Monthly Market Monitor

March 2022

NEI

HIGHLIGHTS

Armed conflict and invasion shake markets

Russia invaded Ukraine in February, raising grave humanitarian and global security concerns across the world. In financial markets, this action caused a selloff in risk assets such as equities, a widening of credit spreads, and higher commodity prices, while elevating near-term inflation expectations. Following a peak period of market stress, however, market response has since been more differentiated.

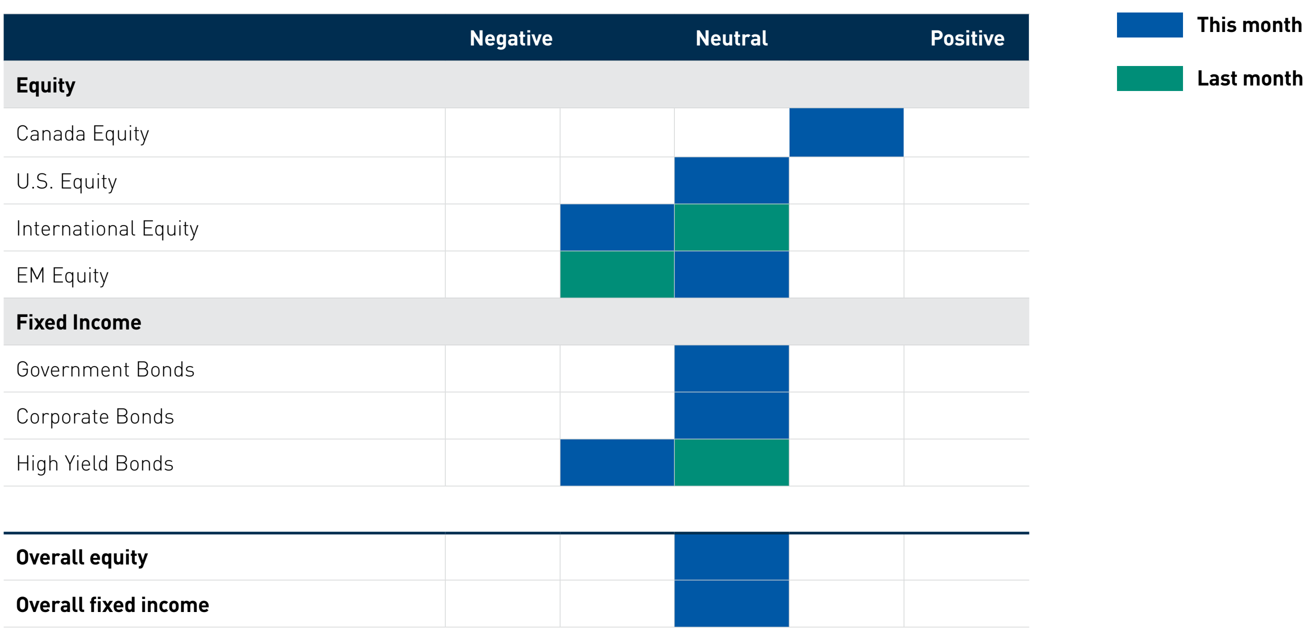
Commodity prices soar on geopolitical worries

The invasion of Ukraine exacerbated an already elevated inflationary environment for commodities, as Russia is a key energy supplier to Europe, as well as other critical industrial and agricultural resources. While current sanctions have not so far targeted Russian energy exports, traders have avoided Russian supply on uncertainty over sanctions, resulting in a global increase in oil prices.

Policy uncertainty in wake of Ukraine attack

Russia's invasion has changed policy expectations, generating uncertainty as to the previously aggressive stance against inflation of central banks. Policymakers now must contend with the geopolitical pressures of Russia's actions and increased inflation risk brought on by the Ukraine invasion. The Bank of Canada's recent 25-basis-point rate hike without quantitative tightening reflects a compromise position that could be adopted by other central banks, such as the U.S. Federal Reserve.

