NEI MONTHLY MARKET MONITOR

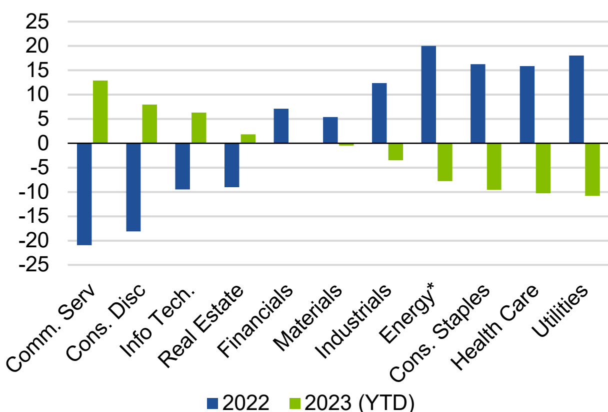
January 2023

Five surprises to start 2023

The markets began the year with a stunning rally. U.S. bonds had the best January since 1988, stocks had the best start since 2019; providing a favourable backdrop for the 60/40 balanced portfolio after a horrendous 2022. Market breadth around the rally started off narrow but has since widened. The Europe 600 Index rallied nearly 16% since falling to tis October lows to reach a new high on January 18th. China's CSI 300 also extended its rally since hitting a bottom at the end of September, to rise nearly 16% by the end of January. The remarkable improvement on sentiment was fueled by speculation that the central banks will reach the end of the monetary tightening and will start easing rates later this year, in addition to China's re-opening and Europe's stronger-than-expected growth momentum. The subpar start to the Q4 earnings season for the S&P 500 has not been enough to derail price momentum, as a number of large technology companies had negative earnings surprises.

In what looks like a mirror image of the safety and quality seeking investor behavior in 2022, investors flocked to the high risk and low-quality areas in January such as FAANG, ARKK, crypto, etc. Companies with low profitability outperformed; Cyclical segments outperformed defensives; High volatility names outperformed low volatility; technology and communications outperformed utilities.

S&P 500 Returns by Sector



Data: Bloomberg, as of January 31, 2023

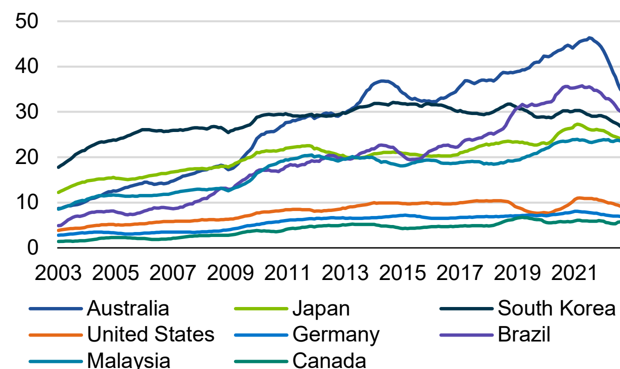
Here's a closer look at the five surprises that drove market upside despite economic data pointing to high probability of a recession.

1. China's abrupt re-open provides near term boost

In a surprise move, the Chinese government reopened the country on January 8th. Most observers were expecting a more measured easing after enforcing the country's zero-Covid policy in a draconian fashion for three years. Market sentiment turned positive overnight, as the re-opening provides a path to a sustainable recovery in China's domestic economy.

China's re-opening also provides a strong tailwind to global growth. Economies globally have benefited from China's rapid economic growth and the rising demand for goods over the past two decades as it's become the world's second largest economy. The resumption of tourism and removal of most pandemic restrictions lifts demand for energy and commodities such as oil, copper, and iron ore. However, it also posts upside risk on inflation with commodity prices pushed higher. The International Monetary Fund (IMF) revised their global growth forecast upwards by 0.2% to 2.9% in 2023, citing China's re-opening as a key factor. The MSCI China Index extended the rally that began late last year, rising by over 50% since November 2022, while the MSCI Emerging Market Index also jumped by over 20% from the trough in October.

Per cent of country's total exports consumed by China



Data: Bloomberg, as of January 31, 2023

Bottomline: While the reopening supports domestic companies in the near term, we believe the longer term outlook for China remains challenged, as the country struggles with a deleveraging real estate sector coupled with a population that has started to shrink. We see a better risk and reward trade-off in European and Asia Pacific companies that benefit from China's re-opening. We have increased our EM and EAFE exposure from an underweight to a neutral position in our tactical portfolio as growth prospects improved and valuation remains attractive relative to North American equities

2. Europe's much welcomed warm winter

With the exception of ski hills operators, Europeans welcomed the record-breaking temperatures this January, which gave the energy crisis in the region much needed breathing room. Gas prices have collapsed over 80% from last summer's highs as lower demand for heating has left gas reserve at a 78% of capacity vs 5-year average of 58%, helping to relieve inflationary pressure. Euro-area headline inflation slowed to 8.5%, well below consensus expectations of 8.9%, with a sharp drop in energy contribution as the main driver of decline.

