Monthly Market Monitor

August 2021

NEI

HIGHLIGHTS

Corporate earnings, revenues beat expectations
Stocks have risen on the back of a strong Q2 earnings season. To date, the percentage of S&P 500 Index companies beating EPS and revenue estimates are at record highs. Q2's year-over-year earnings growth is expected to be 85%.

Low-rate environment may persist
Bond prices have also risen as investors look past peak economic and earnings growth, peak inflation, and peak monetary and fiscal stimulus. The new ECB inflation framework and lagging U.S. employment recovery mean interest rates may stay lower for longer.

Chinese equities dip on regulatory shifts
Changing regulations have negatively impacted Chinese stock prices, from the online payments sector to private tutoring companies. These changes have affected high-profile companies such as Alibaba and Tencent, as well as most recently the IPO of ride-hailing giant Didi.

ASSET ALLOCATION OUTLOOK SUMMARY

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

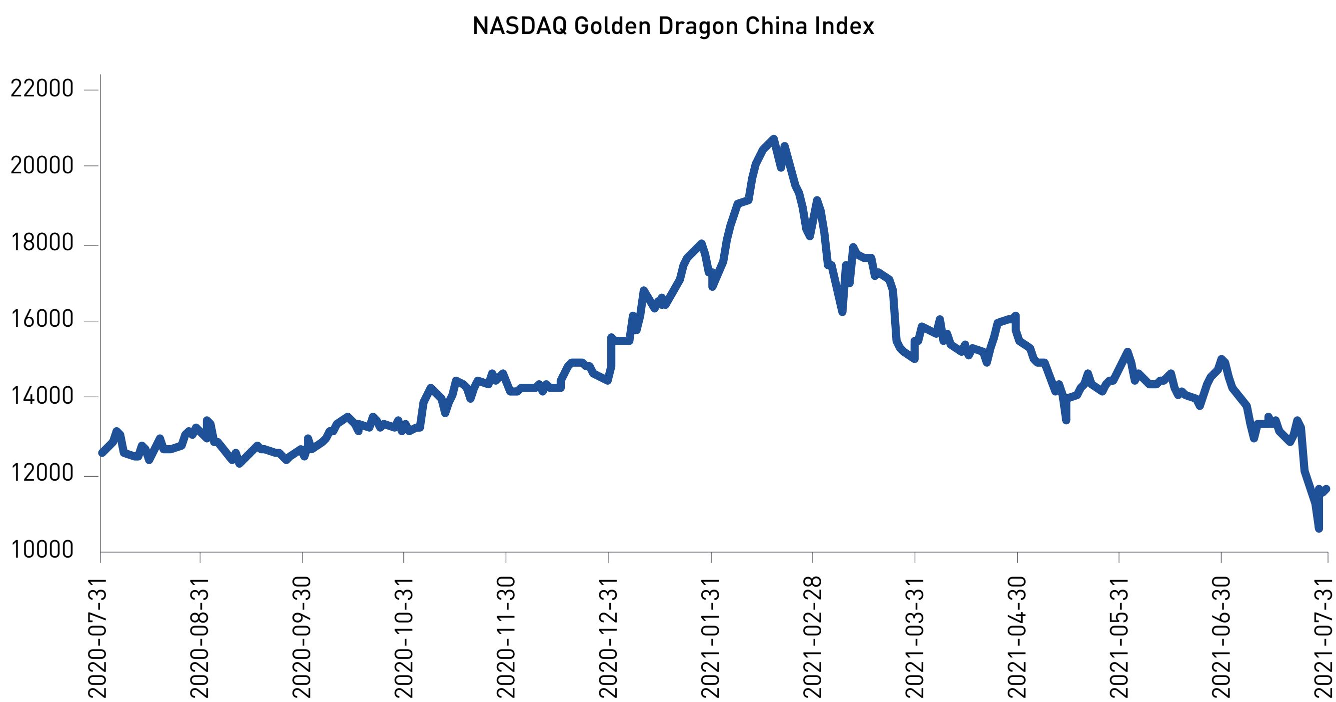
Markets continued to rally in July despite many countries experiencing a renewed wave of COVID-19, especially with a rise in Delta variant cases. Investors remained upbeat despite coronavirus concerns, looking past rising case counts and continuing to anticipate economic reopenings, as hospitalizations have not followed the same trend relative to case counts as have been reported in previous waves. Vaccinations appear to be effective against preventing hospitalizations and, by extension, fatalities.

