NEI MONTHLY MARKET MONITOR

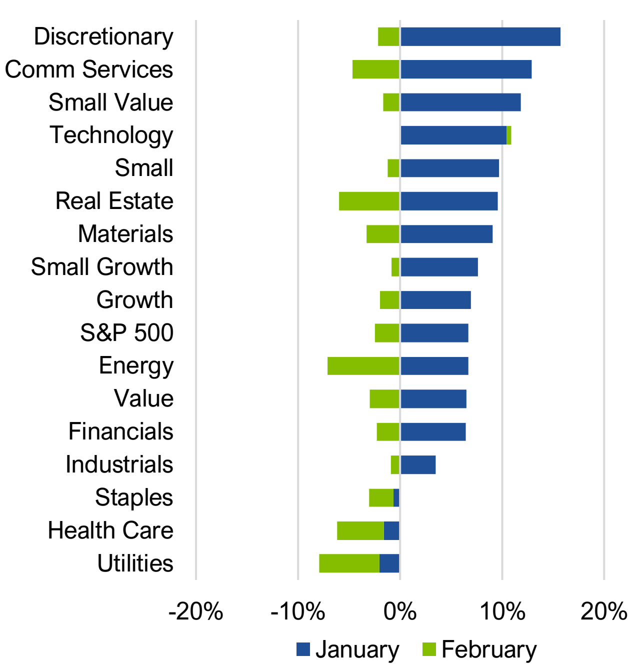
February 2023

Markets fatigued in February as economy runs hot

The sizzling rally in January may have gone too far and markets began to cool in February in response to signals that the economy remains too hot. Central banks may not be done in tightening just yet. Recent surprise in labour market data and an uptick in inflation suggests that rates will need to move even higher and will likely stay higher for longer than anticipated last month. The Federal Reserve and other global central banks will likely have to continue their path of tightening and more rate hikes may be required to tame the sticky inflation.

The markets peaked in early February and began to taper in the middle of the month as investors questioned the sustainability of the rally given rich valuations and elevated recession risks. The risk-on sentiment quickly disappeared after a flash appearance in January. The downside was broad-based, led by energy and interest sensitive and defensive sectors such as utilities and real estate. The S&P 500 index ended the month just below the 4000 level that it has been hovering around since mid last year.

Sector and style performance Jan vs Feb 2023



Data: Bloomberg, as of February 28, 2023

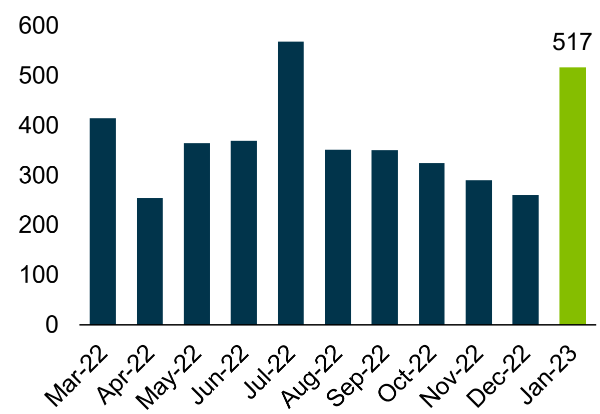
Here's a closer look at some of the key datapoints that pushed the market lower and caused investors to re-consider the path forward.

Lower recession risk

The narrative around recession continues to evolve. Despite heightened probability of recession, economies continue to show resilience and unexpected pockets of strength. The soft-landing/ hard-landing narrative has been usurped by the potential for a "no-landing" scenario, the word-of-the-month for economists in February, which points to continued but anemic economic growth, a low unemployment rate and moderating inflation.

Recent data shows that the labour market remains tight as January's U.S. Non-Farm Payrolls were blowout numbers with 517,000 jobs added, much stronger than expectation at 187,000 jobs. Jobless claims and initial jobless were both below expectation.

U.S. Non-farm payrolls month-over-month



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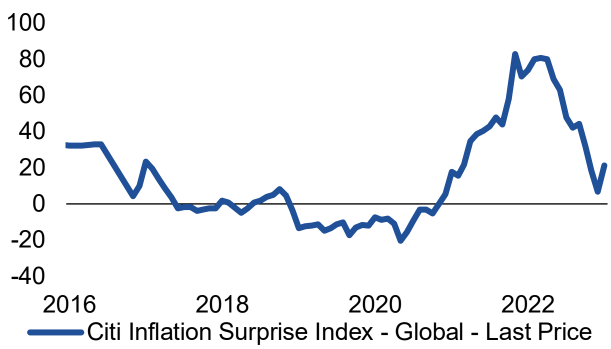
The warmer than usual winter and China's re-opening are clearly a boost to global economy, especially in service industries. The latest Service PMI indices across U.S., Europe and U.K. have bounced past 50.0 back into the expansionary territory, demonstrating remarkable resilience. That is, however, also putting more pressure on service inflation. ISM Services Prices Paid Index in the U.S. continues to retreat from peak of mid 80s but remains elevated at 65.

