Monthly Market Monitor

July 2021

HIGHLIGHTS

Cyclical stocks drive TSX

Canadian equities had their best first half of a year in over a decade, as a strong global recovery and rising inflation expectations lifted cyclical sectors such as energy, materials, financials, and industrials.

Fed rate expectations rise in 2023

The U.S. Federal Reserve acknowledged the rapidly recovering economy and rising inflation by accelerating the expected pace of interest rate hikes. The median forecast of the Federal Open Market Committee is now for two hikes in 2023.

Market cycle maturing

Rates of growth and inflation have likely peaked and are set to decelerate in coming quarters. This means markets may be entering a new phase of the cycle, with more muted returns driven by results and earnings.

ASSET ALLOCATION OUTLOOK SUMMARY

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

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 June 30, 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.

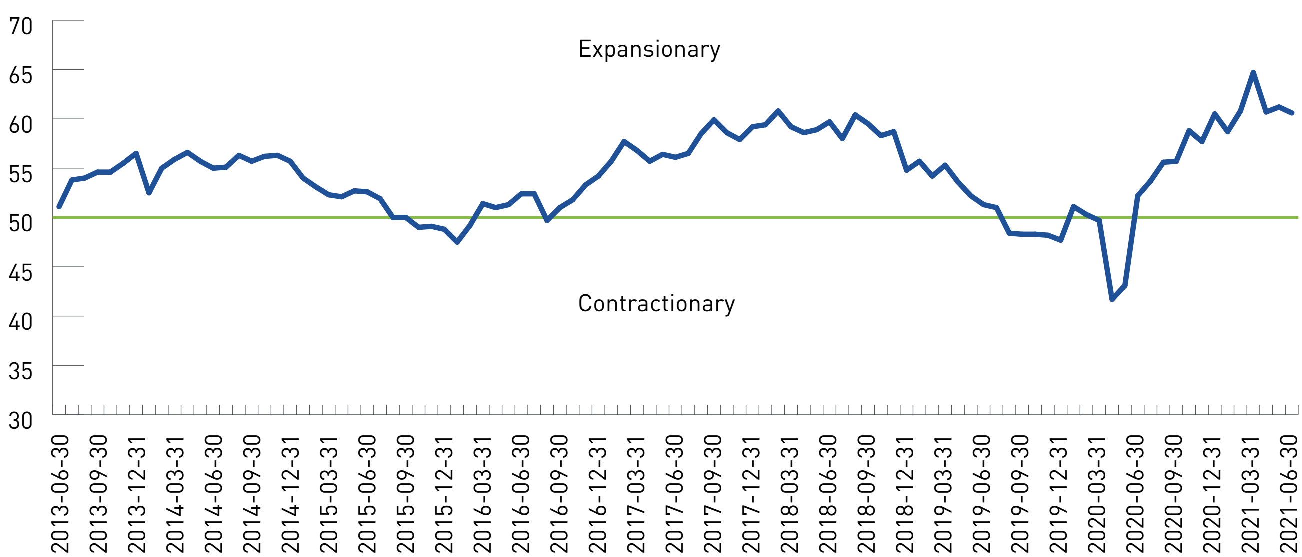
OVERVIEW

Markets continued their impressive 2021 rally in June, as vaccinations picked up speed globally and daily COVID-19 case counts stayed on a downward trend, particularly in Europe. Both bonds and stocks benefitted as investors warmed to the idea that inflation is transitory, despite inflation in the U.S. reaching 5.0% year over year in May. Instead, employment data became the focus, with another disappointing release for May. Bond indices rose in response to falling longer-term interest rates. Stocks with growth characteristics fared particularly well as investor sentiment began to reflect expectations that economic growth may have peaked and is set to enter a period of deceleration, albeit remaining at elevated levels, at least in the short-term. Furthermore, valuation multiples for growth-oriented technology stocks tend to benefit the most from lower longer-term interest rates.

Inflation remains a key risk as higher inflation readings could lead to the Fed tightening monetary policy faster than current market expectations. In fact, at its June meeting the central bank revised its growth and inflation forecasts higher for the year, resulting in more Fed officials forecasting interest rate hikes over the next two years. However, it is important to note that recent year-over-year inflation readings have been distorted by extremely low price levels last year due to the pandemic and transitory reopening factors this year, as the immediate surge in demand caused supply chain bottlenecks. The Fed also echoes this view as the central bank remains on the sidelines, with expectations that inflation will revert closer to the longer-term trend and 2% average target, helping calm markets. Going forward, the distortions of low base prices and supply disruptions are expected to start diminishing in the second half of 2021.

