Monthly Market Monitor

October 2021

NEI

HIGHLIGHTS

Market volatility picks up

Equity markets experienced notable levels of volatility in September. The month started at record highs but stocks ended up in negative territory, snapping a streak of seven straight months of gains. This is not surprising given that September and October tend to be the most volatile months of the year.

Tapering conditions for Fed may be near

U.S. bond yields rose sharply following the U.S. Federal Reserve's monetary policy meeting in September. Fed Chair Jerome Powell signaled that tapering of bond purchases could start as soon as the central bank's next meeting in November.

Wall of worries

Many concerns continue to weigh on investors, including slowing global economic growth, rising inflationary pressures, U.S. debt ceiling negotiations, the U.S. Federal Reserve tapering, and the potential Evergrande default. Nevertheless, periods of short-term volatility are not uncommon, particularly around this time of year, and we encourage investors to take a longer-term perspective.

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			This month		
Government Bonds		This month		Last month	
Corporate Bonds			This month		
High Yield Bonds		Last month	This 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 September 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

Equity markets experienced notable levels of volatility in September. The month started at record highs but stocks ended up in negative territory, snapping a streak of seven straight months of gains. This was not unexpected as September and October tend to be the most volatile months of the year, on a historical basis. That stated, there were specific sources of concern for investors as well. These included slowing global economic growth—amplified by worries of the U.S. nearing its debt ceiling—the U.S. Federal Reserve's potential tapering, and ongoing Chinese regulatory restrictions, as well as the more recent possible Evergrande default. Supply chain disruptions also worsened, in contrast to earlier expectations that these problems would start to abate during the second half of this year. These logistical problems have the potential to both slow growth, as short supplies constrain company product sales, and feed higher prices. This slowing growth and rising inflation dynamic puts the Fed in a challenging position.

U.S. bond yields rose sharply following the Fed's two-day monetary policy meeting in September. Fed Chair Jerome Powell signaled that tapering of bond purchases could start as soon as the central bank's next meeting in November, and Fed projections showed that two more of its officials favoured a rate hike next year, compared to the second quarter. The Fed also revised growth expectations downward for the year, while at the same time also increasing unemployment rate and inflation forecasts. The U.S. 10-year Treasury, which had traded at 1.32% the day before the Fed meeting, ended the month at 1.49%.

Higher interest rates also have a disproportionate impact on certain sectors of the stock market. Many technology stocks that trade at high valuations due to strong expected earnings growth are vulnerable to valuation compression when interest rates rise. On the other hand, financials and other economically sensitive stocks tend to do better in a rising interest rate environment. Not surprisingly, growth stocks underperformed value stocks during the month, a trend that we expect to continue.

