Quarterly Market Commentary

Fourth Quarter 2023

Markets rally on hopes for “pivotal” moves by central banks.

- Global equity markets rallied sharply during the quarter. Signs of slowing inflation, along with the U.S. Federal Reserve’s (Fed) relatively dovish comments and projections regarding monetary policy, spurred investors’ hopes that the Fed and other global central banks could pivot to cutting interest rates sooner than previously expected.
- Global fixed-income assets posted gains for the quarter. U.S. Treasury yields moved lower across the curve, particularly for all maturities of one year or longer (bond prices move inversely to yields).
- SEI believes that the Fed will implement three 25-basis point (0.25%) interest-rate cuts in 2024, dependent on the strength of the economy stays and whether inflation stabilizes or even backs up a bit from current levels. Expectations are that the bank of Canada may follow a similar path.

SEI’s Domestic View

The last quarter of 2024 treated investors to yet another series of global interest-rate shocks. This time, downside inflation surprises and a shift in monetary policy rhetoric—particularly by the U.S. Federal Reserve (Fed)—convinced market participants that central banks would soon start cutting their targets for short-term interest rates. The Bank of Canada (BoC) was not immune to this dynamic. The BoC is now expected to cut its policy rate five times (in 0.25% increments) in the year ahead, which would bring its policy rate to 3.8% by December 2024. As discussed in our most recent Quarterly Economic Outlook and SEI Forward, SEI is highly skeptical of the optimism that’s been priced into rates markets for the Fed. Should that skepticism apply to the BoC as well? Let’s examine the evidence.

The struggles in Canada’s housing market are well known. After some surprising improvement earlier in 2023, both sales volumes and prices have resumed their downward trends since the middle of the year. According to a range of surveys, the outlook in Canada’s manufacturing sector actually worsened recently after a string of already-negative reports. This is consistent with global manufacturing in general, as consumers have meaningfully shifted their activities from stay-at-home purchases early in the COVID era to services and experiences such as dining out and travel.

What about the broader business sector in Canada? After all, there’s far more to the Canadian economy than just manufacturing. Unfortunately, the picture here isn’t much better. Imports and exports declined in the third quarter (the latter more so than the former), indicating weaker demand conditions both at home and abroad. The BoC’s Business Outlook Survey (BOS), as well as the Organisation for Economic Cooperation and Development’s (OECD) Business Confidence Index, also paint a dour picture.

The BoC BOS survey provides additional details that are worth digging into, though readers should keep in mind that this data is as of the third quarter of 2023; fourth-quarter survey results should be released later this month. On the negative side of the ledger, both hiring and investment plans continue to decline, and firms are still reporting that credit is hard to come by.

There were some hopeful signs in the BOS details, however slim. While indicators of future sales, such as bookings and inquiries, were flat on balance, the percentage of respondents expecting future sales to improve versus the previous 12 months exceeded those expecting sales to deteriorate; this was the first time that’s happened since the fourth quarter 2021 survey.

And while respondents reported ongoing labour shortages, an increasing percentage expected wage pressures to subside. Of course, it wouldn’t be ideal for the overall economy if the labour market loosens up too much, but an easing of wage demands (along with falling input costs expected by an overwhelming proportion of respondents) would mean less downward pressure on profit margins and less upward pressure on inflation, all else equal. The inflation aspect will be especially important when it comes to future BoC decisions regarding monetary policy.

When considering this data, it’s important for investors to keep a couple of things in mind. First, economic reality rarely conforms to the picture painted by various survey data, whether from businesses or households. And second, Canada is a relatively open economy—meaning its trade with the rest of the world accounts for a significant portion of its gross domestic product (GDP)—especially compared to the U.S. As a result, Canada’s economic performance will continue to depend heavily on what happens outside its borders.

