NEI MONTHLY MARKET MONITOR

NEI

September 2023

September lives up to its reputation

September lived up to its reputation for being a historically challenging month for markets, as both equity and bond markets saw their worst declines of the year. The S&P 500 Index was down 4.9% in September— its second monthly decline in a row, while the Nasdaq was down 5.8%. Canadian markets did not fare much better than their U.S. peers, with the TSX falling 3.7% for the month.

In September, investors' focus shifted from whether there will be another hike in the near term, to how long rates will be held at restrictive levels. The prevailing narrative is that interest rates will remain "higher for longer" as central banks continue to indicate restrictive rates to be necessary for some time to tame inflationary pressures.

Interest rate concerns pushed yields to reach their highest levels in 16 years with U.S. treasury 10-year yield up 46 bps to 4.57%, while the Canadian 10yr yield also up 46 bps for the month to close at 4.02%, sending fixed income prices lower, especially longer duration issues.

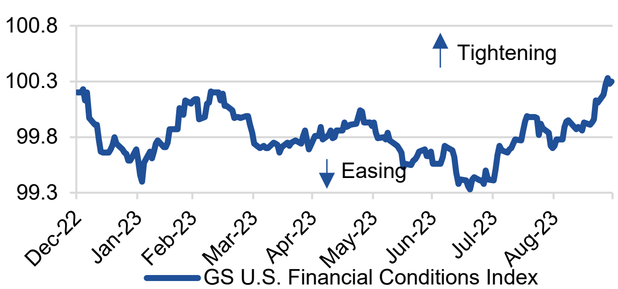
Most asset classes finished the month in negative territory, with the exception of energy related securities as the oil price surged past $90 at the end of the month, up from $81 at the end of August.

Growth trends diverge between regions

U.S. is still the most resilient economy but is showing signs of slowdown

Although the probability of the U.S. falling into recession in 2023 continues to fall, there are nevertheless some signs of slowdown and moderation in the U.S. economy.

Financial conditions tightening in U.S.

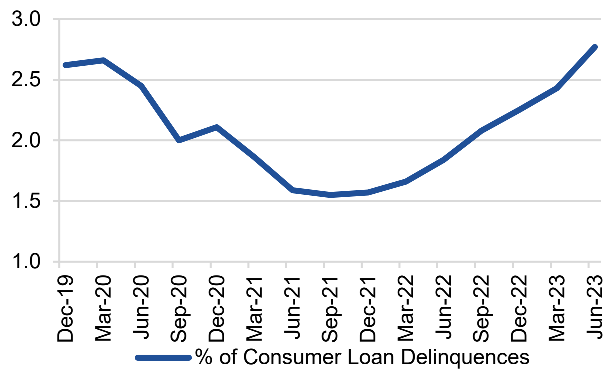


Source: Bloomberg, NEI Investments.

Higher interest expenses are starting to weigh on companies as the strengthening U.S. dollar and rising interest rates have contributed to tighter financial conditions in the U.S. economy, as indicated by the financial conditions index crossing into restrictive territory, which can weigh on growth in the near term.

There is growing evidence that suggests that consumption will slow as well. The excess savings that have largely been responsible for the resilience of consumers is expected to be mostly depleted by the end of the year, and as this buffer erodes, consumer spending will begin to slowdown. Additionally, with the resumption of student loan repayments, consumers are starting to feel the squeeze. With an uptick in credit card and auto loan delinquencies, the resilience of consumers is starting to wane, and they will be less of a tailwind to economic growth going forward.

Consumer loan delinquencies starting to rise

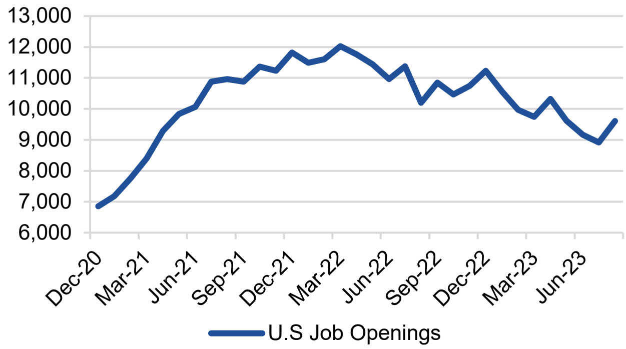


Source: Bloomberg, NEI Investments.

