Monthly Market Monitor

July 2022

NEI

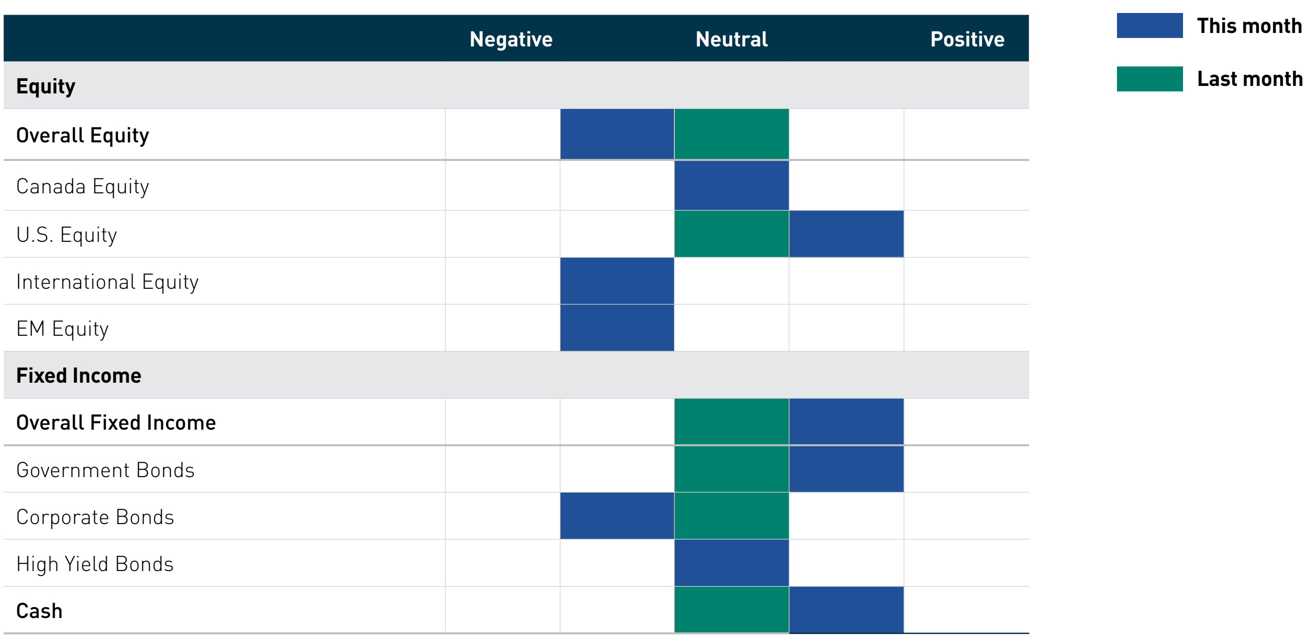
HIGHLIGHTS

High inflation rates driven by energy prices lead to aggressive rate hike in the U.S.
Inflation showed no signs of slowing as it marched higher yet again in June readings, warranting the U.S. Federal Reserve's decisive 75-basis point hike on June 17.

U.S. markets entered bear market territory as growth prospects soured
As odds of a potential recession rise, driven by higher interest rates and higher consumer prices for gas, groceries, and other goods, global growth forecasts are quickly being downgraded.

Path forward hinges on how quickly inflation moderates
Markets may be at a fork in the road—toward a bullish path if inflation were to peak soon, but bearish across asset classes if inflation were to stay persistently high.

ASSET ALLOCATION OUTLOOK SUMMARY



This table illustrates the short-term outlook of NEI's Asset Allocation Team for various equity and fixed income asset classes as of June 30, 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

