Monthly Market Monitor

April 2022

NEI

HIGHLIGHTS

Central banks face inflation vs. growth dilemma

Hawkish signals from policymakers continued in March as many major central banks raised interest rates for the first time since the start of the pandemic. Central banks are caught in a tough situation as they are forced to choose between taming inflation or supporting growth amid a war. For now, central banks have suggested that inflation is the more pressing issue to tackle unless growth outlooks deteriorate.

Case for peak inflation now uncertain

Inflationary impulses were initially expected to moderate in the first half of 2022 on normalized economic conditions. This may no longer be the case, considering the war in Ukraine, its effect on commodity prices, and further supply chain disruptions in China due to new COVID-19 lockdowns. Inflation for most developed economies will likely be higher in 2022 than initially expected.

Bonds, stocks end quarter on negative note

The end of March saw bonds and equities post negative returns for the quarter in an environment of elevated inflation. U.S. bonds had their worst performance in decades as inflation prompted central banks to turn increasingly aggressive. Equities are now facing pressures due to the uncertainty of war, prices, and rates. Commodities, which are driving inflation, were among the few areas of the market that posted positive returns.

ASSET ALLOCATION OUTLOOK SUMMARY

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

A more hawkish tone from policymakers was on display in March as many major central banks raised interest rates for the first time since the start of the pandemic. Inflation continued to prove more persistent than initially expected, which has caused central banks to pivot to an ever more aggressive monetary policy reaction. Inflationary impulses were expected to moderate in the first half of 2022, partly as economies reopened, supply constraints eased, and the job market normalized. This may no longer be the case given the war in Ukraine, its effect on commodity prices, and further supply chain disruptions in China due to new COVID-19 lockdowns. Consequently, inflation will likely be higher this year than initially expected. In response, the European Central Bank made a surprise announcement that it would be more aggressive in paring back bond-buying, while the Bank of England raised rates for a third consecutive time. The U.S. Federal Reserve and Bank of Canada also hiked rates for the first time since the pandemic. It was clear that policymakers have ramped up policy rate projections, and markets now expect that the Fed could raise interest rates eight more times this year, relative to the prior Fed median projection of three rate increases reported in December.

While acknowledging the uncertainties related to the global geopolitical situation and its economic implications, central banks have so far suggested that they view inflation as the more pressing problem to tackle unless the growth outlook markedly deteriorates. This view is in stark contrast to last year, as central banks were focused on a labour market recovery to prevent longer-term economic damage. Last month, Fed Chairman Jerome Powell emphasized the importance of stable prices for economic growth, stating "price stability is essential if we are going to have another sustained period of strong labour market conditions." The risk of failing to tackle inflation means that higher inflation expectations could become entrenched. The main inflation concern for policymakers would be a wage spiral, in which higher prices lead to workers demanding higher wages, which in turn would force businesses to drive prices higher once again as they pass costs along to consumers. The risk of a wage spiral is that it creates a cycle that is hard to contain and would require even tougher measures from central banks that would surely push the economy into recession.

Central banks are caught in a dilemma as the latest economic projections are seeing higher inflation numbers and lower growth forecasts for 2022. At the same time, high energy prices already represent an immediate tax on consumers' disposable income. As such, central banks will likely walk a tightrope going forward. Increasing policy rates too quickly could result in demand destruction, increasing the likelihood of a recession. On the other hand, moving too slowly could result in higher inflation for longer, creating a possible no-win situation.

