Monthly Market Monitor

February 2022

NEI

HIGHLIGHTS

Market volatility escalates

December's meeting minutes from the Federal Open Market Committee of the U.S. Federal Reserve revealed a more aggressive central bank stance against inflation, which sent markets downward as investors tried to reassess how to price assets in an environment of rising interest rates.

Bank of Canada holds firm

While investors were bracing for a rate increase announcement from the BoC, the central bank instead held the overnight rate steady at 0.25%, with some guidance. The bank's Governing Council expects interest rates will need to increase, with the timing and pace of those increases guided by the BoC's commitment to achieving the 2% inflation target.

Russia-Ukraine tension heats up

Heightened tensions between Russia and Ukraine took centre stage in January. NEI Investments is actively keeping an eye on developments in the region, including the implications of possible additional sanctions, disruptions in energy supply chains, or further fraying of diplomatic relationships.

ASSET ALLOCATION OUTLOOK SUMMARY

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

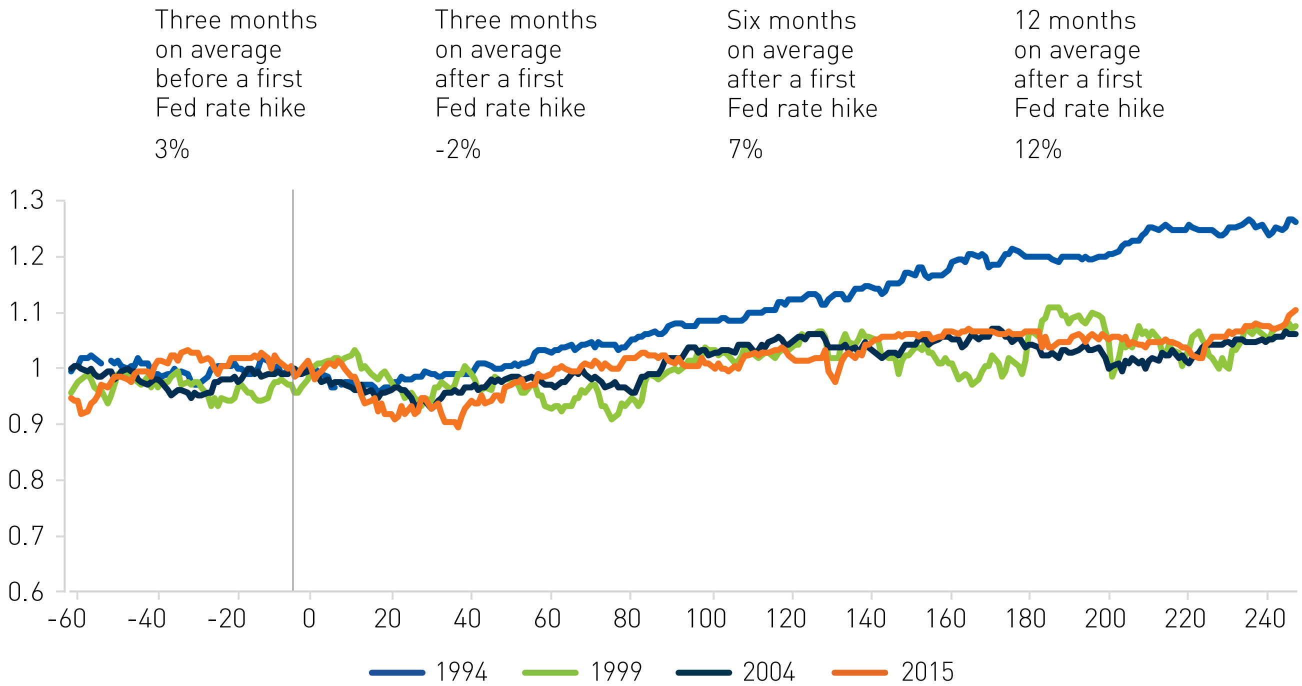
OVERVIEW

January was a rough start to the year for equity investors. Bucking the seasonal trend known as the January Effect, in which stocks typically trade higher in the month, equities had their worst monthly performance since the beginning of the pandemic in March 2020. Inflationary pressures have remained stubbornly persistent, moving consumer price indices to multi-decade highs in many regions around the world. As a result, central banks signaled that they were prepared to move more aggressively to pull back the record accommodative policies in their fight to keep inflation expectations well anchored to the 2.0%–2.5% range. Bonds sold off as both short- and longer-term interest rates moved higher to price in a new central bank rate hiking cycle. Major stock indices across the world declined in January, led by the tech-heavy U.S. market. Energy stocks helped Canadian equities, but the S&P/TSX Composite Index still ended down for the month. Technology names led the decline as higher interest rates have a disproportionately negative affect on stocks with strong growth characteristics. Small-capitalization stocks were also hard hit. Outperformers included value stocks, as well as energy shares as oil prices rallied 20% during the month.

The turbulence in the market was precipitated by the early January release of minutes from the Federal Open Market Committee's (FOMC) December meeting, which suggested a more aggressive central bank reaction to rising inflation. In 2021, the U.S. Federal Reserve had taken a more patient approach to ensure "substantial further progress" on maximum employment, the first goal of its dual mandate. But the minutes revealed that there were growing concerns amongst FOMC members about inflation. 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%.

