Monthly Market Monitor

NEI

February 2024

From yield concerns to record highs

The market rally continued into February in equities, with resilient economic data and relatively strong earnings reports fueling the S&P 500 Index to new record highs in February, gaining 6.9% for the month. Both the Nasdaq and S&P 500 Index had their best February since 2015. The Japanese market also continued to rally, with the Nikkei 225 Index reaching a new all-time high for the first time in over 30 years. Canada also had some encouraging news on the inflation front, helping the TSX rise by 2.2% in February.

By contrast, fixed income markets were broadly lower, with the Bloomberg Global Aggregate index losing -0.74% in February, as the overly ambitious expectations for rate cuts were pared back, causing yields to rise in response.

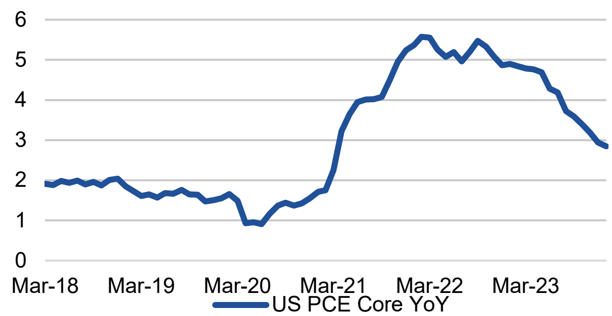
Rate cut expectations pared back

Inflation has moderated considerably in all regions globally, leading market participants that previously predicted aggressive cuts in policy rates to start the year, to recalibrate. At the peak in January many assumed 6 cuts for both the U.S. and Canada throughout 2024. The bond future markets have pared back the expected number of rate cuts since then, though the timelines for the first rate cut is slightly different by region.

U.S.: if economic growth remains high, rates may stay at current level for longer

The U.S. economy continues to be surprisingly strong, with a tight labour market and positive wage gains boosting consumer spending. The stronger than anticipated core inflation in the U.S. at 3.8% year-over-year, mainly driven by services, led to some market volatility mid-month. Although this somewhat reduced expectations for rate cuts in 2024, it did not derail the case for disinflation as real time indicators of inflation components are still moving in the right direction. The Fed's inflation gauge of choice, the Personal Consumption Expenditures (PCE), has been tamer and strongly supports the disinflation narrative.

U.S. core PCE downtrend continues



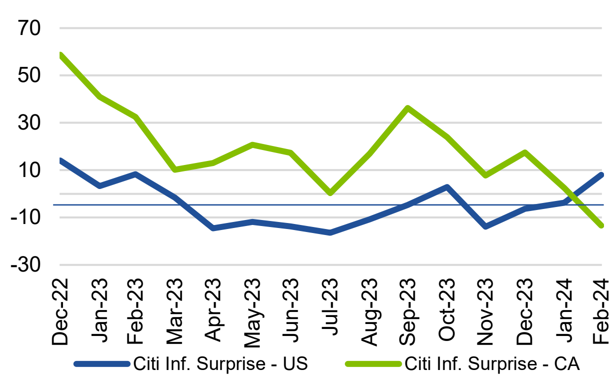
Source: Bloomberg, NEI Investments

However, if economic growth remains resilient in the U.S., it may take longer for the Fed to gain confidence that inflation is firmly under control. This could make the case for interest rate cuts difficult, and we may see rates staying at their current levels for longer.

Canada: in a bind

Unlike the U.S., inflation cooled in Canada in January, rising by 2.9% year-over-year, compared with the economist consensus of 3.3%, attributable to declines in energy and food prices. At the same time, shelter is the largest contributor to inflation and remains elevated due to higher mortgage interest costs. Rise in rental prices is also a key factor, which is unlikely to cool anytime soon, given the rapid population growth. Although overall inflation continues to move in the right direction, Bank of Canada reiterated the need for more evidence of disinflation before pivoting to interest rate cuts.

