Monthly Market Monitor

February 2020

NEI

HIGHLIGHTS

Alarming headlines spook markets

2020 is off to quite the start. From Australian bushfires, to Middle East tensions and the downing of a Ukrainian passenger jet, to the impeachment of a sitting U.S. president, and now a global coronavirus epidemic – all in less than a month.

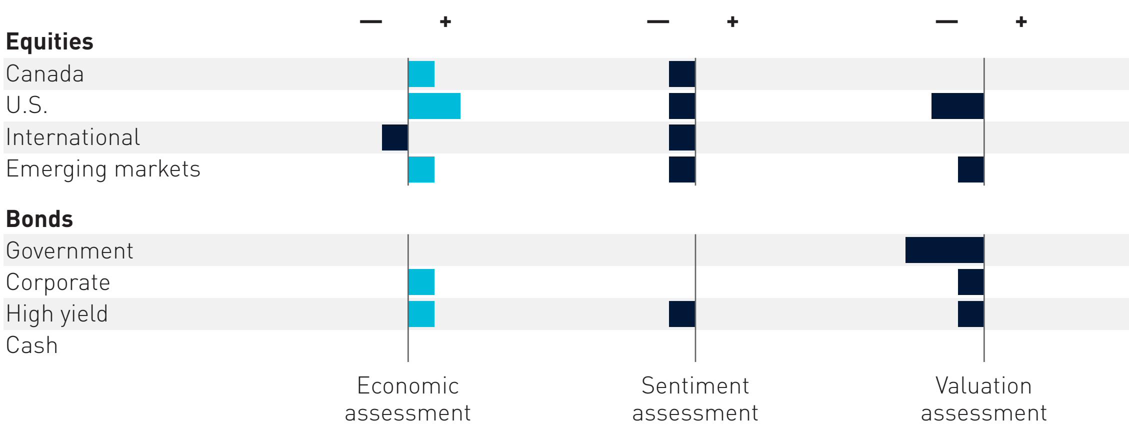
Volatility will continue

On the back of a U.S.-China phase one trade deal last year, equity markets rallied in December and into the new year. With the coronavirus outbreak, investor euphoria suddenly turned to investor panic. One thing we know for sure, investor sentiment will continue to drive market swings in the near-term.

Focus on the fundamentals

Leading economic indicators have been steadily improving, inflation is picking up, and corporate earnings are expected to improve. We are in the middle of Q4 earnings season, and while 2019 will likely be a flat year for earnings growth, analysts generally expect a nice rebound in 2020 and 2021 which should be positive for stocks.

OUTLOOK SUMMARY



Source: NEI Investments. Data as of January 31, 2020.

