Monthly Market Monitor

June 2022

NEI

HIGHLIGHTS

Stocks stage late-May relief rally, muted returns for month

After consecutive weeks of equity market declines, the S&P 500 Index, Nasdaq Composite, and global equities market experienced a moderate relief rally in the final week of May. That week, the technology-heavy Nasdaq rallied 7.3% off lows due to the strong performance of large-cap technology stocks. The S&P 500 Index closed the month up 0.72%, while the Nasdaq was fairly flat.

The BoC hikes by 50 bps, prepares to act "forcefully" if needed

On June 1, the Bank of Canada increased its overnight interest rate by 50 basis points, adopting a more forceful, hawkish tone toward moderating inflation. The hawkish position moved yields upward, especially on the shorter end of the Canadian sovereign bond curve. Questions remain as to whether the BoC could hike rates to more restrictive levels or make other policy changes if inflation pressures continue.

As economies combat inflation, world growth in question

Global growth is expected to moderate as central banks tighten monetary policy, as economies continue to deal with inflation pressures stemming from supply chain disruptions and the Russia-Ukraine war. The IMF projects healthy growth rates in Canada (3.9%) and the U.S. (3.7%) relative to Europe (2.8%). However, some analysts believe tightening monetary policy could tip the world into a recession.

ASSET ALLOCATION OUTLOOK SUMMARY

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

This month
Last month

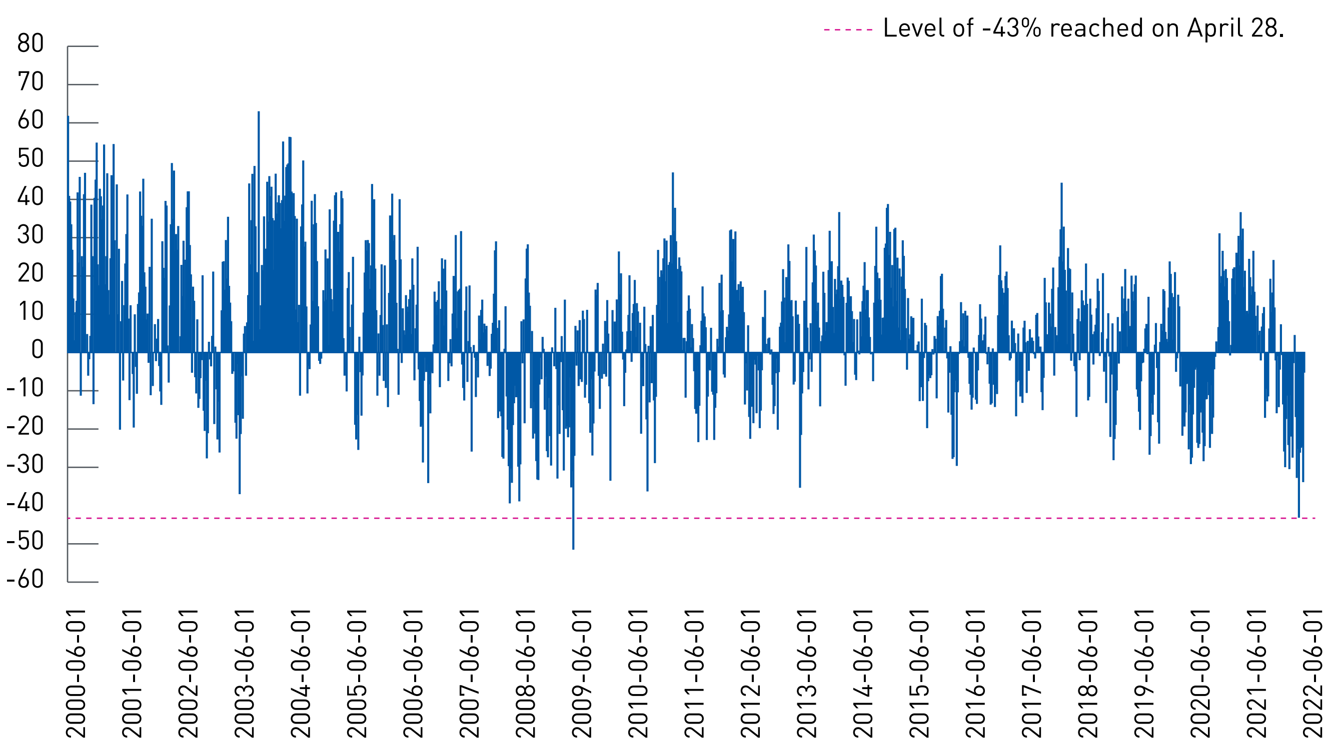
This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of May 31, 2022. If an asset class has a blue box in its row and no green box, it means this month's outlook is the same as the prior month's.

