NEI MONTHLY MARKET MONITOR

NEI

April 2023

Markets tread water amid growth and inflation uncertainty

There isn't much evidence of a looming recession, but the debate about whether the central banks can achieve a soft landing continues. Economic growth remains positive albeit at anemic levels. Strength in the labour market makes a strong argument that we're in for a gentle touchdown. Inflation, however, remains significantly above target with pressure coming from wage and shelter inflation. The bond markets still indicate there's a lot of turbulence ahead, refusing to believe what U.S. Fed Chairman Jerome Powell has consistently been preaching: that no rate cuts are in the cards this year, while the equity markets stay within a tight trading range, waiting for more clarity on the economic front.

Equity markets had a positive month as the S&P 500 was up 1.8% in April, bringing its year-to-date returns to 9.3%, while the Nasdaq was up 0.25% for the month. Equity markets were up across in the board in Europe, the U.K, Canada and Japan, while China and Emerging market equities were down for the month.

Fixed income markets also ended the month positively. US and Canadian 10-year yields gyrated by more than 30bps to end the month about 10bps lower. Global fixed income index returned 0.5%, while the Canadian fixed income index was up by 1.0%.

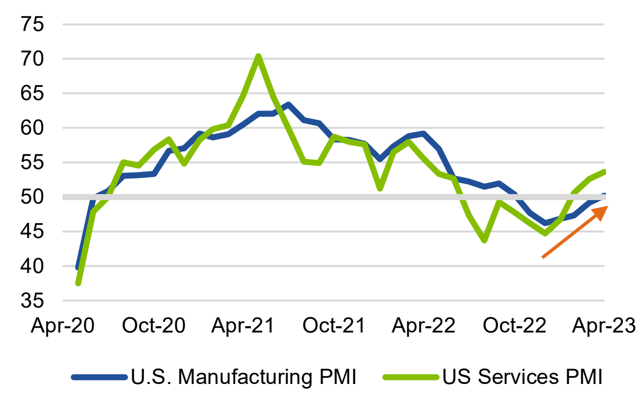
Recession? What Recession?

Recession has been top of mind for investors since 2022, as many have expected a recession or hard landing as the likely outcome of the Federal Reserve's aggressive tightening over the past 12 months. However, strong economic data continues to challenge that narrative, making it much more difficult to see a recession in the near-term.

The U.S economy has continued to grow through 2023 according to the latest data from the U.S. Manufacturing Purchasing Manager's Index that showed new orders returned to expansionary territory and production increased at the fastest pace since May 2022. The latest GDP data in the US shows positive quarter-over-quarter growth of 1.1%, despite that being below estimates, while Canada's GDP also grew 1.8%. This has helped boost employment, with the latest data of job creation showing an uptick.

The Services Sector in the U.S. also showed the biggest expansion in the past year thanks to strong demand in the domestic market. While this has kept employment strong, it also contributes to keeping inflationary pressures high.

U.S. Manufacturing and Service PMIs

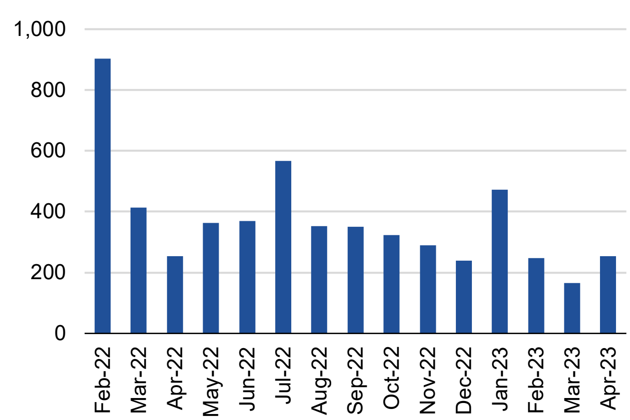


Source: Bloomberg

Labour market still hot

The April U.S. employment data released shows that the labour market continues to be strong as with job gains of 253K, bringing the unemployment rate down further to 3.4% from 3.5%, a multi-decade low. There was a moderate uptick in jobless claims as they rose to 242k from 229k.