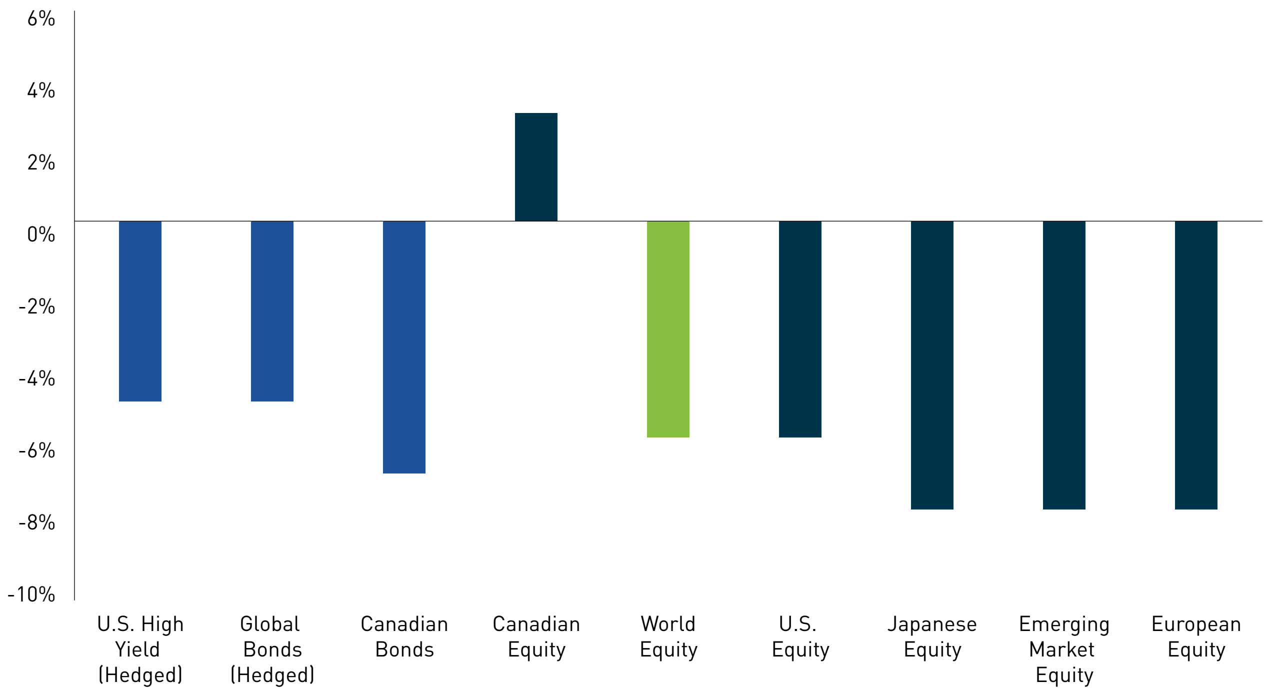
The toolkit available to central banks is quite limited. Negative supply shocks surrounding food and energy prices linked to the war in Ukraine cannot be mitigated through monetary policy alone, and as such it is likely that government fiscal policy will come into play, a recent example being the U.S. government announcing the largest release ever of emergency U.S. oil reserves in an attempt to bring down gasoline prices.

Bonds faced another rough month as yields surged, with investors preparing for higher interest rates. The yield curve approached inversion (when short-term yields rise above long-term yields), a commonly cited recession indicator. Yields across the curve rose aggressively, with U.S. bonds posting their worst performance in decades. Although equities generally fared better in March, for the first quarter as a whole equities also declined as the support of easy, stimulative monetary policy that stocks have enjoyed in recent years started to recede.

Consequently, markets broadly ended the quarter in negative territory, with few areas of the market providing gains for investors. Commodities were among the few asset classes posting positive returns, supporting Canadian equities.

Looking ahead, NEI Investments believes the odds of a recession have increased. Central banks are clearly having to play catch up to inflation, and now need to raise rates more aggressively than previously planned. Russia's invasion of Ukraine has only exacerbated inflationary pressures. That stated, a recession for 2023 is still not our base case. We continue to expect volatility within both the stock and bond markets over the near term, however, as investors digest more news on the effects of higher inflation and higher interest rates on the economy, earnings, sentiment, and valuation levels.

Few sources of positive returns in Q1, 2022



Source: Morningstar Direct, as of March 31, 2022. Based on the returns of Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg), Bloomberg Barclays Global Aggregate (C$ Hdg), Bloomberg Barclays Canada Aggregate, MSCI Canada, MSCI World (Developed Markets), MSCI USA, MSCI Japan, MSCI EM (Emerging Markets) and MSCI Europe.

