NEI MONTHLY MARKET MONITOR

NEI

October 2023

Long term yields spooked the markets in October

Both equity and fixed income markets continued their fall in October as bond yields rose sharply, while heightened geopolitical uncertainty also weighed on market sentiment.

In fixed income markets, the upward spike in bond yields caught many by surprise. The U.S. 10-year Treasury yield pushed above 5% for the first time since 2007, driven mainly by positive economic data from the U.S. making it increasingly likely that rates will be 'higher for longer', and higher U.S. deficits. The bond market volatility was not all negative as the Israel-Hamas conflict in the Middle East increased demand for Treasuries as safe haven assets. A move higher in yields was then seen across the global government and corporate bond markets. Widening spreads had a negative impact on monthly returns for both investment grade and high yield credit markets.

Stocks fell across countries as the prospect of 'higher for longer' rates hurt equity valuations and the conflict in the Middle East dampened risk appetite. The S&P 500 Index was the best performing developed market, down -2.1% for the month, but still up 10.7% year-to-date, while in Canada the S&P/TSX Index fell -3.2%. Commodities were the notable outperformer, as energy prices rallied and investors fled to gold as a safe haven.

Conflict in the Middle East and markets

The Israel-Hamas war in the Middle East have not driven equities much lower, but it has led to increased volatility over the month and a flight to safety in gold. In addition to the supply-deficit situation prior to the conflict, oil prices also rallied amid concerns that an escalation into a wider regional conflict could disrupt oil supply.

War often brings about a level of uncertainty which markets typically dislike, leading to short term selloffs and flight to safety. Historically, however, stock markets have shown resilience and often quickly recover as the situation stabilizes and as the scope of the conflict becomes clearer.

Asset reaction to geopolitical events

3-month subsequent returns (%)

Event	Date	S&P 500	UST 10y	Brent	Gold
Apartheid Sanctions	Sept-86	9%	4%	26%	-7%
Invasion of Kuwait	Aug-90	-10%	1%	38%	-1%
Gulf War I	Jan-91	20%	2%	-24%	-8%
9/11 Attacks	Sep-23	4%	0%	-30%	2%
Gulf War II	Mar-03	12%	7%	2%	6%
Madrid Bombing	Mar-03	2%	-6%	1%	-3%
London Bombings	Mar-04	-1%	-2%	5%	12%
Lebanon War	Jul-05	7%	3%	-10%	-6%
Crimea Annexation	Jun-06	5%	3%	6%	-2%
Paris Attacks	Nov-15	-5%	5%	-21%	16%
Ukraine Invasion	Feb-22	-4%	-8%	24%	-5%
Average		**3%**	**1%**	**2%**	**0%**
Median		**4%**	**1%**	**2%**	**-2%**
Hit Ratio		**64%**	**64%**	**64%**	**36%**

Source: Bloomberg, Goldman Sachs Global Investment Research.

Bottomline: A major impact on the markets is not expected as long as the crisis remains locally contained. A larger regional conflict could lead to higher oil prices and add uncertainty to the path of inflation. Geopolitical risks are the main focus at this point, and they are overshadowing the underlying strength in company fundamentals.

Markets look past strong earnings

Above-average earnings surprises

At the time of writing, the U.S. is midway through the Q3 earnings season. The quarter-over-quarter growth are remarkably strong, with both % of companies and the magnitude of earnings surprises above their 10-year averages. According to Factset, surprises to the upside have also been widespread across all sectors except energy:

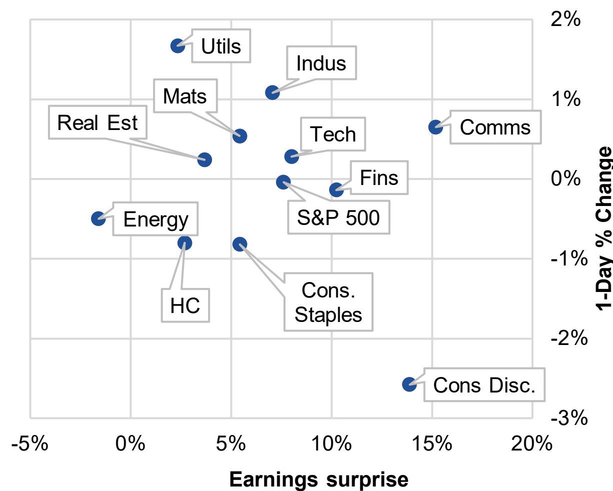
- 78% of companies beat EPS estimates, vs. 10-year average of 74%
- 56% beating EPS expectations by more than a standard deviation vs. the long-term average of 48%
- Earnings are 7.7% above estimates, in aggregate