ASSET ALLOCATION OUTLOOK SUMMARY



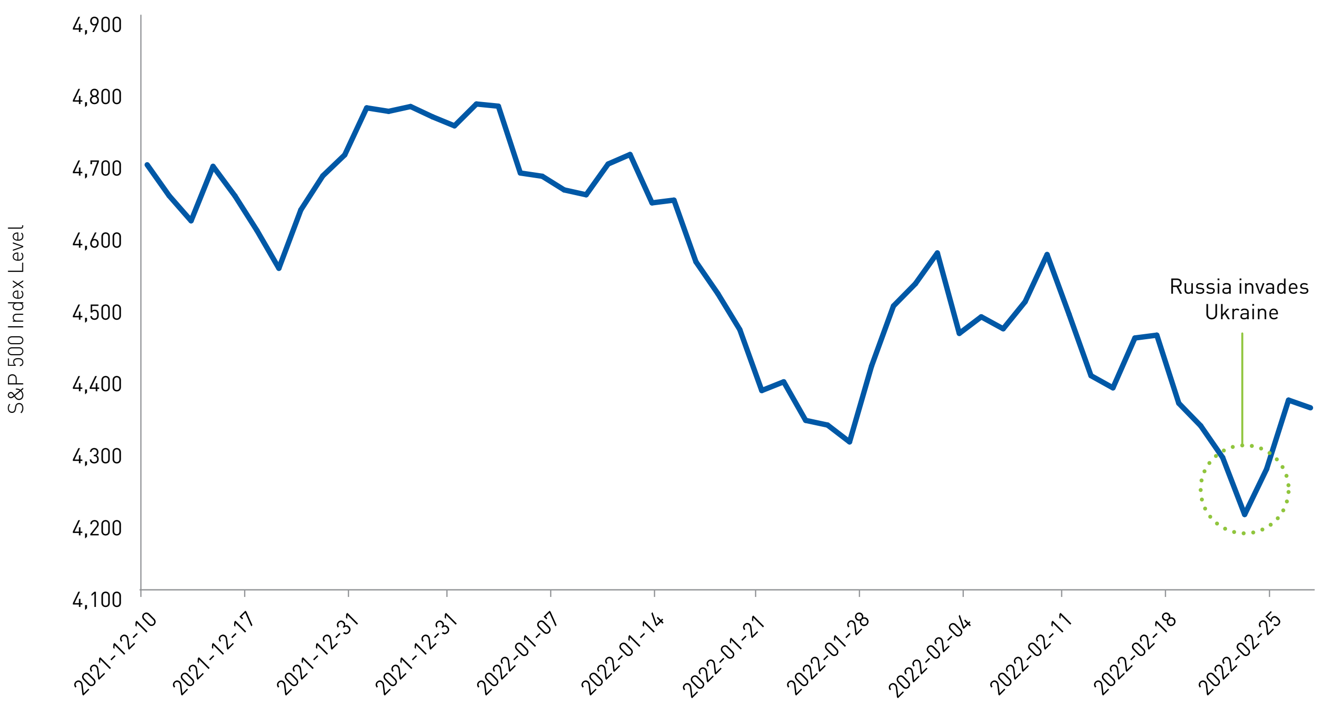
This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of February 28, 2022. If an asset class has a blue box in its row and no green box, it means this month's outlook is the same as the prior month's.

OVERVIEW

The tough start to 2022 continued in February as Russia invaded Ukraine, raising grave humanitarian and global security concerns across the world. In financial markets, this caused a selloff in risk assets such as equities, a widening of credit spreads, and higher commodity prices, while elevating near-term inflation expectations.

During the period of peak market stress on February 24, when Russian forces commenced the invasion, most global equities experienced a swift decline. However, market response has since been more differentiated. For example, the S&P 500 Index recouped the losses it had previously incurred following the invasion, a recovery partly due to the market pricing in a lower level of risk arising from the tensions and also a possibly less aggressive Fed stance against inflation.