With major central banks positioning themselves to increase interest rates, we expect volatility could become more commonplace as we get closer to the start of the interest rate hiking cycle, as investors reassess how to reprice assets in an environment of rising interest rates, the end of asset purchases, and lower levels of liquidity. Investors have not experienced such a shift and paradigm change in two years. As a result of the downturn in investor sentiment, the S&P 500 Index saw a 10% pullback in January. At NEI Investments, we see this correction as potentially healthy. Historical data illustrate that in the three months before and after the first Fed rate hike of a given rising-rates cycle, stocks tend to trade in a narrow 10% range. However, investors who stand pat during and after such periods of volatility could benefit, as stocks on average have gained 7% in the six months following this first hike, and 12% in the 12 months after.

Historical S&P 500 Index (USD) moves before and after Fed rate increases



Source: Bloomberg. 1994 data from Aug. 16, 1994, to Nov. 15, 1995. 1999 data from Mar. 31, 1999, to June 30, 2000. 2004 data from March 31, 2004, to July 1, 2005. 2015 data from Sept. 17, 2015, to Dec. 17, 2016. S&P 500 Index price level baselined at 1 at the start of each historical rate hike cycle.

The Bank of Canada held its overnight rate steady at 0.25%, but stated that the overall slack in the economy has been absorbed and thus decided to end its extraordinary commitment to the lower boundary of its inflation target range. This means that interest rates are expected to rise, with the timing and pace of those increases guided by the BoC's commitment to achieving a 2% inflation target. Currently, the market has priced in six rate hikes for 2022.

As investors brace for higher rates from the BoC, a concern often raised is the impact of such rate hikes on various asset classes. Data from the past six BoC hiking cycles show that Government of Canada bond yields tend to increase leading up to the start of the cycle's first rate hike, but show little upward momentum after. In terms of equities, data show that the S&P/TSX Composite Index has risen by over 5% on average in the first 100 days after the first rate hike. While historical data provide a baseline view on possible movements in the equity and fixed income spaces, the direction of asset classes this time could be influenced by factors such as the pace of tightening and market liquidity relative to past cycles.

To close out January, friction between Russia and Ukraine took centre stage. As tensions at the Ukrainian border continue to escalate with Russian troop buildups, the U.S. and its allies have asked Russia to de-escalate the situation. These ongoing tensions could create greater disagreements amongst nations who are allies of the U.S. versus allies of Russia, with the possibility of the U.S. and its allies imposing further sanctions on Russia. We are actively keeping an eye on the developments in the region and the potential implications of any disruptions in the energy supply chain between Russia and Europe or disruptions in diplomatic relationships.

