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We hope this update finds you well and enjoying the fall colours.

Although the economy remains resilient, it is likely that it will face some headwinds over the next few quarters as student loan repayments in the U.S. have started again and rising rates have dampened the desire for large purchase items.

Employment remains robust, retail sales are solid, and the U.S. economy appears to be accelerating into the fourth quarter, which is consistent with traditional seasonal patterns. We have begun to see that wage growth has not kept pace with inflation, which diminishes spending power. This is a key area of focus for Central Banks.

There are indications that lower- and middle-class consumers are feeling pressure. Inflation has come down from 9.1% to 3.9% and should continue to moderate as producers may find it increasingly difficult to pass through increased costs to consumers. Although fears of a recession appear to have been pushed back, there will be economic slowing that will ultimately help Central Banks attain their inflation goals.

The recent market volatility is largely due to the rapid rise of interest rates and the uncertainty surrounding whether the U.S. Federal Reserve and the Bank of Canada are near the end of their rate hiking cycles. Bond yields spiked recently causing bond prices to fall and stock markets to become uneasy with the pace of these rate increases. Rates will remain elevated; however, the unknown is for how long before easing begins. The irony is that for interest rates to come down, we will need to see economic weakness. This runs counter to traditional valuations and is leading to instability.

Following the last U.S. Federal Reserve meeting, Governor Powell's comments made investors realize that rates may stay elevated for much longer than hoped. He also indicated that even higher rates might be required to tame inflation. This caused bond yields to adjust higher, especially longer duration bonds. Investors depending upon income were especially vulnerable as both bond and dividend growth equities valuations fell. The positive is that the rise in rates at the longer end of the curve helps the Central Banks inflation fight and this may limit future rate hikes, ultimately stabilizing markets.

Interest rates on both sides of the border appear to be near their peak. It takes about 18 months for rate increases to be broadly felt within the economy and we are beginning to see some cracks. There may be an additional hike in December and/or in the New Year, but it is also likely that the next move will be an extended pause followed by lower rates in the future. It is unlikely that rates will come down near term.

Earnings season has begun, and we have seen decent numbers thus far. This indicates that earnings may have troughed in the second quarter. Although they may strengthen, growth will likely be limited if the economy does slow. On the positive side, companies are focused on shareholder value and are committed to bottom line results to avoid earnings disappointments.

The conflict between Israel and Hamas is a wild card that will cause increased uncertainty in the markets. Thus far, the market reaction has been muted. This is likely because the conflict appears to be contained at this point. The concern is that Iran and Hezbollah may get involved on a second front. Iran controls shipping traffic in the Gulf and could prevent tankers from moving oil which would impact oil prices. Iran, likely could not go it alone in an embargo scenario. The political world is far different now than 20 years ago. Egypt, Saudi Arabia, and other Arab countries are far less likely to back Iran. As a result, Iran may find itself even more isolated and marginalized.

The real beneficiary of an escalation of hostilities is Russia, as Ukraine is no longer front-page news and resources may be diverted from going to Ukraine to support Israel.

It is important to keep an eye on the stalemate in the U.S. Congress. The disfunction, laid bare by the inability of the Republican Party to select a Speaker of the House, could have political, economic, and global ramifications if it causes the U.S. government to shut down and prevents funding for Ukraine and Israel.

We also need to keep an eye on the increasing debt levels being proposed by Governments. Over time, these need to be addressed. This concern may be leading to some of the increase in bond yields as the U.S. Federal Reserve has ended their Quantitative Easing program. Supply is meeting demand, however, with higher required yields.

We are adjusting to a return to a normal interest rate environment with a range of 4-5% with inflation running at 2-3%. Fixed income and equity prices are adjusting accordingly. Ultimately, this is a positive, however the pace of this adjustment is what has investors on edge.

Dividend paying stocks, especially utilities, came under extreme pressure with competing short term fixed income securities. As inflation moderates and rates eventually decline, buyers should begin to look for bargains and focus on companies with solid cash flow and well covered dividend pay outs. This should lead to a rotation to dividend growth and longer duration bonds as investors attempt to lock in yield. The timing of this rotation is difficult to predict as it will probably begin in anticipation of rates dropping.

In the meantime, dividend growth stocks appear to be undervalued. Regulated utilities, which can get rate base adjustments to account for inflation, appear to be oversold.

Banks will probably face increased loan loss provisions, but have fortress balance sheets, and should continue to pay dividends and appear to have been overly punished.

Pipelines, especially senior issues which are self-funding, should be able to continue to increase dividends over time and are trading at multiyear lows.
Oil and Gas companies appear highly discounted. Cashflow and the focus on shareholder value should provide solid returns.

Although it may be tempting to pare down dividend paying equities and invest short term fixed income, we believe this would be a poor course of action. Even if we remain in a period of elevated inflation, dividends remain an important part of a portfolio because well managed companies tend to increase their dividends and pass inflation costs on to consumers.

This provides inflationary protection and helps to maintain purchasing power. Fixed income doesn't offer this, as coupon payments are established and ultimately equity prices rise to reflect their discounted cash flow.

Technology stocks with high cash reserves and increasing cash flows should hold up well and may act as defensive stalwarts.

Volatility is likely to continue. We have seen the traditional patterns of weakness in the late summer and fall months come to pass and it is possible that the trend will continue with a rise in equity prices as the snow begins to fall going into the holiday season.

As always, if you have any questions we are here to help.

Sincerely,

The Andras Group

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