Monthly Market Monitor

August 2022

NEI

HIGHLIGHTS

Risk is back as the market reprices Fed action

Risk-on behaviour was back in July as equites reversed some year-to-date losses, especially growth stocks. The market repriced for a Fed pivot, as weak economic data increased expectations the Fed will cut rates in early 2023. We think it's too early to make that call, as the tug-of-war between inflation and growth could result in a hawkish surprise from central banks.

Q2 Earnings came in fairly strong, but Q3 looks weaker

Q2 earnings in the U.S. and Europe were fairly strong. Stocks moved up due to better-than-expected earnings despite a weakening economy, rising labour and cost of goods. However, there are macro risks to earnings as tighter monetary policy takes effect.

Equity bear market rally or sustained rally?

In the near term we expect short bouts of rallies followed by periods of market downturns, as the market struggles to find direction. Market uncertainty will persist, based on recession risks and policy responses, both of which are inflation dependant. However, there may be a silver lining as stocks have historically bottomed four months before the end of a recession.

ASSET ALLOCATION OUTLOOK SUMMARY

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

Risk-on behaviour was turned up in July with equites reversing some of its year-to-date losses, especially in the growth segment of the market. Equities generally outperformed bonds during the month. In Canadian dollar terms, the S&P 500 rose 8.6% during the month, the S&P/TSX Composite rose 4.2% and the STOXX Europe 600 was up 4.2%. The S&P 500 outperformed the Bloomberg US Aggregate Total Return Bond Index, up 2.4%. Despite evidence of weak data such as the Eurozone PMIs dipping into contractionary territory, U.S PMIs falling below expectations, U.S consumer confidence falling to the lowest level since February 2021 and U.S GDP contracting for the second consecutive quarter, the performance across assets has been risk-on. The VIX continued to move lower towards the low 20s. Investors use the Cboe Volatility Index (VIX) to measure the level of risk, fear, or stress in the market. VIX values greater than 30 are generally linked to large volatility resulting from increased uncertainty, risk, and investors' fear. VIX values below 20 generally correspond to stable and less risk averse market environment. The appetite for risk assets has been prompted by market expectations that the Fed may have to be slower in its hiking cycle given already tightening financial conditions. These sentiments have been expressed in the futures market with a significant repricing since mid-June, as the market now expects that the Fed will be unable to hike rates meaningfully beyond the neutral rate. The neutral rate is the theoretical federal funds rate at which the stance of Federal Reserve monetary policy is neither accommodative nor restrictive. Additionally, equities were given a further boost as U.S 10-year real rates headed lower. Real rates tend to be inversely corelated to the performance of risk assets such as equities.

We think that it may be too early to call a Fed pivot, given that core inflation will likely remain elevated despite a decline in headline inflation. Factors such as wage gains and shelter costs may result in stickiness in core inflation. It is uncertain how deep into an economic contraction the Fed is willing to go, in order to rein in wages and create slack in the job market. The tug-of-war between inflation and growth could predispose the market to a hawkish surprise from the central bank. Even more so if core inflation doesn't show signs of a turnaround as the central bank struggles to hit its 2% target.

From a regional perspective, while other economies continue to struggle with elevated levels of inflation and a toss-up between inflation versus economic growth, we continue to favour the U.S and Canada over Europe. Weak economic data and political uncertainty could weigh further on European assets.

It is likely that we could see short stints of rallies followed by periods of market downturn as the market struggles to find direction given market uncertainty as reflected in the wide range of market views.

