Quarterly Market Commentary

April 2023

Performance Returns YTD

S&P TSX Comp (PR):	3.69%
DJI (PR):	0.30%
S&P 500 (PR):	7.03%
Nasdaq Comp (PR):	16.77%
Canada Bond Index (5-10):	3.85%

As at March 31, 2023

The first quarter of 2023 saw both equity and bond markets rebound from the abysmal performance in 2022. On the surface, some might feel that this bounce back is more than just a rebound off the low levels last year. However, if you look at both the stock and bond markets, they are telling a different story of the economic climate.

Bond Market

Despite elevated levels of inflation, interest rates have declined in this quarter because many bond investors fear that the combination of high interest rates and the challenges in the banking system may result in an economic recession. Banks are an integral part of economic growth. The ability for a bank to lend is tied to the deposits on hand. If they are worried about their deposit base, their propensity to lend diminishes. There are over 4,000 different banks in the US. Many are facing similar challenges to what Silicon Valley Bank faced – namely, they have not properly matched their liabilities (bank deposits) to their assets (how they invested the deposits). The Global Rates Strategy Team at TD Securities estimates that the increase in bond rates has driven down bond values at banks to the tune of over $600 billion dollars. Unless this somehow reverses, or the US Treasury unilaterally guarantees all deposits, many banks may be less likely to seek out new loans. As for the US Federal Reserve (the Fed), I think it's unlikely that they will increase rates much more than where we are today. Their job of slowing down the economy will be taken care of by the banking sector. We continue to like the risk/reward of the bond market, particularly, short-dated corporate bonds and long-dated government bonds.

Equity Markets

Equity markets have rebounded this quarter based on hopes that the increase in interest rates is over and a "Fed Pivot" is in the cards. A Fed Pivot is a change in the direction of interest policy from the current policy. So rather than raising rates, the US Federal Reserve would start cutting rates. Before we delve into the possibility of a Fed pivot, let's look at what drives equity prices. Equity valuations are driven by interest rates and earnings. The lower the interest rate, the higher an investor is willing to pay for earnings. The reverse is also true. The concept of a Fed pivot where they cut interest rates would support higher equity prices. The second thing that drives share prices is earnings – not just the absolute number, but it also matters if earnings are accelerating or decelerating. Investors will pay higher for earnings that are accelerating versus decelerating. If equity investors are hoping for a Fed pivot, it will likely only happen if the economy is in a recession. If the economy is in a recession, it's most likely that corporate earnings will drop. Lower earnings mean lower share prices. As much as equity investors are hoping for a Fed pivot, I think you must be careful of what you hope for.

We have not deviated from our opinion that the current environment warrants caution. A portfolio of high-quality bonds, solid companies that historically pay dividends in healthcare, consumer staples, and utilities along with exposure to select commodity names will serve us well. In the next few months, we will have a better idea of the impact of high interest rates and inflation pressures on corporate earnings.

In the coming quarter the debt ceiling will most likely take centre stage. In the US, the debt ceiling is the legislative limit on the amount of national debt that can be incurred by the US Treasury. Once the debt ceiling is reached, the federal government cannot increase the amount of outstanding debt, losing the ability to pay bills and fund programs and services. The current debt ceiling limit of $31.4 trillion has already been reached. However, the Treasury can use an extraordinary measure to delay the deadline until June or July. At that time, there needs to be an agreement in Congress among Democrats and Republicans to increase the debt ceiling. Similar events have happened in 1995 and 2011. Republicans will agree if the Democrats agree to spending cuts. It ends up being a game of "chicken" between the politicians and, in the balance, equity and bond prices tend to be volatile.

The coming quarters will likely provide a better opportunity to increase equity and risk exposure in portfolios.

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Source: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return.

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