Monthly Market Monitor

December 2021

NEI

HIGHLIGHTS

Levels of inflation increase, expand

Inflation continues to climb to levels not seen for decades, driven by robust demand, supply chain issues, and higher commodity prices, while also broadening from transitory categories like hotels and car rentals to food, gasoline, and shelter costs.

Ushering out QE policies

Central bankers now acknowledge the persistence of inflationary pressures and are setting the stage for less accommodative monetary policies. The newly reappointed U.S. Federal Reserve Chair signaled that a winding down of quantitative easing could be faster than expected, while the Bank of Canada has already ended its own measures.

Moving to earnings-driven markets

The gradual removal of accommodative policy signals a move to a more fundamentals-driven market, in which earnings become a key driver of share-price movement. So far, Q3 earnings have been better than expected, lifting share prices.

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 (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 November 30, 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

Inflation rates continued to climb in November. Last month, the U.S. consumer price index (CPI) increased by 6.2%, its fastest pace since 1990. Furthermore, price gains broadened from more transitory categories like hotels and car rentals to more core categories like food, gasoline, and shelter costs. Canadian inflation also rose, with the country's CPI increasing 4.7%, matching the highest level since the Bank of Canada started to target inflation in 1991. Earlier in the year, central bankers ran with the narrative that inflation pressures were temporary, driven by the imbalances of a recently opened-up economy. Six months later, inflationary pressures persist, however, and now will likely continue into 2022. Importantly, there is increasing acknowledgment that some of the extraordinary accommodative policies currently in place, such as record-low interest rates, are creating excess demand that is pushing inflation even higher.

As a result, central bankers around the world are now setting the stage for less accommodative monetary policy going forward. Newly reappointed U.S. Federal Reserve Chairman Jerome Powell told the Senate Banking Committee that he no longer considers inflation as "transitory" and that the Fed is considering ending its asset purchase program earlier than expected. Currently, the quantitative easing program is scheduled to end in mid-2022. In Canada, the BoC unexpectedly ended its quantitative easing program in November and signaled that it could hike its policy rate as early as April 2022, rather than the second half of that year. Across the pond, the Bank of England is seeing a strong case to start hiking rates on higher inflation expectations. While the European Central Bank doesn't expect to raise its key rate next year, it is expected to end its emergency bond buying program in March.

Just as investors were digesting these monetary policy developments, South African scientists announced they had identified a new COVID-19 variant that was responsible for the recent spike in daily new cases of the coronavirus in that country. The World Health Organization quickly designated it as a "variant of concern," giving it the name Omicron. At this early stage there is still much to learn about this variant. Early observations suggest that it is easily transmittable and there are also reports that symptoms are less severe, but this will need to be verified with more rigorous research. Encouragingly, reaction to the new variant has been swift. Scientists were quick to analyze samples, identify the variant, and alert the world. Politicians followed with swift action to place travel restrictions to try to curb the global spread of the variant.

It is too early to assess fully the effects of the Omicron variant on the global economy, but so far it has created more uncertainty as to the path of growth and future inflation rates. Investors were quick to sell off assets with a higher risk profile, such as equities, and conversely bid up risk-off assets such as high-quality government bonds. Reopening beneficiaries such as the travel, hotel, cruise, and ride-sharing sectors were among those most negatively impacted at first. The effects of the Omicron variant on inflation are also not clear. More back-to-work and travel restrictions may add to supply chain disruptions that could have the effect of pushing prices even higher. However, as we noted previously, the world has become better at reacting to new variants, and the economic impact of each new virus strain has been diminishing.

While volatility has picked up, recent equity selloffs point to the continued benefit of diversified portfolios. The relative safety of bonds has helped mitigate losses from equities for many investors. Over a longer-term period, we continue to believe the global economy will continue to grow at above-trend rates in 2022, and inflation will begin to moderate. This provides a favourable backdrop for investors.

However, as Omicron has demonstrated, all forecasts are subject to developments on the pandemic front. We will continue to monitor the situation closely.

U.S.

The Federal Open Market Committee (FOMC) minutes released this month suggested that several committee participants are open to a faster removal of policy accommodation. This would include accelerating the pace of bond purchase reductions, also known as tapering, and an earlier first interest rate hike of the cycle, which could mark the liftoff stage of a potential series of interest rate hikes. The Fed could make an announcement at its December meeting that it will double the pace of tapering to US$30B per month, which would mean the final taper could come March 2022 instead of June.