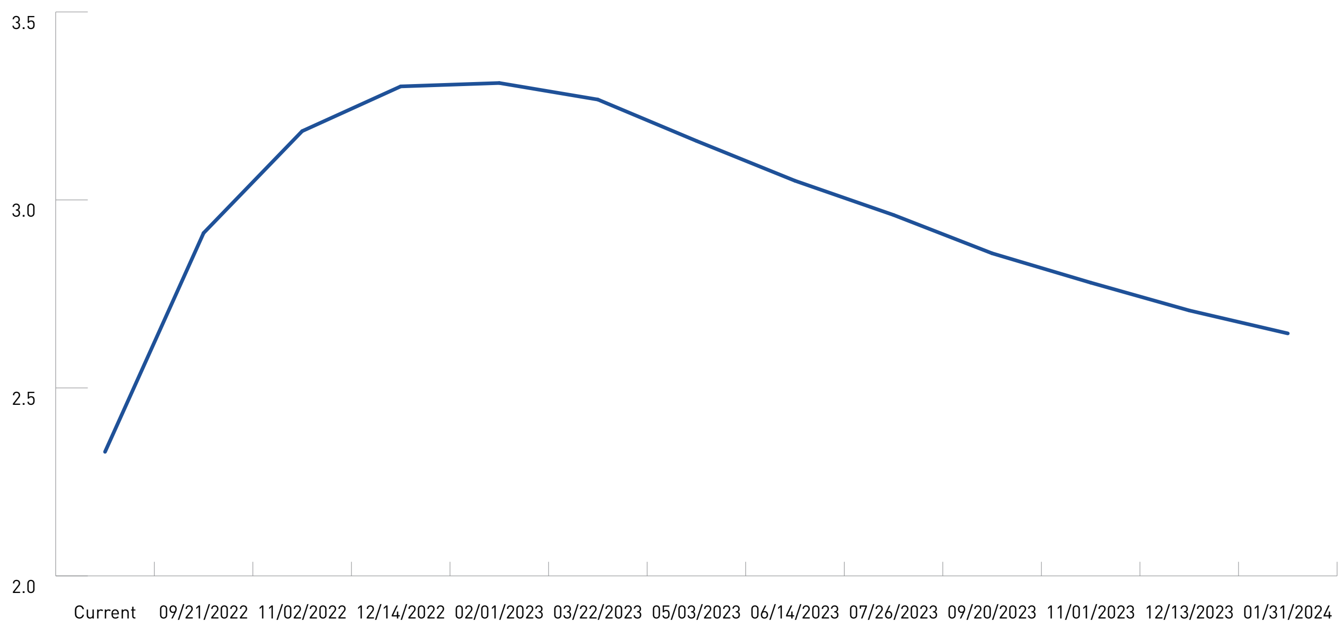
MARKET EXPECTS A LESS HAWKISH FED

At the July 26-27 meeting, the FOMC voted unanimously to increase policy rates by 75 basis points to 2.25% - 2.50%, the fourth consecutive hike since the beginning of the year. This was in line with economists' expectations and consistent with the Fed's commitment to continued monetary tightening to help tame inflation. This follows other recent increases from global central banks as the Bank of Canada's raised rates by 100 basis points on July 13 and the European Central Bank's raised rates by 50 basis points on July 21.

Despite the sizable rate increase by the U.S Central Bank, the equities and bond markets looked through the jumbo rate hike by extending gains since the hitting lows in mid June. The positive price reaction came as the market tried to balance recession expectations against rate expectations. Recession expectations have been pulled forward given softening of economic data, weakness in the housing market and continued tightening of financial conditions.

These sentiments have been expressed in the futures market with a significant repricing since mid-June, as the market now expects that the Fed will be unable to hike rates meaningfully beyond the neutral rate. The neutral rate is typically believed to be between 2.50%-3.00%. The bond futures markets have moved up the timeline of expected rate hikes, indicating that the Fed will hike policy rates to 3.30% by December and will then start to cut rates in the spring of 2023. However, other indicators such as a strong U.S. jobs market, inflation and treasuries suggest it may be too early for a fed pivot.