The labour market in the U.S. remains remarkably strong. However, a growing number of leading indicators suggest that conditions are continuing to normalize back to pre-pandemic trend.

Shown in the following chart, job openings are trending lower since hitting a peak last spring. Furthermore, the three-month average job creation gain slipped to only 150K, below the 163K average in 2019. As the prime-age participation rate is at its highest since 2002 and labour force participation rebounded to near pre-pandemic levels, it suggests that labour supply and demand have mostly normalized, putting less pressure on wage growth.

Job openings still strong but normalizing



Source: Bloomberg, NEI Investments.

The ongoing strikes by the United Auto Workers (UAW) aimed at the major U.S. automakers is not expected to have a significant drag on the economy, but a prolonged disruption could lead to supply shortages. Upward pressure on labour costs could also affect the prices of new and used vehicles and present a downside risk to economic growth.

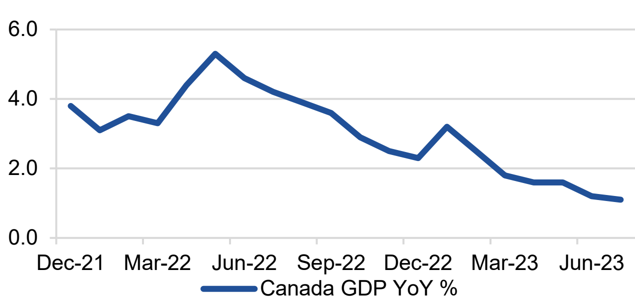
Finally, a U.S. government shutdown would cause further negative impact on economic growth. While the shutdown was averted thanks to a bi-partisan compromise at the last minute, it was only a temporary funding agreement. The looming threat of a government shutdown still remains on the table before the end of the year.

As much of a media sensation it can be, the impact of government shutdowns on the markets has been short-lived and muted. Of the 21 government shutdowns since 1976, the average stock market gain was 0.5% one month later and 1.5% three months later.

Recession risk in Canada Rising

While the U.S. has greater prospects of making a soft landing, recession risk in Canada is rising. The economy has entered a period of weaker growth, with a marked weakening in consumption and a contraction in manufacturing activity. The disruption caused by wildfires in June likely also played a role in most recent contraction in Q2 GDP.

Canadian GDP on downtrend since spring 2022

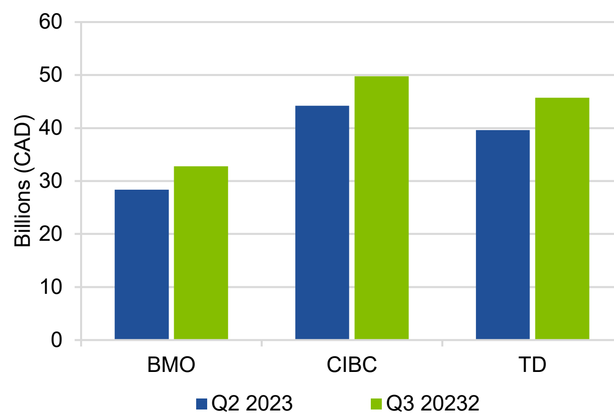


Source: Bloomberg, NEI Investments.

This weakening in consumption could be indicating that Canadian consumers are starting to feel the weight of tighter monetary policies. With more mortgages in shorter terms and variable rates, there is greater evidence that rising mortgage payments are impacting Canadian consumers. A key risk being watched by banks and regulators is the rising number of mortgages in negative amortization, a situation when monthly mortgage payments are no longer enough to cover interest payments.

Statistics from big Canadian banks' Q3 2023 earnings reports show that negative amortizations make up 22% of BMO's total mortgage portfolio, 19% of CIBC's total mortgage portfolio and 18% of TD's mortgage portfolio, but minimally in RBC and Scotiabank. Mortgages with negative amortizations have alarmingly been rising last quarter. This could lead to the continuation of weaker consumer spending in Canada so long as the monetary policy stays restrictive.

