# NEI MONTHLY MARKET MONITOR

June 2023

## Economic resilience extends late-cycle rally

Equity markets had another positive month as the S&P 500 was up 6% in June, bringing year-to-date returns to 14.5%, while the Nasdaq is officially back in bull market territory, up 36.7% year-to-date. Equity markets were up across the board in Europe, Canada, Japan and Emerging Markets while China was down for the month.

Fixed income markets ended the month lower as yields surged on strong economic data, raising expectations that central banks will need to stay hawkish for longer.

Coming into this year, the Bloomberg survey of 25 Wall Street strategists showed a negative S&P 500 return target for the first time since the survey's inception in 1999. Despite or maybe because of the pessimism, the market staged one of its best first half returns on record. The quick recovery from the regional banking crisis brought skeptics off the sidelines. The Nasdaq Composite soared 38.4% in US dollar terms on excitement for artificial intelligence (AI), marking its strongest start since 1983 and third best since data began in 1972.

Better-than-expected economic conditions in the first half of 2023 has also contributed to this dynamic. The U.S. Economic Surprise Index has surged, indicating that economic data releases have been coming in above consensus forecasts. The previous concerns about an impending recession seem to have diminished, or at least expectations for a recession have been pushed out further to a later date.

Given the resilience of the U.S. economy over the last quarter, we expect this strength to persist through the summer, which should offer continued support for the equity rally in the near term.

Core inflation is starting to moderate, although still at elevated levels, following the aggressive tightening cycle over the last 18 months. Employment growth remains strong, unemployment remains low and wage growth has kept pace with inflation in most major economies. Excess savings accumulated during the pandemic continue to support consumers and the expectation is that these savings will be able to keep consumer spending resilient over the near term.

Although the market rally has been mainly driven by the largest stocks in the index, June saw some improvement in breadth, while investment sentiment indicators have also improved significantly. Valuations in the U.S. remain above their long-term average; however, outside of a few of the largest stocks with high multiples (like NVIDIA, Tesla and Amazon) the valuations in the rest of the index are much more reasonable.

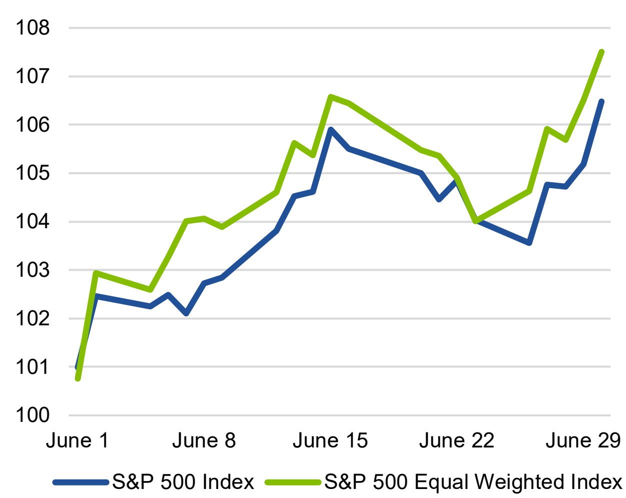
The upcoming corporate earnings season in July could contribute to further strength and positive sentiment in the markets, as the earnings expectations have been set quite low, making it more likely for companies to be able to beat estimates.

### U.S. market rallied past trading range

The S&P 500 Index broke out of its 3800-4200 trading range and entered a technical bull market after returning over 24% since hitting a low in October.

While the performance of AI exposed mega-cap technology companies has led the markets, the rally has recently broadened with the equal-weighted index outperforming the market-weighted index in June, pointing to an improvement in breadth and potential for continued upside.

