July 2023

Sunshine and lollipops as growth continues to surprise on the upside

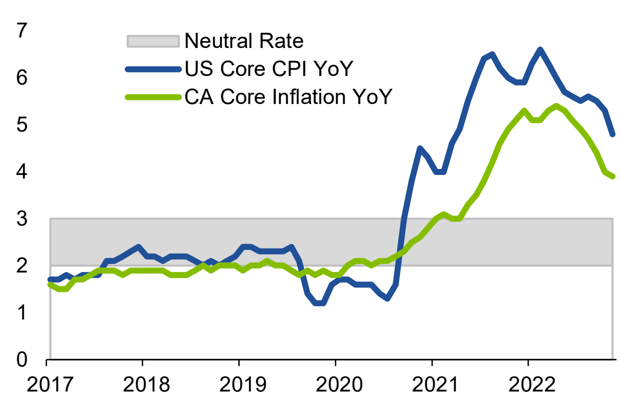
U.S. markets marched into bull market territory in July as economic data continues to show resilience with strong growth and key inflation indicators easing. Positive economic growth and strong labour market triggered a number of upward revisions in economic growth forecasts and even fuels speculation that the economy may avoid a recession. The market has seen a strong rally amid falling inflation, steady economy, strong employment, and better-than-expected Q2 corporate earnings reports. The S&P 500 returned 3.21% in July (USD), bringing its year-to-date returns to 20.64%. Equity markets were up across the board in Europe, Canada, Japan and Emerging Markets.

Both the Fed and Bank of Canada raised rates by another 25bps in July and stopped short on ruling out the potential for additional rate hikes to come, with strong growth posing additional risk on inflation. U.S. 10-year yields ended the month up 12 bps to 3.96%, while the Canadian 10yr rate closed at 3.50%, up 23 bps for the month. Most fixed income markets ended the month lower.

Inflation moderating and risks resurgence

Inflation is softening and reaching the lowest levels since the peak inflation a year ago. In the U.S., Canada and U.K., inflation has surprised to the downside suggesting that the central banks' policies may be starting to curtail the worst of inflation. Long-term inflation expectations have also returned close to the neutral rate between 2-3%.

Inflation levels still above neutral rate

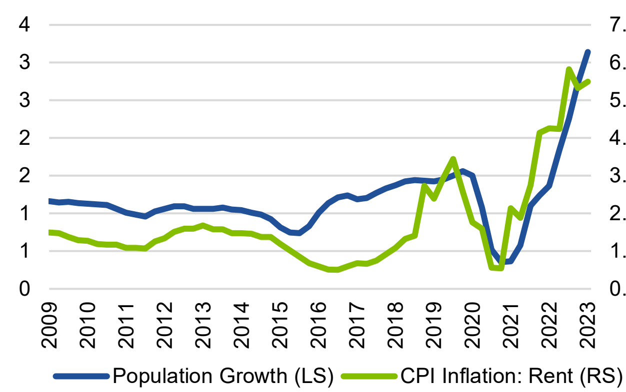


Source: Bloomberg, NEI Investments

However, we're not out of the woods yet and could see inflation rebound moderately higher in the near term:

- Oil has surged by 15.8% in July, which could push the year-of-year headline inflation higher
- The base-effect will no longer be a tailwind to the year-over-year comparison as the peak inflation levels reached last year will be rolled off
- Real income now exceeds inflation in the US, as inflation recedes. Real income growth could boost spending and pose addition inflation risks
- The stickier components of inflation, like rent, are continuing to put pressure on inflation. Rent has shown signs of retreat in the U.S. The higher-than-expected growth in population in Canada, however, coupled with the undersupply in the Canadian housing market, is triggering a rebound in housing prices despite the rising mortgage rates

Population growth triggers rent inflation in Canada



Source: Bloomberg, NEI Investments

Bottomline: While inflation has reasons to rebound in the near term, we continue to expect core inflation to resume its decline over the next two to three quarters, as consumers deplete excess savings and tighter credit conditions weigh on spending.

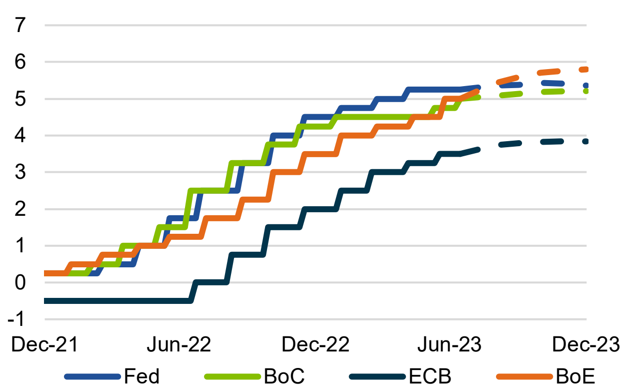
U.S. policy rates closer to peak than in Europe

While the news of improving inflation seems to have rekindled optimism, particularly on the stock markets, the battle to bring inflation back in line with the central banks' target is not over yet.

