Monthly Market Monitor

November 2021

HIGHLIGHTS

Reopening continues, but momentum is slowing

The global economy continues to recover from the coronavirus-induced shutdown, albeit at a deaccelerating rate.

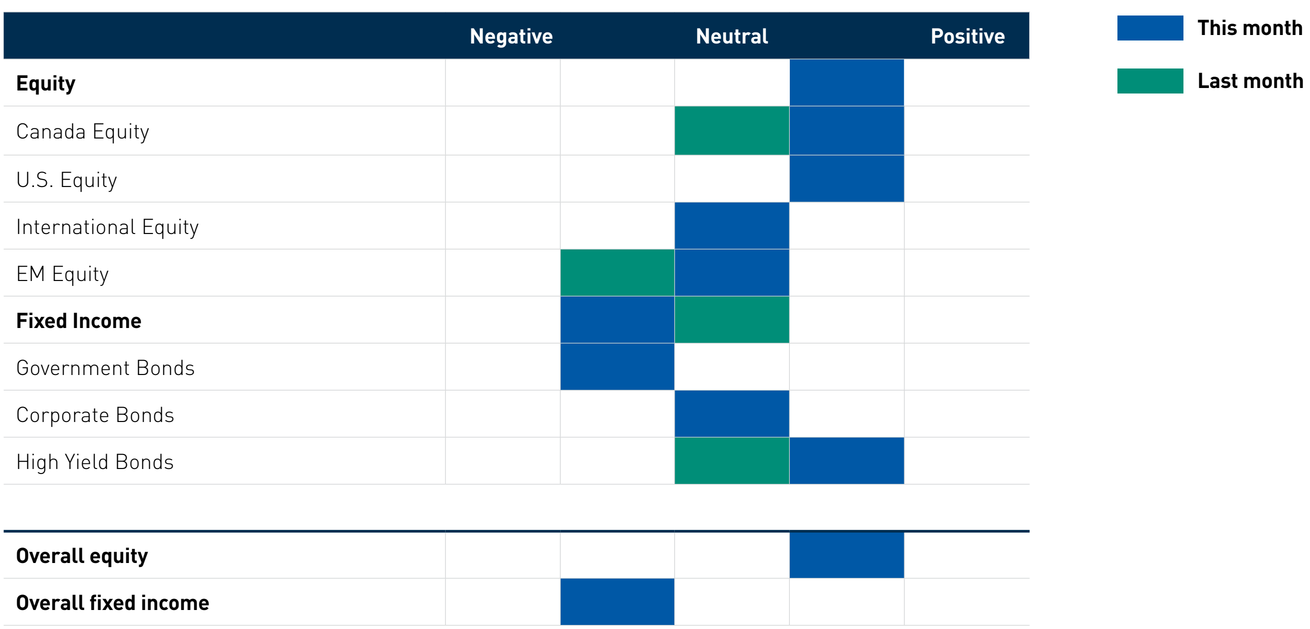
Central banks weigh in on inflation

Inflation worries driven by recovering demand, supply chain disruptions, and now rising energy prices have many central bankers contemplating or starting to remove accommodative measures that have been in place since the start of the pandemic.

Equity market to get back to basics

The gradual removal of accommodative policy signals a move to a more fundamentally driven market in which earnings become a key driver of share-price movement. So far, Q3 earnings have been better than expected, lifting share prices higher.

ASSET ALLOCATION OUTLOOK SUMMARY



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

The mountain of worry and volatility that equity markets built up in September eased as October rolled in. October proved to have been the best month for U.S. equities since the start of the year, with the S&P 500 Index recording its largest monthly gain of 5.7%, helped by the release of strong corporate earnings. With 56% of S&P 500 Index companies reporting results as of October 29, 82% of those companies reported a positive earnings-per-share (EPS) surprise, which is above the five-year average of 76%. However, a few big technology names such as Amazon and Apple posted earnings that fell short of expectations. The S&P/TSX Composite Index also ended the month higher, with only 20% of companies having already reported earnings.

