Monthly Market Monitor

September 2022

NEI

HIGHLIGHTS

Nowhere to hide as major asset classes declined further

Markets retreated in August as central banks delivered a blunt message that they are willing to risk economic growth to tackle inflation. Global equity and bond markets pulled back from the July rebound and repriced lower as it became evident that there could be some "pain for businesses and households" in the near term.

Headline inflation may have peaked, but core inflation remains elevated

Headline inflation may have peaked in the U.S. as commodity prices continue to roll over and supply chains improve. However, core inflation remains unacceptably high across most regions due to wage gains and housing, for central banks to consider pausing rate hikes.

Rising risk of a sharp downturn in China threatens global economic growth

China has been plagued by several headwinds which have hampered economic growth: from a severe property sector slump and global consumption rotating from goods to services, to numerous Covid outbreaks and lockdowns. China has cut lending interest rates and recently launched a broad stimulus plan in hopes of stimulating credit demand and economic growth.

ASSET ALLOCATION OUTLOOK SUMMARY

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

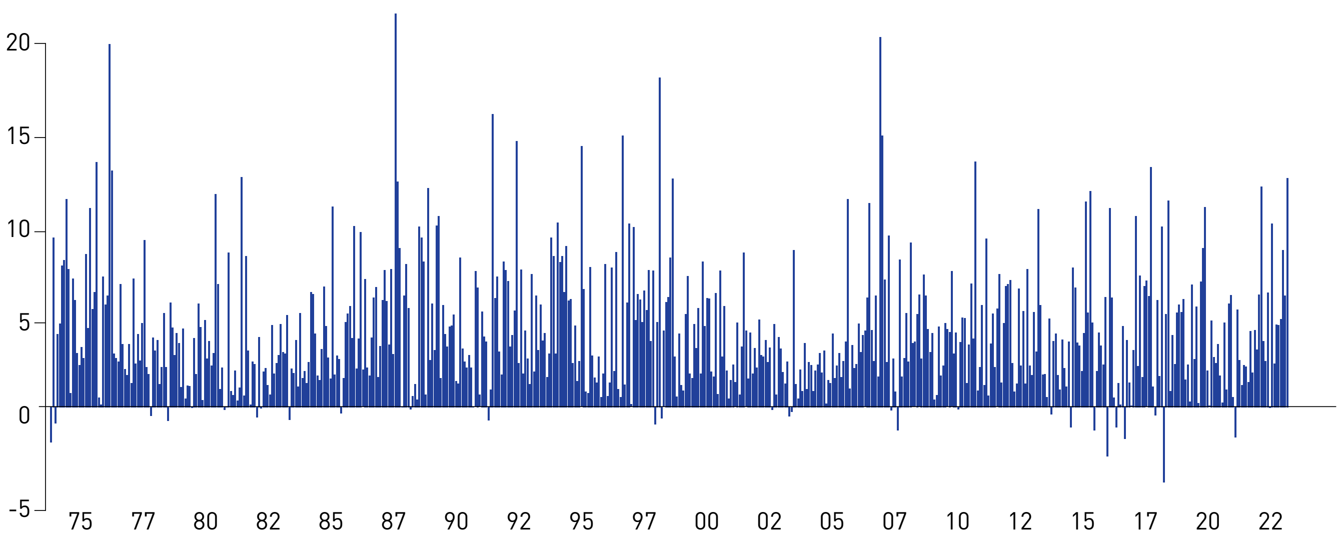
OVERVIEW

The market was not able to hold on to the relief rally in July, every major asset class slid into negative returns for the month of August and extended their year-to-date losses. August was a tale of two halves as easing price pressures provided support to equities in the first two weeks, but the market lost steam mid-month as hawkish central bank messages and rising recession fears pushed global bond yields higher and equities lower. Investors remain convinced that central banks will have to pivot and stop raising rates next year, contrasting the narrative maintained by central bank officials that they need to continue to raise rates until inflation subsides.