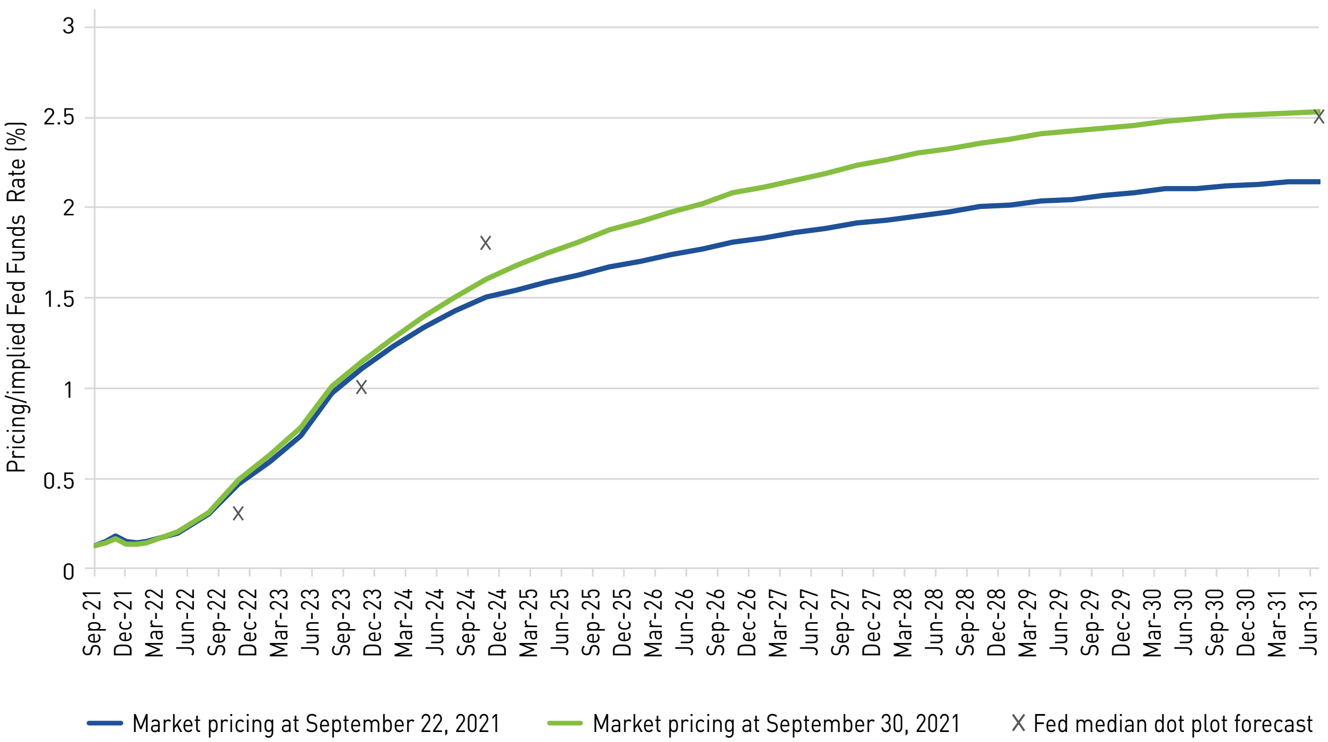
News that Chinese real estate giant Evergrande Group could potentially default on its debt made headlines worldwide, intensifying slowing growth concerns with markets also worried about the potential downstream effects and contagion. The heavily indebted firm missed several bond payments and saw its bond due March of next year trade as low as 25 cents on the dollar. Market concerns decreased somewhat when authorities stepped in. The Chinese government has pushed Evergrande to not default and meet its obligations, while the People's Bank of China injected hundreds of billions of yuan into the financial system through reverse repo injections (an infusion of security purchases from commercial banks with an agreement to sell them back).

U.S.

Fed Chair Powell stated the central bank's "substantial further progress" goal required for tapering could be deemed to be met as soon as the next meeting scheduled for November. Overall, the Fed's inflation target has been met and the Fed has been closely watching the employment recovery, with Powell saying that it would take just a "decent" employment report to meet the test for tapering. In that case, the Fed's views that a gradual tapering process ending the middle of next year will likely be appropriate if the economy continues at its current pace.

Two more Fed officials felt that a rate hike would be appropriate next year in the latest dot plot rate projection. This brings the number of officials that favour a rate hike in 2022 to nine, up from seven in June, but still only represents half of the voting members. However, many question the predictive power of the "dot plot," as it reflects personal views of policymakers and not an official policy position. Furthermore, the resignation of two Fed members due to questions over their stock trading means that the removal of these members' votes, known to lean toward rate hikes to manage inflation, could alter the median forecast to no hikes next year. Nevertheless, investors heard the message that tapering is coming and sent bond yields higher.

Markets react following U.S. Federal Reserve's September meeting; more in line with Fed forecasts



Source: Bloomberg, U.S. Federal Reserve, as of September 30, 2021. Implied Fed Funds rate derived from three-month Eurodollar futures. Fed median dot plot forecasts for the end of 2022, 2023, and 2024, and for long-term estimates.