S&P 500 Index recovers after late Feb. selloff

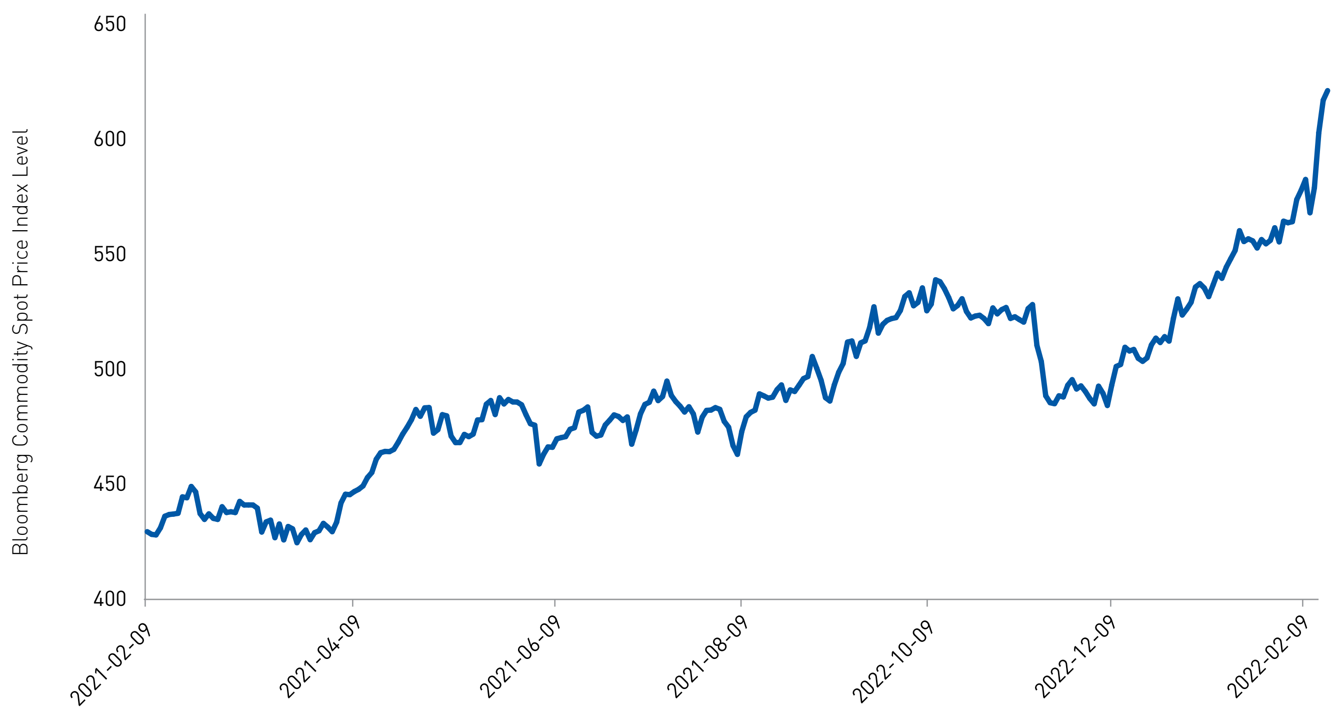


Source: Bloomberg, as of Feb. 28, 2022.

Emerging market equities and European assets reversed some of their weakness following the invasion, but still priced in considerable downside risk as oil prices rose. While the situation continues to be quite fluid, we see the greatest impact as being regional in nature, with economies such as those in Europe disproportionately affected given its dependence on Russian natural gas. Additionally, European equities may be more vulnerable to underperformance compared to global equities given geographic proximity. In terms of the broader economy, the risks are more nuanced. For example, Canada and the U.S. are net exporters of oil, which makes the impact of higher energy prices less severe. However, a key risk to the broader economy is the possibility of tighter commodity supplies, such as metals and grains, affecting the broader global economy.

The invasion of Ukraine exacerbated an already elevated inflationary environment for commodities. Russia is a key global exporter of various commodities, and not just oil and European gas. At the time of this writing, current sanctions have not targeted Russian energy exports. However, traders have avoided Russian supply on uncertainty over sanctions, resulting in a global increase in oil prices. Aluminum, nickel, zinc, and wheat also rose during the month. Consumers could face more challenges in terms of higher prices of corn and wheat products, as global supplies tighten due to the crisis; Russia and Ukraine together account for nearly 25% of the world's wheat exports. Russia also produces 37% of the world's palladium, which is essential for global automobile manufacturing. The conflict could affect semiconductor supply chains, which were a challenge throughout the pandemic that had only just started to ease. Many of the previously mentioned commodities rallied during the latter parts of the month, pricing in near-term supply premiums in light of geopolitical risks.

Commodities sharply higher after invasion commenced



Source: Bloomberg, as of Feb. 28, 2022.

Russia's invasion has changed monetary policy expectations, generating uncertainty as to the previously aggressive stance against inflation of central banks such as the Fed. These central banks now must contend with both the geopolitical pressures of Russia's actions and the increased inflation risks brought on by the Ukraine invasion. Recently released minutes from the Federal Open Market Committee's (FOMC) January meeting acknowledged broadening inflationary pressures with little mention of reducing the central bank's balance sheet or of any Fed appetite for a 50-basis point rate increase. However, higher energy and commodity prices following the Russian invasion could mean that consumers' purchasing power will be directly hit, which would by extension automatically curb demand. However, rising wages have been a concern that the Fed will have to consider when deciding on the appropriate pace and speed of policy tightening.