This peaking and decelerating growth, alongside low interest rates, is indicative that the economy looks to be entering a new phase of its cycle. Expectations have been set that a full reopening of the economy is well underway. The early-cycle recovery phase saw the S&P 500 Index rally over 90% in U.S.-dollar terms since March 2020 lows as markets price in a synchronized global recovery. Returns so far have been driven by heightening expectations, mainly reflected through higher price/earnings multiples. As we enter a mid-cycle phase, any further appreciation will likely come from companies delivering strong earnings and results, leading to more muted returns.

U.S. ISM Manufacturing Purchasing Managers Index at Extreme Levels; Growth Should Continue at a Slower Pace

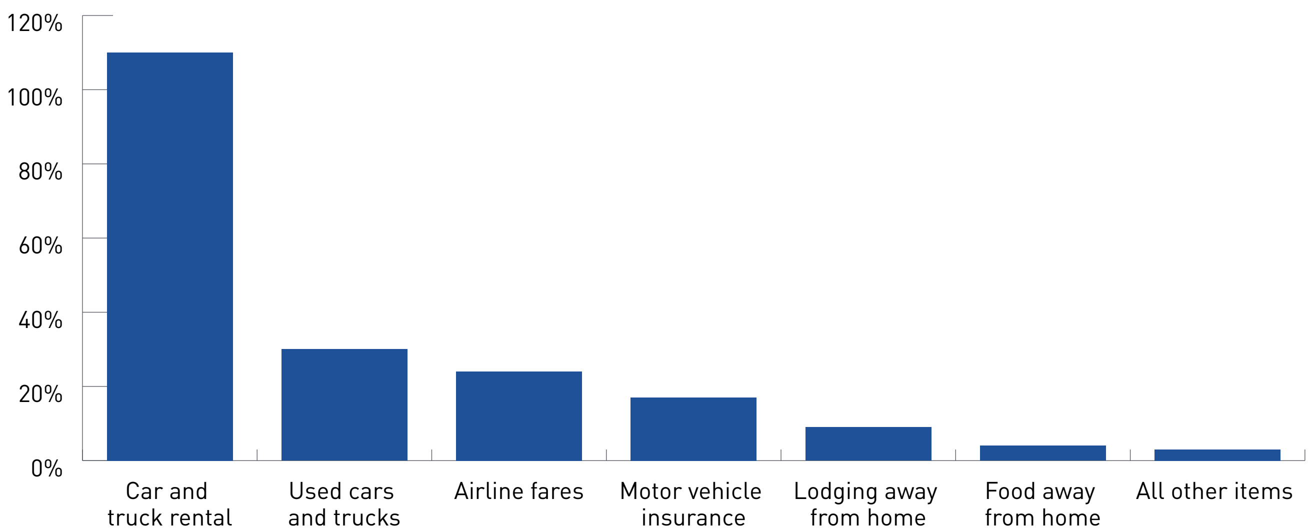


Source: Bloomberg. Data as of June 30, 2021. Index readings above 50 are considered expansionary, and readings below 50 are considered contractionary.

U.S.

Inflation accelerated again in May, with the U.S. Consumer Price Index rising 5.0% year over year, exceeding expectations of 4.7%. The reading was skewed by low base effects as strong demand from the economic reopening was compared to previously plunging demand due to the pandemic. A closer look at the details unveils transitory reopening factors. April and May inflation saw used car prices rise due to a supply crunch, contributing to over a third of the monthly readings. Other reopening sectors including car rentals, lodging, vehicle insurance, airline fares, and food away from home experienced surging prices. Overall, these six categories that made up just 13% of the basket of goods and services used to measure inflation accounted for 32% of the increase in May's CPI inflation reading.

Recent CPI Readings Driven by Reopening Factors; 32% of CPI Increase Due to Just Six Categories



Source: U.S. Bureau of Labour Statistics. Data as of June 30, 2021. Percentages reflect unadjusted year-over-year price changes from May 2020–May 2021.