Dutch TTF natural gas price

Data: Bloomberg, as of January 31, 2023

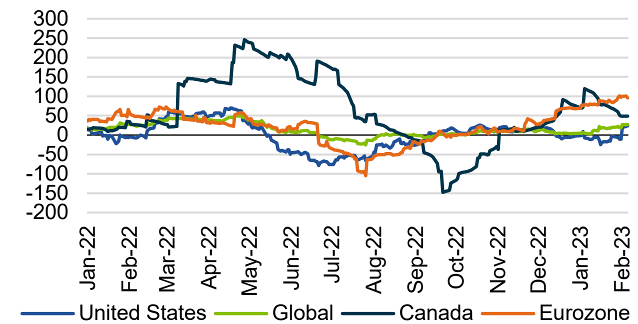
Bottomline: With its energy crisis eased, Europe looks attractive as it is supported by below historical average valuations, large valuation discount relative to other regions, and prospects of a rebound based on demand and tourism from the re-opening of China.

3. Economic resilience surprising to the upside

The global economy is in better shape than expected, as the most recent economic data has been beating markets expectations. Canada beat expectations on year-over-year GDP growth at 2.8%, with resilience in retail sales ex autos. Europe has also been showing resilience since the last quarter of 2022, Eurozone's GDP grew by a positive 0.3%, when economists expected a contraction of 0.2%. This resilience provides a strong boost to the markets. Europe's Stoxx 600 Index has been outperforming the US, rallying over 20% from the September lows, when market sentiments hit overly bearish levels on recession fears.

Numerous forward-looking data such as manufacturing PMI, factory orders and industrial production across countries including Europe, UK, and Eurozone continue to point to significant economic contraction. Strong GDP growth in the U.S. also masks the underlying weakness in personal consumption. Probability of recession across developed markets remains heightened at 65-70%, the worst being the U.K. at 90%.

Citi Economic Surprise Index



Data: Bloomberg, as of January 31, 2023

Bottomline: With mixed economic signals, near term strength may not be sustainable and global economies are likely not out of the woods yet, especially in Europe, as central banks are nowhere near reaching the end of the tightening cycle and financial conditions continue to tighten.

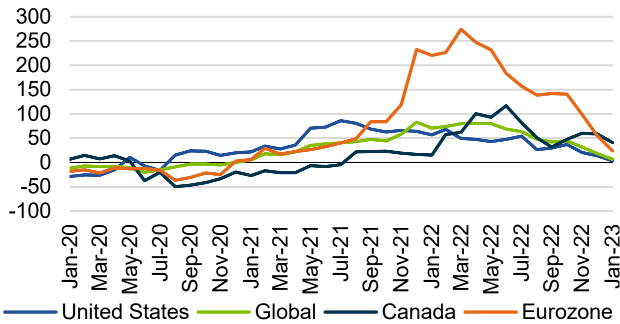
4. Inflation is moderating rather quickly

It may not feel that way at the grocery store, but inflationary pressures have been cooling as expected, as supply chain bottlenecks continue to heal, commodity prices retreat, and tight monetary policies have started to work through the system to bring supply-demand dynamics back in balance.

Despite inflation cooling on cue, central banks are keeping with their hawkish tone and continue with their policy tightening (notwithstanding Fed Chairman Jay Powell's dovish off-script comments after the press conference). Major central banks including Bank of Canada, Bank of England, European Central Bank, and the Fed have delivered rate hikes, inline with market expectations in their first meetings in 2023. While Canada may be done with rate hikes for now, other central banks are expected to have more to come in the coming months. The bond markets are still convinced that the Fed will need to cut rates if the economy falls into a recession in the second half of 2023; but the January rally in the equity markets are suggesting the prospects of a soft-landing is rising

which is very much contrary to what the current economic data is indicating.

