NEI MONTHLY MARKET MONITOR

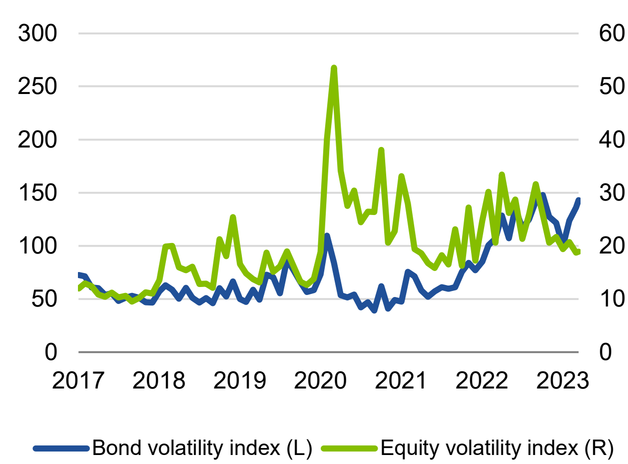
March 2023

Equities look past crises while fixed income signals bad times ahead

There were plenty of reason to expect a much weaker equity market given everything that happened in March, but somehow investors were able to look past bank failures, rate hikes, and slashed earning estimates with a surprising level of optimism, betting on the strength of economic data and the Fed to start cutting rates as soon as mid-year. The S&P 500 was able to end the month in the green up 1.57% and 7.03% for the quarter. The Nasdaq was also up 4.56% in March and a remarkable 16% for the quarter, its best quarter since 2020. The TSX was dragged down by lower energy prices, falling -2.37% in March, but still up 3.66% for the quarter.

The fixed income market, however, seems to be living on a different planet, speculating that the banking crisis will lead to tighter lending standards, raising the probability of recession, which in turn alleviates the need for higher rates. The treasury markets saw dramatic volatility, with 2-year yields taking a plunge of over 100 basis points (bps) in March following the banking crisis. 10-year treasuries also fell by over 50bps to just below 3.5% over the month and ended the first quarter down roughly 40bps. Investors piled into the safety of Treasuries and money market funds. The Canadian aggregate bond index rose 2.2% in March and was up 3.0% for the quarter while the global aggregate bond index was up 3.2% and 3.0% for the month and the quarter respectively.

Bond volatility at highest levels since the GFC



Data: Bloomberg, as of March 31, 2023

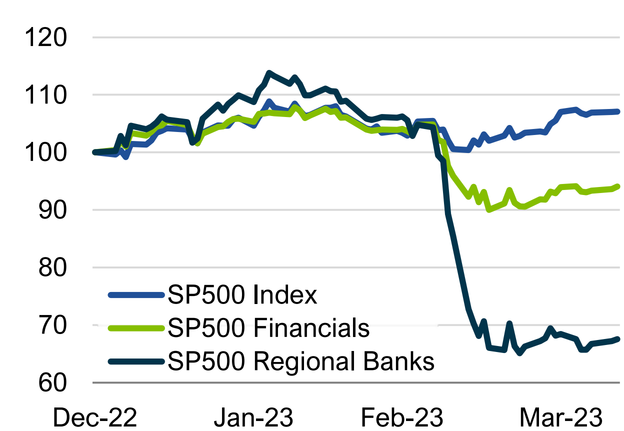
Here's a closer look at some of the key events that drove the markets in March and caused investors to re-consider the path forward.

Biggest bank collapses since GFC

The collapse of two U.S. regional banks in early March sparked fear about potential contagion to other regional banks and the stability of the broader banking sector. On March 10th the U.S. regulators took control of Silicon Valley Bank (SVB) following a run on the bank when panicked customers withdrew US$42 billion of deposits in a few days. Similarly, U.S regulators also closed Signature Bank of New York a few days later when depositors withdrew large sums of money. The panic quickly spread to Europe as concerns centered around Credit Suisse defaulting on its debts. Despite the Swiss National Bank's effort to intervene by providing a CHF 50 billion lifeline, Credit Suisse was ultimately taken over by UBS on March 19th in a deal brokered by the Swiss government and regulators.

The bank failures led to a substantial drop in value of regional banking stocks in the U.S. and the financial sector more broadly. The overall equity market, however, bounced back with remarkable resilience, as investors interpret the fallout of the banking crisis as disinflationary, hence alleviating the need for more tightening.