Inflation running hot has caused some concern that the Fed could be forced to raise rates at a faster pace to control prices. At its latest meeting, the central bank shifted to a less-stimulative tone. Acknowledging the rapidly recovering economy, the Fed's Summary of Economic Projections reported a rise in 2021 GDP expectations to 7.0%, from 6.5% previously, and inflation expectations for personal consumption expenditures (PCE) jumped to 3.4%, from 2.4%. The more upbeat sentiment was also reflected in the Fed's heavily scrutinized "dot plot" chart, in which each central bank official's forecast for the key interest rate is represented by a dot. This chart shows that the median expectation for 2022 remains unchanged with no rate hikes while the median forecast for 2023 now estimates two rate hikes, compared to none just three months ago. However, Fed Chairman Jerome Powell further explained that the dot plots should be taken with "a big grain of salt." It is worth remembering that the Fed has a dual mandate of ensuring stable inflation and maximum sustainable employment levels. Current inflation numbers may be elevated, but employment is a long way off from a full recovery with U.S. employment still down 7.6 million jobs from pre-COVID peaks. Powell signaled that it is too soon to be increasing rates, stating that, "Lift-off is well into the future," and adding, "We're very far from maximum employment."

Following the Fed's meeting, interest rates moved lower, with the 10-Year Treasury yield falling to 1.47%. Other aspects to consider are peaking growth in the U.S. and low inflation readings internationally. In May, retail sales fell 1.3%, personal incomes fell 2.0%, and personal consumption was unchanged. Markit PMI surveys are reaching record levels, with the services survey already starting to turn lower in June. Although readings in the U.S. have been high, eurozone inflation was just 2.0% year over year in May, while Japan inflation fell 0.1%. Although growth will continue at elevated levels, slowing momentum and subdued inflation globally could prevent yields from pushing higher in the near term.

Accordingly, analysts will closely examine future employment numbers, especially as recent releases have missed market expectations. Firms have reported difficulty in hiring the staff needed to help meet surging demand. Many such employers have cited generous unemployment benefits as a main reason that workers have not returned to the workforce, and with some U.S. states starting to decrease these benefits employment could accelerate in the coming months.

Overall, we continue to prefer stocks over bonds within our asset allocation solutions as the recovery continues, with a slight preference for higher-quality stocks as they provide the benefit of being able to pass on inflationary cost pressures to end consumers. There is also potential for growth names to outperform as bond yields remain contained. Within bonds, we prefer corporate over government bonds.

CANADA

The Canadian economy slightly contracted in May, according to preliminary estimates from StatsCan. Similarly, employment declined by approximately 68K jobs and retail sales fell an estimated 3.2% as lockdowns and restrictions continued into the month. However, indicators appeared to be changing course in June, with the economy looking to be gaining strength after lagging the U.S. recovery. Coronavirus case counts have significantly declined and provinces have gradually eased restrictions as they achieve vaccination targets. In fact, vaccination rates in Canada now lead the world. According to OurWorldInData, as of June 68.1% of the country's population has received a first vaccine dose, compared to 57.7% at the end of May.

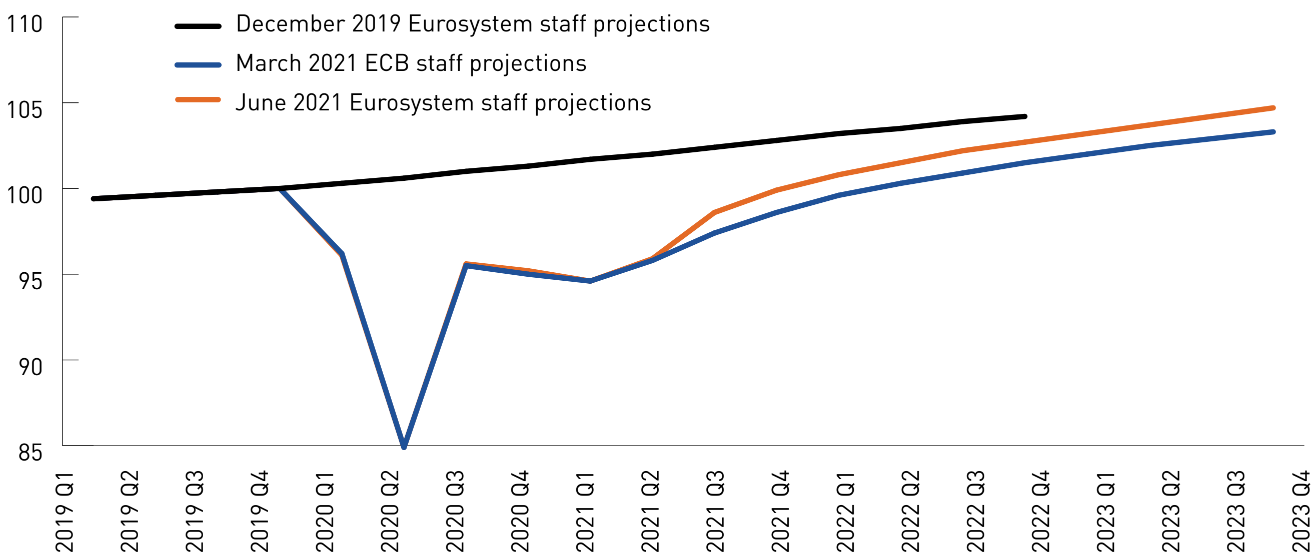
The Bank of Canada appeared unfazed by CPI rising to 3.6% year over year, signaling similar expectations as the Fed. Inflation is expected to remain elevated, near 3% at least in the near term, but like the Fed the BoC expects that base-year effects will diminish and excess capacity will exert downward pressure on price increases.

