

August 2023

Markets cool in August

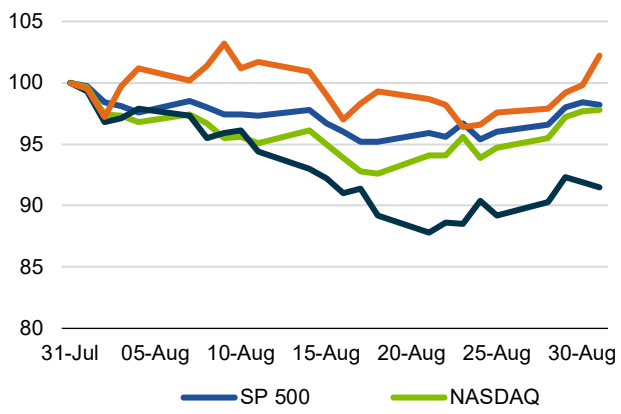
The end of July marked the peak for the S&P 500 so far this year, as the steady market uptrend that began in mid March started to retreat as soon as August began. Following a 20% S&P 500 Index return in the first seven months of the year, the index fell -1.77% in August. Rising yields and uncertainty surrounding the path of China’s economic recovery were chief concerns among investors in recent weeks, which contributed to a volatile month in global markets.

Global stocks sold off through the month with the MSCI All Country World Index declining 2.96% over the month. Developed markets outperformed emerging markets, which lost 3.54% in US dollar terms.

Fixed income markets also fell in August as yields rose, especially on the long end. Yields on the 10-year U.S. Treasury increased by 15 basis points (bps) to 4.11%, while 30-year US Treasury rose by 21 bps to 4.21%

The brief market narrative of a “Goldilocks” scenario that would ideally support global markets in the second half of the year was likely too good to be true. Aside from the energy sector, most asset classes finished the month in negative territory and August’s volatility highlighted renewed fears about China’s inability to re-start their economy, negatively affecting global growth.

Oil price rose while key indices fell in August

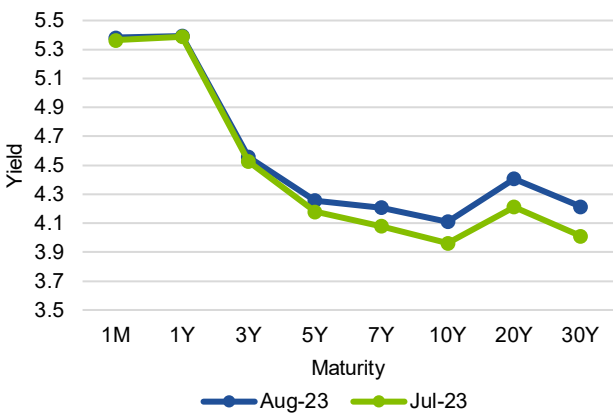


Source: Bloomberg, NEI Investments.

U.S. long-dated treasuries sold off

Long bond yields have steadily moved higher over the past few months. Although US inflation has fallen from around 9% to just above 3% over the last year, the yield on the 10-year to 30-year Treasuries continued to move up in August, reflecting an ongoing reassessment of the long-run neutral rate of interest, as the U.S. economy continues to prove resilient to higher rates.

Long dated U.S. Treasuries climb in August



Source: Bloomberg, NEI Investments.

But there are other factors working at the margins and their influence could be magnified going forward.

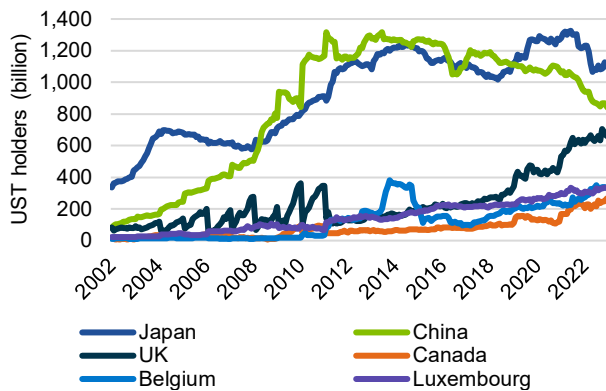
Decreased demand from foreign investors

The all-important foreign investor base that supporting the value of U.S. Treasuries (USTs) has been retreating from the market. On a relative basis, ownership share of privately-held Treasury securities by foreign investors (i.e., excluding the Fed) slipped from just under 50% pre-COVID to less than 40% in June. Moreover, the largest non-resident holders of USTs—China and Japan—have also continued to pull back from the Treasury market on both a relative and absolute basis. Recently the Chinese monetary authority is having to defend its currency and Japan is slowly inching closer to policy normalization, neither of which argue for marginal re-engagement.

