Monthly Market Monitor

November 2022

Highlights

Central Banks decelerating rate hikes, but may take longer to get to peak
Central banks have front loaded their tightening cycles with oversized rate hikes throughout the year, but that could change as policy leaders may take a more cautious approach going forward as they analyze how higher rates are impacting different parts of the economy. A slower pace of tightening may result in a longer journey to peak rates.

Economic growth weakens as monetary tightening takes effect
The lagging impact of monetary tightening is starting to show up as Manufacturing PMI is contracting and GDP growth projections weaken in the year ahead. On the other hand it appears inflation may finally be moderating according to recent data on input prices, supply chains and food prices.

No patience for earnings misses
US equities have been buoyed by a relatively benign earning season given low expectations. However, companies that missed earnings—including mega-caps like Alphabet, Amazon and Google—have seen significant drops in share price as investors expect slower earnings growth in Q4.

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		
Fixed Income					
Overall Fixed Income		This month			
Government Bonds		This month		Last month	
Corporate Bonds			This month		
High Yield Bonds			This month		
Cash			This month	Last 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 October 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.

Is bad news good news?

The month of October gave markets a breather as most global financial assets rebounded, following weak performance in the prior two months. The market responded positively to soft economic data such as downward revisions to global growth and weakening manufacturing PMIs, as a sign that tightening policies are effective and central banks could pause on hikes sooner. The market speculated on the idea of a 'downshift' in central bank hikes as the European Central Bank (ECB) softened its hawkish tone and the Bank of Canada (BoC) surprised markets by slowing the pace of hikes to 50 basis points (bps), relative to the 75bps hike that was widely expected. Signs pointing to an easing of inflation also gave support to the view that central banks would become more dovish. However, there were many areas of strength in economic data. U.S labor market continued to show strength with non-farm payroll increasing by 263K in September, exceeding the five-year monthly average, and retail sales consumption remained resilient.

US equities benefitted from an earnings season which saw 71% of companies on the S&P 500 beating what were relatively low growth expectations. Companies that beat earnings estimates were rewarded by the market, while those missing expectations and weakened next year's outlook, such as the mega caps Facebook, Alphabet, and Amazon, were punished. Technically, the relatively more favorable economic backdrop in the U.S. also attracted capital inflow. The S&P 500 closed the month up 7.12%, with market breadth widening beyond the mega-cap names. Global equities closed the month up 6.40%, while European equities advanced by 6.39%. Bond yields fell as investors priced-in a slowdown in the pace of rate hikes, reflecting a dovish shift in central bank rhetoric. US HY 2% bonds ended the month higher by 2.59%. Global bonds closed the month almost flat -0.3%.

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Central banks may take longer to get to peak

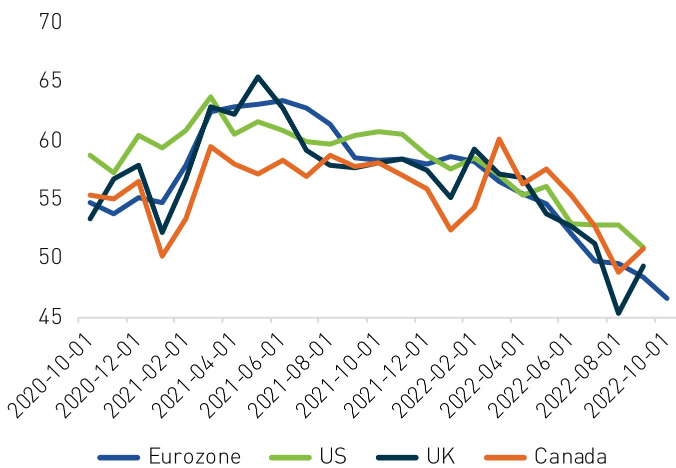
Persistently high inflation has pressured major central banks globally to take a more aggressive path in tightening monetary policy. The Bank of Canada (BoC) was among the most hawkish central banks during this tightening cycle, with an outsized rate hike of 100 basis points (bps) in July. This tightening cycle has been the fastest in history for many countries, with the U.S, for example increasing rates from 0.25% in February 2022, to 3.25% in a span of 7 months, making this the fastest hiking cycle in 40 years. Similarly, other central banks such as BoC and the ECB front-loaded rates in order to tame inflation which has turned out to be more persistent, as inflation broadened beyond the transitory components. With 350bps and 125bps of rate hikes already under the belt in Canada and Eurozone, policy leaders are now taking a more balanced and cautious approach. During the month, the ECB softened their hawkish tone and the BoC slowed the pace of hikes to reduce the risk of "over-tightening" as the impact of higher rates work its way through the economy, while acknowledging that inflation concerns are still not in the rear-view mirror.

