Volatility Rears its Ugly Head

Global stocks increased in July, gave most of that back in August, and then fell sharply through the back half of September to finish the third quarter down 3.4%. Despite the recent weakness, global equity markets find themselves up 11.6% in 2023. Market leadership continues to reside in a handful of AI themed mega cap stocks located in the U.S., where nearly 85% of the S&P 500's gain through the first nine months of the year is attributable to the Magnificent-7 stocks (Nvidia, Apple, Microsoft, Alphabet or Google, Meta or Facebook, Amazon and Tesla).

This is now the most concentrated stock market we have data for, with these seven companies representing over a third of the value of the U.S. market. If you are looking for the strongest bull arguments in the years to come, look no further than productivity gains and disinflationary forces supported by an explosion in artificial intelligence. To frame the magnitude of this shift, one of the world's largest equity research firms recently concluded that 75% of the companies in their coverage universe would see a positive financial impact from AI in the next five years including a 2.5% average increase in corporate operating margins. Many of our clients will find names tied to this outlook in their portfolios, including five of the seven Magnificent-7, along with others like Adobe (which we entered in mid-2022 alongside Nvidia).

The Canadian stock market continues to show lower volatility in comparison to global stocks, outperforming in down markets and not keeping up fully in good times. On the quarter, the TSX Composite index fell 2.2%, but is up a much more modest 3.4% year-to-date after significantly outperforming most global stock markets in 2022.

Not to be outdone, the Canadian bond market continues its losing streak in 2023, down ~1.5% for the first nine months after a stock-like sell-off in the latest quarter of nearly 4%. This marks the longest bond market sell-off back to the mid-70s. In fact, this sell-off for fixed income is now more than double the length of time of the next worst market performance since that time (posted in 1980 and 1981). Bond yields for the 10-year U.S. treasury increased nearly 20% in the third quarter, and are up a historical 40% from the yield lows set back in April on the year. As global investors became all too familiar with in 2022, when bond yields are up, bond prices are down.

What on Earth is Happening

When all but a handful of international stock indices are down and only one sector in the global economy (energy) is up in a quarter, the natural question is what on earth caused the selling? In our last several quarterly commentaries, we have been speaking to our reservations on a number of economic fronts, namely rates staying higher for longer (a reasonable expectation of concerned Central Bankers in light of ongoing inflation above target) and a weakening economy (in part from these higher for longer rates). We think both realizations came to pass in the market psychy in reviewing commentary from many of our global partners in recent weeks.

The eurozone for instance added another 0.25% to their interest rate, taking it to the highest level its been at in its monetary union dating back to 1999. Business surveys continue to point to recession there, with both manufacturing and services sluggish and the risk outlook being "tilted to the downside" according the the Chief Economist of the European Central Bank.

Across the Atlantic, at the U.S. Central Bankers annual economic symposium in Jackson Hole, Fed chair Jerome Powell confirmed that inflation remained above the Bank's target and that further hikes could be on the horizon. This was in stark contrast to the market believing cuts would occur in 2023 not long ago. Today, expectations for easing across the U.S. and Europe have been pushed back to mid-2024.

In Canada, the first cuts are priced in for an earlier April 2024, as a more heavily indebted consumer weighs on economic expectations. High debt levels aren't just a domestic problem, but are very acutely weighing on the Chinese economy, where the heavily indebted real estate sector continues to make headlines. Any significant weakness in China could create headwinds abroad, particularly impacting export-driven countries like Germany. For context over the past several decades, roughly 40% of global GDP growth has been attributable to the Chinese economy.

Surprised, but Not How You Would Think

While higher for longer interest rates and a slowing economy have been focal points of a surprised market in the third quarter, we were more surprised with the strong performance to begin the year as our base case included both of these factors. In fact, if history is to provide any guide, then the recession window is still wide open as historically recessions south of the border (which impact the global economy) typically begin 2.5 years after the first Fed rate hike. We remind our readers that the first hike occurred in March 2022.

We continue to monitor signals and data points of a weakening economy. Today some of these include weaker activity in housing starts and resale, negative bank loan growth and increasing corporate default in the bond market (our data shows a spike that is fourth highest in the past 20 years – surpassed only by the Great Financial Crisis, the energy collapse in ~2015 and the onset of the global pandemic).

Suffice it to say no matter which of our global economic prognosticating partners we look to for objective analysis, the balance of probabilities continues to point to a recession, or at minimum a continuing slowing of global economic activity. Succinctly put by one of our counterparties, "a slow-motion slowdown is ongoing, with the consumer facing multiple pressures due to higher inflation and higher borrowing costs". Looking back nearly a century, we find recessions of various magnitudes occur roughly 15% of the time. They are very much a normal occurrence.

It's a Great Time to Have Investment Capital

Outside of a stretch in the 1970s and 1980s, we find that over the past 150 years 10-year bonds trade in the range of 2-5% yields. Today, the U.S. 10-year treasury yields 4.7%, as attractive as it gets in the normal trading range of over a 130 year period. In prior recessions, returns on 10-year bonds over the year following the beginning of the recession's onset have ranged from +1% to +22%. In other words, we see a significant upside asymmetry to bond returns in the coming years. Since 1990, the returns generated by fixed income within a global balanced investor's portfolio generally accounted for ~40% of their portfolio's total return. In the low interest environment of the past ten year period (2013-2022), fixed income only generated ~15% of a global balanced portfolio return.

The low outlook for traditional government and high quality corporate bonds led to excessive risk taking in other areas of the market. These risks came home to roost this past 18 months. Today, we are back to a normal investment climate, where we can take on significantly less risk than two years ago and generate guaranteed returns that are equal or higher than the past decade. Put another way, today many safe fixed income securities are going to deliver higher returns than the higher risk stock market has over the past century. As we continue to decrease our client's portfolio risks (most recently by trimming equities, particularly those that have rallied to unsustainable levels), we look forward to a reasonably likely future where bond returns support portfolio performance, and we get our next attractive entry point into equity markets.

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