Quarterly Market Matters

Summary for Q3 2022

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Highlights

Summer equity rally fizzles out and reverses course, ending below June lows.

US Federal Reserve (Fed) even more hawkish, interest rates expected to be raised above 4% by end of year.

Corporate earnings better than expected in Q2. Bar remains high going into the back half of this year.

US dollar soars to two-decade high, tightening financial conditions.

Make it three in a row

It was a tale of two halves for equities in the third quarter. The first half saw gains extend off the June 16 low as investors leaned into hopes of a dovish Fed pivot. However, in August, Fed committee members doubled down on their commitment to tame inflation, reinforcing their hawkish positioning and prompting markets to abruptly reverse course. The subsequent sell-off pushed equities back below their June lows and marked the third consecutive quarterly loss. By aggressively raising interest rates, the risk remains that the Fed and other central banks will tip the global economy into a recession.

Despite ongoing supply constraints, commodities were under pressure as investors focused on the weaker growth outlook. WTI crude oil plunged from US$105/bbl to below US$80/bbl, copper prices extended their YTD decline to >20%, while gold's struggle to catch a bid continued as real yields jumped higher. The US dollar (USD) reaching a two-decade high was also a significant detractor (more below). The one outlier in the commodity complex was natural gas prices, which continue to climb higher amid the European energy crisis that appears to be worsening.

Inflation remains sticky

US CPI inflation was firmer than expected, up 0.1% m/m in August. Although the annual figure eased to 8.3% from 8.5% y/y, the result was higher than the 8.1% y/y expected. The big surprise was core inflation accelerating sharply to 6.3% from 5.9%, indicating that inflation will likely be stickier than markets expected. Services inflation remains the primary concern, with wages and shelter prices continuing to rise. Rent and owner's equivalent rent components recorded another 0.7% m/m gain and are both up >6% y/y. The result was particularly disappointing considering the double-digit decline in gasoline prices (-11%). Still, forward inflation breakeven rates remain anchored, as markets expect inflation to subside eventually.

King Dollar reigns supreme

If this year's 17% surge in the US dollar (USD) holds, it will mark the strongest annual return since 1984. The move higher has been underpinned by the Fed delivering its clearest signal that controlling inflation would take precedence over preventing a recession. Mounting growth concerns and a sharp drawdown in

Canadian Fixed Income	Level	Quarter	YTD
FTSE Canada Universe Bond	1,050	0.5%	-11.8%
FTSE Canada All Corporate Bond	1,230	0.2%	-10.8%
Bloomberg Canada High Yield	156	0.5%	-6.4%
Global Equities	**Level**	**Quarter**	**YTD**
S&P/TSX Composite	18,444	-2.2%	-13.1%
S&P/TSX Small Cap	638	-3.0%	-17.6%
S&P 500	3,586	-5.3%	-24.8%
NASDAQ	10,576	-4.1%	-32.4%
Russell 2000	1,665	-2.5%	-25.9%
UK FTSE 100	6,894	-3.8%	-6.6%
Euro Stoxx 50	3,318	-4.0%	-22.8%
Nikkei 225	25,937	-1.7%	-9.9%
MSCI China (USD)	56	-23.2%	-32.6%
MSCI EM Index (USD)	876	-12.5%	-28.9%
Currencies and Commodities	**Level**	**Quarter**	**YTD**
CDN $	$0.723	-6.9%	-8.6%
US Dollar Index	112.12	7.1%	17.2%
Oil (West Texas)	$79.49	-24.8%	3.2%
Natural Gas	$6.77	22.6%	78.7%
Gold	$1,661	-8.1%	-9.2%
Copper	$3.41	-8.3%	-22.6%
Canadian Interest Rates	**Level**	**Quarter**	**YTD**
3-month T-bill	3.58	150	342
GOC bonds 2-yr	3.79	70	284
GOC bonds 10-yr	3.17	-5	175
GOC bonds 30-yr	3.09	-4	142
Canadian Sector Performance		**Quarter**	**YTD**
Energy		-6.4%	15.6%
Materials		1.9%	-7.3%
Industrials		3.9%	-6.4%
Cons. Disc.		3.6%	-15.1%
Info Tech		-4.8%	-57.5%
Health Care		-6.9%	-57.4%
Financials		-2.2%	-14.7%
Cons. Staples		2.2%	0.4%
Comm. Services		-8.7%	-11.3%
Utilities		-5.5%	-6.1%
Real Estate		-7.3%	-28.6%

Source: Bloomberg & FactSet September 30, 2022 – local currency unless noted, equity price only returns, bonds total return risk assets added to the dollar strength as investors piled back into the world's reserve currency as a haven. The strength of the USD has provoked a response from several countries. China has seen the yuan fall to the weakest level since the Great Financial Crisis, forcing authorities to beef up its FX fixings against the USD. Japan's Ministry of Finance announced a surprise intervention to support the yen for the first time since 1998, hoping to end the 20% slide against the USD this year. Lastly, the Bank of England's underwhelming 50 bp hike, alongside the government announcing additional fiscal measures when inflation is rising at a nearly double-digit pace, has sent the British Pound plummeting to the lowest level against the dollar in 37 years. Meanwhile, the energy crisis in Europe continues to weigh on the euro, dropping the currency below parity against the greenback. Even the Canadian dollar, which has held up the best amongst major global currencies, is closing in on a 2-year low against the USD due to softening commodity prices and a growing divergence in the expected terminal rate (where markets see interest rates peaking) between the Bank of Canada and the Fed.