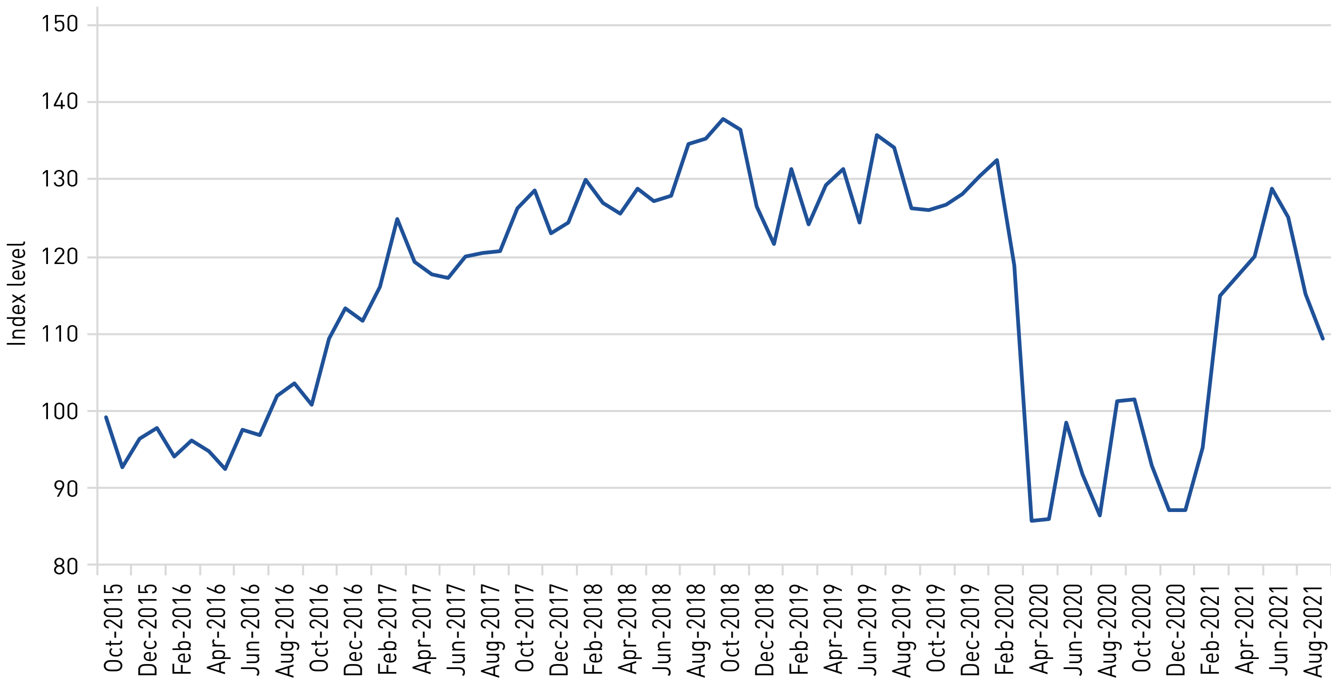
The Delta variant of the coronavirus continues to cast a shadow of uncertainty on the economic recovery, and its effects are being closely watched by the Fed. Any further recovery hinges on having a strong recovery in the labour market. There has been widespread consensus that the roll off of pandemic unemployment benefits could boost employment numbers in the last few months of the year. However, the Fed noted that the Delta variant is changing job market dynamics as healthcare worries resurface and childcare remains an issue as schools are at risk of closing. Recently, the FDA amended its emergency authorization for the Pfizer-BioNTech vaccine, authorizing a booster shot for those deemed highest at risk, including older adults, high-risk patients, and high-contact workers. Boosting protection to those most at risk could keep hospitalizations under control as the economy continues its path forward.

Inflation, on the other hand, tempered slightly in August. The reading still came out at a significant 5.3% year over year, just a notch down from 5.4% in July. Persisting supply constraints continue to cause tensions. Hurricane Ida hit the Gulf of Mexico, and so far the recovery has seen U.S. oil inventories shrink to levels not seen since before the pandemic. The production disruption for oil, combined with strengthening demand, may increase inflation further.