The Bank of Canada raised its policy rate by 25 bps to 5% in July. The Fed also hiked by 25 bps as expected, to the highest level in 22 years. In the latest announcement, however, Fed Chairman Powell did acknowledge the strength of the economy and the better-than-expected inflation data. In the press conference, Powell also revealed the Fed's considerations and readiness to begin monetary easing if and when conditions warrants, indicating the central bank's resolve in lowering inflation while trying to lower the damage to the economy in the process.

The ECB also hiked 25 bps as expected. Europe is farther behind on their tightening cycle as inflation rates are still much higher than tolerable levels, while interest rates in the US are likely near peak in this tightening cycle.

U.S. rates near peak, but expectations of rate cuts lowered



Source: Bloomberg, NEI Investments.

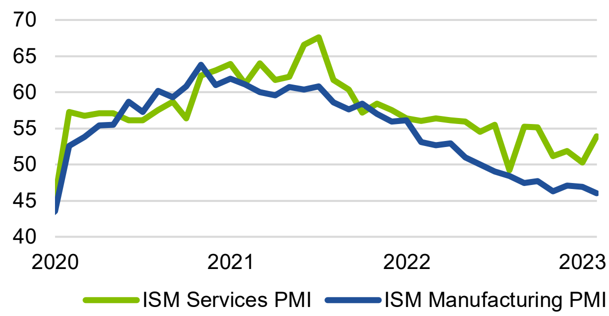
Bottomline: We expect interest rates to stay higher for longer with strong economic growth, tight labour market, and receding inflation. There aren't enough compelling reasons for rate cuts in the near term.

Economic growth remains resilient with signs of bottoming in manufacturing activities

U.S. real GDP growth has been surprising to the upside with the latest quarter-over-quarter growth at 2.4%. The growth momentum continues to be strong, as indicated by the most updated Nowcast by Atlanta Fed showing 3.9% growth in Q3 23. The forward-looking estimates has also seen a number of upward revisions, raising the year-over-year growth consensus forecast now to 1.6% for the year 2023.

New orders in manufacturing has also shown an uptick which could signal a bottoming in manufacturing activities. At the same time, services seem to be normalizing from the extremely high levels as re-opening enthusiasm fades.

Services providing support on economic growth



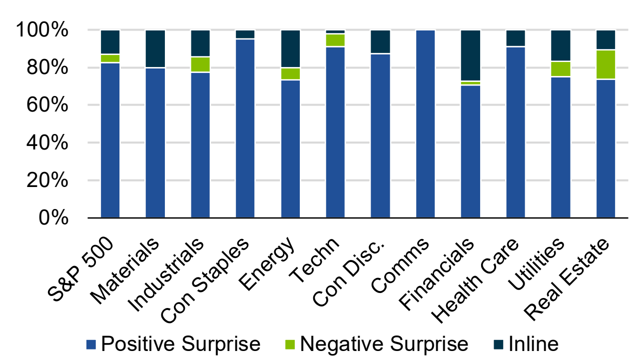
Source: Bloomberg, NEI Investments

Bottomline: Recession is nowhere in sight as the economy is still showing strong momentum on growth. Although we still expect personal consumption and spending to decline over the next few months, corporate industrial capital expenditures that's been delayed by the pandemic may pick up the baton to support economic growth. A rebound in U.S. manufacturing could make a very positive environment for risk assets and have a significant impact on global markets.

Strength in corporate earnings extending economic expansion

The Q2 earnings season is in full swing and companies has been widely beating consensus estimates which were set at a very low bar at –7.8% year-over-year growth prior to the start of the season. Of the 365 companies that have reported, profitability was also more resilient than expected, with 83% companies beating expectations on earnings, while only 55% companies beating expectations on revenues.