Mortgages with negative amortizations increase



Source: Canadian Bank Q3 financial reports, NEI Investments.

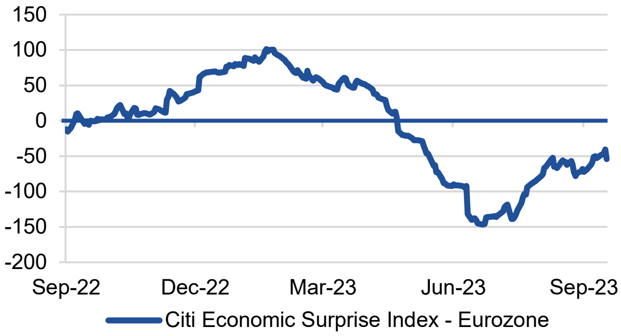
The combination of easing labour demand, weakening job vacancies and immigration-fueled growth in the labour force could push the Canadian unemployment rate higher.

However, higher oil prices are supportive of Canadian economy, if sustained at current levels. Oil prices reached 2023 highs this month, with WTI at one point hitting US$95 as supply concerns, including production cuts by Saudi Arabia and fuel export bans by Russia, have pushed crude prices higher.

Europe headed for recession

Economic data coming from Europe continues to surprise negatively, as tighter monetary policy weighs on consumers and businesses. Both the manufacturing and the service indices were in contractionary territory and forward-looking indicators point to further declines in output ahead.

Eurozone economic surprises remain negative

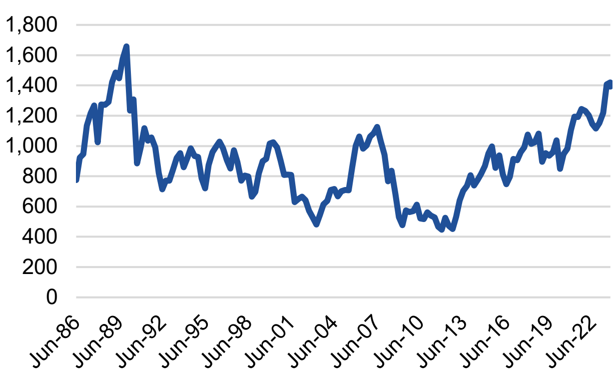


Source: Bloomberg, NEI Investments.

Foreign investors bullish on Japan

Recent months have seen a chorus of bullish calls on Japanese equities and a surge in overseas investor interest, pushing the main indices back to levels not seen since 1989. This growth is attributed to the late reopening of Japan's economy after the COVID-19 pandemic, leading to confidence in corporate earnings and attractive stock valuations. Additionally, the Tokyo Stock Exchange's call for companies to focus on sustainable growth and raising their price-to-book ratios has also played a role. These factors have led to increased foreign investments as the Japanese market displayed attractive valuation metrics relative to the rest of the world, however the weakening yen has limited gains for overseas investors.

Japanese equities climb to multi-decade high



Source: Bloomberg, NEI Investments.

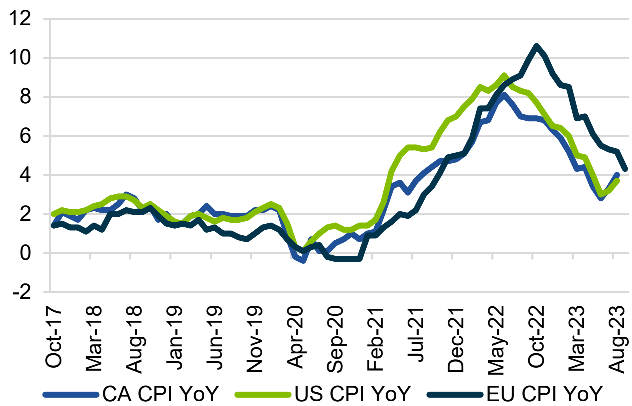
Bottomline: Historically speaking, in an environment where economic growth is positive and inflation is falling, equity investments typically have positive returns. High growth assets may pullback mildly, given their higher valuation as growth weakens and interest rates stay higher for longer. However, the majority of the market is at reasonable valuation and can provide support.

We have a preference on the U.S. markets over other regions given the relatively greater resilience in its economy and higher expected earnings growth in 2024 and 2025.