In the U.S. political arena, debt ceiling negotiations have also been a source of uncertainty and volatility in September. The United States Congress will need to raise the debt limit by mid-October so that the Treasury Department can continue to operate and make scheduled payments. In their testimony to Congress, Treasury Secretary Janet Yellen and Powell stated that raising the ceiling is essential, and the consequences of a failure to reach a deal would be severe. Powell went as far as to say that the Fed does not have the ability to protect the economy or financial markets should the U.S. default. In the meantime, politicians have passed a stopgap spending bill to avoid a government shutdown until December 3, hoping to reach a compromise by then.

These factors all look to be feeding into a more subdued level of consumer confidence. Consumer sentiment has steeply dropped in recent months as concerns have increased about the state of the economy and its prospects. Spending intentions for big-ticket items also declined, also in part due to higher prices. This deteriorating optimism is indicating potential weakening in income prospects and consumer spending.

Conference Board Consumer Confidence in U.S. is waning



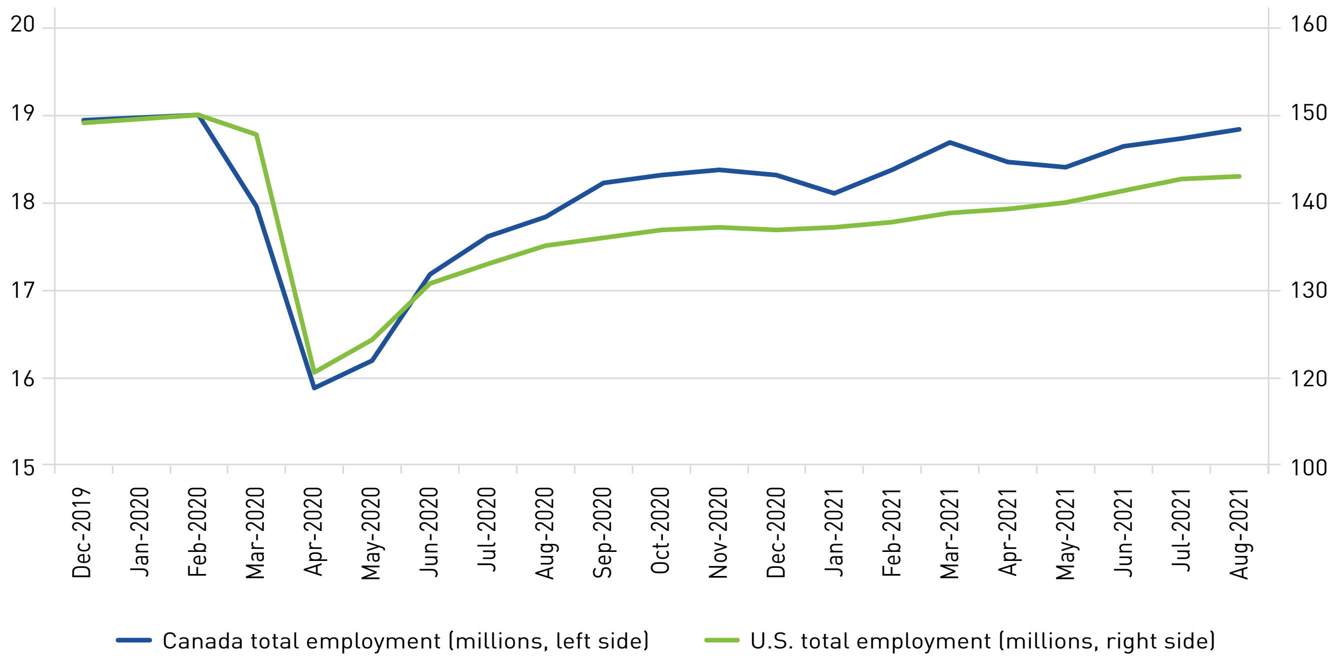
Source: The Conference Board, Consumer Confidence Index; Bloomberg, as of Sept. 30, 2021. The Consumer Confidence Index uses survey data from 1985 as a base of 100.