Citi Inflation Surprise Index

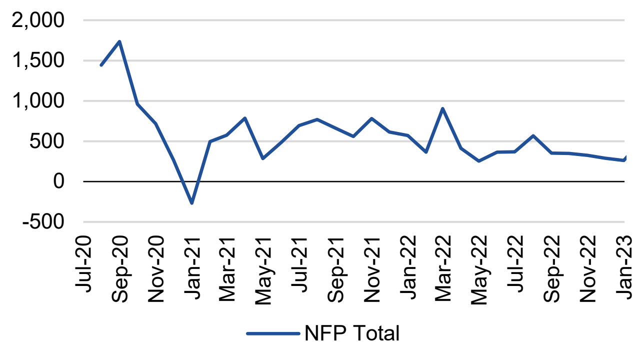


Data: Bloomberg, as of January 31, 2023

5. Labour markets remain surprisingly resilient

Many factors that drove inflation higher during the pandemic have since retreated. One of the remaining drivers that is still concerning is the tightness in the labour market. Despite many large corporations announcing massive layoffs and hiring freezes (especially technology companies that over-hired during the pandemic), unemployment rate continues to fall to record low levels while job openings still massively exceed people looking for jobs. This gives investors hope that the labour market is still healthy, we are far from recession, and the Fed might be able to stop tightening without causing too much damage to the economy.

Nonfarm Payrolls Total Month-Over-Month Net Change



Data: Bloomberg, as of January 31, 2023

Bottomline: Although the labour market has been resilient, it will likely deteriorate going forward as companies right-size their cost base amidst slowing revenue growth. The good news is that wage growth is already slowing, which will continue to alleviate the pressure on inflation.

Defensive stance warranted on valuation concerns

The most recent market rebound since last October has propelled the US market to over 18x forward earnings, much richer than its 20-year historical average of 15x forward earnings. This valuation puts U.S. markets at an overbought level even without considering recession risk and is at significant downside risk if we are indeed marching towards one. Further to that, we think that earnings estimates are likely to be revised further downwards from current levels with companies lowering their forward guidance for 2023, putting downward pressure on prices. The valuation gap against the US markets has narrowed somewhat, but Europe's Stoxx 600 Index continues to be more attractive at around 13x forward earnings, back to the 20-year historical average after the recent rebound.

On the fixed income side, sovereign yields have room to fall further if recession materializes. US high-yield credit spreads are trading barely above 400 bps, below the 20-year average and far lower than the median spreads during recessionary episodes (~1000 bps).

On a technical front, the deep inversion across the US Treasury yield curve and U.S leading economic indicators continue to flag heightened recession risk. Negative trending economic and technical signals, along with elevated valuation keeps us in a defensive stance with a moderate underweight in equities with a preference towards dividend paying high quality names in our tactical Managed Asset Allocation Pool (MAAP).

Asset allocation outlook summary

	Negative		Neutral		Positive
Equity					
Overall Equity		This month			
Canada Equity			This month		
U.S. Equity		This month			
International Equity			Last month	This month	
EM Equity			This month	Last month	
Fixed Income					
Overall Fixed Income			This month		
Govt				This month	
IG Corp			This month		
US HY Corp		This month			
Cash				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 January 31, 2023. 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.

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 Canada Aggregate TR USD	2.91	1.35	4.15	-0.18	2.91	-5.57	-5.16	-2.13
Bloomberg Global Aggregate TR Hdg CAD	2.26	0.99	3.54	-2.93	2.26	-8.07	-5.29	-2.64
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	3.74	3.04	5.24	1.03	3.74	-5.82	-2.02	0.57
Equities								
MSCI World NR USD	5.45	0.91	7.27	6.37	5.45	-2.90	6.14	7.90
MSCI World Growth NR USD	8.02	1.36	7.44	1.83	8.02	-10.17	-0.37	7.70
MSCI World Value NR USD	3.08	0.49	7.09	10.93	3.08	3.97	12.21	7.02
MSCI Canada NR CAD	7.35	2.01	7.53	7.03	7.35	0.52	12.40	8.49
MSCI USA NR USD	4.93	-1.34	3.33	3.38	4.93	-4.99	6.72	9.51
MSCI EAFE NR USD	6.45	6.48	17.75	14.05	6.45	1.95	4.23	4.56
MSCI Europe NR USD	7.02	6.98	18.39	15.64	7.02	1.49	6.67	5.40
MSCI Japan NR USD	4.60	4.82	14.26	9.40	4.60	-2.15	-2.53	1.78
MSCI Pacific Ex Japan NR USD	6.97	7.37	22.36	14.94	6.97	13.56	5.33	5.34
MSCI EM NR USD	6.26	4.70	19.50	9.26	6.26	-7.80	-7.72	1.70
World Currencies								
US Dollar	-1.52	-1.57	-2.18	4.14	-1.52	4.92	2.20	0.30
Euro	0.21	3.82	7.49	10.92	0.21	1.65	-3.37	-0.38
Pound Sterling	0.79	1.75	4.60	5.35	0.79	-3.73	-3.23	-1.96
Yen	-0.08	5.61	11.81	7.02	-0.08	-7.04	-8.30	-5.61

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