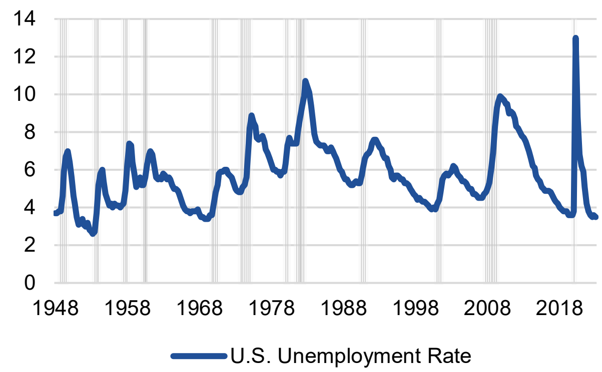
U.S. Employee Nonfarm Payroll MoM Change



Source: Bloomberg

Historically speaking, low levels of unemployment rate are generally followed by recessions and recessions typically start when unemployment level begins to rise. It's debatable whether 'this time can be different'.

Historical unemployment rate and recessions



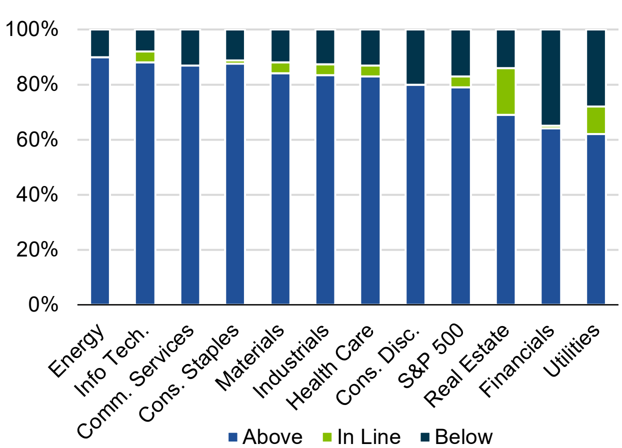
Source: Bloomberg

Bottomline: Currently there is no evidence in the data that we are in or ahead of a recession. However, we continue to expect the effects of the aggressive monetary tightening over the past 12 months to weigh on the economy, consumer demand to decline, credit conditions to tighten sometime between late 2023 and early 2024. These could have a significant impact on the markets, even if the economy doesn't technically fall into a recession by definition.

Earnings beat rather downbeat estimates

Earning expectations for Q1 2023 were set at a fairly low level following numerous downward revisions based on assumptions of a slowing economy hampered by higher rates, persistent inflation, and tapped out consumers. However, out of the 53% of S&P 500 companies that reported results by the end of April, 78% of them reported positive earnings surprise and 68% reported positive revenue surprise. The actual decline in earnings was 3.3%, vs estimated earnings decline at 6.7%