CANADA

At its latest meeting, the Bank of Canada kept monetary policy unchanged, in line with market expectations, as rates remained at 0.25% and asset purchases continued at a weekly pace of $2 billion. More importantly, the central bank started to look further ahead toward reducing quantitative easing to a reinvestment phase, in which the central bank's total holdings in government bonds is maintained but will not be added to. To do this, the BoC will need to use the proceeds of maturing bonds to purchase new bonds. The central bank is not there yet, stating that it would communicate when the reinvestment phase is live. The BoC did, however, estimate that during the reinvestment phase it would be required to purchase approximately $1 billion a week on average, indicating that reinvestment is not far off. This phase would remain in place at least until rate hikes begin.

Employment continued to rise steadily in August, with the Canadian economy gaining 90.2K jobs. Total Canadian employment has almost seen a full recovery to pre-pandemic levels, with just 156.2K jobs to go. Since the onset of the pandemic, Canada has recovered over 92% of jobs lost, compared to just 76% in the U.S. However, the latest Canadian unemployment rate is 7.1%, compared to lows of 5.6% prior to the pandemic.

Canadian employment levels recovering faster than the U.S.



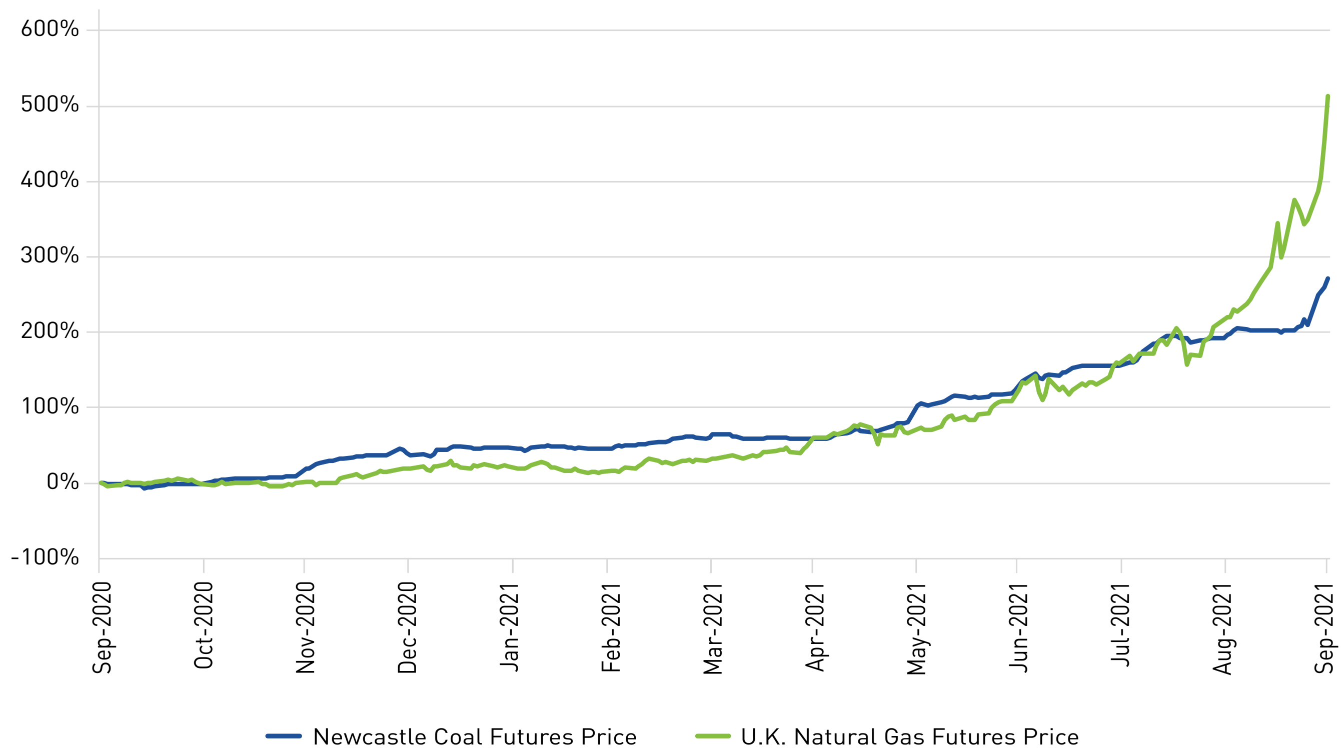
Source: Statistics Canada, U.S. Bureau of Labor Statistics, as of September 2021.

