Seymour
INVESTMENT MANAGEMENT

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Equities experienced heightened volatility during the quarter, as economic data fueled speculation that interest rates may stay higher for longer.

The S&P/TSX Composite Total Return Index declined by 2.2% in the third quarter and is up 3.4% year-to-date. The S&P 500 Total Return Index declined 3.3% in the quarter and is up 13.1% year-to-date. Resource companies buoyed market returns in Canada. In the U.S., seven of the largest technology companies contributed to nearly all of the U.S. market's outperformance.

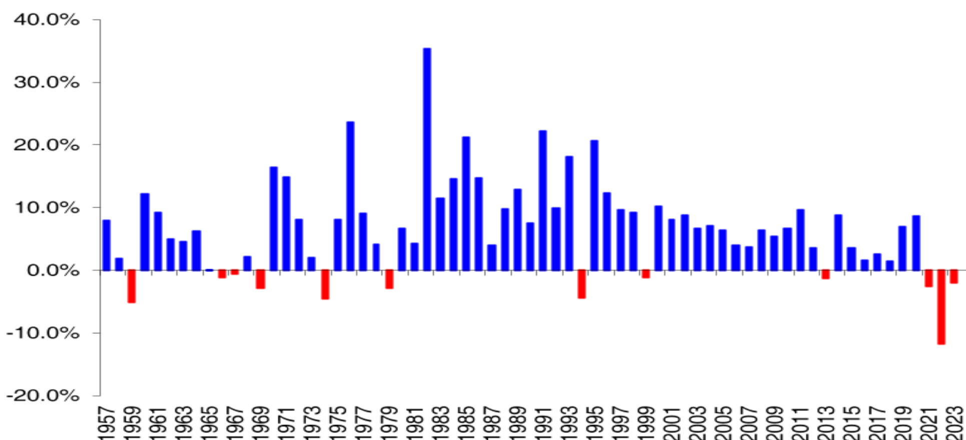
The muted quarterly returns do not tell the full story of the volatility experienced month to month and day to day across most asset classes. The volatility of equities and fixed income, as well as the divergence of valuations between different geographies, market capitalizations and asset classes has broader implications which we explore below.

Surging Bond Yields Have Negative Implications for Most Asset Classes

Bond investors are facing another particularly painful year in 2023. Long bond yields around the world have continued to rise, notably in the United States where the 10-year bond yield recently reached a new cycle high of just over 4.8%.

This marks the first time since World War II that the U.S. Treasury market will suffer three straight annual declines. Similarly, the FTSE Canada Bond Index is also headed for a third consecutive annual decline.

Exhibit 1: Canadian Bond Market En Route to Suffer Third Consecutive Annual Decline (TR%)



*FTSE CDA LT Bond index (TR) prior to 1980, and the FTSE CDA Universe Bond index (TR) since then.
Source: Scotiabank GBM Portfolio Strategy, Bloomberg, FTSE Russell.

Higher interest rates have implications for most all asset classes. As we have seen, equities are impacted both by the slowing effects higher rates have on the economy as well as the negative effect on valuations. As a

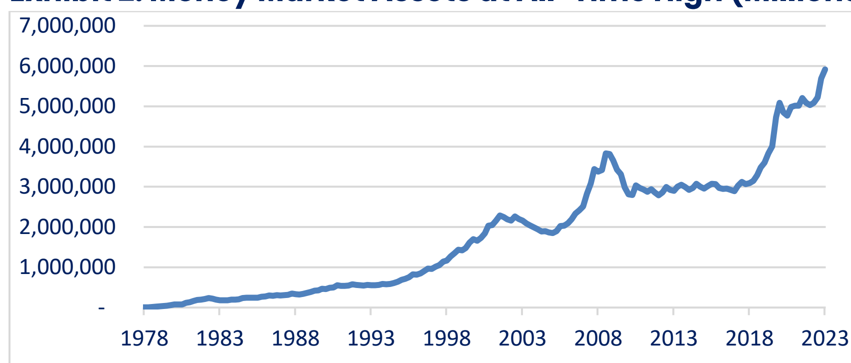
result of these higher yields, equities have experienced broad-based weakness. From large-cap, familiar blue-chip names, such as Royal Bank of Canada and CN Rail which are both down 10% year to date, to small and mid-cap names which have seen continued volatility, equities have been under pressure this year. With 2022 also a negative year for equity returns, 2023 has not yet provided the rebound that investors were hoping for.