Bottomline: Recession does not seem to be on the horizon in the near term, as the economies continue to grow, attributable to strength in personal spending and a strong labour market. We expect aggregate demand to continue to fall and the labour market to deteriorate, as the effects of higher rates continue to work through the economy. We still have a narrow path to a "no-landing" scenario in 2023, however, recession is still lurking around the corner, potentially pushed out to late this year or 2024.

Inflationary pressures re-ignited

Globally, inflation has been cooling since it peaked in early 2022 partly due to falling energy prices, partly due to prices of durable goods as the supply chain continued to heal. However, January's inflation data surprised to the upside in the U.S., Germany, and Japan, with pick up in spending on goods and services, including motor vehicles, food services, and accommodation.

Citi Inflation Surprise Index

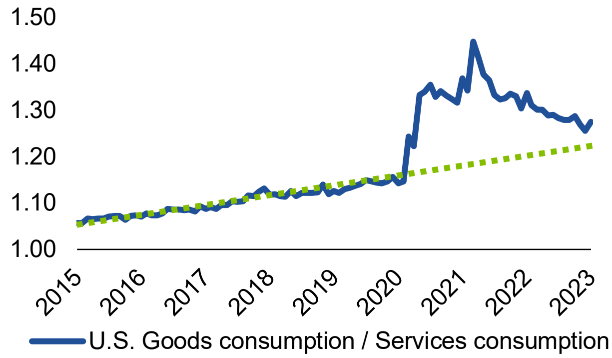


Data: Bloomberg, as of February 28, 2023

Inflationary pressures aren't falling everywhere and vary by country. For example, the U.S. PCE slowed to 5.4% in January, higher than 5.3% in December and ahead of market expectations of 5.0%. Eurozone's core CPI ticked higher at 5.6% YoY in February, compared to 5.3% in January. Other regions are seeing inflation cooling, but not falling fast enough to relieve pressure on consumers. For example, UK's inflation slowed from 10.5% in December to 10.1% year-over-year in January, while Germany and Italy's harmonized CPI also remain high at 9.2% and 10.7% respectively.

While consumer demand for goods is starting to fall in the U.S, consumption of services is still above trend. The combination of jobs gains, higher consumer demand, and rising wages will continue to put pressures on service inflation.

U.S consumption goods /services



Data: Bloomberg, as of February 28, 2023

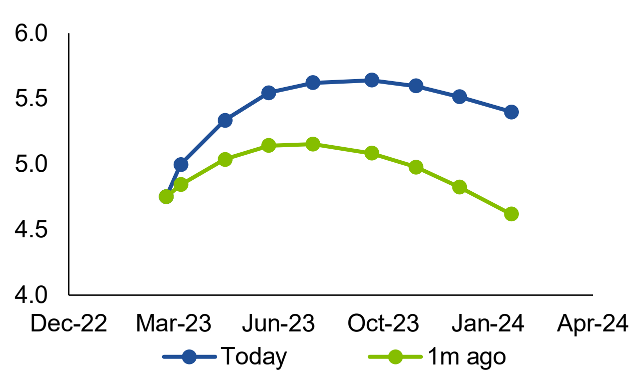
Bottomline: Rates may need to be higher and stay higher for longer. Despite significant tightening over the last year in an effort to tame inflation, inflation remains elevated, at levels far beyond what is acceptable to central banks. It may not be a straight line, but we believe it will continue to moderate over the year, the current estimate for inflation is at 3.0% at the end of 2023.

Peak rates moved higher

With tight labour markets and stubborn inflation, the Federal Reserve has, towards the end of the month, doubled down on their hawkish rhetoric and expressed the need to raise rates further. Bond markets sold off quickly, 10-year government yield rallied from a low of 3.39% in early February to end the month at 3.92%. The expectation for peak rate in the U.S. also moved much higher, from under 5% to over 5.5% in June 2023. The market no longer expects meaningful rate cuts by the Federal Reserve in 2023. Current expectations are for rates to remain above 5% through early in 2024.

Bank of Canada is the only central bank that is believed to have reached the end of this tightening cycle and is expected to stay on pause till the end of this year.

