Monthly Market Monitor

May 2022

NEI

HIGHLIGHTS

Central banks open to tradeoffs between growth, price stability

Despite geopolitical uncertainties, many central banks continued to signal upcoming reductions in policy accommodation to address inflation. Expectations for aggressive policy tightening fostered a rise in bond yields, as did recent inflation data and comments from U.S. Federal Reserve officials and the Governor of the Bank of Canada. The BoC raised rates by 50 basis points and alluded to another double hike.

Equity market volatility continues

Developed-market equities had a tough April as investors assessed the economic impact of the aggressive stances of major central banks. The tech-heavy Nasdaq fell 13%, its worst monthly performance since the height of the Global Financial Crisis. The S&P 500 Index was off to its worst start to a year since 1939. Volatility is expected to continue until there are clearer signs that inflation is nearing its peak.

Commodities take a breather

The commodity rally slowed in April as WTI crude oil traded down to US$105/barrel, off its US$115 highs of mid-March. Copper and aluminum prices also moderated. COVID-19 lockdowns in China and expected softening in global growth should moderate commodities demand and help balance demand–supply dynamics. Supply shocks relating to the Russia-Ukraine war continue to be a risk factor.

ASSET ALLOCATION OUTLOOK SUMMARY

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

■ 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 April 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

Market movements in April were largely influenced by the more hawkish (cautious on inflation and price stability) language by major central banks such as the U.S. Federal Reserve, Bank of Canada, and European Central Bank. In a statement before the House of Commons, BoC Governor Tiff Macklem indicated that higher rates were needed to rebalance supply and demand in Canada's economy, while pointing out that "everyone wants to know where rates might end up—how high they will need to go. It is important to remember that we have an inflation target, not an interest rate target. We are committed to using our policy interest rate to return inflation to target and will do so forcefully if needed." The language confirmed widely held market expectations that the BoC's policy rate changes will likely be front loaded, similar to the U.S., with one or more 50-bp increases in order to moderate inflation and ensure it does not stray too far from the BoC's 2% target.

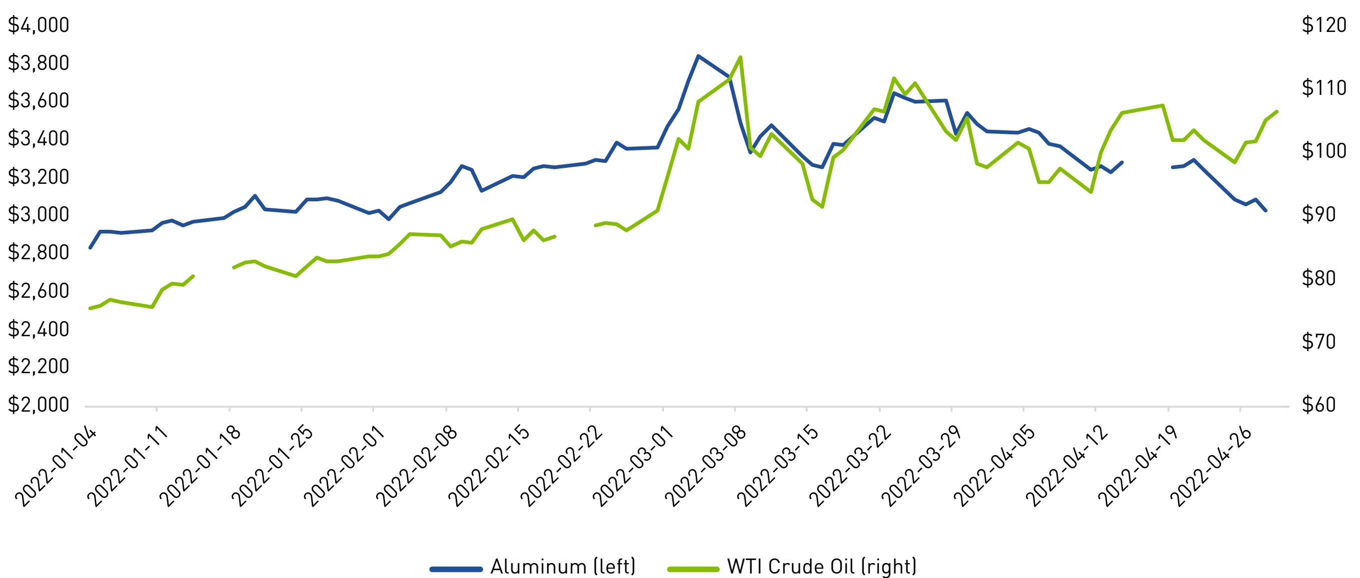
In the U.S., minutes from the Federal Open Market Committee (FOMC) meeting of the Fed also signaled openness to one or more 50-bp rate increases in the target range at future meetings, particularly if inflation pressures remained elevated. Following the release of the minutes on April 6, market pricing in the Fed Fund futures market quickly moved to reflect expectations of 10 rate hikes by the end of the year, from eight previously. Market pricing shows a double rate hike (50 bps) is expected at the Fed's meeting in May, with another two 50-bp increases following that. The U.S. 2-year Treasury yield rose to 2.7% during the month, while the 10-year yield rose by 55 bps to 2.93%. The Bloomberg Barclays Global Aggregate (C$ Hdg) closed the month lower at -2.74%.