The Bank of Canada's recent 25-bp rate hike without quantitative tightening reflects a compromise position that could be adopted by other central banks. Currently, the market has repriced for one rate increase from the Fed in March, relative to mid-February, when the Fed funds futures market was pricing in two rate increases.

At this time, NEI Investments sees the financial-market implications of the Ukraine invasion as being limited by region at the moment. However, the situation remains quite fluid, which could result in tail risks from a global economic perspective. Macroeconomic and geopolitical factors will dominate for some time. Until these factors stabilize, we should expect a high degree of daily volatility. As such, our belief in having a balanced portfolio with diversified exposure to growth, value, and quality remains strong.

NEI is taking action on behalf of its investors and in line with the international community following Russia's invasion of Ukraine. By suspending new purchases of Russian securities and beginning the divestment process for existing holdings, and by applying pressure through corporate engagement, NEI joins others in sending this clear message: responsible investors will not stand for such flagrant violations of international law, and we are committed to stopping this deplorable behaviour using all our tools.

The NEI Investment Team and ESG Services Team have agreed to:

- Implement an immediate moratorium on the purchase of any new Russian sovereign debt and bonds or equities issued by Russian-domiciled companies
- Direct sub-advisors to divest of any existing Russian securities as soon as possible, recognizing that capital markets trading restrictions currently in place make it extremely challenging to set a time frame for completing the process
- Through corporate engagement, influence companies that operate in Russia or have other economic interests there to publicly align with international efforts to maximize economic pressure on Russia, such as by pausing or ending their involvement in the country

As always, NEI has taken a measured and thoughtful approach to the situation as it affects its holdings and its position as a leading responsible investment manager, and most importantly, its duty to investors. NEI has considered, and continues to consider, the objectives and outcomes it is seeking to achieve using the tools of active ownership, specifically corporate dialogue, exclusions, and divestment.

U.S.

Prior to the February 24 start of the Ukraine invasion, the FOMC released minutes from its meeting held in January. The minutes acknowledged broadening inflationary pressures, with projected inflation risks skewed to the upside. As a result, central bank officials noted that it would be appropriate to remove policy accommodation at a faster pace than they currently anticipate if inflation does not come down. There was little mention of reducing the central bank's balance sheet or of any Fed appetite for a 50-bp rate increase.

The U.S. Consumer Price Index (CPI) increased at a pace of 0.6% in January, while advancing at a pace of 7.5% year on year. Increases in the indexes for food, electricity, and shelter were the largest contributors. While the inflation surge in 2021 was dominated by pandemic-driven supply–demand imbalances for durable goods, inflationary pressures have been broadening out over the past few months. A key concern with a broadening of inflationary impulses is that if inflation gets high enough, that could raise inflation expectations in a way that begets higher current inflation. As an example, employees demand for higher wages could increase further if it is believed that future inflation will be higher. That could set off a wage spiral.

Furthermore, Russia's invasion of Ukraine has considerably changed the landscape for inflation risk, for the near term at least. The armed conflict has led to increases in commodity prices and the possible supply chain disruptions have become a growing concern. U.S. two-year break-even inflation, which looks at inflation expectations two years out, rose to 4% during the month, but longer-term inflation expectations have seen less movement.

The U.S. economy continued to show good health as retail sales rebounded 3.8% seasonally adjusted in January, after falling 2.5% in December. Sales were driven by non-store retailers (+14.5%), furniture stores (+7.2%), and motor vehicle dealers (+5.7%).

Industrial production rose 1.4% in January, following the 0.1% decrease in December. However, the increase was driven by utilities, which surged 9.9% due to heating demand from cold weather. Mining production increased just 1.0%, and manufacturing was even more muted at 0.2%. Capacity utilization rose 1.0% to 77.6%.

The IHS Markit Flash US Composite Purchasing Managers' Index (PMI) jumped to 56.0 in February, from 51.1 in January. A PMI reading over 50 suggests economic expansion, while a reading under 50 suggests economic contraction. The increase in PMI in January was driven by the Services PMI, which rose to 56.7 from 51.2, while the Manufacturing PMI also saw an increase to 57.5 from 55.5. The retreat of the pandemic boosted underlying demand. Firms reported stronger output and new business on employees returning from sick leave and greater availability of raw materials. On the inflationary side, pressures continued to intensify as companies looked to boost inventories.