To the extent to which the dollar continues to strengthen, it will likely act as a headwind on several fronts. First, a rising USD translates to higher costs for goods, particularly commodities that are predominately priced in dollars. It also makes servicing dollar-denominated debt more expensive for governments and corporations (acutely relevant for emerging market economies). Lastly, US companies, especially multinationals that rely on foreign sales, will see a hit to their corporate earnings when repatriating their overseas profits. These factors tighten financial conditions and point toward slower global economic growth should the dollar remain elevated. Our bullish view on the USD remains intact. The rationale remains unchanged: the US economy is in a stronger economic position to raise interest rates relative to its global counterparts. This is particularly apparent in Europe, where the energy crunch appears to be spiralling out of control as winter approaches – notably, the Euro and Pound combine for ~70% of the DXY Index. Not only will this adversely affect the global economy, potentially prolonging the risk-off environment, but it will also hinder the ECB and Bank of England from aggressively raising interest rates despite soaring inflation. This should translate to more strength for the greenback in the upcoming months.

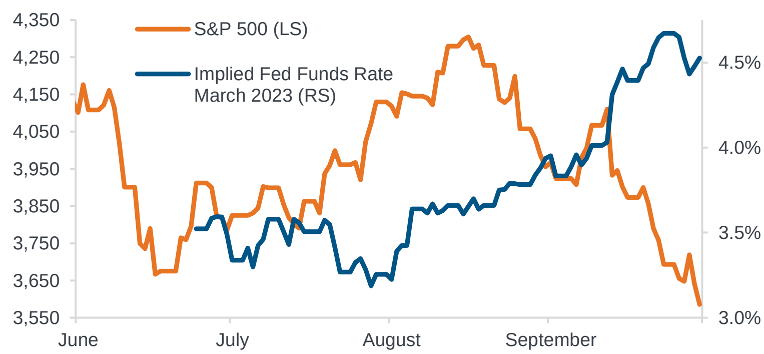
Whatever it takes

Although the US Federal Reserve (Fed) delivered the 75 basis point (bp) hike that was widely expected, raising the target range for the Fed Funds Rate (FFR) to 3% to 3.25%, the entirety of the announcement was decisively hawkish. Indeed, Chairman Powell's press conference ensured that his hawkish views from Jackson Hole remained unaltered. However, the surprise was found in the Committee's updated 'dot plot', where the median estimates shifted sharply higher from their June projections. The Committee now sees rates ending the year at ~4.4%, implying a 75 bp move in November followed by a 50 bps in December. In other words, the Fed is now expected to raise interest rates by 400-425 bps in a nine-month timeframe! Market expectations for the Fed's terminal rate had already climbed sharply to ~4.5% from 3.2% over the past two months leading up to the announcement. The fact that the Fed's 2023 estimate came in higher strongly signals that they are ready to do whatever it takes to get inflation back down to their 2% target. The Fed's recent actions and their unrelenting commitment to tame inflation have undoubtedly increased the probability of a US recession.

Will earnings hold up?

The laundry list of reasons for why economic growth is expected to slow is growing. FedEx Corp. announced that its fiscal Q1 revenue and profit results fell short of expectations and withdrew its earnings forecast for the 2023 fiscal year amid deteriorating business conditions. Nike announced they are facing their own inventory glut, which could squeeze future profit margins. This echoes past warnings from Walmart and Target. Apple is scrapping prior plans to ramp up iPhone 14 production due to faltering demand. Yet, despite these warnings, S&P 500 earnings estimates for 2022 and 2023 have barely budged lower. Although Q2 earnings held up better than expected, the stakes are high for companies to continue delivering results. In our view, this will be a challenging feat to accomplish, given the economic backdrop of a lower savings rate, sticky price pressures and rising interest rates. In this light, a downward revision in earnings estimates seems inevitable.

Chart in focus: The only game in town



We've long stated that this is a market predominantly driven by Fed policy. As depicted in this month's chart, interest rate expectations have had a significant negative correlation to where the S&P 500 trades next. Case in point after the perceived dovish July announcement, markets began lowering their expectations for the US Federal Funds Rate to peak below 3.2% − a move higher in equities ensued. However, a hotter-than-expected inflation report and numerous hawkish announcements from Fed members, punctuated by Chairman Powell's brief, but decisive hawkish Jackson Hole speech followed shortly. The combined effects have effectively eliminated the market's optimism for a dovish pivot in the short-term. Market-implied odds for the terminal rate have been climbing higher as a result. This has forced stocks to reverse course lower as investors somberly realize the likely end of the zero-interest rate policy (ZIRP) era that has propelled risk assets higher. Although there are several factors at play in determining where equities trade next, it has become apparent that the Fed holds all the cards.

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