U.S.

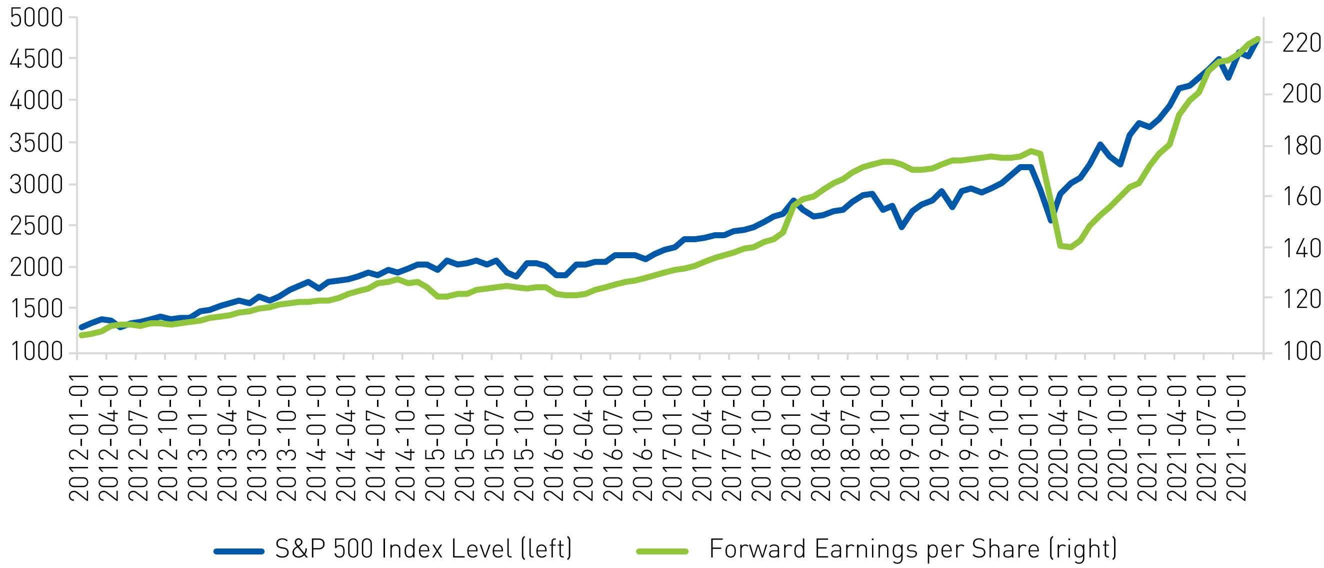
The U.S. Consumer Price Index jumped to almost 40-year highs in December, with a reading of 7% year over year. Furthermore, unemployment fell to near pre-pandemic levels of 3.9%, prompting the Fed to indicate that the start of the rate normalization cycle is soon. In a recent press conference, the Fed indicated that it would continue to reduce the monthly pace of asset purchases, bringing them to an end in early March. The conclusion of this accommodative policy would allow the central bank to increase rates as early as its March meeting. Fed chair Jerome Powell indicated that most Fed governors agreed that the U.S. is at maximum employment and that there is considerable room to raise interest rates without hurting the labour market, but also emphasized that the central bank would continue to be nimble and flexible with policy changes being data driven. While the federal funds rate will be the primary means to tighten policy, there was no major announcement on reducing the size of the balance sheet (an action that would involve the Fed letting its bond purchases mature and not reinvesting the proceeds). There was also no indication of pace and timing, other than the fact that the Fed intends to reduce its balance sheet at some point after the first hike. The Fed will continue to discuss this issue at upcoming meetings.

Real U.S. GDP rose 6.9% annualized in the fourth quarter, according to the advance estimate. Consumption rose 3.3%, driven by services. Investment surged, driven by a large increase in inventories. Excluding inventories, private investment rose just 1.3%. Government spending detracted from the reading, declining 2.9% in the quarter. If the advance estimate is accurate, real GDP increased 5.7% for the year.

