Monthly Market Monitor

December 2022

Highlights

Price pressure eases but wage inflation remains high

Price pressures are easing as tighter monetary policy is starting to curb excess demand, and easing supply chains are lowering costs for materials and freight. Wages have declined in real terms, but are increasing in nominal terms. As a result, core inflation may remain higher for longer, even as headline inflation begins to moderate.

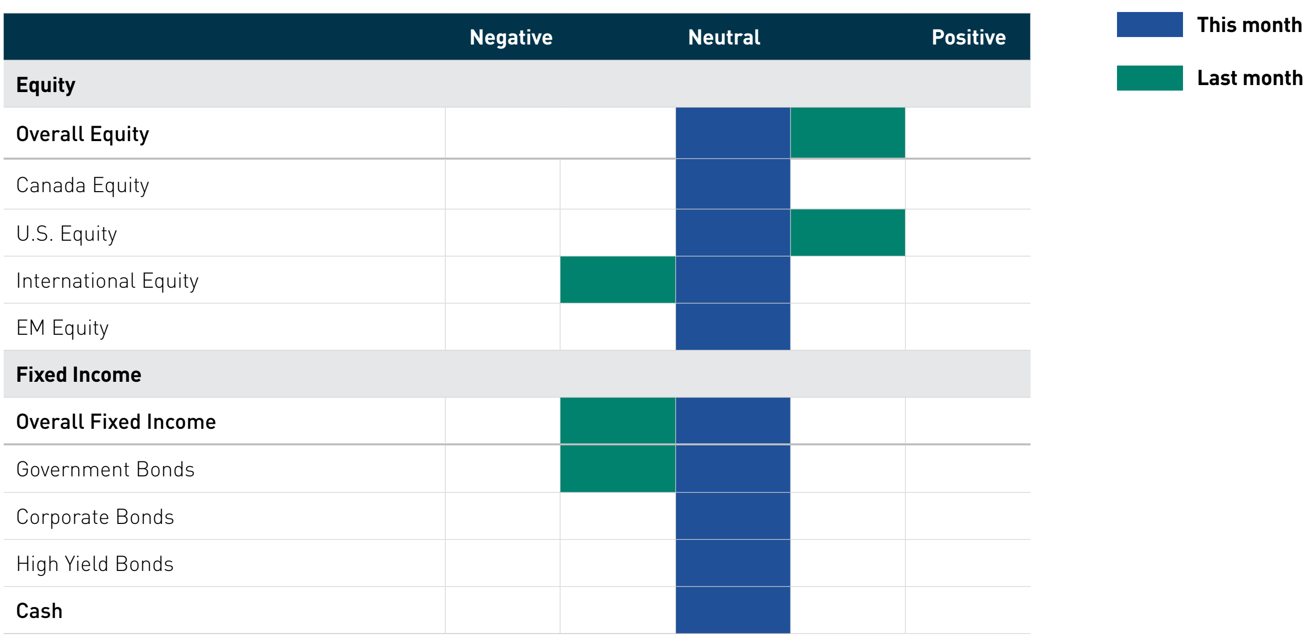
Recession risk looms

Recent data shows the global economy is weakening with both manufacturing and services slowing as business and consumer confidence hit their lowest point in two years. The spread between the 10-year US Treasury yield and the 2-year yield, points to the possibility of a looming recession in the US.

Market prices not reflecting recessionary concerns

Despite earning estimates being revised downward since the summer, markets may still not be fully pricing in the impact lower demand and higher costs will have on corporate profit margins. Earnings estimates may have to be revised further downwards as current market pricing may still be too optimistic if a recession is on the horizon.

Asset allocation outlook summary



This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of November 16, 2022. 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.

Overview – Markets advance to the "next round"

Argentina's progress so far in this year's staging of the FIFA World Cup, provided a reminder that despite an upset in the early stages of the tournament, things could turnaround meaningfully to advance to the next round. Argentina, arguably one of the best football teams, suffered a major blow in the early stages of the World Cup Championship, losing their first game to Saudi Arabia, only to come back to win the next two rounds of games to advance to the "round of 16". Like Argentina, markets bounced-back in November as major asset classes ended the month in positive territory despite a pull-back in mid-October. U.S equities advanced on the back of better-than-expected U.S CPI data, further boosting optimism that the Fed may be able to tame inflation without causing a recession. At the close of the month, US Fed chair also signalled that the Fed will slow the pace of rate hikes next month, which fuelled another rally of U.S assets. The S&P 500 closed the month up 4.7%.

The relief rally extended to European equities as the November's euro zone inflation data came in lower than expected. This stoked optimism that the European Central Bank (ECB) could be closer to peak hawkishness than markets expect. European equities advanced 10.7% during the month. Canadian equities also had a strong month with gains north of 5%. Emerging markets, which have been underperforming year-to-date, made a strong comeback in November. Investors piled in to take advantage of depressed valuations, as the Chinese government unveiled guidelines to ease its zero-Covid approach.

