20 CHARTS FOR 2020

NEI MARKET OUTLOOK
Great global uncertainty leads to... record high stock prices?

Opinions as of December 13, 2019

It’s been said many times that “markets hate uncertainty.” Well, not in 2019.

In fact, data to November 30 show the S&P 500 hit 19 new highs in 2019 and is on track to end the year with a total return of roughly 28% in U.S. dollar terms. The S&P/TSX Composite has also been reaching record highs as it closes in on a year-to-date total return of 22%. And it’s not just equities powering ahead. Bonds have also had a strong year, with some markets delivering double-digit returns (as well as negative yields...).

All this at a time of record policy uncertainty; the U.S.-China trade war; the slowest global economic growth since the Great Recession; the neverending saga known as Brexit; and a U.S. president facing impeachment and an election. And now we can finally add this: a growing acknowledgement of the risk of climate change to the financial system, courtesy of global central banks.

So, what’s next?

To help you prepare for client conversations about what could be in store for markets next year, we offer 20 charts for 2020, assembled in collaboration with many of our global sub-advisors. In one form or another, the charts we’ve included speak to the following main points:

• We do not expect a global recession as central banks maintain accommodative policies, with room for governments to add fiscal stimulus if needed.

• Stocks are likely to rise further, but we don’t expect next year’s returns to be as impressive as last year’s.

• Longer term, we expect equity leadership to rotate out of the U.S. and into international and emerging markets, but we need more concrete evidence the global economy is rebounding before taking a stronger stance.

• Given global uncertainties, bonds will continue to be an important part of portfolios, but expect lower returns than what we got in 2019.

• We expect the policy response to climate change to rise ever higher on the priority list of global financial leaders, which will in turn find its way into asset prices, with both positive and negative impacts.

As we look forward to the 2020s, we expect climate change and other responsible investing themes to dominate the financial headlines. These themes will become more important to our political, regulatory and financial systems, creating opportunity for those willing to adapt and risks for those who are not. As Canada’s leader in responsible investing, we welcome these changes and believe the 2020s will be a decade of true impact, where responsible investors can help improve the world’s environmental and social conditions in meaningful ways.

John Bai, CFA
VP and Chief Investment Officer
NEI Investments
2019: A strong year for most asset classes

Stocks and bonds performed exceptionally well in 2019. Many indices closed not just at or near the highest level of the year, but at or near their highest levels on record.

Source: Bloomberg and Morningstar, data as of November 30, 2019.
The economic backdrop

While we do not see recession on the horizon, we do expect continued slower global growth in 2020.

Downside risks remain elevated as uncertainty abounds.
Secular trends point to slower growth ahead in developed economies

Shrinking workforce + declining productivity growth = lower potential growth across developed economies. Expect this to result in lower equity returns and the ongoing suppression of bond yields.

Working age population as % of total population

Annual change in GDP per hour worked

Global growth increasingly driven by emerging economies

The growth and maturation of emerging economies will present ever-increasing investment opportunities outside North America.

- Emerging economies made up only 25% of the world’s economy in 1980
- By the end of 2019, emerging economies are expected to make up 40% of world GDP

World economy breakdown

Source: International Monetary Fund, data accessed November 30, 2019.
Emerging economies expected to grow at twice the pace of developed economies

Over the next year, the anticipated economic rebound in emerging economies could lead to outperformance of EM equities, debt and currencies.

- Economic growth likely to slow further for developed economies in 2020
- Emerging economies expected to rebound slightly in 2020
- Gap between developed and emerging markets is expected to widen, though downside risks continue to dominate

Source: Amundi Research forecast, data as of November 4, 2019.
U.S. economic growth driven by strong consumer spending

Despite the presence of global macro headwinds, a strong domestic economy will likely prevent a U.S.-led recession in 2020.

- Consumer confidence is an important leading indicator, used to estimate future consumption behaviour
- Confidence tends to stem from job security and wage satisfaction, providing insight into the labour market

University of Michigan Consumer Sentiment Index

Uptick in key leading indicator a sign of hope

Some Composite Purchasing Managers’ Indices may have bottomed in September 2019, with a continued rebound acting as a potential driver of further equity upside.