As polls had predicted, Justin Trudeau won the snap election he had called for, but failed to gain the majority government he had hoped for. As of month end, Trudeau's Liberals won 159 seats in the House of Commons, short of the 170 required for a majority (noting that at month end, certain recount, mail-in-ballot, and caucus management issues were still outstanding). Just as before, Trudeau and his Liberal party will need to gain the support of other parties to pass legislation.

INTERNATIONAL

Euro-area inflation accelerated to 3.0% year over year in August, from 2.2% in July. High energy prices were the largest contributor, but all major categories saw prices accelerate with goods also seeing strong pressures. However, the underlying numbers suggest that this increase was due to changes in the timing of summer sales in certain countries, which saw lower prices in July instead of August this year, and also due to supply constraints, as household goods exhibited sharp price increases. Europe could see further inflation pressures from energy as natural gas prices in the region have spiked on worries of a shortage heading into the winter.

Europe's energy prices spiking on low inventories



Source: ICE Futures Europe Commodities, Bloomberg, as of Sept. 30, 2021. Using September 30, 2020, as starting base.

The European Central Bank provided updated inflation forecasts. Inflation for the year is now expected to be 2.2%, compared to 1.9% previously, while 2022 inflation is now forecasted at 1.7%, compared to 1.5%. Nonetheless, ECB President Christine Lagarde seemed to take the inflation outlook in stride, saying that the impact on supply chain bottlenecks remains to be seen and that the ECB is not seeing a significant increase in wages. The ECB also announced it would start to slow the pace of its pandemic-era bond purchase program for the next three months. Lagarde called the move a "recalibration" as opposed to a taper, as the total size of the Pandemic Emergency Purchase Programme of €1,850B was unchanged, and any further decisions on asset purchases would not be made until December.

The Bank of England, on the other hand, came out with a more cautious stance on inflation and policy. The central bank's meeting minutes indicated a less stimulative positioning from committee members, bringing forward a stronger case for an interest rate hike as U.K. inflation is expected to peak above 4% this year. The central bank wants to keep inflation expectations under control while also being wary of possibly disrupting the U.K.'s nascent recovery.

Japanese equities rallied during the month. Prime Minister Yoshihide Suga announced he would not seek re-election and would step down as President of the Liberal Democratic Party of Japan. Infections have also plummeted from a nearly 21K seven-day rolling average case count to under 2K in the span of a month, in part due to vaccination efforts—over 70% of the population has now received at least one vaccine dose. Equities rallied on expectations of potential new economic stimulus under a new leader and the lifting of a COVID-19 state of emergency that has been in place for months, before retreating slightly due to global volatility.

EMERGING MARKETS

China once again made headlines this month, on the possibility that Chinese real estate giant Evergrande Group could default on its debt. Markets were quick to react as the heavily indebted company, which owes more than US$300B, missed an interest payment due date. Investors worried about the downstream effects and contagion this could have on the Chinese economy, as suppliers, employees, and contractors would not be paid and could also face default. The other concern is a tightening in financial conditions, both in China and globally. Evergrande's debts are owned by domestic and foreign banks, which is cause for concern as large losses could see banks rein in lending in response.

