Quarterly Commentary

Fall 2023

The Recession That Wouldn't Be

I read a book some time ago called "A Dog That Wouldn't Be" by Farley Mowat. It is a fascinating story about his childhood dog's very quirky, un-doggish behavior. He was a dog that just wouldn't follow the normal, preordained biological path typical of his canine genetics.

In my 38-plus years of being in financial services, I cannot recall a time when there has been more agreement around a pending economic forecast than there has been for the 'inevitable' recession that has loomed large on the global horizon since mid-2022. From that time until well after the U.S. regional bank scare in March of this year, the 'R-word' dominated the headlines, and there was little doubt the economy was on the brink of a downturn. And yet, as summer wore on and economic data continued to defy forecasts, more and more economists (and talking heads) began touting the so-called 'soft-landing' scenario. And why not? So far it has been the recession that just wouldn't be.

Most recently, even the U.S. Federal Reserve (the Fed) joined the chorus, presenting an economic forecast at their latest policy meeting that looked decidedly non-recessionary: They raised the GDP forecast for 2023 to 2.1% from 1%, while their projection for 2024 was increased to 1.5% from 1.1%. Not great, but not contractionary, either. So much for the predictive qualities of an inverted yield curve supposedly flashing recession—we've been inverted since early 2022 and still we wait.

In January of this year, our Team forecasted a recession to begin in early 2024. While the U.S. story may turn out to be one akin to Farley Mowat's dog, our Team is concerned the same may not be true for Canada, where higher consumer debt loads and fewer potential economic growth catalysts cloud the outlook. Looking across the big blue pond, we do not appear to be alone in this boat—countries outside North America are hampered by similarly high inflation, slowing manufacturing, falling consumer spending, and high interest rates (at least by recent historical standards).

Of the major global economies, economic indicators appear to be weakening in Europe, China, and Canada. As we continue to evaluate the outlook for these economies (as well as the U.S.), there are four key economic drivers that our Team is focusing on, all of which are closely intertwined:

1) Consumer Spending/Consumption

- This accounts for 68% of GDP in the U.S., 54% in Canada, 52% in Europe, and only 38% in China (a key component in their struggle for growth post COVID lockdowns)

2) Tight Labour Markets

- If people begin to worry their current job is at risk and there's no longer one waiting for them across the street, how likely are they to continue to spend their income?

3) House Prices

- Despite some softening in highly overheated markets like Toronto and Vancouver, house prices have remained remarkably resilient in North America in spite of higher interest rates

4) Corporate Earnings

- If spending falls and economic growth falters, corporate earnings are likely to follow

Outlook

1) Consumer Spending/Consumption

- Canada's Household Debt-to-Disposable Income and Household Debt Service Ratios continue to rise, in contrast to the U.S. – At some point in the not-so-distant future, we believe this will drive lower levels of consumption in Canada and will be a drag on economic growth

2) Tight Labour Markets

- Although labour shortages in North America appear to be easing somewhat, we do not foresee a dramatic rise in unemployment in the near term – We monitor this closely, as it's a key force in driving wages (and therefore inflation) higher; it also serves as a buoy for consumer confidence/spending (also a driver of inflation)

3) House Prices

- Much like labour markets, we believe house prices are a significant factor behind consumer confidence/spending – If your income feels secure, and your largest asset is maintaining its value (or growing), you feel confident in your overall life situation, and your willingness to spend rises
- We had been struggling to understand why house prices had remained so strong in both Canada and the U.S., despite significantly higher interest rates – While the underlying reasons are different, the ultimate effects have been the same:

  – In Canada, about one-third of total outstanding mortgages are variable rate. This follows from over a decade of rock-bottom interest rates and benign inflation, leading many to believe interest rates would stay low well into the future, thus making variable-rate mortgages look attractive. Why then, given the significant rise in interest rates, have consumers not been more heavily impacted? It has to do with the way that variable rate is applied.

  Many of these mortgages are set up to have fixed payments. With this structure, monthly payments don't change during the mortgage term, it is only the percentage of the payment that's applied to interest versus principal that varies. If rates rise, more of the fixed payment goes towards paying interest, and vice versa. If interest rates rise so much that the monthly fixed payments don't cover the interest costs, then the excess amount owing is added to the loan principal. These loans are said to be in negative amortization, as the excess interest added to the loan principal serves to extend the amortization period of the mortgage. As of Q2 2023, Royal Bank disclosed that 43% of their total residential mortgage portfolio had amortization periods longer than 25 years.

That compares to just 26% in January of 2022. Other banks have also seen average mortgage terms increase.

The real pain will therefore be felt when these mortgages come up for renewal. At that time, payments will be recalculated at the prevailing interest rate and the amortization period will be reset to the maximum allowable term of 30 years. For those with amortization periods that have extended beyond that, the increase to their monthly payments could be shocking. Potentially compounding this problem is the fact that approximately half of all fixed-rate mortgages are set to renew in 2025 and 2026. It is very likely that these mortgage rates will be considerably higher than they were in their previous terms.

It is our view that this reality may hurt future consumer spending levels more than house prices, as Canadians tend to prioritize mortgage payments over most anything else. High levels of immigration are also likely to continue to provide support for house prices in Canada—potentially even more so in desirable centers where values have already increased the most.

