

HIGHLIGHTS



Central banks stay focused on inflation mandate

Central banks continued to press forward with aggressive rate hikes as they remain laser focused on combatting persistently high inflation. Synchronized monetary tightening is resulting in weaker economic forecasts for the rest of the year. Though easing commodity prices may present a silver lining, higher core inflation points to higher rates ahead.



New UK economic program causes market chaos

New UK Prime Minister Liz Truss unveiled a new economic program aimed at sparking economic growth that included aggressive tax cuts sent UK bond and currency markets into a panic. As a result, UK bonds experienced their worst quarterly drop ever and the Sterling hit a new low against the US dollar, causing the Bank of England to intervene.



Global economic growth forecasts weaken in 2023

The OECD forecasts weaker economic growth for the remainder of the year and further weakness in 2023. The slowing growth is due to the many factors that have plagued markets throughout the year including rising energy and food prices, persistent inflation and tightening monetary policy. China appears to be the only country set to rebound in 2023.

ASSET ALLOCATION OUTLOOK SUMMARY

| | Negative | Neutral | Positive |
|----------------------|----------|--------------|--------------|
| Equity | | | |
| Overall Equity | | ■ This month | |
| Canada Equity | | ■ This month | |
| U.S. Equity | | | ■ This month |
| International Equity | | ■ This month | ■ Last month |
| EM Equity | | ■ This month | ■ Last month |
| Fixed Income | | | |
| Overall Fixed Income | | ■ This month | ■ Last month |
| Government Bonds | | ■ This month | ■ Last month |
| Corporate Bonds | | ■ This month | |
| High Yield Bonds | | ■ This month | |
| Cash | | ■ 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 31, 2022. 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.

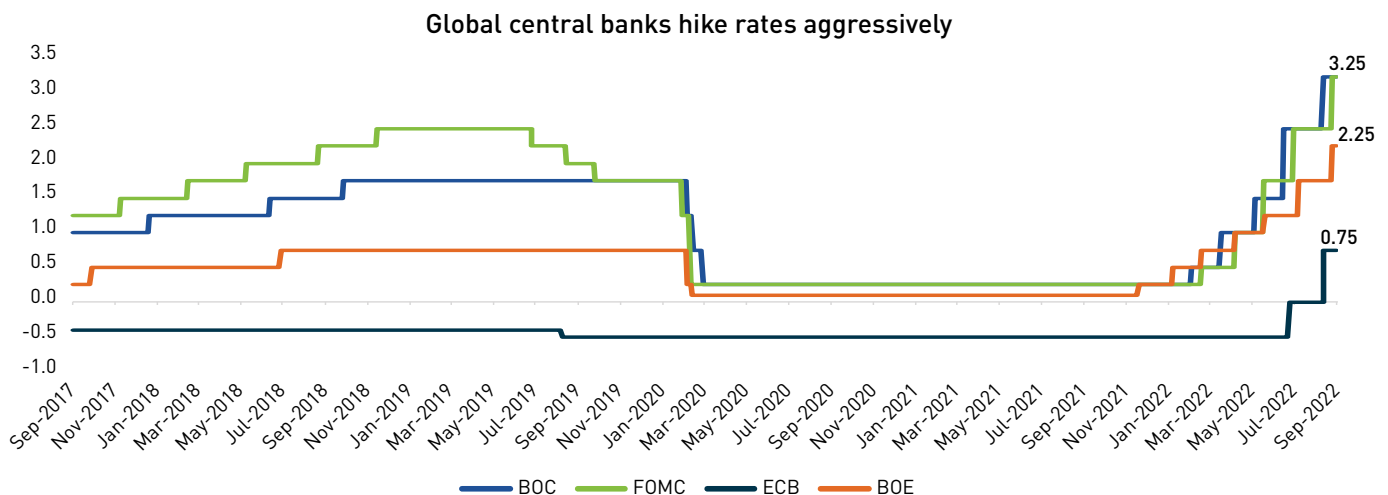
OVERVIEW

In September both equity and fixed income markets saw steep selloffs as global financial markets continue to factor in the synchronized policy tightening by central banks and weakening economic conditions. Global economic forecasts were revised lower, pointing to a slow second half of 2022 and to weaken further in 2023. Volatility was acute in the bond markets with rate hike expectations rising sharply. The latest inflation data remained hot which caused investors to reassess how much higher the peak policy rates will need to be to bring inflation back to the 2% range, and whether the economy can withstand these rates without going into a recession.