The repricing in the fixed income market was played out in equities during the month. Developed market stocks had a tough April as investors weighed the impact of aggressive language coming out of major central banks and what that could mean for the economy and corporate earnings. Investor sentiment appeared to reflect some concern over the potential for central bank policies to tip the U.S. economy into a recession with rate hikes that are not well paced. The tech-heavy Nasdaq fell 13% in April, its worst monthly performance since the autumn of 2008—the height of the Global Financial Crisis. The index declined 21% for the year, solidly in bear-market territory. The S&P 500 Index was off to its worst start to a year since 1939. Technology stocks posted the steepest decline in the S&P 500 as higher interest rates compressed valuations. The selloff rippled through the majority of GICS sectors in the index despite strong corporate earnings releases. Cyclical and growth-oriented sectors have been hit the hardest since the end of March. Communication services, information technology, and consumer discretionary stocks led the S&P 500 lower, while traditionally defensive stocks (such as in consumer staples) have done slightly better. NEI Investments expects market volatility to continue until there are clearer signs that inflation is nearing its peak, which would provide greater indication as to how aggressive central bank actions will have to be and would help moderate rises in bond yields.

On corporate earnings, of the 233 companies in S&P 500 that have announced their results in the first quarter, 80% have posted better-than-expected earnings compared to 83% for the whole season a year ago, according to data compiled by Bloomberg. About 16% missed analysts' earnings-per-share estimates, compared with 15% a year ago. That companies are exceeding estimates, albeit with a slight falloff from last year, is as an encouraging sign given the backdrop of higher levels of inflation and less monetary and fiscal accommodation. Consumer staples and industrials names in particular have been the most represented among companies exceeding estimates on an EPS basis. As interest rates increase and economic growth moderates, companies that can generate sustainable profits and exceed estimates will be rewarded by the market, and those that miss expectations will likely be negatively affected to a greater extent. As a result, this could set the stage for further volatility, with all eyes being focused on earnings. NEI continues to expect to see U.S. corporate earnings growth of 10% this year, helped by forecasts for economic growth remaining above long-term trends.

On the commodities side, the rally slowed in April as WTI crude oil traded down to US$105/barrel, off its US$115 highs in mid-March. Copper and aluminum prices also moderated from the highs of the previous month. European natural gas was over 38% lower for the month despite Russia cutting off natural gas supplies to Poland and Bulgaria, dramatically escalating its response to Western sanctions over the war in Ukraine. Continued COVID-19 lockdowns in China and the expected softening in global growth should bring some balance to demand–supply dynamics within the commodities market as demand moderates. In the IMF's recently released World Economic Outlook, global growth is projected to slow from an estimated 6.1% in 2021 to 3.6% in 2022 and 2023. This is 80 and 20 bps lower for 2022 and 2023, respectively, than projected in January. This is consistent with the OECD's estimate that the Russia-Ukraine war would cut 1% from global growth, more in Europe and less for the developed North America and Asia. However, supply shocks relating to the war continue to be a risk factor if there is no de-escalation of the conflict.

