Monthly Market Monitor

September 2021

NEI

HIGHLIGHTS

Stock market gains continue
Global equities rallied to all-time highs for the seventh consecutive month as investors focused on strong corporate earnings and accommodative fiscal and monetary policies over Delta-variant concerns. Volatility in equity markets has been unusually low despite mixed economic data.

Extreme summer weather underscores urgency on climate
This summer has seen several extreme weather events, such as wildfires and floods. These events had a high human cost, but also brought public attention to climate change and other ESG issues. We expect this to continue leading up to the United Nations Climate Change Conference (COP26) in November.

All eyes on the Fed's next tapering announcement
Stock valuations appear expensive compared to historical price-to-earnings multiples. Compared to bonds, equities remain attractive, but these relative valuations could depend on whether the U.S. 10-year bond yield stays low. Consequently, investors continue to focus on the U.S. Federal Reserve's next move.

ASSET ALLOCATION OUTLOOK SUMMARY

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

Global equity markets rallied to all-time highs for the seventh consecutive month as investors focused on strong corporate earnings and the still-accommodative fiscal and monetary policies of central banks, rather than Delta-variant headwinds. Coronavirus case counts and hospitalizations in various U.S. states have risen to new highs since the start of the pandemic. Nonetheless, markets remain optimistic for a return to normal. The U.S. Food and Drug Administration fully approved the Pfizer-BioNTech vaccine, which could lead to further increases in vaccinations as certain employers mandate vaccines and provide the needed push for those who have been hesitant.

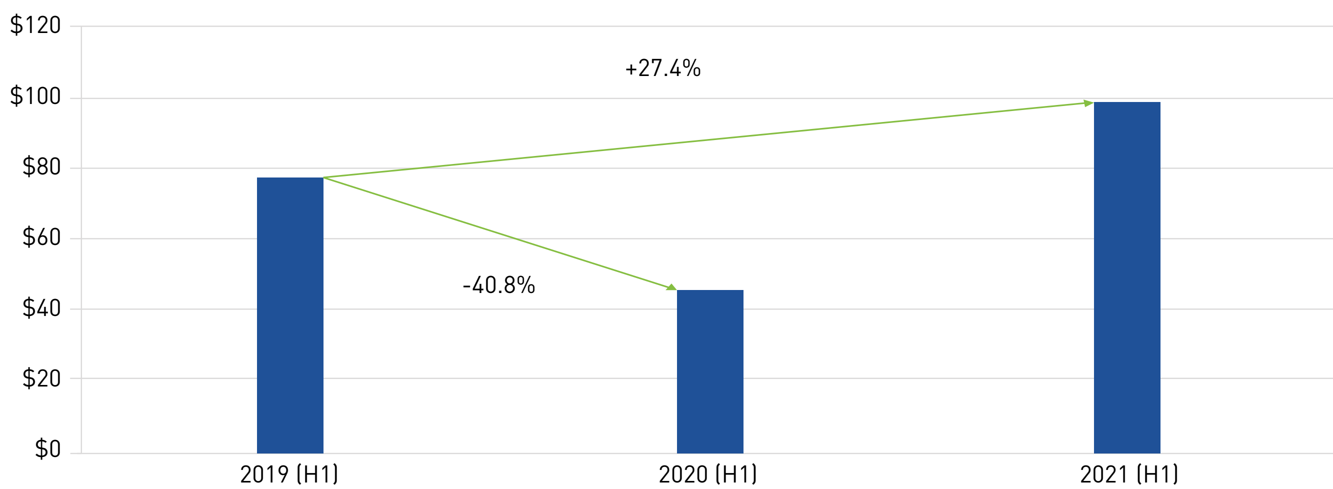
The summer of 2021 has also been concerning because of extreme weather, made worse by climate change. In Canada, the town of Lytton, B.C., set multiple temperatures records (including a Death Valley-like temperature of 49.6°C) before it was devastated by fire. Millions of acres of forest burned in California and the Mediterranean, while Germany and China had to deal with deadly floods and torrential rains. Climate change and other ESG issues are becoming more of a focus for investors, companies, regulators, central bankers, and other financial intermediaries. We expect this to continue leading up to the United Nations Climate Change Conference (COP26) in November.