- Germany and the larger eurozone showing a notable bounce-back
- China, emerging markets rising since June 2019
- Developed markets overall still headed lower – but for how long?

Composite Purchasing Managers’ Indices

Source: Bloomberg, data as of November 30, 2019.
Policy uncertainty at record high, driven by trade tensions

The abatement or escalation of historically high trade tensions can have a significant impact on markets on a day-to-day basis.

- Current concern over trade policy is having a greater impact on overall sentiment than any other factor in recent past
- Risk of U.S./China trade tension spreading to other regions – notably Europe and Japan – has hurt business and investor sentiment

Monetary and fiscal policy

- Central banks have responded to slowing growth by lowering interest rates and increasing balance sheets.
- Additional stimulus from fiscal policy is available if needed.
- Central banks are increasingly turning their attention to climate change as a key risk to financial stability.
U.S. Fed rate cuts may neutralize once-reliable recession indicator

Proactiveness of U.S. central bank is another reassuring sign that a recession may not come just yet.

U.S. yield curve, Federal Reserve rate, and recessions

-300bps -200bps -100bps 0bps 100bps 200bps 300bps 400bps
0% 5% 10% 15% 20%

• Inverted yield curve (dark blue line falling below orange line) has consistently preceded past recessions
• Overly tight monetary policy stifles economic growth, and a closer look reveals the Fed has raised rates in the lead-up to each yield curve inversion
• This time, the Fed has cut rates prior to August 2019 yield curve inversion, preventing a longer and more pronounced period of inversion.

Source: Bloomberg, data as of November 30, 2019.
How much lower can central banks go?

With rates at rock bottom (and below zero), central banks will have to forego a primary policy tool for combatting crisis conditions like what we saw in 2008.

- 2019 saw another wave of global central bank easing amid softening economic data and escalating trade uncertainty
- Most developed nations already have policy rates below the rate of inflation, meaning majority of policy rates around the world are actually negative in real terms

Central bank policy rates

Source: Bloomberg, data as of November 30, 2019.
New ECB president may help shift focus to fiscal policy in eurozone

Christine Lagarde may attempt to improve coordination between monetary and fiscal policies.

- Christine Lagarde took over as ECB president in November, making the case for investing “in a common future that is more productive, more digital and greener”
- Eurozone austerity measures since 2011 have brought down the amount of public investment as % of GDP, so this has significant room to grow

Public investment as % of GDP

Central banks acting on climate change

Almost 50 central banks and regulators have formed Central Banks and Supervisors’ Network for Greening the Financial System, defining best practices in climate risk management.

The importance of climate-related issues for financial stability and monetary policy have become increasingly clear. This is particularly true for Canada, where resources play a vital role in our economy and where the natural environment is a defining feature of our national identity.”

– Bank of Canada Governor Stephen Poloz

Bonds

We don’t expect double digit returns to repeat in 2020 – we’d likely need a recession for that

We emphasize more defensive positioning:

• Higher quality investment grade credit
• Shorter duration
Core bond yields expected to stay low

Yields should stay in a low range as major developed economies continue to experience slow growth next year; expect bond volatility around trade concerns.

Inflation – developed economies

10-year bond yields – developed economies

Source: Bloomberg. Inflation data as of October 31, 2019; bond yield data as of November 30, 2019. 2019–2021 projections are based on Bloomberg consensus estimates. Bloomberg consensus estimates for both inflation and bond yields are indicated with dotted lines.
Respect credit cycles

U.S. firms are more leveraged than ever, but this risk is not currently reflected in credit spreads.

- Historically, high yield spreads have been closely correlated with an increase in corporate debt.
- Since the 2008 financial crisis, loose monetary policy has lowered borrowing costs and encouraged corporations to take on more debt.