The biggest story of the month was the unveiling of a stimulative fiscal package from UK's new government that caused panic to UK bond and currency markets. Economists and central banks criticized the package claiming it could further exacerbate inflation and result in more rate hikes. In response to the announcement UK bond markets sold off by a historical -20.1% and the Sterling fell by -0.8% against the USD in September, down 16.0% year over year. The moves in the UK reverberated across global markets, with German and Italian bonds falling sharply, as well as a significant, though more muted, moves in the US Treasuries. The threat of economic dysfunction forced the Bank of England to intervene by buying long-dated bonds in order to calm the market. The Bloomberg Global Aggregate Index closed the month down -3.36%, while U.S High yield also fell by -4.17%. Sentiment indicators now shows that markets are in oversold territory. The S&P 500 Index closed the month down by -4.85%, S&P/TSX Composite Index by -4.01%, while MSCI World Index was also down by -4.83%.

CENTRAL BANKS STAY FOCUSED ON INFLATION MANDATE

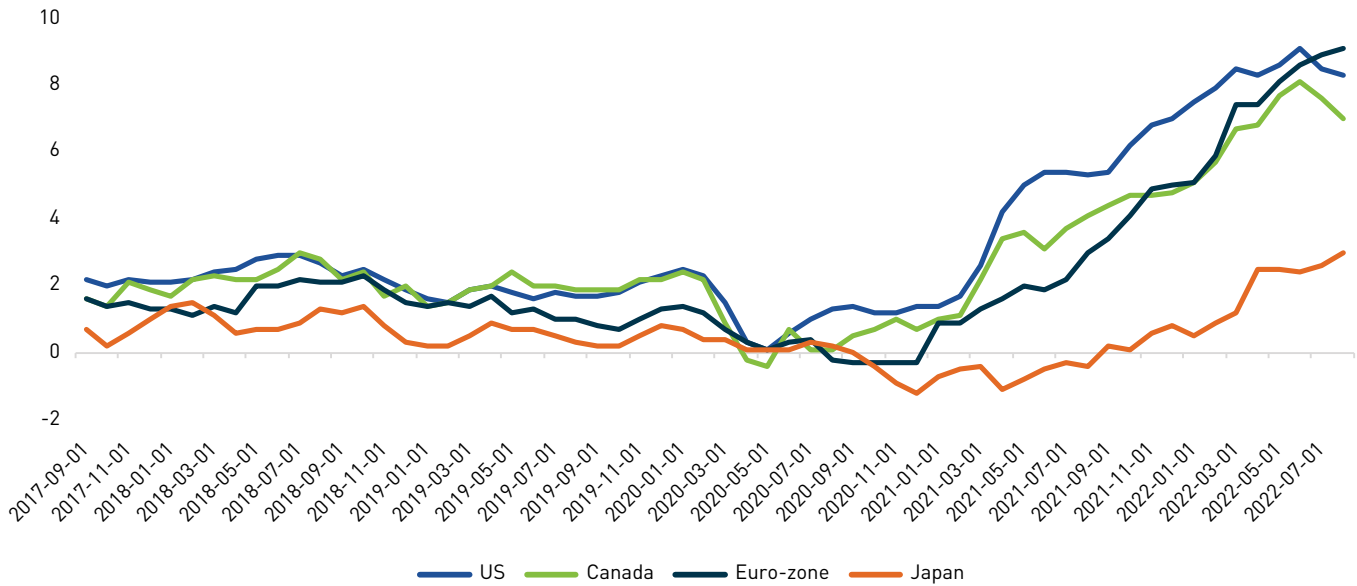
In September, central banks made it clear that they are singularly focused on inflation and intend to follow through on their hawkish rhetoric, as many of them delivered outsized hikes on policy rates. The BoC was first out of the gate, raising rates by 75 basis points (bps) to 3.25%, a move that was widely anticipated by the market. The BoC re-iterated the need for rates to rise further, with the pace of hikes being guided by its ongoing assessment of the economy and the rate of inflation. Other central banks followed suit, with Sweden's Riksbank hiking by 100bps, the Bank of England and Swiss National Bank lifting rates by 50bps and 75bps, respectively. ECB also delivered an unprecedented 75bps hike, lifting rates to 75bps. Bank of Japan only exception to hold rates unchanged. The U.S Federal Reserve also delivered its third consecutive 75bps rate hike, while revising the inflation projections upwards for 2022, and revising economic growth projections downward for 2022, 2023, and 2024. Based on the revised rate projections by the FOMC Committee, the Fed now anticipates rates reaching 4.4% by the end of this year, meaning a little over 100bps of hikes remain. Investors fled en masse as global markets slid, repricing to reflect the synchronized tightening, with equities selling off and bond yields rising across the developed markets.



