Market Review

as at September 30, 2023

Investors worldwide are closely watching the surging U.S. Treasury yields, which have reached levels not seen since the 2007 financial crisis. Most financial experts attribute this to the belief that markets are preparing for "higher interest rates for a longer time." While this is true, it's essential to note that bond markets have grown frustrated with both major U.S. political parties' inability to address the growing fiscal deficit. They've taken on the role of "bond vigilantes" to push for fiscal responsibility.

Geopolitical tensions have also risen, especially after the recent tragic events in Israel, which could potentially lead to broader instability in the region.

Market Returns

Major global stock markets have declined in the last quarter, but they have still posted positive gains for the year. The MSCI World Index has gained 10% since the beginning of the year, and the S&P 500 Index and Bloomberg European 500 Index have risen by 13% and 8%, respectively. These gains indicate that, despite concerns about a potential U.S. recession, inflation has eased, and rising interest rates haven't hit the economy as hard as feared. In the coming months, investors will likely remain focused on inflation and interest rates, especially in the U.S.

Inflation: Down But Not Out

In August, the U.S. Consumer Price Index increased by 3.7% year-over-year. This is significantly lower than the peak inflation levels of 9.1% in June 2022 but still above the U.S. Federal Reserve's long-term target of 2%.

In September, U.S. interest rates remained in the range of 5.25% to 5.5%, but Federal Reserve Chair Powell noted that they need to see more progress on inflation before ruling out additional interest rate hikes.

The International Monetary Fund (IMF) shares this sentiment and has raised its forecast for global consumer price inflation for the next year to 5.8%, up from 5.2%. They recommend keeping monetary policy tight in most places until inflation starts coming down consistently.

Growth: Holding Steady

The IMF's outlook for global growth is stable but modest, with a projected rate of 2.9% for the next year. However, this falls below the 3.8% average in the two decades before the pandemic.

Within this global outlook, the IMF has revised its expectations for U.S. growth to 2.1%, up from the previous estimate of 1.8%. They anticipate stronger business investment in the second quarter and resilient consumption growth.

Impact of Rising Bond Yields

Rising bond yields pose a risk to this scenario. Yields on longer-term U.S. government bonds have surged, with 10-year yields reaching 4.8% and 30-year yields going over 5%. This surge could significantly impact the wider economy and make borrowing more expensive for products like residential mortgages and auto loans, as their rates are tied to U.S. Treasury yields. It also raises concerns about corporate defaults and sectors like U.S. regional banks and commercial real estate.

Moreover, the combination of higher long-term interest rates and decreasing inflation is reflected in rising real interest rates. Currently, 30-year mortgage rates are above 7.5%, while market expectations for future inflation are around 2.3%. This gap of more than 5 percentage points is unusual, and it hasn't been seen since the 1990s. It was much narrower, around 2.5 percentage points, in the 2010s. While consumption growth might be holding up for now, it could face challenges down the road when the impact of higher mortgage and car loan payments becomes more pronounced.

Political Challenges

A substantial portion of the increase in bond yields may be attributed to concerns about the U.S. structural budget deficit finally affecting markets. The debt ceiling was raised by Congress in June without the spending cuts that fiscal conservatives had hoped for. The recent deal to prevent a government shutdown until at least mid-November only cut aid to Ukraine, leading to the bond market's skepticism about deficit reduction in 2024.

With a presidential election on the horizon, it's unlikely that deficit reduction will be a central theme in political campaigns, given the current lack of political will to address this issue.

The Bond Market's Message

A significant budget deficit requires a substantial supply of Treasury bonds to finance it, which puts upward pressure on long-term yields. Short-term yields, on the other hand, are influenced by Federal Reserve policy, and it may be some time before the stock market experiences rate cuts. The recent surge in Treasury yields signifies the bond market's displeasure with Congress for not taking significant action to address the fiscal deficit.

The concern here is that the economic outcome may be taken out of the Federal Reserve's hands as they strive to prevent a recession while dealing with inflation.

Outlook

The Fed is reaching a critical point in its fight against inflation, and the next couple of months may determine whether or not it can navigate a so-called soft landing for the U.S. economy without tipping it into a recession. The U.S. Treasury yield curve has been inverted since mid-2022, a historically strong recession indicator. In fact, the New York Fed's recession model predicts a 60.8% chance of a U.S. recession sometime in the next 12 months.

So far, the most convincing argument a soft landing may be possible has been the resilience of the U.S. labour market. The Labour Department reported the U.S. economy added 336,000 jobs in September, significantly more than Wall Street economists expected. The unemployment rate remained at 3.8%. However, against this backdrop, wage growth has been slowing – with September's reading being the lowest since February 2022.