Perspective – We expect that the pace of rate hikes will slow but the length of the tightening cycle could lengthen, meaning we may not get to the peak rate until farther into 2023 and the ultimate peak rate for this cycle may be higher than previously expected. Markets have been volatile with heightened sensitivity to comments and statements from central bank officials, looking for any changes in the pace of hikes. Markets may not sustainably rally until rates reach to a peak.

Economic growth weakens as monetary tightening takes effect

Manufacturing PMIs across many regions have dipped below 50, indicating economic contraction. Declines in new orders and output were general themes across Canada, U.S and other regions. In Canada, S&P Global Manufacturing PMI registered at 48.8 in October, down from 49.8 in September.

Manufacturing PMI heading into contraction territory

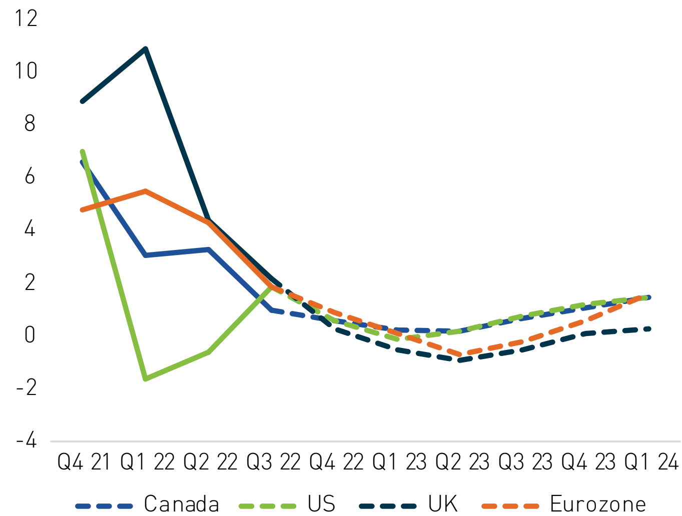


Source: Bloomberg

The latest result pointed to a quicker deterioration in operating conditions, and one that was the second strongest since the tail-end of the first wave of the COVID-19 pandemic in June 2020. Weak demand conditions were apparent in October's survey data with firms often mentioning that high prices deterred demand. New orders fell solidly and at one of the quickest rates in the survey's history. Export conditions were also subdued with international demand for Canadian goods contracting for the fifth month in succession.

Similarly, the sub-indices of the Global Manufacturing PMI, pointed to a sustained reduction in production amid deteriorating demand conditions and a worsening outlook. While the easing of supply chain delays and price pressures were welcoming news, this however stemmed from the cooling of global demand.

GDP growth to weaken further before rebound in 2024



Source: Bloomberg

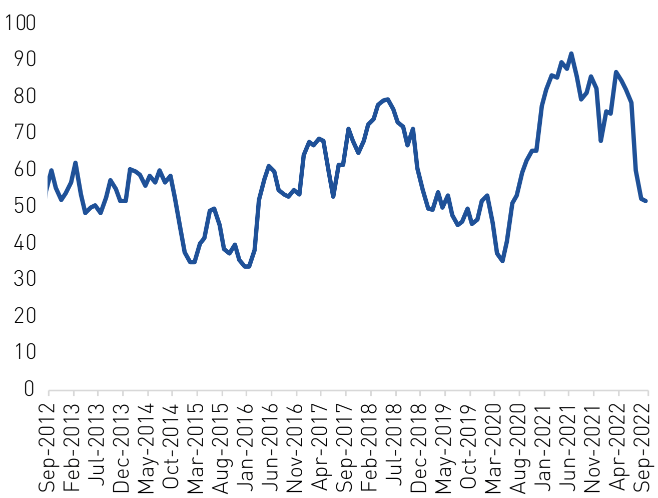
Already, there are signs of economic weakness as growth is expected to stall in Canada through the end of this year and the first half of next year as the effects of higher interest rates spreading through the economy. The Canadian economic growth is expected to slow from 3.75% this year to just under 1% next year before rebounding to 2% growth in 2024. Softer growth prospects are also expected for Europe and the U.S, with the U.S expected to grow below trend next year. Globally, growth estimates have been revised downwards to 2.2% in 2023 and 2024 by the OECD in its Interim Economic Outlook Report.