Equity valuations have been a source of risk for many investors. Most multiples, whether price-to-earnings, price-to-book, or price-to-sales, indicate that equities are expensive on a historical basis. S&P 500 Index valuations are currently at a forward P/E ratio of approximately 20x, compared to a historical range of 8.8x to 22.1x over the last 20 years. However, equity valuations look more attractive when compared to bonds, given that the equity earnings yield is significantly higher than bond yields at roughly 5% compared to just 1.31% on the U.S. 10-year bond. These relative valuations depend on whether the U.S. 10-year bond yield stays low. Consequently, investors continue to focus on the U.S. Federal Reserve's next policy move. At the same time, the effect from rising yields could also be offset by a contracting P/E multiple on strong earnings.

U.S.

The continued equity rally has seen the S&P 500 Index surge over 100% from its March 2020 lows. Impressive earnings results have come through and have contributed greatly to this rally. The Q2 2021 earnings season has seen 96% of companies report in, with earnings surging 94.5% year over year. While pandemic-induced shutdowns led to many companies struggling in the first half of 2020, with earnings declining 40.8% year over year, earnings have come back even stronger thanks to fiscal stimulus and accommodative monetary policy. Earnings in first half of 2021 have more than recovered the loss seen last year, and are now 27.4% above 2019 numbers.

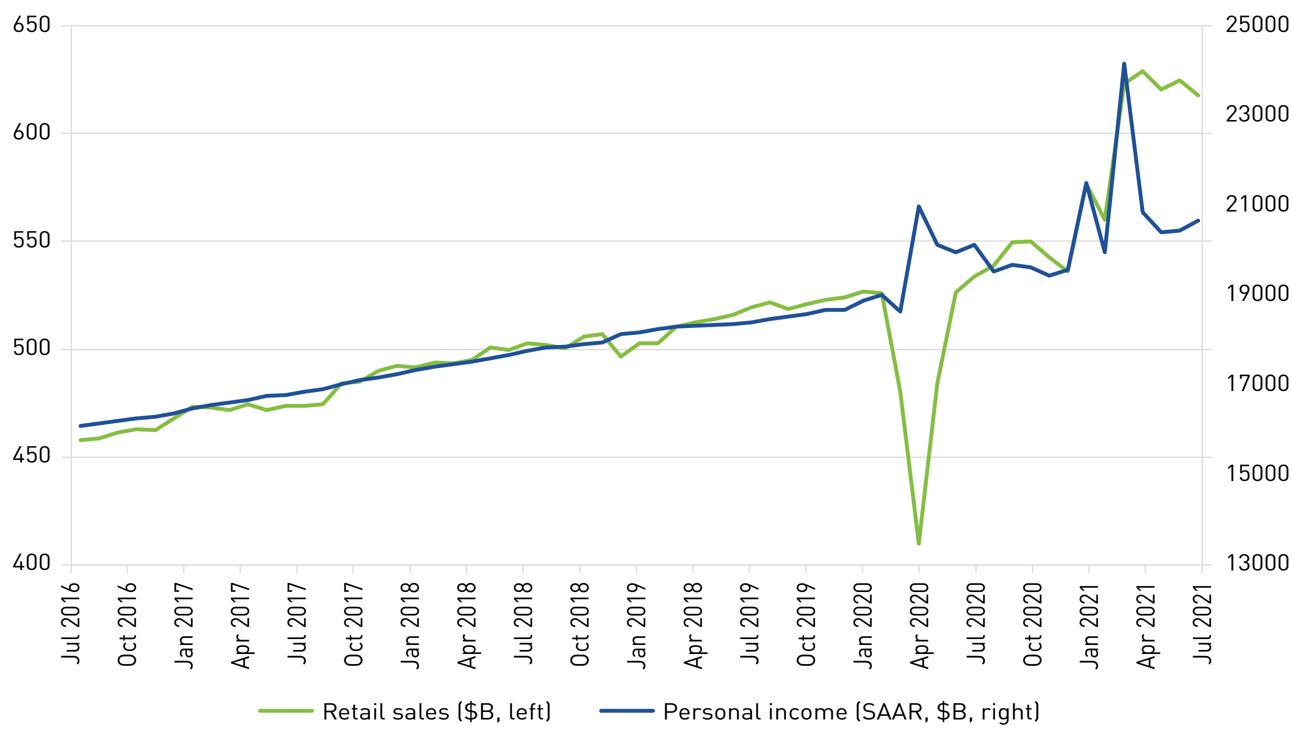
S&P 500 earnings per share (H1, 2021) rose significantly above pre-pandemic levels