Fed Funds Futures indicate peaking of rates in February 2023



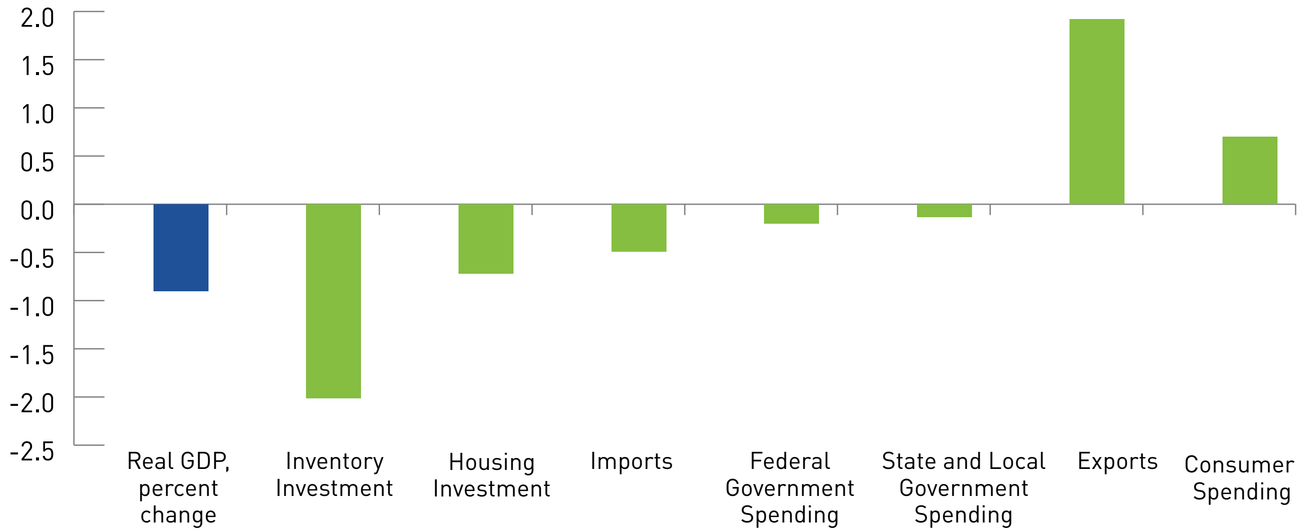
Source: Bloomberg. Data as of July 31, 2022.

The revision to market pricing also coincided with evidence of a weaker US economy as the Bureau of Economic Analysis recently released Q2 GDP figures, which indicated that the U.S economy contracted by an annualized 0.9% in the quarter instead of expanding 0.4% as per consensus. This followed a 1.6% drop in the first quarter. With two quarters of economic contraction under the belt, this occurrence typically satisfies the "technical" definition of a recession. However, the "official" recession determination is normally made by the National Bureau of Economic Research (NBER), the official recession scorekeeper—defines a recession as "a significant decline in economic activity that is spread across the economy and that lasts more than a few months." There are no fixed rules or thresholds that trigger a determination of decline, although the committee does note that in recent decades, they have given more weight to real personal income less transfers and non-farm payroll employment.

Whether NBER officially declares a recession is debatable and will take some time. However, GDP contraction in Q2 was not quite broad-based, as inventories predominately contributed to the decline. Since the decline in Q1 was mainly driven by net exports, the GDP contraction may not meet the "spread across the economy" criteria as per NBER's definition of a recession. Despite the downturn in Q2 2022, U.S GDP still remains above the pandemic recession level of -5.1% in Q1 of 2020.

Contributions to Real GDP, Second Quarter 2022

Real GDP decreased 0.9%



- The decrease in inventory investment primarily reflected a decrease in retail trade (led by general merchandise stores as well as motor vehicle dealers).
- The decrease in business investment reflected decreases in structures and equipment that were mostly offset by an increase in intellectual property product.
- The increase in consumer spending reflected an increase in services (led by food services and accommodations as well as health care) that was partly offset by a decrease in goods (led by food and beverages)

Source: U.S. Bureau of Economic Analysis. Data as of July 28, 2022.

Personal income is one that NBER will be watching closely alongside other indicators such as employment. Real personal income excluding transfer receipts decreased -0.3% in June, while non-farm payroll employment rose by a healthy pace of 372K in June, with an unemployment rate of 3.6%.

As financial conditions continue to tighten, we expect to see this reflected in further softening of economic data. Typically, it takes six to twelve months before the effect of rate hikes are fully felt, though we are already seeing immediate impact. As the effect of higher rates get filtered through the economy it is likely that will be see further contraction in Q3, with the effects being more broad-based relative to Q2. While the jobs market remains strong, we expect to see a moderate increase in the unemployment rate.

