Monthly Market Monitor

June 2021

NEI

HIGHLIGHTS

Commodity price correction
Commodities corrected last month as China clamped down on rising prices, though gold bounced back on stagflation concerns.

Slowdown in U.S. economic growth
The U.S. Federal Reserve is keeping policy easy as markets process historically high inflation and disappointing employment data. U.S. growth momentum may have peaked in the near-term.

Europe and Japan looking stronger
We expect the rest of the world to pick up the slack from slowing U.S. growth. Signs of economic strength are emerging in Europe and Japan as both regions try to accelerate vaccine distribution.

ASSET ALLOCATION OUTLOOK SUMMARY

	Negative		Neutral		Positive
Equity					
Canada Equity				This month	
U.S. Equity				This month	
International Equity			Last month	This month	
EM Equity			This month		
Fixed Income					
Government Bonds		This month			
Corporate Bonds			This month		
High Yield Bonds			This month		
Overall equity				This month	
Overall fixed income		This month			

This month (blue)
Last month (green)

This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of May 31, 2021. 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.

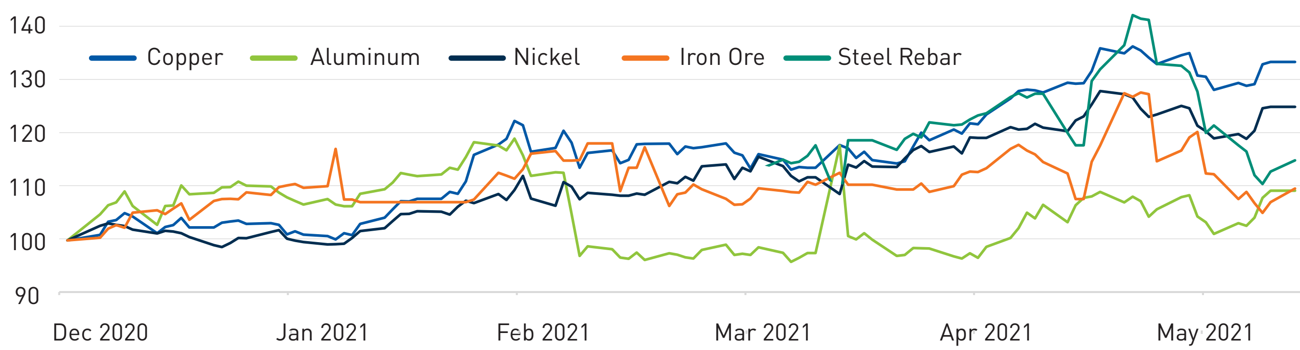
OVERVIEW

Markets consolidated in May and continued to process the strength of the economic recovery, a decline in global COVID-19 cases and the potential for inflation. Global stock markets were essentially flat, while bond indices rose as investors looked past historically high inflation readings and instead focused on disappointing employment data. Markets are currently in a holding pattern as they await direction from incoming economic data. Investors are positioned for a reflationary environment but due to a near-term peak in U.S. growth momentum, they may be evaluating the possibility of stagflation in the short-term.

Rising commodity prices have been another source of inflation concerns; however, they have also provided confirmation of the economic recovery. Chinese policymakers have also noticed the rise. (China is the largest consumer of industrial metals.) Chinese regulators warned domestic steel mills that steel prices were too high and threatened "zero tolerance" for "abnormal transactions and malicious speculation." This action, as well as slowing Chinese growth, have led to a pullback in industrial metals prices. Net long positions in commodities are at 25-year highs and we believe the overly bullish sentiment will correct. A falling U.S. dollar and supply constraints should put a floor under commodity prices.

Gold rallied 5.85% (C$) during the month with prices driven by rising inflation expectations, the Federal Reserve's dovish stance holding down real rates, and a falling U.S. dollar. Last year's bullish sentiment and extended speculative positioning have also been worked off, allowing the precious metal to bounce back. Digital currencies on the other hand had a rough month, with Bitcoin falling more than 50% in a span of 2 weeks. The collapse in cryptocurrencies may put a drag on other speculative assets but it should help increase gold's appeal as a hedge against central bank policy errors.