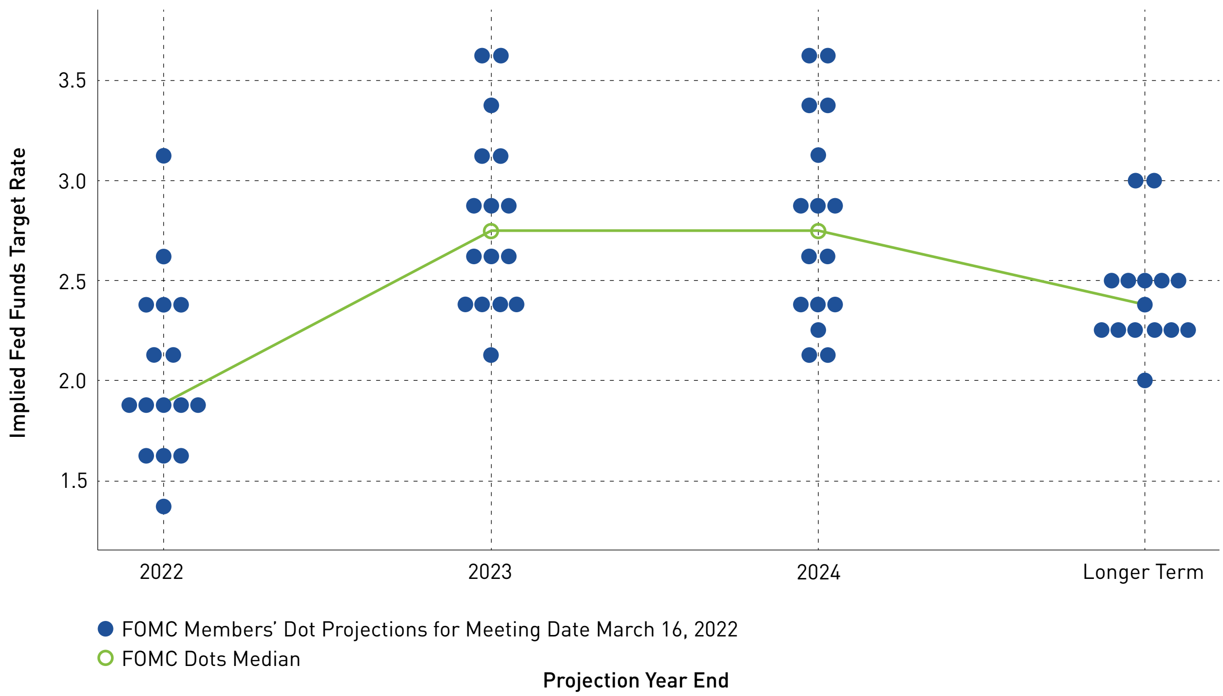
U.S.

The Fed hiked interest rates for the first time since the onset of the pandemic, increasing rates by 25 basis points to 0.50%. The move was widely expected as inflation soared and the labour market had significantly tightened, but markets were surprised that the Fed signaled an even more aggressive policy stance to come.

The Fed follows a "dual mandate," in which the central bank is tasked with facilitating both optimal employment levels and stable prices. The onset of the pandemic saw unemployment rise to the highest rate recorded by the Bureau of Labor Statistics, and the Fed responded by cutting rates to zero and asset purchases to stimulate the economy. Since then, the labour market has been recovering and has continued to post strong gains, with the latest February unemployment rate at 3.6%, comparable to the pre-pandemic February 2020 levels of 3.5%. This strong labour market may now provide the Fed comfort in hiking interest rates, with markets pricing in a 50-bp rate hike at the next meeting on May 4.

