March 2024

Unstoppable equity market rally on soft landing narrative

Resilient economic data throughout the first quarter supported the soft landing narrative and pushed equity markets around the world to new record highs. Global equities posted strong returns with the MSCI ACWI Index up 11.0% during the first quarter. In Canada the TSX gained 6.6% and in the U.S., the S&P 500 rose 10.6%, driven once again by several of the mega-cap names which posted strong earnings growth. However, the best performing market of the quarter was Japan, up 13.9% for the quarter in Canadian dollar terms.

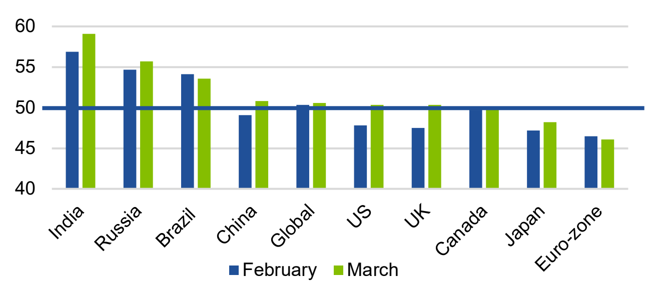
Many European indices reached new all-time highs in March. While they lagged the U.S. and Japan for the quarter, Europe was the top performing region in March. Investors are looking to mitigate the concentration risks in the U.S. market, while turning to Europe for its cheaper valuation and re-acceleration of earnings.

While equity investors welcomed strong economic data, it was a more challenging period for fixed income investors. Stickier inflation and resilience in economic activity have shifted market expectations of rate cuts and push yields higher. The FTSE Canadian Universe Bond Index was 1.2% lower and Global Aggregate Bond index fell -0.1% for the quarter.

Continued strength in economic activities

Global Manufacturing PMIs are showing signs of improvement, bucking the trend of contraction over the past year. U.K. is the latest to join the group of countries in expansionary territory (index level above 50). Although this is only one data point and both Europe and U.K.'s GDP growth are still below trend, this could be tentative indication of an inflection point.

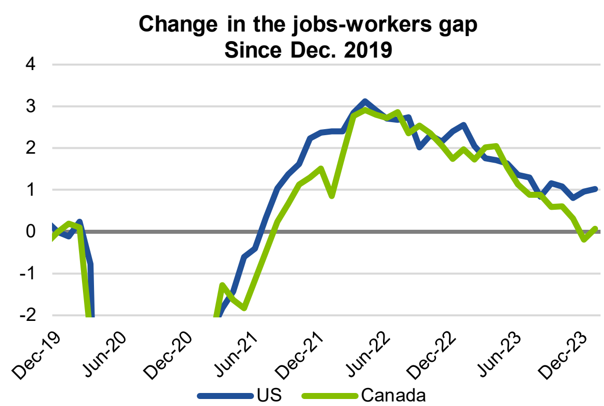
Manufacturing PMIs improving in many countries



Source: Bloomberg, NEI Investments.

Labour market conditions are cooling, with labour force expansion outpacing growth in job creation. In the U.S., job openings continue to exceed labour supply, albeit at a lower rate, helping the unemployment rate to remain low at 3.8% in March. In Canada, however, employment growth has slowed in recent months while the labour force has been expanding rapidly, leading to a jump in the unemployment rate from 5.8% in February to 6.1% in March.

Excess labour demand cooling faster in Canada than the U.S.



Source: Goldman Sachs, NEI Investments.

Central banks pause on stubborn inflation

In Canada, inflation data came in lower than expected with CPI at 2.8% vs. forecast of 3.1%, marking the weakest pace since June of last year and down from the prior month's reading of 2.9%, helping the Bank of Canada's case to pivot to cutting interest rates in the months ahead. The trend of easing inflation is leading many to predict the easing cycle to start in June as the economy weakens and the labor market cools.