U.S. regional bank stocks weighed by bank collapses

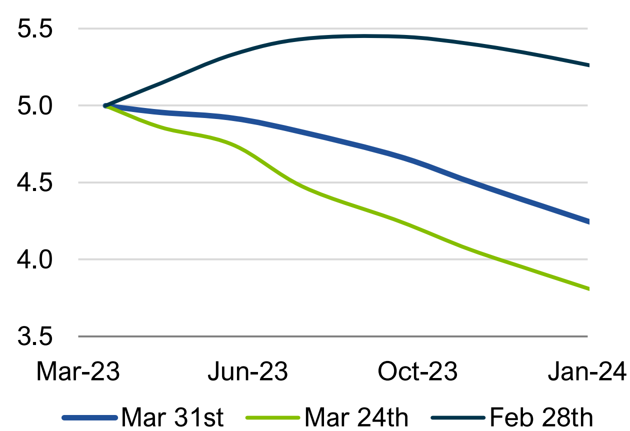


Data: Bloomberg, as of March 31, 2023

Tighter lending standards raises recession odds

The bank collapses demonstrated to the broader banking industry what poor risk management and duration mismatch could lead to. As the regulators get busy in tightening up regulations, the more immediate fallout of the banking crisis will likely be tightening of lending standards. If tighter lending standards do materialize, it will have a tightening effect on financial conditions, not unlike the effect of rate hikes. This increases the likelihood of the economy slipping into recession later this year. The fixed income markets swiftly softened their views on the path of policy rates. Currently, markets are pricing in Fed rate cuts of 0.75% and Bank of Canada cuts of 0.50% by year end. At the beginning of March, December policy rates for both BoC and Fed were expected to be flat from current levels.

Dramatic shift on market implied U.S. policy rates expectations in March from over 5% to 4.25% by the end of 2023



Data: Bloomberg, as of March 31, 2023

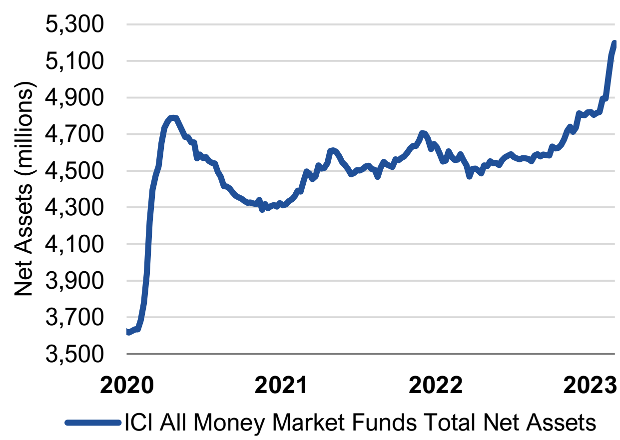
While some analysts speculate that central banks may pause on tightening given the uncertainty on how much the banking crisis may weigh on the economy, central banks stayed the course and remained focused on inflation. The European Central Bank hiked rates by 50 bps on March 16 and the U.S. Federal Reserve hiked by 25bps the following week. Despite the Fed's insistence that there is still more tightening required to tame inflation, contrary to market views that they will need to start cutting rates by the summer this year to mitigate economic contraction.

Bottomline: Although the banking crisis is so far idiosyncratic in nature and the hit to sentiment could be short-lived, but lending standards is set to tighten and raises the likelihood of the economy slipping into recession later this year.

Money markets see record inflows

The steep rise in interest rates and the confidence crisis on banks improved the attractiveness of money market funds as a safe haven, contributing to increased flows to money market funds over the past 12 months. As much as $600 billion of deposits have left banks since the hiking cycle began. By the end of March, US$5.2 trillion is sitting in money market funds, a new record high.

Record level of assets in money market funds



Data: Bloomberg, as of March 31, 2023

Bottomline: The short-term respite from market volatility could be comforting, but it could also be detrimental to long term financial success if the capital is not redeployed and markets staged a rebound. Importantly, record levels of money market funds provide plenty of dry powder that could be deployed to the stock and bond markets when risk appetite returns, providing support for a stronger market rebound.

Canada ramps up spending in "green" budget

On March 28, 2023, Finance Minister Chrystia Freeland tabled the Liberal government's 2023-24 Federal Budget in Parliament. The budget includes plans to spend nearly $70 billion more between now and 2027-28 – with $59.5 billion rolling out over the next five years – while offsetting this with close to $25 billion in cuts and savings. As a result, the federal deficit is projected to be $43 billion this fiscal year.

A core focus of the budget is developing Canada's green economy by introducing new corporate tax credits meant to encourage investment in clean energy, by focusing on clean electricity and for clean technology manufacturing and processing and critical mineral extraction. Plus $20 billion commitment to the Canada Infrastructure Bank to support building of major clean electricity and clean growth infrastructure projects.