That latter fact will remain an important consideration for the BoC as well. Although we have seen early signs of labour-market loosening in Canada, this is just one of many factors influencing domestic inflation trends, and the BoC will have to remain attentive to the larger picture. In a recent report, economists from the BoC's Financial Markets Department estimated that the likelihood of inflation returning to the Bank's one-percent-to-three-percent target in 2024 had increased meaningfully over the course of 2023; however, they were careful to point out that their modelling still implied a 25% chance that inflation would exceed this range, well above the historical probability of 8%.[1] Thus, it's still too early to say whether the BoC will cut interest rates to the extent that markets are currently implying.

Despite all of this uncertainty, it's still natural for investors to wonder how the current business cycle might ultimately play out. If a recession does unfold in 2024, will it be particularly deep or persistent? And what might that mean for a portfolio? As of December 2023, economists at Oxford Economics were predicting a downturn to last from the third quarter of 2023 through the second quarter of 2024. But they also expected a fairly healthy rebound in the second half of this year, led by recoveries in consumer purchases, business investment and residential investment.[2] Of course, no forecaster has a crystal ball, and the mixed views coming out of business surveys, as well as the well-known overhang of household debt in Canada, call for a reasonable degree of caution. As such, we continue to believe that investors are likely to be best served by having a well-diversified portfolio designed to help them meet their financial objectives whatever the economic and market winds might throw at them.

SEI's Global View

Among the seven largest developed economies, the U.S. was the standout performer in 2023. The U.K. and Europe posted minimal gains in overall economic growth in the first three quarters of the year, while Japan managed to register a notable year-to-date gain in GDP despite a contraction during the third quarter. Our more sanguine view on the U.S. contrasted with the consensus of economists, the majority of whom saw a better than 50/50 chance that the U.S. was or would soon be in recession.

We expect more subdued economic growth in the U.S. in 2024, perhaps deteriorating into a stagnant/mildly recessionary environment along the lines currently seen in much of Europe. While interest rates may no longer be rising, they remain high and are starting to bite harder. Households have smaller savings cushions to draw upon to sustain spending in excess of their incomes. Credit-card usage is up sharply and, as a result, delinquency rates are climbing. The situation is not yet critical or indicative of recession, but households will be more heavily reliant on a continued robust jobs market and strong wage growth in the months ahead. The good news is that the jobs market is still tight. However, there are signs of weakness cropping up.

Although we acknowledged this time last year that inflation was trending lower, the rate of increase has decelerated more dramatically in recent months than we had expected. The U.S. led the global acceleration of inflation in 2021 and 2022; in 2023, it has been leading the way down. Both the U.S. and the eurozone have enjoyed a fall in inflation back toward the 2% level, measured on a year-over year basis. The U.K. and France have been lagging in terms of inflation levels, but have, nonetheless, registered a rather sharp slowdown from their inflation-rate peaks.

Does the slowdown in inflation mean that central banks can confidently declare "mission accomplished"? In our opinion, the answer is a firm "no." This is admittedly a minority view in the aftermath of the Fed's latest policy meeting in December, but we note that the bulk of the improvement has come in volatile food and energy prices.

Consistent with the Fed's benign assessment of the economic outlook, the central bank sees three federal-funds rate decreases next year, to 4.6%, four additional cuts in 2025, and more reductions in 2026 to 2.9%. Traders in the futures market appear even more optimistic than the Fed, pricing in 150-basis point (1.50%) of cuts in the federal-funds rate by the end of 2024. In contrast, we lean much closer to the Fed's view, penciling in three 25-basis point reductions. It all depends, of course, on the strength of the economy and whether inflation stabilizes or even backs up a bit from current levels.

Investor sentiment is currently enthusiastic over the prospect of a soft economic landing and a return to 2% inflation. In our view, both bonds and stocks appear to be overbought on a near-term basis, so some kind of price consolidation would not be surprising. The extent of any correction in risk assets will, of course, depend on changing perceptions on economic growth, the corporate-profits outlook, the path of inflation, and central-bank responses.

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1 Bruno Feunou and James Kyeong, "Finding the balance—measuring risks to inflation and to GDP growth," Bank of Canada Staff Analytical Note 2023-18, December 19, 2023.
2 Tony Stillo et al, "Canada Chartbook," Oxford Economics, December 2023.