Though commodity prices have stalled, oil continues to rise, supporting Canada's recovery. The synchronized global recovery has resulted in large stockpile drawdowns, with the U.S. Energy Information Administration reporting six consecutive decreases in oil inventory. Demand for oil has seen Western Canada select crude oil prices reaching US$60/barrel, the highest since 2014. We remain overweight Canadian stocks in our asset allocation solutions, and underweight in government bonds.

INTERNATIONAL

European stocks underperformed the world, despite vaccinations ramping up and pandemic-related restrictions starting to be removed, opening up economies for travel and services exports. The respective percentages of the populations of Germany and France who received at least one vaccine dose have surpassed 50%, according to OurWorldInData. The European Central Bank now projects economic activity to rebound strongly going into the second half of 2021, upwardly revising growth and inflation forecasts for 2021 and 2022.

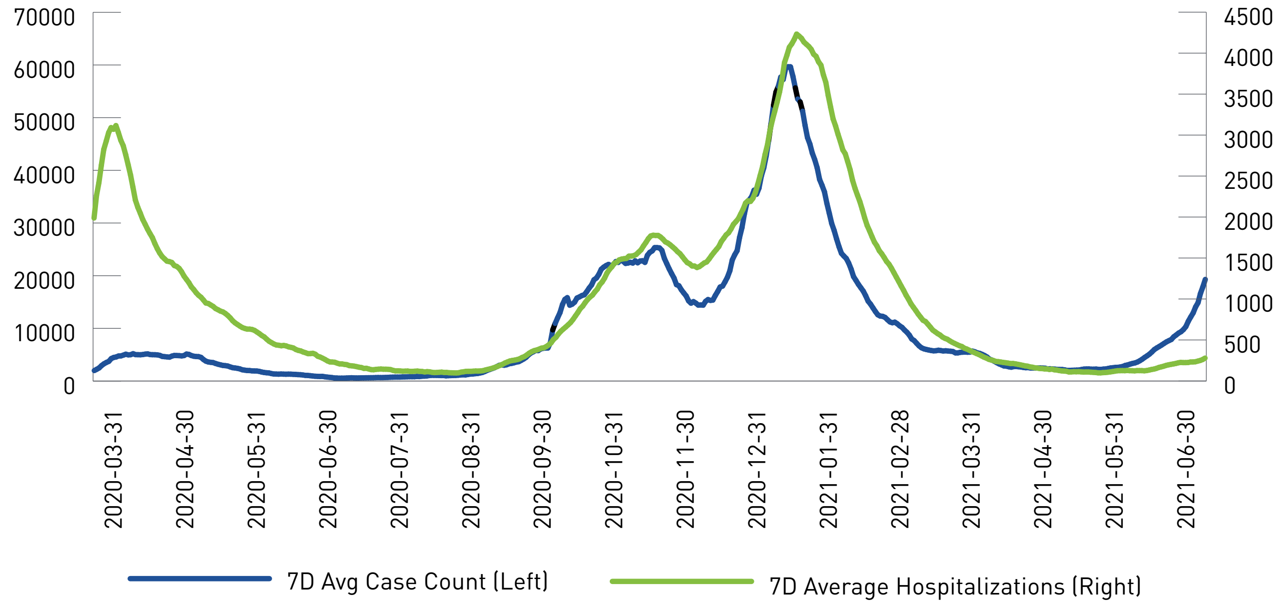
ECB Forecasts 2022 GDP Will Be 1.3% Lower Compared to Pre-Pandemic Projections