During the month, major central banks acknowledged the accelerated pace of inflation, though most maintained the view that inflation is transitory. Inflation worries have been driven by recovering demand, supply chain disruptions, and now rising energy prices. The year-on-year pace of consumer price increases accelerated in September to 4.4% in Canada, and remained elevated at 5.4% in the United States. There were also signs that inflation broadened beyond the reopening components.

The global increase in energy prices and the accelerated pace of inflation seemingly reflected expectations that central banks may have to recant the transitory inflation narrative and raise rates sooner. As a result, shorter-dated bond yields, such as the two-year benchmark yield, increased notably in both the U.S. and U.K. The two-year U.S. Treasury yield rose to a high of 0.49% in October from 0.28%.

Energy pressures have been felt across global economies, with the U.K, Europe, and Asia feeling the brunt of the squeeze and North American markets also facing similar challenges. As economies reopen, the supply of energy has not been able to keep pace with demand, which has led to marked price increases in natural gas, liquefied natural gas (LNG), coal, and retail fuel sales. This demand has come at a time when inventories should be building up ahead of the heating season in regions of the Northern Hemisphere.

The U.K. and Europe experienced declining renewable power generation, due to factors such as low wind output and dry conditions. Declining renewable power generation and low inventories of natural gas combined were key factors driving electricity prices to their highest levels in years. Disruptions and delays in the delivery of natural gas from pipelines in Russia and Ukraine to other economies in Europe contributed to low natural gas inventories and higher power prices in Europe. We believe current energy pressures magnify the importance of alternative sources of energy, such as renewables, and the importance of building a robust framework for a low-carbon transition energy plan. The U.S. has been able to fare better than Europe and Asia in terms of energy supply, with a more optimal combination of renewable and non-renewable sources of energy.

Natural gas price climbs

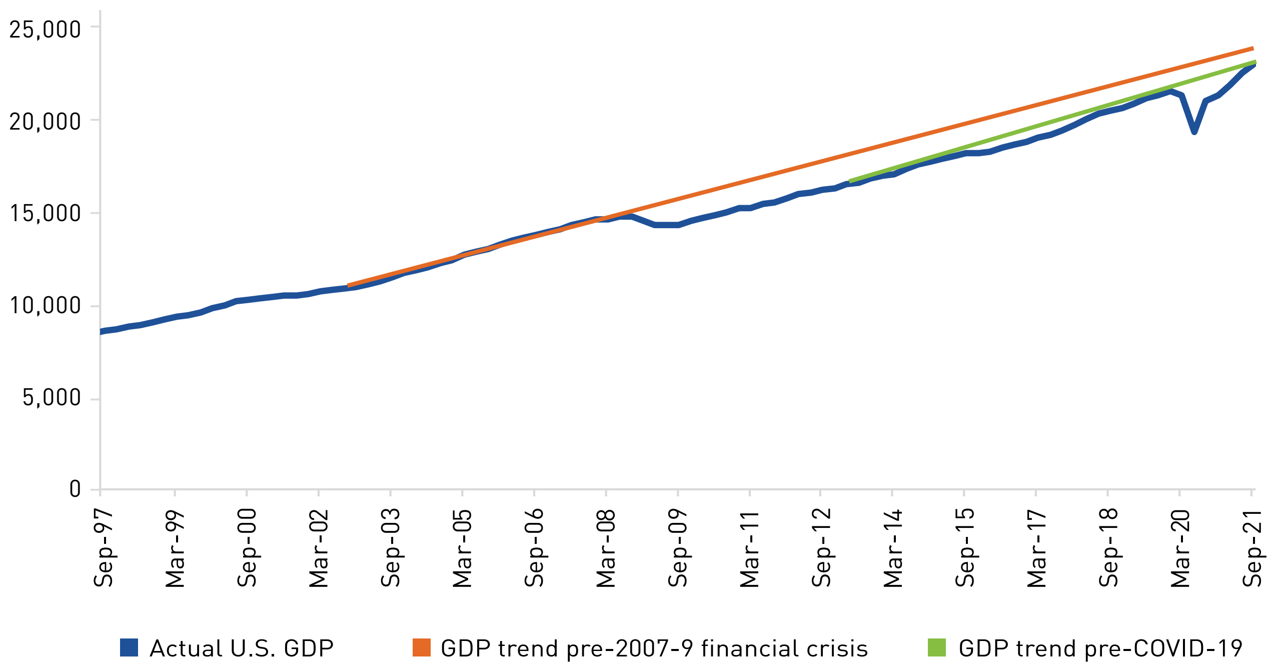
Source: Bloomberg, as of Oct. 29, 2021. Natural gas futures prices measured by the price of the Natural Gas (NYM $/mmbtu) Front Month contract.