S&P 500 earnings surprises by sector



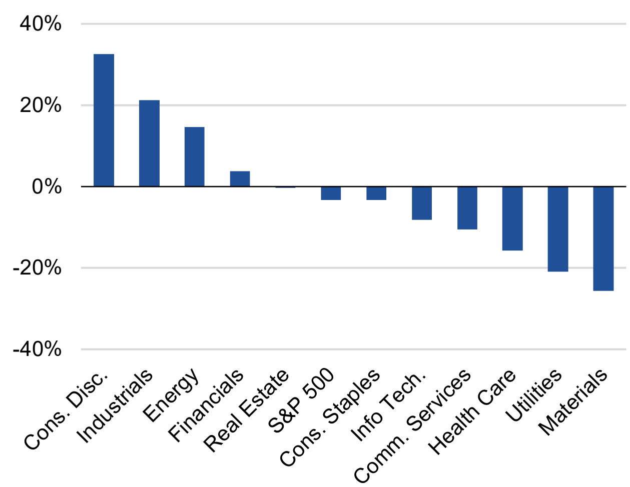
Source: Factset

Large dispersion on earnings growth between sectors

Of the 11 sectors in the S&P500, only 4 of them were growing earnings over the quarter, most notably consumer discretionary, which had earnings growth at 32.6%, (skewed by standouts such as Amazon which beat estimates by 70%). industrials had earnings growth at 21.2% and Energy had earnings growth at 14.6%. At the other end of the spectrum, materials, utilities and health care reported negative earnings growth at -25.7%, -20.9% and -15.8% respectively.

The banking sector also proved resilient in the first quarter results despite mounting concerns on the stability of their deposit base. Most of the big U.S. banks, with the exception of Goldman Sachs, posted strong results. Smaller regional banks continue to face headwinds following the collapse of Silicon Valley Bank and Signature Bank of New York. First Republic Bank's earnings revealed they had over US$100 billion of outflows, resulting in them being taken over by JPMorgan Chase Bank, brokered by the regulators.

S&P 500 reported earnings growth by sector



Source: Bloomberg

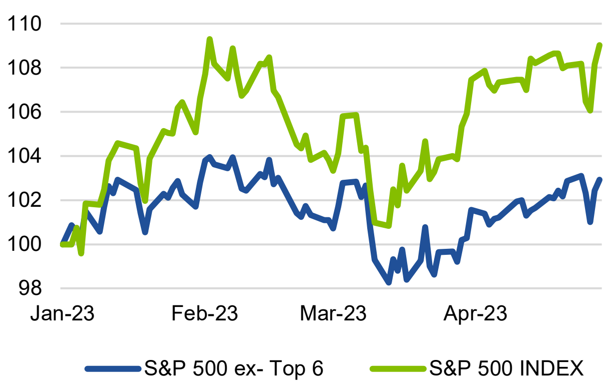
Index concentration at record levels

Looking beyond sectors, the year-to-date market rally has mostly been driven by the handful of mega cap companies including Microsoft, Apple, Nvidia, Tesla, Meta, Amazon, and Alphabet. All these mega cap tech names beat estimates in Q1, with Microsoft and Meta having the strongest price performance following earnings. Nvidia had a whopping 90% price return this quarter, only closely followed by Meta at 76%. Alphabet was relatively flat following their beat and Amazon was lower the day after earnings (despite a large but brief gain in after hours) on warnings about AWS's Q2 revenue.

As mega cap companies continue to lead the rally on the back of strong earnings, they are not only dominating on their year-to-date returns, they are also having an outsized impact on the index. The top seven mega cap stocks represent a total of 22% of the S&P 500 and 47% of the Nasdaq Index's total market cap, they also accounted for 82% of the S&P 500 Index's year-to-date gains this year. For perspective, the 10 largest stocks in the S&P 500 now make up 26.6% of the total market cap of the index. Apple, the largest company on the S&P 500 Index, has a current market cap of C$3.6T, which is approximately 7% greater than the market cap of the entire Canadian S&P/TSX Composite Index.

As these mega cap companies continue to gain dominance in the cap-weighted S&P500 index, there are increasing concerns about concentration risk along with their rich valuations, as some names continue to climb despite lower growth expectations and falling revenues.