Wall Street strategists were quick to play down concerns that the Evergrande fallout was a potential "Lehman Moment" for China, or in other words a bankruptcy that might spark a global financial crisis. In pursuit of its goal of achieving "common prosperity," the Chinese government had introduced new rules to limit speculation, in order to cool the housing market. In response to these changes, banks tightened mortgage lending standards, hampering demand. Evergrande was unable to find sources of financing as a result, which inevitably led the real estate giant into its current state. Markets have always known Evergrande to be a highly leveraged company, and its junk bond rating had reflected that assessment. Even well before its debt concerns made global headlines, Evergrande's stock and bond prices have been falling, reflecting the company's struggles leading up to the potential default.

Current expectations are for what many market observers have coined a "controlled demolition," or soft bailout, of Evergrande to avoid a harder landing. Chinese authorities have already started to make moves: the government has pushed Evergrande to not default and to meet its obligations, the People's Bank of China injected hundreds of billions of yuan into the financial system through reverse repo injections, and a local government purchased a regional bank owned by Evergrande Group while demanding that proceeds be used to settle debts. Even prior to the potential default, the People's Bank of China had started at hinting toward easing monetary policy in response to slowing growth. The Evergrande shock event may see some acceleration toward that policy.

Chinese economic activity continued to slow in August. Retail sales slowed to 2.5% year over year for August from 8.5% in July, and industrial production slowed to 5.3% year over year from 6.4% previously. Furthermore, reports of energy shortages, which have affected homes and businesses, could see economic activity further decrease as factories have been forced to temporarily close in the absence of power.

We maintain our underweight to emerging markets as their recovery continues to lag. Many emerging market countries have struggled to get to the high vaccination rates required to get their economies up and running. In addition, although we do not expect an even more severe global fallout from the Evergrande situation, there could likely be some further contagion that would have a larger effect on China and its regional neighbours.

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	-1.34	-0.48	1.06	-3.95	-3.46	4.24	2.16	3.23
Bloomberg Barclays Global Aggregate (C$ Hdg)	-0.94	0.10	1.08	-1.43	-0.63	4.24	2.44	3.67
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	0.00	0.91	3.67	4.53	11.07	5.95	5.69	7.17
Equities								
MSCI World (Developed Markets)	-3.91	2.30	8.59	12.40	22.18	12.38	12.91	14.90
MSCI World Growth	-4.96	3.14	12.66	11.41	19.59	18.43	17.78	17.88
MSCI World Value	-2.77	1.45	4.66	13.12	24.87	5.99	7.77	11.73
MSCI Canada	-2.36	-0.28	8.11	16.88	26.99	9.42	8.59	7.90
MSCI USA	-4.51	2.62	10.00	14.34	23.25	15.35	15.81	18.42
MSCI EAFE	-2.66	1.85	5.54	7.74	19.25	6.90	8.02	10.23
MSCI Europe	-4.54	0.72	6.59	9.45	20.69	7.09	8.05	10.29
MSCI Japan	3.01	6.98	5.10	5.31	15.77	6.82	8.56	10.49
MSCI Pacific Ex Japan	-3.36	-2.19	0.95	4.19	19.31	6.04	6.95	9.52
MSCI EM (Emerging Markets)	-3.73	-5.97	-2.69	-1.80	12.11	7.86	8.43	8.18
World Currencies (relative to CAD)								
US Dollar	0.25	2.31	0.80	-0.56	-5.16	-0.67	-0.73	1.97
Euro	-1.57	-0.02	-0.61	-5.81	-6.27	-0.74	-0.12	0.49
Pound Sterling	-1.78	-0.15	-1.49	-1.91	-1.08	0.44	0.01	0.51
Yen	-1.29	1.77	-0.18	-7.99	-10.30	-0.08	-2.64	-1.73

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

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