Money Market Yields Are Reaching New Highs, Prompting Massive Inflows

An asset class benefiting from higher rates has been cash and cash equivalents. With the increasing interest rates offered on money market products, an influx of funds has poured into money market and other short-term products. Money market products, which encapsulates funds that invest in highly liquid instruments such as cash, cash equivalent, and high-credit, short-term debt, have recently risen to an all-time high.

In the U.S. there is more than $6 Trillion US dollars sitting in money market products. The chart below illustrates the run up of money market funds since 2007. Similar run ups occurred prior to the Covid recession in 2020 and the Great Financial Crisis recession in 2008.

Exhibit 2: Money Market Assets at All-Time High (Millions of Dollars)



Source: Bloomberg, Forbes

In Canada, household currency and deposits grew by almost half a trillion dollars since the first quarter of 2020. Although currency and deposits have recently slowed, due in large part to continued discretionary and non-discretionary spending by Canadian households, the flow of funds into cash investments, such as Money Market Exchange Traded Funds (ETFs), has not seen a slowdown.

As with all asset classes, whenever considering the risk-return trade-off, it is important to also consider your time horizon. After nearly a decade of minimal to no returns, cash is able to generate a reasonably material, nearly risk-free rate of return, a great option for savers and investors with short-term spending requirements.

Over the short-term, risk is often measured in terms of volatility. By that yardstick, cash-based products can offer a great option. However, as your time-horizon grows, the concept of risk shifts from volatility towards the ability to beat inflation. Over the long term, it is your ability to grow your purchasing power, at a rate that exceeds inflation, which ultimately builds wealth.

The graph below details the growth of $1 in various asset classes in the U.S. with records going back to 1926. From large and small-cap equities to short and long-term fixed income, the graph compares them to each other and to inflation.

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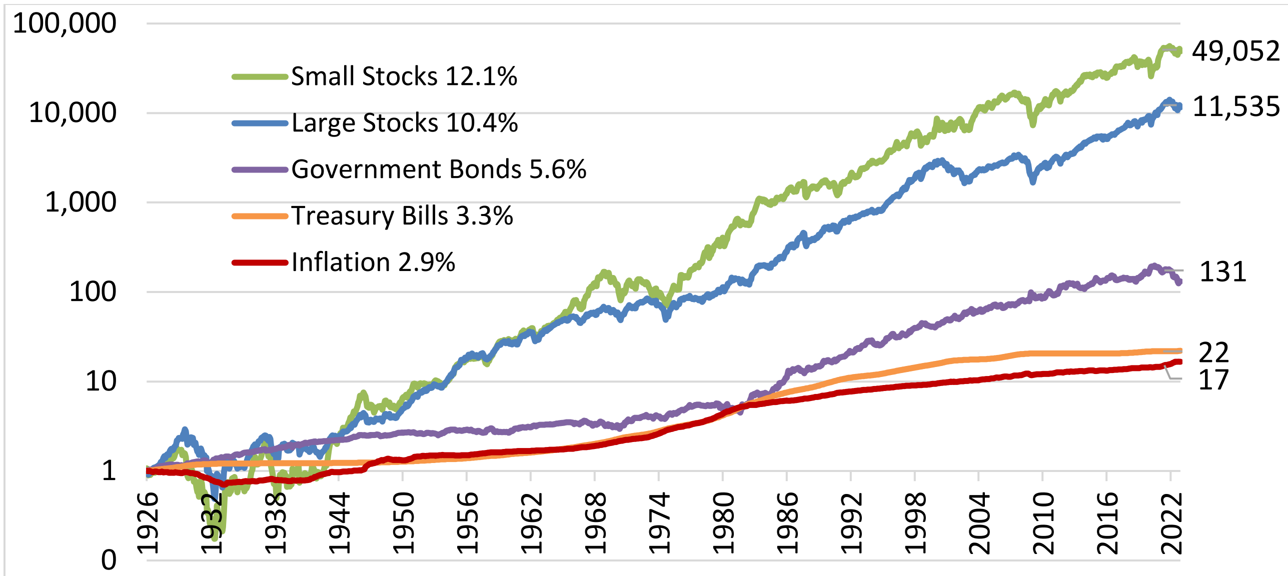
Over the mid-to-long-term, the ability for cash products to stay ahead of inflation diminishes greatly. Conversely, equity investors are rewarded for embracing volatility with earnings growth and potentially valuation upside, supporting higher long-term returns that exceed inflation.

