REVIEW AND COMMENTARY
2nd QUARTER – 2023

Haze on the Horizon

"At worst, North American economies will experience a mild recession in 2023." This was the last of 5 predictions made in our 2022 annual review. So far, so good. The US Federal Reserve has temporarily paused increasing interest rates, but the narrative surrounding future increases remains hawkish. Discussion regarding the potential of two more raises abound but like most things, it will depend on economic conditions at the time. While inflation appears to have ebbed, prices remain stubbornly high. An important question is what will it take to bring them back down?

Certainly, a recession would likely quell inflation, but faced with the increasing rates for more than a year, the resilience of the North American economies has been surprising. An inverted yield curve (where short- term rates are higher than long term rates) often precede recessions but the consumer continues to push the economy higher, keeping a recession at bay. Uncertainty surrounding equity markets is based, in part, on trying to anticipate how far Chairman Powell will go to reduce inflation. Would an engineered recession require draconian measures- more than two additional rate hikes? And, if so, would the economic fallout be difficult to resuscitate? These concerns are increasing the trepidation of equity investors and will likely continue for the remainder of the year.

Is a self- induced recession the only way to beat inflation? Not at all. Bank of America recently posited that inflation could 'drop like a rock' without a recession. Their premise is that the inverted yield curve is signaling a hard landing for inflation not the economy. Welcome news to our ears, however the capital markets are telling a different story- the present inversion between the 2 -year and 10-year US Treasuries is the largest differential in almost half a century. And while the consumer has continued to buoy the economy to date, higher prices are showing signs of moderating spending habits. More evident in the US than Canada, real estate prices are falling in most markets and real estate related costs have a more significant weighting in the US inflation data than the Canadian composite.

Equity markets were positive over the quarter but there was significant outperformance by the US indices, particularly the SP500 and Nasdaq, which have a larger concentration of technology stocks than the SP TSX index which increased by just over 1% for the quarter. The Dow Jones was up 1.8% (measured in Canadian dollars). These numbers pale in comparison to the aforementioned indices which were up 6.5% and 10.5% (in Canadian dollars) respectively. Most widely followed indices, including the ones named so far, are market cap weighted (the bigger the market capitalization of a company, the higher the weighting in the underlying index). Apple, Microsoft, and Nvidia are among the more influential names presently in the SP500 and Nasdaq. Artificial Intelligence (AI) is all the rage, but valuations are extreme. We have seen this investment craze many times before and it is important to remember the important distinction between demand and profitability. While we had anticipated growth stocks would outperform defensive stocks for 2023, the level of out- performance to date leads us to believe that the defensive names will be better relative performers for the remainder of 2023.