The IHS Markit Flash U.S. Composite Purchasing Managers' Index (PMI) fell to an 18-month low of 50.8 in January, compared to 57.0 in December. A PMI reading above 50 suggests expansion, while below 50 suggests contraction. The Manufacturing PMI fell to 55.0 from 57.7 and the Services PMI fell to 50.9 from 57.6. Output growth slowed significantly on a combined spike in COVID cases and ongoing supply and labour shortages. Demand, on the other hand, remained resilient as new orders stayed strong, and firms expanded their workforce numbers modestly. Input price inflation continued to soften but output prices continued to rise, driven by upward wage pressure.

In terms of Q4 corporate earnings, it is still early days yet, with 33% of S&P 500 Index companies having reported earnings so far. Of those already reporting, 77% of companies posted earnings higher than estimates. In terms of net profits, margins for Q4 are projected to be slightly thinner than the previous quarter due to higher costs. At the sector level, four sectors are reporting net profit margins in Q4 2021 that are above their five-year averages, led by energy, information technology, and materials.

Strong corporate earnings drive stocks: S&P 500 Index vs. forward EPS



Source: Bloomberg, as of 12/31/21.

Looking ahead, we expect 2022 earnings to deaccelerate to the high-single-digit range. Sectors with the highest expectations for earnings growth include energy, industrials, and materials. However, downside risks include wage and cost inflation and supply chain bottlenecks.

CANADA

Canadian equities were relatively flat for the month, performing better than other regions. Oil prices rose to a seven-year high toward the end of January, even as the OPEC+ coalition continues to steadily increase output, since markets are historically tight. Low inventories and the Russia-Ukraine tensions helped drive high demand for oil. The U.S. released oil reserves once again in January in an attempt to help to control prices. A lot of eyes will be on OPEC+, which has repeatedly pushed back against market pressure to increase output to ease the supply strain.

Canadian CPI accelerated to 4.8% year over year in December, marking the highest reading since 1991. Supply disruptions contributed to price appreciations as the prices of goods rose 6.8% for the year, while the prices of services were more subdued at 3.4%. Employment also continued to gain in December even as COVID case counts rose, and the unemployment rate fell to 5.9%. Labour data continue to suggest a tight market, as the unemployment rate was 5.7% pre-COVID in comparison. However, employment data showed that wages were only up 2.7% for the year, indicating Canadians were facing a decline in purchasing power.

Inflation worries were reflected in both Bank of Canada surveys for Q4: the Business Outlook Survey and Canadian Survey of Consumer Expectations. The surveys reported 97% of firms expect inflation to come in over 2% over the next two years, with two-thirds anticipating inflation above 3%. Businesses have continued to report widespread capacity pressures as a result of labour shortages and supply disruptions, and rising wages and higher input prices are expected to contribute to this higher expectation next year. Consumer expectations for inflation increased to 4.9% for the year ahead.

Elevated inflation expectations and a tightening labour market saw investors price in a high probability for a rate hike at the BoC's January meeting. However, the central bank instead held rates steady while stating that economic slack was essentially absorbed and that the BoC had "decided to end its extraordinary commitment to hold its policy rate at the effective lower bound." Nonetheless, the central bank expects inflation to remain close to 5% for the first half of the year before moving lower. Going forward, the BoC indicated that interest rates will need to increase to achieve its 2% inflation target. Markets now expect the first hike to come at the next meeting in March and are pricing in as many as six hikes this year.

INTERNATIONAL

In Europe, inflation remained well above the European Central Bank's target at 5%. The overall European PMI index fell from 53.3 in December to 52.4 in January, as pressure from the Omicron variant added to the pre-existing challenges of rising energy prices and supply chain constraints. The Manufacturing PMI rose to 59.0 from 58.0, while the Services PMI declined to 51.2 from 53.1. The spread of the Omicron variant saw many countries reimpose restrictions, adversely affecting the services sectors. Manufacturing growth, on the other hand, accelerated despite being held back by capacity constraints due to staffing issues. The economic health of Europe lags the U.S. and has resulted in the ECB remaining more accommodative than the Fed. The appointment of Sergio Mattarella to serve a second term as President of Italy saw the spread on Italian government bonds narrow versus German bunds.