Source: Bloomberg data as of Sept 30, 2022.

High gas prices are still driving Eurozone’s headline inflation higher, with prices up 10.0% year-over-year in the latest reading. By contrast, headline inflation in North America is starting to ease as commodity prices retreat, latest reading in August in Canada and the US both eased, to 7.0% and 8.3% respectively. Core inflation, which is a better indicator for policy rate decisions, are still getting upward pressure due to rising wages and shelter inflation in what continues to be an extremely tight labour market. Core inflation fared better in Canada, which eased to 5.2%, vs. the US which continued to rise to 6.3% y/y, from 5.9% in July. Both central banks vow to stay hawkish, but given weakness in the housing market and softening of the jobs market, it is likely that the BoC could reach its terminal rate sooner than in the U.S.

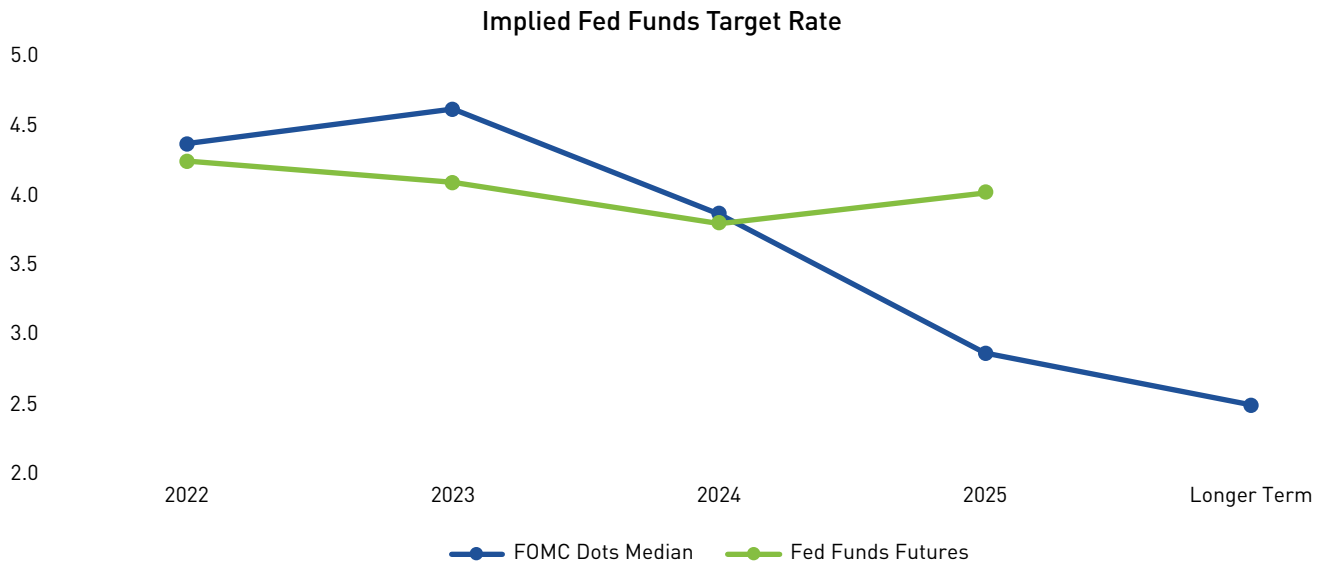
Headline inflation remains elevated in major economies



Source: Bloomberg data as of Sept 30, 2022.