The uncertainty surrounding current geopolitical tensions will likely increase market volatility in the near term with potential knock on impacts to energy prices, inflation and central banks' monetary policies. Therefore, some caution is warranted.

Macro Indices Report as at September 30, 2023 (percent)

	SEP	AUG	JUL	Q3 2023	YTD	2022	Annualized 3 Years	Annualized 5 Years
GLOBAL EQUITY								
MSCI AC World Total Return	-4.1	-2.8	3.7	-3.4	10.1	-18.4	6.9	6.5
MSCI EAFE	-3.4	-3.8	3.3	-4.0	7.6	-13.9	6.4	3.8
NORTH AMERICA EQUITY								
S&P 500 Total Return	-4.8	-1.6	3.2	-3.3	13.1	-18.1	10.2	9.9
DOW JONES INDUSTRIAL AVG	-3.4	-2.0	3.4	-2.1	2.7	-6.9	8.6	7.1
S&P 400 Net TR	-5.3	-2.9	4.1	-4.3	3.9	-13.5	11.5	5.5
NASDAQ COMPOSITE	-5.8	-2.1	4.1	-3.9	27.1	-32.5	6.6	11.4
RUSSELL 2000 INDEX	-5.9	-5.0	6.1	-5.1	2.5	-20.5	7.1	2.4
S&P/TSX COMPOSITE INDEX	-3.3	-1.4	2.6	-2.2	3.4	-5.8	10.0	7.3
EUROPE EQUITY								
BLOOMBERG EUROPEAN 500	-2.0	-2.3	1.9	-2.4	8.1	-10.0	10.2	5.6
FTSE 100 INDEX	2.4	-2.6	2.3	2.1	5.2	4.6	13.0	4.1
CAC 40 INDEX	-2.4	-2.4	1.4	-3.4	13.4	-6.7	17.3	8.4
DAX INDEX	-3.5	-3.0	1.9	-4.7	10.5	-12.3	6.4	4.7
ASIA EQUITY								
MSCI AC Far East Ex Japan	-3.8	-7.5	6.2	-5.5	-4.2	-23.6	-8.1	-3.2
NIKKEI 225	-1.7	-1.6	0.0	-3.4	24.3	-7.3	13.3	7.8
HANG SENG INDEX	-2.6	-8.2	7.2	-4.2	-6.8	-12.6	-5.8	-5.5
S&P/ASX 200 INDEX	-2.6	-0.5	2.9	-0.3	5.0	0.5	12.5	8.0
SHANGHAI SE COMPOSITE	-0.2	-5.1	4.1	-1.4	3.3	-12.8	1.4	4.5
SOUTH AMERICA & EM EQUITY								
MSCI EM Net Total Return USD Index	-2.6	-6.2	6.2	-2.9	1.8	-20.1	-1.7	0.6
S&P LATIN AMERICA 40	-1.9	-8.2	4.9	-5.6	14.2	11.4	16.1	2.2
BRAZIL IBOVESPA INDEX	0.7	-5.1	3.3	-1.3	6.2	4.7	7.2	8.0
S&P BSE SENSEX INDEX	1.5	-2.3	2.9	2.0	9.4	5.8	21.5	14.0
FIXED INCOME								
ICE BoA 1-3 Year US Treasury Index	0.0	0.4	0.4	0.7	1.7	-3.6	-0.8	1.1
Bloomberg US Agg	-2.5	-0.6	-0.1	-3.2	-1.2	-13.0	-5.2	0.1
Bloomberg Multiverse (Unhedged)	-2.9	-1.4	0.8	-3.5	-1.9	-16.0	-6.6	-1.5
Citi World BIG US Hedged	-2.0	-0.3	0.0	-2.3	0.4	-13.1	-4.7	0.1
ICE BoA US High Yield Index	-1.2	0.3	1.4	0.5	6.0	-11.2	1.8	2.8
JPM EMBI Global Core – US$	-2.9	-1.6	1.9	-2.7	1.0	-18.4	-14.3	-2.4
JPM EM Global Cove – Local	-3.4	-2.4	2.3	-3.6	3.7	-10.2	-7.2	-1.1
COMMODITIES								
BLOOMBERG Commodity Index	-1.1	-1.2	5.8	3.3	-7.1	13.8	14.0	4.2
GOLD	-3.7	-1.4	3.1	-2.2	3.1	0.1	-0.9	57.5
OIL (WTI)	9.8	3.4	16.5	32.3	18.4	27.6	42.6	-4.1

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