In the Fed's latest Summary of Economic Projections, 2022 growth expectations for the year were revised down to 2.8% from 4.0%, while inflation expectations as gauged by personal consumption expenditures rose to 4.3% from 2.6%. Despite the slowing growth, the Fed dot plot, which reflects Fed officials' outlook for the Fed Funds Rate, saw the median projection rise to seven hikes for 2022, compared to just three hikes previously forecasted in December. This median projection implies that there are six hikes to come in the remaining six meetings. The focus has now shifted toward the stable price component of the dual mandate, in which the Fed will look to contain inflation at all costs. Inflation rose higher to 7.9% in February and is projected to go even higher. This mounting inflation has the Fed seeing the need for rates to increase above the neutral rate, as indicated by the longer-term rate, over the next two years in order to counter these elevated levels of inflation.

Fed's "dot plot" implies higher Fed Funds target rate than previously anticipated



Source: U.S. Federal Reserve, as of March 16, 2022.

Bond yields soared as result of these monetary policy expectations, with the 2-year Treasury yield rising 90 bps in March and ending the month at 2.33%, and the 10-year yield rising 51 bps and ending the month at a very similar rate of 2.34%. The faster rising short-term yield environment could push the Treasury yield curve toward inversion, which markets generally view as a strong indicator of a recession. Combined with the war in Ukraine, a more aggressive Fed, and higher energy prices, markets are facing greater challenges than they did at the beginning of 2022.

In NEI Investments' view, the odds of a recession have risen, but a recession itself is unlikely at this time. The labour market has continued to post strong gains and the underlying economy is still strong with COVID restrictions easing. Corporate earnings should hold strong as a result. The inversion is simply indicating that the Fed will have to raise rates higher in the short term to combat inflation before returning to a more normal level, telling the "soft landing" story that the Fed is hoping for. That stated, uncertainty is definitely elevated, and as we are still early in the rate hike cycle we expect more volatility to come in the months ahead.

CANADA

In response to inflation, the Bank of Canada increased interest rates for the first time since the pandemic, raising rates by 25 bps to 0.50%. The stronger-than-expected economic growth is confirming that economic slack has been mostly absorbed and, combined with the elevated pace of inflation, has turned the BoC's focus to taming inflation.

At a CFA Society Toronto speech, BoC Governor Tiff Macklem added some colour to the central bank's "unusual rise in inflation" observation. Beyond Canadians spending more on goods and services due to the pandemic and supply chain disruptions, inflation has been driven by high oil prices contributing to transportation costs that in turn makes all goods more expensive, food prices being affected by extreme weather damaging crops, and strong demand pushing up prices for single-family homes. Macklem admitted that although the higher interest rates would not resolve supply chain disruptions or lower the cost of oil, they would make borrowing more expensive, which should dampen inflation. The rate hike is the first of many to come, as Macklem said the BoC's policy interest rate remains the most important monetary policy tool available that can help return inflation to the central bank's 2% target.

Inflation has continued to accelerate, as Canada's Consumer Price Index rose 5.7% year over year in February, from 5.1% in January, marking the largest increase since 1991. The increases were widespread with prices rising in all eight major index categories, led by transportation as gasoline prices were up 6.9% in the month amid the Russia-Ukraine conflict.