– The U.S. is different in that many households took advantage of the low rates being offered during the pandemic to lock-in long-term mortgages at very affordable rates. Approximately 96% of mortgages in the U.S. are fixed-rate mortgages, and, unlike in Canada, they are not subject to the same 3- to 5-year refinancing terms that are standard here. The rise in interest rates have therefore not had a material effect on household debt serviceability in the U.S. What it has done, however, is reduced the supply of houses for sale in that market. People do not want to move if their 2% mortgage rate jumps to 7% (or higher) during the course of financing their new home purchase. As a result, house prices have stayed high because of a supply-demand imbalance. As well, when interest rates were low, Americans were quite willing to borrow against the equity in their homes to fund various expenses. As higher interest rates continue to make this source of cash less affordable, spending is likely to decrease.

4) Corporate earnings are holding up well in the face of higher wages and input costs. With the forward price-to-earnings multiple at just over 19x for the S&P 500, earnings will need to remain strong and growing. This may be a challenge in the face of a recession that just might be.

Market Commentary

Both the equity and fixed income markets held up well throughout the summer, until September rolled in.

U.S. Equities

- The S&P 500 gave back 3.3% in Q3, while the Dow Jones Industrial Average fell 2.1%
- Energy and Communication Services outperformed, while rising interest rates once again drove the utility sector lower — Of the eleven sectors in the S&P 500, nine had negative returns
- The 'Magnificent 7' mega-cap technology stocks remained the primary contributors to U.S. market outperformance year-to-date, but even they could not keep the NASDAQ above water as it fell 3.9% during the quarter

Canadian Equities

- The S&P/TSX mirrored the lackluster performance of the U.S. markets with a pullback of 2.2% — The only bright spots being the Healthcare and Energy sectors
- High-yielding sectors, such as Utilities and Real Estate, continue to battle against the headwinds posed by high interest rates

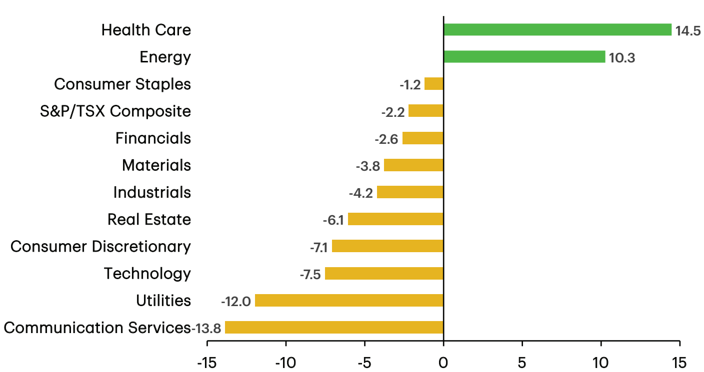
Fixed Income

- Global fixed income markets suffered a sharp decline over the quarter, following a significant repricing of government yields
- Developed countries reported stronger economic growth that surprised to the upside, and with a tight labour market, central banks stood by their conviction for higher-for-longer interest rates
- The FTSE Canada Universe Bond Index reported a loss of 3.9%, while the Bloomberg U.S. Aggregate Bond Index (CAD-hedged) retracted 3.4% for the quarter

International Equities

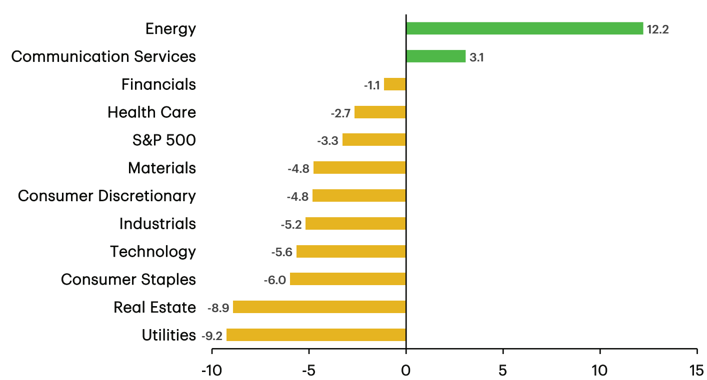
- The majority of overseas markets fared worse than their North American counterparts, with the only positive performance coming from the United Kingdom's FTSE 100, which eked out a 0.44% return for the quarter in Canadian-dollar terms
- The MSCI European Monetary Union Index was at the other end of the spectrum, registering a decline of 4.94% in Canadian-dollar terms

Q3/23 S&P/TSX Sector Returns



Source: FactSet as of September 30, 2023. Index total returns.

Q3/23 S&P 500 Sector Returns



Source: FactSet as of September 30, 2023

Team Update

We are pleased to welcome Jimmy Underdahl to the Borger Griffiths Wealth Management Team. Jimmy attended the University of Calgary and attained his Bachelor of Commerce degree while being a leading member of the Dinos football team.

Jimmy brings significant experience in the financial services industry, having most recently served as Vice President of Sales at a global alternative asset management firm based out of Toronto. Prior to that, Jimmy held roles of increasing responsibility at one of Canada's largest financial services companies, ultimately serving as Senior Business Development Manager over his final three years.

Jimmy has the Chartered Investment Manager (CIM®) and Chartered Alternative Investment Analyst (CAIA) designations.

The Borger Griffiths Wealth Management Team would like to thank you for your business and continued trust in us. We look forward to continuing to work with you and your family as we help 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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Wealth Management

TD Wealth

Source:
Bloomberg Finance L.P. as of October 3, 2023. Total returns including dividends and distributions in native currency.
TD Wealth Investment Office and FactSet. Bank of Canada. OECD. BCA Research. CP24News