Source: S&P Dow Jones Indices, as of August 31, 2021.

Going forward, we may start to see consumer demand wane as U.S. government stimulus starts to roll off. Personal incomes have returned to trend. At the same time, although retail sales declined 1.1% in July, sales remain elevated. There are also expectations that spending will shift back to services from goods as economies continue to reopen.

U.S. personal incomes rise, while retail sales remain elevated



Source: Bloomberg, as of July 2021.

Monetary policy continues to be a focus as investors try to anticipate when the Fed will announce a decrease in monthly purchases of U.S. Treasuries and mortgage-backed securities. Fed Chair Jerome Powell said members of the central bank's Federal Open Market Committee thought it could be appropriate to start reducing asset purchases this year at the Jackson Hole Symposium. The "substantial further progress" goal for inflation has been met, but employment remains a point of contention. Although the consumer price index has exhibited strong year-over-year increases, Powell attributed the gain to supply chain disruptions driving prices higher. Increases have also been concentrated in durable goods, which could see some reversal especially as spending is expected to shift back toward services. The labour recovery meanwhile has been solid but remains below pre-pandemic levels, and the Fed is worried the spreading Delta variant could knock the recovery off track. The lagging employment has been partly blamed on weak supply due to COVID-related benefits disincentivizing some Americans from returning to the workforce. However, this dynamic could shift as benefits roll off starting September, also slowing wage growth—which could also put further downward pressure on inflation.

Views among Fed governors are widespread. There are "hawks" who are worried about persistent inflation and a possible continued inflation run-off above the Fed's targets, while "doves" would like to see a better employment situation. Overall, it seems the Fed believes the U.S. is not yet near maximum employment, and would need more employment readings before it makes a decision on tapering. Fed Chair Powell had also emphasized that the tapering decision is not indicative of the timing of an interest rate lift-off, which again brings up a possibility of lower rates for longer.

