Monthly Market Monitor

January 2022

NEI

HIGHLIGHTS

Stocks make customary holiday gains

Pandemic concerns generated some market volatility, but equities recovered amid low volume over the holidays. Stocks rose to another all-time high on the back of a "Santa Claus" rally.

Global responses to Omicron

The rapid spread of the Omicron variant of COVID-19 led to governments across the world reintroducing restrictions. Booster shots are being pushed by various governments as a means to contain the outbreak.

Eyes on policy moves at 2021's end

Market attention at the end of last year was focused on various central bank meetings as markets look to better understand the path of future rate hikes. Despite Omicron, central banks are pushing on with tightening policy as inflation remains elevated and the labour market tightens.

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		This month			
Corporate Bonds			This month		
High Yield Bonds			This month	Last month	
Overall equity				This month	
Overall fixed income		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 December 31, 2021. 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.

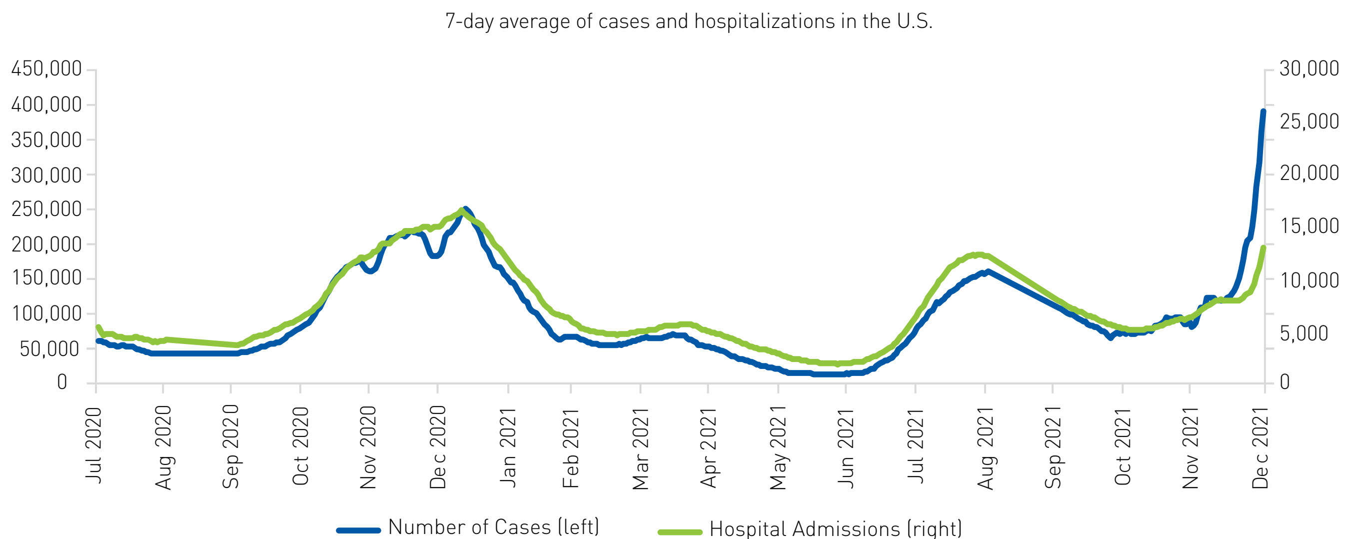
OVERVIEW

Equities rose to another all-time high on the back of a customary December "Santa Claus" rally. The Omicron variant of COVID-19 had initially generated some market volatility, but equities recovered amid low volume over the holidays. In fact, the S&P 500 Index hit its 70th all-time high for 2021 and the S&P 500 Index returned an impressive 27.6% for the year, in Canadian-dollar terms. The large gains were driven by the five largest stocks in the S&P 500 Index at the start of 2021, all mega-capitalization technology names. Other positive sectors included energy, real estate, and financials.

The final month of 2021 was also characterized by central bank actions. Market attention was focused on the various major central bank meetings that occurred in December as markets sought a clearer picture on the path of rate hikes to come. The Bank of Canada renewed its inflation mandate with an increased focus on maximum employment, and the U.S. Federal Reserve announced a faster pace of asset purchase tapering. Across the pond, the European Central Bank unveiled its path of tapering, and the Bank of England surprised markets by hiking rates in the face of rising Omicron cases.