Foreign investor pullback pressures bond yields

Aside from the tightening of monetary policy, softer demand for U.S. treasuries have led to yields on the 10-year U.S. treasuries jumping from 3.0% to 4.3% over the past year, including a steady and unrelenting sell-off over recent weeks/months. To be sure, today's higher interest rates predominantly reflect an ongoing reassessment of the long-run neutral rate of interest as the U.S. economy continues to prove resilient to higher rates (long-dated SOFR futures imply a rate of ~4% today versus ~3% a year ago).

China's falling appetite for U.S. Treasuries



Source: Bloomberg, NEI Investments.

Increased supply from large issuances to fund the U.S. fiscal deficit

The U.S. Treasury announced that there would be \$1.0 trillion of U.S. Treasury issuance in Q3, \$274bn larger than the previous projection made back in May, with heavier-than-expected issuance of longer-maturity debt.

By some measures the U.S. appears to be on a seemingly unsustainable fiscal path and bond issuance will remain the main tool to fund the growing deficits and elevated borrowing costs. This was one of the contributing factors to Fitch's well-publicized credit rating downgrade for the U.S. earlier this month. Congressional Budget Office analysis suggests that publicly held debt could jump from ~\$26 trillion in 2023 to ~\$45 trillion by 2033.

Fitch's US debt downgrade

At the start of August, the credit rating agency Fitch downgraded the US government's credit rating from AAA to AA+, citing unsustainable debt and deficit trajectories and increased political dysfunction. However, this decision had little impact on 10-year US Treasury yields, which hardly increased in the days following Fitch's announcement.

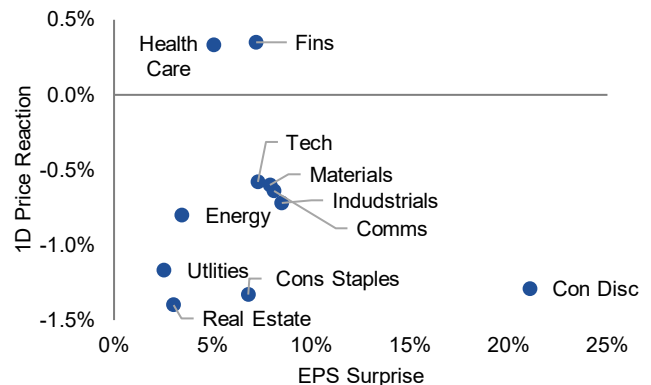
Bottomline: We still expect 10-year treasury yields to fall, as we're also expecting inflation to be lower by the end of the year. We also think that U.S. has likely

reached its peak policy rate in July. Signs are still pointing to a slowdown in economic growth over the coming months as consumers deplete their excess savings, wage pressures moderate, credit conditions tighten and higher rates continue to weigh on growth. We expect the economic news over the next few months to be less rosy and long bond yields will likely retreat to lower levels.

Profit taking on strong quarterly earnings

Majority of companies beat consensus estimates in the second quarter earnings by a wide margin, as they were set at a very low bar prior to the start of the quarter. Given the strong market performance this year, valuations are on the high end of the historical range and investors are already looking past the weaker earnings in the near term and are banking on a rebound in earnings in the forward-looking earnings growth guidance. As a result, price reaction in the few days following positive earnings surprises didn't reward the companies that beat consensus as much as the negative price return for companies that lowered their forward guidance.