The focus remains on central banks and markets attempting to pre-empt monetary policy changes. Bonds gained in July as longer-term yields fell, even as inflation readings gained in June. Investors continued to warm to the idea that inflation is transitory and should normalize over the next 12–24 months. The U.S. Federal Reserve's acknowledgement of economic progress hints that the central bank is moving closer towards tightening. However, when considering the Fed's dual mandate of maximum employment and price stability, lagging employment recovery is expected to keep the federal funds rate low for now.

The European Central Bank unveiled changes to its new inflation target framework following a strategy review. The central bank now seeks to keep to a symmetric 2% inflation target over the medium term, compared to its previous stance of "close, but under 2%." This change allows for more flexibility and would allow for short-term deviations should inflation temporarily overshoot 2%. Markets interpreted the change as "dovish," as the move implies the ECB intends to keep rates lower for longer. Previous ECB macroeconomic projections only saw inflation at 1.4% in 2023. The ECB has shown hesitancy in unwinding support from asset purchases, as such an action could lead to a rise in market rates that could dampen the recovery and inflation dynamics.

China's announcement of an increased scope to its regulatory clampdowns impacted market sentiment. Regulators announced a probe into ride-hailing company Didi over data security, just days after the company's IPO. Soon after, sweeping regulatory changes were announced for education firms, banning companies that teach school curriculums from making profit, raising capital, or going public. Investor concerns spread into the technology sector, which markets worried could be the next to face increasing regulation.

Regulatory concerns impact Chinese stocks in the NASDAQ Golden Dragon China Index



Source: Bloomberg, as of July 31, 2021.

U.S.

GDP grew 6.5% quarter-over-quarter on an annualized basis in Q2, missing market expectations of 8.4%. However, market reaction was muted as personal consumption kept pace with expectations, growing a solid 11.8% annualized. The most significant laggard was investments, which contracted 3.5% on an annualized basis, as dropping inventories subtracted approximately 1.1% from the headline reading. Firms were faced with supply constraints throughout the quarter as demand surged, forcing firms to draw down inventory. This inventory drag is expected to reverse in future quarters as supply issues are resolved.

The U.S. Federal Reserve has also acknowledged the economic progress. Previous meeting statements had stated the Fed would continue its asset purchases program "until substantial further progress" is made toward the central bank's goals of maximum employment and price stability. The tone has since changed: at its last meeting the Fed reported that "the economy has made progress toward these goals, and the (Federal Open Market) Committee will continue to assess progress in coming meetings." This shift confirmed market expectations that asset-purchase tapering is on the horizon and that a more concrete plan will be laid out at either the upcoming Jackson Hole Symposium or September Fed meeting.

The rising COVID case count also had markets on edge as infections steadily increased throughout July. Florida is being watched closely as infections and hospitalizations surge even as 57.7% of the state's population has received at least one vaccination dose. However, reports that the large majority of hospitalizations are unvaccinated individuals have kept markets calm and hopeful that another widespread lockdown can be avoided. U.S. Federal Reserve Chairman Jerome Powell has stated that although downside risks persist with respect to the pandemic, they are expected to be limited as successive waves of COVID have tended to have decreasing economic impact.

The earning season for Q2 is also being closely watched as the quarter is expected to mark peak growth. As previously mentioned, companies will likely have to back up their valuations going forward through strong results as markets shift to a mid-cycle stage. The strong economic backdrop has seen earnings expectations being repeatedly pushed higher. According to FactSet, approximately 60% of S&P 500 Index companies at present have reported results, and 88% of those companies have reported earnings above estimates. Current expectations for S&P 500 Index companies are for an astounding 85.1% increase year over year for the quarter, with double-digit earnings growth rates continuing into the rest of the year.

Overall, we continue to prefer stocks over bonds within our asset allocation solutions, maintaining our preference for higher-quality stocks that have a greater ability to absorb inflationary cost pressures. Higher growth names could also continue to outperform as bond yields remain contained. Within bonds, our fixed income portfolios hold positions in high-yield bonds, which offer an enhanced yield and shorter duration to help absorb any rise in bond yields from their currently low levels.

CANADA

The country's real GDP fell another 0.3% in May as provincial lockdowns continued into the month. Once again, there were notable declines in high-touch service sectors such as retail trade and accommodation and food services. For goods producers, a cooling housing sector also saw construction decline 2.3%. However, the economy looks to be taking a turn for the better. The June reopening should see a significant improvement in activity as consumers are able to spend on high-contact services such as indoor dining and travel. Statistics Canada's preliminary estimate indicates that GDP expanded 0.7% in June. If accurate, this means GDP would be just 0.8% below pre-pandemic February 2020 levels.