In China, the economic slowdown was further confirmed, as Q3 GDP slowed to a pace of 4.9% year on year, relative to the 7.9% year-on-year rate in Q2. The pace of growth also eased quarter on quarter due to pandemic related lockdowns, a slowdown in real estate, and a moderation in industrial production linked to ongoing energy pressures. On the property side, real estate company Evergrande avoided a debt default for the second time by making an overdue interest payment on dollar bonds.

U.S.

The nation reported an advance estimate of Q3 GDP growth of 2.0% (annualized, quarter on quarter), compared with the 6.7% seen in Q2. While the number was softer than expected, there are some encouraging signs. First, the U.S. has now recovered to pre-pandemic trend. This is significant, as the U.S. was never able to recover to trend after the global financial crisis of 2007–9.

U.S. nominal GDP recoveries following major drawdown events



Source: U.S. Department of Commerce, as of Sept. 30, 2021.

Furthermore, the main growth detractors were the concerns over delta-wave infections, which negatively impacted the service sector. Manufacturing input shortages, particularly in the auto industry, also contributed to the slowdown in consumption expenditure to 1.6%. Interestingly, the decline in sales of motor vehicles and parts alone contributed to a 2.7 percentage point falloff in GDP. This suggests that GDP ex-auto sector would have been 4.7% in Q3 which is in line with its pace earlier this year.

As vaccination rates improve and infection rates ease, we expect to see a boost to consumption in the services sector in coming quarters. However, the path of GDP growth for Q4 2021 and subsequent quarters will also depend on how acute supply chain disruptions continue to be. That stated, the growth trajectory continues to be a supply story. Accordingly, any easing of these challenges will provide a stronger path for a more robust pace of growth. Of note, the White House offered an interim solution to supply chain disruptions by announcing that the Port of Los Angeles would begin 24-hour operations, seven days a week.

On the earnings side, Q3 has so far been proven to be a good quarter for U.S. companies, as earnings releases have been more skewed to the positive side. With 56% of S&P 500 Index companies reporting results to date, 82% of these companies have reported a positive earnings-per-share surprise, which is above the five-year average of 76%. Strong earnings from major companies gave a boost to the equities market, with the S&P 500 Index reaching a record level on October 28 to close at a record high of 4,596.42, and the tech-heavy Nasdaq Composite Index jumping 1.39% to close at its own record of 15,448.12.

With a meaningful number of companies having already reported earnings, and beating analysts' estimates, the S&P 500 Index is reflecting higher earnings levels for the third quarter today compared to the expected earnings reflected in the benchmark at the end of the third quarter (source: FactSet). Positive earnings surprises reported by companies in the financials, health care, information technology, communication services, and energy sectors have been the top contributors to the overall increase in earnings for the index.

Given the positive earnings surprises so far, this has propped up the blended earnings growth rate for the index to 36.6% as of October 29, compared to an earnings growth rate of 27.4% at the end of September 30 (source: FactSet). The financials sector leads the pack, having the heathiest blended year-on-year growth rate for Q3 2021.