YTD Price performance of S&P500 Index vs S&P 500 Index excluding the top 6 mega cap names



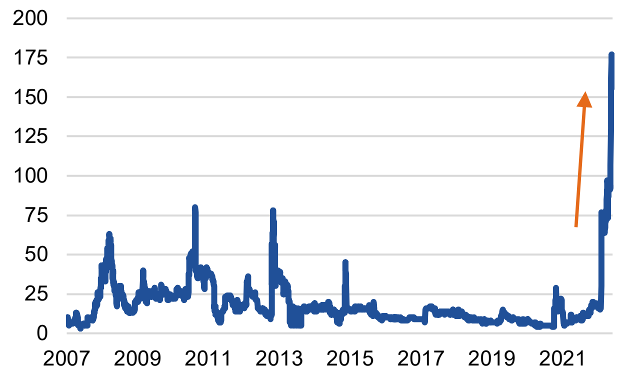
Source: Bloomberg

Bottomline: Using the equity indices can provide a distorted view as a gauge of the overall health of the market as the other 495 stocks in the index actually have much lower growth prospects and price performance this quarter.

U.S. debt ceiling debate at an impasse

A bipartisan deal to raise the debt ceiling alongside modest cuts to government spending is still the most likely outcome. But April's disappointingly low tax receipt mean that the deadline to raise the debt ceiling, the "X-date", is now closer than previously thought and could be as early as early June. The cost of insuring against a default for US government debt has surged above peaks last seen in 2011, 2013, and 2008. Gold prices has also surged past $2,000 as an alternative store of value. According to Moody's, even a short debt limit breach could lead to a 0.6% decline in real GDP, nearly 2 million lost jobs, and a corresponding increase in unemployment rate to nearly 5% in the US. A downgrade in the trustworthiness and liquidity of the treasury market could also lead to $750B in higher federal borrowing cost in the next decade.

U.S One-year credit default swaps



Source: Bloomberg

Bottomline: It is not a likely event. as we do expect the US Congress to be able to reach an agreement before the deadline. A default on US government debt, however, could send shockwaves across markets, sending stock prices and bond yields plunging. This further warrants a defensive stance in portfolio positioning, with short term tactical holdings of cash.

Asset class outlook

Overall Equities – from neutral to underweight: Declining revenues, elevated recessionary risks are not reflected in current valuations, making it vulnerable for corrections.

Canadian Equity – neutral: Attractive valuations offset by lower growth. Economy weighed by higher sensitivity to interest rates and market concentrations in financials and energy.

U.S. Equity – neutral: To remain in tight trading range, bouncing between strong economic data, weakening outlook, and stubborn inflation.

International Equity – neutral: reasonable valuation after strong rebound since October. However, inflation is still not under control, and more tightening required.

Emerging Markets Equity – neutral: China's re-opening is fizzling out and boost to the economy and equity markets is not as strong as expected.

Overall Fixed Income – underweight: Rates not reflective of the risk of inflation to be stubborn, forcing central banks to hold rates higher for longer. Yields may need to rise in the near term, seek safety of cash in the near term.