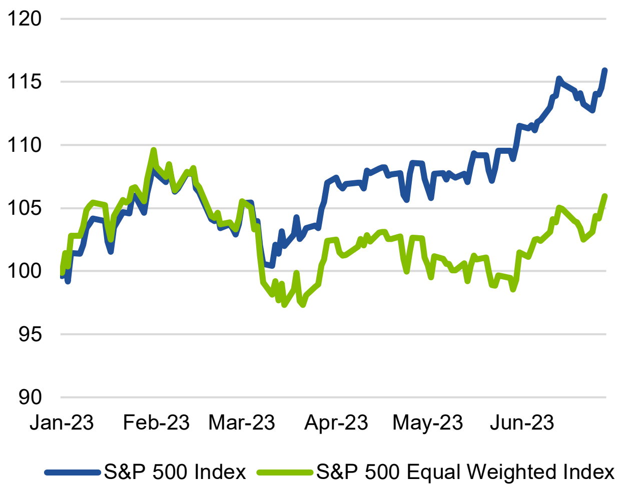
**Equity market breadth widened in June**




Source: Bloomberg, NEI Investments

As recently as late May, the equal weighted index was flat on a year-to-date (YTD) performance basis.

**S&P 500 Index vs S&P 500 Equal Weighted Index year-to-date performance**

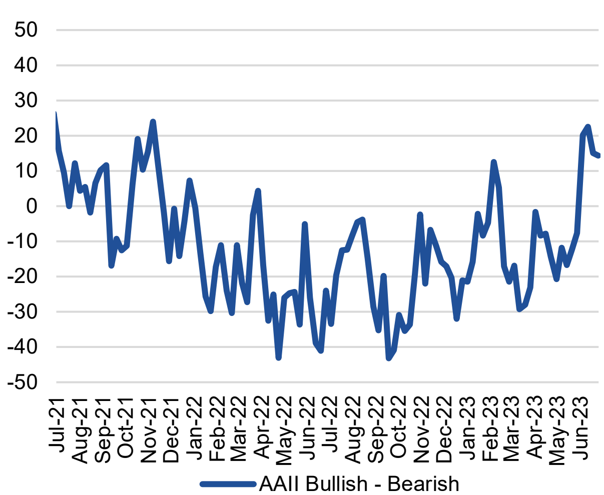



Source: Bloomberg, NEI Investments

## Market strength buoys investment sentiment

Over the course of the past few months, market sentiment has shifted from having more investors in the bearish camp, to having the majority of investors turning bullish. In June, bullish sentiment was at its highest level since November 2021. In other words, this is the most positive investors have been on the markets in almost two years.

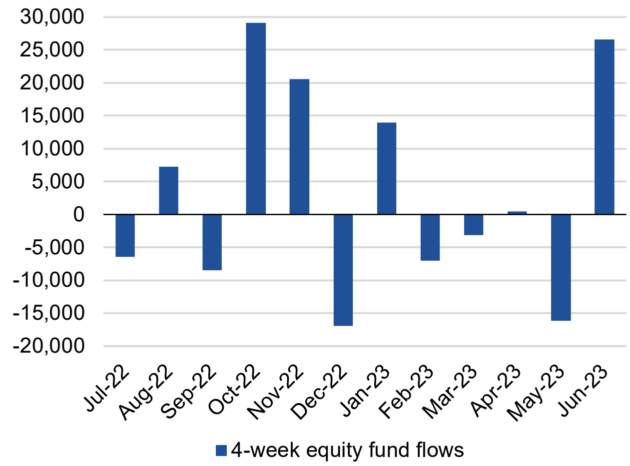
**More investors turned bullish in June**




Source: Bloomberg, NEI Investments.

This can also be seen in investor flows. After several months of outflows, investors moved off of the sidelines and invested into equities in June.

**Positive fund flows into equities in June**




Source: Bloomberg, NEI Investments.