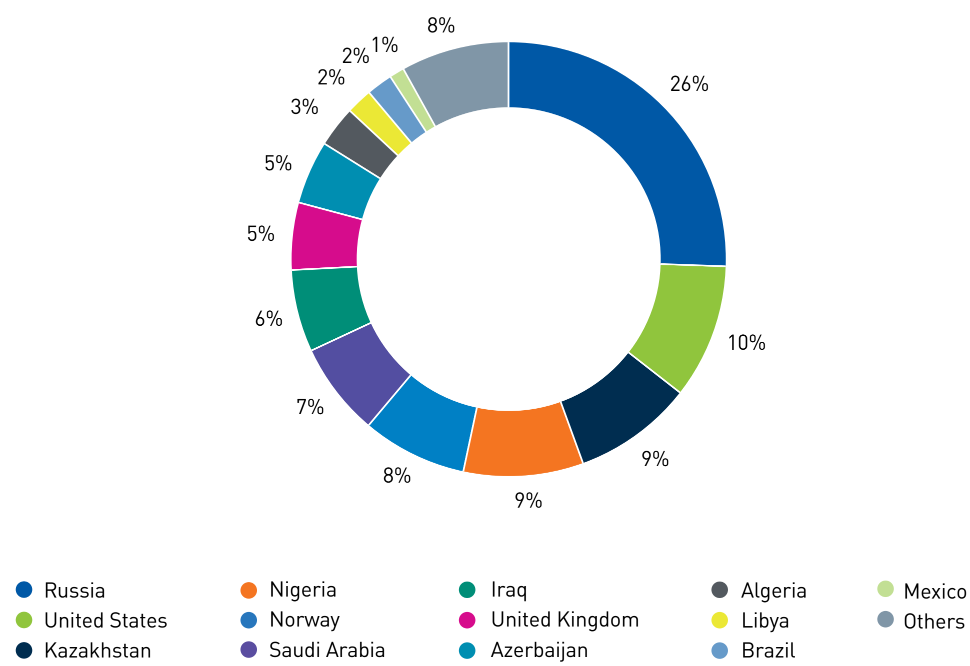
Employment has continued to rebound strongly as pandemic restrictions and concerns eased in February. Total employment increased by 337K jobs in February, substantially beating consensus estimates of a 127K increase. The unemployment rate fell to 5.5%, which is below pre-pandemic February 2020 levels of 5.7%. The reading is a strong indicator that economic slack has been absorbed since the pandemic shock and is likely a strong reason the BoC is comfortable proceeding with interest rate increases.

Employment indicators will be key to watch in coming months, and will likely dictate central banks' appetites for interest rate hikes. Continued strong readings could see the BoC hike 50 bps (also called a "double hike") at future meetings. As of the end of March, markets are pricing as many as eight more hikes to come (25 bps each), which already means that there are double hikes priced in, but we will watch for strong job numbers to confirm these expectations.

INTERNATIONAL

The Russia-Ukraine war has put Europe in a very difficult position, being at or close to the frontline of the conflict and, given proximity, having a much closer trading relationship with and reliance on Russia than the rest of the western world. The world governments supporting Ukraine have been sanctioning Russia as a consequence of the invasion, but the side effects of these sanctions are also being felt by the sanctioning nations themselves. Already facing an energy crisis, the effects of war are making conditions worse for Europe. As of 2020, Russia was the European Union's largest supplier of energy products, with approximately 26% crude oil imports and 44% of natural gas imports originating from Russia.

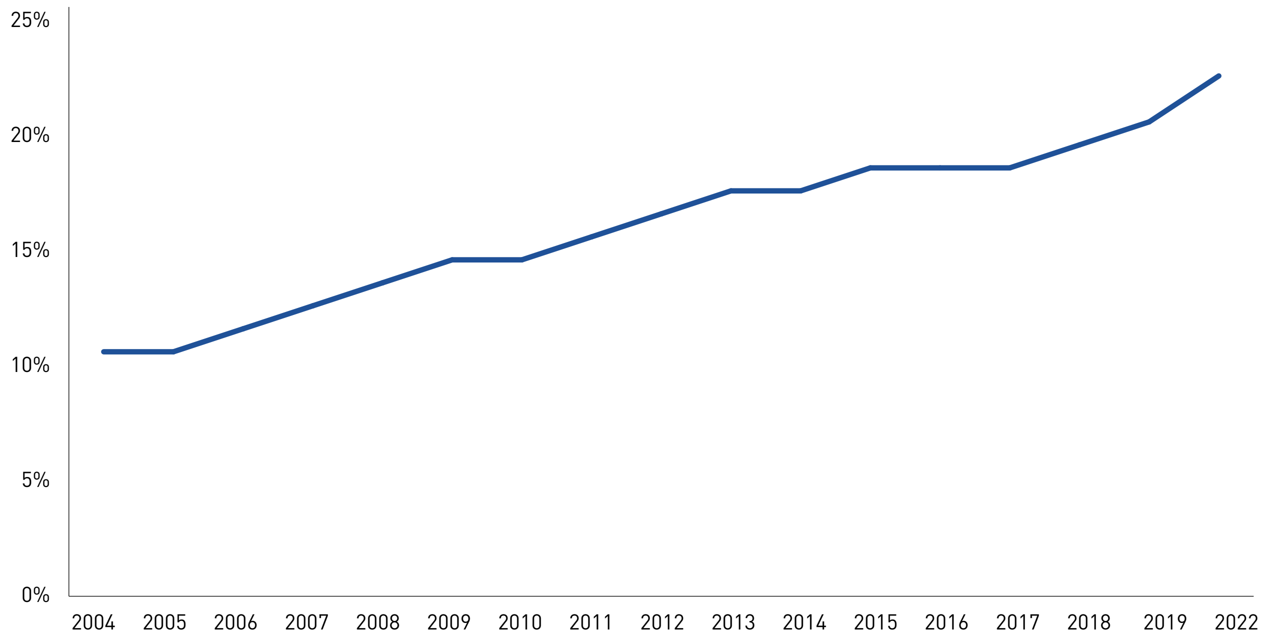
The E.U.'s oil imports from Russia compared to other sources (2020)