Despite good economic data, consumer confidence further declined in February to 110.5, down slightly from 111.1 in January. Inflationary concerns rose and consumers viewed their future prospects as weaker. Large-purchase intentions over the next six months declined.

Personal incomes rose marginally (less than 0.1%) in January. An increase in compensation was offset by a decrease in government benefits. Spending on the other hand increased 2.1%. The increase was concentrated toward goods, led by motor vehicles.

Durable goods new orders rose a solid 1.6% in January. The transportation sector continues to see a solid recovery, with orders rising 3.4%. Other areas of strength were within machinery. Excluding transportation, new orders rose 0.7%.

In terms of corporate earnings, 76% of reporting S&P 500 Index companies registered a positive EPS surprise for Q4 2021, with 95% of index companies reporting results. Positive earnings surprises reported by companies in the consumer discretionary, information technology, health care, and financials sectors have been the top contributors to the overall increase in earnings for the index since the end of the fourth quarter. For the 2022 calendar year, analysts are projecting high-single-digit earnings growth of 8.5%.

CANADA

Canadian equities were relatively flat for the month but with a less rocky route to get there compared to other global markets. Canada was aided by its energy sector as oil prices continued to hit new highs in February amid the global geopolitical crises. There is a near-term risk for further increases in oil prices as the market digests the ongoing Ukraine invasion and looks to how major developed nations will levy sanctions on Russia.

Canadian CPI once again accelerated to a new high of 5.1% year over year in January. Canadian consumers felt the impact of inflation most notably in the areas of housing, food, and gasoline. Shelter prices contributed the most to CPI as they were up 6.2% year over year. Goods inflation continued to outpace services with a 7.2% increase while services remained steady at 3.4%. Excluding gasoline, CPI was still up 4.3% year over year, which is the highest it has ever been since tracking started for that index in 1999. Groceries also continued to increase their rate of inflation as they jumped 6.5% in January compared to 5.7% in December.

The inflation trend continued despite various Canadian lockdowns and closures in January. Going into March, indoor capacity limitations will be lifted and vaccine requirements will be at the discretion of each business and not federally mandated. Travel requirements are also becoming more open. These measures being lifted will lead to increases in jobs and likely spending as well, both of which could further drive inflation higher. Omicron has however shown that that route to reopening is not simple and that going forward the path is likely going to have some setbacks.

Q4 GDP in Canada came in above expectation at 6.7% annualized. Investment growth helped drive GDP higher as both residential and business investment had strong quarters. Another positive from the report is the preliminary estimate for January showing a rise in GDP despite the Omicron breakout and subsequent restrictions. In January, Canada is seeing strong growth in construction and professional services, two sectors that have not been hampered by the lockdowns.

INTERNATIONAL

In early February, investors were primarily focused on central bank action, prompted by the Bank of England hiking rates a second time at the beginning of the month. The BoE hiked rates by 25 basis points to 0.5%, but the striking factor was the voting. The rate hike had narrowly passed on a 5–4 vote, with the four dissenters surprisingly wanting to tighten policy even further by 50 basis points instead, a "double hike." Markets had interpreted the vote as being that the central bank was behind the curve, denied by BoE Governor Andrew Bailey, but markets were preparing themselves for a quick tightening cycle. Markets were pricing in another five hikes for the year, as well as the possibility for a double hike at the next meeting come March.

Meanwhile at that time, the European Central Bank kept rates steady, but confirmed that asset purchases were to continue at a lower pace for the quarter. ECB President Christine Lagarde admitted that inflation risks were elevated for the year and forecasts were getting closer to the medium-term target, but did not provide further insight on a potential tightening timeline. Instead, markets will have to wait for the March meeting when new forecast numbers will be released, providing more clues on how the central bank plans to proceed.

All of these hawkish central bank signals were quickly overshadowed as Russia-Ukraine tensions rapidly heated up, leading to the invasion of Ukraine that commenced February 24. Attention instantly turned toward the developing crisis that had been escalating over time. News of Russia preparing for and then starting its invasion of its neighbour quickly swept markets.