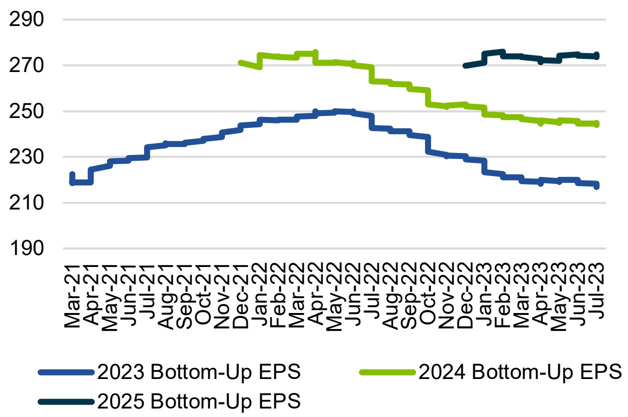
83% S&P 500 companies beating consensus estimates



Source: Bloomberg, NEI Investments

A bigger driver for market valuations is the forward-looking earnings growth guidance. Corporate earnings appear to have bottomed this quarter and consensus is pointing back to growth for the remainder of the year. Earnings estimates for 2024 and 2025 are also pointing to a remarkable level of 12.4% and 12.2% respectively.

High growth expectations in 2024 and 2025 earnings

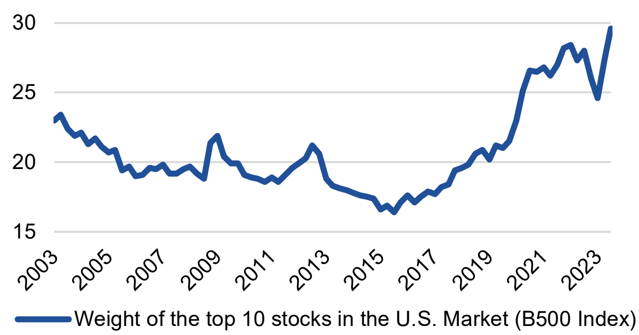


Source: Factset, NEI Investments.

Index valuation not representative of the market

The S&P 500 Index has hit the highest concentration level in recent history with top 10 companies surpassing 30% in weighting. With triple-digit year-to-date gains, these largest companies have contributed over 75% of the index's YTD gains.

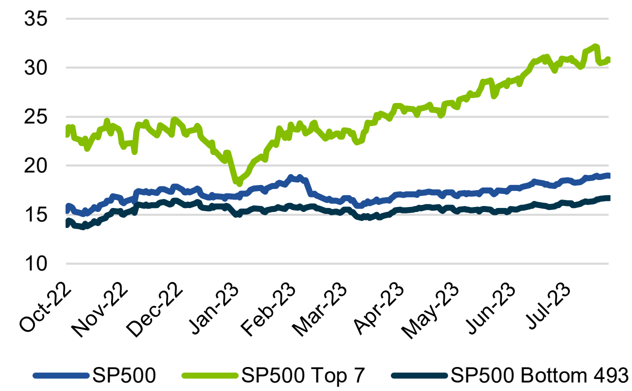
Highest concentration in S&P 500 in recent past



Source: Bloomberg, NEI Investments.

While the eye-popping returns of the mega cap companies are taking all the attention, what goes unnoticed is the significant dispersion in valuations between the top 7 companies and the remaining 493. The market as a whole may look expensive and stretched on a valuation basis, but this is mainly driven by the largest 7 stocks. Valuations of the remaining 493 companies are in line with historical average.

S&P 500 Valuation: Top 7 vs the rest



Source: Bloomberg, NEI Investments.

Bottomline: We believe that over the next few months we will see larger differentiation in performance in the fundamental quality of the company. This is a great environment for active managers as there are plenty of high-quality companies with strong growth that are currently trading at reasonable valuations. With recession risks lowered and pushed out, we may see some of the cash that has been sitting on the sidelines redeployed back into the market and could propel the markets higher.

Asset class outlook

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

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

U.S. Equity – overweight: Strong economic momentum with tight labour market and productivity improvement. Falling inflation and reduced recessionary risks provides room for upside.

International Equity – from neutral to underweight: European economics under pressure as wage gains are still inflationary.

Emerging Markets Equity – from neutral to overweight: Weakening USD a strong tailwind to emerging markets. Long term prospects hindered by China's structural headwinds.

