Quarterly Commentary

Fall 2022

Financial Markets and the US Federal Reserve

The US Federal Reserve has always had significant influence in modern financial markets. This influence, however, has grown substantially over the last 15 years, beginning with the onset of the Global Financial Crisis in 2007 and the adoption of so-called 'Quantitative Easing' ('QE') between 2008 and 2015. The Fed (and nearly all Global Central Banks) shifted into hyper-QE in 2020 with the intent of supporting economies and sheltering markets from the ramifications of unprecedented global shutdowns during the pandemic. Now, after 12 years of actively injecting liquidity into the markets—and holding interest rates at rock-bottom levels—the US Fed has cemented its status as the center of the monetary world, and we are now beholden to them, and their policy decisions, more than ever.

The effect of this influence has been painfully apparent in 2022. As the world has moved further from the all-encompassing grip of the pandemic, it has become increasingly obvious that inflation, rather than being a short-term, pandemic-related aberration that would naturally ease (or, to use the central bank's favourite euphemism, is 'transitory'), is in fact more significant and broad-based than originally appreciated. This reality—and the delay in its acceptance—has prompted the Fed to embark on the fastest rate-hiking cycle in modern history in an attempt to control both inflation and the expectations surrounding its persistence and future growth. The result of these rate hikes has not only inflicted significant pain in equity and bond markets year-to-date, but the speculation surrounding the path of future interest rates has now become the single biggest influencer on the daily movement of financial markets.

This was very clearly illustrated this past summer. As inflation accelerated through the first half of the year and central banks began their rate-hiking efforts in earnest, equity and bond markets sold off, hitting a low in mid-June. On June 16th, the Fed raised interest rates by 0.75%. Economists estimated that US inflation had peaked, and, following a further 0.75% hike on July 27th, pinned their hopes on rapidly falling prices and a potential pivot in Fed policy on the horizon. The market rallied hard in response. That positive momentum abruptly reversed course in late August when Federal Reserve Chairman, Jerome Powell, spoke at the annual Jackson Hole Economic Symposium. During his speech, Chair Powell categorically stated that the Federal

Reserve was committed to tackling inflation with higher interest rates regardless of the negative impacts this may have on economic growth and employment. Although this message was consistent with Fed comments throughout 2022, its hawkishness seemed to catch investors by surprise, dashing hopes of a policy pivot, and firmly sending markets into a downward trajectory that has largely persisted since.

Although it is important that companies continue to report top-line revenue and earnings growth within the current challenging business environment, this important driver of equity valuations seems to have taken a backseat to the actions of the Federal Reserve at the current time. Good economic news has been driving equity markets lower with the speculation that stronger economic growth will drive inflation higher and thereby influence the Federal Reserve to raise rates even further to combat that inflation. Is this now the "new normal"?

We are of the opinion that the Federal Reserve will continue to increase interest rates until it is evident they have made meaningful headway on inflation. Looking forward, the majority of forecasts point to further increases and persistently higher rates being with us throughout most of 2023. We do however expect the biggest percentage increases are now behind us, and evidence suggests the market will continue to speculate on a potential pivot point. This was obvious at the beginning of October when the Bank of Australia increased interest rates by 25 basis points instead of the anticipated 50, sparking an equity rally, only to be quickly dashed upon further comments from the Federal Reserve that interest rate increases will continue on their current glide path.

Looking forward, the tension between inflation, interest rates and the speculation of a future pivot point on monetary policy will continue to drive market volatility. While we do expect inflation will retreat over the coming quarters, the rate of this retreat is unknown, and the Fed is likely to remain hawkish until lagging data shows prices are meaningfully retreating—anything but risks reversing the work they've done thus far. However, this turning point will come, and we believe that as the rate of interest rate increases slow, it will provide room for positive news to once again be viewed as positive rather than merely a motivator for further Fed intervention.

Canada's First Home Savings Account (FHSA)

On August 9, 2022, the Government of Canada introduced draft legislation for the Tax-Free First Home Savings Account. Further comments and suggested amendments to the draft legislation were still being gathered right up until September 30th. Although the legislation is expected to be enacted in 2023, the eventual roll out is subject to service providers and the Canada Revenue Agency being equipped to design and register these plans.

The following provides some details on what we know so far:

- A qualifying individual will be able to contribute up to $8,000, annually up to a total lifetime maximum of $40,000
- The individual may withdraw amounts on a tax-free basis to fund the purchase of a home that is deemed a qualifying transaction
- The individual must be a resident of Canada between the ages of 18 and 71, and cannot at any time during the year, or the four preceding years, have owned or had an interest in a qualifying home
- Contributions by the holder are tax deductible (similar to an RRSP)

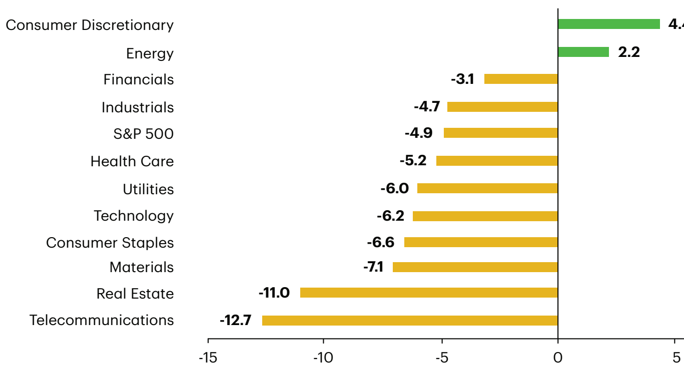
Market Commentary

Equity markets started off the third quarter in a positive direction, but that direction was quickly reversed on the heels of Jerome Powell's speech at Jackson Hole. By the end of the quarter the S&P 500 had fallen 4.9%, the Dow Jones Industrial Average retreated 6.2%, and the NASDAQ Composite was down 3.9%. Energy is the only sector with a positive return to year-to-date in both Canada and the U.S. The Canadian equity markets fared a little better in Q3 as the S&P/TSX Composite Index ended down 1.4% for the quarter.