The Omicron variant of COVID-19 continued to spread globally. Countries are facing the highest daily case counts on record given the higher transmissibility of the variant. Markets, however, appeared to rationalize the high number of infections against the low rate of Omicron hospitalizations relative to cases compared to that of previous waves. The early hypothesis of Omicron being a more infectious but less deadly virus appeared to be increasingly the case.

Hospitalizations decreasing in proportion to COVID case counts



Source: U.S. Centers for Disease Control and Prevention, seven-day average of cases and hospitalizations, as of December 31, 2021.

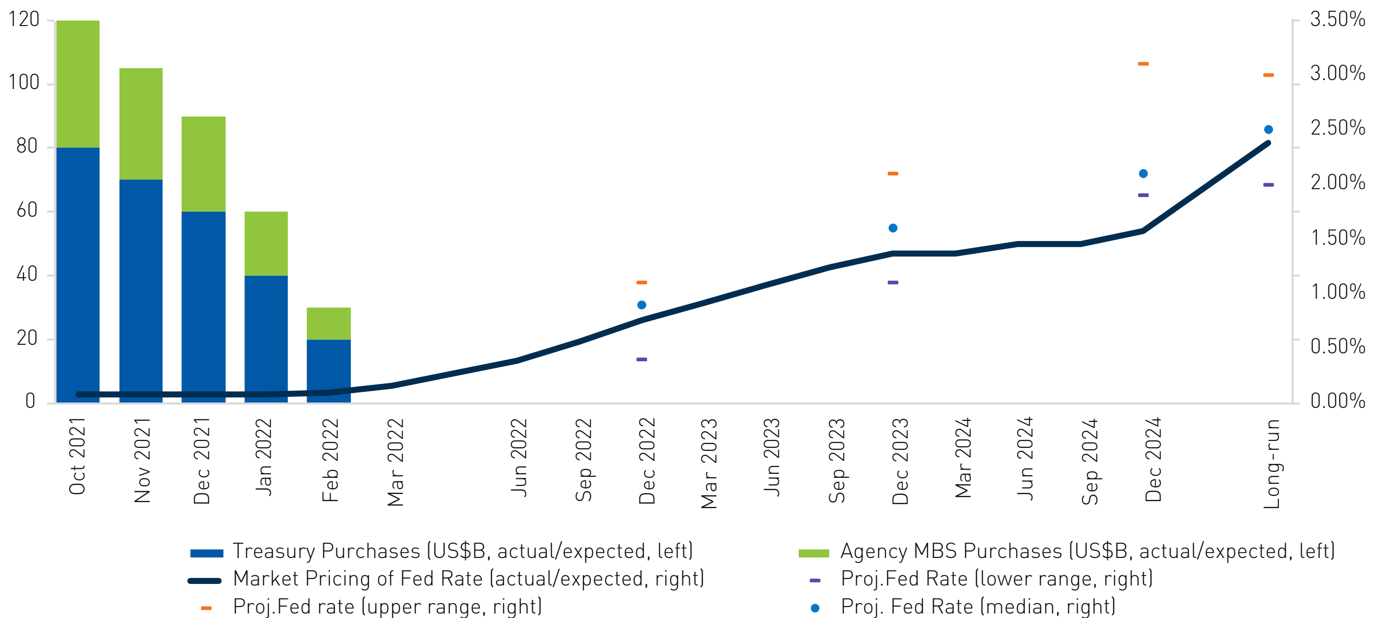
Governments have reintroduced restrictions in response to Omicron. Although hospitalizations remain low relative to case counts, there is still the risk of strained health care systems as the virus spreads exponentially. Booster shots are also being pushed by various governments as a means to contain the outbreak. The U.S. Food and Drug Administration has authorized the use of both Pfizer's and Merck's COVID-19 antiviral pills, with other countries expected to follow suit. Clinical trials showed that Pfizer's pill had an effectiveness rate of nearly 90% in reducing hospitalizations and deaths in high-risk individuals, while Merck's was less effective at 30%. Nonetheless, both pills could be useful new tools in managing infections and could reduce strains on health care systems.

U.S.

The Federal Open Market Committee meeting went mostly as expected. The Fed announced that it was accelerating the rate at which it was tapering its asset buyback program, doubling its reduction to US$30B per month. Going forward, the Fed will purchase at least US$60B of bonds in January, but if this pace of tapering continues the asset purchase program will conclude by the end of March.