OVERVIEW

There's little doubt that 2022 has been one of the most challenging times for investors in recent memory, with few safe havens amid volatility in both equity and fixed income markets. The "four headwinds" of market volatility—inflation, central banks tightening monetary policy, the war in Ukraine, and the pandemic—have applied extreme pressures on investors. Any of these factors separately would be a challenge to investor sentiment, but all four coming together at roughly the same time in early 2022 led to a major decline in risk assets, such as equities and high-yield debt, and even in customarily less-volatile securities such as sovereign debt. In most periods of market uncertainty, investors tend to move out of riskier assets such as equities, and into sovereign debt or other investments with a lower risk profile. However, this time the four headwinds of market volatility, especially the expectation of more aggressive central bank action, pushed even bond prices lower, providing few places for investors to avoid declines.

There are a few recent developments that suggest that we may be nearing an inflection point, however. The stock market selloff in May pushed valuations and many sentiment indicators to more attractive levels. The forward price/earnings ratio on the S&P 500 Index is at the 10-year average of 18-times, after being fairly expensive for the past two years. Some sentiment and technical indicators such as bull/bear surveys, 52-week high/low ratios, and Moving Average Convergence Divergence momentum indicators are at levels typically seen at stock market bottoms, which is a good sign for equities to make a comeback. For example, the American Association of Individual Investors weekly bull/bear survey suggests investor sentiment regaining ground after hitting a low point in April 2022.

AAII bull/bear survey spread indicates heightened market pessimism (%)



Source: AAII Investor Sentiment Survey, as of June 2, 2022. The sentiment survey measures the spread (subtraction) in the percentage of individual investors who are bullish and bearish on the stock market short term; individuals are polled from the AAII Web site on a weekly basis. Only one vote per member is accepted in each weekly voting period.

Finally, the first quarter earnings season concluded on a positive note, with 77% of the companies in the S&P 500 Index exceeding analysts' estimates. Importantly, analysts maintained their full-year earnings estimates for 10% growth for both 2022 and 2023.

That stated, the road ahead for both stocks and bonds will still hinge on inflation. Headline inflation rates are at multi-decades highs, with Canada, the U.S., and the eurozone at 6.8%, 8.3%, and 8.1%, respectively. Central banks have made it clear that they are now fully focused on moderating inflation rates down to their target ranges. The Bank of Canada said it is "prepared to act more forcefully if needed to meet its commitment to achieve the 2% inflation target." Already, the futures market had priced in central bank rates hikes to 3% in both Canada and the U.S. by early 2023, a far cry from the near 0% rate at the beginning of this year. After the BoC statement, the futures market promptly pushed forward the 3% rate to December of this year. If inflation rates remain high, central banks may need to push their policy rates above 3%, which is the upper end of the estimated "neutral rate," a level estimated to be neither stimulative nor restrictive to the economy. If policy rates go above neutral, this could be negative for both bonds and stocks, and the risks of a recession could increase.

For now, NEI Investments' base case scenario remains that we expect no recession in the U.S. or Canada in 2022–2023. The U.S. labour market is extremely strong, with almost two job openings for every unemployed person. Consumer and corporate balance sheets are strong. Corporate intentions toward capital expenditures are high, in response to the need to increase efficiency in an environment in which labour is in short supply and costs are rising. Finally, these economies are still normalizing after years of pandemic-related restrictions, which will help boost demand for services instead of just goods, and improve supply chain issues, particularly in China.

However, we will be watching data carefully to see if inflation rates have peaked or if the central banks need to be even more aggressive and raise rates above neutral, to get inflation down to their target ranges.

U.S.

There were mixed signals coming out of the U.S. during May as the University of Michigan Consumer Sentiment Index's April data showed a decline to 59.1 from 65.2. Declines were broad based, as consumers viewed their financial situation as worse and buying conditions for large purchases declined on higher prices. A separate report showed inflation-adjusted consumer spending rose in April by the most in three months, indicating households were holding up in the face of persistent price pressures by dipping into savings. As it relates to new home sales, there are signs that the U.S. housing market could be cooling. Sales of newly built homes dropped 16.6% in April. Also, the number of home sellers lowering asking prices reached its highest level since October 2019. Despite the softening of some economic data, we still expect the U.S. Federal Reserve to raise its overnight rate by 50 basis points at the next meeting, and by another 50 bps at its meeting in July. Following that, subsequent rate hikes will be more data dependent.