Markets extended losses further towards the end of the month when Central bank leaders met at the Jackson Hole conference and reiterated their resolve on fighting inflation. With tighter financial conditions and rising odds of recession, all major asset classes including equities, bonds, commodities and high yield credit slid in concert, leaving investors with no place to hide. The U.S. dollar was the only safe haven as it strengthened against most currencies. Global equities declined by -2.1%, while commodities in aggregate fell by -1.8% in August.

Nowhere to Hide

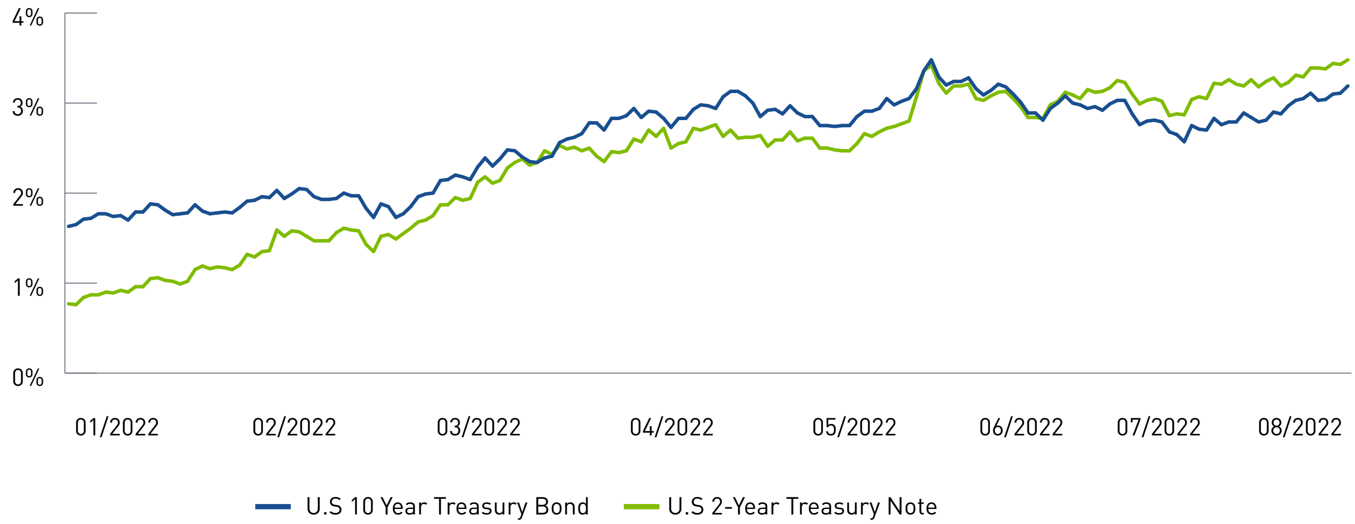
Cross-asset holders had their worst month since 1981



Source: Bloomberg *Major assets (stocks, Treasuries, IG, HY, commodities)

In fixed income markets, the short end of the sovereign bond curve, which is more sensitive to policy rates, rose across most regions along with prospects of more rate hikes to come. The U.S two-year Treasury yield rose to a 15-year high, by more than the rise in 10-year yield, resulting in a deeper yield curve inversion between the 2-year and 10-year yields. The yield curve inversion, typically a harbinger of recessions, may deepen further as central banks continue to raise rates. High yield credits dropped along with other risk assets as spreads moved higher. Global bonds were down -2.7% and U.S high yield credits were down -2.4% in August.