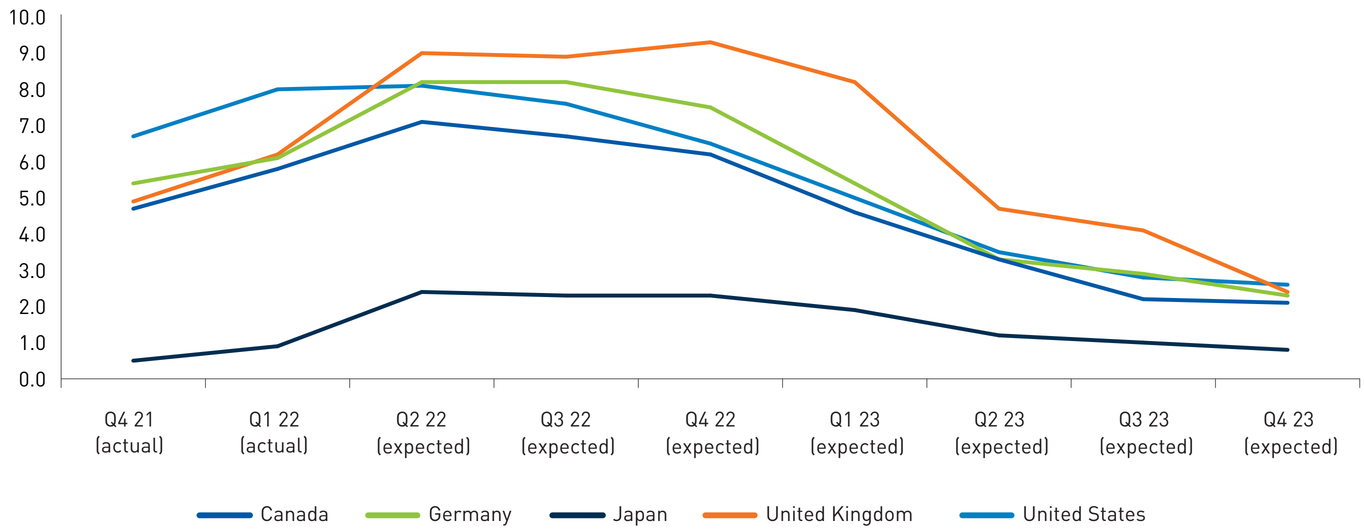
The persistent rise and broadening of inflation, sparked by pandemic-driven supply chain disruptions and compounded by the war in Ukraine, have led to aggressive tightening of monetary policies and increased concerns that many global economies could fall into a recession. These factors have been the main cause of market declines since the beginning of the year, and the U.S. market officially entered bear market territory in June. The latest inflation reading on June 10 gave the U.S. Federal Reserve pause and confirmed the need for even more aggressive tightening to keep longer-term inflation expectations anchored. Equity markets dropped further mid-June and bond prices followed in anticipation of more aggressive rate hikes, with these losses partially reversing toward the end of the month. The S&P 500 Index dropped 6.4% in June to a year-to-date decline of -18.3%, with defensive sectors such as consumer staples and utilities falling less than cyclical sectors. Similarly, the S&P/TSX Composite Index returned -8.7% in June and -9.9% YTD, with industrials, consumer staples, telecommunication services, and utilities declining less. Canadian bonds, as measured by the Bloomberg Barclays Canada Aggregate, were also in negative territory, returning -2.1% for the month and -11.8% year to date.

Inflation is getting too hot for comfort

Inflation marched higher yet again in June. What was broadly thought to be a transitory development, caused by initial pandemic-driven supply chain disruptions, is increasingly becoming more entrenched. Even Janet Yellen, the U.S. Secretary of the Treasury and former Fed chair, had to admit that it was wrong to think of current inflation levels as being transitory. The latest reading in the U.S. again exceeded expectations at 7.6%, and has been rising at a faster pace of approximately 1% each month over the last three months. Persistently higher energy prices continue to be the main driver of high inflation, with oil prices touching US$120 in early June before dropping to a low of US$104 in late June. Inflation has also been broadening into other areas such as shelter and food. While supply shortages are driving goods prices higher, labour shortages are also driving wages higher, which generally leads to inflation becoming more structural. Wages have been rising at over 5% year over year, but have plenty of room for further increases to keep pace with inflation. The labour market across the U.S. and Canada has been very strong, with unemployment at near record lows and fueling near-term wage inflation, while also making it harder for inflation to retreat to lower levels.

However, there are signs that point to some easing of inflation pressures. Higher prices, higher rates, and tighter financial conditions could curb demand so much so that we may see inflation rolling over. The world is adjusting quickly to account for the possibility of a protracted Ukrainian war, and China is beginning to ease its COVID lockdown in some areas, which could help alleviate some supply chain issues. Industrial metal prices have declined substantially, and some commodity prices are peaking, such as iron ore and nickel. In June, some agricultural prices have dropped sharply, such as for cotton, corn, and soybeans. The Energy Information Administration estimates that OECD oil inventory will rise from current levels, and the significant backwardation in the energy futures market, when the prices of energy assets become higher than their trading prices in the futures market, also suggests that oil prices will fall back toward the US$90 range. We continue to expect inflation to peak this year and to moderate in 2023, as higher prices and higher rates dampen aggregate demand, which in turn eases inflationary pressures. The following graph illustrates the expected moderation and anchoring of longer-term inflation.