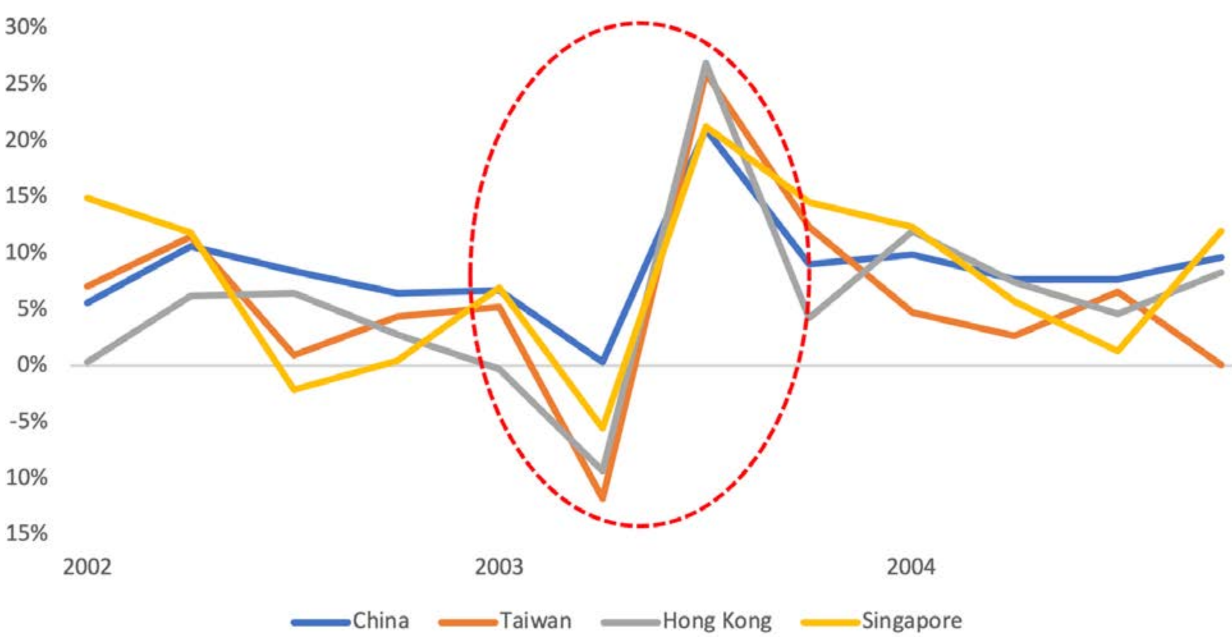
ALLOCATION INDICATOR

MARKET REVIEW AND OUTLOOK

For the first half of January, despite a slew of negative headlines, markets continued to rally on the back of optimism following the U.S.-China phase one deal. On January 3, a U.S. airstrike killed a top Iranian commander in Iraq, sparking increased tensions in the Middle East. What followed was a series of seemingly empty threats, only to culminate with Iran accidentally shooting down a Ukrainian passenger plane. On January 16, President Trump's impeachment trial moved on to the Senate following a majority House vote, making him the third U.S. president in history to be impeached. Meanwhile, Australian bushfires, which started in June last year, continue to ravage the country.

Then there is the coronavirus outbreak. Declared a public health emergency by the World Health Organization, globally there are now over 17,000 confirmed cases and more than 300 deaths at the time of writing. For many, this is a grim reminder of the SARS outbreak which lasted from November 2002 to July 2003 and claimed about 800 lives worldwide. In addition to travel bans in certain cities, China also extended its Lunar New Year holiday by three days. Commodities dipped on the news as industrial activity in China (along with a few other Asian countries) usually comes to a near halt during the week of Lunar New Year. An extension of the holiday only further exacerbates the fall in commodity prices. In addition, containment efforts will likely negatively impact the retail and travel industry. During SARS, there was initially a negative effect on 2003 Q2 GDP, but economic activity quickly rebounded the next quarter.