A faster taper would give the FOMC greater flexibility and policy room as to the timing of its rate hikes as we head into 2022. If tapering ends sooner, and economic data such as employment numbers directionally point to continued improvement, this scenario then provides enough runway for the liftoff to come sooner. In a November 30 Congressional hearing, Fed Chair Powell gave some credence to the possibility of an accelerated tapering process, citing that the strong U.S. economy and elevated inflation could warrant ending the central bank's asset purchases sooner than planned in 2022, though the new Omicron strain of COVID-19 poses a fresh risk to this outlook.

If market data point to labour weakness, large employment gaps relative to pre-pandemic levels, and limited recovery within prime-age labour force participation alongside still-elevated levels of inflation, the Fed then also has the option to continue with a more patient approach before an interest-rate liftoff. Additionally, if the Omicron variant proves to be more severe than initially thought, this still gives the Fed the optionality of delaying liftoff until conditions are more ideal. Decoupling the narrative of tapering from liftoff is a crucial one, as this approach gives the Fed policy space to raise rates or to hold off following the end of the tapering process, depending on economic data.

The Fed could be emboldened to consider an earlier liftoff if inflation continues to broaden out to areas that are considered more structural in nature, and if there are further risks to the upside. The recent remarks by Powell indicating it is time to retire the word "transitory" and to instead propose that inflationary pressures will likely not leave a permanent mark, suggest a more hawkish tilt toward greater concerns over inflation, compared to prior language. The change in tone suggests a Fed that is increasingly considering liftoff scenarios, but this posture will likely be balanced against concerns about Omicron as more data on the virus become available. The path that the virus takes has the potential to cloud the inflationary outcome, and by extension the Fed's policy actions.

While much focus has been placed on the number of rate hikes that the market is pricing in, up from two hikes to three in 2022, increased consideration will likely have to be made as to whether the economy will be strong enough after that first rate hike to continue to see rate hikes beyond that. Considerations as to what the terminal policy rate will look like will also be important.

However, with U.S. household balance sheets still looking strong, and pandemic savings at comfortable levels, it is possible that the economy will be able to face higher rates. The U.S. Personal Income and Outlays report for October sent a reassuring message about U.S. household balance sheets. Personal income rose 0.5% month on month and beat expectations of a 0.2% month-on-month increase. Similarly, personal spending accelerated from 0.6% month on month to 1.3% month on month. More importantly, real personal spending rose by 0.7% month on month. Spending on both goods and services accelerated in October in real as well as nominal terms. A report published by BCA Research indicate that consumers spent 13% of their total expenditures on durable goods in October—which is above the 2019 average of 10%.

The course of the pandemic and its new variant could have one of three possible spending outcomes: 1) precautionary savings increases, which softens aggregate demand; 2) spending favouring goods over services, which would add to strain on supply chains; or 3) pandemic pressures easing and demand rotating from goods and toward services which would help alleviate demand-side pressures on inflation.

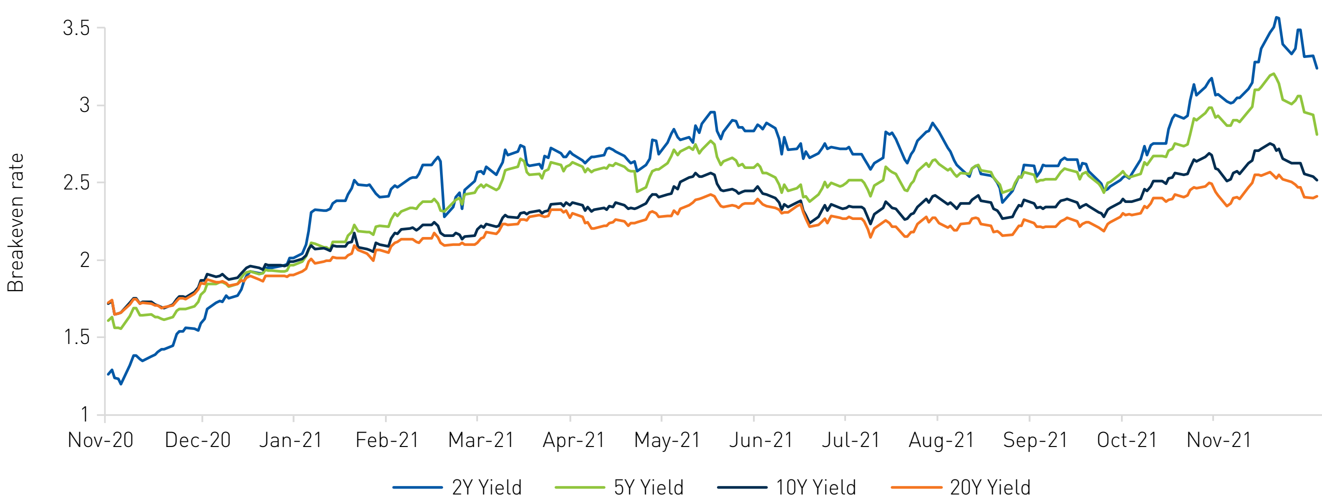
U.S CPI accelerated in October to 0.9% month on month, and 6.2% year on year. The monthly gain was the highest in four months, while the annual increase was at its fastest pace since 1990. There was continued broadening of inflationary pressures outside of the reopening components or COVID-impacted sectors. Energy, shelter, food, used cars and trucks, and new vehicles were among the larger contributors. Shelter costs, which make up about a third of the CPI, rose 0.5% due to higher rents and home prices. As shelter is seen as more of a structural component, a continued rise in the sector could result in more persistent upward pressure in inflationary readings.