Inflation continues to be a bumpy ride in the U.S., with core inflation coming in hotter than expected in February, making it two consecutive months of stronger than expected readings on core inflation. The Fed's preferred measure of underlying inflation, the core PCE price index did moderate, rising by 0.3%, less than the 0.5% increase in February.

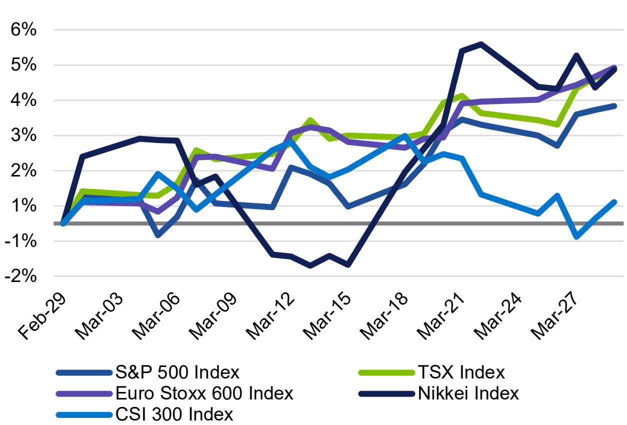
The Fed also held the rates unchanged for the fifth consecutive time in line with expectations as they wait for greater confidence on inflation before initiating rate cuts. With robust economic growth and a resilient labour market, investors may need to remain patient as they wait for the initial cut. The data has led Fed officials to reiterate that the central bank does not feel rushed to cut interest rates, with some economists warning that a rate cut in June may be a little too optimistic. Some strategists are even speculating there won't be any cuts at all in 2024.

While most central banks in developed markets are contemplating rate cuts, the Bank of Japan hiked rates for the first time in 17 years and eliminated the negative interest rate regime to combat rising inflation. However, the bank's cautious remarks have had a negative impact on the Yen, as the dovish commentary and lack of clues on future moves indicated that this is not the start of a full-fledged tightening phase like the ones witnessed in the U.S. and Europe in recent years.

Europe gaining ground

European equities gained 3.5% in March, outpacing other regional peers, as investors look to capitalize on recent re-acceleration in economic activities and earnings in the region, while diversifying away from a very concentrated U.S. market and its relatively high valuations compared to other regions.

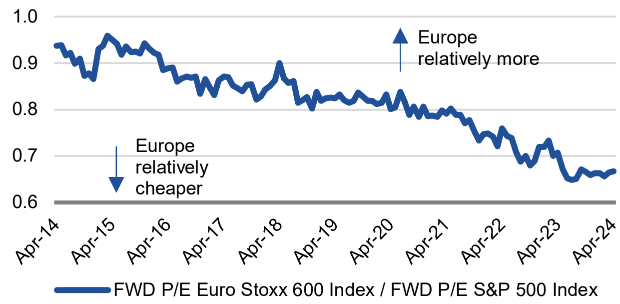
Regional equity performance in March



Source: Bloomberg, NEI Investments.

Despite recent gains, European equities are still trading near record discounts in valuation compared to the U.S.

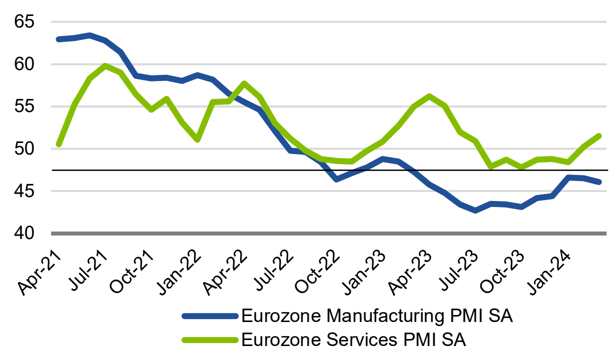
Valuation multiple of European equities near record discount relative to the U.S.



Source: Bloomberg, NEI Investments.