Year to date, there has been a notable increase in share repurchases. The increased level of buybacks could be attributed to a few factors: companies may want to return wealth to shareholders, in lieu of paying traditional dividends, or companies may have built up excess cash reserves last year during the heights of the pandemic and are now finding uses for this cash. Either way, share repurchases are often bullish for stocks, as the reduction in shares outstanding inherently creates upward price pressure on a stock given that its supply has been reduced. Additionally, buybacks may improve the financial ratios of companies, making them even more attractive. Exxon Mobil has been one of the latest companies to commit to a repurchase, pledging to spend $10B.

Looking ahead to 2022, analysts are estimating a slowdown in corporate earnings from the highs of 2021. Earnings growth of 8.6% and revenue growth of 6.9% are projected for the 2022 calendar year. This slowdown is normal, as year-on-year comparisons get harder in the second year of an economic recovery. However, additional factors such as higher input costs, and slower overall economic growth will also play a role. Corporate earnings growth may become more concentrated in sectors that are able to benefit from higher levels of inflation and interest rates. Going forward, we expect to see moderating broad equity gains and more frequent pullbacks as equity markets get back to basics, with decreasing economic stimulus and markets becoming more driven by company earning fundamentals.

CANADA

At its latest meeting, the Bank of Canada took a more cautious stance on inflation risk, winding up its quantitative easing program that had been in place for more than 18 months. As quantitative easing comes to an end, the central bank will now enter the reinvestment phase, in which the BoC will purchase bonds only to replace those that are maturing so that its overall holdings in Government of Canada bonds remain stable. The target range for purchases will be between $4B–$5B per month, involving purchases in both the primary and secondary market. While it is unclear as to how long the reinvestment phase will last, it is likely that the time horizon will depend on the course and strength of the economic recovery, or at least could remain until the BoC's policy interest rate is raised.

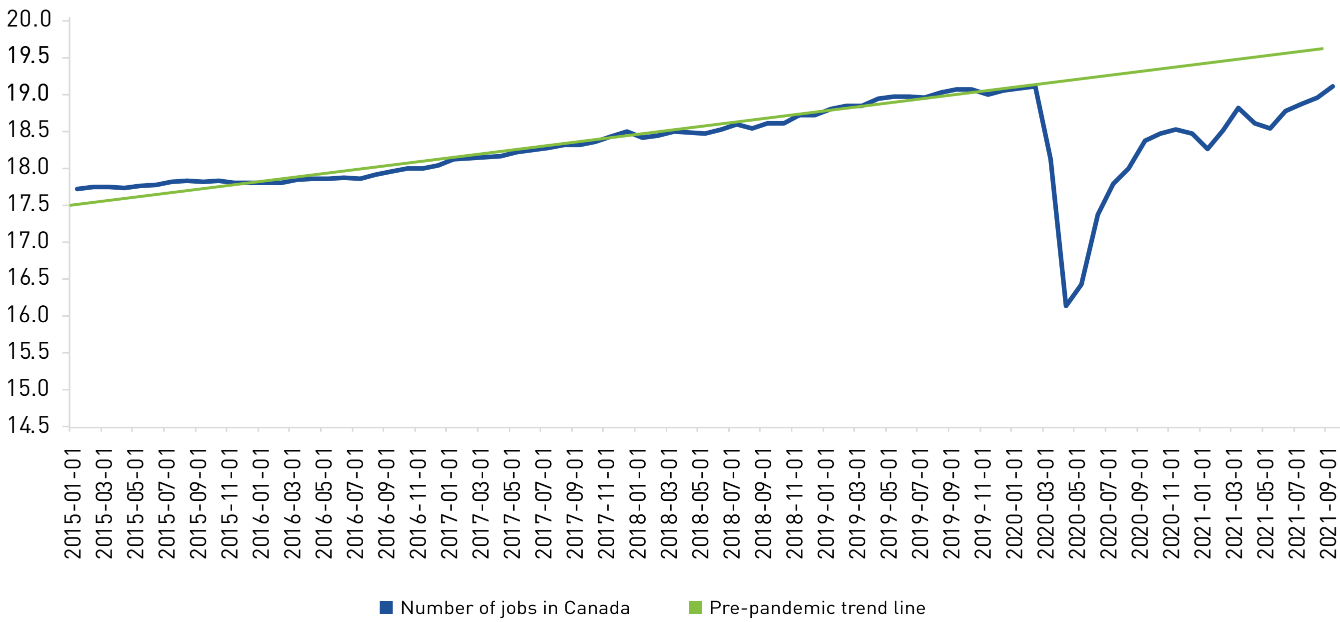
However, the central bank signaled it could raise rates by the "middle quarters" of 2022, as supply constraints challenge economic growth. Given supply constraints and hiring challenges, there are concerns that excess productive capacity could be narrowing, and as such the level of monetary accommodation (i.e., low borrowing costs to support demand) may no longer be warranted. Upon the BoC's more hawkish stance, Government of Canada two-year benchmark bond yields rose to 1.063% and the Canadian dollar strengthened.