International equities were also down, with the MSCI Europe Index and MSCI Emerging Markets Index falling 4.7% and 8%, respectively, in the quarter. Given the current geopolitical risks, together with high inflation and historically high energy costs, we expect both the international equity and bond markets to underperform the North American markets, and we have positioned our portfolios accordingly.

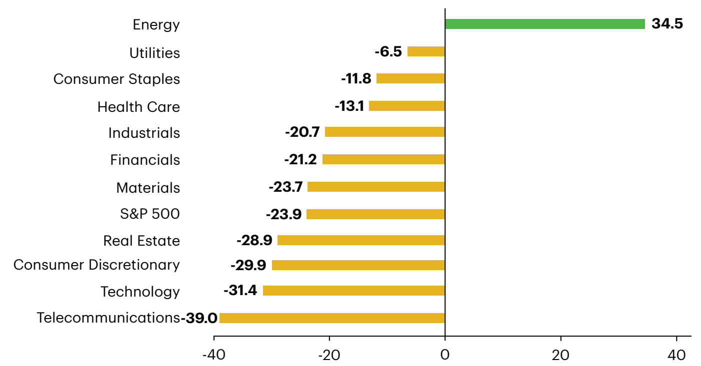
Although the Canadian Investment Grade Corporate Bond Index was able to hold a slight positive return of 0.2% this past quarter, the mirror index in the U.S. fell by 5.4%. Year-to-date these indices had retreated 10.8% and 19.1%, respectively, to the end of the third quarter. With the short end of the yield curve continuing to move up with further increases in interest rates, bonds will be challenged in the foreseeable future to generate sustainably positive capital returns. As inflation gets more under control however, we anticipate longer-dated bonds to generate solid positive returns over the next several years. We have been positioning portfolios to take advantage of that potential outcome accordingly.

Q3/22 S&P 500 Sector Returns



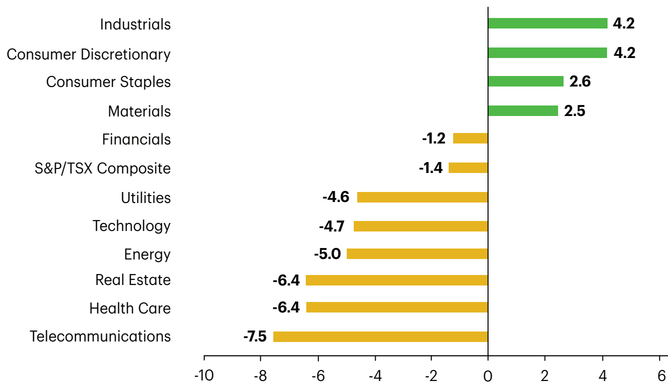
Source: Bloomberg Finance L.P. as of September 30, 2022.

YTD S&P 500 Sector Returns



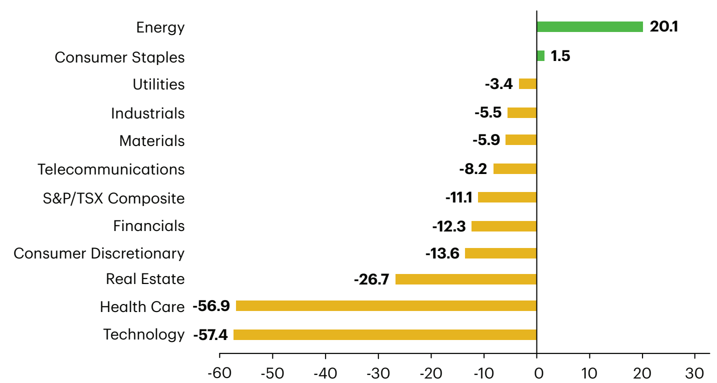
Source: Bloomberg Finance L.P. as of September 30, 2022.

Q3/22 S&P/TSX Sector Returns



Source: Bloomberg Finance as of September 30, 2022. Index total returns.

YTD S&P/TSX Sector Returns



Source: Bloomberg Finance as of September 30, 2022. Index total returns.

Team Update

I am happy to announce that Maddie has rejoined our team upon the recent conclusion of her maternity leave. Her updated phone number is 403-476-0312.

I would also like to take this opportunity to thank Lorenzo Cruz in supporting our team during Maddie's leave. He will be remaining and working within another division of TD Wealth.

Devon, Alejandra, Maddie, and I thank you for your business. We continue to look forward to working with you and your family, and helping navigate your financial journey with deep knowledge, diverse experience, and commitment on your side. If you have any questions or issues you would like to discuss, we would be happy to receive your call.

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