The updated Fed "dot plot" projections, which the central bank uses to signal its outlook for the path of interest rates, put the median number of potential rate hikes expected by the committee at three in 2022 to 0.9%, followed by another three hikes in 2023 to 1.6%. Inflation has surged to a near 40-year high, and the Fed is wary that inflationary risks may be increasing. The central bank's policy statement had also dropped the "transitory" reference to inflation. The Fed acknowledges that price increases had exceeded its 2% target "for some time." Fed Chairman Jerome Powell had explained previously that the term "transitory" from a Fed policy standpoint referred to the fact that inflation would return to the 2% target in the long term as longer-term inflation expectations remain well-anchored.

U.S. Federal Reserve tapering asset purchases, charting rate hikes



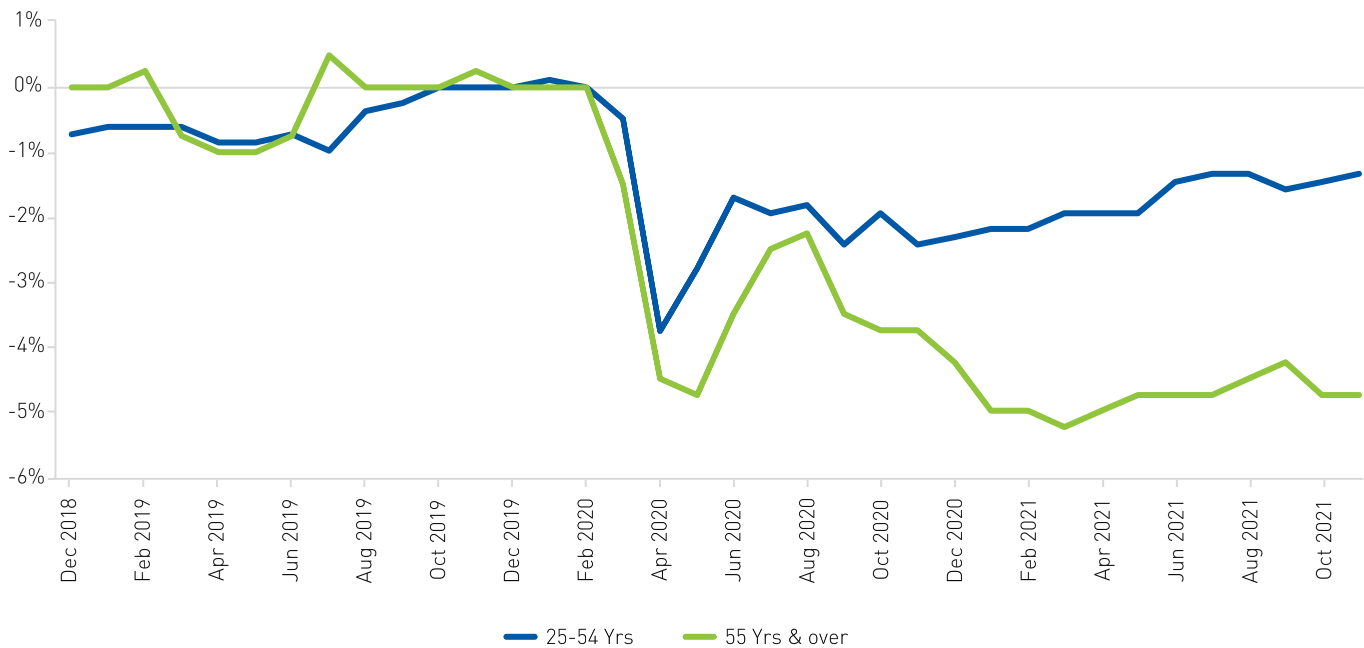
Source: U.S. Federal Reserve, Fed Fund Rate Futures: Chicago Board of Trade, Bloomberg, and NEI Investments, as of December 31, 2021.

U.S. consumer price index inflation rose significantly, increasing by another 0.8% on a seasonally adjusted basis in November. The increase was broad-based, led by goods rising 1.4%, while service prices increased 0.4%. On a year-over-year basis, U.S. CPI accelerated to 6.8%, the highest reading since 1982.

November employment data on the other hand gave mixed signals. Nonfarm payrolls rose by just 210K jobs in November, widely missing consensus expectations of 550K. However, the unemployment rate dropped sharply to 4.2%. The unemployment rate is based on a household survey, which instead indicated that 1.1M jobs were added on a higher participation rate. Markets were able to seek comfort in the stronger latter numbers, believed to be more accurate for the month given the declining coronavirus case backdrop in November and following the expiration of unemployment benefits.