Recent developments in Europe, including fiscal spending programmes and averting of the energy crisis, have improved Europe's medium-term outlook compared to last year, in addition to the recent uptick in economic activity.

Eurozone Purchasing Managers Indices (PMI) are rebounding



Source: Bloomberg, NEI Investments.

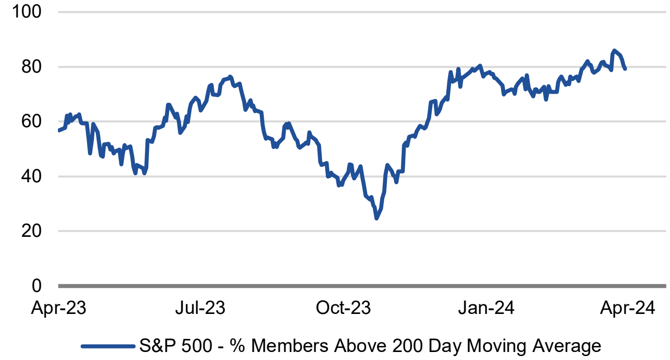
Bottomline: Although the U.S. 'exceptionalism' may continue given the superior level of earnings growth and market dominance in the development of AI capabilities, the rich valuation in U.S. equities has likely sown the seeds for a more muted performance in the future relative to international equities given their much cheaper valuations. It is prudent to consider having appropriate geographic, in addition to sector and style diversification in a well diversified portfolio.

Broadening U.S. market

Over the last few years, the S&P 500 returns have increasingly been dominated by a small group of companies riding the super-cycle of technological development in the growth of e-commerce, cloud computing and most recently artificial intelligence. With many of these names delivering stellar earnings results again during the latest reporting season, the S&P 500 has reached new all-time highs.

Although the market has become and continues to be very concentrated, the recent market rally has started to broaden to more companies.

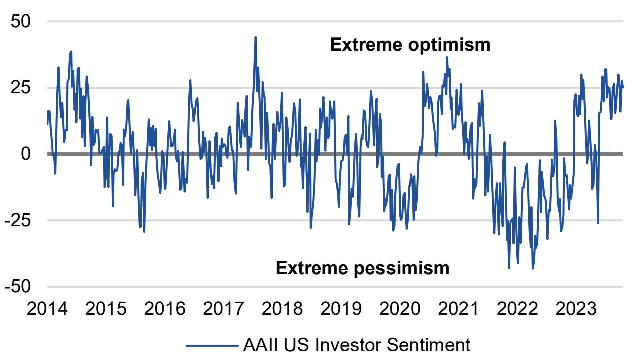
More companies in S&P 500 trading above 200 day moving average



Source: Bloomberg, NEI Investments.

Along with broadening, however, the U.S. market may be overheating and due for a pullback.

Investor sentiment has been optimistic



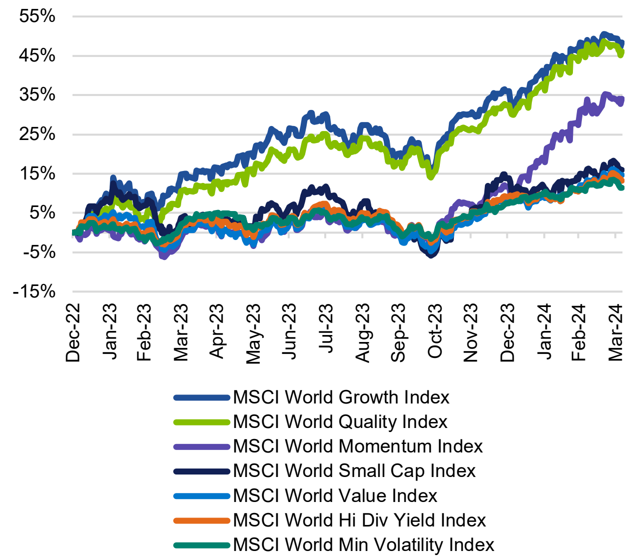
Source: Bloomberg, NEI Investments.