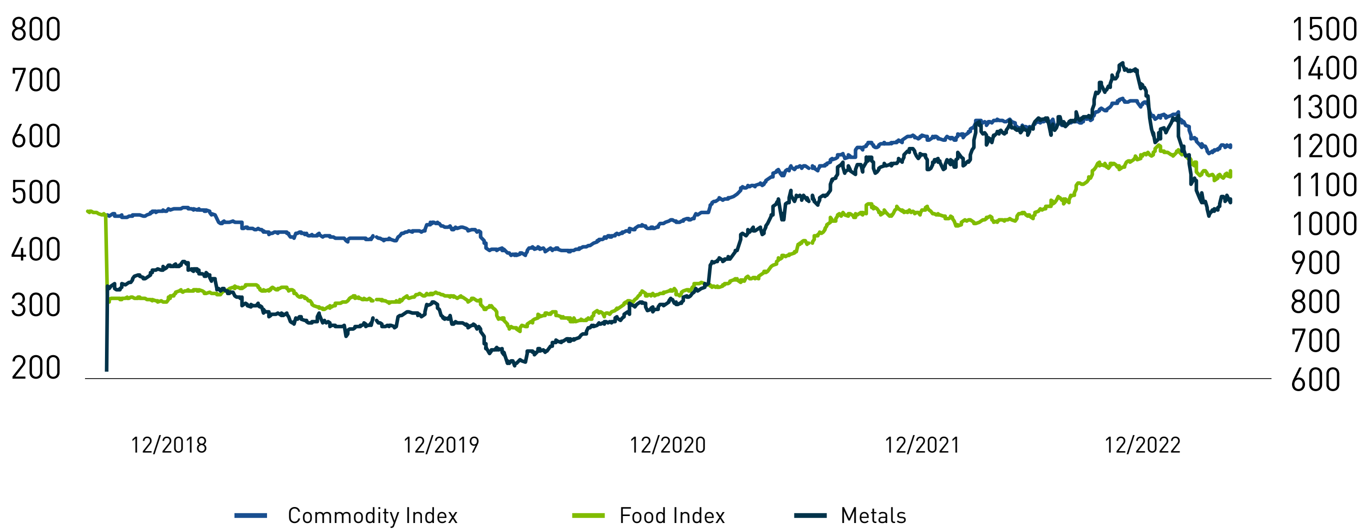
U.S 2 Year Treasury Yield Rises Higher than the U.S 10 year Treasury Yield



HEADLINE INFLATION MAY HAVE PEAKED IN THE U.S., BUT NOT IN EUROPE

Headline inflation may have peaked in the near term in the U.S. as commodities including raw industrial metals such as copper, steel, and zinc continue to roll over, crude oil prices remain steady, and shipping costs have softened with easing of supply chain disruptions. Some of the food types such as wheat and soy have also come off the boil, while others\ like corn prices for instance, are rising again due to climate events such as droughts and floods.

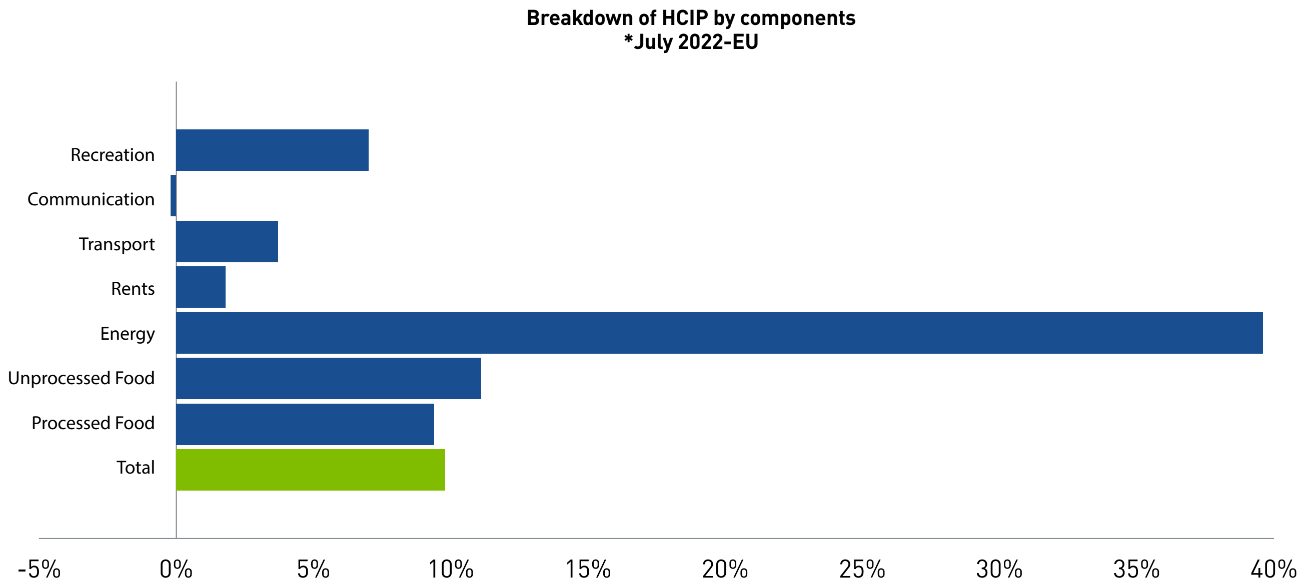
Major commodities have rolled over, but food remains one to watch