- S&P 500 is reporting positive year-over-year growth in earnings for the first time since Q3 2022

Negative price reaction on lower forward guidance

Despite strong earnings surprises, price reaction has not been as positive as the market is increasingly focused on forward guidance. Only companies that beat expectations and gave upbeat forward guidance were rewarded. Companies that guided their growth lower were punished along with the companies that missed expectations. Although the earnings season has been encouraging, there was generally a pessimistic tone in companies' forward guidance. Less than 30% of companies are raising their forward guidance, an early indicator of a potential slowdown of economic strength going forward.

Earnings surprise vs 1-day price reaction by sector



Source: Bloomberg, NEI Investments.

Mixed results for Tech giants

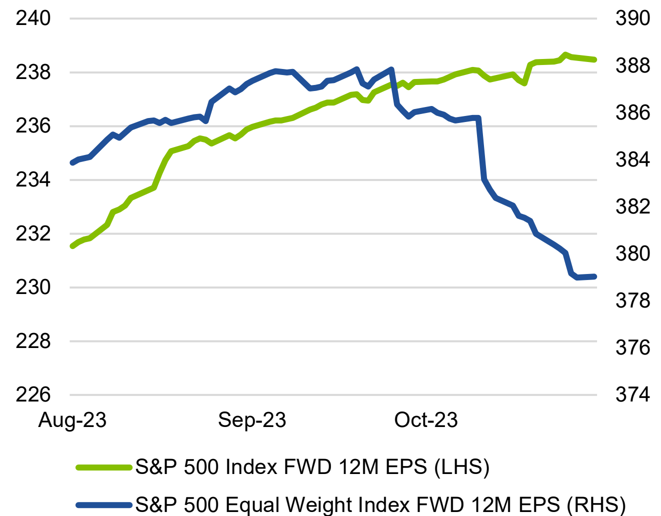
Technology stocks slid towards the end of the month after a wave of poorly received earnings reports from some of the world's largest companies.

Results from Alphabet and Meta drew the most investor scrutiny. Although both companies topped expectations on earnings, their results and commentary led to concerns about trajectory of growth in cloud and ad spending. Alphabet declined the most, despite reporting revenue and profit that topped estimates, as investors focused on lower-than-expected profitability in cloud computing, raising concerns about its position in a market critical to its future.

In contrast, Microsoft's cloud business was a key driver for beating expectations. Helped by AI, it is now bigger and growing faster than Google Cloud. This was much rewarded by investors. Amazon investors also had reason to be optimistic as the CEO reported on very large orders that will be reflected in the upcoming quarter.

Looking at the market as a whole, on a market cap weighted basis, the earnings estimates are expected to grow over the next 12 months, while on an equal weighted basis, we see an expected decline in earnings, which indicates that for the largest companies, earnings expectations are very strong relative to the rest of the market.

Forward earnings -- equal weight S&P 500 vs cap weight S&P 500



Source: Bloomberg, NEI Investments.

Earnings in Canada not as rosy

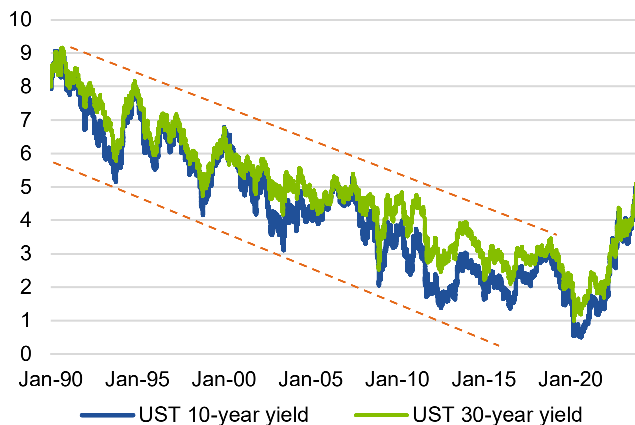
It is still early for Canadian's Q3 earnings season, but results have not been as rosy as in the U.S.. Based on 52 (out of 226 on the TSX) companies that have reported so far, earnings growth was -3.3% quarter over quarter, despite a positive 8% overall earnings surprise. Price reaction has also been flat to negative. This may not be representative of the market until enough companies have reported by next month.