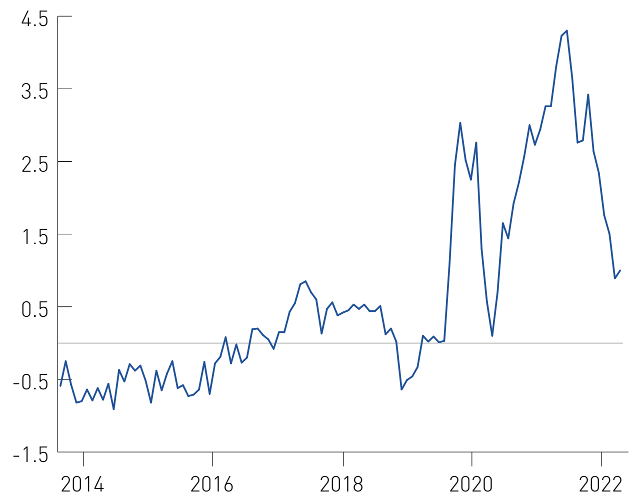
On the fixed income side, 10-year yields dropped by 44bps in the US and 32bps in Canada over the month on hopes that central banks might be able to downshift on the magnitude of rate hikes. US and Canadian bonds gained 3.7% and 2.8% respectively, while Bloomberg US HY 2% bonds closed +2.1%.

Price pressure eases but wage inflation remains high

Price Pressure Eases

Tighter central bank policy across major economies have started to take effect in curbing excess domestic demand and mitigating upward price pressures. Raw material prices and freight costs have cooled dramatically, leading to lower growth in input cost, and output price inflation in the month of October.

Global Supply Chain Pressure Index



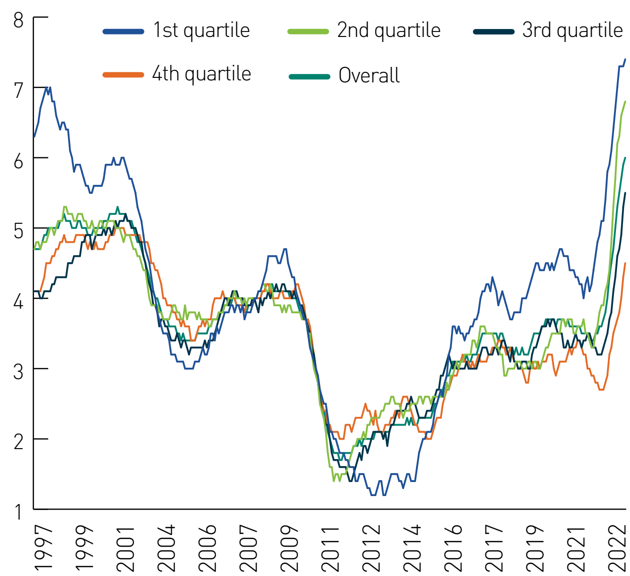
Source: Bloomberg, as of Nov 30, 2022

Wage gains still show no sign of abating

As shown in the International Labour Organization's recent Global Wage Report the, global monthly wages fell in real terms by −0.9% in the first half of 2022, the first negative global wage growth on record. The drop in purchasing power was steepest in advanced economies where inflation has risen substantially. While wages are declining in real terms, the picture in nominal terms is quite different as nominal wages have risen to unsustainable levels in many countries. In the US, wage gains remain strong, driven by a tight labour market. Average hourly earnings continue to increase more quickly than the pre-pandemic average of 3% gains annually, continuing to put pressure on inflation.

Atlanta Fed Wage Growth Tracker

12-month moving average of median wage growth for each category, hourly data



Source: Atlanta Fed

Perspective: Headline inflation likely will continue to retreat, while core inflation may remain higher for longer. Although the bulk of the tightening is already behind us and the central banks may downshift in the upcoming rate hikes, we believe it is likely that the rates will need to remain higher for longer in order for tighter financial conditions to work through the economy, and inflation to moderate to an acceptable level from a monetary policy standpoint.