Source: Bloomberg. Data as of Aug 31, 2022

The path for headline inflation is dicier in the Eurozone relative to its North American counterparts since Europe is a net importer of commodities and is highly dependent on Russian natural gas imports. Sanctions placed on Russia earlier this year by the EU have resulted in constrained supply and record high natural gas prices. European natural gas prices have soared over 10 times their price at the beginning of the year and the average cost to heat a home now exceeds $1,000/month. Headline inflation in major European countries is expected to rise above 10% by year end. As inflation in the Eurozone broaches higher, financial conditions have tightened sharply, making it more likely that the region could face a recession this year. The European central bank is in a tight spot as they try to tame inflation, given that higher policy rates will be ineffective in tackling supply induced inflation, caused largely by higher energy prices.

Inflation Elevated by Higher Energy Prices

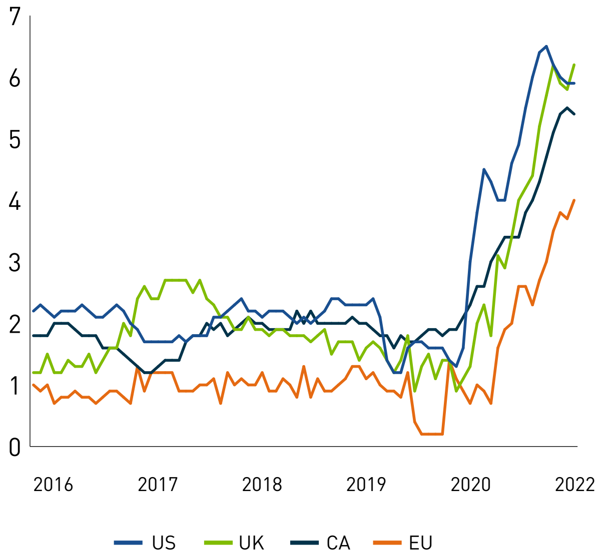


Source: Eurostat
*y/y inflation

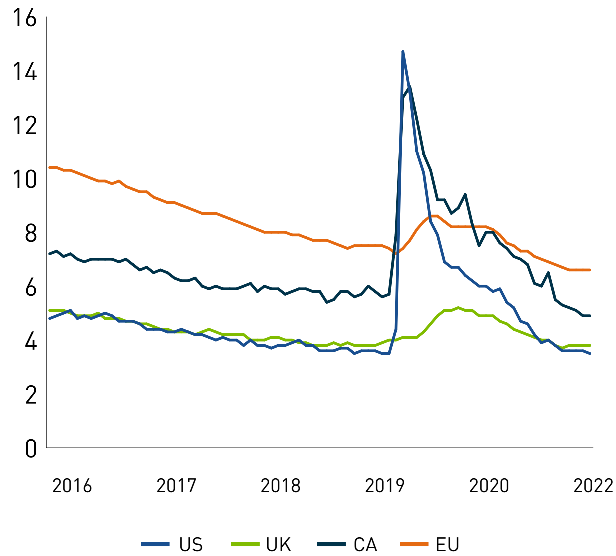
CORE INFLATION REMAINS ‘UNACCEPTABLY’ HIGH