The proximity of the invasion had Europe more exposed as a whole, which was feared given the possibility of the crisis engulfing a larger area. In addition to the escalating humanitarian situation, a pressing economic issue at hand was maintaining a consistent energy supply. Europe as a region is heavily dependent on energy imports, and Russia is one of the largest producers. The idea of banning Russia from SWIFT payment system access was rejected at first on fears of slowing growth. Oil prices were already at multi-year highs and even higher prices would take a further toll on consumers, and potential energy shortages could hamper production, which was still recovering post-pandemic.

Sanctions were nonetheless imposed on Russia with no resolution in sight at the time of this writing. U.S. President Joe Biden stated that the U.S. had no intention to fight Russia, but troops would be stationed in Europe to defend NATO allies should the situation further escalate. Instead, the target was the Russian economy. Germany halted the approval on the Nord Stream 2 gas pipeline originating in Russia. Countries blocked airspace to Russian flights. Sanctions were imposed on Russian officials by various countries including the U.S., E.U., and U.K., and the SWIFT payment banking system was eventually cut off from major Russian banks.

EMERGING MARKETS

Emerging market equities were seriously affected by the month's geopolitical crises. Russian financial securities fell sharply as Western nations imposed sanctions on its key economic drivers, including oil pipelines and the SWIFT payment system. The SWIFT ban on major Russian banks hits a critical nerve, as banks are unable to access international markets and credit. Russia quickly responded, banning brokers from selling securities held by foreigners on the Moscow exchange. The MSCI Russia Index (C$) declined 50% in the month. On the currency side, the ruble declined 26.3%. The Bank of Russia more than doubled its interest rate to 20%, from 9.5% previously, and directed exporters to sell hard currency proceeds for rubles. S&P lowered Russia's rating to BB+, officially into "junk status" territory, and Moody's currently has Russia's bonds under review.

Currently, the economic contagion into other countries from the Russia-Ukraine conflict has been limited. However, these geopolitical risks could see macroeconomic risks expand to other regions. For instance, inflation could increase, as Russia and Ukraine are large commodity exporters, and supply disruptions could also further contribute to concerns with new sanctions in place. This would affect manufacturing hubs that are often concentrated in the emerging market space, such as China. Global liquidity conditions are also a concern. Although the sanctions are specifically Russia-focused, investors around the world could look to de-risk as their investment appetite wanes, especially as rising geopolitical tensions start seeping into growth, inflation, and interest rate concerns.

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	-0.71	-2.37	-3.92	-3.96	-3.02	2.21	2.25	2.74
Bloomberg Barclays Global Aggregate (C$ Hdg)	-1.33	-3.32	-3.76	-2.89	-2.19	2.37	2.26	3.11
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	-1.02	-2.00	-3.17	-3.74	0.53	4.54	4.08	5.60
Equities								
MSCI World (Developed Markets)	-2.79	-4.83	-4.29	-7.31	10.95	13.01	11.09	13.56
MSCI World Growth	-3.76	-11.68	-9.93	-12.12	6.87	17.68	15.20	15.80
MSCI World Value	-1.90	2.35	1.35	-2.47	14.49	7.68	6.58	11.06
MSCI Canada	-0.10	2.83	4.05	-0.28	20.03	11.68	8.66	7.67
MSCI USA	-3.23	-5.97	-3.79	-8.11	14.12	16.37	13.71	16.85
MSCI EAFE	-2.03	-2.84	-6.44	-6.13	3.02	6.44	6.24	8.87
MSCI Europe	-3.09	-2.26	-6.36	-6.89	7.01	7.13	6.86	8.94
MSCI Japan	-1.39	-5.43	-7.03	-5.75	-4.83	5.88	5.21	9.39
MSCI Pacific Ex Japan	2.53	-0.88	-6.19	-2.55	-1.75	3.52	4.93	7.70
MSCI EM (Emerging Markets)	-3.25	-4.13	-9.47	-4.43	-10.52	4.71	6.07	5.89
World Currencies (relative to CAD)								
US Dollar	-0.27	-1.13	0.37	0.41	0.19	-1.25	-0.86	2.56
Euro	-0.08	-1.34	-4.50	-0.82	-7.29	-1.70	0.24	0.78
Pound Sterling	-0.26	0.27	-2.15	-0.53	-3.85	-0.96	0.64	0.79
Yen	-0.23	-2.53	-4.26	0.39	-7.33	-2.36	-1.43	-0.99

Source: Morningstar. Data as of February 28, 2022.

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