The path of future rate hikes and where policy rates peak in this tightening cycle ultimately depends on how quickly inflation can moderate back to an acceptable level. As inflation remains high in stickier areas such as wages and shelter, central banks are under pressure to continue tightening monetary policies further into restrictive levels, presenting a greater risk of causing a recession as financial conditions tighten.

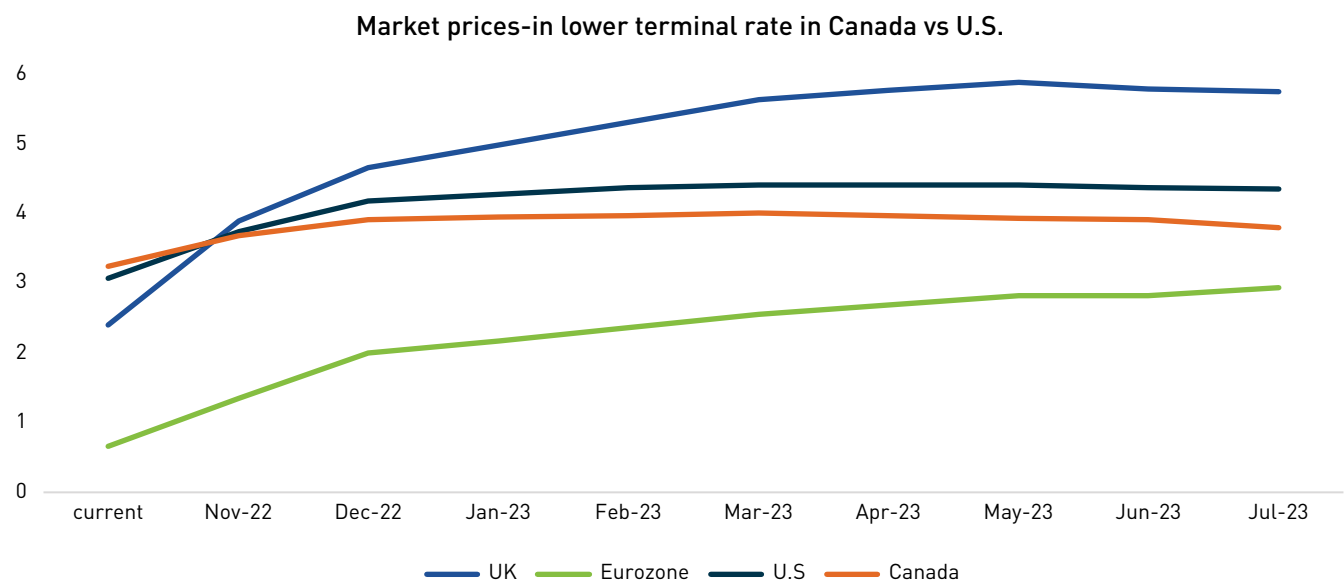
As implied by the Fed fund futures, the market is expecting policy rates to peak at 4.25%, lower than what the Fed is expecting rates to be as indicated by the dot plot on September 21. This suggests that the market is more pessimistic, believing that economic conditions will deteriorate to the point that the Fed will likely pivot towards more dovish policies by next spring.



Source: Bloomberg data as of Sept 30, 2022.

Divergence between UK’s monetary and fiscal policies exacerbated bond market risks this month, as the stimulative fiscal policies threatened to heighten the need to hike rates more aggressively to combat inflation. Overnight futures and swap markets are now pricing in peak policy rates in the U.K at close to 6% by May of next year, over 1.5% higher than at the beginning of the month.

In Canada, the market expects that it will reach terminal rates sooner and with a lower peak rate of around 4% relative to the U.S at around 4.4%, as conditions are already showing signs of softness.