Industrial Metals



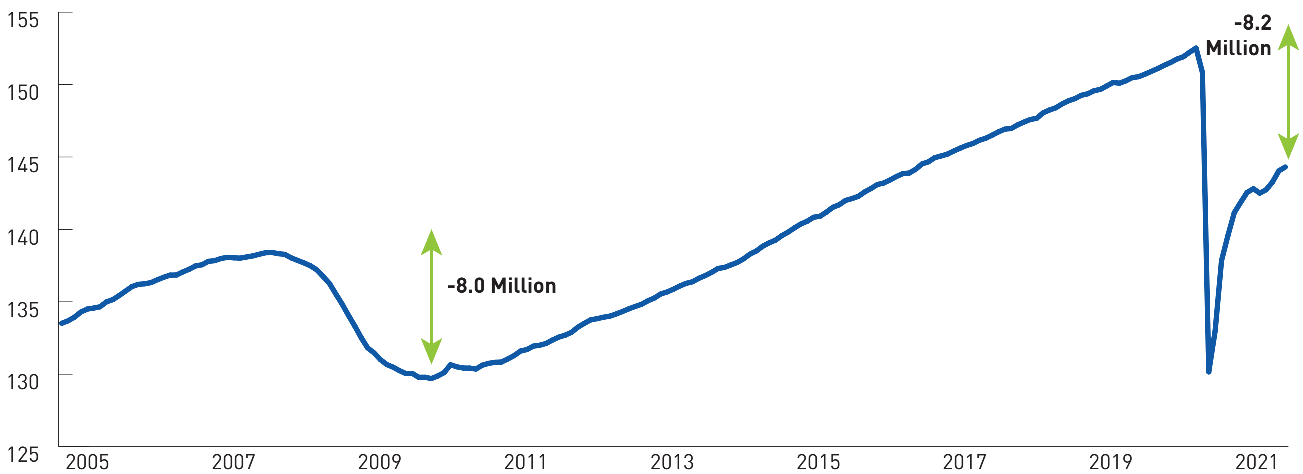
Source: Bloomberg. Data as of May 31, 2021. Prices indexed to 100 as of December 31, 2020.

U.S.

U.S. inflation accelerated sharply, with April CPI rising 4.2% year-over-year, easily beating consensus expectations for a gain of 3.6%. The year-over-year readings are being influenced by base effects and we need to look at month-over-month data to get a better understanding of near-term inflation trends. On a month-over-month basis CPI rose 0.8% in April and the core CPI measure (taking out food and energy) was up 0.9% month-over-month. That is the highest monthly increase in core CPI since April 1982, confirming inflation is running hot right now. Interestingly, bond yields have not moved much on the back of these readings, hinting that the market agrees with the Fed's assessment that current inflation is "transitory."

Another reason bond yields have not moved higher was disappointing employment data. Consensus expectations were for a gain of 1 million jobs in April, but total nonfarm payrolls showed a gain of just 266,000. Labour surveys suggest companies are having difficulty filling vacant positions due to stimulus payments, better unemployment benefits and issues finding childcare. The U.S. economy lost 22.4 million jobs between March and April 2020 and has regained only 14.1 million since. The amount of job losses still exceeds the 2008 Great Recession, and the Federal Reserve has stated a recovery in the labour market is a pre-requisite for talking about tapering the pace of asset purchases and policy normalization. We expect the Fed's easy policy stance to support higher inflation and interest rates into year end.

U.S. Total Employees on Nonfarm Payrolls (Millions)



Source: Bloomberg. Data as of April 30, 2021.

U.S. President Joe Biden recently unveiled a US$6.0 trillion federal fiscal budget proposal for 2022, which includes plans to restore infrastructure, combat climate change, and improve health care, among other things. The proposed budget is likely to see pushback from Republicans, but the White House argues that despite the steep initial costs, economic growth from these investments will pay off in the long term.

Lastly, the latest sign that economic growth has roared back is the ISM manufacturing survey, which hit its highest level since 1983. After reaching such extreme readings we expect that growth data will continue to be expansionary, but at a slower pace. Historically, after the ISM peaks and begins to decline, equity returns remain positive, although increasingly less so as the cycle matures. We believe U.S. growth momentum has peaked for now, but it is not a reason to get defensive on stocks because growth is still at an elevated level, the recovery is faster than past recessions, and government policies remain exceptionally stimulative. Slowing growth may also prevent bond yields from rising too much in the near-term, adding to the possibility that bonds continue to trade in the range they have been in since March.

CANADA

Canada's economic recovery remains robust, benefitting domestic stocks. The S&P/TSX Composite returned 3.44% in May, easily outperforming the -0.38% decline of the MSCI World Index (C$). The pace of vaccinations has increased rapidly, with government statistics showing that over 50% of the population has received at least one dose, a huge improvement from 33% at the end of April.

Canadian inflation data is telling a similar story to the rest of the world with CPI rising 3.4% year-over-year in April, up from 2.2% in March. On a monthly basis CPI was up 0.5% in April, remarkably beating expectations for a gain of 0.2% during a month when there were widespread increases in mobility restrictions across several provinces. The three inflation measures the Bank of Canada tracks averaged 2.1%, the highest level since February 2012, increasing the probability the central bank may tighten monetary policy faster than expected.