U.S. Implied Policy Rate Changes



Data: Bloomberg, as of February 28, 2023

Bottomline: The outlook for future rate hikes is cloudy as the Fed will continue their path of tightening based on data. They have repeatedly stressed that monetary policy is a blunt instrument, and consequences of overtightening is a deeper economic contraction. Although it is not our base case scenario, it warrants defensive and cautious portfolio positioning.

Earnings estimate downtrend

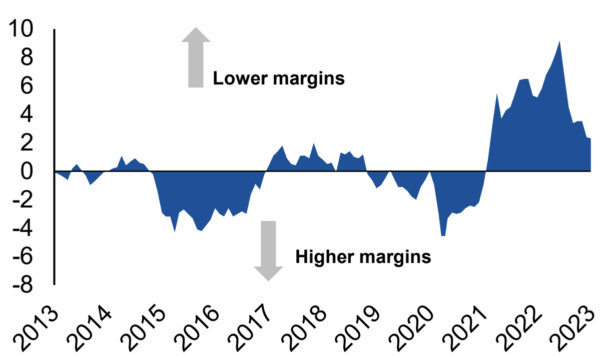
Earnings estimates for 2023 and 2024 have continued their downward trend since mid 2022. While some companies have been able to surprise with their recent quarterly results, the trend at the overall index levels continue to be downward. Companies have been able to grow revenues enough to offset the drop in margins. Profitability is showing early signs of stabilization, as inflation moderates, and supply chain heals. However, earnings growth is still expected to be anemic given decline in demand amidst tightening financial conditions, and if layoffs pick up steam.

2023 Earnings estimates in developed markets

Data: Bloomberg, as of February 28, 2023

Lower profit margins will also impact future earnings, though profit margins remain relatively stable as producer prices have dropped sharply since their peak.

Producer price inflation less consumer price inflation as an indicator of company margin



Data: Bloomberg, as of February 28, 2023

Bottomline: We believe there are more downside risks to the earnings growth estimates which has already been revised downward significantly over the last 6 months, as the economy is only starting to feel the effects of higher rates. Equity market valuations are not reflecting a high probability of recession, which creates vulnerability. It would be prudent to maintain a cautious stance.

Conflicting economic data

The outlook for the global economy remains murky as markets struggle to make sense of conflicting economic data. On one hand a recession appears imminent based on several indicators: the U.S. yield curve being most deeply inverted in 40 years, interest rates are the highest they've been in over a decade (with the potential to go even higher), financial conditions continuing to tighten, and the Composite PMI below 50 in a contractionary level and has activity has been diminishing for four consecutive months.

On the other hand, it is hard to ignore the data that continues to show strength in the global economy. Job gains continue to outpace estimates by a large margin, real incomes are rising across the board and consumer continue to spend, energy prices have come down and remain low, plus China—one of the main engines of global growth—has re-opened.

Bottomline: Given the significant uncertainty about what direction the market and economy will go in the near-term, we remain cautious on our portfolio positioning.

Asset class outlook

Overall Equities – neutral: The strength in economy is helpful for near term earnings but is offset by increased recessionary risk in 2024.

Canadian Equity – neutral: Attractive valuations offset by lower growth. Economy weighed by higher sensitivity to interest rates.

U.S. Equity – neutral: Strong job market and falling inflation provide boost for disposable income and consumer spending. Valuations not reflecting recession risks.

International Equity – neutral: Falling gas prices and warm winter are positive for the region, coupled with low valuations, tempered by low earnings growth.

Emerging Markets Equity – neutral: China
re-opening is clearly supportive, but geopolitical risks increases uncertainty.

Overall Fixed Income – underweight: Pressured by the tug-of-war between risk off sentiment due to looming recession risk, and potential for more rate hikes due to stubborn inflation.