Economic Backdrop

Global equity markets rallied sharply during the fourth quarter of 2023. Signs of slowing inflation spurred investors' hopes that the Fed and other global central banks could begin to reduce interest rates sooner than previously expected. Additionally, there is optimism that the U.S. economy could be primed for a "soft landing," in which growth and inflation slow but the economy does not enter a recession. Developed markets outperformed their emerging-market counterparts for the quarter.

North America was the strongest performer among the major developed markets during the fourth quarter, led by the U.S. The Far East region was the primary market laggard due mainly to underperformance in Hong Kong and Singapore. Eastern Europe was the top-performing region within emerging markets during the period attributable primarily to strength in Poland. In contrast, the Gulf Cooperation Council (GCC) countries—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—recorded comparatively smaller gains and comprised the weakest-performing emerging-market region during the quarter.

Global fixed-income assets, as represented by the Bloomberg Global Aggregate Bond Index, gained 8.1% in the fourth quarter. Corporate bonds were the top performers within the U.S. market for the month, while U.S. Treasury securities saw relatively smaller gains and were the most notable market laggards. Treasury yields moved lower across the curve, particularly for all maturities of one year or longer. Yields on 2-, 3-, 5- and 10-year Treasury notes decreased 0.80%, 0.79%, 0.76% and 0.71%, respectively, over the quarter. The spread between 10- and 2-year notes narrowed from -0.44% to –0.35% during the quarter, and the yield curve remained inverted.

As widely expected, the Fed maintained the federal-funds rate in a range of 5.25% to 5.50% following its meeting on December 12-13. In a statement announcing the continuation of the pause in its rate-hiking cycle, the Federal Open Market Committee (FOMC) commented, "In determining the extent of any additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." During a news conference following the FOMC's meeting, Fed Chair Jerome Powell struck a cautious note regarding the central bank's efforts to tame inflation, commenting, "No one is declaring victory. That would be premature." Nonetheless, Powell acknowledged that FOMC members are considering when to begin to cut interest rates as inflation slows. "That begins to come into view, and clearly it's a topic of discussion," he noted.

On the geopolitical front, long-simmering tensions in the Middle East escalated to war following a surprise attack on Israel by Hamas in early October. In addition to the casualties resulting from Hamas' initial incursion into Israel, the militant group and some of its allies abducted more than 200 soldiers and civilians. A one-week ceasefire in the military conflict between Israel and Hamas expired on November 30, after the two sides could not reach an agreement on an extension. The truce had led to several hostage and prisoner exchanges between Israel and Hamas. Each side blamed the other for the failure to extend the ceasefire, and fighting resumed following the expiration of the truce.

Elsewhere, President Joe Biden and China's President Xi Jinping met in California in mid-November. The leaders of the world's two largest economies agreed to resume military communications in an effort to improve relations between the countries amid speculation about China's intention to invade Taiwan, as well as the Xi administration's support of Russia in its ongoing conflict with Ukraine. At a news conference following the meeting, Biden noted that he and Xi had agreed that if there were concerns about "anything between our nations, or happening in our region, we should pick up the phone and call." In late December, NBC News reported that Xi had informed Biden during the meeting that China's government intended to reunify Taiwan with mainland China, though the timing has not yet been determined. Xi also said that China hoped to complete the takeover of Taiwan peacefully—not by force. A spokesperson for the U.S. National Security Council declined to comment on the situation, according to NBC News.

Global commodity prices, as measured by the Bloomberg Commodity Total Return Index, declined in the fourth quarter. The West Texas Intermediate (WTI) and Brent crude oil prices fell 21.1% and 16.4%, respectively, due to a significant increase in production in the U.S. and weakening global demand. The New York Mercantile Exchange (NYMEX) natural gas price staged a rally in December, but still ended the fourth quarter with a 20.6% loss due to an increase in inventories and forecasts for above-average winter temperatures in the U.S. On the positive side, the gold spot price rose 11.0% for the period, bolstered by a decline in U.S. Treasury yields, as well as higher demand spurred by investors' hopes that the Fed may begin to ease monetary policy sooner than previously anticipated. The 16.0% increase in wheat prices during the quarter was attributable to a reduction in exports from Ukraine due to the nation's ongoing conflict with Russia.