Bottomline: The need to fight against the temptation of chasing past performance has never been greater. The focus should be on companies that can continue to grow and meet elevated earnings expectations on a go forward basis. As the market rally continues to broaden over time, this may be a good opportunity to rebalance to high quality areas with more reasonable valuation, to mitigate concentration risk.

Diverging factor performance

The performance of various investment styles has shown significant divergence, reflecting the underlying macroeconomic conditions, including economic growth that has been more resilient than expected, stabilizing inflation numbers and peaking interest rates.

Growth, momentum and quality factors lead



Source: Bloomberg, NEI Investments.

While quality and growth continue to show strong performance, dividend yield and low volatility lagged in 2023 and YTD 2024 after outperforming in 2022.

Quality has been the strongest factor as investors gravitated towards realized earnings, while growth style also had a strong rebound in 2023 when the tightening cycle largely stabilized, after underperforming in 2022. The more interest rate sensitive factors also lagged, including dividend, low beta, and low volatility companies.

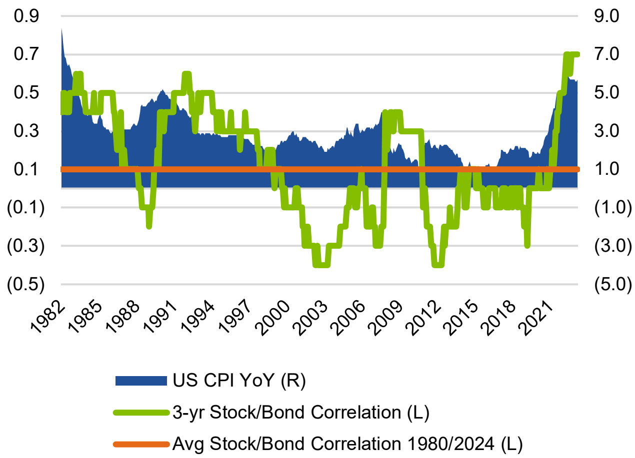
Small-cap factor has also lagged significantly, as mega-cap names have dominated returns. Small-cap companies also saw their valuation multiples hit particularly hard as higher interest rates and recession fears were punitive last year.

Bottomline: The search for risk diversification will likely intensify. The run-up of growth and momentum factors is almost at the point of complacency and may soon be due for a pullback. It is important to be mindful of factor and style diversification.

Going beyond the traditional 60/40

Traditional 60/40 portfolios have been effective in taking advantage of the stock and bond correlation which has mostly been negative since the turn of the century. The dramatic rise in inflation and interest rates in 2022 however, created a difficult environment on both stocks and bonds, hence returns in traditional 60/40 portfolios.

Correlation between bonds and equities increases during high inflation periods



Source: Bloomberg, NEI Investments.

In search of levers to enhance portfolio resilience, investors are increasingly looking for strategies that have different drivers of returns. Alternatives such as long-short equity strategies, real assets, or strategies with absolute return focus are well-suited as they complement traditional asset classes with alternative sources of return that provide portfolio diversification.

Bottomline: Investors should consider expanding their toolkit to utilize strategies with lower correlation to traditional stocks and bonds to help improve portfolio diversification, enhance returns, and protect against volatility. In the case of long-short equities strategy, the flexibility to capitalize on both rising and falling stock prices can be a valuable component of a diversified investment portfolio.