Actual and forecasted inflation rates for major economies (year over year, %)

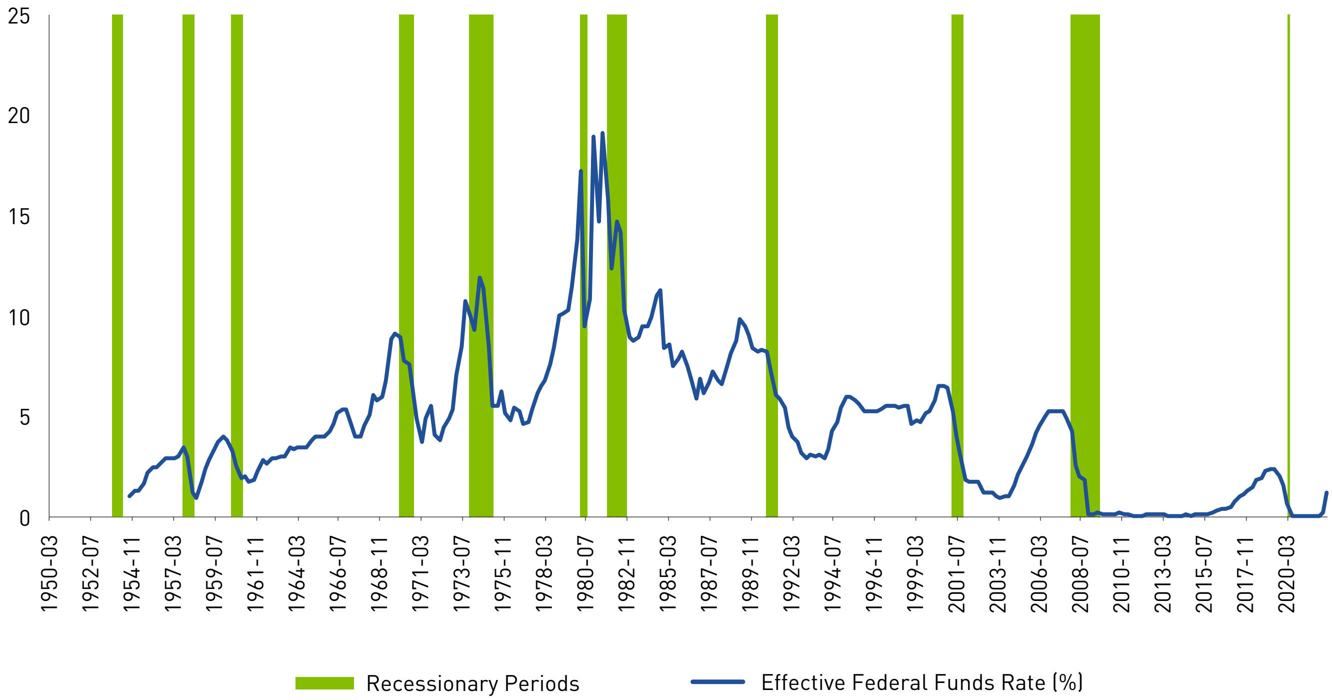


Source: Bloomberg, as of July 2022. Q2 2022 data for Germany reflects actual inflation rate.

"75 is the new 50" for the Fed

Persistently higher inflation has pressured major central banks globally to take a more aggressive path in tightening their monetary policies. Central banks in Australia and Canada hiked rates in early June by 50 basis points. The Fed upped the ante and hiked rates by 75 bps on June 15, in accordance with the market's expectations, as 10-year Treasury yields rallied sharply within the few days following the high inflation reading preceding the 75-bp hike. The most important takeaway from the latest Federal Open Market Committee meeting was not the rate hike, however, although the move showed the Fed's resolve in fighting inflation. What was of particular interest was the move of the Fed's projected median policy rate from 2.8% in 2023 to 3.8%, which is beyond a neutral rate. This pushes the policy rate into restrictive territory, showing that the Fed is willing to aggressively curb inflation even at the expense of pushing the economy into a recession. The Fed's statement also struck out the language about trying to achieve a soft landing while trying to tame inflation, raising the odds of recession significantly within the next 12 months. The Fed's track record of achieving a soft landing has been less than stellar historically, as 10 of the last 13 periods of rate hikes since 1950 have resulted in U.S. recessions.