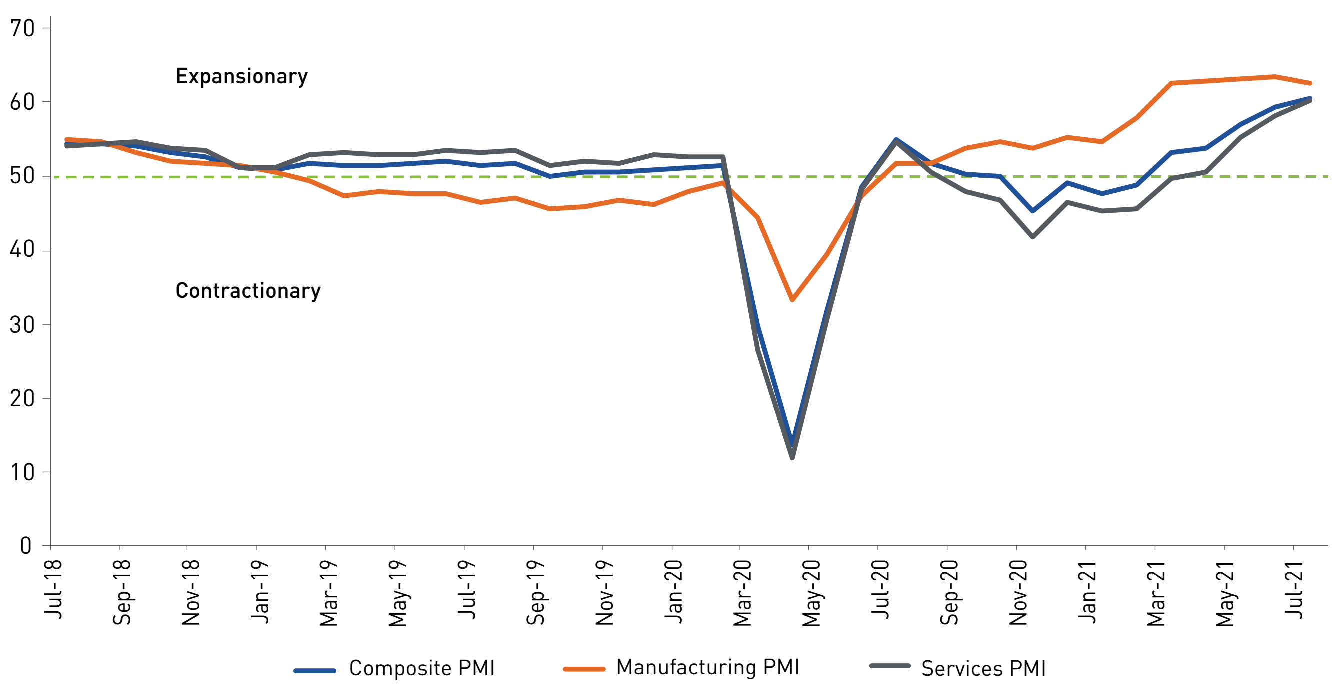
Canada's consumer price index rose a further 0.3% in June. The increase was driven by services increasing 0.4%, consistent with the economic reopening as consumers shifted their spending toward high-touch services. Despite the solid gain, the year-over-year reading slowed to 3.1%, from a previous 3.6% reading in May, as low-base effects roll off and higher-base effects start working against future readings.

The Bank of Canada decreased its rate of asset purchases by another billion to $2B per week going forward. The recent lockdowns and restrictions saw the central bank reduce 2021 growth expectations to 6.0% from 6.5% previously. However, this lost growth was made up for, with 2022 and 2023 projections being revised upwards. Inflation, on the other hand, was revised upwards to 3.0%, before flowing to 2.4% and 2.2% over the next two years as supply chain issues ease and some slack in the economy develops. The BoC affirmed that it remains "committed to holding the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2% inflation target is sustainably achieved," with achievement of the inflation target currently forecasted for the second half of 2022.