Companies have been complaining about widespread labour shortages. The "Great Resignation" has become a popular term used by the media to describe the high numbers of people quitting their jobs. The plethora of job openings has opened a lot of doors for many, however. The U.S. Job Openings and Labor Turnover Survey (JOLTS) indicated there were over 11,000 job openings as of October 2021, compared to just 7,000 pre-pandemic in February 2020. The JOLTS quit rate has steadily risen to 2.8% in October 2021, compared to 2.2% pre-pandemic. Even with plentiful jobs, labour participation has not recovered as many are unable to return to work due to COVID-related reasons. The labour participation data are hinting at the fact that the shortage may be largely attributable to early retirements. Participation amongst prime age workers aged 25–54 has been steadily recovering since the onset of the pandemic, while the participation rate for those aged 55 remains nearly 5% below pre-pandemic levels.

Change in labour force participation rate by age group



Source: U.S. Bureau of Labor Statistics, FRED Economic Data, Federal Reserve Bank of St. Louis, NEI Investments. Change in labour force participation rate is seasonally adjusted, with base value of 0% on December 2019.

On the political front, the U.S. was able to avoid a potential default when President Joe Biden signed a US$2.5T debt ceiling increase. This increase is expected to cover the government's obligations into 2023. On the other hand, the US$1.75T Build Back Better Plan hit an impasse, as Democratic Senator Joe Manchin, characterized as a more conservative member of his party, said he would not support the spending package. Manchin expressed concerns of its inflationary impact and the growing federal debt, amongst other reasons. President Biden and his administration will engage in further negotiations with Manchin to come to an agreement; Manchin has said he would support a scaled-back plan, and winning every Democratic vote is practically a requirement in a U.S. Senate with a 50-50 split with the Republicans.

Looking ahead, weak U.S. consumer sentiment and spending could weigh on future growth. Consumer sentiment remains depressed on a combination of rising prices and indications of limited spending intentions for big-ticket items, all signals that difficult times may be ahead as consumers look to save and curb spending.

CANADA

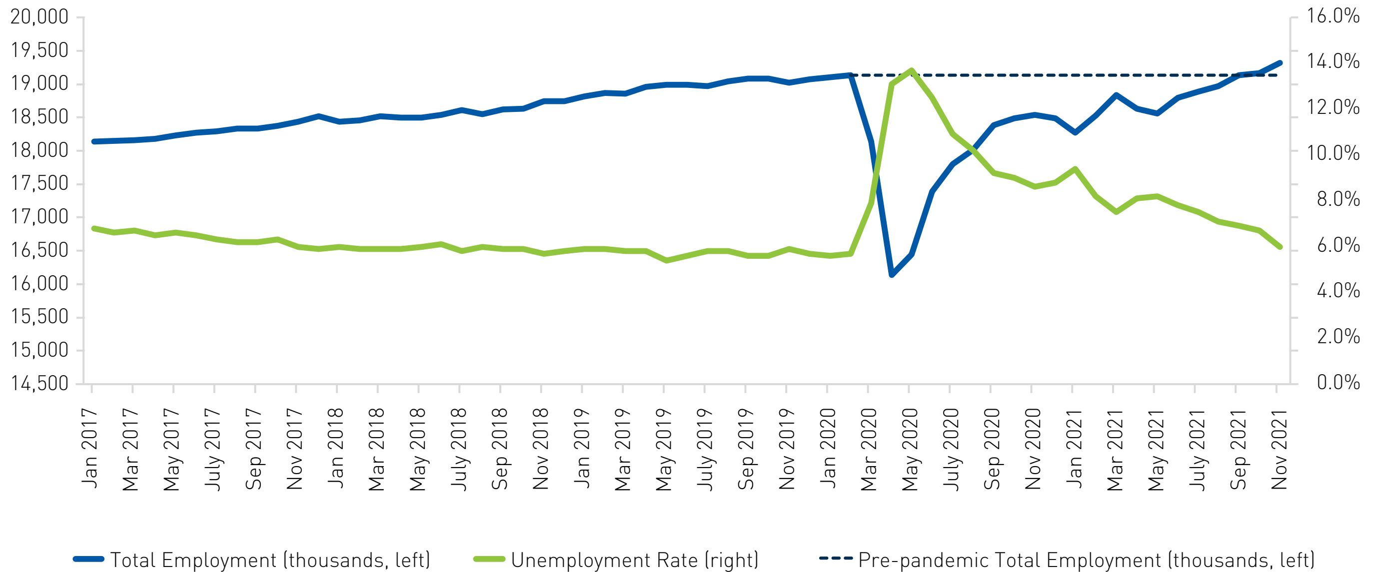
The Bank of Canada left its policy unchanged but became more optimistic overall as economic momentum continued in the fourth quarter of 2021. The BoC noted broad-based job gains in recent months that "brought back employment essentially back to its pre-pandemic level." With respect to inflation, the central bank removed the word "temporary" from its description of inflationary forces, issuing a statement that "the Bank is closely watching inflation expectations and labour costs to ensure that the forces pushing up prices do not become embedded in ongoing inflation." Overall, the BoC noted, "inflation has increased further in many countries, reflecting strong demand for goods amid ongoing supply disruptions." Although inflation will remain elevated in the near term, the central bank expects inflation to ease back toward 2% in the second half of 2022.