Inflation surprises diverging in U.S and Canada



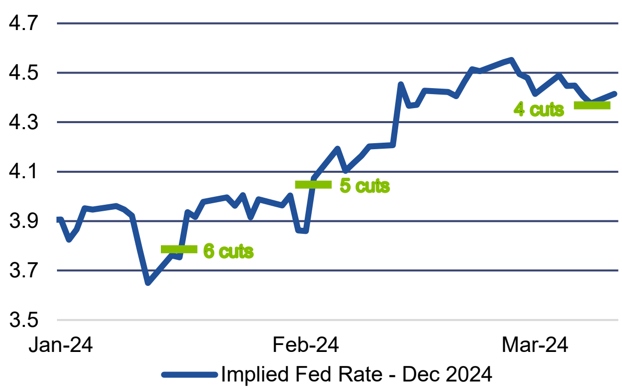
Source: Bloomberg, NEI Investments

Europe: with inflation on track, we may see cuts in June

Although most measures of underlying inflation have eased further, the European Central Bank (ECB) reiterated that domestic price pressures remain high, in part owing to strong growth in wages and service prices. Absent moderation of prices in the coming months, the ECB might not begin cutting rates until June or later.

Despite inflation moving in the right direction, central banks continue to push back against aggressive market expectations for rate cuts, prompting markets to revise their interest rate expectations. The markets now anticipate the first Fed rate cut to take place in June and expect the benchmark rate to end the year at around 4.5%.

Probability of rates cuts in U.S. is dropping



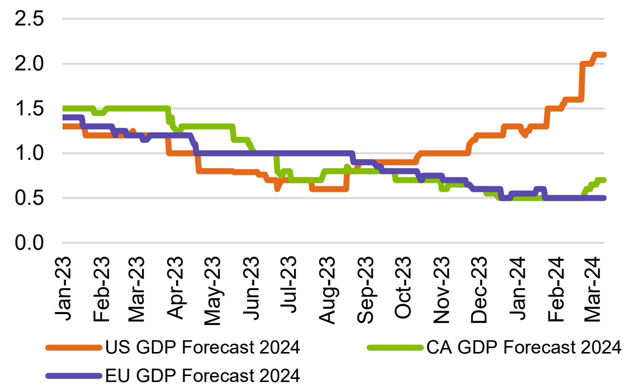
Source: Bloomberg, NEI Investments

Bottomline: Central banks are eager to gain confidence that inflation has reached and will remain at the target range for long enough that they can begin cutting rates, as they also concerned that higher rates for too long could start to cause too much damage to aggregate demand. We're currently most constructive on U.S. equities, as the economy remains robust and inflation continues to moderate, creating a great environment for equity investors. Bond markets have suffered, given the decreased likelihood of imminent rate cuts. Nonetheless, we think bonds still offer compelling yields at current levels, and are able to provide a buffer to equity volatility in the case of an economic downturn.

Strong macro environment supports US equities in the near-term

Despite rate cut expectations being pushed out, equity markets were supported in February by continued strength in the U.S. economy relative to other developed markets like Canada and Europe.

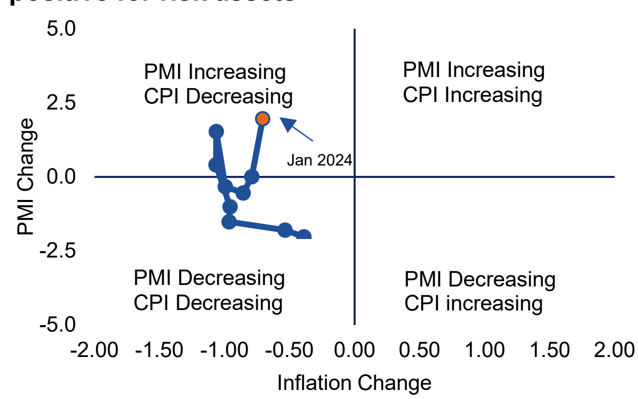
U.S. economic growth gaining ground over other markets



Source: Bloomberg, NEI Investments

The U.S. economy continues to surprise on the upside. Q4 GDP growth was much stronger than expected and Q1 is shaping to be the same. At the same time, inflation is under control in the U.S., falling towards the 2% target. Risk assets tends to perform strongly in this environment.