Bottomline: Investors are weary about growth over the next year and are becoming more selective, creating an extremely narrow market. This trend may very well continue and may become more extreme, as the largest handful of companies on the S&P500 Index have stronger earnings growth, resilient balance sheet strength, and are commanding significant valuation premium relative to the rest of the market.

Rapid rise in real yields since July continued to weigh on markets

Since July, we have been witnessing a roller coaster ride in long term yields in U.S. Treasuries. The consistent upward pressure drove 10-yr and 30-yr yields to levels not seen since 2007.

Yields reverse following 30-year downtrend



Source: Bloomberg, NEI Investments.

Plenty of reasons for yields to rise

Yields have risen to the highest levels in more than a decade. A few key factors for rising yields include:

1. **Resilience of the U.S. economy**

October saw a flurry of data signalling the resilience of the U.S .economy, including a blockbuster jobs report, strong retail sales data and a blowout GDP print of 4.9% annualised for the third quarter. A considerable surge in consumer spending played a crucial role in this uptick as consumers in the U.S. continued to spend despite higher mortgage rates. This resilience in the economy is pushing yields higher contributing to the view that long term neutral interest rates may need to be higher than historical levels going forward.

2. **Fed's higher long term rate expectations**

One of the catalysts for the rise in yields was Fed's expectation that rates will need to stay higher for longer, after the release of the Fed's dot plot in September which implied that we could see only 50 basis points in rate cuts in 2024, much less than the 100 basis points of cuts implied in the dot plot in June.

3. **Supply and demand imbalance**

There has been a growing imbalance between the supply and demand for U.S. Treasuries which is putting negative pressure on the price. On the supply side, the Fed is increasing its bond issuance to finance the U.S. government's budget deficit, the rising interest costs on its existing debt, and to fund its commitments on two ongoing wars. On the demand side, we are seeing reduced demand from two of its largest foreign buyers, China and Japan. This imbalance results in disappointing results in the most recent Treasury auctions.

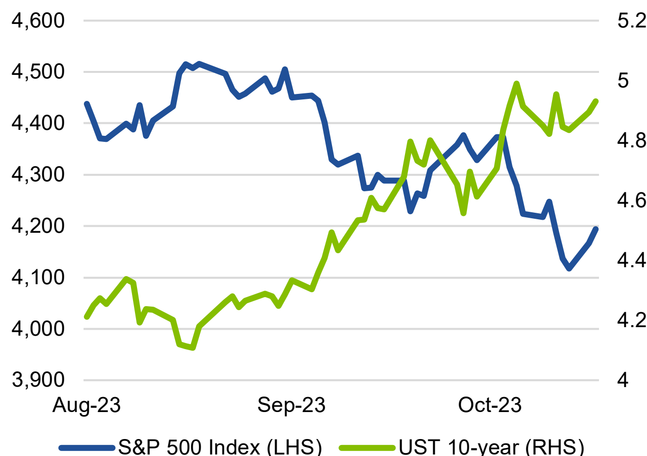
4. **Long term inflation expectations**

Concerns about global geopolitical tensions have intensified in recent years which have negative implications on global financial stability, fueling economic fragmentation and deglobalization. Geopolitical instability could motivate companies to onshore production domestically or reduce cross-border investments, which can drive inflation expectations higher.

The impact of rising yields on equity markets

This rise in yields as well as the rise in the volatility of yields has been the key driver of equity market movements over the last 2 months. Equities typically fare poorly when yields rise sharply. We saw a rise in yields of about 70 basis points from early September to early October, when the S&P 500 declined by about 6%, and later in October a 40 point rise when the S&P 500 declined again. When yields fell a bit in mid-October, we saw a short-lived S&P 500 rally until the rates resumed their upward movement.

S&P 500 Index performance vs yield on 10-year U.S. Treasuries



Source: Bloomberg, NEI Investments.