Equities sell-off following positive earnings surprises



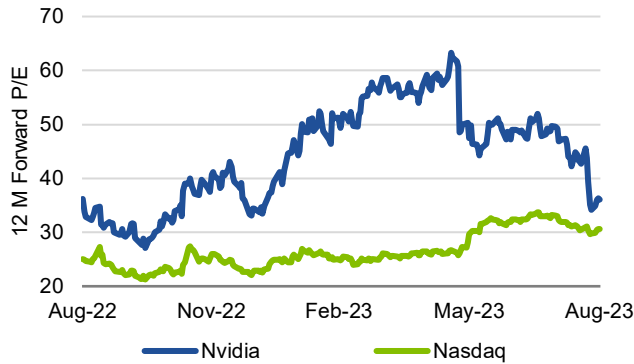
Source: Bloomberg, NEI Investments.

As seen in the chart above, sectors that are the most sensitive to long rates such as utilities and real estate retreated more as yields rose.

Nvidia lifted to the stratosphere

Nvidia's second quarter blockbuster earnings beat analyst estimates by a wide margin. Coupled with projected increases in chip production and the announcement of share buybacks, Nvidia was up over 6% after hours. Nvidia's 245% YTD rally as well as the recent enthusiasm on technology stocks with a focus on AI has put Nvidia under the microscope. Although the stock initially rallied on this news, some profit taking by investors brought the stock back to previous levels the days following the announcement, given the stock's already sky-high valuation.

Forward P/E - Nvidia vs NASDAQ



Source: Bloomberg, NEI Investments.

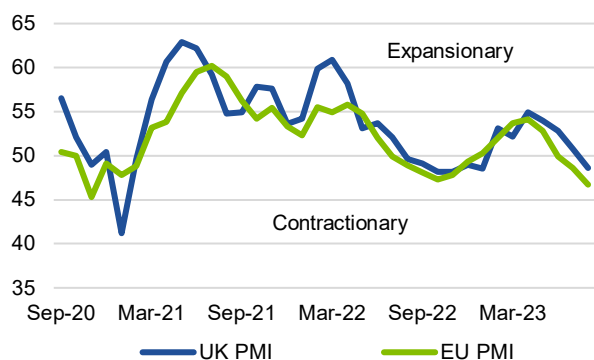
Global growth expected to slow

Due to rising gas prices and base year effects, inflation may register higher levels in the near term, as large monthly declines from summer of 2022 no longer impact the 12-month inflation movement. However, inflation is expected to continue to go lower by year end, as rent and wage growth inflation are showing early signs of moderation.

Multiple early indicators are also pointing to a slowdown in global growth. For instance, the FED's latest Senior Loan Officer Opinion Survey (SLOOS) revealed that consumer and business loans demand weakened and that banks anticipate the ongoing tightening of lending standards to continue in the second half.

August's PMI data revealed a contraction across major developed economies. Eurozone and the UK were hard hit with falling business activity, while the US teetered on the brink of stagnation. The aggressive rate hikes in the US, Eurozone, and UK have finally begun to impact their service sectors, especially industries like travel, tourism, and recreation, that had previously re-bounded strongly when COVID-19 measures were initially lifted.

Purchasing Managers Index in U.K. and Eurozone



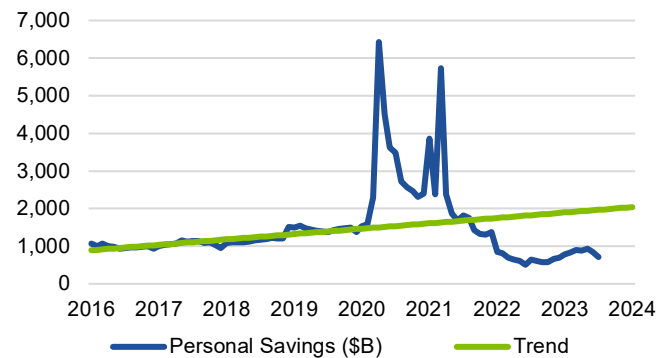
Source: Bloomberg, NEI Investments.

Labour market is still strong but data is pointing to further normalization in July, with job gains of 187,000 that is slightly below consensus expectations for 200,000. Unemployment remains extremely low at 3.5%, while average hourly earnings growth were slightly stronger than expected at 4.4% year-on-year.

Consumers running out of excess savings

The resilience of consumers through 2023 surprised many investors, but we see growing evidence which suggests that many of the factors supporting consumer resilience are winding down. Consumer strength is likely to fade as factors supporting growth in income and spending are waning (labour market normalizing and excess savings are running out). Excess savings for U.S. households adjusted for inflation have now fully been depleted from 2021 highs.