Inflation to recede by year-end but rates to remain higher for longer

Central banks across major developed markets have been maintaining their hawkish bias in a "higher for longer" forward guidance and are not ready to signal easier policy with inflation still above their targets. Japan remains the lone outlier, with growing pressure for the Bank of Japan to tighten policy due to rising inflation and resilient domestic growth.

Consumer Price Index falling



Source: Bloomberg, NEI Investments.

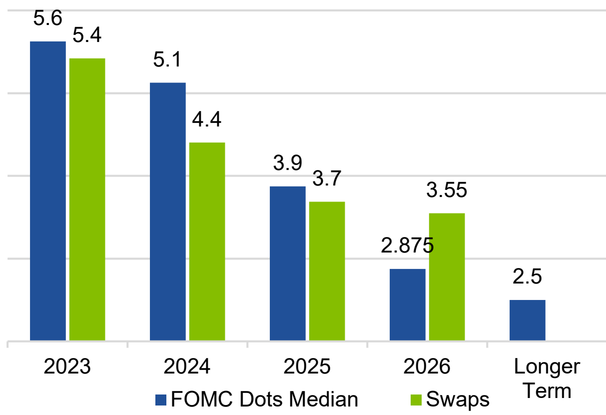
Disinflationary trend continues in the U.S.

The latest U.S. Personal Income and Outlays report shows that the core PCE deflator, the Fed's preferred inflation gauge, slowed to a 33-month low of 0.1% m/m, which was below expectations. This suggests that the disinflationary trend continues. Furthermore, despite an acceleration in income growth, real personal spending slowed from 0.6% m/m in August, to 0.1% m/m. Higher energy prices have reduced consumers' ability to spend on other goods at a time when interest payments are rising. This ultimately suggests that the aggressive Fed tightening campaign is working its way through the economy.

Higher for longer

Although the Fed maintained interest rates at the September FOMC meeting, the revised dot plot shows that rates will likely be higher for longer, a scenario that the bond markets need to adjust to. The meeting clarified that half of the Fed's previous forecast of easing next year was due to expectations of a higher unemployment rate. With unemployment rates still at historical low levels, there isn't enough of a catalyst for a rate cut anytime soon. The Fed is still telegraphing rate cuts next year, but by a trivial amount. This strongly suggests that investors will need to see a sustained period of core inflation below the Fed's end-2024 target for meaningful rate cuts to occur.

Bond markets underpricing the Fed's "higher for longer" resolve



Source: Bloomberg, NEI Investments.

This has led to debate whether long term neutral rate should be higher going forward, sending 10-year and 30-year US treasury bond yields soaring from 4.2% to 4.6% levels.

10-year U.S. Treasury yields surge

Source: Bloomberg, NEI Investments.

Longer duration assets have sold off as a result and as markets reassess greater uncertainty and volatility in the "higher for longer" regime.

Canadian inflation measures surprise to the upside

Core inflation measures surprised to the upside and rekindled concerns over rising inflationary pressures in Canada. Other than the surge in oil prices, one key driver fuelling the inflationary pressure included significant upside surprise in rent inflation. There is little respite in sight for prospective buyers as house price inflation turned positive in August, but with the smaller monthly price gain and easing demand, the housing market is expected to continue to cool. Bank of Canada's recent interest rate hikes also escalated demand for rental units due to reduced housing affordability. The renewed rise in inflation has raised concerns that policymakers may need to consider additional rate hikes to keep long term inflation expectations anchored.

Ironically, the market understates how quickly Bank of Canada would be willing to pivot to rate cuts if the housing market continues to cool or show signs of weakness. The Bank of Canada might be the first major central bank to cut rates if the economy contracts.

In Europe, the drop in inflation in September was largely due to favorable base effects, but core inflation also came in below expectations, which suggests that the ECB has likely reached peak interest rates in this tightening cycle.

Bottomline: We expect economic growth to moderate in the U.S. while Canada and Europe are more likely to fall into a mild recession over the next few months. We believe the market's current belief that interest rates will be "higher for longer" may not be held for long if inflation continues to recede. We believe the market will be in a holding pattern until the end of the year as growth weakens. However, as inflation continues to fall and corporate earnings improve over the next 6-9 months, we believe it will create a positive environment for both equities and fixed income. The recent pullback in equities and rally in yields has created an attractive entry point for long-term investors.