Recession risk looms

Economic activities decelerate

With aggregate demand quickly cooling, growth momentum in manufacturing activities is now firmly on a negative trajectory. In October, the S&P Global PMI confirmed that the global economy is weakening as the slowdown deepened at the start of the fourth quarter with both manufacturing and service activities decelerating and output contracting at a faster rate. Concurrently, business and consumer confidence have weakened to the lowest point in two years, which underscores weakness in future business investments and consumer spending

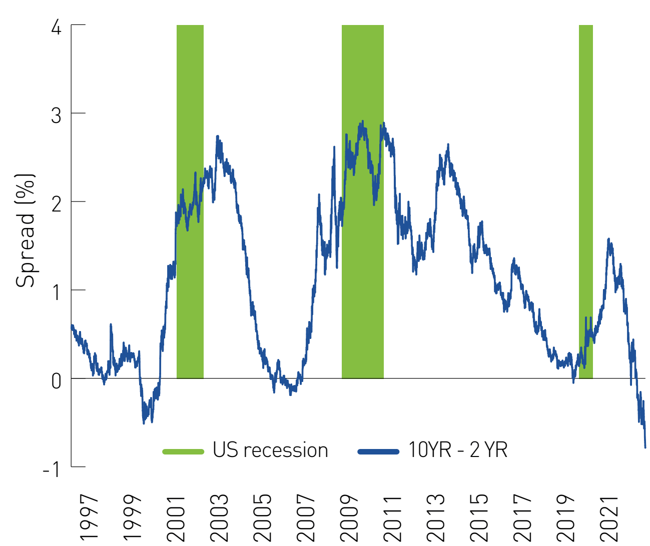
New Orders & Net Export Orders

Source: Bloomberg, as of Nov 30 2022

The yield curve is now deeply inverted

One of the credit conditions indicators most watched by the the market is the spread between the U.S 2-year and 10-year Treasury yields. The indicator has a good track record of predicting recessions, as the economy typically falls into recession shortly after the spread turns negative. It is now in negative territory and is at its lowest level since 1981, with the 10year Treasury yield 83bps below the 2-year yield.

US 10-year vs 2-year yield spread



Source: Bloomberg, as of Nov 30 2022

Perspective: With negative growth momentum and tighter financial conditions, economic growth will likely be below trend across major economies in 2023, with rising probably of slipping into recession.

Europe is arguably already in a recession as they struggle with energy price shock and higher inflation. U.S. remains on relatively firmer footing with stronger personal balance sheet. Canada is weighed by the housing market, which will remain soft given higher interest rates.

Market prices not reflecting recessionary concerns

More downward revisions to come on US corporate earnings

Consensus estimates for next year's earnings growth for S&P 500 companies have gradually been revised lower since July from over 11% to 5.3% for 2023. Further downward revisions are likely as corporate profitability comes under pressure from lower consumer demand, higher input costs and higher labour costs, resulting in lower output prices and shrinking profit margins. Earnings estimates of companies in Europe Stoxx 600 have also been revised lower, which is in contrast to the Asia Pacific region, India in particular, which has shown upward revisions to company earnings estimates.

S&P 500 price and earnings growth estimates

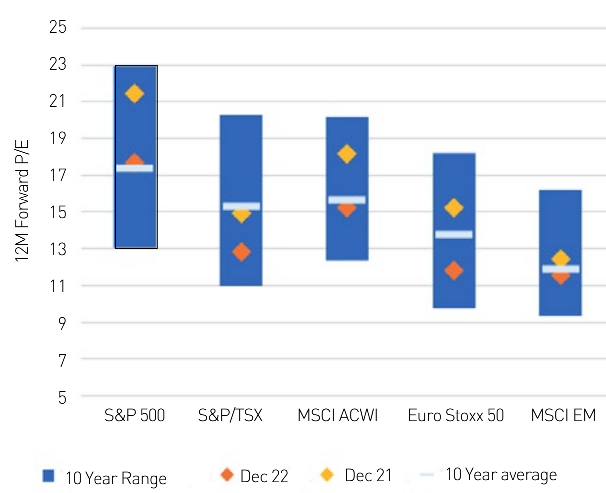
Source: Bloomberg, as of Nov 30 2022

US equity valuations not at recessionary lows

Most of the market drawdown so far this year can be attributed to a contraction of valuation multiples, as they have retreated from a high of over 22x forward earnings, to just below 18x. Although valuations are now more reasonable on the back of resilient delivery of corporate earnings, it is not reflective of the deteriorating economic conditions, as multiples have historically troughed at just above 14x forward earnings during recessions. The US is also more vulnerable to more equity downside given its significant premium relative to all other regions, even when adjusted for sector differences in the makeup of the markets.

In the next year, the USD may lose its momentum against other currencies as central banks will likely have to continue to raise rates after the Fed has paused, closing the interest rate differentials, which have been the main driver for US dollar strength. A strong USD is typically a headwind for equities outside of the US. As the USD loses momentum, US equities may lose the equity performance leadership against other regions in 2023.