INTERNATIONAL

Europe is pushing on with its reopening. A solid manufacturing sector has been the main driver of growth since the onset of the pandemic. Manufacturing growth looks to have peaked in the near term, but sentiment in the lagging services sector has sharply improved as countries enter a new phase of reopening. Travel restrictions are starting to ease just in time for the summer months, and tourism will provide some much-needed support for the high-touch services sector. In fact, this broad-based reopening saw eurozone purchasing managers' indices rise to 21-year highs despite concerns over the Delta variant.

Markit Eurozone PMI continues to rise to 21-year highs, based on July's preliminary readings



Source: Bloomberg, as of July 31, 2021.

The United Kingdom remains of particular interest to markets. The U.K. has targeted a full reopening and has continued to ease restrictions in the face of rising case counts. Infections initially surged but market action was muted as hospitalizations remained low, which markets took as evidence that the vaccine was effective. As restrictions continued to ease, infections look to have surprisingly plateaued mid-July and have started to trend downwards since. There is currently little consensus as to this turn of events, but speculation for its cause has included the end of the Euro 2021 sporting event, general seasonality, herd immunity, and changes in behaviours in response to rising cases. Whatever the reason, data from the U.K. will likely serve as a model for other more vaccinated countries to follow, whether in continuing to reopen in the face of COVID or in dealing with variants.

The ECB unveiled the long-awaited results of its strategy review and changed its inflation target framework. The central bank's previously discussed shift in its stance follows the U.S. Federal Reserve and Bank of Japan, which both have made recent changes to provide themselves with more flexibility in dealing with the crisis and low inflation. In accordance with the change in framework, ECB President Christine Lagarde specified that rates would stay low until the inflation outlook stabilized at 2% over the medium term. This new guidance could see the ECB keep rates lower for longer, as the current 2023 inflation forecast remains at just 1.4%.

The Japanese economy continues to lag the developed world. The Bank of Japan downwardly revised its GDP forecast for the year to 3.8%, from 4.0%. Clusters of COVID infections have resulted in restrictions once again. Furthermore, the hosting of the Olympics led to fears that a renewed wave from visitors could be the catalyst to derail Japan's already fragile recovery, and policymakers largely banned spectators from the games.

