher interest rates have cooled demand, but countered that inflation, though falling, remained too high—around 3% versus the BoC target of about 2%. Further rate hikes remain a possibility if inflation does not moderate further. The next scheduled BoC meeting is scheduled for October 25.

- As previously noted, the Fed maintained the federal-funds rate in a range of 5.25% to 5.50% following its meeting in September. The Fed's so-called dot plot of economic projections indicated a median federal-funds rate of 5.6% at the end of 2023, unchanged from its previous estimate issued in June, implying that the central bank could opt for an additional 25-basis point (0.25%) increase at one of its two remaining policy meetings this year. The Fed also projected a reduction in the federal-funds rate to 5.1% by the end of 2024—down from its current range of 5.25% to 5.50%, but higher than the central bank's previous estimate of 4.6%.

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- In a split 5-4 vote at its meeting on September 21, the Bank of England (BOE) left the Bank Rate unchanged at a 15-year high of 5.25%. Four BOE Monetary Policy Committee members supported a 25-basis point increase. In its announcement of the pause in its rate-hiking cycle, the BOE noted that "inflation is expected to fall significantly further in the near term, reflecting lower annual energy inflation, despite the renewed upward pressure from oil prices, and further declines in food and core goods price inflation. Services price inflation, however, is projected to remain elevated in the near term, with some potential month-to-month volatility."

- The European Central Bank (ECB) increased its benchmark interest rate by 0.25% to 4.25% following its meeting in mid-September. In a statement announcing the rate hike, the ECB's Governing Council noted, "Inflation continues to decline but is still expected to remain too high for too long… [We] will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, the Governing Council's interest rate decisions will be based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission." Additionally, the ECB lowered its economic projections, and currently forecasts that the eurozone economy will expand by 0.7% in 2023, 1.0% in 2024 and 1.5% in 2025.

- The Bank of Japan (BOJ) left its benchmark interest rate unchanged at -0.1% following its meeting on September 21-22. In a statement announcing the rate decision, the central bank commented, "Japan's economy has recovered moderately. The pace of recovery in overseas economies has slowed. Although exports and industrial production have been affected by the developments in overseas economies, they have been more or less flat, supported by a waning of the effects of supply-side constraints." During its previous meeting in late July, the central bank set a rigid upper yield limit of 1.0% for the 10-year Japanese government bond (JGB). The 10-year JGB yield rose 37 basis points to 0.77% over the quarter.

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

- According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI)) remained robust at 0.4% for August and accelerated to 4.0% for the year ending in August. The main driver of higher prices was gasoline costs which rose 0.8% over the past 12 months ending in August compared to a 12.9% decline in costs for the period ended July. Canadians also paid more for rent and mortgage interest—a reflection of higher interest rates corresponding to BoC interest-rate hikes. Meanwhile, costs for travel services declined and price increases for food moderated. Excluding gasoline, consumer price increases held steady at 4.1%. Producer prices were up 1.3% for the Industrial Product Price Index (IPPI) and 3.0% for the Raw Materials Price Index (RMPI), this despite declining 0.5% and 4.3% for the year-over-year period ended August. The Labour Force Survey remained mostly positive—the unemployment rate was unchanged at 5.5% as the economy added a modest 64,000 jobs.

- The Department of Labor reported that the U.S. consumer-price index (CPI) rose 0.6% in August, following a monthly increase of 0.2% in July. The CPI advanced 3.7% year-over-year—up from the 3.2% annual rise in July. However, the 4.3% annual increase in core inflation, as measured by the CPI for all items less food and energy, represented a 0.4-percentage point decline from the 4.7% year-over-year upturn in July. Core inflation rose 0.3% month-over-month in August, following a 0.2-percentage point uptick in July. The government noted that more than half of the month-over-month increase in the overall CPI was attributable to higher gasoline prices, which climbed 10.6% in August. Housing costs also contributed to the upturn in inflation for the month. Food prices rose 0.2% in August, matching the previous month's increase. According to the third estimate from the Department of Commerce, U.S. gross domestic product (GDP) grew at annualized rate of 2.1% in the second quarter of 2023, unchanged from the government's second estimate released in August, and down 0.1 percentage point from the 2.2% rise in the first three months of the year. The largest increases for the second quarter were in nonresidential fixed investment (purchases of both nonresidential structures and equipment and software), consumer spending, and state and local government spending. These gains offset reductions in exports and residential fixed investment (purchases of private residential structures and residential equipment that property owners use for rentals). The marginal decline in the GDP growth rate for the second quarter compared to the first three months of the year was due to slowdowns in consumer and federal government spending, as well as a decrease in exports.