Asset class outlook

Asset class	View	Changes from last month	Rational
Equities	OW	↑	Although recent run up put equities in an overbought situation, broadening of upside participation provides near term support.
Canada Equity	Neutral	↑	Economic growth remains below potential, but better clarity on path of rate cuts may provide relief.
U.S. Equity	OW	–	Resilient macro data and stubborn inflation delay rate cuts further. U.S. continues to be the strongest market despite richer valuation.
International Equity	OW	–	Macroeconomic data showing signs of recovery, and along with disinflation leading to rising expectations of rate cuts, can provide boost to investment sentiment at attractive valuations.
EM Equity	UW	–	Continue to be structurally bearish, but near-term downside could be overdone and easing policies can lead to short term rebounds.
Fixed Income	UW	–	Yields may continue to rebound in the near term along with slight upticks on inflation. There is a low probability of interest cuts in the near term, making equities more attractive.
Govt Bonds	Neutral	–	Government yields rebounded in the near term, may have more room to move higher, making them relatively less attractive than equities in the near term (hence underweight overall fixed income).
IG Bonds	Neutral	–	Spreads tighter than historical average. Absolute yield levels remain attractive for coupon clipping in high-quality issues
HY Bonds	Neutral	–	Spreads tighter than historical average, but default rate expected to remain low and absolute yield levels remain attractive.
Cash	Neutral	↓	Closed the overweight as yields have moved higher. Favor U.S. equities on strong macroeconomic conditions and earnings.

This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of March 31, 2024. "UW" refers to an Underweight position, "OW" refers to an Overweight position. Symbols indicate the change in outlook from the prior month's outlook. The arrows indicate the change in outlook from last month. An upward arrow indicates a positive change on outlook, a downward arrow indicates a negative change on outlook and a dash indicates unchanged outlook.

Market performance

Returns in Canadian Dollars (%)

Returns less than 1 year are not annualized	1 Mo	3 Mo	6 Mo	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs
Fixed Income								
Bloomberg Canada Aggregate TR USD	0.55	-1.33	6.91	-1.33	1.99	-1.49	0.26	2.00
Bloomberg Global Aggregate TR Hdg CAD	0.86	-0.14	5.52	-0.14	3.33	-1.70	0.40	1.97
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	1.14	1.34	8.21	1.34	10.22	1.62	3.44	3.88
Equities								
MSCI World NR USD	2.98	11.74	21.42	11.74	25.10	11.31	12.36	11.65
MSCI World Growth NR USD	1.62	13.13	25.07	13.13	31.20	11.64	15.38	14.28
MSCI World Value NR USD	4.45	10.31	17.60	10.31	18.77	10.32	8.62	8.63
MSCI Canada NR CAD	3.87	6.71	15.76	6.71	15.06	8.98	9.21	7.01
MSCI USA NR USD	2.91	13.19	23.43	13.19	29.66	13.05	14.75	14.58
MSCI EAFE NR USD	3.05	8.56	16.92	8.56	15.31	7.40	7.60	6.95
MSCI Europe NR USD	3.50	7.99	16.97	7.99	14.10	8.84	8.24	6.59
MSCI Japan NR USD	2.78	13.92	20.21	13.92	25.77	6.28	8.05	8.88
MSCI Pacific Ex Japan NR USD	1.06	0.85	9.57	0.85	2.38	1.96	3.23	5.55
MSCI EM NR USD	2.24	5.06	10.52	5.06	8.14	-2.68	2.48	5.07
World Currencies								
US Dollar	-0.23	2.63	0.09	2.63	-0.01	2.49	0.26	2.06
Euro	-0.43	0.34	2.10	0.34	-0.60	-0.35	-0.52	-0.40
Pound Sterling	-0.36	1.70	3.59	1.70	2.16	-0.47	-0.36	-0.73
Yen	-1.33	-4.40	-1.31	-4.40	-12.07	-7.71	-5.82	-1.80
Commodities								
Bloomberg Sub WTI Crude Oil TR USD	7.58	20.79	-2.79	20.79	21.77	26.98	3.74	-6.21
Bloomberg Sub Brent Crude TR USD	6.84	18.68	0.65	18.68	20.80	32.93	15.08	0.78
S&P GSCI Gold Spot	8.69	10.88	20.06	10.88	12.69	12.00	11.79	7.89
Bloomberg Sub Copper TR USD	4.35	6.47	8.35	6.47	0.26	4.21	7.38	4.79

Source: Morningstar data as of March 31, 2024.

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