Perspective – We expect global economic growth to weaken further, as the lagged effects from tighter monetary policy will continue to drag on aggregate consumer consumption. Along with an expectation that inflation will moderate sharply in the coming year, real income will rebound from current levels, fueling a resumption of consumer demand to support stronger economic growth in 2024.

Numerous signs that inflation is moderating

There are numerous signs that headline inflation across many regions is rolling over: WTI crude oil prices have declined over 30% from its June high, after surging close to 60% this year, other commodity prices have continued to moderate, global supply chain disruptions continue to ease, freight costs continue to fall sharply, and prices paid by manufacturers, which is a leading indicator of end-consumer prices, have all softened.

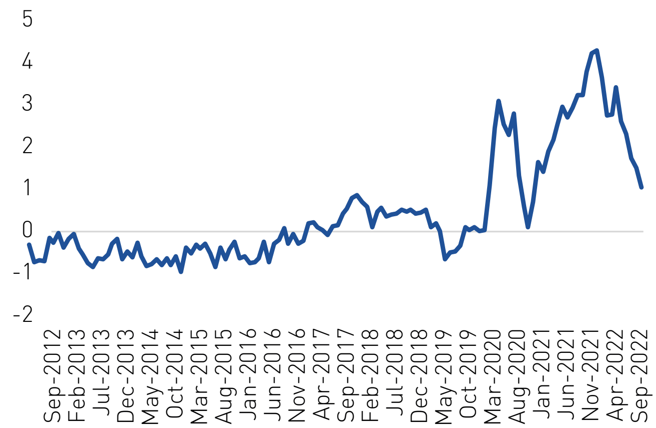
Input prices falling sharply



Source: Bloomberg; ISM Manufacturing Prices Paid Index

The United Nations FAO Food Price Index (FFPI) which is a measure of the monthly change in prices of a basket of food commodities, such as meat, diary, cereals, vegetable oils and sugars, experienced the fourth consecutive month of decline since June and has also declined 17% from peak levels in March. The positive relationship between the US Food CPI Index and the UN Food Price Index indicates that food prices in the U.S are poised to fall lower, paving the way for headline inflation to ease further.

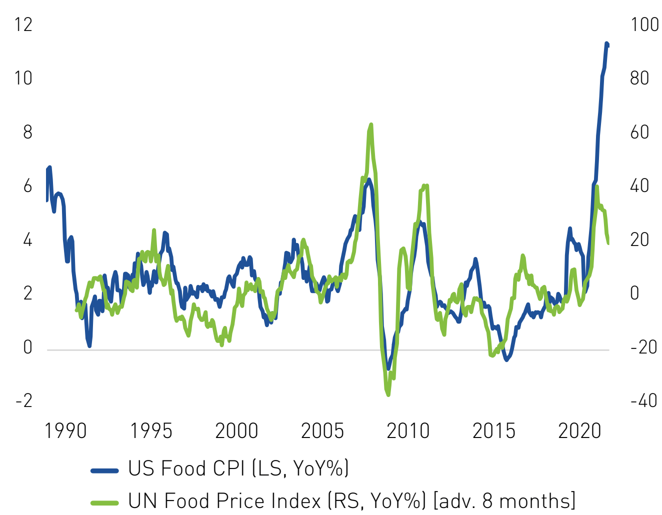
Global supply chain pressure eases



Source: Federal Reserve Bank of New York GSCPI

The World Bank projects that agricultural prices will decline by 5% next year. Wheat prices in the third quarter of 2022 fell nearly 20% but remain 24% higher than a year ago. The decline in agricultural prices in 2023 reflects a better-than-projected global wheat crop, stable supplies in the rice market, and the resumption of grain exports from Ukraine. Metal prices are projected to decline 15% in 2023, largely because of weaker global growth and concerns about a slowdown in China. However, this forecast is subject to risks such as weather events or a deepening of the Russia-Ukraine war.