The BoC renewed its mandate with the federal government with the primary objective to maintain a 2% inflation target for the next five years, also emphasizing that the central bank would promote efforts to achieve "maximum sustainable employment." The BoC will use a broad range of labour market indicators to assess when this employment level is achieved, and will use its monetary policy tools to boost employment levels as long as its efforts don't hinder stable prices. The BoC can keep inflation within a 1%–3% control range, though medium-term inflation expectations must be anchored to 2%. Interestingly, the Bank of Canada first introduced this inflation target in 1991, the first major central bank to do so, and inflation has averaged close to 2% over the past 30 years.

Canada's CPI in November rose 0.2% month over month, or 4.7% year over year. The country has only reached this year-over-year level once in the last 30 years, with November's rate (along with October's) the highest since February of 2003. A core inflation measure, CPI Common, posted a 0.2% increase, suggesting that inflationary pressures are broadening. Transportation and shelter prices continued to post significant gains, while durable goods also saw notable price appreciation, notably in vehicles and furniture. These price gains were driven both by heightened demand and by issues with supply chains, which also pushed food prices higher.

Canada added approximately 153.7K jobs in November, well over estimates of 37.5K. The unemployment rate fell sharply to 6.0% from 6.7%. The high jobs number is attributable to large numbers of Canadians exiting the unemployment ranks as the government cancelled income support for individuals in October and Delta variant case counts fell. Unemployment is not quite at the pre-pandemic level of 5.6% despite the headline jobs number due to population growth. However, total employment is above pre-pandemic levels, which should help the BoC conclude that the country is nearing "maximum sustainable employment" and give the central bank more comfort in raising rates in 2022. Given the strong employment and elevated inflation numbers, the market is now implying five rates hikes in 2022, the most of any G7 nation. The BoC has already ended its quantitative easing program, clearing the way for its first rate hike in early 2022.

Canadian employment has recovered to pre-COVID levels



Source: Statistics Canada, as of November 2021.

Going forward, jobs numbers may not be able to maintain their upward trend as Omicron spreads rapidly, with infection numbers reaching new peaks in December. As a result, the Canadian government has announced new pandemic support of $300 per week. Along with new restrictions in various provinces, this may slow down further hiring, especially in more COVID-impacted industries.

INTERNATIONAL

Any further European economic recovery is becoming increasingly uncertain, as renewed lockdowns returned to Europe as the coronavirus spreads. The Omicron variant is spreading at a notable pace, with many countries hitting record highs.

The Bank of England raised interest rates by 15 basis points to 0.25%, becoming the first major central bank to hike its benchmark rate since the pandemic began. This move surprised markets, which had expected a more dovish and less inflation-wary reaction from the central bank as cases rose. Inflation increased to 5.1% year over year in November, and BoE policymakers project inflation to continue to increase peaking "at around 6% in April 2022" before falling in the second half of that year. Combined with the continually tightening labour market, the BoE states "it would be necessary over coming months to increase Bank Rate in order to return CPI inflation sustainably to the 2% target," indicating that more hikes are to come.