The U.S. Consumer Price Index rose 0.3% seasonally adjusted in April. Inflation continued to post a solid increase even as energy prices fell for that month, with gasoline declining 6.1%. Goods prices rose 0.3% for April, driven by food climbing 0.9%. Services prices rose 0.8%, as shelter prices rose 0.6% and airline fares surged 18.6%. While the surge in airline fares was significant, we believe that this move is cyclical in nature and could roll off toward the end of the summer months. Shelter, on the other hand, is generally less elastic in nature and as such could result in inflation being at elevated levels for longer. On a year-over-year basis, CPI slowed to 8.3%, from its 8.5% peak in March.

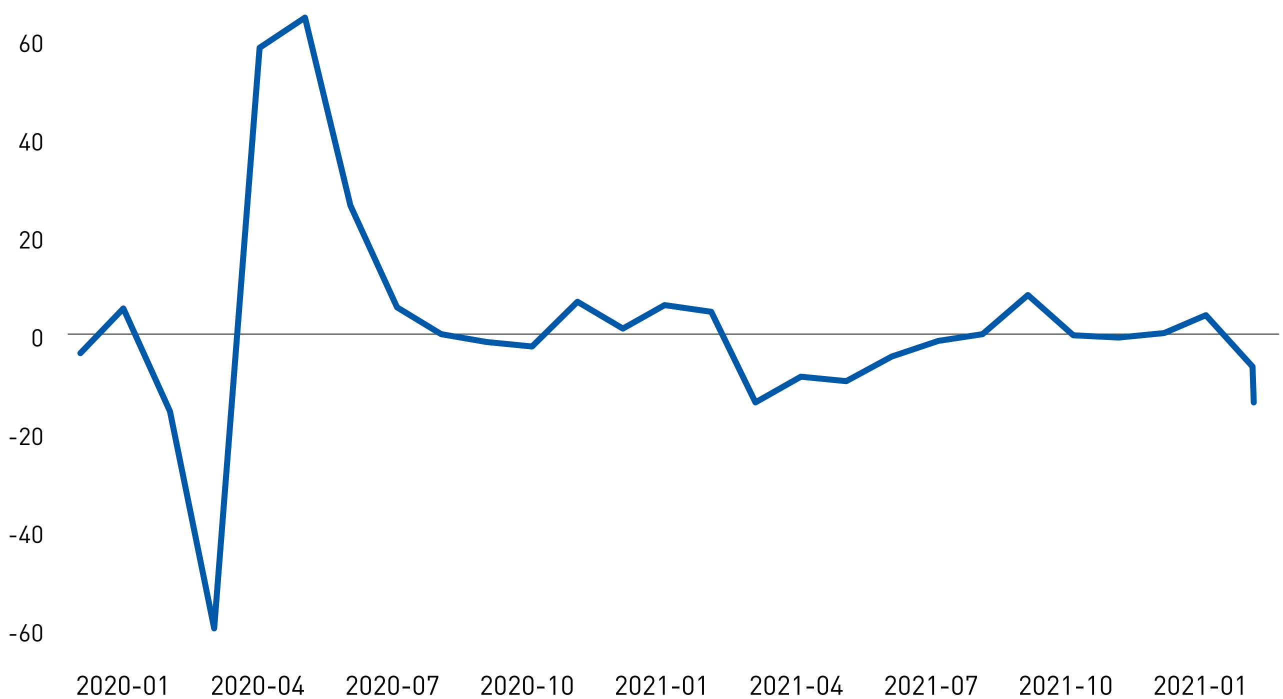
The positive correlation between stocks and bonds observed for much of 2022 shifted back to a more normalized and more negatively correlated relationship in May. As the market shifted its focus away from interest rate and inflation concerns and toward economic growth concerns, this led to a decline in yields of sovereign bonds and a rally in bond prices. The yield on the 10-year U.S. Treasury bond peaked at 3.2%, and then decreased for several consecutive days, meaning that bond prices were climbing even as equity prices declined. This decoupling had not been observed to any notable degree in 2022 at that point. At the close of the month U.S. bonds gained 1.2%.