Commodity prices moderate



Source: Bloomberg, as of April 30, 2022. Commodity prices in U.S.-dollar terms. Aluminum prices based on the LME Aluminum 3 Month Official Price; WTI crude oil prices based on Crude Oil WTI Futures.

U.S.

The U.S. economy unexpectedly contracted last quarter, the first contraction since 2020 as a mounting trade deficit and softer inventory growth belied otherwise solid consumer and business demand. GDP fell at a 1.4% annualized rate after a 6.9% pace of growth at the end of 2021. However, real final sales to domestic purchasers, a measure of underlying demand that strips out the trade and inventories components, increased an annualized 2.6%, an improvement from the 1.7% pace from the fourth quarter. Still, this soft report will likely not deter the Fed from increasing interest rates by 50 bps at its next meeting in May.

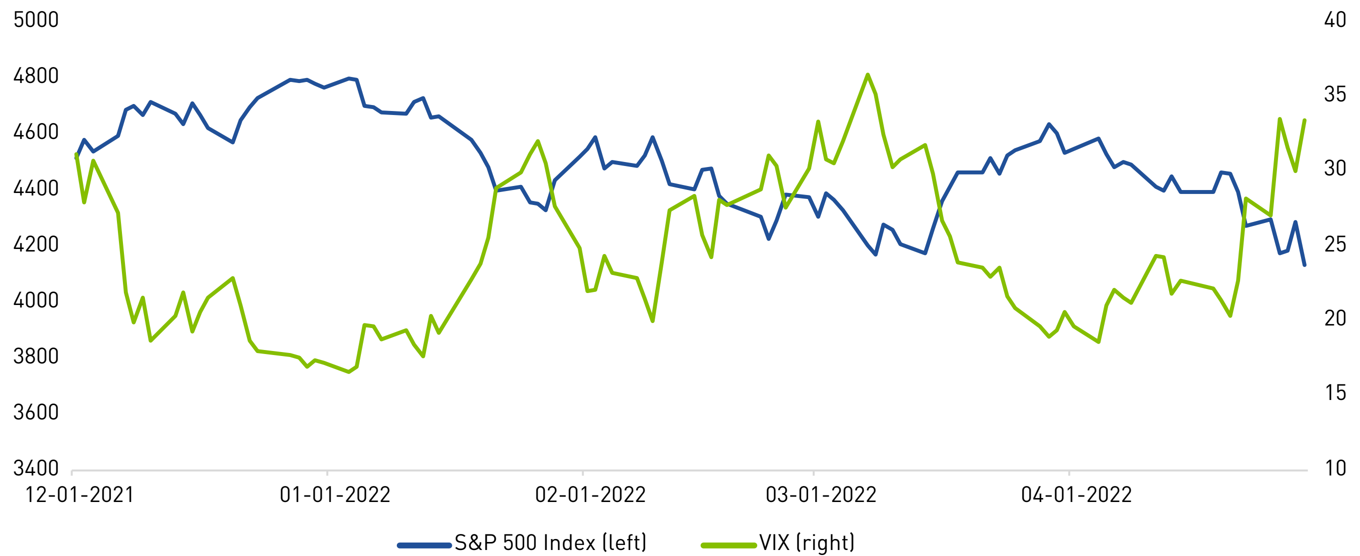
Minutes from the March 15–16 FOMC meeting were released in April and highlighted that indicators of economic activity and employment continued to strengthen. With the U.S. unemployment rate close to the pre-pandemic low of 3.5% and demand for labour being greater than supply, the Fed's goal of maximum employment appears to have been adequately met. However, the goal of maintaining price stability and achieving inflation at a rate of 2% over the long run has been more elusive as inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher energy prices, and broader price pressures. The U.S. Consumer Price Index increased by 8.5% in March relative to a year ago. This reflected the largest 12-month increase since 1981. Prices rose 1.2% month-on-month, after rising 0.8% in February. The main contributors to the increase were gasoline, shelter, and food. Inflation is expected to moderate in the latter part of 2022 as tighter fiscal and monetary policy slows demand and supply chains improve, but it will likely remain above the Fed's 2% target for some time. Additional factors that could further fuel inflation concerns include macroeconomic uncertainty from the Russia-Ukraine war and new COVID-19 lockdowns in China.