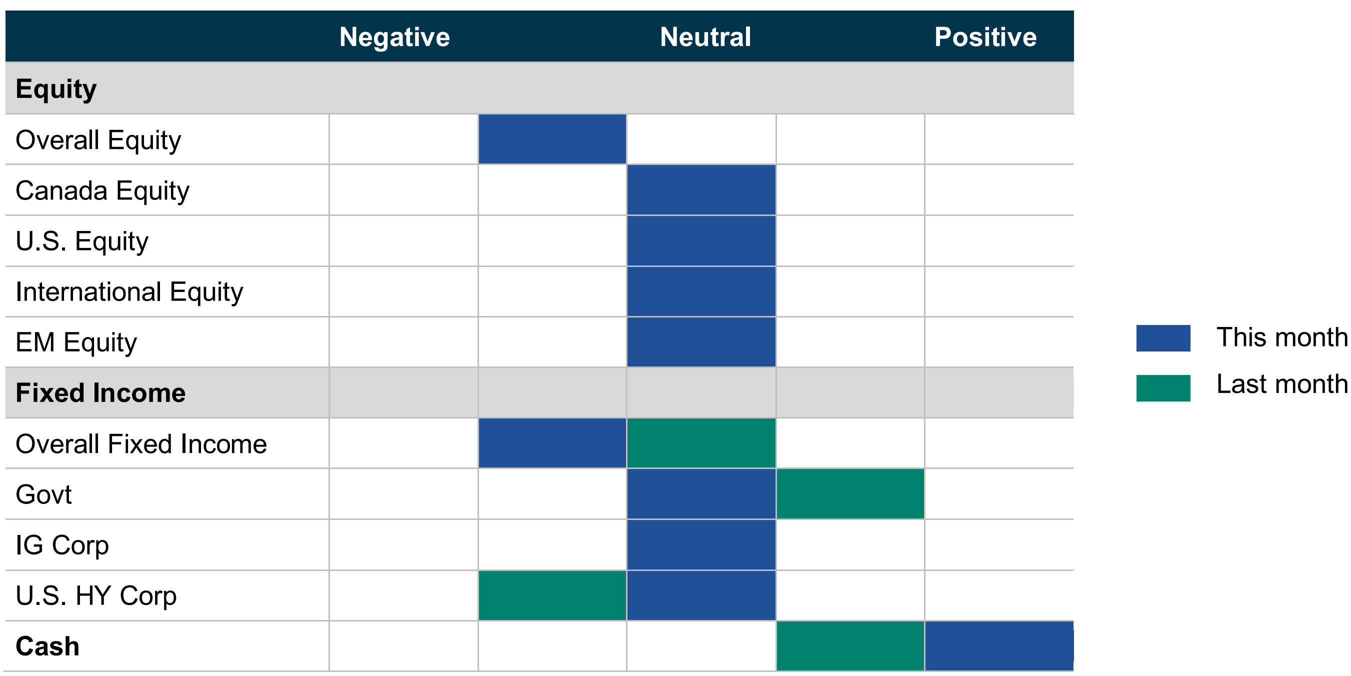
Government Bonds – overweight: Defensive position to overweight higher quality government bonds at the expense of high yield bonds. However recent rally may be overdone causing yields to rise in the near term.

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 April 19, 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	0.97	1.12	5.32	4.07	2.54	-2.56	1.27	1.84
Bloomberg Global Aggregate TR Hdg CAD	0.47	0.96	4.53	3.24	-1.19	-2.69	0.73	1.79
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	0.96	0.64	5.92	4.41	0.49	4.24	2.47	3.61
Equities								
MSCI ACWI NR USD	1.66	3.24	12.04	8.96	8.31	11.16	8.24	11.18
MSCI World Growth NR USD	1.97	4.06	11.62	9.73	9.50	12.21	9.36	12.00
MSCI World Value NR USD	2.13	-0.12	6.96	2.95	8.08	12.52	6.30	9.56
MSCI Canada NR CAD	3.20	0.16	7.69	7.52	2.46	14.20	7.88	7.66
MSCI USA NR USD	1.46	3.92	7.38	9.04	7.63	12.77	11.96	14.83
MSCI EAFE NR USD	3.05	4.87	23.48	11.64	15.06	10.80	4.81	7.94
MSCI Europe NR USD	4.38	7.70	27.51	15.27	18.89	13.45	5.82	8.53
MSCI Japan NR USD	0.58	1.99	16.53	6.68	10.69	4.82	2.36	7.35
MSCI Pacific Ex Japan NR USD	0.40	-4.23	17.19	2.45	4.63	9.03	3.97	6.06
MSCI EM NR USD	-0.92	-3.18	15.70	2.88	-0.79	3.50	0.08	4.89
World Currencies								
US Dollar	0.22	1.64	-0.57	0.10	6.12	-0.79	1.13	3.03
Euro	1.84	3.32	11.07	3.55	11.06	-0.53	-0.67	1.22
Pound Sterling	1.88	3.77	8.55	4.59	6.24	-0.91	-0.70	0.86
Yen	-2.05	-2.92	8.54	-3.00	0.97	-8.47	-3.19	-0.36

Source: Morningstar data as of April 30, 2023