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Rates & Credit - Interest rates increased steadily in Q3 against the backdrop of sticky inflation, strong economic growth, and a tight labour market. In Canada, corporate bonds outperformed government bonds and the broader FTSE Canada Universe Index during the quarter, with a loss of 2.2%, versus a loss of 4.4% for government bonds and a loss of 3.9% for the overall index. The outperformance was primarily driven by the fact that the corporate bond index is less sensitive to interest rates movements (as compared to the government index), all else being equal. The outperformance was also driven by an improvement in risk-appetite, with lower-rated BBBs slightly outperforming higher-rated A bonds. Industries with higher interest rate exposure such as infrastructure, energy, and communications underperformed those with less (notably financials and securitization), consistent with the overall shift in the yield curve.

Equities Lose Traction – Global equity markets lost momentum last quarter with the TSX declining 2.2% while major developed economies from Europe, Australasia, and the Far East (EAFE) fell 1.3% in local currency terms. U.S. equity markets, while falling approximately 3.3%, were cushioned by a strong greenback, with the index declining only 1% in Canadian dollar terms. With inflation prints continuing to be stubbornly high and employment data remaining strong, central bankers emphasized their commitment to a higher-for-longer approach to monetary policy. The hawkish tones out of the Federal Reserve pushed bond yields higher and consequently, pressured equities lower. Furthermore, mixed economic data out of China rattled investor sentiment over the quarter as global growth forecasts came under scrutiny.

U.S. Fundamentals – Although U.S. earnings continue to contract on a year-over-year basis, companies surpassed expectations with investors remaining highly focused on signs of deteriorating operating margins. After bouncing off Q1 2022 lows, forward earnings guidance continues to improve on a quarterly basis. Based on our analysis, ~35% of major companies revised earnings forecasts higher (+2% versus Q2) while ~33% held expectations constant, with the balance expecting deteriorating financial performance. Overall, improved efficiencies through cost-cutting measures and stronger-than-expected pricing power have contributed to resilience in operating margins, and therefore renewed optimism about forecasted financial performance.

Equal Weight S&P 500 versus S&P 500 – Persistent crowding into mega-cap technology stocks – which has driven the majority of market returns year-to-date in the U.S. – slowed at the beginning of the summer before reaccelerating into quarter end. The persistence of this trend has resulted in the equal-weighted version of the S&P 500 index returning a mere 1.8% over the first three quarters of the year, markedly lower than the 13.1% return observed from the S&P 500. We continue to emphasize that a crowded market surge is not uncommon during late stages of the economic cycle, and we remain focused on delivering optimal risk-adjusted returns with quantitative factors.

U.S. Quant Factors – The quality-growth areas of the market continued to outperform last quarter with market participants seeking large cash-rich companies with innovative product offerings and stable operating margins. That said, the pricing power of these companies has weakened more recently with consumers having depleted pandemic-era savings and stimulus. As such, fundamentals are beginning to appear overvalued. Low volatility stocks (i.e. stocks with lower sensitivity to broad market movement and lower price volatility) performed in-line with the overall market for most of the summer before underperforming into quarter-end when crowding into big-tech returned. While top-line projections are forecasted to post stable growth, the basket's relatively lower operating margins remain a headwind amid surging interest rates. Dividend growth companies, which include businesses with a lengthy and established history of increasing dividends, performed approximately in-line with the broader index over the quarter. With the market forecasting overly-negative fundamental performance, this factor is positioned as a contrarian opportunity in the market.

Canadian Fundamentals – Unlike those in the U.S., Canadian companies reported shrinking operating margins in general, pressuring equity pricing. Like in the U.S., Canadian corporate earnings were mostly consistent with expectations but continue to contract on a year-over-year basis. The energy sector benefitted from a ~30% increase in oil prices during the quarter, as OPEC's restrictive oil production schedule pushed crude markets deeper into under-supplied territory. Those higher energy prices buoyed performance of stocks in the energy sector, one of only two sectors with positive performance during the quarter, helping partially offset softer-than-expected results out of the financials and communications sectors. Meanwhile, the Bank of Canada continued with its hawkish monetary policy by raising its overnight interest rate by another 25 basis points, bringing it to 5%. Their efforts to slow economic growth are beginning to cause some deterioration in fundamentals and, with one quarter remaining, analysts are expecting Canadian earnings to contract ~9% for the year.

Canadian Quant Factors – With central banks around the world continuing to hike interest rates and uncertainty surrounding China's economic health, global growth prospects fluttered over the quarter. The cyclical nature of the Canadian market, and therefore its reliance on global partners, saw equity prices put under pressure by growth concerns. As a result, the quality bucket benefitted from defensive positioning by investors and thus resumed its climb in Canada. Investors continue to prefer mature, large businesses that are better positioned in a restrictive economic environment due to their more stable operating margins. The value factor – which was beaten down in Q2 – rebounded last quarter with supply-driven energy strength helping to propel energy stocks higher. Low volatility initially displayed similar performance to the TSX, but energy's rapid surge into the end of summer pressured the group lower. Given higher risk-free rates, the dividend factor also underperformed over the quarter, with dividend yields becoming less attractive on risk adjusted basis.

Views From the Frontline

Rates – Both nominal and real – rose sharply in Q3 to levels not seen since the Great Financial Crisis of 2008. A healthy labour market, strong consumer spending, persistent inflation and excess supply concerns drove the interest rate increase. Although the economy is starting to witness a deceleration in consumer spending and tighter credit conditions, central banks remain committed to maintaining a higher policy rate for longer to bring inflation back to the 2% target.

Credit – The risk premium for corporate bonds (versus government bonds) has been range-bound over the past quarter as investors' evaluations of a variety of scenarios have evolved: soft-landing versus a recession, geopolitical uncertainty, further central bank increases, among other things. On the balance, we do not think the current risk premium adequately compensates for downside risk, and as such, we remain cautious on corporate bonds and have a bias towards higher-quality, shorter-dated credit where we view the risk / reward dynamic as being more favourable.

Equities – Geographically, we began the quarter with a preference for U.S. equities relative to Canada and EAFE. In-line with our expectations, U.S. stocks outperformed the two regions in Canadian dollar terms. That said, weakness in the Euro versus the Canadian dollar was a headwind for our EAFE exposure. With earnings yield – which is the percentage of earnings relative to price – becoming less attractive compared to risk-free rates in the U.S., and the greenback strength becoming overstretched from a technical perspective, we have pared back our overweight U.S. position. Moreover, with Chinese officials focusing efforts on the introduction of new stimulus packages, we believe that more cyclical markets like Canada and EAFE will retrace some of their losses in the near term. Within the U.S., we entered Q3 with a constructive view on high quality growth segments of the market that provide strong operating margins during the current late economic cycle conditions. The factor moved in-line with our expectations, as highlighted in the "U.S. Quant Factor" section, and we are tactically decreasing our exposure amid stretched fundamentals. In Canada, we continue to prefer high-quality companies due to their strong fundamentals, with the group currently displaying momentum versus the broader TSX. Tactically, we are participating in the oil supply shock through the value factor.

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