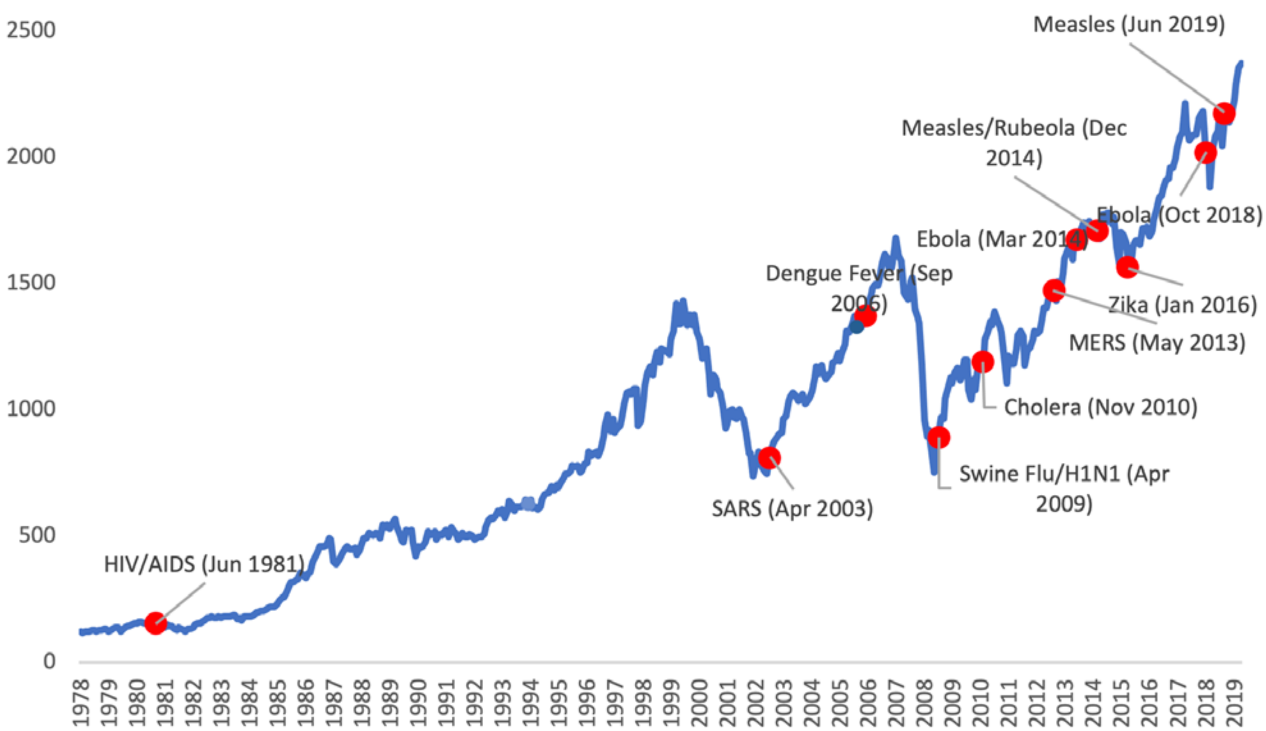
SARS Impact on GDP growth (q/q annualized)



Source: Capital Economics. Data as of December 31, 2014

It is too early to estimate the full economic impact, but there are reasons investors shouldn't panic. First, we are seeing much more of a global coordinated effort this time in terms of dealing with the outbreak. Second, the mortality rate so far is only about 2%, compared to 10% for SARS and over 50% for Ebola. Last and most importantly, epidemics typically don't have a prolonged market impact, as shown in the chart below.