While economic progress has been made since the pandemic, the recovery has not been without challenges. The BoC forecasted that annual economic growth will be approximately 5.00% in 2021, 4.25% in 2022, and 3.75% percent in 2023. Global supply chain disruptions and shipping bottlenecks are expected to weigh on growth and boost prices into next year. BoC Governor Tiff Macklem stated that, "The main forces pushing up prices now appear to be stronger and more persistent than expected," adding, "The bank is closely watching inflation expectations and labour costs to ensure that the temporary forces pushing up prices do not become embedded in ongoing inflation."

In September, inflation rose further to 4.4% due to both renewed supply disruptions and the easing of travel restrictions. This increase was slightly higher than consensus estimate of 4.3%. The BoC indicated that it expects inflation to rise to close to 5% by the end of this year, before coming back down to around the 2% target by the end of next year, with medium- to longer-term inflation expectations remaining well anchored to the 2% target.

In terms of employment, Canada has fully recovered all the jobs lost during the pandemic as 151K jobs added in September pushed employment to pre-pandemic levels. However, employment is still below the pre-pandemic trend line for job growth for the last 18 months, which suggests that while a lot of progress has been made in the right direction, there are still some ways to go.

Canadian jobs back to pre-pandemic levels, but remain below trend



Source: Statistics Canada, Sept. 30. 2021.

INTERNATIONAL

Unlike the more inflation-conscious posture from some central banks, the European Central Bank has decided to maintain pandemic stimulus despite rising consumer prices. ECB President Christine Lagarde acknowledged the presence of higher than desired inflation, but was of the view that inflation was temporary, and the economy still needed support from the bank's €1.85T pandemic emergency purchase programme. Lagarde's view on transitory inflation is predicated on the basis that high inflation levels at present are mainly rooted in rising energy prices, recovery in demand (albeit challenged by weak supply), and base effects, with all of these factors considered transitory.

The ECB signaled that it was in no rush to raise rates and would not be overly concerned if other central banks such as the Fed and the Bank of England were to get a head start. The ECB's interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.00%, 0.25%, and -0.50% respectively.

The central bank's communication was not enough to assuage markets that the ECB would remain dovish. Sovereign bond yields rose across the euro area following ECB's October meeting. Investors are now pricing in 22 basis points of rate hikes over the coming year, or two hikes of approximately 10 bps each.

EMERGING MARKETS

An economic slowdown in China was recently confirmed, as GDP in Q3 slowed to a pace of 4.9% year on year, relative to the 7.9% year-on-year rate in Q2, the lowest since 2010. The pace of growth also eased quarter-on-quarter due to pandemic related lockdowns, a slowdown in real estate, and a moderation in industrial production linked to ongoing energy pressures. While industrial production eased, retail sales held up, accelerating from 2.5% to 4.4% year on year in September.