Source: Eurostat database (Comext) and Eurostat estimates, as of December 31, 2020.

Russian oil has yet to be sanctioned by the E.U., as some member states are worried about decoupling from Russia due to their dependence on Russian energy. Nonetheless, some traders and refineries have started to avoid Russian crude and other Russia-sourced commodities, in fear of reputational damage and the possibility of upcoming sanctions. In any event, Europe is already looking to reduce its dependence on Russia, looking for other sources as well as trying to secure domestic energy through renewables. Green energy in the E.U. accounted for about 22% of consumption in 2020, and this geopolitical development has pushed the E.U. to accelerate its renewables timeline.

Growth in renewables as a % of E.U. energy consumption



Source: Eurostat, as of December 31, 2020.

The euro-area's CPI soared in March, expected to come in at 7.5% year over year according to a preliminary reading. Prices rose 2.5% alone in the month, driven largely by energy prices which were up 12.5%. However, there are early indications that the increases were more widespread as food prices rose 0.9% and non-energy industrial goods rose 2.5%.

European central banks in turn are taking a more aggressive stance towards tightening. The European Central Bank announced an accelerated winding down of its asset purchases, and indicated that policymakers would keep an open mind on the possibility of a rate hike sometime in Q4 this year. The ECB signaled strong concerns about the recent record inflation numbers, even more so than slowing economic growth.

The Bank of England raised interest rates for a third consecutive time, by 25 bps to 0.75%. Inflation was previously expected to peak around 7.25% in April before dissipating over time, but the Russian invasion of Ukraine is applying further pressure through energy and commodity prices. Inflation is now projected to increase to approximately 8% in the second quarter, and could run even hotter for the rest of the year. One committee member voted against the action, preferring to keep rates steady. While recognizing the high inflation and tight labour market, the member was concerned about the negative effects on real incomes and activity given the higher prices, as well as about the increase of uncertainty and decline in business confidence that appear to be exacerbated by Russia's invasion of Ukraine.

The reality is the risks of a recession are much greater for Europe than in the U.S. The reliance on Russian energy is one factor, but the E.U.'s economy is also much more dependent on trade, which could be negatively affected by continuing geopolitical problems that could reduce trade as firms look to decrease their foreign exposures to reduce risk. As such, the challenges for Europe are greater than North America, where the corporate landscape looks more favourable.

EMERGING MARKETS

China's National People's Congress held its annual session in early March. Its main objectives included setting the economy on course for a steady expansion in 2022, prioritizing job creation, and increasing social welfare. The government announced a target growth rate of "around 5.5%" for 2022. This goal is lower than the 8.1% growth of 2021 but is nonetheless considered a "stretch goal" that the country could achieve with major fiscal spending programs. The budget allocation to military spending increased by 7.1%, which is especially notable given the geopolitical crisis created by the Russia-Ukraine conflict. The Chinese government's plan suggested that it was looking to keep economic growth as a key focus and that it will use regulatory and fiscal spending tools to amplify such growth.