**U.S. corporate debt versus credit spreads**

Stocks

» We expect equities to outperform bonds over the next year

» Regionally, we see opportunity in international and emerging market equities

» From a style perspective, value may be making a comeback
U.S. by far the strongest stock market since 2009 crisis low

The longest bull market on record has helped drive the S&P 500 to a gain of more than 300%, while the S&P/TSX Composite, MSCI World and MSCI Emerging Market indices have lagged significantly.

Total equity returns for major regions (C$)

International equities: comparable earnings growth, cheaper valuations

While rest of the world has lagged the U.S. in terms of historical equity performance, the fundamentals favour international equities going forward.

Equity characteristics: U.S. versus rest of world

Source: Factset, data as of November 2019. Index shown for comparison purposes only.
Lower interest rates supportive of equities

Equity risk premiums (ERP) have risen globally versus year-ago levels; ERP around the world suggest equity markets outside the U.S. hold more opportunity.

The equity risk premium is the difference between the earnings yield and the 10-year U.S. Treasury, representing the “extra” return you receive for owning equities over bonds.

- **CANADA** ERP Sep 2019: 5.8%
- **U.K.** ERP Sep 2019: 7.6%
- **CHINA** ERP Sep 2019: 5.8%
- **GERMANY** ERP Sep 2019: 8.3%
- **JAPAN** ERP Sep 2019: 7.8%
- **BRAZIL** ERP Sep 2019: 0.8%
- **U.S.** ERP Sep 2019: 4.2%
- **AUSTRALIA** ERP Sep 2019: 5.1%

Numbers may not sum due to rounding. Source: FactSet, MSCI and AB, data as of September 30, 2019.
Canadian equity dividend yield higher than long bond yield
Investors can earn better income from stocks than bonds, but volatility risks are higher with stocks.

- Bond yields and inflation have both been falling on a secular basis since the early 1980’s
- The dividend yield on the Canadian stocks have slowly risen over the past twenty years
- On a cross-asset class basis, data suggest stocks are likely the better investment from a yield perspective, though full equity valuations plus elevated macro risk warrant a cautious approach

S&P/TSX dividend yield versus 10-year Govt Canada bond yield

Source: Bloomberg, data as of November 2019.
Value stocks underperformance versus growth stocks near record levels

Value stocks displaying compelling risk/reward characteristics

Rolling 10-year total return difference: FAMA-French HML (value vs growth)

- Relative to growth, value is experiencing its weakest performance in nearly 8 decades
- Underperformance gap between value and growth exceeds that of the tech bubble and is second only to the Great Depression
- Opportunities to find quality and value have opened up in industrials, financials and energy sectors

Source: Kenneth French, QV Investors, Data as of December 31, 2018: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
The global plastics problem – an opportunity for the responsible investor

From 1950 to 2015, plastic waste production has soared across major sectors.

The transition to a more sustainable economy presents opportunities for investors and risks to companies that choose to ignore strong trends in changing consumer preferences for more sustainable products, advances in technology and innovation, changing global regulations, and the impact of larger societal factors.”


IMPAX Asset Management
The “first corporate casualty of climate change”


- PG&E named the “first corporate casualty of climate change” by The Wall Street Journal
- After facing more than US$30 billion in liabilities related to wildfires, PG&E sought bankruptcy protection in January 2019
- The utility company has been found responsible for the destruction of hundreds of acres of land

Stock Price of PG&E

Source: Bloomberg. Data as of November 27, 2019.
Too few companies reacting to the challenges of climate change

The Transition Pathway Initiative says 21% of companies do not disclose enough information to allow investors to understand their exposure to the transition to a low-carbon economy, presenting an opportunity for shareholder engagement.

Alignment to Paris Agreement benchmarks by sector

2020 should be the year when a strategic focus on climate change becomes a necessity and those companies who are ahead of the trend should flourish. Investors can play an important part in this by engaging with companies to facilitate and encourage the transition, particularly in those sectors which continue to lag.”

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The bottom line

We remain optimistic the economic cycle will continue to be supportive of stocks over bonds, though as always, we take a balanced approach in our portfolio solutions to insulate investors from ongoing volatility and the potential for a more pronounced downturn.
The outlook

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