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Turbulence and tightening define markets, but Canada still relatively well positioned in Q4

Canada Outlook | October 2022

Q3 review and outlook

The third quarter opened with a sharp bounce in financial markets as stagflation fears from the first half of the year began to recede. But ultimately, the quarter was defined by turbulent markets in the face of central bankers continuing to tighten monetary policy.

The Bank of Canada hiked its target for the overnight rate by 0.75 percentage points to 3.25% on September 7. The Bank is also continuing its policy of quantitative tightening. In a statement, the Bank said the global and Canadian economies are evolving broadly in line with its July projection. It sees global growth slowing to about 3.5% in 2022 and 2% in 2023 before strengthening to 3% in 2024. It pointed to the effects of COVID-19 outbreaks, ongoing supply disruptions, and the war in Ukraine continuing to dampen growth and boost prices.

At its September 20 meeting, the Federal Open Market Committee of the US Federal Reserve hiked the target range for the federal funds rate by 0.75 percentage points to 3%-3.25%. The Fed sees the federal funds rate peaking at around 4.5% and remaining at that level through 2023, before declining gradually to around 3% by the end of 2025. These hikes are likely to take rates into restrictive territory for a sustained period—something Fed Chair Jerome Powell emphasized as being necessary to slow the economy down and bring inflation back under control.

Evolving views on the probability of a recession in Canada

The prospect of a recession in Canada in 2023 has risen. However, Canada will likely fare better than other developed economies.

Canadian investors still have potential to weather volatility better than most

On balance, we still see Canadian investors weathering the current volatility better than most, based on four positive factors: a strong job market, high consumer savings levels, solid corporate earnings, and robust commodity prices.

However, we have tempered our views somewhat, as core inflation has remained higher and stickier than expected, despite overall inflation coming down from its recent highs. Canada's annual inflation rate eased more than expected in August, but some sectors continued to post higher inflation numbers—food prices rose 11.9%, their fastest pace since 1981, according to Statistics Canada. Annual inflation rate slowed to 7% in August, below consensus forecasts of 7.3% and down from 7.6% in July. The overall easing was mainly driven by lower gasoline prices and slower gains in the shelter index.

Key takeaways:

- The third quarter opened with a sharp bounce as stagflation fears from the first half of the year began to recede.
- Ultimately, the quarter was defined by turbulent markets in the face of central bankers continuing to tighten monetary policy.
- We still see Canadian investors weathering the current volatility better than most, based on four positive factors: a strong job market, high consumer savings levels, solid corporate earnings, and robust commodity prices.
- The risk of a recession in Canada in 2023 has increased.

The US dollar rallied against the euro and pound sterling

Both the euro and UK pound fell sharply against the US dollar in the third quarter amid Fed hawkishness and safe-haven demand for the greenback. Sterling's underperformance reflected investor concerns about new British Prime Minister Liz Truss's controversial plans to jump start economic growth with tax cuts and borrowing. The Canadian dollar remained one of the best-performing G-10 currencies against the US dollar but still lost some ground to it.

Canadian investment strategy and market highlights

Investment strategy highlights

The return potential of Canadian equities still looks more attractive than that of Canadian fixed income on a relative basis. Canadian equities also look competitive compared with equities in other countries, and we are finding selective opportunities that potentially represent good long-term investments.

Overall, we remain underweight domestic bonds and overweight Canadian equities. We have a neutral weighting in US equities and are underweight in global equities. We are also underweight in emerging market equities and fixed income.

Market highlights

Canadian equities, as measured by the S&P/TSX Composite Index, finished the third quarter 1.41% lower. Canadian bonds, as measured by the FTSE Canada Universe Bond Index, finished largely unchanged, up 0.52%, in the third quarter. US equities, as measured by the S&P 500 Total Return Index, were up 1.32% in the third quarter. Global equities, as measured by the MSCI World Index were almost unchanged, down 0.07% in the third quarter.
(All returns in Canadian dollars.)

- Overall, we remain underweight domestic bonds and overweight Canadian equities.
- We have a neutral weighting in US equities and are underweight in global equities.
- We are underweight in emerging market equities and fixed income.
- The S&P/TSX Composite Index was down 1.41% in the third quarter.
- The FTSE Canada Universe Bond Index finished the third quarter up 0.52%.

S&P/TSX Composite Index and Sector Performance
(period ended September 30, 2022)

	3-Month	1-Year	3-Year*	5-Year*	10-Year*
S&P/TSX Composite Index	-1.41%	-5.39%	6.59%	6.54%	7.30%
Healthcare	-6.44%	-64.76%	-36.89%	-21.76%	-19.57%
Materials	2.53%	4.08%	8.53%	6.94%	0.30%
Energy	-5.27%	26.34%	11.86%	5.52%	3.09%
Real estate	-6.44%	-19.94%	-3.55%	4.06%	7.09%
Information technology	-4.69%	-57.98%	0.36%	11.94%	17.00%
Financials	-1.24%	-4.08%	7.08%	7.19%	10.71%
Consumer discretionary	4.18%	-6.94%	5.35%	3.92%	11.71%
Consumer staples	2.62%	9.39%	7.56%	9.91%	14.75%
Communication services	-7.54%	-3.81%	3.61%	5.18%	8.66%
Utilities	-4.63%	1.78%	8.24%	9.82%	8.24%
Industrials	4.23%	-0.81%	10.66%	10.48%	13.98%

*Compound annual rate of return. Source: Bloomberg as at September 30, 2022. Performance stated in Canadian dollar total returns.