10 year valuations across major equity markets



Source: Bloomberg, as of Nov 30 2022

Perspective: Current market pricing levels across bonds and equities are rather optimistic, in our view. Fed fund futures are pricing in a dovish pivot and rate cuts to start by the end of 2023, while equities are reflecting an expectation of a soft landing with corporate earnings at robust growth rates. This optimism could lead to near-term market volatility as core inflation may persist, rates may need to remain higher for longer, economic growth momentum may continue tis negative trend, and earnings estimates continue to be revised lower. We believe a defensive stance is warranted for the near term, until central banks reach peak hawkishness and inflation shows sustained signs of moderating.

Market Outlook

The most recent data suggests inflationary pressure is abating somewhat, but central banks will need to continue on their tightening path until inflation returns to an acceptable level. The Bank of Canada is still expected to deliver another 25 or 50bps of hikes by the end of 2022 and the Fed fund future rates are also implying a peak rate at 5.0% by mid-2023, 75-100bps higher than current levels, putting monetary policies squarely in restrictive territory that weighs on economic growth.

The path forward still hinges on how quickly inflation moderates. There are plenty of signs that indicate the transitory drivers of inflationary pressure are abating, as commodity prices are rolling over and the supply chain is recovering. However, inflationary pressure stemming from the stickier drivers, such as wage and shelter inflation, remains high. This leads us to believe that core inflation will likely remain higher for longer. While the bulk of the tightening is already behind us and the central banks may downshift in the upcoming rate hikes to get to the peak rate of this tightening cycle, we believe it is likely that rates will also need to remain higher for longer in order for tighter financial conditions to work through the economy, and inflation to moderate to an acceptable level from a monetary policy standpoint.

With higher rates and tighter financial conditions, economic growth will likely be below trend in 2023. GDP growth forecasts have been revised sharply lower to around 0.4% in the US and 0.6% in Canada for 2023. Resilient consumer spending and strong personal balance sheet is providing support to the US on a narrow path to achieve a soft landing, or a mild recession in a bearish scenario. The Canadian economy, being more interest rate sensitive, is also expected to experience a slowdown in 2023. Housing prices are already cooling but residential construction activities remain resilient and may provide support to the Canadian economy. European countries are arguably already in a recession as they suffer from a significant energy price shock, much higher inflation, and negative real wage growth. Emerging markets also struggle with strong USD, negative terms of trade, and China's draconian zero covid measures and an ailing property market.

We remain relatively neutral in positioning relative to the benchmark, with a quality and dividend tilt in our equity exposures. We believe markets will continue to be under pressure early in the new year, until policy rates reach their peaks in this tightening cycle sometime in spring of next year. In 2023, we expect inflation to be cooling sufficiently to provide support to real incomes, consumer consumption, manufacturing activities, and corporate earnings, hence a boost for equity markets. Declining inflation will also be a boost to fixed income investments in 2023, when rates are no longer rising and yields have room to decline across the term spectrum. This will create a much more supportive environment for multi asset portfolios.

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 Barclays Canada Aggregate	2.76	1.26	0.07	-9.89	-8.39	-1.99	0.52	1.74
Bloomberg Barclays Global Aggregate (C$ Hdg)	2.52	-1.25	-2.96	-10.42	-10.81	-2.45	0.24	1.80
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	2.14	0.42	-3.33	-11.11	-9.51	0.21	1.68	3.91
Equities								
MSCI World (Developed Markets)	6.30	7.64	5.28	-8.25	-5.79	8.26	8.45	12.99
MSCI World Growth	6.00	3.78	3.89	-19.08	-18.66	8.71	10.20	14.39
MSCI World Value	6.57	11.44	6.60	2.86	7.94	6.70	6.01	11.20
MSCI Canada	5.41	7.01	-0.12	-1.64	1.43	8.38	7.00	7.66
MSCI USA	4.73	6.75	6.36	-8.56	-6.43	10.95	11.44	16.16
MSCI EAFE	10.58	10.02	3.34	-8.26	-5.04	2.62	2.89	8.31
MSCI Europe	10.67	12.79	3.49	-8.85	-4.32	3.35	3.22	8.18
MSCI Japan	9.01	4.79	2.93	-10.78	-10.48	0.29	1.34	9.42
MSCI Pacific Ex Japan	13.96	6.59	3.23	0.51	2.23	3.00	3.90	7.30
MSCI EM (Emerging Markets)	14.13	1.68	-1.55	-13.01	-12.74	0.82	0.60	5.29
World Currencies (relative to CAD)								
US Dollar	-0.61	3.52	7.18	7.33	5.68	0.68	1.03	3.16
Euro	3.54	6.00	3.02	-2.82	-3.32	-1.59	-1.90	0.78
Pound Sterling	2.80	5.95	1.28	-5.63	-4.87	-2.05	-1.53	0.14
Yen	5.87	2.84	-1.19	-11.43	-14.00	-7.13	-3.34	-2.13

Source: Morningstar. Data as of November 30, 2022.

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