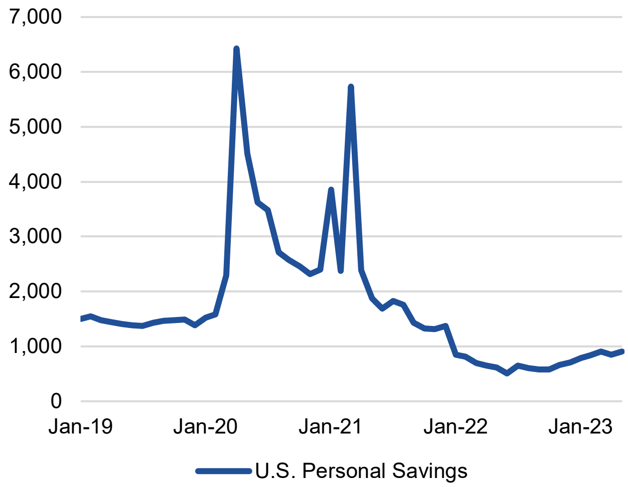
## How sustainable is this rally?

The question going forward is whether the equity rally will continue. On this front, we believe there is scope for economic data to remain strong and continue to support equities over the near term.

### Services sector to remain resilient until excess savings are spent

Consumers accumulated excess savings to the tune of $2 trillion during the pandemic as restrictions limited consumer spending. As consumption of services recovered with the removal of COVID-19 restrictions, the excess savings have helped maintain consumer spending level despite the high inflation level, resulting in the resilient economic growth to date. Economic activity in the US services sector expanded in June for the sixth consecutive month. The sector has grown in 36 of the last 37 months, with the lone contraction occurring in December of last year. The excess savings have gradually been declining to about $600 billion, however, and are expected to be spent down over the next few months. This should continue to provide support for corporate revenues and earnings over the next quarter or so, but this tailwind may become a headwind going forward once the excess savings dwindle.

**Excess savings bolstering consumption, especially in services**




Source: Bloomberg, NEI Investments.

### Jobs are still hard to fill, causing labour hoarding

Historically speaking, low levels of unemployment are almost always immediately followed by a recession. However, the pandemic has caused such level of disruptions to the labour market that this recession indicator may not be effective this time. Although the number of job openings has significantly declined, the most recent data still indicates that there are still 1.6 jobs for each unemployed person in the U.S., and the unemployment rate continues to be near historical lows.

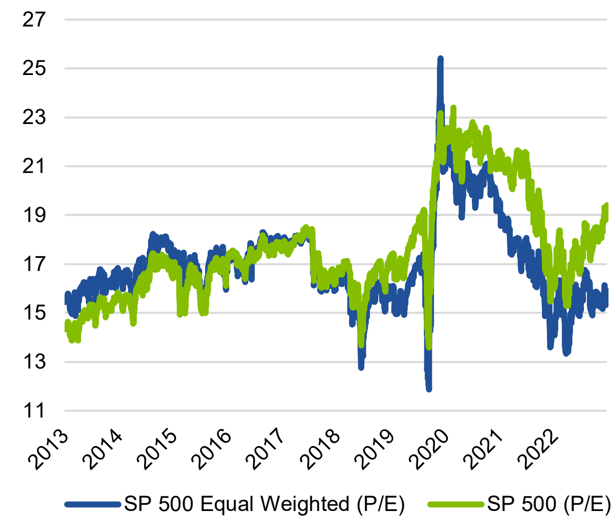
As companies are having a difficult time filling some of the jobs, they became reluctant to reduce the workforce, resulting in labour hoarding. While wage growth has kept pace with inflation, the participation rate amongst the older age group has remained below pre-pandemic levels. With labour hoarding, the number of job openings may continue to decline without causing a spike in unemployment. As a result, the risk of falling into a recession may also remain lower for now.

### U.S. equity reasonably valued, except some of the largest names

The largest companies have been sought after due to their high cash balances and strong economic moats, a key driver in their significant year-to-date gains. Their dominance in driving market movements has triggered concerns regarding concentration in the largest names in the U.S. market.

When the difference in market cap has been removed, the picture is quite different. The majority of the U.S. companies are reasonably valued. The 12-month forward P/E valuation of the S&P500 Equally Weighted Index is currently 15.7x, much more reasonable than the market cap weighted S&P 500 Index at 19.1x. Excluding the pandemic, the valuation gap between the two indices is at its widest level since 2000.