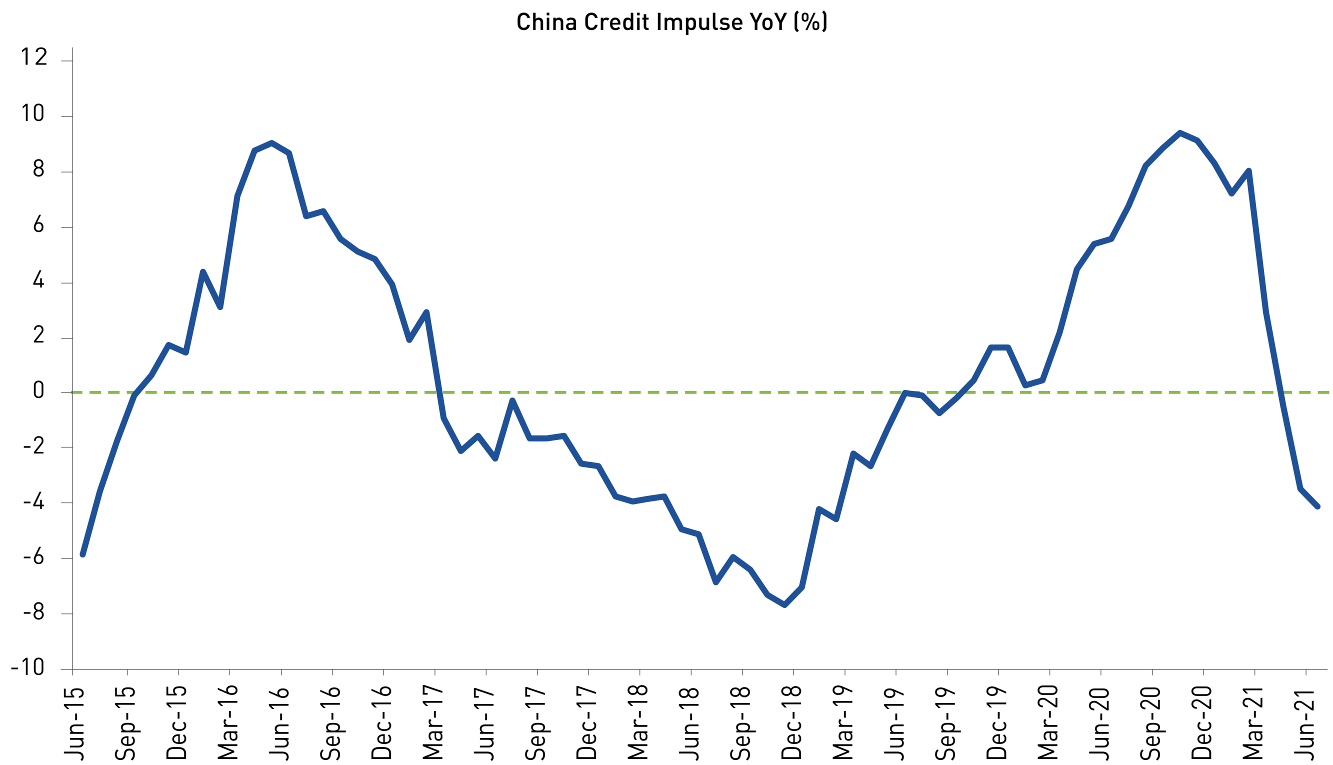
EMERGING MARKETS

In our asset allocation solutions, we have a slightly negative tilt away from emerging market equities. Vaccinations in these economies overall remain below widely accepted herd immunity rates of about 50%–60%. Chinese GDP in Q2 also came in under market expectations, growing at just 1.3% quarter-over-quarter. Overall, the first half of the year could see 3.8% annualized growth in China compared to a previous target of over 6% as Chinese policymakers have focused on reducing financial leverage while positioning to benefit from strong global stimulus.

Overhanging regulatory issues have also been an issue as policymakers look to reduce market excesses. The year started with China clamping down on online payments in a move that hurt both Ant Group and Tencent. Early July saw Chinese regulators launch a probe into ride-hailing company Didi due to data security issues, just days after Didi's IPO. More recently, the government announced sweeping regulations that affected the private education sector, stating that the industry was "hijacked by capital." As previously mentioned, companies that taught school curriculums were banned from making profit, raising capital, or going public. Investor concerns spread to technology stocks, which could be the next to face increasing regulation, resulting in a mild selloff. Market reactions to increased regulation appear to be mostly contained for now as these changes were specifically targeted, though the Chinese government could announce further initiatives.

These recent moves have highlighted the uneasy relationship between global investors and the Chinese government. With the widening gap between U.S. and Chinese technology companies, there is potential for Chinese stocks to rebound as markets regain confidence that the regulatory changes are more or less settled. However, we continue to prefer developed-market equities in light of these uncertainties.

China's "credit impulse" (new financing growth over GDP) has turned negative year-over-year, suggesting peaking growth



Source: Bloomberg, as of June 30, 2021.

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	1.00	2.53	-1.44	-2.52	-2.84	4.66	2.52	3.72
Bloomberg Barclays Global Aggregate (C$ Hdg)	1.26	1.99	0.25	-0.29	0.16	4.57	2.66	4.00
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	0.38	2.04	3.65	3.98	10.34	6.18	6.15	6.30
Equities								
MSCI World (Developed Markets)	2.62	6.34	13.58	12.75	25.88	12.90	13.29	14.08
MSCI World Growth	3.78	8.95	12.90	12.10	25.42	19.63	18.12	16.99
MSCI World Value	1.42	3.63	13.94	13.10	26.09	5.86	8.20	10.97
MSCI Canada	0.69	6.82	18.98	18.03	28.09	8.94	9.28	6.93
MSCI USA	3.17	7.17	15.74	14.95	27.77	16.67	16.15	17.95
MSCI EAFE	1.57	4.39	8.31	7.44	21.44	6.16	8.40	9.03
MSCI Europe	2.68	6.19	12.91	11.58	23.48	6.63	8.89	9.03
MSCI Japan	-0.46	1.45	-1.29	-2.02	16.73	5.16	7.59	9.55
MSCI Pacific Ex Japan	-0.69	0.48	4.77	5.79	20.12	5.45	7.69	8.29
MSCI EM (Emerging Markets)	-5.97	-2.99	-4.98	-1.80	12.43	6.43	9.42	6.43
World Currencies (relative to CAD)								
US Dollar	0.81	1.48	-2.28	-2.01	-6.80	-1.39	-0.87	2.72
Euro	0.80	-0.04	-4.62	-5.04	-6.54	-0.95	0.30	0.77
Pound Sterling	1.46	1.90	-1.06	-0.33	-1.28	0.54	0.05	1.03
Yen	1.95	1.06	-6.78	-7.82	-10.22	-0.74	-2.22	-0.83

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

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