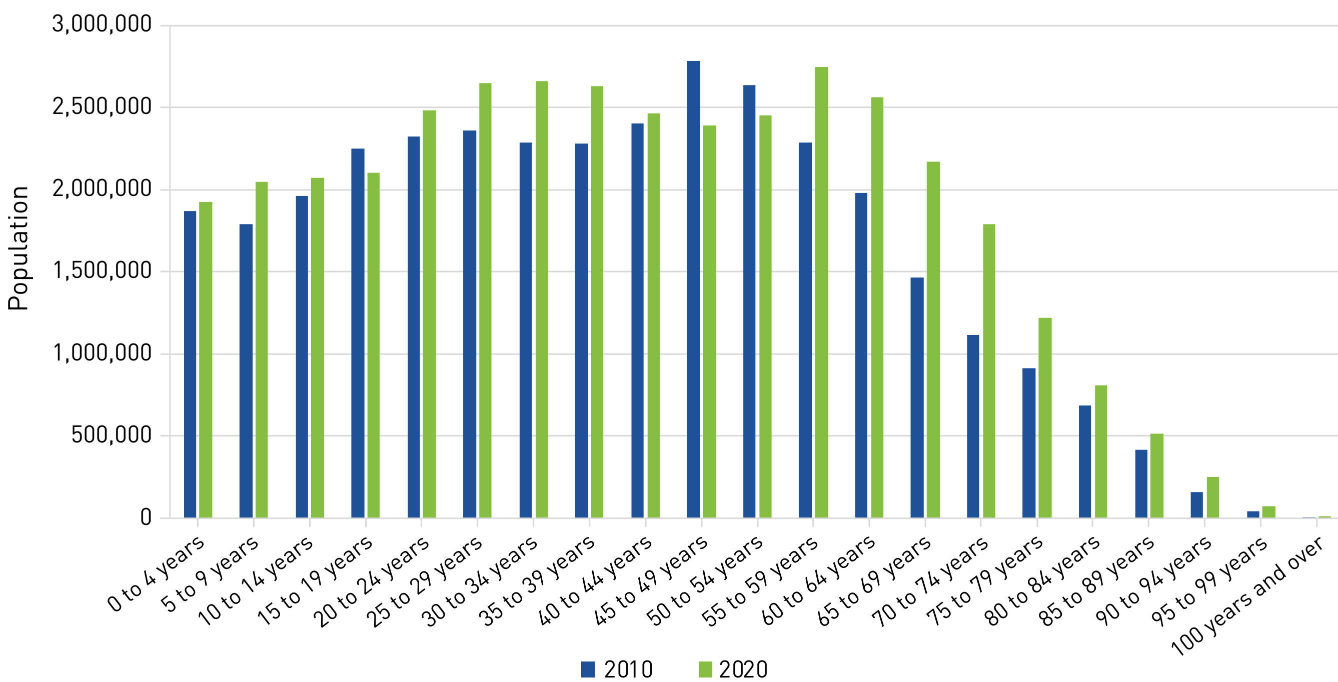
CANADA

The nation's GDP rose 0.7% in June, driven by the easing of public health restrictions resulting in accommodation and food services expanding 15.0% and retail trade growing 4.0%. Overall, Q2 GDP still exhibited a contraction, declining 0.3% due to a drag from exports. Supply chain disruptions and shortages of semiconductors and other inputs resulted in automobile plant shutdowns. This led to lower production resulting in automobile exports dropping 18.9%.

A rising coronavirus case count is slowing the recovery. Preliminary data from StatsCan estimated that July GDP contracted and that retail sales declined in July. Employment rose in July but slower than market expectations. Yet, the public health situation has worsened as Canada appears to be in a fourth wave, with infections trending upwards throughout August. It should not come as a surprise to see further economic weakness in the data to come.

Housing prices have risen across Canada and strong investment in housing has supported the recovery. According to the Teranet-National Bank Home Price Index, prices have risen 17.9% year over year as of July. Low interest rates and a higher savings rate resulting from the pandemic drove the increase. Changing age demographics also appear to be exacerbating the issue. Excluding the 55–59 year age group, the most populous demographics now lie in those aged 25–29, 30–34, and 35–39, representing a large cohort looking to purchase their first homes.

Shifts in Canada's age demographics over 10 years



Source: StatsCan, as of July 2021.

Prime Minister Justin Trudeau called for an early election scheduled for September 20. Trudeau hopes to win a majority in the House of Commons, which would allow the Liberal Party to advance their agenda without relying on support from other parties. The results of the election could determine the path the country will take in terms of COVID aid, pandemic responses, and balancing the books.

Liberal campaign promises include raising corporate income taxes on large banks and insurers, a proof of vaccination fund for participating provinces and territories, and extending the Canada Recovery Hiring Program. The Conservative Party's campaign promises include balancing the federal budget by 2031, restoring millions of jobs lost due to the pandemic while extending wage subsidies and expanding EI benefits, and increasing corporate taxes on foreign tech companies while cutting income tax rates on new patented technologies developed in Canada. Although these two largest parties have received the bulk of media attention, current polling suggests neither is likely to win a majority, highlighting the importance of smaller parties such as the NDP and Bloc Québécois in supporting any governing party.