China has faced growth challenges due to a severe housing market slump and slow recovery in domestic consumption. Household loan growth is weak and had fallen to an all-time low in February. The government is trying to maintain stable home prices and does not want to further inflate the housing bubble. As a result, access to funding for borrowers and developers has remained weak, and the government is unlikely to encourage significant renewed leveraging in the property sector.

COVID cases continued to rise steeply in China as well, and the country is facing its worst outbreak since the start of the pandemic. Restrictions and lockdowns have been exacerbated by China's "zero-COVID" policy. Shanghai, China's primary business and finance hub, went into lockdown on March 28. In other areas of the country, cities like Shenzhen and Shenyang and the entire province of Jilin have also been in lockdowns. This has caused significant disruption to the operations of global supply chains. A group of economists have estimated that these lockdowns could decrease China's GDP by up to 4% during this period.

As for Russia, its invasion of Ukraine escalated further. This caused negative sentiment around supplies of oil, gas, and other commodities. Russia is a key energy supplier to Europe, and Russia and Ukraine collectively are also known as the "breadbasket of the world" due to their significant production of food commodities such as wheat and corn. Sanctions imposed on Russia during the month were designed to cripple its economy by hurting its financial and trade ties to the rest of the world. This included removing access for many large Russian financial institutions to the Society for Worldwide Interbank Financial Telecommunication (SWIFT) messaging system. The Moscow Stock Exchange was closed for nearly a month in the immediate aftermath of the invasion. It partially reopened trading toward the end of March. In currency news, the Russian rouble sharply dropped in value as a result of the sanctions, moving from approximately 85 RUB to approximately 133 RUB against the U.S. dollar during the month. An ongoing development is Russia's insistence that payments from "unfriendly states" for its energy supplies be made in roubles. This led to some recovery in the currency. Meanwhile, talks between Russian and Ukrainian negotiators continue, although there has been no concrete agreement or ceasefire so far.

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	-2.97	-6.82	-5.51	-6.82	-4.51	0.39	1.54	2.47
Bloomberg Barclays Global Aggregate (C$ Hdg)	-2.14	-4.96	-4.92	-4.96	-3.90	1.06	1.84	2.90
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	-1.13	-4.82	-4.26	-4.82	-0.75	3.85	3.90	5.48
Equities								
MSCI World (Developed Markets)	1.18	-6.21	0.78	-6.21	9.44	12.43	10.96	13.38
MSCI World Growth	1.67	-10.65	-3.65	-10.65	8.55	16.85	15.05	15.64
MSCI World Value	0.73	-1.76	5.00	-1.76	9.89	7.35	6.47	10.87
MSCI Canada	3.70	3.41	10.51	3.41	19.47	12.76	9.21	8.24
MSCI USA	1.90	-6.36	2.67	-6.36	12.94	15.86	13.96	16.54
MSCI EAFE	-0.89	-6.96	-4.74	-6.96	0.54	5.39	5.33	8.67
MSCI Europe	-1.62	-8.40	-3.50	-8.40	2.86	5.83	5.53	8.67
MSCI Japan	-2.02	-7.65	-11.57	-7.65	-7.05	4.47	4.72	8.86
MSCI Pacific Ex Japan	5.29	2.61	2.22	2.61	3.19	4.50	5.33	8.41
MSCI EM (Emerging Markets)	-3.75	-8.01	-9.48	-8.01	-11.92	2.61	4.60	5.69
World Currencies (relative to CAD)								
US Dollar	-1.52	-1.12	-1.41	-1.12	-0.62	-2.22	-1.30	2.25
Euro	-2.45	-3.25	-5.34	-3.25	-5.92	-2.51	-0.52	0.43
Pound Sterling	-3.36	-3.88	-3.72	-3.88	-5.16	-1.88	-0.28	0.29
Yen	-6.55	-6.18	-9.37	-6.18	-9.52	-5.18	-2.98	-1.64

Source: Morningstar. Data as of March 31, 2022.

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