Excess savings during pandemic depleted in the U.S.



Source: Bloomberg, NEI Investments.

In addition, although still at low absolute levels, we're also starting to see a pickup in credit card and auto loan delinquencies, an early indicator of slowdown in consumer spending.

China's trade growth underwhelms

In China, trade activity data was much weaker than expected. Deteriorating trade data continued to deliver a pessimistic signal about the global manufacturing cycle. The most recent export data in August was marginally higher, but exports have seen their sharpest drop since early in the pandemic in 2020.

This matters a lot to Europe. On the manufacturing front, exports to China as a share of Europe's GDP has been growing over the past two decades. China's deceleration in growth momentum can severely impact countries like Germany that are heavily reliant on Chinese demand.

China's exports at multi-year lows



Source: Bloomberg, NEI Investments.

Bottomline: Current valuations already reflect the good news from economic resilience, limiting the upside potential. Going forward we expect that as economic news starts turning negative, the market will be quite vulnerable to downside surprises, which is why we reduced our tactical positioning in equities from an overweight to neutral during the month

Asset class outlook

Overall Equities – from overweight to underweight: Current prices reflect the positive economic good news, making it more vulnerable for downside if economic growth trends downward from here.

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 relative to other developed economies with reduced recessionary risks. Falling inflation and tight labour market supports consumer spending and economic growth.

International Equity – from underweight to neutral: European economics under pressure as wage gains are still inflationary. Stagflationary environment, along with disappointing demand from China weights on markets.

Emerging Markets Equity – from overweight to neutral: Diverging developments between EM countries; China continues to disappoint on growth and demand, affecting its trade partners. India's strength in services shines.

Overall Fixed Income – from underweight to overweight: Recent rise in long term yields makes for attractive entry point in the US as rates are close to peak in the near term.

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

Asset allocation outlook summary

	Bearish	Neutral	Bullish	
Equity				
Overall Equity				
Canada Equity				
U.S. Equity				
International Equity				
EM Equity				
Fixed Income				
Overall Fixed Income				
Govt				
IG Corp				
U.S. HY Corp				
Cash				

This month

Last month

This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of August 31, 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	-0.22	-1.27	0.09	0.93	0.66	-4.18	0.38	1.94
Bloomberg Global Aggregate TR Hdg CAD	-0.18	-0.32	1.86	2.44	-0.09	-3.30	0.45	1.98
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	0.24	3.17	4.19	6.66	6.37	1.34	2.51	4.02
Equities								
MSCI World NR USD	0.33	6.49	10.42	15.94	19.43	0.33	6.49	10.42
MSCI World Growth NR USD	0.68	6.49	18.28	27.93	24.58	0.68	6.49	18.28
MSCI World Value NR USD	-0.05	6.49	2.68	4.83	13.89	-0.05	6.49	2.68
MSCI Canada NR CAD	-1.51	4.87	1.99	6.83	8.63	-1.51	4.87	1.99
MSCI USA NR USD	1.00	7.85	13.51	18.56	19.01	1.00	7.85	13.51
MSCI EAFE NR USD	-1.15	3.31	4.09	10.70	21.82	-1.15	3.31	4.09
MSCI Europe NR USD	-1.29	3.23	3.45	12.26	26.56	-1.29	3.23	3.45
MSCI Japan NR USD	0.30	4.15	10.52	13.43	19.11	0.30	4.15	10.52
MSCI Pacific Ex Japan NR USD	-3.23	1.94	-3.58	-1.57	5.31	-3.23	1.94	-3.58
MSCI EM NR USD	-3.54	2.98	2.97	4.40	4.60	-3.54	2.98	2.97
World Currencies								
US Dollar	2.79	-0.47	-0.62	-0.15	3.31	1.26	0.74	2.52
Euro	1.19	1.33	1.70	1.55	11.51	-1.96	-0.65	0.54
Pound Sterling	1.23	1.76	4.01	5.19	12.50	-0.58	0.23	0.49
Yen	0.31	-4.48	-7.02	-9.50	-1.63	-8.89	-4.60	-1.45

Source: Morningstar data as of August 31, 2023.

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