CANADA

April CPI rose 0.6% month over month and 6.8% year over year (a new cyclical high). This was its highest annual growth rate since January 1991. Core CPI, which excludes food and energy, grew 4.6% year over year. Price gains were widespread across CPI categories. Shelter prices, which tend to be less elastic, grew 7.4% year over year on higher utilities, rent, and home price appreciation, plus mortgage interest costs. Food prices grew 8.8% year over year, driven by the continued conflict between Ukraine and Russia, which has affected agricultural supply chains. Services prices rose by 4.6% year over year. Gasoline prices declined, which offered some downward pressure that could be short lived given that prices were tracking higher in May. Of note, from May 2022 onwards CPI measures will include a new pricing index for used car prices.

The impact of the BoC's tightening bias was seen in the Canadian housing market. Sales nationally dropped by 12% and prices fell by 6% month over month. The average Canadian house in April was $746K, down from its peak of $816K in February. Home prices have now dropped for a second consecutive month. Home sales are down 25% over the past 12 months. The House Price Index (HPI), which adjusts for volume and type of home sold and reduces the impact of more expensive cities like Vancouver and Toronto, dropped 0.6% in April, its first monthly decline in two years. The sales-to-new-listing ratio continued to drop in April, pointing to the increased inventory in the market.

Canadian existing home sales cooling from tightening policy (% change)



Source: Canadian Real Estate Association, May 2022. Graph measures month-over-month change in existing home sales, in percentage terms.

Canada's trade surplus narrowed to C$2.49B in March, down from C$3.08B in February. Exports rose 6.3%, while imports grew 7.7%. The surge in crude oil prices over the past year has helped post recurring surplus readings for the first time since 2014. Exports of energy products rose 13% in March and represented 28% of total shipments. Import growth was driven by higher oil imports and domestic demand for foreign goods, alluding to the domestic economy quickly moving up against capacity limits. The trade report was widely viewed positively because of exports surging to a new record high and imports indicating a buoyant Canadian consumer. Two-way trade in the automobile sector rose to its highest level since August 2019, suggesting supply-chain issues that have affected that industry starting to ease.

INTERNATIONAL

Eurozone inflation hit an annual 8.1% in May, exceeding expectations and marking a seventh consecutive record high. This record annual CPI was driven by soaring energy costs, which increased 39.2% (up from 37.5% in April) and by a 7.5% increase in food, alcohol, and tobacco prices (up from 6.3%). These readings caught the fixed income market by surprise, resulting in a rise in sovereign bond yields in Europe, which also spread to North America.

According to Germany's preliminary CPI data for May, year-over-year inflation has reached a nearly 50-year high, at 7.9%, up from 7.4% in April. Month-over-month inflation has come in at 0.9%, which is up from 0.6% the month prior. Both inflation measures were higher than consensus estimates for the month. The main contributors to inflation were energy (38.3%) and food (11.1%). Germany was a major importer of Russian gas and, consequently, the price of energy in Germany steadily inflated after the Russia-Ukraine conflict started. The price of rent is also steadily creeping higher and is up another 0.1%, reaching 1.7% for the month of May. This is the second consecutive month Germany has seen a 0.1% increase in rent. Surprisingly, services have become cheaper, with inflation falling from 3.2% in April to 2.9%, almost reaching services inflation levels from two months ago.

Germany's Ifo Institute released its business climate survey, which managed to exceed expectations with an index value of 93. Sentiment for each sector managed to improve in the past month. The manufacturing component saw its value increase from –0.7 to 2.8, showing positive sentiment after two months of negative outlook. The services sector continues its positive outlook, increasing from 5.5 to 8.1.

Manufacturing output in Germany is currently supported by a large order backlog rather than new orders. New manufacturing orders have decreased for two consecutive months: February and March. Despite the improving sentiment for services found in the Ifo survey, the services purchasing managers' index declined to 56.3, lower than consensus estimates of 57.1.

The S&P Global Flash Eurozone Composite PMI came in at 54.9, below the prior month and below consensus estimates. The manufacturing PMI declined to 54.4, from 55.5 in the prior month. The eurozone has seen modest growth in manufacturing output, but growth continues to be limited by supply chain issues. Similarly, the services PMI came in at 56.3, down from 57.7 in the prior month. Services growth slowed in May due to the financial and industrial services sectors' weaker performance. Industrial services are also related to manufacturing output, and it is safe to assume that the weaker performance hampered the manufacturing PMI as well.