Exhibit 3: Growth of $1 Since 1926



Source: S&P 500, Industry Stocks, Bonds, Bills, and Inflation 1926 –2022 per Ibbotson SBBI

Equities Have Historically Generated Superior Returns, Albeit with Volatility

Small-cap equities experienced another challenging quarter, with global developed market small-cap indices down 4.8% in the third quarter. Resources partially buoyed the Canadian small-cap index compared to its global peers. Notwithstanding the strong commodity prices, small and mid-cap companies have experienced considerable pressure during this interest rate hiking cycle.

Funds have flowed out of small-cap stocks in a 'flight to safety' to large-cap companies and into cash equivalents. This trend is typical during periods of uncertainty as investors seek the relative comfort of large, well-established businesses. What is notable, is just how exacerbated this gap currently is.

Detailed in the chart below, small-cap companies are back to a level of relative underperformance as compared to their large-cap peers, not seen since the dotcom bubble 23 years ago.

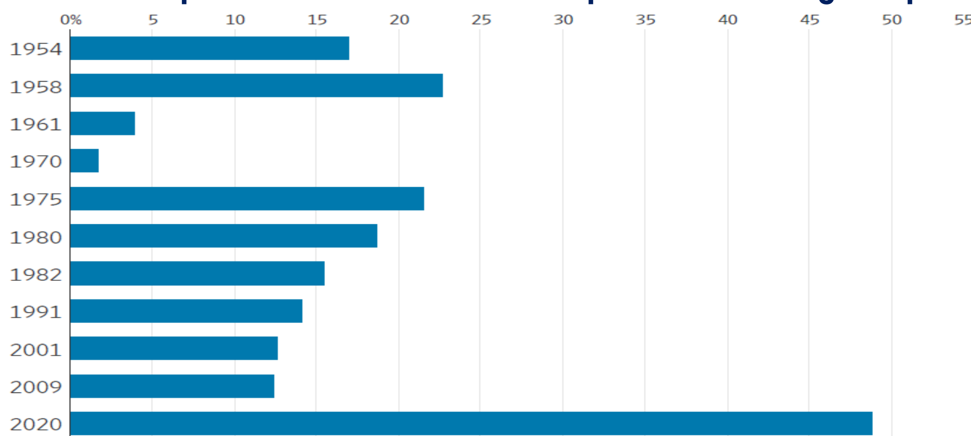
Exhibit 4: U.S. Small-cap Relative to Large-cap, 23 Year-Round Trip

Source: Wolfe Research Technical Analysis, Bloomberg

When investing across all asset classes, investors are typically rewarded for greater volatility with higher long-term returns. In the case of small-cap and mid-cap companies, this means that they are comparatively good at signaling and pricing in recessions with early volatility as compared to their typically less-volatile large-cap peers.

However, this also means these small and mid-cap companies have been the best to own after a recession has materialized. As illustrated in Exhibit 5, over the past 11 recessions, the MSCI small-cap stock index beat large-caps in the 12 months after a recession was declared every time. The graph below details this, pointing to a 16.5% small-cap average outperformance.

Exhibit 5: Outperformance of U.S. Small-Cap Stocks over Large-Cap in 12 Months Following Recession



Smallest 30% vs Largest 30%. Source: MSCI, Wall Street Journal

While small and mid-cap equities have experienced a significant sell-off, 'good things can come in small, cheap packages'. Following the recent pullback in both Canadian and smaller-cap equities, the longer-term outlook has improved, suggesting potential for material upside through a combination of valuation re-rates and acceleration in earnings.

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As we look forward, economic activity continues to soften as the impact of higher interest rates works its way through the economy. Although this creates a headwind for corporate earnings and market sentiment in the short-term, we remind investors of the importance of staying disciplined during periods of economic uncertainty. Markets are forward looking, and interest rates are showing signs that much of the heavy lifting is behind us. Down markets require patience and a long-term focus. Patient, long-term investors who can embrace the volatility are rewarded over time with excess returns and greater wealth accumulation.

As always, we thank you for your support and welcome you to reach out to any member of our team anytime.

Sincerely,
The Seymour Team