The au Jibun Bank Flash Japan Composite PMI declined to 48.8 in January, from 52.5 in December. The Manufacturing PMI held at 54.6 compared to 54.3, while the Services PMI declined to 46.6 from 52.1. The Omicron variant significantly impacted the services sector as restrictions came back in various regions of the country. The manufacturing sector continued to show solid growth in output and new orders, with increased hiring amid a strong outlook.

The ifo Business Climate Index rose to 95.7 in January, from 94.8 in December. Manufacturing and construction firms reported more optimism as supply bottlenecks saw some easing and capacity utilization rose. The services and trade sectors believed they were worse off, but are expecting their business situation to improve in coming months.

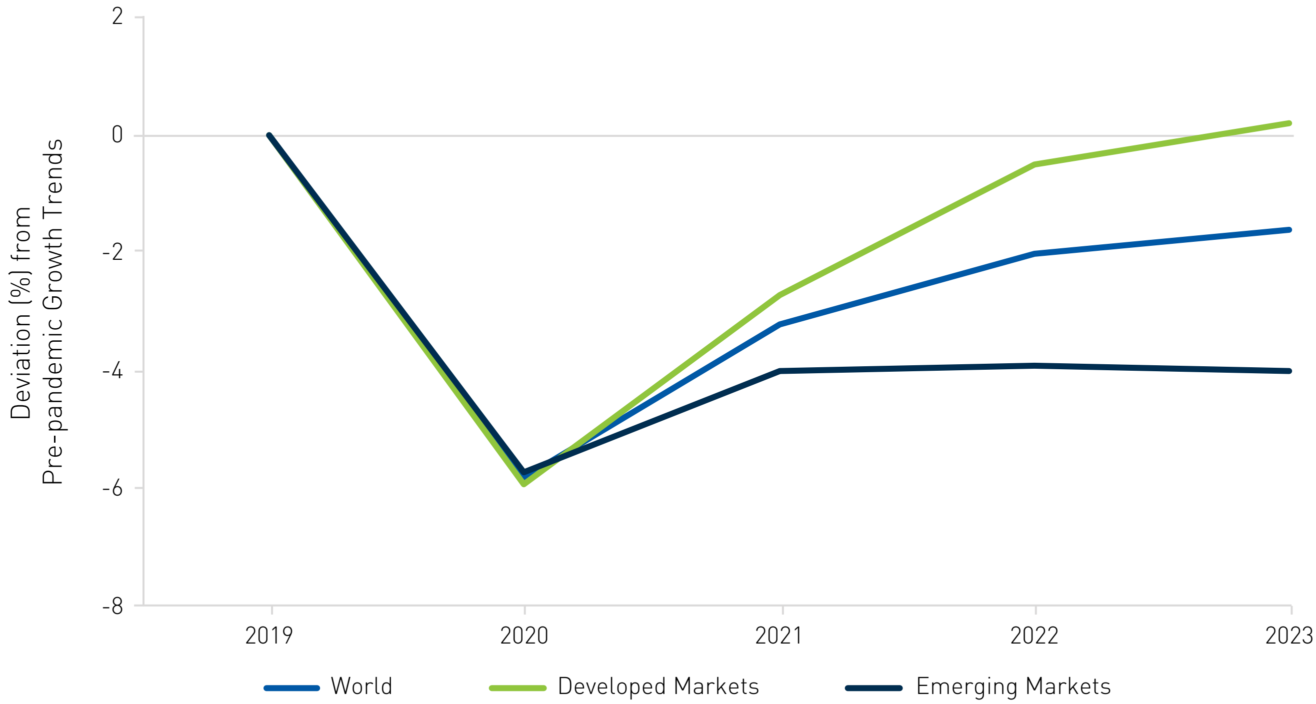
EMERGING MARKETS

Responding to downward pressure on growth linked to renewed COVID-19 outbreaks and an ongoing zero-tolerance policy toward any risk of spreading infection, the People's Bank of China increased liquidity through open market operations, cutting the 7-day repo rate and 1-year medium-term lending facility rate by 10 basis points each for the first time since March 2020.