EMERGING MARKETS

China's lockdown continued to weigh on the country's economy throughout May. Economic indicators declined and most failed to meet consensus expectations. During the lockdown, demand within the housing sector saw a sharp fall. Property sales fell for the third consecutive month. In an effort to reverse the slump, policymakers decided to pump a US$5T stimulus package into the economy. China also lowered the five-year prime loan rate by 15 bps to 4.45%. However, the one-year lending rate was kept constant at 3.70%. Markets reacted positively to the stimulus package, with a sharp rise in the Shanghai Composite Index on May 19 after the news was announced.

Chinese retail sales fell 11.1% year over year in April, coming in well below estimates of a 6.6% drop. This was attributed directly to the zero-tolerance COVID policy reducing consumption and demand throughout the Chinese economy. Sales of food (10%), beverages (6%), gas (4.7%), and medicine (7.9%) increased for the month of April. However, these gains were wiped out by large losses in automobiles (-31.6%) and garments (-22.8%), among other less severe decreases.

Chinese export growth flattened in April, falling to 3.9% from 14.7% in March. Despite the stark drop, exports were one of the few indicators that managed to beat consensus forecasts. The drop in exports was due to a mix of supply chain issues and COVID policy.

China's National Bureau of Statistics PMI survey continued its downward trend from March. The manufacturing index fell to 47.4. PMI values under 50 suggest pessimism, whereas values over 50 suggest optimism. Every component of the index fell from the previous month's values, but the most significant decreases were in new orders, supply delivery time, and production. The manufacturing new orders index fell to 42.6, implying that demand for manufactured goods was down. The supply delivery time index fell to 37.2, putting the supply chain issues into focus. The production index fell to 44.4, highlighting a slowdown in production caused by nagging supply chain issues.

In contrast to other parts of the world, China's non-manufacturing PMI fell by a larger amount than the manufacturing index. The index fell to 41.9. The new order index was the most significant area of weakness, falling to 37.4. This was due to a mix of two aspects: the real estate slump and the widespread lockdown. China includes construction when calculating non-manufacturing PMI, and the sector was negatively affected firstly by a decline in investment in real estate, which brought down new construction orders, and secondly by the lockdown constraining services companies in their revenue-generating activities, detracting from new services orders.

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	-0.03	-6.24	-8.46	-9.96	-8.34	-1.25	0.38	1.91
Bloomberg Barclays Global Aggregate (C$ Hdg)	-0.13	-4.94	-8.09	-7.68	-7.08	-0.36	1.01	2.41
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	0.24	-4.48	-6.40	-8.05	-5.40	2.64	2.78	5.15
Equities								
MSCI World (Developed Markets)	-0.96	-5.98	-10.52	-12.85	-0.34	10.18	8.29	13.30
MSCI World Growth	-3.27	-11.37	-21.71	-22.11	-7.24	11.67	10.39	14.74
MSCI World Value	1.02	-1.06	1.26	-3.51	5.75	7.59	5.52	11.48
MSCI Canada	0.40	-1.25	1.55	-1.52	7.51	10.90	8.39	8.50
MSCI USA	-1.30	-6.44	-12.03	-14.03	1.89	13.18	11.23	15.95
MSCI EAFE	-0.29	-5.42	-8.11	-11.22	-6.17	4.09	2.82	9.31
MSCI Europe	-0.29	-5.41	-7.54	-11.92	-5.51	4.78	2.74	9.53
MSCI Japan	0.59	-8.03	-13.03	-13.32	-9.25	2.79	2.32	9.15
MSCI Pacific Ex Japan	-1.43	-0.08	-0.96	-2.63	-4.30	2.66	4.07	8.66
MSCI EM (Emerging Markets)	-0.60	-7.54	-11.37	-11.64	-16.06	2.69	2.45	6.27
World Currencies (relative to CAD)								
US Dollar	-1.03	-0.28	-1.40	0.13	4.70	-2.19	-1.30	2.02
Euro	0.50	-4.89	-6.16	-5.67	-8.27	-3.47	-2.26	0.57
Pound Sterling	-0.65	-6.33	-6.07	-6.83	-7.18	-2.20	-1.78	0.00
Yen	-0.33	-10.72	-12.97	-10.37	-10.97	-7.57	-4.25	-2.91

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

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