Source: European Central Bank. Data as of June 10, 2021

However, case counts in the U.K. are once again rising at an alarming rate. The delta variant has been pinpointed as the cause, and is now the dominant strain in the country. The good news is that studies show that vaccines are still effective against the variant, though slightly less so, but are effective against hospitalizations. The situation in the U.K. will be closely monitored by investors as it has often been the first developed country to experience variant outbreaks. With the country's established health care system and reliable data reporting structure, the U.K.'s experience could be used as a guide for other countries on handling COVID-19 variants.

U.K. Coronavirus Cases and Hospitalizations



Source: Public Health England. Data as of June 30, 2021.

Japanese equities have lagged the world as the country's extended emergency conditions have weighed on its economy. Vaccinations have lagged, with only approximately 24% of Japan's population having received a first dose compared to more than 50% for many other developed countries, according to OurWorldInData. The country is on the verge of entering another pandemic-induced recession, but the global recovery could help boost exports.

EMERGING MARKETS

In our asset allocation solutions, we remain neutral on emerging market equities, which lagged global stocks in June. Concerns over tightening monetary policy and regulatory issues have weighed on China as the country attempts to reduce financial leverage and contain market excesses. At the same time, China is also experiencing growth concerns as its consumer consumption has missed market expectations.

The Chinese yuan has appreciated 9.4% against the U.S. dollar in the last 12 months, and China's producer price index rose 9.0% year over year in May on rising raw material costs. Rising currency and higher costs have resulted in concerns of a slowing recovery, with Chinese agencies acting in response. The People's Bank of China increased its foreign currency reserve requirements to help temper the strengthening yuan, and China's National Food and Strategic Reserves Administration announced it would release national metal reserves to help stabilize prices. We continue to see opportunities in emerging markets for our asset allocation solutions, slightly favouring stocks outside of China, but prefer European and Japanese equities in light of China's currency and raw material concerns.

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	0.86	1.54	-3.49	-3.49	-2.60	4.04	2.50	3.86
Bloomberg Barclays Global Aggregate ($C Hdg)	0.50	0.97	-1.53	-1.53	-0.03	4.13	2.52	3.99
Bloomberg Barclays US HY 2% Issuer Cap ($C Hdg)	1.37	2.74	3.59	3.59	14.95	6.41	6.64	6.39
Equities								
MSCI World (Developed Markets)	4.03	6.15	9.88	9.88	26.42	12.70	13.74	13.44
MSCI World Growth	7.07	9.23	8.02	8.02	27.02	18.77	18.43	16.35
MSCI World Value	1.08	3.16	11.51	11.51	25.38	6.27	8.78	10.35
MSCI Canada	2.45	8.41	17.21	17.21	32.59	9.18	9.95	6.50
MSCI USA	5.32	7.18	11.42	11.42	28.98	16.42	16.38	17.22
MSCI EAFE	1.35	3.62	5.78	5.78	20.33	6.11	9.23	8.56
MSCI Europe	1.11	5.83	8.67	8.67	22.82	6.49	9.30	8.25
MSCI Japan	2.20	-1.75	-1.56	-1.56	13.50	5.10	9.14	9.86
MSCI Pacific Ex Japan	0.87	3.21	6.52	6.52	22.00	6.01	9.39	8.20
MSCI EM (Emerging Markets)	2.68	3.50	4.44	4.44	28.11	9.05	11.96	6.92
World Currencies (relative to CAD)								
US Dollar	2.50	-1.48	-2.80	-2.80	-9.08	-1.99	-0.95	2.52
Euro	-0.58	-0.59	-5.79	-5.79	-4.00	-1.48	0.35	0.48
Pound Sterling	-0.39	-1.35	-1.77	-1.77	1.65	-0.50	-0.29	0.99
Yen	1.03	-1.91	-9.58	-9.58	-11.63	-2.06	-2.49	-0.68

Source: Morningstar. Data as of June 30, 2021.

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