EQUITIES GET ANOTHER LIFELINE

An interesting observation from this earnings season has been positive price reaction from companies that reported earnings below consensus estimates. According to FactSet, the share price of S&P 500 companies missing estimates rose by 2%, while those exceeding estimates gained 2.2%, suggesting that the market looked through some of this bad news and instead shifted attention to the possibility of a less hawkish Fed as inflation nears its peak, commodity prices continue to roll-over and recession risks grow.

Q2 earnings season in the US came in fairly strong with 73% of S&P 500 companies having reported a positive EPS surprise and 66% of S&P 500 companies having reported a positive revenue surprise as at July 29th. In aggregate, companies are reporting earnings that are 4.18% above expectations and sales that are 2.12% above expectations.

However, this earnings surprise percentage is below the 1-year average (+9.8%), the 5-year average (+8.8%), and 10-year average (6.5%) (Source: Factset).

Earnings growth and surprise came in strong in the Eurozone, with the 55% of companies on the Stoxx Europe 600 having reported earnings so far. In aggregate, companies are reporting earnings that are 7.43% above expectations and Q2 earnings growth has averaged 14.45%.

However, there are macro risks to earnings given weakening US and European PMIs. The July Eurozone manufacturing PMI fell to 49.6, which signals a contraction in manufacturing activity. The pressure from higher energy costs and slowing global activity may push the Eurozone into a recession this year.

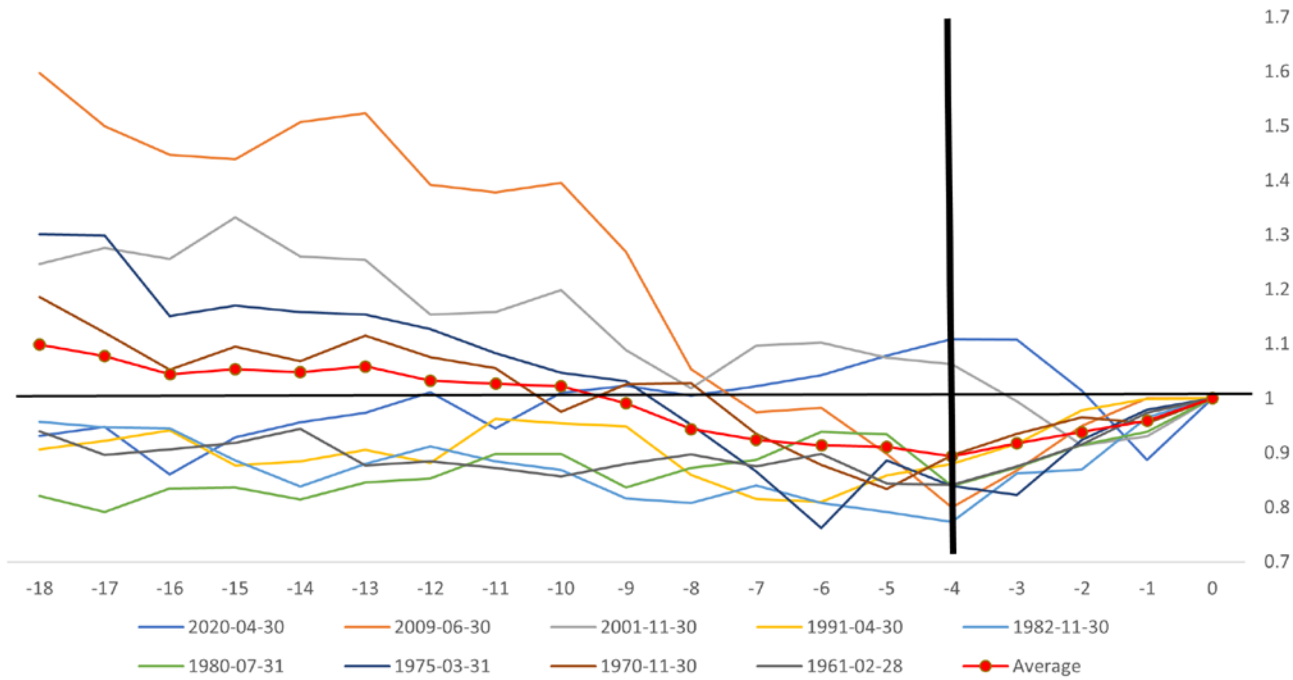
On the US side, analysts lowered EPS estimates for the third quarter by a larger margin than average and also lowered Q4 estimates. For CY 2022, analysts are predicting earnings growth of 8.9% (source: Factset). The forward 12-month P/E ratio for the S&P 500 is 17.1. This P/E ratio is below the 5-year average (18.6) but above the 10-year average (17.0).