The ongoing slowdown could prompt Chinese officials to offer an economic stimulus package. However, any stimulus would likely be moderate and targeted, to prevent an unintended surge in the real estate market. Over the past few months, the government has been keen on implementing regulations to contain the real estate market, which has historically been a major driver of China's growth. The liquidity and debt repayment problems faced by Evergrande, one of China's largest property developers, in addition to bankruptcies experienced by other property developers, have sounded the alarm on the need to contain the level of debt that these companies can own relative to assets. Chinese authorities have also been trying to limit speculative activity in the property market, which, together with related industries such as construction, account for a significant portion of China's GDP.

Notable challenges for China in the coming quarters include energy supply concerns and possible blackouts, which will limit production. While a stimulus package would present the opportunity to increase demand, if there is no commensurate supply of goods, then this could present inflationary pressures. The ongoing challenges in China will likely continue to weigh on Chinese equities and push long-term government bond yields lower.

With growing challenges in China, this has intensified debates on the merits of splitting emerging-markets investment mandates into China and EM ex China strategies. China's share of the MSCI Emerging Markets (EM) Index is currently 35%, causing many EM investors to have an inherently large exposure. China's dominance in the EM index magnifies the effect of country specific risks, such as changes in regulations, could have on overall benchmark performance.

The benefit of an EM ex China exposure lies in the fact that ex China, regions such as India, Taiwan, and Latin America are less correlated to China's growth and offer different market, sector, and macroeconomic exposures to investors (source: Goldman Sachs). Moreover, there are potential value-add opportunities in these markets considering that they are generally underexplored by global investors.

On a sector exposure basis, the MSCI EM ex China Index is quite distinct from China. The tech hardware and semiconductor sector accounts for 24% in the EM ex China index, 17% in the MSCI EM Index, but only 5% in the MSCI China Index. On the other hand, Internet and consumer retail/tech jointly account for 45% in the MSCI China Index but only 6% in the MSCI EM ex China (source: Goldman Sachs).

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	-1.11	-2.56	-0.10	-5.02	-3.81	4.08	2.14	3.15
Bloomberg Barclays Global Aggregate (C$ Hdg)	-0.25	-1.38	0.57	-1.67	-0.87	4.25	2.60	3.65
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	-0.17	0.36	2.41	4.35	10.36	6.50	5.58	6.55
Equities								
MSCI World (Developed Markets)	3.39	3.07	9.60	16.21	30.55	15.95	13.66	14.71
MSCI World Growth	4.42	3.78	13.06	16.34	29.34	23.46	19.09	17.72
MSCI World Value	2.29	2.31	6.03	15.71	31.68	8.17	8.01	11.50
MSCI Canada	5.30	4.27	11.38	23.07	38.56	13.78	9.48	7.91
MSCI USA	4.64	4.09	11.56	19.65	32.69	19.33	16.87	18.29
MSCI EAFE	0.25	0.53	4.94	8.01	24.74	9.41	8.09	9.77
MSCI Europe	2.25	0.30	6.52	11.92	31.02	10.20	8.83	9.80
MSCI Japan	-5.45	1.62	3.10	-0.43	11.44	7.41	6.65	10.43
MSCI Pacific Ex Japan	1.01	-0.52	-0.04	5.24	21.42	9.11	7.20	8.62
MSCI EM (Emerging Markets)	-1.19	-1.19	-4.15	-2.97	8.73	10.16	7.70	7.23
World Currencies (relative to CAD)								
US Dollar	-2.15	-0.70	0.76	-2.70	-7.03	-1.91	-1.55	2.24
Euro	-2.30	-3.10	-3.14	-7.98	-7.64	-1.21	-0.48	0.35
Pound Sterling	-0.53	-2.11	-0.24	-2.43	-1.44	0.42	0.76	0.58
Yen	-4.26	-4.43	-3.41	-11.90	-14.77	-2.24	-3.14	-1.57

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

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