**Large cap companies skewing index level valuation higher in the U.S.**




Source: Bloomberg, NEI Investments.

### Earnings expectations overly bearish

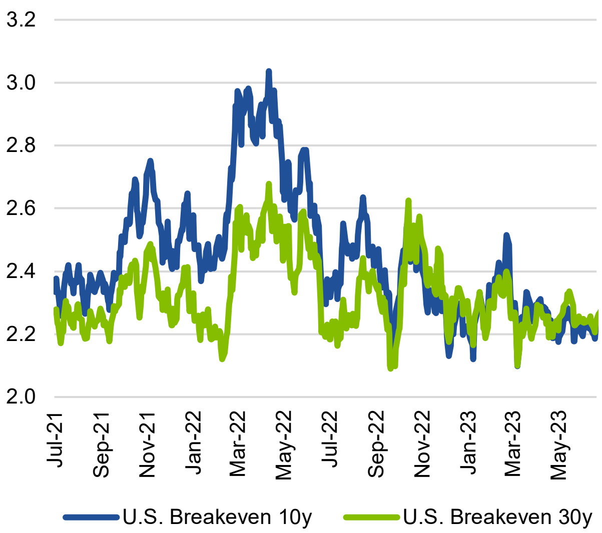
The market is expecting companies to report a 9% year-over-year decline in the upcoming Q2 earnings seasons in July, driven by flat sales growth and margin compression. We believe this is a relatively low bar and companies should be able to beat consensus which provides support for equity upside. The key is the companies' go forward guidance over the next 12 to 18 months in earnings trajectory. Analysts have been consistently revising earnings estimates downward and they may have reached bottom for this year and next year's estimates. An upward revision in forward earnings estimates would provide the equity markets with a boost in sentiment.

## Risk of recession still lurking, but timeline has been pushed out

### Central banks' job on taming inflation not done yet

Although longer term inflation expectations have moderated to close to the 2% level, the near term inflation is still much too high, significantly above the level acceptable to central bankers.

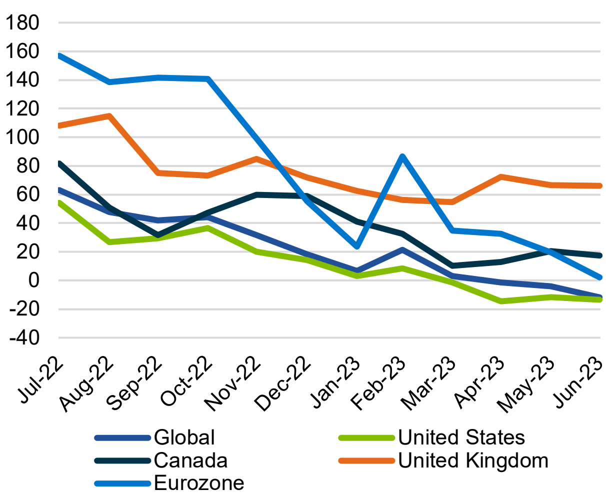
**Long term inflation expectation returns to reasonable levels**




Source: Bloomberg, NEI Investments.

The most recent inflation data has also surprised to the upside in some economies, although the magnitude of positive inflation surprises have been decreasing.

**Inflation surprise index is diminishing in most countries**

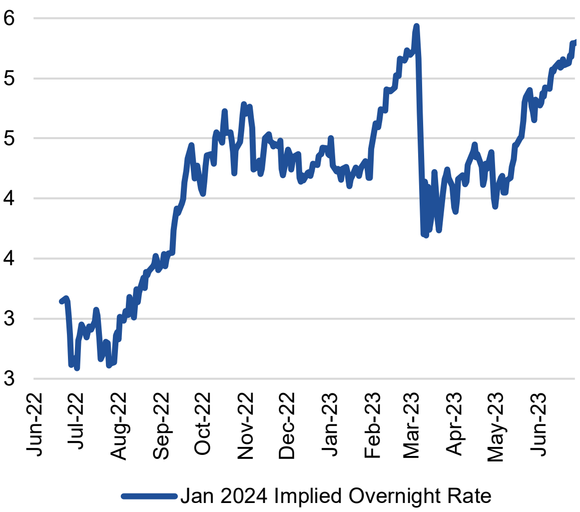



Source: Bloomberg, NEI Investments.