INTERNATIONAL

European economic activity continues to grow at a strong pace on further reopenings and vaccination rates trending higher. The IHS Markit Flash Eurozone Composite Purchasing Managers' Index pulled back slightly to 59.5 in August, from the 15-year high 60.2 reading in July. Firms reported sustained demand continuing to outstrip supply, resulting in continued cost pressures and rising prices. Supply chain disruptions also appear to be putting on some pressure.

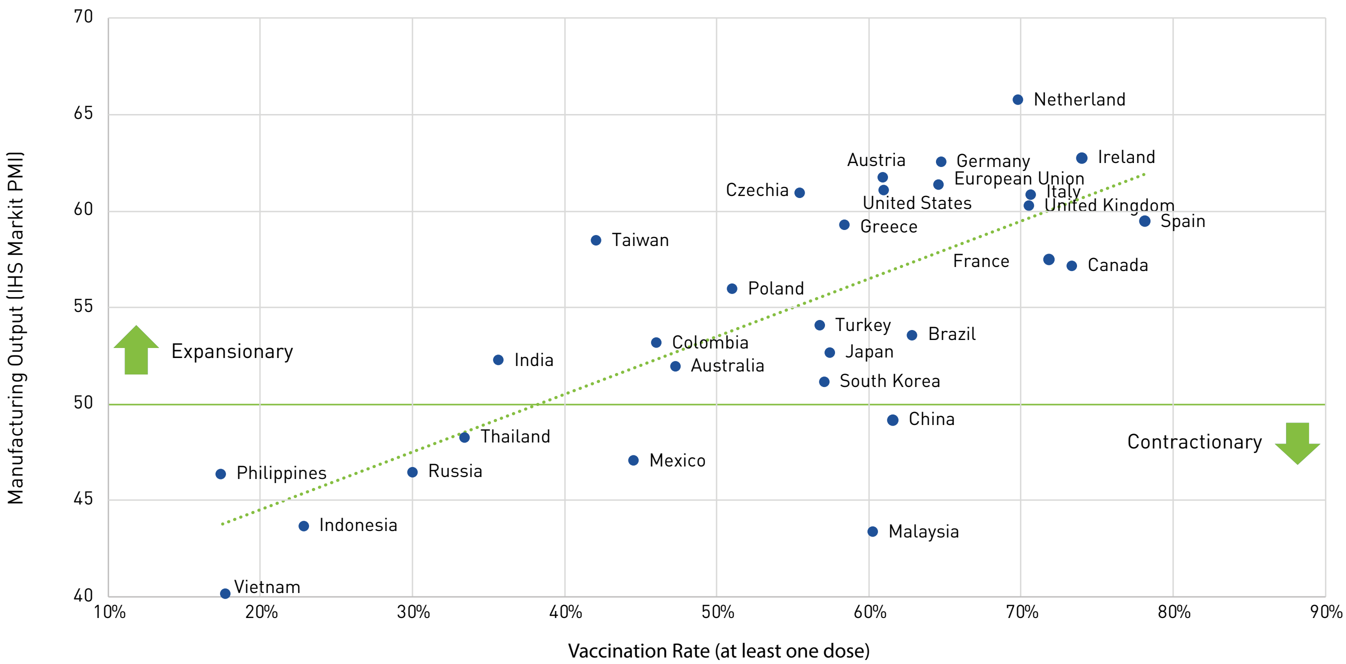
The Bank of England kept its policy steady, and the central bank's Monetary Policy Committee remains mostly content with letting asset purchases continue in the meantime, noting that the recovery is unbalanced and weighted towards goods. This shifting demand has exacerbated frictions in the global supply chain, but these pressures should diminish as demand switches back to services, and inflation in the medium term is expected to slow back to the central bank's 2% target by 2023. More importantly, the BoE also provided some guidance on how its asset purchase program would be scaled back, only ceasing to reinvest the maturing current stock when the bank rate rises to 0.5% and if appropriate given economic circumstances. For reference, the current bank rate sits at 0.1%.