The Bank of Canada has already announced reductions to its quantitative easing program, making it one of the more hawkish developed country central banks in the world. Improving economic data, higher commodity prices, and the central bank's relative hawkishness is causing Canadian dollar appreciation. The Bank of Canada has voiced concerns over the stronger loonie, which hurts exports; however, a stronger currency is disinflationary as it lowers import prices. The Bank of Canada may be willing to accept a stronger Canadian dollar in the near-term to offset high inflation.

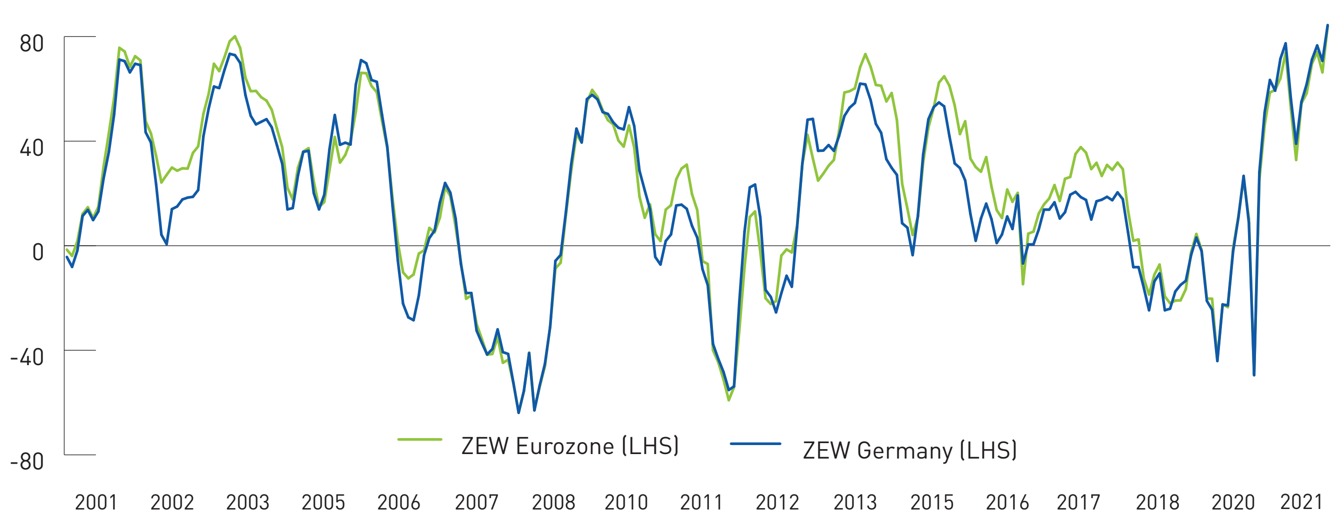
Canada should continue to benefit from faster vaccinations, reduced health restrictions, and high commodity prices. Higher inflation and a more hawkish central bank should drive interest rates and the Canadian dollar higher. We remain overweight Canadian stocks in our asset allocation solutions and underweight government bonds. We have also hedged a portion of the U.S. dollar equity exposure to defend against a rising Canadian dollar.

INTERNATIONAL

Global growth is picking up just as economic momentum peaks in the U.S. There have been positive surprises in European and Japanese economic data, and we believe those countries are positioned to benefit from improving economic sentiment and increased vaccination rates. We are beginning to tilt our positioning positively towards those regions in our asset allocation solutions.

The Germany ZEW Indicator of Economic Sentiment Index rose to 84.4 in May from 70.7 in April, the highest level since February 2000. The Eurozone ZEW also reflected the jump in economic sentiment, which was confirmed by a 3.1-point rise in the IHS Markit Flash Eurozone Composite PMI to 56.9 in May. The Manufacturing PMI was relatively unchanged at 62.8, while the Services PMI surged to 55.1 from 50.5. The manufacturing, trade and export sectors in Europe have been strong, while the service sector has suffered from health restrictions and low vaccination rates. However, this dynamic is changing with surging vaccinations and falling infections. Europe is well-placed for better growth if the reopening resembles other economies with successful vaccination programs.