EQUITY BEAR MARKET RALLY OR HAVE WE SEEN A BOTTOM?

Over the next few months, we expect to see short bouts of rallies followed by periods of market downturn as the market struggles to find direction given market uncertainty. Market uncertainty will persist prompted by recession risks and central bank action, both of which are hinged on the path of inflation. However, there may be a silver lining as historical data shows that stocks typically have been up double digits above their trough by the time the economy bottoms. Stocks typically bottom four months before the end of a recession.

If we assume that the Fed gets to peak policy rate by the end of 2022, the effect of this is expected to be felt in Q1 2023, which could mark the bottoming of U.S economy. Four months prior to the early spring of 2023 suggest the equity market could bottom by the end of this year, though it is not uncommon to see short stints of rallies leading up to that.

Markets typically bottom 4 months before the end of a recession



Source: Bloomberg. Data as of July 31, 2022.

Markets typically up double digit 12-months after the recession

	3 month	**6 month**	**1-yr**	**2-yr**
2020-04-30	12%	12%	44%	42%
2009-06-30	15%	21%	12%	44%
2001-11-30	-3%	-6%	-18%	-7%
1991-04-30	3%	5%	11%	17%
1982-11-30	7%	17%	20%	18%
1980-07-31	5%	6%	8%	-12%
1975-03-31	14%	1%	23%	18%
1970-11-30	11%	14%	8%	34%
1961-02-28	5%	7%	10%	1%
	8%	**9%**	**13%**	**17%**

Source: Bloomberg.

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	3.74	1.58	-5.40	-8.50	-8.57	-1.09	1.34	1.99
Bloomberg Barclays Global Aggregate (C$ Hdg)	2.53	0.83	-5.29	-6.79	-7.82	-0.70	1.22	2.38
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	5.87	-1.16	-6.78	-9.34	-8.33	1.27	2.27	4.58
Equities								
MSCI World (Developed Markets)	7.22	-1.08	-8.72	-12.96	-6.76	8.68	9.34	12.95
MSCI World Growth	10.79	0.04	-11.78	-19.45	-13.67	11.10	12.42	14.88
MSCI World Value	3.87	-2.45	-6.28	-6.82	-0.39	5.28	5.65	10.67
MSCI Canada	4.19	-4.42	-6.08	-6.25	-0.78	8.24	7.50	7.79
MSCI USA	8.56	0.19	-8.10	-12.73	-4.81	11.74	12.72	15.91
MSCI EAFE	4.28	-3.80	-10.61	-14.34	-12.05	2.32	3.12	8.42
MSCI Europe	4.25	-4.54	-12.23	-15.67	-12.85	2.71	3.05	8.46
MSCI Japan	4.99	-0.79	-10.55	-14.51	-12.01	2.01	2.99	9.08
MSCI Pacific Ex Japan	3.14	-4.94	-1.20	-6.10	-7.87	0.58	3.62	7.27
MSCI EM (Emerging Markets)	-0.91	-6.22	-15.61	-16.64	-17.98	0.08	1.45	5.40
World Currencies (relative to CAD)								
US Dollar	-0.67	0.26	0.75	1.44	2.64	-0.81	0.49	2.49
Euro	-3.12	-3.10	-8.36	-9.05	-11.74	-3.68	-2.39	0.57
Pound Sterling	-0.47	-2.82	-8.62	-8.86	-10.16	-1.02	-1.11	-0.07
Yen	0.97	-2.81	-13.14	-12.60	-15.71	-7.45	-3.26	-2.87

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

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