Core inflation, which excludes the most volatile food and energy categories, allows central bankers to look through temporary shocks, and provide them with a better gauge on the underlying trend of inflation. It is therefore more informative for predicting the trend of policy rates. Core inflation remains at levels that are too high for central banks to consider a dovish pivot. In a statement, the US Fed chair indicated that “reducing inflation is likely to require a sustained period of below-trend growth.” Moreover, “there will very likely be some softening of labor market conditions.” Labor markets remain tight, and both wage inflation and services inflation rates continue to accelerate in the major economies at a pace well above central bank inflation targets. However, cooling in the North American housing market is expected to ease the inflationary pressure on rent and shelter. Until core inflation shows signs of peaking, central banks will continue to push up policy rates until inflation subsides towards their targets.

Core CPI Remains Elevated Regionally



Unemployment Rate
Labor Market Remains Tight



Source: Bloomberg. Data as of Aug 31, 2022

RISING RISK OF SHARP DOWNTURN IN CHINA THREATENS GLOBAL GROWTH

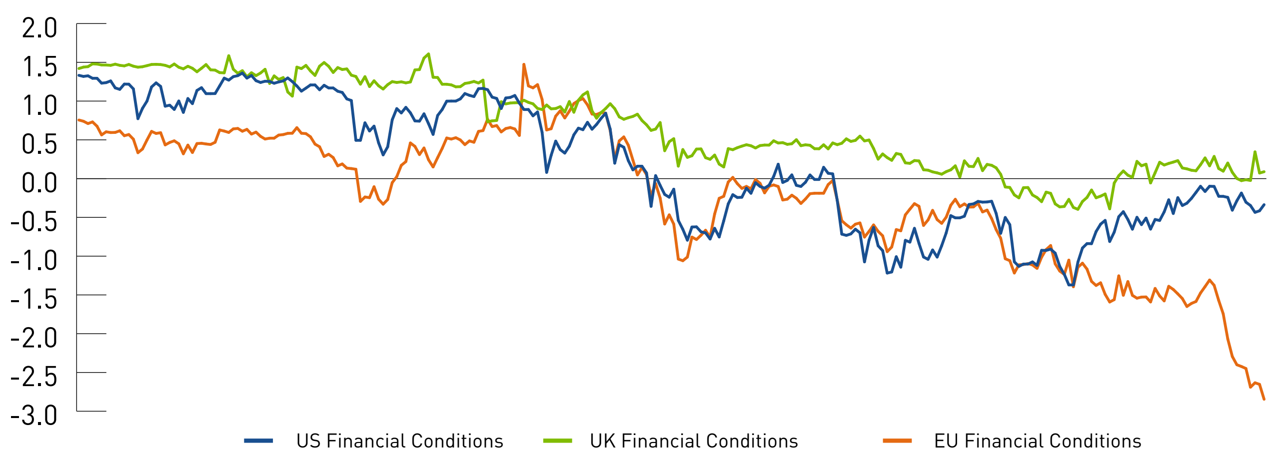
Deteriorating domestic demand is becoming more evident in China. The largest emerging market has been plagued by several headwinds which have hampered economic growth. The economy faces several challenges: from a severe slump in the property sector, global consumption rotating from durable goods to domestically driven services to Covid outbreaks and restrictions that have hampered consumer and business confidence. With the manufacturing hub in Chengdu and the southern technology and electronics hub in Shenzhen being locked down in addition to some areas around Beijing, the risk of a sharp downturn is increasing. Power outages due to a recent heat wave have also complicated the recovery. The drops in construction activities and in consumer demand due to the various lockdowns has led to significant declines in a wide variety of commodity prices. Officials have declared that they will be "more forceful" in rolling out economic policies to support growth. On August 15th China cut its lending interest rates for the second time this year, but the effect on reviving credit demand has been questionable. On August 24th, Beijing also announced a new 1 trillion yuan (US$145B) stimulus plan, mostly in the form of credit facilities and infrastructure financing in various areas including energy generation, housing supply, agricultural materials and business aid. The plan also included policies intended to clear logistical hurdles and help businesses move workers more easily. EM equites responded favorably to the announcement on August 24th. The MSCI China Index was up by 2.3%, while the MSCI EM Index rose by 2.2% in Canadian dollar terms in August.