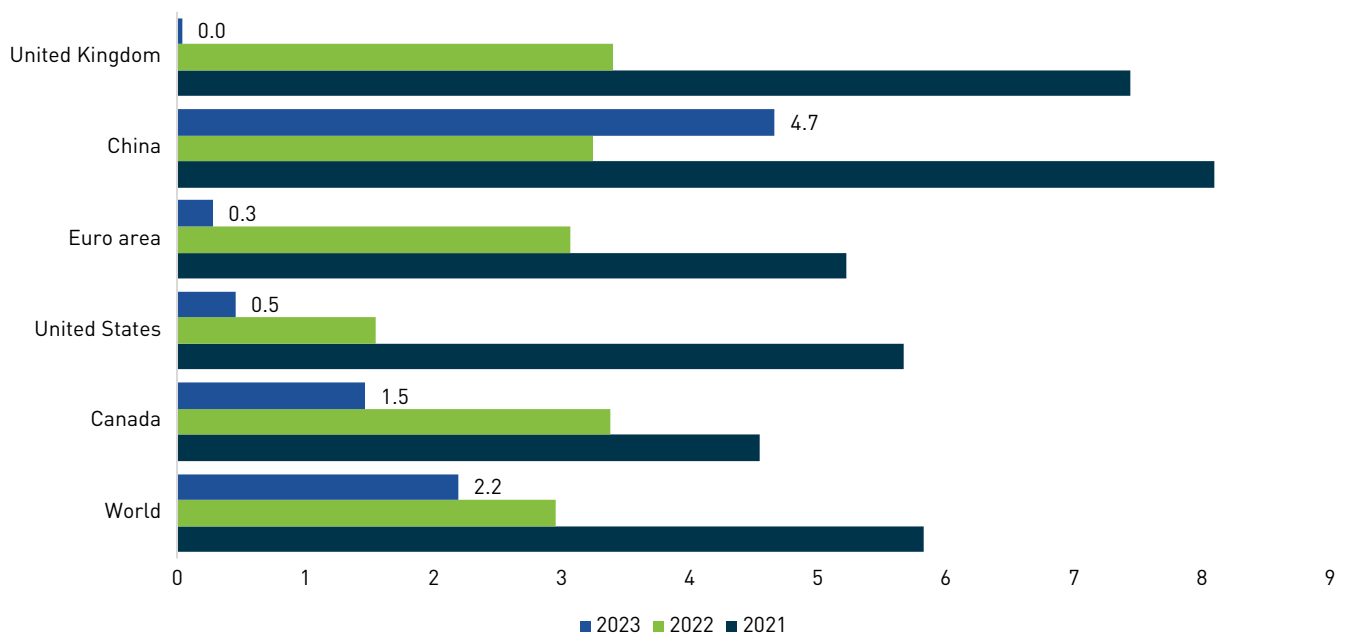
Source: Bloomberg data as of Sept 30, 2022.

GLOBAL GROWTH PROSPECTS WEAKEN

In the OECD interim economic outlook report in September 2022, the war between Russia-Ukraine was cited as a significant catalyst which exacerbated the prices of energy and food, at a time when cost of living was already rising around the world. As a result, Global growth is projected to remain subdued in the second half of 2022 and to weaken further in 2023. One key factor slowing global growth is also the ongoing tightening of monetary policy in most major economies in response to the greater-than-expected overshoot of inflation targets over the past year. In addition, the erosion of real disposable household incomes, low consumer confidence and high prices for some energy products, especially natural gas in Europe, will negatively affect both private consumption and business investment.

In China, fiscal support package worth up to 2% of GDP designed to strengthen infrastructure investment, plus the re-opening effect from COVID-related restrictions later this year, are expected to help growth in China to recover to 4.75% in 2023 after unusually weak growth of 3.2% in 2022.

OECD Expects global growth to weaken in 2023



Source: OECD (2022), OECD Interim Economic Outlook, September 2022.

