We hope that you are well and looking forward to the warmer weather to come.

The first quarter was transitional for the Canadian and US economies. The Canadian Central Bank halted interest rate hikes and are currently holding rates at 4.5% to see what the impact on inflation, the economy and employment will ultimately be.

The US Federal Reserve has raised rates to the 4.75-5.0% range and opinion is split as to whether they will pause or continue to increase rates. It is likely that they will remain data dependent and we are close to the end of the rising rate cycle. Although still well above the 2% inflation target set by both Central Banks, it is widely believed that inflation will continue to trend lower.

Jobs numbers are beginning to weaken and wage inflation is cooling which favours a pause in rate hikes.

We have recently seen the effects of Incrementally higher interest rates on the financial system. The risk with rapidly raising rates was that there would be unforeseen consequences that may cause something to “break”. This would lead to tighter credit conditions and a slowing economy. The silver lining was that this would allow the U.S. Federal Reserve and other Central Banks to pause their restrictive stance and markets would price in fewer rate hikes and an eventual pause.

The collapse of Silicon Valley Bank and Signature Bank in the US as well as the forced marriage of Credit Suisse with UBS in Europe triggered that market response after an initial period of turmoil. The valuation of bank shares was negatively impacted as questions were raised concerning the stability of the banking system. SVB was a major provider of venture capital to junior technology companies and its failure caused many shares in this sector to decline.

The quick action by governments to support depositors in the wake of the bank failures appears to have stemmed a run on the U.S. regional banks. It is likely the issues were not systemic to the banking system and confidence is slowly returning and share prices are beginning to recover. Early earnings results from the major banks that exceeded expectations continue to improve the tone of this sector.

The interest rate raising cycle appears to be nearing an end. Although there may be room for modest increases in rates from these levels, they should stabilize, and a pause is likely. The issue facing markets at this point is how long interest rates stay at these levels before the economy slows, reducing inflation to target levels. This holding period could cause a recession that would lead to potential rate cuts in the future. The bond and equity markets appear to be pricing in these cuts by year end. This is possible, but not probable.

Inflation is falling, but not at the pace desired. The U.S. Federal Reserve continues to use aggressive language in the face of slowing economic data and this has forecasters in a bind because there is no real clear path forward. As bond and equity markets gain traction the rhetoric gets more hawkish to maintain a balance between optimism and pessimism. This has led investors to be very cautious, with funds flowing into near cash assets yielding north of 4%. This takes investment capital away from the bond and equity markets and may be one of the principal reasons that the equity markets seem to be caught in a trading range of plus or minus 10%.

Once there is more clarity and barring any unanticipated shocks to the financial system, the transition to a falling rate environment should be constructive for equities, especially those paying high and sustainable dividends. This is because the impact of elevated interest rates tends to put pressure on dividend paying equities as rates offered by money market deposits, GICs and bonds become increasingly competitive.

Equity and bond markets are beginning to trend higher because of the perceived pause in rate hikes as inflation eases. Guidance was also lowered in 2022 and the beginning of first quarter earnings season is in line with these revised expectations. This bodes well for the shorter term, however as the economy slows the effect on earnings will become apparent and this will likely cause markets to reprice based on reduced guidance and slower projected growth. What is yet to be ascertained is whether we face a substantial correction. There are signs that we have already priced in some of the negativity and had a period of rolling recessions that have affected certain sectors already as could be seen in the technology sector in 2022 and the financial sector this year.

The re-opening of the Chinese economy as COVID restrictions were lifted is beginning to become supportive of commodity prices and oil appears to have stabilized. China and India have been major beneficiaries of western sanctions against Russia allowing them to become buyers of discounted Russian oil, helping them build reserves. This and the fears of economic slowdown caused oil prices to fall, even though the demand picture remained favourable. When oil dropped to $70 range, and the U.S. didn’t fill their strategic reserves it caused OPEC Plus to support prices by lowering production, putting a floor under them. Oil has since rallied and there is now some price stability even if demand were to decline if the global economy slows.

Of concern longer term is the fracturing of the global economy into spheres of influence between western democratic leaning countries and eastern autocratic countries. Sanctions will only lead to greater polarization and tension.
The first quarter of the year saw invested funds move towards large cap

technology companies because of perceived safety and cash flow. Gold and commodities also benefitted from this flight to tangible assets.

Higher dividend paying utilities, financials and industrial companies suffered in this environment because their yields were in competition with low-risk cash options. Going forward it is likely that funds will return to these areas as value-based sectors gain momentum with confidence returning and funds coming out of cash instruments as their yields drop.

The U.S. dollar has also declined which is good for equities, especially multinationals. Other sectors like health care and energy should benefit as well. For now, it makes sense to keep elevated levels of cash as the markets find direction.

As always, if you have any questions or just want to touch base, we are just a phone call or e-mail away.

The Andras Group

To contact your advisor, email info@researchcapital.com.