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Asset class outlook

Overall Equities – from underweight to neutral: Recent pullback brought valuations back to historical average levels. Corporate earnings have likely troughed and will improve from here onwards.

Canadian Equity – from underweight to neutral: Reasonable valuations reflective of negative momentum in the economy; helped by rally in the oil price if recent strength can be sustained.

U.S. Equity – overweight: Strong economic momentum relative to other developed economies with reduced recessionary risks. Falling inflation and real income growth supports consumer spending and economic growth.

International Equity – neutral: European economies under pressure as inflation remains too high. Strength in Japanese economy helps offset weakness, although currency weakness weighs on foreign investors returns.

Emerging Markets Equity – from neutral to underweight: China continues to disappoint on growth, but government stimulus may provide short term boost. India's strength in services shines, but fully reflected in price.

Overall Fixed Income – from overweight to neutral: Recent rise in long term yields makes for attractive entry point in the US as rates are close to peak in the near term.

Government Bonds – from overweight to neutral: Recent yield rally may be overdone, creating an attractive entry point for longer term investors.

Investment Grade Corporate Bonds – neutral: Attractive yields to partially offset volatility in spreads.

High Yield Bonds – from underweight to neutral: Recent rally in spreads may be overdone, attractive entry point and yields to partially offset volatility in spreads. Default rate expected to remain low in the near term.

Asset allocation outlook summary

	Bearish	Neutral	Bullish
Equity			
Overall Equity	Last month	This month	
Canada Equity	Last month	This month	
U.S. Equity			This month
International Equity		This month	
EM Equity	This month	Last month	
Fixed Income			
Overall Fixed Income		This month	Last month
Govt		This month	Last month
IG Corp		This month	
U.S. HY Corp	This month		
Cash		Last month	This month

This month

Last month

This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of September 30, 2023. If an asset class has a blue box in its row and no green box, it means this month's outlook is the same as the prior month's.

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	-2.59	-3.80	-4.60	-1.68	-1.42	-5.11	0.05	1.62
Bloomberg Global Aggregate TR Hdg CAD	-1.77	-1.95	-2.07	0.63	1.55	-3.99	0.18	1.71
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	-1.24	0.32	1.86	5.33	9.63	1.28	2.16	3.78
Equities								
MSCI World NR USD	-4.38	-1.36	3.03	10.86	20.00	8.52	8.22	11.27
MSCI World Growth NR USD	-5.73	-2.83	4.90	20.60	24.54	5.70	10.41	13.47
MSCI World Value NR USD	-2.89	0.25	1.00	1.80	15.18	10.86	5.37	8.70
MSCI Canada NR CAD	-3.06	-1.96	-0.60	3.56	9.70	9.52	6.27	6.79
MSCI USA NR USD	-4.79	-1.07	5.04	12.88	19.09	9.46	10.31	14.28
MSCI EAFE NR USD	-3.48	-2.03	-1.38	6.85	23.63	6.18	4.17	6.71
MSCI Europe NR USD	-4.04	-2.89	-2.45	7.72	26.78	7.66	4.89	6.71
MSCI Japan NR USD	-2.17	0.55	4.63	10.97	23.90	3.23	2.98	7.28
MSCI Pacific Ex Japan NR USD	-3.13	-2.68	-6.56	-4.65	8.80	4.57	2.70	5.67
MSCI EM NR USD	-2.68	-0.82	-2.15	1.60	9.91	-1.33	1.46	4.91
World Currencies								
US Dollar	-0.07	2.17	-0.10	-0.22	-1.60	0.40	0.90	2.78
Euro	-2.52	-0.85	-2.65	-1.01	6.34	-2.96	-0.95	0.28
Pound Sterling	-3.75	-1.91	-1.38	1.25	7.59	-1.50	-0.42	-0.09
Yen	-2.51	-1.04	-10.90	-11.77	-4.56	-10.55	-4.46	-1.44

Source: Morningstar data as of September 30, 2023.