Prices for new cars rose 1.4% as a global shortage of semiconductors continue to hamper production. It is likely is that some of that demand spilled over or was diverted into the used car market, in which prices were up 2.5% during the month of October. A broad theme across the economy is that businesses, experiencing solid demand but hindered by supply chain bottlenecks and a shortage of qualified workers, have been raising prices for consumer goods and services.

From a fixed income perspective, inflation expectations on the shorter end of the yield curve have notably increased. For example, the two-year breakeven rate, which represents the market's view on the annual pace of inflation over the next two years, rose to 3.3%. The breakeven rate is the yield difference between an inflation protected bond and a nominal bond of the same maturity. If breakeven rates are rising, this suggests that the market perceives that economy will face higher inflation in the future.

Of note, inflation expectations on a longer-term horizon as represented by the 10-year breakeven rate remains lower than the shorter end, suggesting that the market expects inflation to abate over time.

Yield curve suggests inflation expected to fade over time



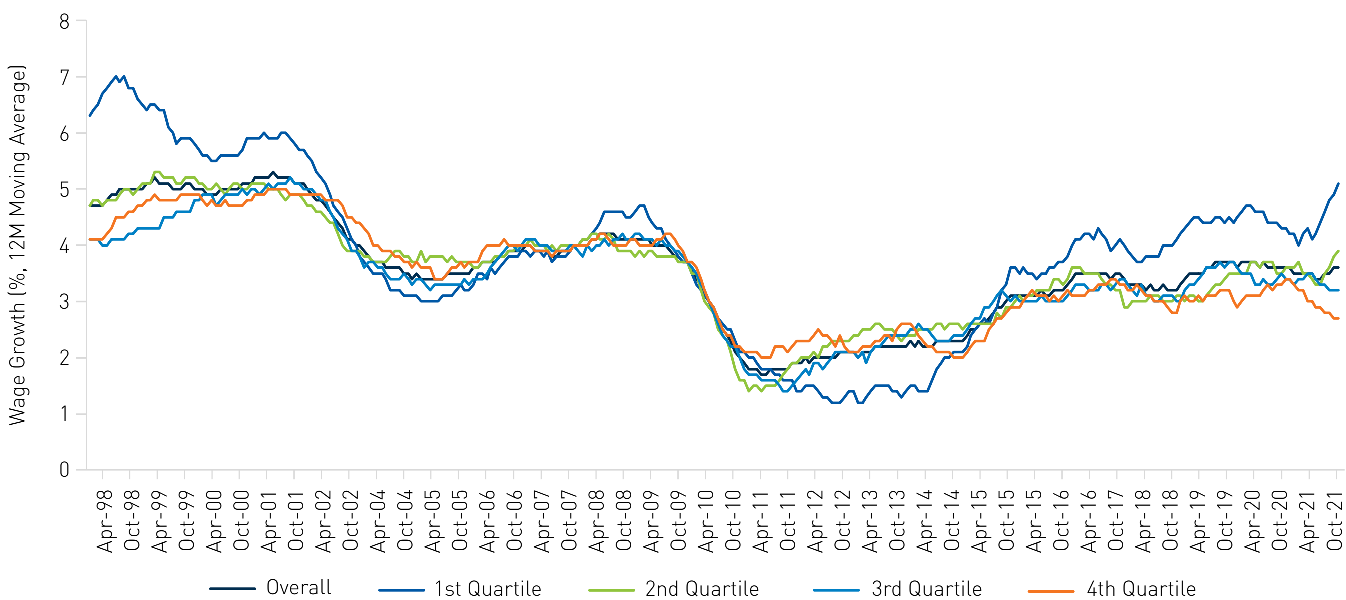
Source: Bloomberg, as of Nov. 30, 2021.