Central Banks

- The BoC held its overnight interest rate steady at 5.00% and continued its policy of quantitative tightening following its December meeting. BoC Governor Tiff Macklem noted that the global economy has continued to slow and that inflation pressures have eased. A further softening of the global economy is expected as interest rate hikes seemed poised to reign in robust consumer spending in the U.S., while the European economy has notably weakened. While inflation has eased it remains elevated above the bank's target level and the BoC noted is remains prepared to raise rates further if needed.

- The Fed's so-called dot plot of economic projections, released in December, indicated a median federal-funds rate of 4.6% at the end of 2024, down from its previous estimate of 5.1% issued in September, signaling that the central bank could cut interest rates by roughly 75 basis points (0.75%) next year. The dot plot also projected that core personal-consumption-expenditures (PCE) inflation could slow from its most recent annual increase of 4.0% in November to 2.6% by the end of 2024. The PCE price index is the Fed's preferred gauge of inflation, as it tracks the change in prices paid by or on behalf of consumers for a more comprehensive set of goods and services than that of the consumer-price index (CPI).

- In a split vote at its meeting on December, the Bank of England (BOE) left the Bank Rate unchanged at a 15-year high of 5.25%. Three of the nine BOE Monetary Policy Committee members supported a 25-basis point increase. In its announcement of the rate decision, the BOE commented, "In the most likely, or modal, projection, CPI inflation returned to the 2% target by the end of 2025 and fell below the target thereafter. The Committee continued to judge that the risks to its modal inflation projection were skewed to the upside, such that the mean projection for CPI inflation was 2.2% and 1.9% at the two- and three-year horizons."

- The European Central Bank (ECB) left its benchmark interest rate unchanged at 4.50% following its meeting on December. In a statement announcing the rate decision, the ECB's Governing Council commented, "Underlying inflation has eased further. But domestic price pressures remain elevated, primarily owing to strong growth in unit labour costs." The central bank also reiterated its commitment "to ensure that inflation returns to its 2% medium-term target in a timely manner. Based on its current assessment, the Governing Council considers that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal. The Governing Council's future decisions will ensure that its policy rates will be set at sufficiently restrictive levels for as long as necessary."

- The Bank of Japan (BOJ) left its benchmark interest rate unchanged at -0.1% following its meeting in December. The central bank also maintained the upper yield limit of 1.0% for the 10-year Japanese Government Bond (JGB) that it had established in July 2023 as an "upper bound" rather than a stringent cap. In a statement announcing the monetary policy actions, the central bank noted, "Japan's economy is projected to continue growing at a pace above its potential growth rate. The year-on-year rate of increase in the CPI (all items less fresh food) is likely to be above 2 percent through fiscal 2024, due to factors such as the remaining effects of the pass-through to consumer prices of cost increases led by the past rise in import prices. Thereafter, the rate of increase is projected to decelerate owing to dissipation of these factors."

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)) ticked up 0.1% in November and rose 3.1% for the year ending in November. Mortgage interest costs rocketed higher by nearly 30% year-over-year, while price increases for food and rent remained robust. Meanwhile, energy costs dipped as the price of fuel oil declined 23.6% year-over-year. Producer prices were notably weaker, falling 0.4% for the Industrial Product Price Index (IPPI) and 4.2% for the Raw Materials Price Index (RMPI) in November. For the year ending November, both the IPPI and RMPI declined 2.3% as the price of key inputs such as petroleum products, chemicals, lumber, and metals decreased. The Labour Force Survey indicated that employment was steady in December following modest gains in October and November. Similarly, the unemployment rate held firm at 5.8%.