OUR OUTLOOK

We expect that the path of further interest rate increases will continue to be data dependent. August's economic data was a mixed bag, as there was a broad-based deterioration in manufacturing activities in developed markets and consumer confidence hit decade lows in Europe. However, unemployment rates are still near cyclical lows in the US, Europe and other developed markets. Inflation rates remain far too elevated, and labor markets remain far too tight, for policymakers in major central banks to pivot away from their hawkish trajectory. Central banks are now willing to risk economic growth to tackle inflation. With increasing odds of recession across regions and markets, we expect equity markets to continue to struggle, until there are indicators of core inflation peaking causing central bankers to pause rate hikes. However, sector diversification to favor defensives could lessen the blow. On the fixed income side, bond yields could be range bound for the remainder of the year and would serve as a hedge against recession.

From a regional perspective, we continue to favor U.S over Europe and Emerging Markets. With tighter financial condition in Europe, further upside risks to inflation, weakening PMIs and consumer confidence, we believe that it is more likely that Europe will face a recession this year.

Financial Conditions Tighten the Most in the EU



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

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	-2.74	-1.17	-7.34	-11.01	-10.97	-2.61	0.50	1.73
Bloomberg Barclays Global Aggregate (C$ Hdg)	-2.67	-1.73	-6.59	-9.28	-10.10	-2.32	0.50	2.07
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	-2.36	-3.73	-8.05	-11.48	-10.96	0.36	1.80	4.20
Equities								
MSCI World (Developed Markets)	-2.07	-2.19	-8.04	-14.76	-11.99	8.25	8.80	12.61
MSCI World Growth	-3.20	0.11	-11.26	-22.02	-20.08	9.84	11.40	14.37
MSCI World Value	-0.94	-4.34	-5.36	-7.70	-4.08	5.66	5.57	10.49
MSCI Canada	-1.96	-6.66	-7.83	-8.08	-4.09	7.52	7.00	7.29
MSCI USA	-1.85	-0.37	-6.78	-14.34	-10.31	11.28	12.18	15.61
MSCI EAFE	-2.65	-6.07	-11.17	-16.61	-16.89	1.90	2.52	8.01
MSCI Europe	-4.16	-8.24	-13.20	-19.18	-18.72	1.73	2.11	7.70
MSCI Japan	-0.41	-1.77	-9.66	-14.85	-16.01	1.82	2.86	9.28
MSCI Pacific Ex Japan	0.42	-3.16	-3.24	-5.70	-9.22	2.33	3.60	7.46
MSCI EM (Emerging Markets)	2.63	-3.18	-10.48	-14.45	-18.96	2.24	1.47	5.87
World Currencies (relative to CAD)								
US Dollar	2.20	3.54	3.25	3.68	3.64	-0.48	0.88	2.87
Euro	0.79	-2.81	-7.56	-8.33	-11.72	-3.45	-2.45	0.57
Pound Sterling	-2.27	-4.41	-10.46	-10.93	-12.38	-1.98	-1.16	-0.28
Yen	-1.46	-3.92	-14.21	-13.88	-17.87	-8.96	-3.67	-2.84

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

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