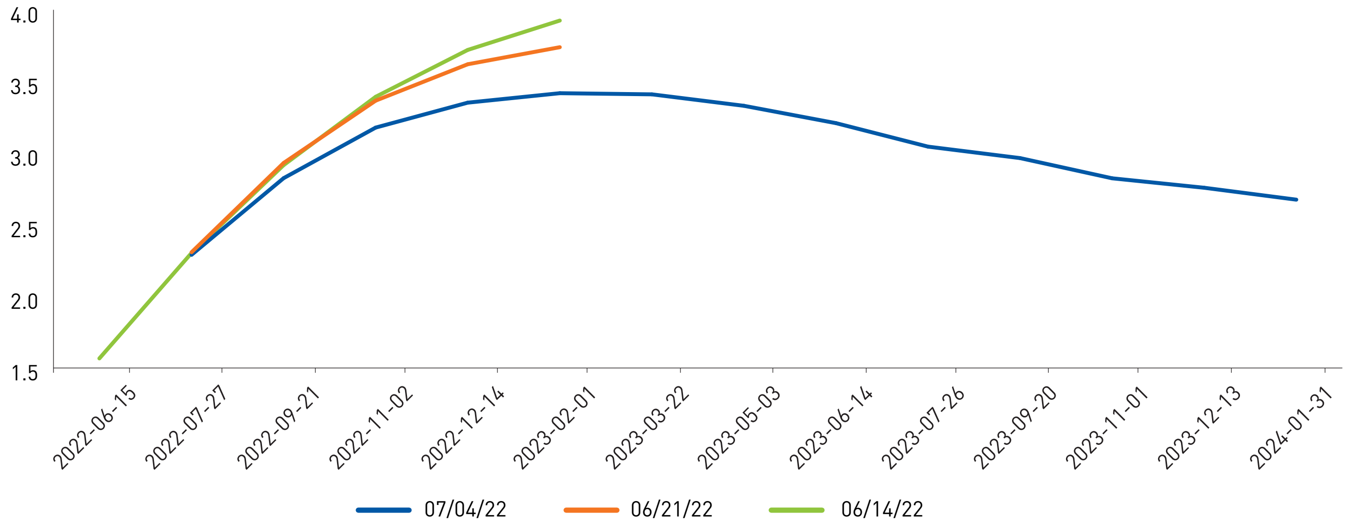
Fed's rate hike cycles often come before recession



Source: Bloomberg, as of July 2022.

Now that the Fed has set a precedent with its 75-bp hike, other central banks such as the Bank of Canada may follow suit. Bond market movements across the U.S. and Canada in mid-June reflected expectations of a more aggressive hiking schedule by central banks, with 10-year Treasury yields hitting a high of 3.48% on June 15, reflecting market expectations of seven more Fed hikes of 25-bp increments by early 2023. Yields eased off toward the end of the month and settled at around 3.10%, as weakening economic data and rising risk of recession may call for the Fed to hold off on tightening any further. The bond futures market is suggesting that we may see the first rate cut near the middle of 2023, but the Fed would need evidence that inflationary pressure has eased off at a sustained level before that happens.

Fed Funds Futures reflect increasing expectations of rate cuts in Spring 2023

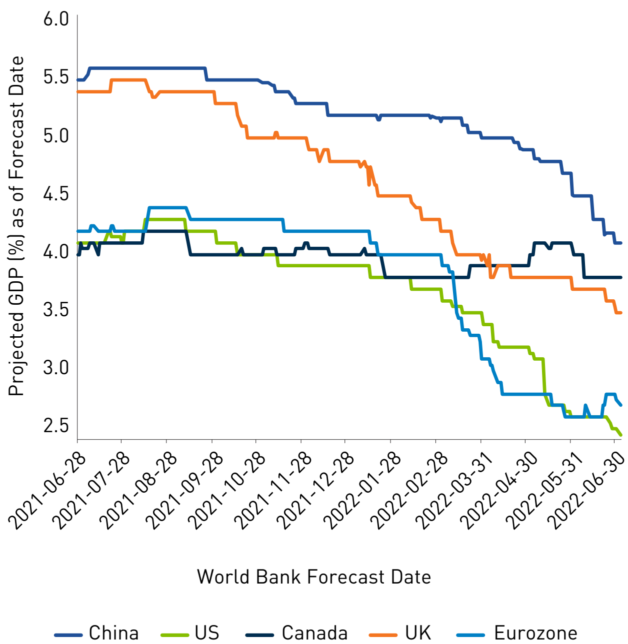


Source: Bloomberg, as of July 2022.