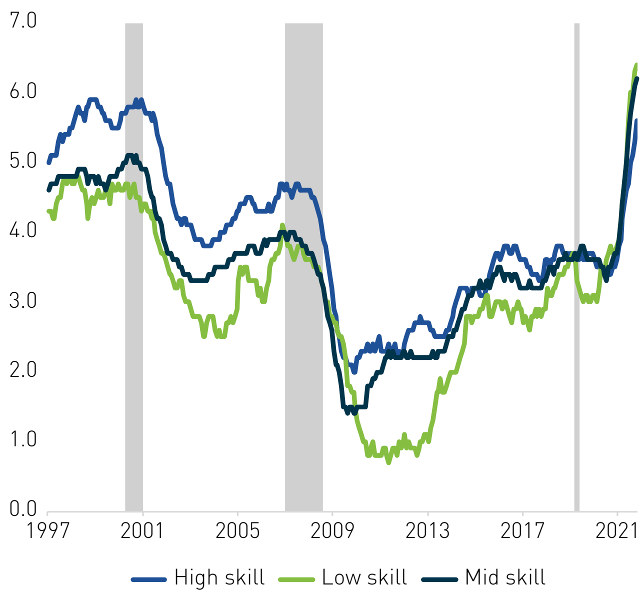
Food price inflation poised to ease



Source: Bloomberg

While several inflationary impulses are moderating, wage inflation remains elevated as the jobs market in many regions remains tight and overheated. In the U.S., there are still 1.8 job openings for every unemployed person in September, down from 2.0 in July but back up from 1.7 in August. Demand has been easing due to fewer openings as opposed to an increase in layoffs. Despite higher interest rates and inflation, tighter financial conditions and weaker business and consumer confidence, the labor market remains healthy.

Wage inflation remains elevated



Source: Bloomberg; US Atlanta FED Wage Tracker by Occupation

Perspective – As tighter monetary policy continues to work its way through and economic activities slow, labour demand historically speaking tends to ease and unemployment rate typically rises, especially when the economy falls into recession. However, with the unemployment rate at historical lows across many regions, we think job openings will decline but we don't expect the negative impact on the labour market to be too painful and the unemployment rate may not rise significantly.

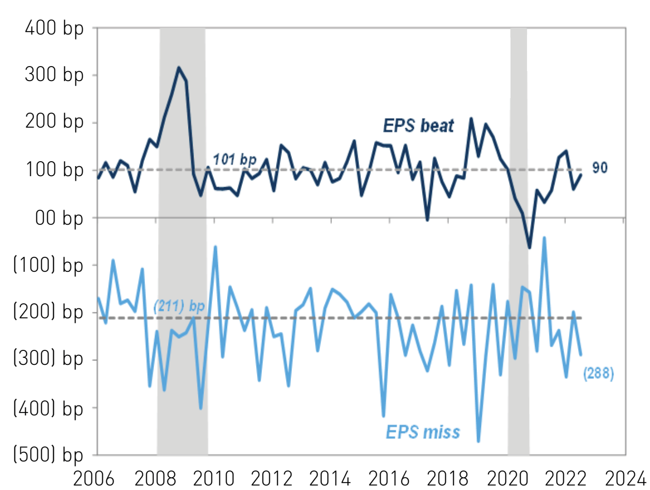
No patience for earnings misses...

Investors didn't have much patience for lackluster quarterly earnings performance.

As of October 28, 52% of the companies in the S&P 500 have reported Q3 results, about 71% are beating earnings expectations and 68% have reported positive revenue surprise, according to FactSet. That compares with the five-year average of a 77% beat rate. Companies missing earnings and revenue expectations, for instance Alphabet, Meta, and Amazon this quarter, were dealt heavy-handedly by the market with shares plunging significantly. On average, companies missing expectations underperformed the index by 6.7% on the next day.

Even though companies are beating estimates, these beats are quite small relative to the historical average. Overall, companies are reporting earnings 4.4% above estimates, which is below the five-year average of 8.7%. Much of the earnings surprise has come from the energy sector, which has so far surpassed earnings estimates by 12.2%.

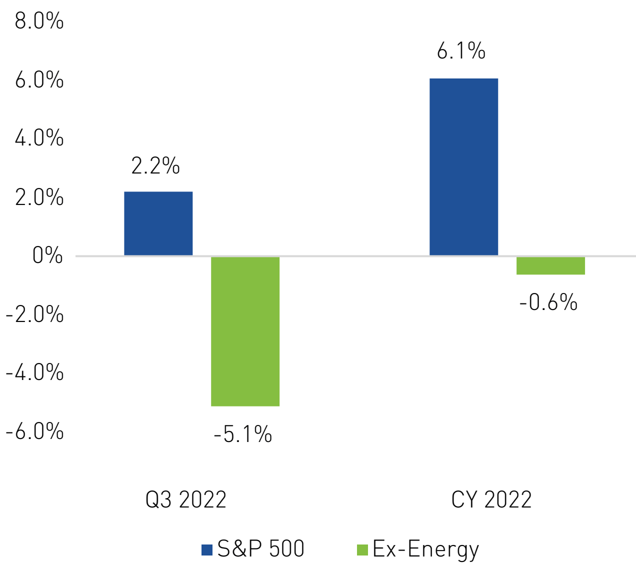
Median excess return vs. S&P 500 on day after earnings report