Central banks in several countries, notably Australia and Canada, were forced to resume rate hikes after signaling an end to tightening with the expectation that inflation risks had faded. The Fed and the European Central Bank have both indicated that the terminal rate is likely to be higher than they expected. Moreover, the Bank of England faced renewed acceleration in inflation, resulting in a much higher rate profile than initially thought.

European Central Bank, the Federal Reserve and Bank of Canada have all reinforced their hawkish bias signaling further rate hikes, with the Fed now expected to hike two more times.

**Rate hikes expectations increased, erasing bank crisis concerns**




Source: Bloomberg, NEI Investments.

Yields of bond futures have repriced dramatically higher as a result of hawkish expectations, presenting an attractive entry point for the fixed income asset class for long term investors, but could be vulnerable to any positive inflation surprises in the near term.

## Asset class outlook

Better-than-expected economic news is propelling the rally forward. In our tactical positioning, we upgraded our views on equities from a more bearish positioning last month to neutral, then to a more bullish positioning towards the end of the month as the timeline for recession has been pushed out further, and we expect the upcoming earnings will be stronger than consensus which will continue to support equities over the near-term.

Here is a summary of our views across asset classes:

**Overall Equities – from bearish to bullish:** Recessionary risk pushed out, bullish on strong corporate earnings prospects and improved investor sentiment.

**Canadian Equity – from neutral to bearish:** Negative momentum in the near term; Economy under pressure as housing market strength push central bank back to hawkish mode.

**U.S. Equity – from bearish to bullish:** Strong consumer spending boosts corporate earnings; should likely beat the overly bearish consensus estimates.

**International Equity – from bullish to neutral:** European economics under pressure as wage gains are still inflationary. Japan attractive on valuation and economic momentum.

**Emerging Markets Equity – neutral:** China's re-opening boost is tapering off and boost to the economy is not as strong as expected.

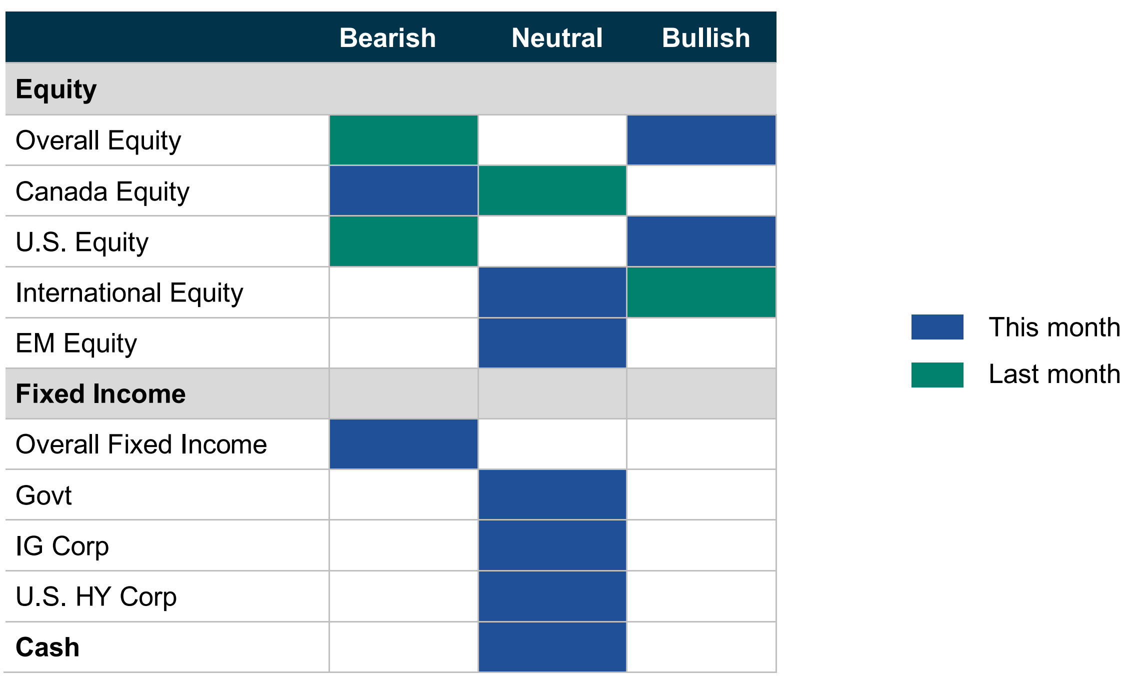
**Overall Fixed Income – bearish:** Yields may need to rise further to reflect expectations of hawkish policies for longer, moderately bearish to favor equities.