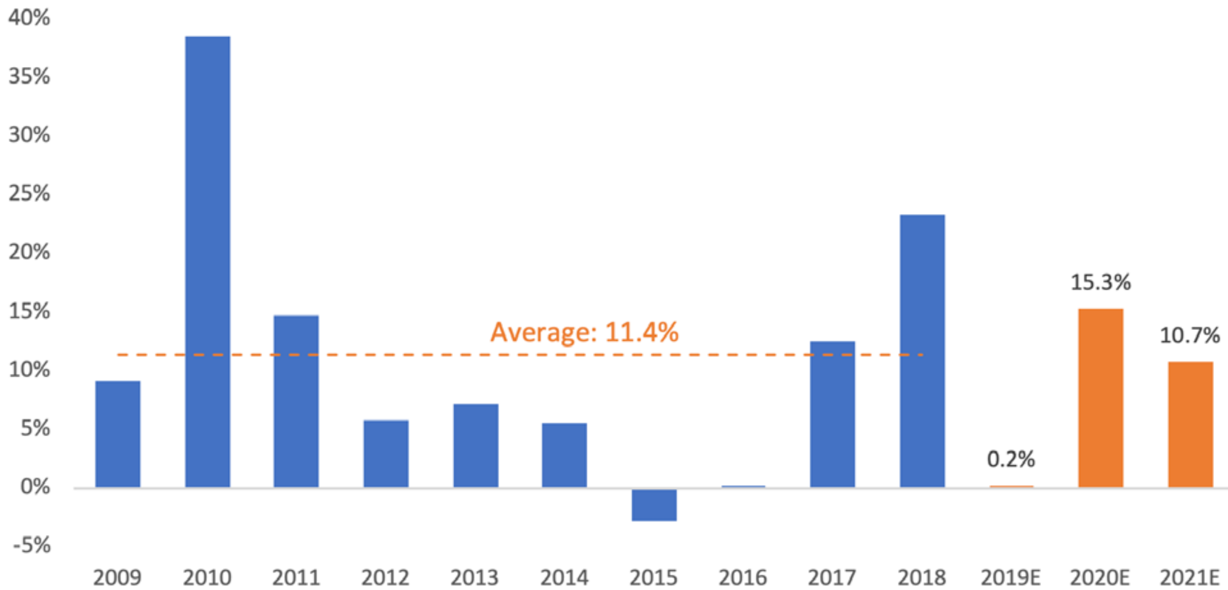
Global epidemics v.s. MSCI World Index



Source: Bloomberg. Data as of January 31, 2020.

Looking out into 2020, both economic and market fundamentals paint a rosier picture. 2019 was marked by slowing global growth along with what is widely expected to be relatively flat U.S. corporate earnings growth for all of last year. For 2020, earnings growth expectations are higher and in fact trending above the recent average of 11.4%.

S&P 500 earnings growth

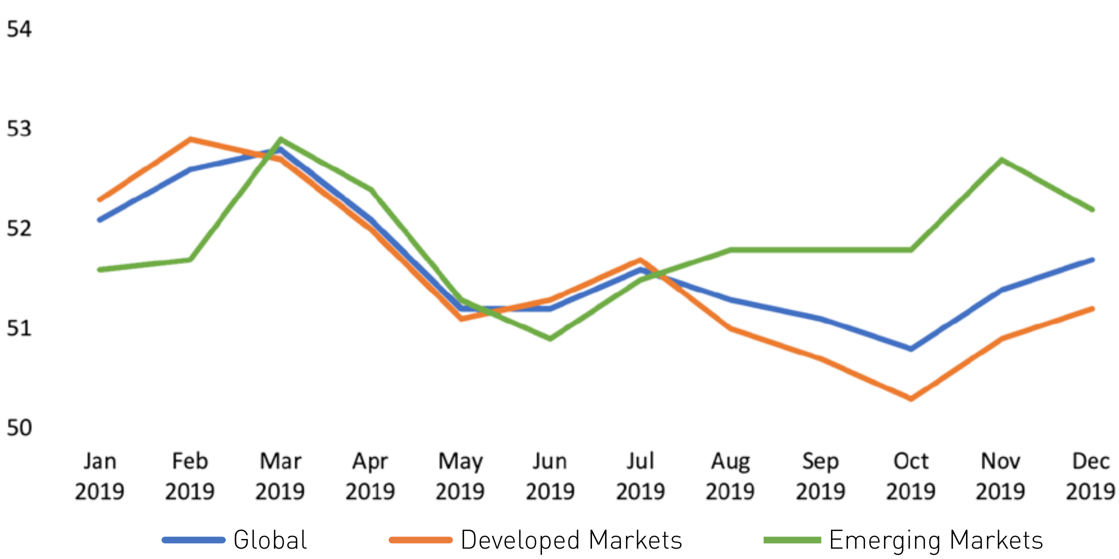


Source: Bloomberg consensus estimates. Data as of January 31, 2020.

On a regional basis, equity valuations remain more attractive outside the U.S. Our long-term views favour Canadian, international, and emerging market equities over the U.S., and we will gradually start adjusting our asset allocation accordingly.