Bottomline - Higher yield is one of the key ingredients for tightening of financial conditions, which in essence is likened to rate hikes. The longer the yields remain high, the lower the need for the Fed to hike rates any further. We believe it is likely that the U.S. is at peak rates, creating a positive environment for risk assets. In addition, seasonality factors are favorable, and a year-end rally is possible.

Central banks on pause

In October, a number of major central banks kept rates steady. For Europe, the pause came after 10 consecutive rate hikes. The European Central Bank (ECB) recognized that the risks to economic growth is leaning to the downside but also noted that any discussion on rate cuts is premature. The Bank of

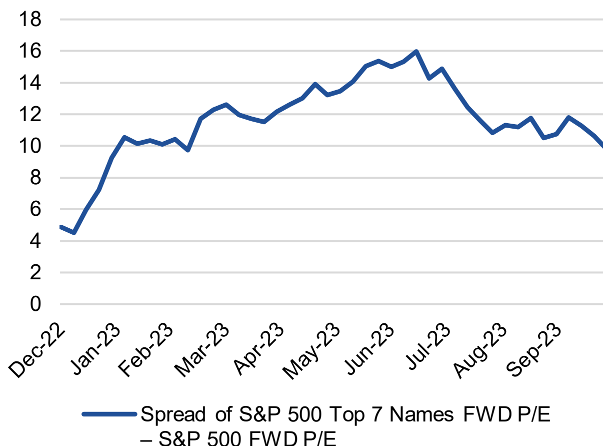
Canada kept rates unchanged for the second consecutive meetings in a row following 10 rate hikes and held their key interest rate at 5%, inline with expectations from the majority of economists. The U.S. Fed has also hit the brakes on further rate hikes for the third time in last 5 months. The decision at the Fed's November meeting to leave rates unchanged followed a pause in September, an increase in July and a pause in June.

Bottomline: Many economies are beginning to show cracks after a period of unsustainable strength. If this trend continues, the "higher for longer" narrative could shift. In the face of slowing economies many central banks may need to cut rates sooner than market is anticipating. This could create opportunities for bonds, since the market is not currently pricing in cuts anytime soon.

High valuation dispersion in equity markets

The dispersion in valuations remains wide between sectors and between the largest 7 stocks and the rest of the market. This indicates that most of the market is still trading at reasonable valuation levels, in line with historical averages.

Forward P/E – Top 7 S&P 500 names vs S&P 500 Index



Source: Bloomberg, NEI Investments.

The high concentration in the largest names in the market is still very significant and continues to have an impact on market performance. The equal weighted index year-to-date return is now negative at -2.6%, vs the traditional cap weight index with year-to-date returns of 10.7%. This is further evidence that market performance is not representative of the broad equity market and economy, due to the high concentration of a few outperforming mega cap names.

- The largest 7 companies in the S&P500 represented 117% of YTD returns. Only 26% of SPX constituents beat the index
- The equivalent metrics for equity markets outside of U.S., represented by MSCI EAFE Index, it takes 40 companies to represent 117% of YTD returns. 43% of index constituents beat the overall index returns

Bottomline: It has been a tough environment for active managers this year – especially in the U.S. – due to the narrow nature of market performance.

Canada on the brink of recession

August's GDP data was weaker than expected, and preliminary indicators are pointing to stagnating growth in September again. These figures point to -0.1% of GDP growth in Q3, a second quarterly contraction. CD Howe Institute relies on a broader set of indicators before calling a recession, including breadth of GDP contraction and changes in employment. However, there are clear signs of softening in the labour market, with layoffs across the banking industry. Desjardins is laying off nearly 400 employees, Scotiabank is cutting 3% of its global workforce, and RBC is planning to cut 2% of its staff in the coming months. The breadth of contraction has also widened recently to approximately 60% of sectors that have contracted over the last three months.

The Canadian consumers are not as robust as in the U.S. as Canadian households have the highest debt levels amongst G7 countries driven by housing, making Canadians very sensitive and vulnerable to rise in shorter term rates. This has constrained the Canadian consumers and has negative impact on consumer driven businesses.

