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INVESTMENT COUNSEL LTD.

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Investment Commentary

Table one below shows the price performance of the S&P/TSX and the S&P 500 index over the periods indicated. The TSX has experienced very little price performance in both the first nine months of 2023 and over the last one-year period. This was due to the weak performance of the heavily weighted financial services index. During the last nine months the index declined 6.2% and during the last year it declined 4.8%.

By comparison the S&P 500 index had a robust 12% return over the last nine months, and a 17% return over the last year.

The S&P index enjoyed a strong 28.4% appreciation over the last three years. There was a somewhat smaller 18% gain for the TSX over this period. The large gain over three years is largely explained by the fact that three years ago the market was in the early stages of a recovery from the COVID induced sell-off that occurred in March of 2020.

Table 1

Price Performance of the S&P 500 Index and the S&P/TSX Index

% Change

	S&P/TSX	S&P 500 Index
Nine Months 2023	0.5	12
1 Year	2.2	16.9
3 Years	19.1	27.4

Source: Factset

The U.S. Market in The First Nine Months of 2023

While the U.S. market enjoyed a 12% return year-to-date, as of the end of July the S&P 500 Index was up 20% for the year. In the third quarter the index declined 3.6%. This abrupt reversal was the result of two factors. Firstly yields on long term government bonds increased steadily over the quarter, see Table 2. As of September 30th, 10 year Treasury bond yields were at their highest level since 2007. Secondly technology stocks declined in the quarter, with shares of Apple and Microsoft the largest companies in the U.S. market falling by 12% and 17.3% respectively.

Table 2

U.S. Treasury Bond Yields - %

	March 2023	June 2023	September 2023
10 Year Treasury Bonds	3.47	3.88	4.57
2 Year Treasury Bond Yields	4.03	4.90	5.05

Source: Factset

The Inflation Rate – Still Above the Federal Reserve Board Target Level

On October 12th the consumer price index for the month of September was released. For the last twelve months the index increased 3.7% before seasonal adjustment. This was equal to the 3.7% increase for the month of August. Core inflation which excludes the volatile food and energy components of inflation, increased by 4.1% over the last twelve months ending in September.

The positive news from this number is that core inflation continues to trend down from its year ago level. In September of 2022 core CPI was 6.6% and the all-items CPI was 8.2%.

One of the key guidelines the Federal Reserve Board is using to move inflation back to the 2% level is the tightness of the labour market. The theory first put forward in the U.K. in the 1950's by William Phillips was that higher unemployment leads to lower wage demands and hence slower price growth. The Phillips Curve showed a positive relationship between higher unemployment and lower wage demands. However, beginning in the 1970's with stagflation the relation began to be questioned.

The apparent conclusion from this evidence is that just as a strong economy has not prevented inflation from coming down there is no guarantee that a cooling economy will move it to 2% or lower.

What Direction Does The Economy Go From Here?

The performance of the economy thus far in 2023 has been better than many expected. The resiliency of the expansion has largely been by consumer spending. The spending was driven by consumers reducing their liquid savings built-up during the pandemic. Drawing on those sources of funds might continue for a period of time but will end shortly. Additionally, the economy faces a UAW strike, a potential government shutdown, and volatile oil prices.

Most importantly however is the lagged impact higher interest rates have on the economy. One of the most dramatic impacts of higher interest rates is tightening credit conditions. Banks have indicated this phenomenon is occurring at present.

The Challenge of Generating a Soft Landing For The Economy

Shortly before the recessions in 1990, 2000, and 2007 many economists proclaimed that the U.S. was on the cusp of a soft landing which indicated that inflation had been slowed without causing a recession. This is a very difficult objective to realize, and it faces four threats: the Federal Reserve Board holds rates too high for too long, economic growth accelerates, energy prices rise, or a financial crisis arises.

If the Federal Reserve Board holds rates too high for too long, it would risk an unnecessarily severe downturn. Officials have indicated that they will hold rates at high levels for longer than they might have to ensure that price pressures do not resurge. Further, if inflation is reduced it will require keeping rates at close to their so-called neutral level, that neither spurs nor slows growth. Because this rate cannot be observed it is hard to identify. It is realistic to expect that next year the Federal Reserve Board will discover that it has raised rates higher than necessary, or not high enough.

Rising oil prices threaten to drive inflation higher, while reducing growth by slowing discretionary spending. Production cuts by OPEC have lifted crude oil price in the second and third quarters of the year. Oil price spikes after the Federal Reserve Board started cutting rates in 1990, and 2008 contributed to serious recessions.

The Impact of The Hamas Attack on Israel on The Price of Oil

On October 7th Hamas, the Islamic resistance movement in Palestine launched an attack on Israel. One of the primary concerns of this conflict is that oil prices may spike, causing a resurgence in inflation, and weakness in the markets. In my opinion this concern is overblown. If the conflict remains within Israel, price changes will be muted. The last major war in the area in 1973 resulted in an oil embargo by several Arab states protesting the U.S. support for Israel. Today no such unity amongst the Arab states exists. Additionally, today the U.S. is the world's dominant oil producer. Further, it has a strategic petroleum reserve. The only likely country to

be impacted by the war is Iran as a result of its apparent involvement in the attack by Hamas. Iran produces about 3% of global production. If there is an embargo on Iranian oil it will not materially affect global oil prices.

Summary and Assessment:

Inflation remains well above the target level of both the Bank of Canada and the Federal Reserve Board. Our concern is that inflation in the 4 - 5% range becomes more secular than transitory. Wage inflation could remain high in the event of a generous settlement between the auto manufacturers and the UAW for example.

The risk-free rate of return – the yield on two-year bonds – is now 5%. This provides a modest hurdle for equities as an alternative to bonds. However, with core inflation at more than 4% bonds still do not provide meaningful protection against inflation. Hence either bond yields have to move higher, or inflation has to decline. At this point it is too difficult to provide any clear direction on which outcome will occur.

Ian Osler, CFA
Portfolio Manager

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