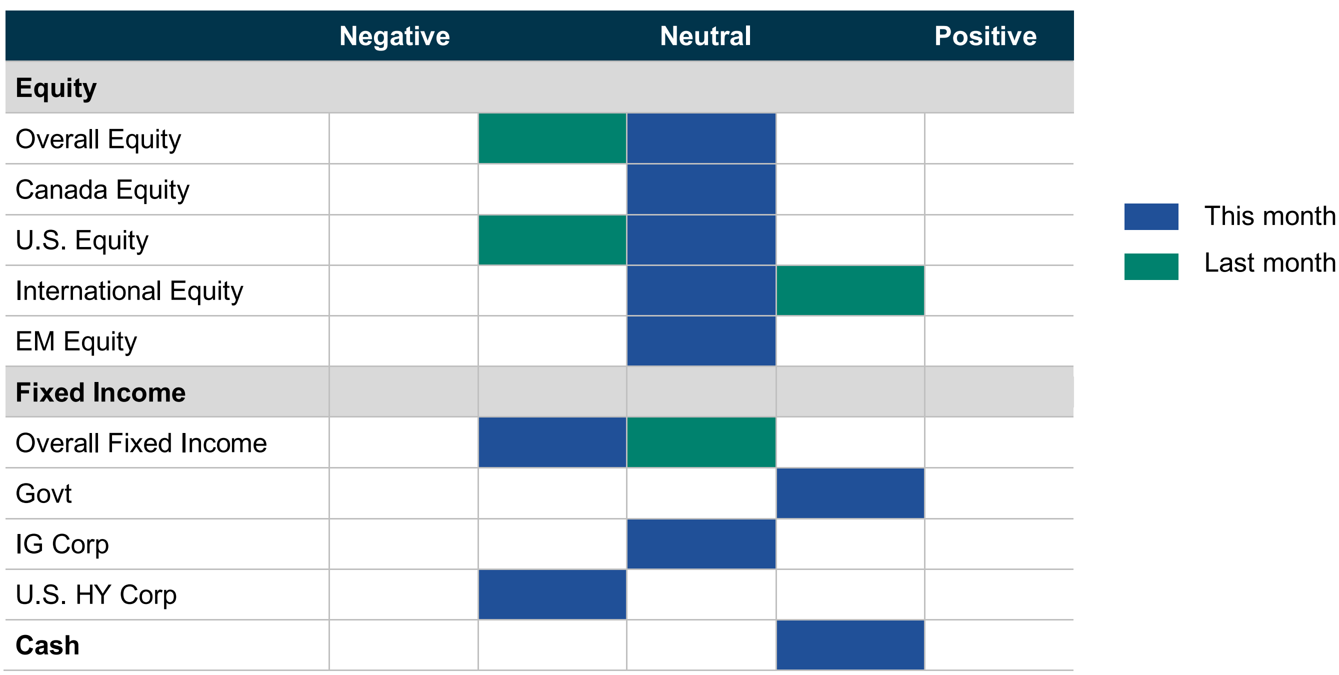
Government Bonds – overweight: Already reflecting a higher terminal rate of 5.5%. Good vehicle as hedge for increased recessionary risk.

Investment Grade Corporate Bonds – neutral: Attractive yields while spreads expect to remain stable.

High Yield Bonds – underweight: Favour government bonds as risk off hedge.

Cash: Offers attractive yield while waiting for better clarity.

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 February 28, 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	-2.01	0.85	-0.68	0.58	0.85	-6.81	-4.93	-3.02
Bloomberg Global Aggregate TR Hdg CAD	-1.65	0.57	-0.68	-1.92	0.57	-8.38	-5.34	-3.58
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	-1.33	2.36	1.67	2.09	2.36	-6.12	-2.85	0.61
Equities								
MSCI World NR USD	-0.42	5.00	0.49	8.16	5.00	-0.53	5.05	10.42
MSCI World Growth NR USD	0.13	8.16	1.49	5.32	8.16	-6.54	-0.06	9.98
MSCI World Value NR USD	-0.95	2.10	-0.47	10.91	2.10	4.97	9.63	9.79
MSCI Canada NR CAD	-2.43	4.75	-0.46	6.51	4.75	-1.83	8.55	9.81
MSCI USA NR USD	-0.46	4.45	-1.79	4.85	4.45	-2.27	5.61	11.96
MSCI EAFE NR USD	-0.10	6.35	6.38	17.04	6.35	3.97	3.49	7.35
MSCI Europe NR USD	1.40	8.52	8.47	22.34	8.52	6.19	6.60	8.84
MSCI Japan NR USD	-1.89	2.63	2.84	7.77	2.63	-2.64	-3.74	3.91
MSCI Pacific Ex Japan NR USD	-4.57	2.08	2.47	9.22	2.08	5.69	1.90	5.99
MSCI EM NR USD	-4.59	1.38	-0.10	1.58	1.38	-9.07	-9.80	1.45
World Currencies								
US Dollar	2.03	0.48	0.42	3.96	0.48	7.34	3.70	0.47
Euro	-0.37	-0.16	3.43	9.64	-0.16	1.35	-3.07	-0.70
Pound Sterling	0.34	1.13	2.09	8.16	1.13	-3.15	-3.50	-1.31
Yen	-2.59	-2.67	2.88	5.80	-2.67	-9.24	-8.29	-7.05

Source: Morningstar data as of February 28, 2023

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