The European Central Bank confirmed it would end its Pandemic Emergency Purchase Programme at the end of first quarter of 2022 and stated that asset purchases under the program would be continued at a lower pace in the quarter. The latest inflation expectations for 2022 jumped to 3.2%, from just 1.7% back in September. Furthermore, the unemployment rate is expected to fall to its pre-pandemic level by the end of 2021. However, the ECB's Asset Purchase Programme will look to pick up the slack to allow an orderly taper of purchases, purchasing €40B per month in the second quarter of 2022 and €30B in the third quarter, before returning to its original €20B per month in the fourth quarter. The central bank expects that continued asset purchases will be required as inflation for both 2023 and 2024 is forecasted at just 1.8%, implying that policy rates will also remain at their current levels.

The Bank of Japan meanwhile maintained its status quo when other major central banks globally are turning towards tapering. The Japanese economy has picked up, but "has remained in a severe situation due to the impact of COVID-19 at home and abroad," in the BoJ's words. A big reason for the non-action from the central bank is the fact that Japan's inflation is bucking the global trend. Japan's CPI ex-fresh food, the central bank's preferred measure of inflation, rose just 0.5% in November. The measure is skewed compared to the rest of world, as communication prices declined 33.9% in the country due to competition in the industry. However, when even accounting for the 1.5% drag of communication, CPI ex-fresh food would only be at approximately 2.0% today.

EMERGING MARKETS

The People's Bank of China stated that it would cut the reserve ratio requirement for banks by 50 basis points, unleashing CN¥1.2T of liquidity, a move that may mark the first easing move with more to come. The Chinese economy has seen a significant slowdown this year, with Q3 GDP growing just 0.2% quarter over quarter. The government introduced regulatory crackdowns on various industries, and the economy has been plagued with a slumping housing market. Chinese CPI is also running below the 3% central bank target, running at 2.3% year over year as of November.

Evergrande Group missed an interest payment due in November, and has technically entered default having missed the 30-day grace period this month. Fitch Ratings cut Evergrande to "restricted default" and S&P Global Ratings followed suit, downgrading the company to "selective default." The move comes as other Chinese property developers also face deep discounts on their bonds and downgrades to their ratings. Policymakers have stepped up to take part in the restructuring in order to prevent an uncontrolled collapse, but have also stated that they have no interest in bailouts at this point.

At the same time, the economy is being hit by lockdowns as China implements its zero COVID strategy, in which a single case has seen whole cities effectively enter a full lockdown. China is now attempting to carry on this strategy against the more contagious Omicron variant, and is facing its largest outbreak since the onset of the pandemic. The city Xi'an saw just over 1,000 cases as of the end of December, which locked down the city of 13 million residents. China may look to further escalate its zero COVID strategy, given that the 2022 Beijing Winter Olympics will take place in February.

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	1.66	1.41	0.92	-2.60	-2.60	4.12	3.21	3.16
Bloomberg Barclays Global Aggregate (C$ Hdg)	-0.44	0.04	0.14	-1.39	-1.39	3.72	2.96	3.57
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	1.80	0.59	1.50	5.14	5.14	7.94	5.47	6.57
Equities								
MSCI World (Developed Markets)	2.68	7.45	9.92	20.78	20.78	18.57	13.66	15.15
MSCI World Growth	0.51	7.84	11.22	20.15	20.15	26.10	19.51	18.18
MSCI World Value	4.94	6.88	8.43	20.91	20.91	10.71	7.62	11.92
MSCI Canada	3.12	6.87	6.56	24.91	24.91	16.09	8.90	8.34
MSCI USA	2.32	9.65	12.53	25.38	25.38	22.71	16.71	18.49
MSCI EAFE	3.51	2.39	4.29	10.32	10.32	10.62	8.25	10.38
MSCI Europe	4.97	5.35	6.11	15.31	15.31	11.95	8.83	10.54
MSCI Japan	0.33	-4.24	2.44	0.84	0.84	8.80	7.22	10.70
MSCI Pacific Ex Japan	1.71	-0.38	-2.57	3.79	3.79	6.88	7.02	9.09
MSCI EM (Emerging Markets)	0.32	-1.60	-7.48	-3.37	-3.37	8.09	8.57	7.79
World Currencies (relative to CAD)								
US Dollar	-1.53	-0.29	2.01	-0.85	-0.85	-2.57	-1.19	2.18
Euro	-0.52	-2.16	-2.18	-7.85	-7.85	-2.74	0.31	0.84
Pound Sterling	0.81	0.16	0.01	-1.76	-1.76	-0.55	0.64	0.78
Yen	-2.91	-3.39	-1.68	-11.11	-11.11	-4.13	-0.94	-1.86

As of December 31, 2021. All returns in Canadian dollars.

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