Emerging market and developing economies (EMDEs) are experiencing a weaker recovery than advanced economies, owing to slower vaccination progress, more muted policy support, and more pronounced lingering effects from the pandemic. Vaccine access remains unequal, with very low rates in low-income countries.

According to the World Bank's *Global Economic Prospects* report, most EMDEs are expected to suffer substantial damage to their output from the pandemic, with growth trajectories not strong enough to return investment or output to pre-pandemic trends over the forecast horizon of 2022–23.

Emerging markets behind on growth recovery to pre-pandemic levels



Source: The World Bank, *Global Economic Prospects: January 2022*; Consensus Economics; Our World in Data (database); Oxford Economics. Economic output determined by real U.S. GDP weights at average 2010-19 prices and market exchange rates, with percent deviations based on the difference between the baseline level of pre-pandemic January 2020 World Bank results and projections and those of its 2022 results and projections. For 2023, the January 2020 baseline is extended using projected growth for 2022.

EMDE growth is projected to slow from 6.3% in 2021 to 4.6% in 2022, as the ongoing withdrawal of macroeconomic support, together with COVID-19 flare-ups amid the spread of the Omicron variant and continued vaccination obstacles, weigh on the recovery of domestic demand. In one third of EMDEs, many of which are tourism-reliant economies or small states, output this year is expected to remain lower than in 2019. The World Bank projects growth in China to ease to 5.1% this year, reflecting the lingering effects of the pandemic and additional regulatory tightening.

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	-3.28	-0.81	-3.35	-3.28	-4.75	2.51	2.57	2.77
Bloomberg Barclays Global Aggregate (C$ Hdg)	-1.58	-1.30	-2.66	-1.58	-2.42	2.85	2.71	3.29
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	-2.75	-2.01	-1.66	-2.75	1.93	5.46	4.59	5.96
Equities								
MSCI World (Developed Markets)	-4.64	-0.89	2.14	-4.64	16.01	15.33	12.69	14.22
MSCI World Growth	-8.69	-5.70	-2.13	-8.69	10.49	20.66	17.20	16.62
MSCI World Value	-0.59	3.88	6.28	-0.59	21.10	9.39	7.82	11.57
MSCI Canada	-0.18	1.31	5.64	-0.18	25.70	12.84	8.68	7.87
MSCI USA	-5.04	-0.50	3.58	-5.04	19.88	19.04	15.70	17.52
MSCI EAFE	-4.18	-2.13	-1.62	-4.18	6.55	8.17	7.32	9.51
MSCI Europe	-3.92	-1.01	-0.71	-3.92	12.11	9.56	8.13	9.76
MSCI Japan	-4.42	-3.21	-1.64	-4.42	-2.91	6.46	6.08	9.88
MSCI Pacific Ex Japan	-4.96	-6.27	-6.75	-4.96	-2.31	4.03	5.37	7.71
MSCI EM (Emerging Markets)	-1.22	-1.63	-2.80	-1.22	-7.64	6.05	7.76	6.67
World Currencies (relative to CAD)								
US Dollar	0.68	2.60	1.88	0.68	-0.44	-1.06	-0.50	2.40
Euro	-0.75	-0.61	-3.69	-0.75	-8.14	-1.83	0.24	0.83
Pound Sterling	-0.27	0.42	-1.69	-0.27	-2.73	-0.41	0.79	0.76
Yen	0.62	1.53	-2.96	0.62	-9.54	-2.93	-0.96	-1.74

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

2200066E 02/22 AODA