Inflation as measured by the Producer Price Index (PPI) rose 0.6% month on month in October, and 8.6% year on year. The annual increase in PPI was the highest since 2010. Excluding food and energy components, which tend to be more volatile, core PPI rose 0.4% month on month and 6.8% year on year. More than 60% of the headline increase in PPI was driven by goods prices, which rose 1.2%. This was mainly due to higher energy costs, including gasoline. Transportation bottlenecks, materials shortages, and increasing labour costs continue to be drivers of higher producer prices. Worker compensation in particular has generated growing price pressures, with wage levels at service providers hitting a 16-year high.

Rising wages have sounded the alarm on the prospects of a wage spiral. However, we believe that a strong enough case for that has not been made yet. A wage spiral refers to a scenario where workers begin to demand higher wages to keep up with the rising cost of living. This in turn fuels greater inflation as businesses then pass these costs along to end consumers, creating a vicious cycle.

While U.S. wage growth has been rising, as indicated by data from the Atlanta Fed Wage Tracker and the Employment Cost Index, the increase in wages has been concentrated in workers whose wages are in the first quartile, the lowest 25% of wages, and have been concentrated in the services and hospitality sector. The growth in this area has been primarily as a result of pandemic entry. Moreover, wage growth in the lower-paying segment is not quite concerning at this time and is not considered sustainable.

U.S. first quartile (lower end) wages see the most growth



Source: Federal Reserve Bank of Atlanta, as of October 31, 2021.

Currently wages are rising, but at a slower pace relative to headline inflation. Quarterly data released by the Bureau of Labor Statistics (BLS) regarding the movement of the Employment Cost Index indicate that wages and salaries increased 4.2% for the 12-month period ending in September 2021, when consumer prices rose by 5.4% for the same period.

While acknowledging the increase in wages, a more welcome move would have been against the backdrop of increased productivity . The third quarter "Productivity and Cost" report published by the BLS indicates that U.S. productivity declined as labour costs rose. Unit labour costs in the U.S. nonfarm business sector rose by an annual rate of 8.3% in Q3, reflecting a 2.9% increase in hourly compensation and a 5% decrease in productivity.

CANADA

The economy added 31.2K jobs in October, coming in below estimates of 41.6K. However, the jobs report signaled an underlying economy that continues to recover well from the pandemic. Job gains continue to normalize towards pre-pandemic levels when the economy averaged a gain of 23K jobs per month in the two years prior to the pandemic. Numerically, Canada has fully recovered all the jobs lost during the pandemic. However, employment is still below the pre-pandemic trend line for job growth for the last 18 months, which suggests that while a lot of progress has been made in the right direction, there are still some ways to go.

While the momentum in the housing market calmed during the summer relative to the pace of sales in the spring, things heated up in October. Data from the Canadian Real Estate Association indicate that home sales were up 8.6% month on month, marking the largest month-over-month increase since July 2020. Home prices rose 2.7% during October and were up 23.4% year on year. It is likely that the October reacceleration, being just one data point, will likely calm as the BoC announced the end of its accommodative policy in October.

The most recent Monetary Policy Report issued by the BoC, which showed data up to September 2021, pointed to housing resales and construction activity remaining elevated but having declined from historically high levels. This occurred amid signs that the pandemic-related boost in demand for more living space is easing. While multiple-unit housing starts have remained relatively robust, single-family starts have seen a more significant decline since the first quarter. Nonetheless, housing markets remain tight, and high disposable incomes and low borrowing rates should continue to support solid levels of housing activity.

Canadian housing market has declined, but remains elevated

Source: Bank of Canada Monetary Policy Report: Canadian Real Estate Association, Canada Mortgage and Housing Corporation and Bank of Canada home index calculations. Residential resales and housing starts are seasonally adjusted, as of September 2021.