The FOMC minutes also provided insights into plans to reduce the size of the Fed's balance sheet. All meeting participants agreed that elevated inflation and tight labour market conditions warranted commencement of balance sheet runoff at a coming meeting, with a faster pace of decline in security holdings than the 2017–19 period. Balance sheet runoff, or quantitative tightening (QT), is when a central bank normalizes the size of its balance sheet that has grown from large-scale asset purchases conducted during periods of quantitative easing or accommodative monetary policy. For any upcoming QT, the Fed is expected to allow maturing securities to naturally roll off its balance sheet, as opposed to conducting outright sales of securities. FOMC members generally agreed to monthly caps on the rolloffs of approximately US$60 billion for Treasury securities and about US$35 billion for mortgage-backed securities. We think having these caps will help to minimize money market disruption as liquidity is withdrawn from the system. The process of reducing the size of the Fed's balance sheet is expected to start as early as after the conclusion of the FOMC's upcoming meeting in May. These actions may affect long-term bond yields, though the magnitude of this impact could be hard to quantify.

Despite slower expected real GDP growth in the U.S. this year, given reduced monetary and fiscal accommodation and higher prices caused by the Russia-Ukraine war, the U.S. economy continues to appear fairly strong. Above-trend growth is expected to continue, which should help to sustain the labour market. Demand for labour continued to substantially exceed available supply across many parts of the economy. The unemployment rate has fallen to a post-pandemic low, and resignations and job openings were at all-time highs. Although payroll employment is below its pre-pandemic level, the shortfall has been concentrated in just a few sectors and reflects a shortage of workers rather than insufficient demand for labour.

Retail sales rose 0.5% in March. The increase, however, was driven by gasoline station sales rising 8.9%, while retail sales excluding gasoline stations declined 0.2% as consumers shifted spending due to higher gasoline prices. The S&P Global Flash U.S. Composite Purchasing Managers' Index declined to 55.1 in April, from 57.7 in March. The Manufacturing PMI rose to 59.7 in April from 58.8, while the Services PMI declined to 54.7 from 58.0.

During the month, the CBOE Volatility Index (VIX), a major measure of market volatility, temporarily rose above 30. This is a key indicator of heightened uncertainty in equity markets, and was congruent with the volatility exhibited in the U.S. equity market.



Source: Bloomberg, as of April 30, 2022.

CANADA

The Bank of Canada increased its overnight policy rate by 50 bps to 1.00% and announced that Canada's QT will begin April 25. The BoC affirmed its messaging at its Standing Finance Committee meeting, where Governor Macklem stated the central bank's commitment to using its policy interest rate to return inflation to target, and will do so forcefully if needed. How high rates go will depend on how the economy responds and the inflation outlook. Given the importance of the housing sector to Canada's economy, and the sector's sensitivity to interest rates, it is possible that the economy responds quickly to the first few rounds of rate hikes, resulting in less forceful hikes to follow.

Despite the backdrop of higher rates to come, robust business investment, improved labour productivity, and higher immigration should help boost the economy's productive capacity. The BoC forecasts the Canadian economy will grow 4.25% this year, before moderating to 3.25% in 2023 and 2.25% in 2024. On the jobs front, the unemployment rate is at a low of 5.3%, the lowest rate on record since comparable data became available in 1976. Job vacancies are elevated and wage growth has reached pre-pandemic levels.

Canada's CPI rose 1.4% in March, following a 1.0% increase in February. On a 12-month basis, headline CPI rose 6.7%, the largest increase since January 1991. Inflationary pressure remained widespread in March, as prices rose across all eight major components. Prices increased against the backdrop of sustained price pressure in Canadian housing markets, substantial supply constraints, and geopolitical conflict, which has affected energy, commodity, and agriculture markets. The BoC expects inflation to average almost 6% in the first half of 2022, remaining well above its 1%–3% control range throughout this year. Inflation is then expected to ease to about 2.5% in the second half of 2023 before returning to the 2% target in 2024.

INTERNATIONAL

The European Central Bank stated that data had reinforced the need for asset purchases to end sometime in the third quarter. Although Russia's invasion of Ukraine would have "material impact" on economic activity and inflation through high commodity prices, disruption of trade, and weaker confidence, the ECB viewed underlying economic conditions as solid. The labour market had continued to improve as coronavirus headwinds were waning, while compensatory fiscal measures could help offset the energy shock for consumers. Even with the downward revision to growth, the euro economy is still expected to post robust expansion for the year. Euro-area GDP rose 0.2% seasonally adjusted in the first quarter and is expected to gain 2.8% for the year according to the latest IMF projections.