Canadian companies are attractively valued

Rate hikes are normally positive for banks as lenders can generate better net interest margins, however the speed of rate hikes in Canada is driving fears that businesses and highly indebted homeowners are going to default on their loans and mortgages, and rising interest rates are putting a dampener on further loan issuance. Share prices of the large Canadian banks has dropped considerably this year and are now trading at levels not seen since late 2020. Dividend yields in Canadian banks and many other Canadian companies have now risen to very attractive levels.

Bottomline: It's not clear yet if inflation in Canada has come under control. Financial assets are currently priced based on the expectation that Canada will need to keep rates higher for longer than other markets. Current yields and valuations, at 12.9x forward 12-month earnings are attractive for long-term investors.

Asset class outlook

Overall Equities – from neutral to bullish: Despite expectations that economic growth will slow in the coming quarters, we believe an equity rally to year end is still possible. Valuations, seasonality and earnings growth should favour equities in the near term.

Canadian Equity – neutral: Valuations are attractive as equites remain under pressure, oil ended its rally, but the risk for oil is to the upside after the price is over 10% lower in October. But earnings growth has been weak.

U.S. Equity – bullish: Macro data remains positive with inflation moving lower. Valuations of the "Magnificent 7" along with the whole S&P 500 are less demanding and corporate earnings are expected to show positive y/y growth for the first time in over a year.

International Equity – neutral: European macro data continues to be weak, and earnings disappoint as companies are seeing declining profit margins. Japan's economy is continuing to offset this weakness.

Emerging Markets Equity – bearish – China's economic turnaround has not yet materialized and there are no definitive signs of a stimulus plan in the near term. China's weakness and influence in the region is leading to more attractive investments elsewhere.

Overall Fixed Income – bearish: We may be nearing peak rates globally, but there is a low probability of interest cuts in the near term, making equities more attractive compared to bonds.

Government Bonds – neutral: Government yields continued to make new highs but may begin to run out of steam and the elevated coupon is attractive.

Investment Grade Corporate Bonds – bullish to neutral: Elevated yields continue to be attractive within the asset class but slowing economic growth may move spreads wider.

High Yield Bonds – from bearish 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		This month	
U.S. Equity			This month
International Equity		This month	
EM Equity	This month		
Fixed Income			
Overall Fixed Income	This month	Last month	
Govt		This month	
IG Corp		This month	
U.S. HY Corp	Last month	This month	
Cash		This month	Last month

This month (blue)
Last month (green)

This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of October 31, 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	0.36	-2.45	-5.17	-1.32	-0.13	-4.76	0.25	1.56
Bloomberg Global Aggregate TR Hdg CAD	-0.78	-2.72	-3.29	-0.16	1.09	-4.24	0.07	1.53
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	-1.27	-2.26	-0.39	4.00	5.50	0.69	2.25	3.38
Equities								
MSCI World NR USD	-0.30	-4.35	0.73	10.53	12.44	9.61	9.48	10.65
MSCI World Growth NR USD	0.20	-4.90	3.22	20.84	20.19	7.02	12.26	12.94
MSCI World Value NR USD	-0.83	-3.74	-1.93	0.96	4.89	11.68	6.01	7.99
MSCI Canada NR CAD	-3.10	-7.49	-6.67	0.35	0.51	9.67	6.99	5.95
MSCI USA NR USD	0.29	-3.55	3.83	13.21	11.49	10.62	11.63	13.66
MSCI EAFE NR USD	-1.48	-6.01	-5.71	5.26	16.43	7.16	5.26	6.05
MSCI Europe NR USD	-1.15	-6.37	-7.62	6.48	17.79	9.41	5.99	5.99
MSCI Japan NR USD	-1.94	-3.78	2.00	8.81	18.86	3.17	4.08	6.92
MSCI Pacific Ex Japan NR USD	-1.90	-8.04	-8.70	-6.46	6.99	4.16	3.87	4.86
MSCI EM NR USD	-1.31	-7.36	-2.54	0.27	12.77	-2.37	2.73	4.12
World Currencies								
US Dollar	2.68	5.47	2.36	2.46	1.77	1.35	1.12	2.90
Euro	2.51	1.11	-2.00	1.47	8.84	-1.88	-0.28	0.34
Pound Sterling	2.08	-0.53	-1.18	3.36	7.26	-0.77	0.08	0.05
Yen	1.18	-1.05	-7.97	-10.73	-0.11	-10.43	-4.66	-1.47

Source: Morningstar data as of October 31, 2023

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