- According to the Office for National Statistics (ONS), consumer prices in the U.K. rose 0.4% month-over-month in August—up sharply from the 0.3% decrease in July. Inflation advanced 6.3% over the previous 12-month period, down marginally from the 6.4% annual upturn in July. Prices for alcohol and tobacco, along with clothing and footwear, were the largest contributors to the rise in inflation in August, while food and alcoholic beverages, and alcohol and tobacco posted the most notable price increases over the previous 12-month period. Core inflation, which excludes volatile food prices, rose at an annual rate of 5.9% in August, down from the 6.4% rise in July. The ONS also reported that U.K. GDP dipped 0.5% in July (the most recent reporting period), after rising 0.5% in June, and increased 0.2% over the previous three-month period. Production output decreased 0.7% month-over-month in July, compared to the 1.8% growth rate in June. The services and construction sectors each fell 0.5% in July, versus upturns of 0.2% and 1.6%, respectively, during the previous month.

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- Eurostat pegged the inflation rate for the eurozone at 4.3% for the 12-month period ending in September, down 0.9 percentage point from the 5.2% annual increase in August. Prices for food, alcohol and tobacco rose 8.8% in September, but the pace of acceleration slowed from the 9.7% annual rate for the previous month. Energy prices fell 4.7% year-over-year, following a 3.3% decline in August. Core inflation, which excludes volatile energy and food prices, rose at an annual rate of 4.5% in September, down 0.8 percentage point from August. According to Eurostat's third estimate, eurozone GDP grew 0.1% in the second quarter of 2023, marginal improvement from the flat growth rate in the first quarter, and increased 0.5% year-over-year. The economies of Lithuania and Iceland were the strongest performers for the second quarter, expanding 2.9% and 2.2%, respectively, while Poland's economy contracted 2.2% during the period.

Index Data (Q3 2023)

- The S&P/TSX Composite Index declined 2.20%.
- The FTSE Canada Universe Bond Index returned -3.87%.
- The S&P 500 Index, which measures U.S. equities, declined 1.17%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, was down 1.30%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 0.40% (currency hedged) and 2.72% (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," jumped from 13.59 to 17.52.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, spiked from US$70.64 to US$90.79 a barrel to end the quarter.
- The Canadian dollar weakened to C$1.35 per U.S. dollar. The U.S. dollar was stronger versus the world's other major currencies, ending September at US$1.06 versus the euro, US$1.22 against sterling, and at 149.23 yen.

Glossary of financial terms

A **soft landing** occurs when a country's economic growth slows, but does not enter recession.

A **hard landing** occurs when a country's economy rapidly shifts from growth to slow growth to flat as it approaches a recession, usually resulting from a government's attempts to slow inflation.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value.

Mortgage-backed securities (MBS) are pools of mortgage loans packaged together and sold to the public. They are usually structured in tranches (a slice or portion of a structured security) that vary by risk and expected return.

Yield curve represents differences in yields across a range of maturities of bonds of the same issuer or credit rating (which is used to assess the risk of default of companies or countries). A steeper yield curve represents a greater difference between the yields. A flatter curve indicates that short- and long-term yields are closer together.

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An **inverted yield curve** occurs when short-term yields exceed long-term yields. While an inverted yield curve historically has predicted economic recessions, it is an indicator—not a forecast.

The **federal-funds rate** is the interest rate charged to lending institutions on unsecured overnight loans. It is set by the U.S. Federal Reserve's Federal Open Market Committee. The rate is increased when the Federal Reserve wants to discourage borrowing and slow the economy and decreased when the Federal Reserve wants to spur economic growth.

Economic output comprises a quantity of goods or services produced in a specific time period.

Monetary policy refers to decisions by central banks to influence the amount of money and credit in the economy by managing the level of benchmark interest rates and the purchase or sale of securities. Central banks typically make policy decisions based on their mandates to target specific levels or ranges for inflation and employment.

A **recession** is a significant and prolonged downturn in economic activity.

The **personal-consumption-expenditures (PCE) price index** measures the prices that consumers pay for goods and services to reveal underlying inflation trends. The core PCE price index, the primary inflation monitor used by the Federal Reserve, excludes volatile food and energy prices.

Input price inflation measures changes in the prices of materials and fuels purchased by manufacturers for processing.

Price/earnings (P/E) ratio is calculated by dividing the current market price of a stock by the earnings per share. Price/earnings multiples often are used to compare companies in the same industry, or to assess the historical performance of an individual company.

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