Global economic growth forecast slashed

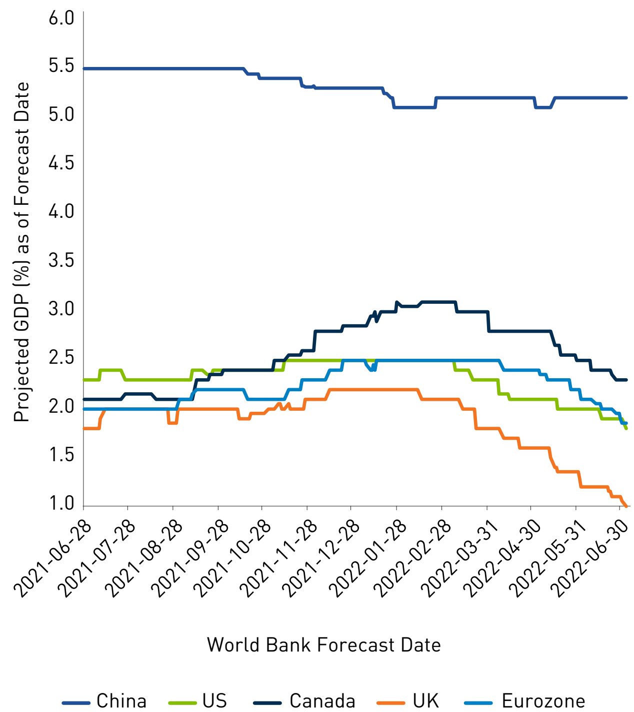
Recently, not much is going up other than inflation. With inflation the dominant economic theme, the World Bank and OECD downgraded their global growth outlooks for 2022 from 4.1% to 2.9%, citing Russia's invasion of Ukraine and the resulting surge in commodity prices as compounding the COVID-induced damage to the global economy. Meanwhile, economies globally have experienced weakening demand amid higher prices. The eurozone's retail sales trended lower in June, and business climate indicators and expectations also decreased month over month as the region experiences the negative consequences of being a net importer of energy products. China's 5.5% annual growth target has become increasingly out of reach as the country struggles with its zero-COVID policy, the rotation of global demand from durable goods to services, and the deleveraging of its real estate industry. Industrial production globally remains somewhat resilient as the purchasing managers' indices in most major economies remain above 50, which is still expansionary, but the latest readings have been trending lower. The latest consumer sentiment reading in the U.S. and the eurozone's consumer confidence both fell to their lowest levels on record, indicating that consumer demand is weakening. Aside from the World Bank, consensus estimates of GDP growth also saw significant downgrades across countries over the last few months as economic growth data are expected to continue to soften in the near future.

World Bank's GDP forecasts for full-year 2022 declined over past 12 months



Source: World Bank Group, as of June 2022

World Bank's GDP forecasts for 2023 also weaken over past 12 months



Source: World Bank Group, as of June 2022

OUTLOOK

Increasing odds of a recession over the next 12 months, albeit a shallow one

The Fed's latest dot plot suggests that policy rates will reach 3.5% by the end of this year, which is in restrictive territory for economic growth. With persistent inflation, rising rates, and tighter financial conditions, we expect retail sales to decline as consumers move from durable goods consumption to services and hospitality. We expect to see unemployment rates to move slightly higher from their historically low levels, as companies deal with overcapacity and overstock built up during the pandemic. We also expect manufacturing activity to fall moderately from elevated expansionary levels. All in all, we believe that the odds of recession have risen to close to 50% over the next 12 months. However, even if we slip into a recession, we think it will be relatively shallow given underlying economic strength.

Reasonable valuations and strong earnings growth equals resilience

The equity market declines this year have been driven entirely by compressions of price valuations, falling from a peak of over 27-times forward earnings to just over 16-times, below the 10-year historical average, while eliminating some of the unsustainably high share prices stemming from speculative segments of the market. Despite sharply lower valuations, company earnings and profit margins are in fact growing remarkably well. The earnings growth estimates in the S&P 500 Index remain strong at 11% and 8% for 2022 and 2023, respectively. With rising input costs and wages in a tight labour market, we believe we may see some downward adjustments to earnings estimates, which will otherwise remain resilient with moderate growth rates. Beginning in July, we will be watching the second quarter earnings season for indications of profit margin pressures and earnings growth outlook.