INTERNATIONAL

Bank of England Governor Andrew Bailey borrowed a page from Jerome Powell's playbook and opted for a more patient approach to monetary policy. The BoE's decision comes despite upwards revisions to its 2021, 2022, and 2023 inflation projections. Instead, the BOE highlighted near term labour market uncertainty as a reason to favour a more cautious approach to interest rates.

The BoE voted 7–2 to keep the Bank Rate on hold at 0.1%, surprising markets as a number of committee members had recently expressed a stronger desire to tighten policy given rising inflation expectations. Instead, the central bank expressed concerns over slowing growth momentum, and only saw it necessary to increase rates in coming months if its inflation projections materialized. Near-term labour market uncertainty was also cited as a reason to favour a more cautious approach. The BoE downgraded U.K. GDP for the year to 6.7%, from 8.5% previously, and CPI rose to 4.3%, from 4.0%. Asset purchases also remained unchanged on a 6–3 vote.

November's eurozone inflation data came in higher than expected. The increase in headline inflation from 4.1% in October to 4.9% in November was higher than the consensus forecast of 4.5%. Food inflation rose to 2.2% while energy inflation continued to rise rapidly, reaching a new record high of 27.4%. Of note, core inflation (which excludes energy, food, alcohol, and tobacco) also rose to a record high of 2.6%.

On a forward-looking basis, the impact of the Omicron variant may have an uncertain outcome on inflation depending on the path the virus takes. Lower oil prices will reduce energy inflation, but if the variant results in consumer spending favouring goods over services, then this situation will worsen global demand–supply imbalances, causing goods inflation to grind higher for longer.

EMERGING MARKETS

China's official Purchasing Manager's Index (PMI) suggest that industrial activity rebounded in November due to easing disruptions from power shortages, while a renewed virus flareup held back the recovery in services. While we know little about its transmissibility and severity, the new Omicron variant could also hold back a further economic recovery.

The manufacturing PMI rose from 49.2 in October to 50.1 in November. The output component also came in above 50, hinting at faster growth in industry. A PMI reading over 50 indicates growth or expansion of the manufacturing sector. Conversely, a reading under 50 suggests contraction. The improvement was largely attributed to an increase in power supply capacity. There continue to be signs of supply shortages in the PMI survey breakdown. Delivery times lengthened while firms continued to draw down their inventories of raw materials, although at a slightly less rapid pace than in October. More notably, falling prices of raw materials are feeding through to lower output prices.

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	0.87	-1.59	0.13	-4.19	-3.90	4.02	2.76	3.18
Bloomberg Barclays Global Aggregate (C$ Hdg)	0.74	-0.46	1.10	-0.95	-0.68	4.35	3.10	3.78
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	-1.03	-1.19	1.06	3.28	5.17	6.47	5.47	6.67
Equities								
MSCI World (Developed Markets)	1.22	0.56	11.37	17.63	20.55	15.52	13.54	14.86
MSCI World Growth	2.75	1.97	18.48	19.54	23.32	23.81	19.64	18.01
MSCI World Value	-0.43	-0.98	4.43	15.21	17.29	7.01	7.26	11.51
MSCI Canada	-1.58	1.19	5.88	21.13	23.31	12.62	8.55	7.78
MSCI USA	2.40	2.33	15.82	22.53	25.38	19.06	16.54	18.34
MSCI EAFE	-1.33	-3.71	2.11	6.57	9.65	8.54	8.17	9.92
MSCI Europe	-1.85	-4.19	2.20	9.85	13.07	9.42	8.83	9.85
MSCI Japan	0.94	-1.69	4.35	0.51	2.89	7.18	7.30	10.77
MSCI Pacific Ex Japan	-3.03	-5.35	-3.37	2.04	5.61	6.54	6.49	8.82
MSCI EM (Emerging Markets)	-0.73	-5.57	-5.30	-3.68	1.66	7.99	8.49	7.64
World Currencies (relative to CAD)								
US Dollar	3.49	1.52	6.18	0.69	-1.01	-1.17	-0.94	2.35
Euro	0.66	-3.20	-2.25	-7.37	-6.85	-1.37	0.24	0.54
Pound Sterling	-0.12	-2.41	-1.18	-2.55	-1.90	0.03	0.20	0.60
Yen	3.93	-1.78	2.30	-8.44	-9.09	-1.17	-0.87	-1.47

As of November 30, 2021. All returns in Canadian dollars.

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