The Japanese economy is still lagging. The Olympics had proceeded in the absence of an audience and restrictions were extended on a rising coronavirus case count. Japan's real GDP expanded just 0.3% in Q2, barely avoiding a second consecutive contraction and consequently a technical recession. Strong consumption and business investment drove the increase, while net exports detracted. Core machine orders had also declined 1.5% in June, but this indicator could be turning around as manufacturers expect orders to rise 11.0% in Q3. Vaccination rates are also quickly improving, with 57.4% of the population now having received at least one dose.

EMERGING MARKETS

We maintain our underweight to emerging markets as the Asia-Pacific recovery continues to lag, driven in part by low vaccination rates seen in the region. Surging case counts in many countries have prevented any semblance of a widescale reopening seen in developed countries. Although the overall economic impact from these economies seems small in comparison to developed economies, there are larger implications especially for downstream supply chains.

Strong relationships between manufacturing output and vaccination rates



Source: IHS Markit, Bloomberg, Our World in Data. As of August 31, 2021. A manufacturing PMI reading above 50 indicates growth, while a reading below 50 indicates contraction.

Economic activity in China, according to data on retail sales, exports, and industrial production, slowed due to the Delta variant outbreak, severe flooding in the country, and persistent supply chain disruptions. Despite the slowdown, the Chinese government is continuing its campaign to reduce financial leverage, and rhetoric surrounding "common prosperity" has become increasingly prevalent and has been a main driving force behind regulatory changes. These moves are showing China's willingness to sacrifice short-term growth to combat inequality and promote more sustainable longer-term growth.

These regulatory changes have resulted in weakened investor sentiment, with some commentators going as far as calling China "uninvestable" as markets weigh the risk of further initiatives. Regulatory risks have always been difficult to price in, and China's recent moves have shown that pleasing investors is not a priority. Despite these changes, however, it looks that the government remains somewhat concerned about economic growth rates. Recently, the People's Bank of China pledged to provide "appropriate money growth," hinting that policy easing could be on the table.

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	-0.12	1.75	0.93	-2.64	-1.83	4.38	2.49	3.59
Bloomberg Barclays Global Aggregate (C$ Hdg)	-0.20	1.56	1.63	-0.49	0.68	4.42	2.63	3.84
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	0.53	2.28	3.82	4.53	9.88	6.13	5.83	6.80
Equities								
MSCI World (Developed Markets)	3.74	10.75	15.93	16.98	25.85	13.77	13.97	15.05
MSCI World Growth	4.57	16.19	18.65	17.23	24.28	20.19	19.21	18.05
MSCI World Value	2.87	5.46	12.97	16.35	27.44	7.01	8.48	11.86
MSCI Canada	1.42	4.63	15.35	19.71	26.79	9.94	9.38	7.21
MSCI USA	4.17	13.19	18.62	19.74	27.34	16.96	16.94	18.83
MSCI EAFE	3.01	6.04	10.11	10.68	22.32	7.86	8.90	10.12
MSCI Europe	2.76	6.67	14.28	14.65	25.29	8.57	9.28	10.22
MSCI Japan	4.33	6.14	2.37	2.23	16.34	6.52	8.29	10.68
MSCI Pacific Ex Japan	1.92	2.09	4.73	7.81	18.99	6.70	8.29	8.83
MSCI EM (Emerging Markets)	3.88	0.29	-1.16	2.00	17.47	8.72	9.58	7.57
World Currencies (relative to CAD)								
US Dollar	1.23	4.60	-0.19	-0.81	-3.02	-1.04	-0.75	2.60
Euro	0.77	0.99	-2.93	-4.31	-4.27	-0.56	0.41	0.58
Pound Sterling	0.20	1.27	-1.74	-0.14	-0.31	0.86	0.24	0.89
Yen	1.12	4.16	-3.20	-6.78	-6.38	-0.73	-1.94	-1.05

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

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