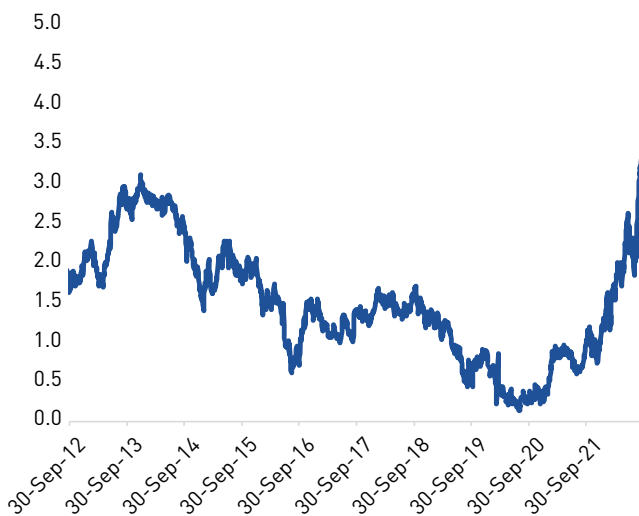
CONFLICTING MONETARY AND FISCAL POLICIES IN THE U.K SENDS SHOCKWAVES ACROSS MARKETS

Following a 50bps rate hike in early August in an attempt to tame UK's rising inflation, the new government under the leadership of freshly minted Prime Minister Liz Truss unveiled this month a massive package which included £45 billion in tax cuts and £60 billion in energy support over the next six months. The central bank will finance the package by issuing debt, which in essence is a form of quantitative easing. The policy caused concern in the market as the fiscal measures would be potentially putting more upward pressure on inflation at a time where the BoE, through rate hikes, has been trying to tame inflation.

The bond market responded with a sharp rally in yields, leading to a sell-off in prices of U.K. Gilts, particularly in longer dated bonds, as it priced in expectations that BoE would not be able to contain long-term inflation and the stability of UK's financial system was in question. The 30-year Gilts yield jumped by 95bps on September 27th in an unprecedented one day move, while the Pound fell to a 37-year intraday low of 1.03USD. The moves in the UK sent shockwaves across global markets. German and Italian bonds falling sharply, as well as a significant, though more muted, move in the US.

The malaise resulted in a swift intervention by the BoE on September 28, where the central bank decided to suspend its quantitative tightening plans, but instead begin to temporarily buy long-dated bonds in order to calm the market. This resulted in a swift retreat of bond yields. The 10-year Gilt yields soared by 33bps, GBP/USD fell 3.7% to close the month.