Source: Goldman Sachs

The Energy sector is also the largest contributor to earnings growth for the S&P 500 for Q3 2022. In fact, if the Energy sector is excluded, the S&P 500 would be reporting a year-over-year decline in earnings of 5.1% rather than a year-over-year increase in earnings of 2.2%, according to Factset. This would mark the second consecutive quarter in which the index would be reporting a year-over-year decline in earnings excluding the Energy sector.

S&P 500 earnings growth: ex-energy



Source: FactSet

For the whole year 2022, the index is expected to report a year-over-year decline in earnings of 0.6% excluding energy. Rather than an increase of 6.1%. From Q2 2023 onwards, the Energy sector is projected to report year-over-year declines in earnings, detracting from the overall earnings growth.

Analysts are predicting that earnings growth will slow to 0.5% in Q4 2022. Earnings growth for CY2022 has been revised downwards to 6.1%, relative to the almost double digit forecast earlier in the year.

Perspective – Much of the market's drawdown so far has been driven by a contraction in earnings multiples, in reaction to rising real yields, deteriorating economic outlook, as well as increasingly bearish investor sentiment. The downtrend in corporate earnings could lead equity markets lower, as companies deal with higher input and labour costs, and weaker demand. Going forward, we believe moderation of inflation will support improvements in consumer demand. After a difficult year, both stocks and bonds valuations now look much more reasonable. While equity valuations are not at recessionary lows, they provide an attractive entry point for long term investors. Yield-to-maturity in bonds, which are usually a good proxy for total returns, are also now attractive relative to the beginning of the year. As rates peak, we expect expansion of market multiples to drive equity market recovery as risk appetite improves, and bond yields may see the opportunity to provide better capital gains.

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	-0.93	-4.16	-2.64	-12.31	-10.07	-2.75	0.13	1.53
Bloomberg Barclays Global Aggregate (C$ Hdg)	-0.33	-6.25	-5.47	-12.62	-12.36	-3.29	-0.24	1.61
Bloomberg Barclays US HY 2% Issuer Cap (C$ Hdg)	2.59	-4.00	-5.12	-12.97	-12.31	-0.39	1.20	3.78
Equities								
MSCI World (Developed Markets)	6.40	-0.83	-1.91	-13.68	-10.29	7.43	7.58	12.38
MSCI World Growth	3.82	-5.23	-5.19	-23.66	-21.16	8.23	9.39	13.89
MSCI World Value	8.90	3.58	1.04	-3.49	0.84	5.53	5.09	10.49
MSCI Canada	5.76	-0.46	-4.86	-6.69	-5.29	7.74	6.00	6.97
MSCI USA	7.12	0.04	0.23	-12.69	-8.51	10.97	11.05	15.62
MSCI EAFE	4.61	-3.14	-6.82	-17.04	-15.26	-0.04	1.04	7.42
MSCI Europe	6.39	-2.33	-6.76	-17.63	-15.14	0.76	1.18	7.30
MSCI Japan	2.21	-4.26	-5.02	-18.15	-17.10	-2.03	0.19	8.67
MSCI Pacific Ex Japan	-0.24	-6.07	-10.71	-11.80	-13.01	-0.98	1.55	6.02
MSCI EM (Emerging Markets)	-3.81	-8.56	-14.25	-23.78	-24.10	-3.23	-1.99	3.97
World Currencies (relative to CAD)								
US Dollar	-0.73	6.45	6.73	7.99	10.04	1.24	1.14	3.16
Euro	0.15	3.19	-0.01	-6.15	-6.02	-2.76	-2.13	0.40
Pound Sterling	2.39	0.72	-2.12	-8.20	-7.57	-2.62	-1.71	-0.25
Yen	-3.33	-4.28	-6.97	-16.34	-15.58	-8.95	-4.15	-3.05

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

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