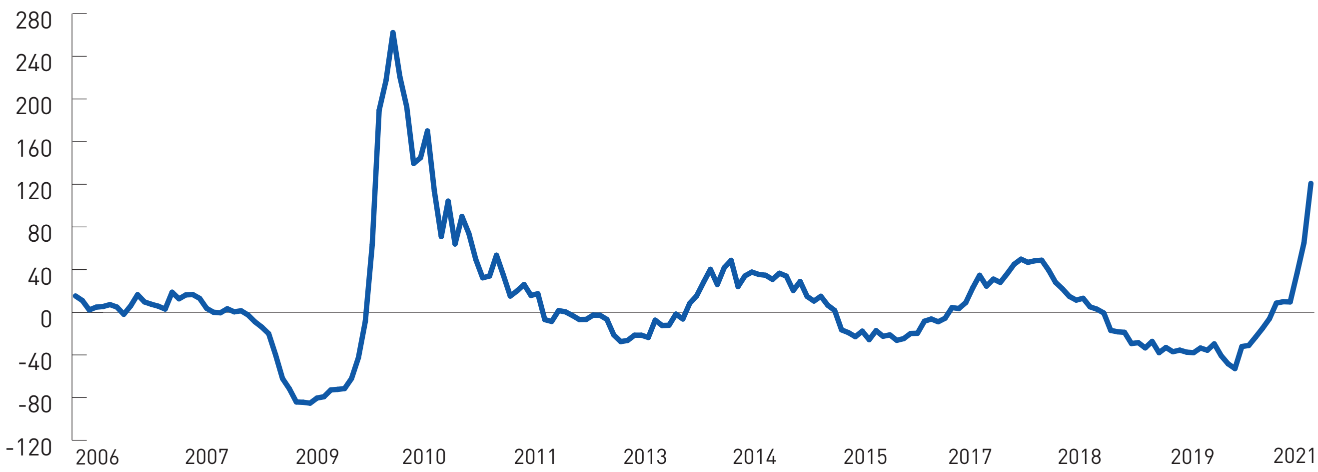
Expectation of Economic Growth - Europe



Source: Bloomberg. Data as of May 31, 2021.

Japanese stock returns have trailed global stocks year-to-date despite the higher cyclical sector weight. Japan's proximity and export ties to China are one reason, but its vaccination campaign has also been incredibly slow. Information from Our World in Data shows that only about 7% of the population has received its first dose. However, recent economic data points to an improving recovery in foreign demand as machine tool orders jumped 121% year-over-year, the most since 2010. Japan should benefit from global growth and vaccinations this summer and Japanese equities also provide more attractive valuations than their U.S. counterparts.

Japan Machine Tool Orders Year-over-Year %



Source: Bloomberg. Data as of May 31, 2021.

EMERGING MARKETS

We remain neutral in our view on emerging markets, mainly due to headwinds faced by China. The focus of policymakers in Beijing is not to achieve the fastest growth possible, but to maintain economic and social stability while shifting the economy from foreign to domestic demand. After record GDP growth in 2020, China's priorities have shifted in favor of reducing financial system leverage and containing market excesses.

As discussed in prior commentaries, China's credit impulse leads growth by about 6 months. The People's Bank of China (the country's centra bank) is exiting crisis mode support and reining in credit growth, which we expect will lead to growth levels that are significantly lower than those seen before the pandemic. We are positive on emerging markets outside China but we prefer Europe and Japan for their potential to benefit from higher global growth. Emerging market returns have suffered lately and could be poised to play catch up to the rest of the world.

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 Barclays Canada Aggregate	0.64	-0.80	-4.02	-4.31	-1.89	3.97	2.70	3.76
Bloomberg Barclays Global Aggregate ($C Hdg)	0.22	0.07	-1.76	-2.02	-0.04	3.99	2.80	3.93
Bloomberg Barclays US HY 2% Issuer Cap ($C Hdg)	0.29	1.51	4.06	2.19	14.48	6.04	6.55	6.15
Equities								
MSCI World (Developed Markets)	-0.38	4.68	8.24	5.62	22.91	11.73	12.43	12.77
MSCI World Growth	-1.95	2.12	4.08	0.89	22.19	16.66	16.41	15.33
MSCI World Value	1.09	7.12	12.31	10.32	23.08	6.33	8.12	10.01
MSCI Canada	3.54	10.25	16.47	14.41	32.14	8.88	9.34	5.90
MSCI USA	-1.37	4.80	8.25	5.79	23.38	15.20	15.06	16.36
MSCI EAFE	1.41	3.84	7.38	4.38	20.98	5.70	8.04	8.24
MSCI Europe	2.30	7.13	10.64	7.48	24.57	6.36	7.91	7.88
MSCI Japan	-0.27	-3.55	-1.40	-3.68	9.42	3.94	7.97	9.74
MSCI Pacific Ex Japan	0.31	2.58	9.30	5.60	28.73	5.61	9.21	7.88
MSCI EM (Emerging Markets)	0.48	-1.44	7.35	1.71	31.98	7.08	12.08	6.43
World Currencies (relative to CAD)								
US Dollar	-1.80	-4.57	-6.78	-5.17	-12.60	-2.34	-1.58	2.23
Euro	-0.26	-3.88	-4.71	-5.24	-3.93	-0.82	0.28	0.59
Pound Sterling	0.83	-2.98	-0.74	-1.39	0.50	-0.17	-2.04	0.74
Yen	-1.88	-7.06	-11.14	-10.50	-13.92	-2.57	-1.31	-0.77

Source: Morningstar. Data as of May 31, 2021.

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