Further evidence to support our continued long-term optimism on equities is in the leading economic indicators. The Composite Purchasing Managers' Index, an indication of business sentiment and future economic activity, bottomed out in October and has since seen two consecutive monthly increases. As indicated in the chart below, even with the emerging markets PMI dip in December, it was more than offset by strength across developed markets, resulting in a net increase for the overall global measure (chart below).

Composite Purchasing Managers Index



Source: Bloomberg. Data as of January 31, 2020.

Within fixed income, valuations continue to favour credit over government bonds. We have been reducing our high yield bond exposure in various portfolios over the last few months as spreads were near all-time lows, driven down by investors in search of higher yield. When the news of the coronavirus broke out, high yield spreads jumped 65 basis points, and we were able to avoid much of the resulting loss.

Ahead of the various central bank meetings this month, we increased our overall duration target from below that of the Canadian bond benchmark to neutral. Sure enough, on January 22 the Bank of Canada, while holding rates steady, had a more dovish tone than expected. The bank raised concerns over weak Q4 growth and sluggish consumer spending despite lower trade risk, and they also removed the word "appropriate" in describing their current policy. Odds of an April 15 rate cut jumped from 16% to about 55%, and the 10-year Government of Canada bond yield dropped 26 basis points. Most of the movement in bond yields is already baked in, but we may see further weakness in the Canadian dollar, which should provide a tailwind for our export-driven economy.

Negative headlines often lead to short-term dislocations in growth prospects and market sentiment, creating opportunities for investors with an appropriate tactical asset allocation framework. The market rally in Q4 reflected optimism toward a rebound in economic growth and easing of trade uncertainty amid a backdrop of accommodative central banks. Improving leading indicators are not enough – we would also need to see an improvement in the actual economic data releases to take a more bullish stance. In the near-term, in light of heightened market volatility, we favour taking a slightly defensive portfolio positioning.

MARKET PERFORMANCE

Percent return in Canadian dollars

	1 Mo	3 Mo	6 Mo	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs
Bonds								
Bloomberg Barclays Canada Aggregate	2.88	2.17	3.04	2.88	8.52	4.58	2.74	4.37
Bloomberg Barclays Global Aggregate (CAD Hdg)	1.82	1.46	2.97	1.82	8.36	4.42	3.20	4.40
Bloomberg Barclays US High Yield 2% Issuer Cap (CAD Hdg)	0.00	2.25	3.15	0.00	8.57	5.04	5.38	7.31
Equities								
MSCI World (Developed Markets)	1.37	5.88	8.71	1.37	18.56	11.99	9.93	12.27
MSCI World Growth	3.71	9.03	11.78	3.71	26.32	16.71	12.58	14.25
MSCI World Value	-0.99	2.70	5.63	-0.99	11.03	7.32	7.23	10.23
MSCI Canada	1.56	5.32	6.29	1.56	13.11	6.07	5.58	6.63
MSCI USA	2.15	7.52	9.81	2.15	22.02	14.46	12.58	15.75
MSCI EAFE	-0.14	2.87	6.88	-0.14	12.89	8.28	6.01	8.07
MSCI Europe	-0.57	3.45	7.01	-0.57	14.00	8.61	5.41	7.85
MSCI Japan	0.60	1.89	10.13	0.60	11.99	7.62	7.82	8.56
MSCI Pacific Ex Japan	0.30	1.62	0.05	0.30	9.35	8.05	6.23	8.71
MSCI EM (Emerging Markets)	-2.76	2.95	4.10	-2.76	4.54	8.39	5.37	6.05
World currencies (relative to CAD)								
US Dollar	1.99	0.62	0.72	1.99	0.70	0.48	0.85	2.18
Euro	0.69	-0.05	0.25	0.69	-2.74	1.32	0.48	-0.10
Pound Sterling	1.49	2.51	8.43	1.49	0.92	2.05	-1.75	0.21
Yen	2.26	0.36	0.89	2.26	1.12	1.76	2.48	0.38

Source: Morningstar. Data as of January 31, 2020.

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