10 Year UK Government Bond Yield



British Pound vs US Dollar

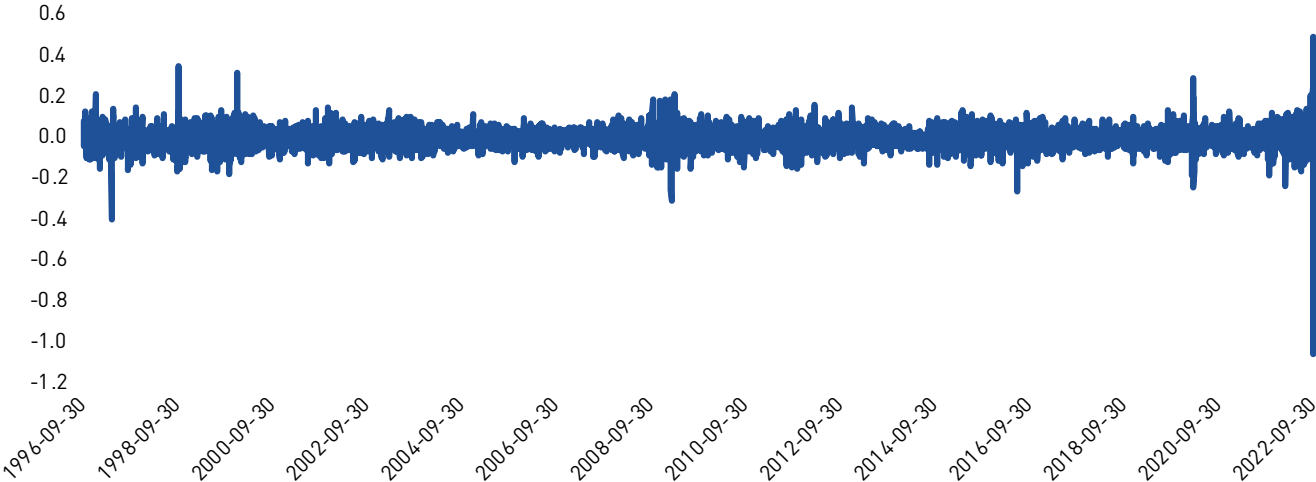


Source: Bloomberg data as of Sept 30, 2022.

Pension funds with exposures to longer-dated bond issues are more sensitive to yield changes, the sharp rise in bond yields may push them into insolvency as they need to raise cash as collateral or sell bonds in an already illiquid and depressed environment. With these investors trying to sell bonds into an illiquid market, there was the risk of a downward spiral in prices of government bonds, leading to financial instability.

The sharp rise in bond yields disrupted the mortgage market and lending market as well, as loans are priced based on longer term government bond yields. A sharp rise in borrowing costs could lead to a dire economic fallout.

UK 30-year yield is set for a record drop two days after historic jump



Source: Bloomberg data as of Sept 30, 2022.

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 | -0.53 | 0.35 | -5.01 | -11.49 | -10.24 | -2.51 | 0.66 | 1.59 |
| Bloomberg Barclays Global Aggregate (C\$ Hdg) | -3.36 | -3.56 | -7.75 | -12.33 | -12.30 | -3.26 | -0.09 | 1.68 |
| Bloomberg Barclays US HY 2% Issuer Cap (C\$ Hdg) | -4.17 | -0.94 | -10.87 | -15.17 | -14.67 | -1.16 | 0.76 | 3.61 |
| Equities | | | | | | | | |
| MSCI World (Developed Markets) | -4.83 | -0.07 | -13.50 | -18.88 | -12.83 | 5.86 | 7.30 | 11.78 |
| MSCI World Growth | -5.70 | 1.14 | -17.70 | -26.47 | -20.70 | 7.68 | 9.83 | 13.47 |
| MSCI World Value | -3.98 | -1.20 | -9.79 | -11.37 | -5.28 | 3.03 | 4.15 | 9.74 |
| MSCI Canada | -4.01 | -1.94 | -14.68 | -11.77 | -5.71 | 5.42 | 5.41 | 6.50 |
| MSCI USA | -4.85 | 1.39 | -12.96 | -18.50 | -10.63 | 8.96 | 10.69 | 14.79 |
| MSCI EAFE | -4.89 | -3.45 | -14.76 | -20.69 | -18.80 | -0.61 | 1.05 | 7.19 |
| MSCI Europe | -4.20 | -4.29 | -15.48 | -22.58 | -18.44 | -0.49 | 0.63 | 6.96 |
| MSCI Japan | -5.95 | -1.65 | -13.29 | -19.92 | -23.32 | -1.44 | 1.26 | 8.40 |
| MSCI Pacific Ex Japan | -6.24 | -2.88 | -13.83 | -11.58 | -11.92 | -0.16 | 2.50 | 6.40 |
| MSCI EM (Emerging Markets) | -7.38 | -5.81 | -13.86 | -20.76 | -22.03 | -0.85 | 0.06 | 4.48 |
| World Currencies (relative to CAD) | | | | | | | | |
| US Dollar | 4.92 | 6.52 | 10.01 | 8.78 | 8.46 | 1.24 | 1.90 | 3.40 |
| Euro | 2.22 | -0.18 | -3.14 | -6.29 | -8.32 | -2.30 | -1.86 | 0.62 |
| Pound Sterling | 0.66 | -2.09 | -6.73 | -10.35 | -10.20 | -2.04 | -1.78 | -0.35 |
| Yen | 0.49 | -0.02 | -7.75 | -13.46 | -16.39 | -8.15 | -3.10 | -2.83 |

Source: Morningstar. Data as of September 30, 2022.

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