Global equity markets fell as the US Federal Reserve re-emphasized an almost "whatever it takes" approach to combatting inflation. Many investors are concerned that the Fed is remaining more hawkish for longer than anticipated. Updated US economic projections also showed lower growth, higher unemployment, and higher core personal consumption spending price index inflation. Fed Chair Jerome Powell also noted that the chances of a soft landing for the economy were diminishing.

European equities posted losses on heightened fears of sharp monetary policy tightening and fresh escalations in the Russian invasion of Ukraine. The hawkish Fed decision set the backdrop for the stock sell-off, but that was compounded by further rate hikes in the UK, Switzerland and Norway. Asian stock markets also moved lower, amid heightened investor worries over global recession risks following hawkish central bank policy moves and rising bond yields.

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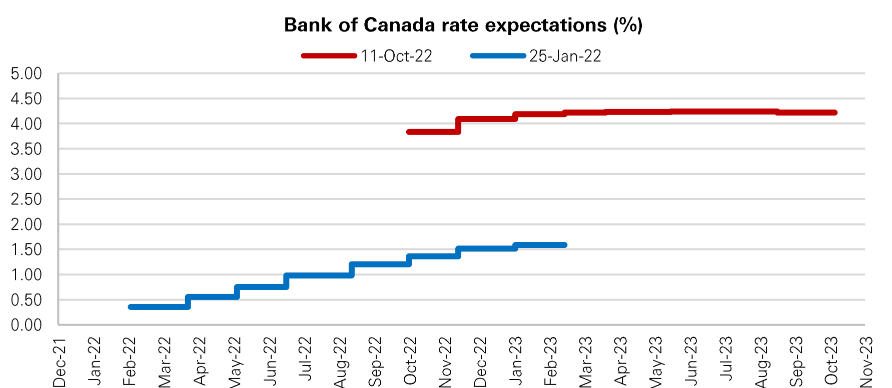
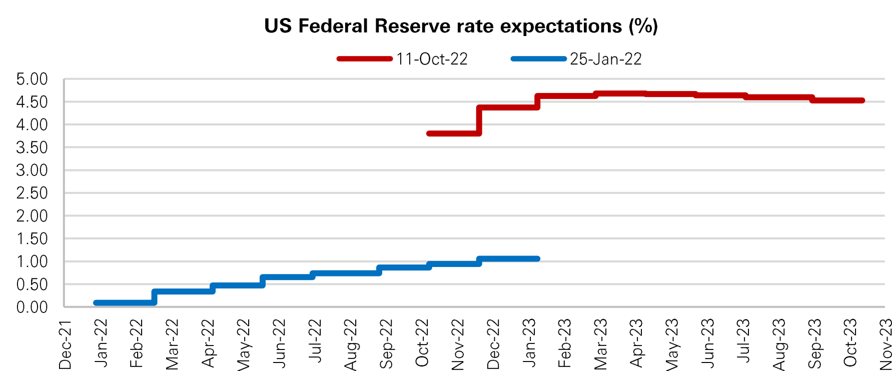
- The hawkish Fed decision set the backdrop for the stock sell-off, but that was compounded by further rate hikes in the UK, Switzerland and Norway. Asian stock markets also moved lower.
- The number one market driver will remain inflation and its effect on interest rates.

Fourth-quarter outlook: inflation and interest rates remain primary drivers

The number one market driver will remain inflation and its effect on interest rates. The main positive news is that a lot of negative news is already priced into markets. Recession fears, rate hikes, and the Russian invasion of Ukraine will continue to keep volatility at the forefront of investors' minds. Market expectations are for the Bank of Canada to raise its target for the overnight rate to 4.25% and the US federal funds rate to be 4.5% in early 2023.





Source: HSBC and Bloomberg, as at October 11, 2022. Past performance is not an indication of future returns.

Staying invested but with an emphasis on resilience and diversification

Making short-term investment decisions in a challenging environment such as today's is usually not prudent. Responding to short-term volatility by deviating from long-term investment plans rarely yields positive results. We encourage investors to stay invested, but with an emphasis on building resilience and diversification in portfolios.

Important Information:

All quoted returns are total returns as at September 30, 2022 in Canadian dollars. Sources include HSBC Global Research, Bloomberg, RIMES, Statistics Canada and the Bank of Canada.

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