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The Quarter That Was

The Fed’s determination to wrestle inflation with large rate hikes dominated financial headlines, preoccupied investors and steered market performance during the quarter.

Despite a bright start to Q3, U.S., Canadian and global equities gradually lost momentum as the Fed reiterated it would continue its monetary tightening path. In bond markets, U.S. and Canadian yields rose on the outlook for interest rates, inflation and the pound falling to a record low after the U.K. government announced huge tax cuts funded by increased borrowing.

There were several positive U.S. and Canadian economic indicators during the quarter. U.S. job creation remained solid, jobless claims fell, and wage growth increased. Retail sales and consumer spending rose as well, and the federal deficit shrank 50% compared to the same period last year. In Canada, the unemployment rate remained at a record low, job vacancies grew, retail sales increased, house prices continued cooling and the trade surplus widened to its largest in 14 years.

The CEOs of two major grocery chains also said food prices have started stabilizing. More evidence the worst of the pandemic may now be hopefully behind us was seen at the end of September when the Canadian federal government removed its COVID-19 travel restrictions. These included mandatory vaccinations, testing and quarantine of international travelers and masking on planes and trains. In addition, the ArriveCAN app was made optional.

Q3 also witnessed many major central banks around the world coordinating with the Fed on hiking rates. These included the Bank of Canada, Bank of Australia, Bank of England, European Central Bank, the Nordic central banks and the Swiss National Bank which notably ended its negative rate policy. The Bank of Japan and China's central bank were outliers. Japan held its benchmark rate at -0.1%. China introduced a 10-basis point rate cut as supply chain disruptions, falling real estate activity and the ruling communist party's "zero-COVID" policy affected economic growth.

U.S. inflation eased during the quarter, to 8.3%, although this was considered disappointing by investors as expectations were for a drop to 8.1%. Food and housing costs continued to be the main inflationary drivers. As a result, the Fed hiked rates 0.75% twice in Q3. At its annual Jackson Hole summit in Wyoming, Fed chair Powell said the Fed would continue hiking rates until inflation was fully under control. He added restoring inflation to the Fed's 2% target was its "overarching focus right now."

In Canada, inflation also moderated, to 7%, which was much lower than expected. This largely stemmed from falling gasoline prices which mitigated the cost of groceries remaining high. The welcoming news led some economists to anticipate inflation may have peaked. Aligning with the Fed, the Bank of Canada increased its benchmark rate twice during Q3, 1% in July and 0.75% in September. Its official statement also made clear more hikes are still required.

Capital Markets in Q3

The S&P/TSX Composite Index ended the quarter down 1.4% while the S&P 500 Index posted a gain of 1.3% and the MSCI EAFE Index a loss of 3.4%.

Despite the challenging investment climate, U.S., Canadian and global equities started Q3 brightly, rising steadily through July. The three leading U.S. indexes - the S&P500 Index, Dow Jones and Nasdaq - notched their biggest monthly gains since 2020. Then heading into August, equities started to fade and finished the quarter flat over uncertainty about how long the Fed's rate hiking cycle might last.

In July, a raft of U.S. banking, tech, retail and oil companies released quarterly earnings which were mixed. August was third quarter reporting season for seven of Canada's largest banks and their results were mixed as well.

In bond markets, U.S. treasuries and Canadian bond yields, which move in the opposite direction to bond prices, continued to rise through Q3. Key drivers were the outlook for interest rates, inflation and the pound falling to a record low after the U.K. government announced huge tax cuts funded by increased borrowing. The yield curve, which is the difference between 10 year and 2 year U.S. treasury yields, became inverted, highlighting tighter Fed rate policy at the short end and forecasts for slower growth at the longer end.

The price of oil, considered a leading barometer of inflation, steadily declined through the quarter falling under US$80 a barrel towards the end of September, its lowest level so far in 2022. The decline was driven by anticipation the Fed's rate hiking plans, a surging U.S. dollar and slowing growth and ongoing lockdowns in China will continue to dampen demand and as a result, inflation.

The loonie, due to its close ties with the oil sector, weakened against the greenback, but not as much as the pound, euro, yen, yuan and other major currencies. The Canadian dollar remains the best performing G10 currency relative to the U.S. dollar, which has been seen as a buffer against rising interest rates.

What can we expect now?

The focus continues to be on monetary tightening to combat inflation and the impact this has on markets and the broader economy. Even though there are promising signs inflation may have peaked, a clearer indication will be once we achieve a few more months of declining inflation.

Markets will likely stay choppy until then. For active fund managers and investors, the current environment does offer select buying opportunities. Economic fundamentals also remain healthy and supply chains are normalizing. In time, a sustained recovery will occur, and history has proven investors are rewarded over the long-term.

Regardless of where we are in the market cycle, it’s important to take a disciplined approach to investing and stay focused on your long-term goals. **This strategy helps you keep your emotions out of investing, typically buying high and selling low like many investors do**. Ongoing monitoring and reviewing of your portfolio also ensure it remains on track. Diversifying investments reduces risk as well.

I hope you have a chance to enjoy the beautiful fall colors before they are gone.

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