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Wealth Management
Dominion Securities

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Quarterly Update

Rewind one year. Equity and fixed income markets were experiencing one of the worst years in history. Central banks had begun 2022 prepared to be somewhat tolerant of a pick-up in inflation, but changed their tune as prices rose much faster than policymakers expected in the early months of the year. Mid-2022 would mark the opening stages of what would come to be the steepest series of rate hikes ever. Still to come for the U.S. Federal Reserve (the Fed) would be an unprecedented run of four successive 75 basis point jumps, followed by four more subdued increases totaling an additional 125 basis points (bps). This was accompanied by the S&P 500 Index being down 27% from its January 2022 peak, while the Nasdaq was a whopping 38% off its highs in November 2021.

Fast forward, and we're once again reminded that the economy is resilient. We sit here in 2023 with equity markets rallying back to their all-time highs, a bond market that looks robust given the possible end of the rate hike cycle, and a labour force that finally may be showing signs of cooling down.

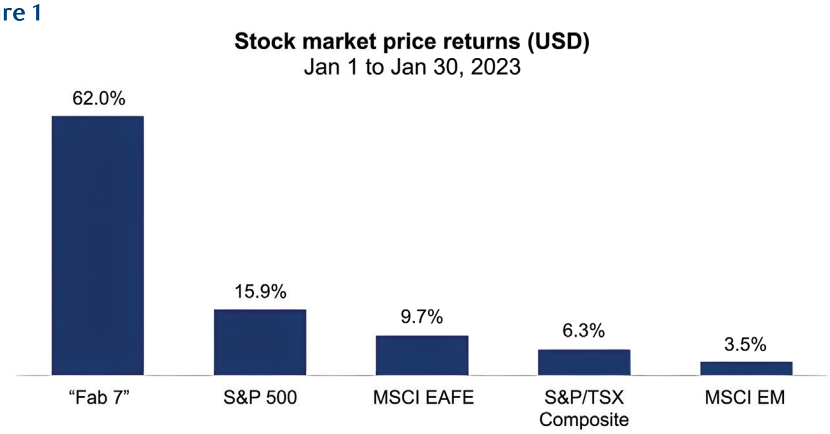
Equities

Since November, stocks rose higher as Artificial Intelligence (AI) took centre stage. Equity markets continued their grind higher from the Fall 2022 lows, helped by:

- Gradually decelerating inflation
- Surprisingly resilient economic activity
- The potential for central banks to stop raising interest rates soon

The knock on the market's recent rally is that it has been unusually carried by a handful of names. Returns were heavily concentrated in a handful of mega-cap technology stocks. The promise of AI proved to be a major catalyst. The "Fab 7" – a basket that comprises Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla – was considered by investors to most likely to benefit from emerging trends in AI. Collectively, the group was up an impressive 62% in the first six months of this year (see Figure 1). Making up about 30% of the weighting of the S&P 500 Index, these companies' stellar stock performance has contributed most of the returns for the broad indexes thus far. The once down

Figure 1



Note: Fab 7 includes Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Source: Bloomberg, RBC GAM

Continued on page 2

and out-of-favour names are once again reminding us that good quality companies that grow their earnings more than the S&P 500 will prevail in the long run.

Bonds

With 2022 marking one of the worst years on record for bond markets, we expected bonds to bounce back, and then some, in 2023. But through the first six months of the year, it has clawed back ... just 2%. Has the "year of the bond" been canceled, or has it simply been delayed? As we see it, one obstacle still standing in the way of above-average fixed income returns has been hawkish central banks remaining firm in their resolve to bring inflation down via rising policy rates. We believe that, before bonds can begin the kind of rally that we have been anticipating, inflation will need to be well and truly on its way back toward target levels.

The near-constant "will they, won't they" of recent months has kept fixed income markets on edge but, ultimately, we think the Fed will take a break from rate hikes, while other central banks may still require further tightening. June was the first time in over a year that the Fed decided against raising rates and opted to stay put. This was short lived when they elected to raise by 25 basis points at the July meeting. However, in Powell's speech following the announcement, he gave the impression that the "wait and see" approach may be implemented due to the rapid increase over the last year. Nevertheless, the data will ultimately be the key decider, and the actions implemented over the last year by the Fed are starting to finally work as we have seen inflation moving dramatically downwards.

Labour

As central banks continue to reel in inflation, one key force we're watching is wage growth. If left unchecked, excessive wage growth would risk fueling high inflation in a repetitive cycle. That's because when workers earn more, costs for businesses rise. In response, businesses are likely to raise their prices, causing consumers to again demand higher wages to keep up with rising costs. You can imagine why this is a cycle worth avoiding. In the U.S., the rate of annual wage growth looks to have peaked at 6.7% between June and August 2022 – around the same time inflation peaked. Wage growth has since cooled, coming in at 5.6% in June 2023. That's better, but likely needs to go lower yet to achieve and maintain the Fed's 2% inflation target.

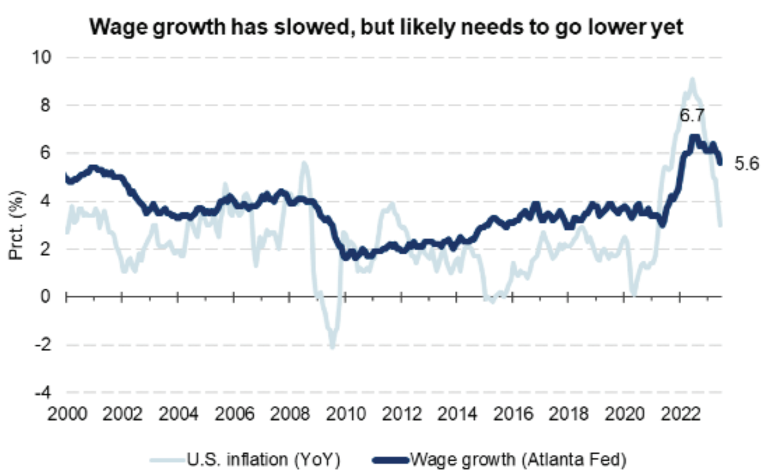
Achieving a 2% inflation rate, however, does not mean wage growth also needs to go all the way down to 2%. Looking at the chart (see Figure X), you'll notice that, since the year 2000, wage growth has spent most of its time in the range of 3% to 4% without inflation being a lasting problem. That's possible, in part, because of productivity improvements over time. If the economy experiences an increase in productivity, where workers can produce more output per hour worked, it can lead to higher wages without necessarily triggering higher prices.

In assessing the ability and likelihood of workers to achieve higher wage growth, we can look to the health of the labour market. When labour markets are tight, employees are in a strong position to demand wage increases. That's exactly the sort of environment we saw last summer when wage growth was at its highest. By hiking interest rates, central banks have put pressure on the labour market. That's because when interest rates rise, the cost of borrowing for businesses increases. This can squeeze profit margins and hinder expansion plans, making employers more cautious about hiring or even lead to job cutting, particularly when they have concerns about the risk of recession.

What are we doing?

Our messaging is consistent with our first quarter note from earlier in the year – we continue to add to our equity bucket as discounted valuations present themselves. Over the last quarter, we have been focused on increasing equity allocation across Canada, the United States, and international markets. We have added to sectors of the economy like emerging trends in AI/growth and Canadian and U.S. financials. We believe that inflation peaked in 2022 and continues to move downwards, interest rates are nearing the end of the hiking cycle, and the economy will continue to grow. While we remain cautious of further economic slowdown, we believe this presents an interesting backdrop for adding to high-quality, blue-chip companies.

Figure 2



As of June 2023. Source: Bloomberg, RBC GAM.

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