The upside risks to inflation seem to be more pressing for the central bank, with the ECB citing the risk of higher inflation expectations. Rising energy prices have been a significant driver of inflation, with ECB analysis showing that around 3% of core inflation had been driven by indirect effects from energy. Inflation was unchanged at 7.5% year over year as of April's preliminary release and is expected to be 5.3% for the year. This reiteration that asset purchases could end in Q3 heightened expectations that the ECB could hike rates as early as that same quarter, as the central bank had indicated rate increases would start shortly after quantitative easing ended.

Japan meanwhile faces the opposite problem as many other countries. Japanese inflation has remained muted as the country is still in the recovery phase, while yields globally have risen in the face of decade-high inflation prints. The Bank of Japan therefore stressed it would maintain ultra-loose monetary policy to support the economic recovery, announcing it was boosting efforts to maintain its yield curve control target. Unlike other developed economy central banks, the BoJ targets the 10-year yield with a current target of 0% with an implicit 0.25% buffer. The central bank announced it would buy an unlimited amount of 10-year Japanese government bonds at the upper target of 0.25%, showing its commitment to easing policy.

EMERGING MARKETS

China's zero-tolerance policy stance on COVID-19 sent two of its major cities, Shanghai and Beijing, into lockdown during the month. Continued lockdowns pose a risk for elevated inflation given the implications for supply chains. Supply chains risks have resulted in increased calls by various countries for ways to onshore or regionalize supply chains as a way of limiting external shocks. If economies deglobalize and onshore business activities in a bid to ensure food and energy security and to shorten supply chains, this could lead to structurally higher levels of inflation.

Toward the end of the month China's top leaders promised to boost stimulus and contain the country's worst COVID outbreak since 2020, issuing a sweeping set of pledges that was light on details but enough to spark steep gains in stocks and the yuan. Vows by the Communist Party's Politburo to meet growth targets and support the "healthy" development of tech platform companies improved investor sentiment.

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	-3.34	-6.88	-7.64	-9.93	-7.73	-0.69	0.56	2.11
Bloomberg Barclays Global Aggregate (C$ Hdg)	-2.74	-6.07	-7.29	-7.56	-6.76	0.13	1.14	2.54
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	-3.63	-5.69	-7.58	-8.27	-5.35	2.12	2.90	4.98
Equities								
MSCI World (Developed Markets)	-6.18	-7.72	-8.55	-12.01	0.23	8.54	8.69	12.92
MSCI World Growth	-9.88	-11.82	-16.84	-19.48	-5.98	11.08	11.59	14.63
MSCI World Value	-2.77	-3.92	-0.20	-4.48	5.82	5.10	5.23	10.88
MSCI Canada	-5.15	-1.74	-0.45	-1.92	10.88	9.44	7.98	7.74
MSCI USA	-6.98	-8.27	-8.73	-12.90	1.82	11.38	11.53	15.90
MSCI EAFE	-4.30	-7.08	-9.06	-10.96	-4.57	2.67	3.37	8.53
MSCI Europe	-3.56	-8.06	-8.99	-11.66	-3.06	3.10	3.52	8.65
MSCI Japan	-6.69	-9.84	-12.73	-13.82	-10.02	1.39	2.55	8.59
MSCI Pacific Ex Japan	-3.73	3.94	-2.57	-1.22	-2.62	2.37	3.91	7.96
MSCI EM (Emerging Markets)	-3.37	-10.01	-11.48	-11.11	-15.15	0.51	2.92	5.58
World Currencies (relative to CAD)								
US Dollar	2.32	0.49	3.11	1.18	3.89	-1.69	-1.34	2.61
Euro	-2.98	-5.43	-6.01	-6.14	-8.96	-3.65	-1.96	0.31
Pound Sterling	-2.43	-5.96	-5.56	-6.21	-5.79	-2.92	-1.93	0.00
Yen	-4.14	-10.63	-9.26	-10.07	-12.35	-6.53	-4.26	-2.24

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

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