Falling inflation amidst positive growth is strongly positive for risk assets



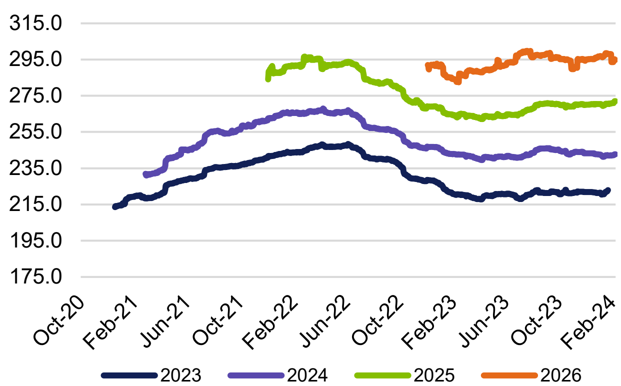
Source: Bloomberg, NEI Investments

Bottomline: While the timing of rate cuts may be pushed out until later in the year, we believe the current environment of moderate growth coupled with declining inflation creates a constructive environment for risk assets. At this point, resilience in the labour market, healthy job growth, moderate wage gains, strong consumer spending, and robust GDP growth are yielding a goldilocks environment that makes the U.S. more favorable than other markets.

Successful earnings season in the U.S.

Mega cap companies broadly met or exceeded earnings expectations, contributing to increasingly strong investor sentiment in the markets. It was not only in the S&P 500, but also globally, as equity indices are making new record highs. On Feb. 22, major equity indexes in the U.S., Europe, and Japan reached new record highs. In addition to Nvidia, whose strong earnings delivery and margin expansion prospects propelled prices for the whole semiconductor sector significantly higher, the majority of companies also delivered earnings that were stronger than expectations. By month end, 97% of S&P 500 companies had reported their Q4 earnings, with 75% of them beating estimates.

S&P 500 earnings estimates revised upwards for 2025



Source: Bloomberg, NEI Investments. As of February 26, 2024.

With respect to mega cap names, earnings reports for the last several quarters for the "Magnificent Seven" have largely confirmed the validity of the excitement around them.

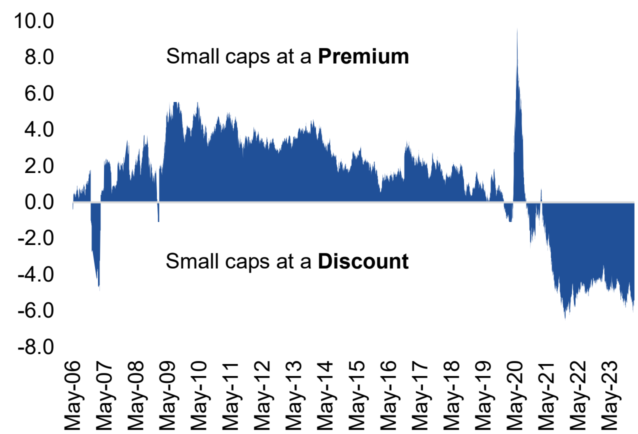
Valuations for these mega caps remain elevated compared to the broader U.S. equity market. They are, however, justified by their estimated earnings growth of 14%, significantly higher than the 2% year-over-year growth for the remaining 493 stocks in the S&P 500 over the next year. Additionally, the average margin of the 7 companies at 23% is also expanding, much more favorable than the other 493 that is at 9% on average, and slightly contracting next year.

Following an 11% rally upon Nvidia's earnings announcement, Nvidia was trading at a P/E of just over 30x, back to the same valuation multiple as it was in late 2023, even though its market cap has gone up by approx. US$250B. It took the semiconductor manufacturer 24 years to grow to $1 trillion in market cap, and it took only 8 months to grow the next $1 trillion.

Bottomline: With strong economic moat, earnings delivery, and margin expansion, the mega cap names are expected to continue to dominate the markets in the near term. Despite lofty valuations, their price levels are well supported as long as they continue to deliver on earnings and revenue growth. They are not currently exhibiting the type of "irrational exuberance" market behavior as seen historically.

Positive outlook for small caps when market rally broadens

Smaller cap companies have lagged in recent periods due to their increasing debt servicing costs as rates climbed higher, affecting their profitability. Their valuation multiples are hit particularly hard over the last few years and are now trading at attractive valuations with a wide discount to large caps. This provides an attractive entry point for high quality small cap companies when rates fall.