**Government Bonds – neutral:** Recent yield rally may be overdone, creating an attractive entry point for longer term investors, although vulnerable to inflation surprise.

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

**High Yield Bonds –neutral:** Attractive yields while spreads expected to remain stable.

## 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 June 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 | -0.03 | -0.83 | 2.21 | 2.21 | 2.84 | -3.75 | 0.61 | 2.02 |
| Bloomberg Global Aggregate TR Hdg CAD | -0.13 | -0.12 | 2.64 | 2.64 | -0.11 | -3.13 | 0.53 | 2.01 |
| Bloomberg US HY 2% Issuer Cap TR Hdg CAD | 1.56 | 1.53 | 5.00 | 5.00 | 8.25 | 2.65 | 2.54 | 4.00 |
| **Equities** | | | | | | | | |
| MSCI World NR USD | 3.24 | 4.45 | 12.40 | 12.40 | 21.57 | 11.10 | 9.20 | 12.01 |
| MSCI World Growth NR USD | 3.31 | 7.96 | 24.11 | 24.11 | 29.62 | 10.01 | 11.92 | 14.51 |
| MSCI World Value NR USD | 3.15 | 0.74 | 1.54 | 1.54 | 13.51 | 11.45 | 5.79 | 9.14 |
| MSCI Canada NR CAD | 3.69 | 1.38 | 5.63 | 5.63 | 9.71 | 11.73 | 6.49 | 7.63 |
| MSCI USA NR USD | 3.80 | 6.18 | 14.11 | 14.11 | 22.05 | 12.51 | 11.74 | 14.73 |
| MSCI EAFE NR USD | 1.78 | 0.66 | 9.06 | 9.06 | 21.84 | 7.89 | 4.51 | 7.82 |
| MSCI Europe NR USD | 2.01 | 0.45 | 10.93 | 10.93 | 24.95 | 9.62 | 5.31 | 8.12 |
| MSCI Japan NR USD | 1.33 | 4.05 | 10.36 | 10.36 | 21.19 | 4.69 | 3.25 | 7.64 |
| MSCI Pacific Ex Japan NR USD | 1.47 | -3.98 | -2.03 | -2.03 | 8.58 | 5.52 | 2.79 | 6.73 |
| MSCI EM NR USD | 1.04 | -1.35 | 2.43 | 2.43 | 4.38 | 1.34 | 1.05 | 5.31 |
| **World Currencies** | | | | | | | | |
| US Dollar | -2.65 | -2.22 | -2.34 | -2.34 | 2.58 | -0.96 | 0.12 | 2.29 |
| Euro | -0.38 | -1.81 | -0.17 | -0.17 | 7.05 | -1.91 | -1.23 | 0.52 |
| Pound Sterling | -0.14 | 0.54 | 3.22 | 3.22 | 7.39 | -0.01 | -0.63 | 0.50 |
| Yen | -5.90 | -9.97 | -10.85 | -10.85 | -3.58 | -10.16 | -5.07 | -1.47 |

Source: Morningstar data as of June 30, 2023