Asset allocation: relatively neutral with a defensive tilt

The path forward for investors hinges on how quickly inflation moderates. In one bullish scenario, inflation could peak this year as interest rates and prices are high enough to curb demand, allowing central banks to pull back on further rate hikes in the back half of 2022, thus avoiding a recession. This could trigger a pivot in sentiment and could result in gains in equity markets given strong earnings fundamentals and reasonable valuations. In a less sanguine scenario, inflation can continue to increase as China emerges from lockdown, supporting demand for commodities and oil prices which pushes central banks to hike interest rates beyond 4%. Corporate earnings, margins, and growth outlooks could be revised significantly lower with higher input and wage costs and lower demand, leading to further equity declines. Given the extreme macroeconomic uncertainty, any high conviction asset allocation tilts can be costly. As illustrated in the following breakdown of our previous asset allocation table, we are relatively neutral with a defensive bent in our positioning, while keeping a small amount of dry powder if opportunities present themselves in the near term.

	Negative		Neutral		Positive	Comments
Equity						
Overall Equity		This month	Last month			Room to fall further in recessionary scenario, we favour defensive names with stable earnings and strong cash flow generation.
Canada Equity			This month			Losing momentum with energy tailwind in the past; more sensitive to rates with high household debt, and the cooling of housing may weaken banks.
U.S. Equity			Last month	This month		Most favourable region despite higher valuations—justified by stronger earnings growth. Valuations below 10-year average.
International Equity		This month				European net energy importers suffering from negative consumer sentiment and high inflation. Anemic earnings growth at risk of further downward revision.
EM Equity		This month				China's easing to offset COVID lockdowns, weakening durable goods demand, and real estate sector deleveraging may not be positive contributors. EM countries under pressure from high rates and a strong U.S. dollar.
Fixed Income						
Overall Fixed Income			Last month	This month		More attractive as an asset class given higher beginning yields and longer-term yields peaking.
Government Bonds			Last month	This month		Safe haven as risk sentiment turns more negative. Longer-term issues beginning to look attractive if inflation shows signs of peaking.
Corporate Bonds		This month	Last month			Spreads widened but could remain rangebound, watching for further indicators of profit margin pressures and revenue outlooks.
High Yield Bonds			This month			Select opportunities with attractive yield levels of over 8%. Default rates expected to remain low given strength in fundamentals.
Cash			Last month	This month		Allowing for some flexibility should inflation roll over and yields peak.

This month **Last month**

This table illustrates the short-term outlook of NEI's Asset Allocation Team for various equity and fixed income asset classes as of June 30, 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.

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	-2.05	-5.34	-11.80	-11.80	-10.98	-2.25	0.22	1.70
Bloomberg Barclays Global Aggregate (C$ Hdg)	-1.53	-4.35	-9.10	-9.10	-8.97	-1.29	0.76	2.26
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	-6.87	-10.03	-14.37	-14.37	-13.08	-0.47	1.31	4.18
Equities								
MSCI World (Developed Markets)	-6.85	-13.44	-18.82	-18.82	-10.77	6.54	7.52	12.12
MSCI World Growth	-6.65	-18.63	-27.29	-27.29	-19.13	7.95	9.86	13.69
MSCI World Value	-7.03	-8.69	-10.30	-10.30	-2.74	4.07	4.53	10.18
MSCI Canada	-8.62	-12.99	-10.02	-10.02	-4.11	6.73	6.64	7.39
MSCI USA	-6.50	-14.15	-19.62	-19.62	-9.55	9.44	10.48	14.91
MSCI EAFE	-7.48	-11.71	-17.86	-17.86	-14.34	0.64	2.06	7.91
MSCI Europe	-8.16	-11.69	-19.11	-19.11	-14.17	0.80	2.02	7.95
MSCI Japan	-6.07	-11.83	-18.57	-18.57	-16.59	0.58	1.62	8.10
MSCI Pacific Ex Japan	-6.51	-11.28	-8.96	-8.96	-11.30	-0.53	3.07	7.45
MSCI EM (Emerging Markets)	-4.79	-8.55	-15.88	-15.88	-22.17	0.13	2.04	5.52
World Currencies (relative to CAD)								
US Dollar	1.98	3.27	2.12	2.12	4.17	-0.43	-0.14	2.38
Euro	-0.47	-2.96	-6.12	-6.12	-8.17	-3.23	-1.86	0.42
Pound Sterling	-1.73	-4.74	-8.43	-8.43	-8.42	-1.97	-1.47	-0.20
Yen	-3.43	-7.73	-13.44	-13.44	-14.89	-7.84	-3.86	-2.92

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

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