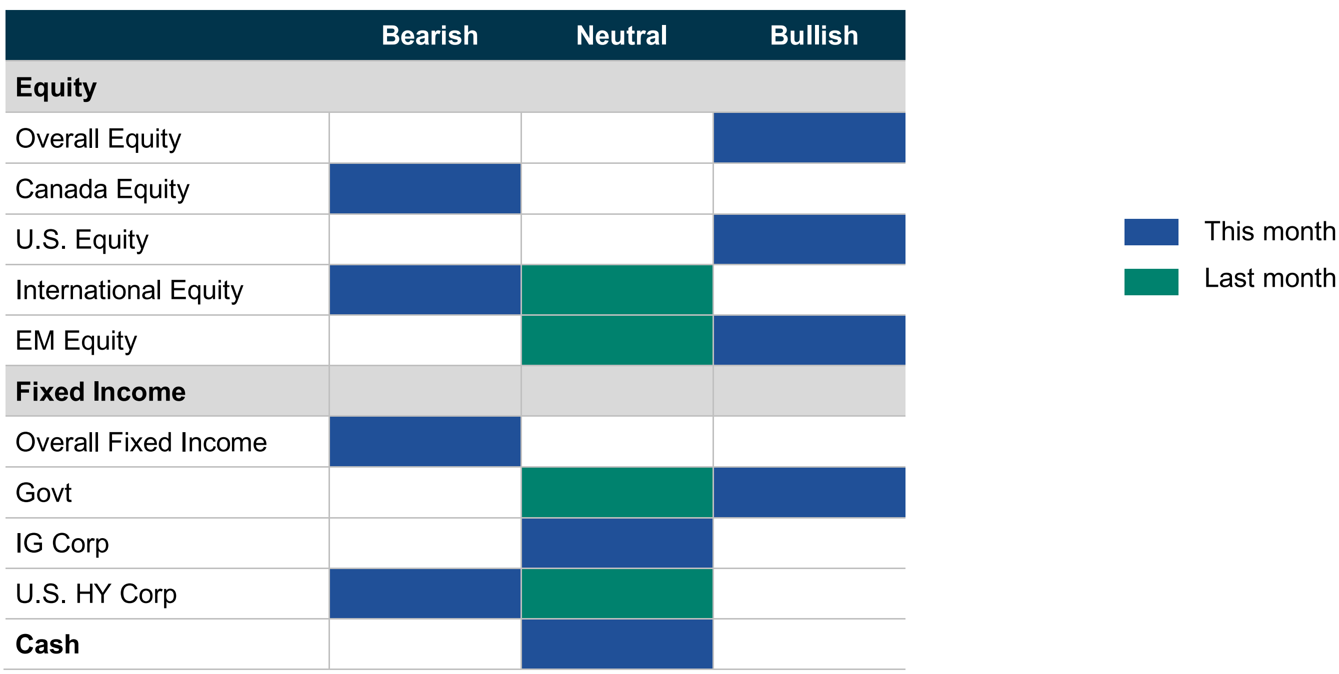
Overall Fixed Income – underweight: Moderately bearish to favor equities; opportune entry point in the U.S. to add duration as rates close to peak.

Government Bonds – from neutral to overweight: 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 to partially offset volatility in spreads.

High Yield Bonds – from neutral to underweight: Attractive yields to partially offset volatility in spreads. Default rate expected to remain low in the near term..

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 July 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	2.69	0.88	1.04	8.47	8.14	11.18	6.76	7.59
Bloomberg Global Aggregate TR Hdg CAD	0.00	-0.59	0.36	2.63	-2.58	-3.47	0.53	1.96
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	1.34	1.91	2.56	6.40	3.62	1.58	2.61	3.93
Equities								
MSCI World NR USD	2.81	5.31	9.59	15.56	16.57	11.02	9.36	12.04
MSCI World Growth NR USD	2.38	8.54	17.63	27.06	19.78	9.05	12.10	14.47
MSCI World Value NR USD	3.29	1.88	1.76	4.89	12.88	12.34	5.93	9.23
MSCI Canada NR CAD	2.69	0.88	1.04	8.47	8.14	11.18	6.76	7.59
MSCI USA NR USD	2.87	7.65	11.87	17.38	15.65	12.04	11.82	14.77
MSCI EAFE NR USD	2.69	0.31	5.20	11.99	19.98	8.62	4.77	7.83
MSCI Europe NR USD	2.52	-1.34	6.27	13.73	22.88	9.76	5.36	7.90
MSCI Japan NR USD	2.47	6.01	8.12	13.09	18.28	6.70	3.89	8.12
MSCI Pacific Ex Japan NR USD	3.82	-0.72	-4.92	1.71	9.29	6.54	3.37	7.06
MSCI EM NR USD	5.66	5.21	1.86	8.24	11.30	0.87	1.94	6.06
World Currencies								
US Dollar	-0.53	-2.95	-1.36	-2.86	2.72	-0.58	0.22	2.50
Euro	0.52	-3.08	0.14	0.36	11.08	-2.87	-0.97	0.61
Pound Sterling	0.67	-0.66	3.09	3.91	8.61	-1.24	-0.17	0.83
Yen	1.19	-6.99	-9.71	-9.79	-3.37	-9.91	-4.45	-1.20

Source: Morningstar data as of July 31, 2023

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