Source: Bloomberg, NEI Investments

In addition, rate cuts could help boost an acceleration in economic growth later this year. This could cause a broadening of the stock market, with smaller caps and cyclicals potentially performing better in anticipation of an economic rebound.

Japanese rally continues and China rebounds

The Japanese market continued rising despite a weaker than expected fourth quarter GDP growth, as robust corporate earnings growth expectations have driven the recent equity rally. The Nikkei Index made a record high on February 22. It has been 35 years since previous time back in 1989.

On the other hand, Chinese equity markets had hit five-year lows coming into the month. However, activity data over the Lunar New Year holiday period strengthened, and the Chinese government announced a number of supportive interventions aiming to stimulate the economy, including a cut to their reserve ratio requirements, curbs on short selling, and stock purchases by state-owned investment firms. The MSCI China Index consequently gained 8.5% in February.

Asset class outlook

Asset class	View	Change	Rational
Equities	Neutral	⬇	Strong earnings delivery provide support to equities. Recent run up put equities in an overbought situation, vulnerable to near term correction.
Cdn Equity	UW	⬇	Canadian equites to remain under pressure as economic growth remains below potential and earnings growth has been weak.
US Equity	OW	–	Macro data and earnings delivery surprises to the upside with inflation moving lower. Continues to be the strongest market despite richer valuation.
Intl Equity	OW	⬆	European macro data continue to weaken, making U.S. investments more favourable. However, weakening economic growth may lead to rising expectations of rate cuts, which can provide boost to buying sentiment at attractive valuation
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 have 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, making them relatively less attractive. Absolute yield levels remain attractive for coupon clipping in high-quality issues
HY Bonds	Neutral	–	Spreads tighter than historical average, making them relatively less attractive than a few months ago, but default rate expected to remain low and absolute yield levels remain attractive.
Cash	OW	⬆	Short term overweight to shorten portfolio duration, with expectation of yields to rise as rate cuts expectations are pushed out.

This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of February 29, 2024. Symbols indicate the change in outlook from the prior month's outlook.

Market performance

Percent return in Canadian Dollars

	1 Mo	3 Mo	6 Mo	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs
Fixed Income								
Bloomberg Canada Aggregate TR USD	-0.40	1.58	3.57	-1.87	3.66	-2.15	0.62	1.92
Bloomberg Global Aggregate TR Hdg CAD	-0.74	2.05	2.77	-0.98	4.69	-2.11	0.57	1.90
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	0.25	3.79	5.66	0.19	10.10	1.29	3.38	3.79
Equities								
MSCI World NR USD	5.82	10.71	12.75	8.51	24.49	11.17	12.32	11.30
MSCI World Growth NR USD	7.60	13.09	16.02	11.33	37.23	11.08	15.89	13.95
MSCI World Value NR USD	3.97	8.25	9.33	5.62	12.27	10.50	8.03	8.26
MSCI Canada NR CAD	2.19	6.67	8.04	2.73	10.18	9.09	8.54	6.72
MSCI USA NR USD	6.92	11.97	14.20	9.99	29.63	13.08	14.83	14.29
MSCI EAFE NR USD	3.38	7.90	9.50	5.35	13.98	6.88	7.40	6.53
MSCI Europe NR USD	3.10	6.54	8.44	4.34	12.18	8.43	7.93	6.09
MSCI Japan NR USD	4.56	12.50	14.42	10.84	26.46	5.42	7.88	8.41
MSCI Pacific Ex Japan NR USD	2.05	5.81	5.02	-0.21	1.26	1.69	3.49	5.65
MSCI EM NR USD	6.35	3.84	5.20	2.75	8.32	-4.12	2.49	5.12
World Currencies								
US Dollar	1.52	0.04	0.25	2.86	-0.37	2.32	0.59	2.05
Euro	1.14	-0.78	-0.04	0.77	1.66	-1.52	-0.43	-0.41
Pound Sterling	0.84	-0.04	0.08	2.07	4.09	-1.03	-0.41	-0.78
Yen	-0.85	-1.19	-2.48	-3.11	-9.33	-8.64	-5.19	-1.78

Source: Morningstar data as of February 29, 2024