- The Department of Labor reported that the U.S. consumer-price index (CPI) ticked up 0.1% in November following a flat reading in October. The CPI advanced 3.1% compared to the same period a year earlier—down slightly from the 3.2% annual rise in October. Core inflation, as measured by the CPI for all items less food and energy, posted a 12-month increase of 4.0%, unchanged from the rise in October. Core inflation rose 0.3% in November versus 0.2% during the previous month. Housing costs made the largest contribution to the annual rise in the CPI in November, offsetting lower prices for fuel oil and gasoline. Food prices rose 0.2% and 2.9% during the month and previous year, respectively. According to the third estimate of the Department of Commerce, U.S. gross domestic product (GDP) grew at an annualized rate of 4.9% in the third quarter of 2023—down modestly from the second estimate of 5.2%, but sharply higher than the 2.1% year-over-year rise in the second quarter. GDP has increased for five consecutive quarters following declines in the first two quarters of 2022. The largest contributors to economic growth in the third quarter were consumer spending, private inventory investment (a measure of the changes in values of inventories from one time period to the next), and exports. These gains offset an increase in imports, which are a subtraction in the calculation of GDP.

- The Office for National Statistics (ONS) reported that consumer prices in the U.K., as measured by the Consumer Prices Index (CPI), fell 0.2% in November, following a flat reading in October. The CPI rose 3.9% year-over-year, down from the 4.6% annual upturn in the previous month. The largest contributors to the 12-month rise in inflation included alcoholic beverages and tobacco, as well as food and non-alcoholic beverages. These more than offset declines in prices for housing, water, electricity, gas and other fuels, as well as transportation. Core inflation, which excludes volatile food prices, rose at an annual rate of 5.1% in November, down from the 5.7% year-over-year increase in November. The ONS also announced that U.K. GDP dipped 0.1% in the third quarter of 2023, following a flat growth rate in the second quarter, and rose 0.6% over the previous year. Production output increased 0.1% during the quarter, compared to the 0.9% upturn during the second quarter. The services sector saw a downturn of 0.2% in the third quarter versus a 0.1% decrease during the second quarter. Output in the construction sector rose 0.4% in the third quarter, compared to a decrease of 0.1% over the previous three-month period.

- Eurostat pegged the inflation rate for the eurozone at 2.4% for the 12-month period ending in November, down from the 2.9% annual increase in October. Prices for food, alcohol and tobacco rose 6.9% year-over-year in November, but the pace of acceleration slowed from the 7.4% annual rate for the previous month. Costs for services and non-energy industrial goods rose 4.0% and 2.9%, respectively, over the previous 12 months. Conversely, energy prices fell 11.5% year-over-year, following an 11.2% decline in October. Core inflation, which excludes volatile energy and food prices, rose at an annual rate of 3.6% in November, down 0.6 percentage point from the 4.2% year-over-year increase in October. According to Eurostat's second estimate, eurozone GDP decreased 0.1% in the third quarter of 2023, a modest downturn from 0.1% growth rate in the second quarter, and was flat compared to the same period a year earlier. The economies of Malta and Poland were the strongest performers for the third quarter, expanding 2.4% and 1.5%, respectively. GDP for Iceland fell 3.8% and Ireland's economy contracted by 1.9% during the period.

Index Data (Q4 2023)

- The S&P/TSX Composite Index jumped 8.10%.
- The FTSE Canada Universe Bond Index returned 8.27%.
- The S&P 500 Index, which measures U.S. equities, soared 8.93%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, was up 8.29%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned 6.68% (currency hedged) and 4.42% (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," slid from 17.52 to 12.45.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, plunged from US$90.79 to US$71.65 a barrel to end the quarter.
- The Canadian dollar strengthened to C$1.32 per U.S. dollar. The U.S. dollar was also weaker versus the world's other major currencies, ending December at US$1.10 versus the euro, US$1.27 against sterling, and at 140.98 yen.

Glossary of financial terms

A **basis point** equals .01%.

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.

Yield curve represents differences in yields across a range of maturities of bonds of the same issuer or credit rating are (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.

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.

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.

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.

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