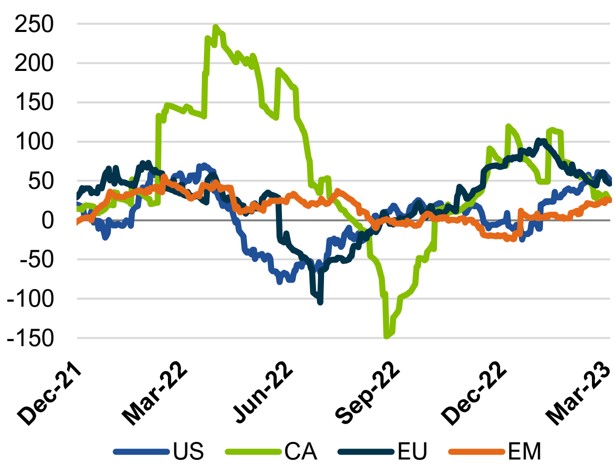
Despite the federal budget spending pushing deficit well into 2027-2028, it was well received by markets. Canadian stocks, bonds and CAD gained modestly for the day.

Bottomline: The increase on spending provides targeted support for clean and sustainable growth projects, which is essential to keep Canada competitive, especially considering the Inflation Reduction Act in the U.S. It is, however, unlikely to materially improve the growth outlook of Canada in the near term.

Surprising economic strength

Economic data across North America, Europe and Emerging Markets continues to surprise to the upside and show that economies are stronger and more resilient than forecasts assume.

Citi economic surprise index



Data: Bloomberg, as of March 31, 2023

In the U.S., manufacturing activities remain in contractionary territory, but is trending higher than in February, as the manufacturing PMI beat expectations. Services PMI surprised to the upside at 52.6 in March. This was the sharpest rise in output since June 2022, driven by warmer weather, and new business expansion.

In Canada, GDP rose in January by 0.5% month-over-month (3% year-over-year), above market estimates at 0.4%. Retail sales was also strong, up 1.4%, above expectations of 0.7% while inflation continued to fall.

Composite Eurozone PMI rose to 54.1 in March, up from 52 in February and ahead of market forecast of 51.9. These preliminary estimates would mark the fastest expansion in nearly a year, driven by the warmer than usual weather. The growth was driven by the services sector, which expanded the most in 10 months, offsetting the contraction for manufacturing.

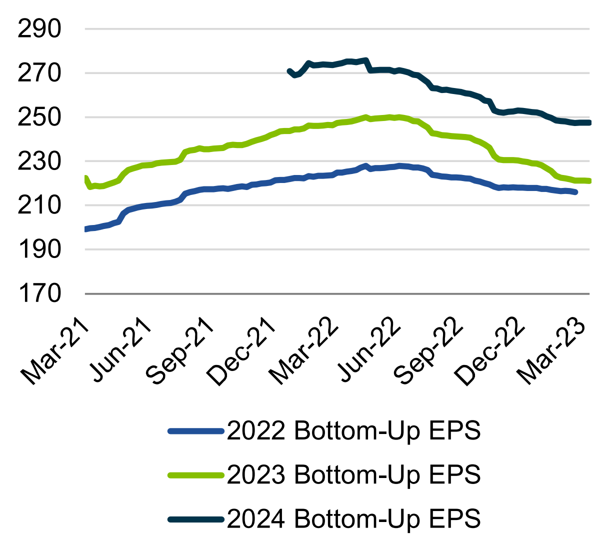
China's composite PMI went up from 56.4 to 57.0 in March, marking the highest level since 2011 and signalling that the re-opening recovery is still going strong**.**

Bottomline: Strength in recent data stems primarily from the re-opening of China as well as the warmer than usual winter in Europe and North America. The sustainability of the resilience is debatable as the lagged and varied impact of monetary tightening over the past 12 months is yet to be felt in the economy, putting central bankers at a tough position amidst inflation rates that are still above the neutral rate. This is keeping us in a defensive positioning in the portfolio with underweight positions in both equities and fixed income, waiting for better clarity on paths of rates and economic growth.

Earnings estimates cut again

Analysts continue to drop their earnings estimates for the S&P 500 companies. S&P 500 earnings are now expected to be flat for 2023, down from 10% growth last summer. Estimates for next year have been cut as well. Whether this is enough in the face of a slowing economy remains to be seen. The banking sector earnings in particular will be closely watched to see how the recent turmoil is affecting balance sheet, earnings and credit growth.

Forward earnings estimates for 2023 and 2024 currently stands at 1.4% and 12.2%



Data: FactSet, as of March 31, 2023

Bottomline: Given the strong Q1 price performance for equity markets, the potential for more downside earnings revisions, and the anemic growth rates at 1.4% for 2023 and 12.2% for 2024 earnings, equity valuations may be too high. The market is not pricing in a recession or further negative fallout from the banking crisis, making it more vulnerable to market corrections.

Asset class outlook

Overall Equities – from neutral to underweight: Increased recessionary risk is not reflected in current valuations, making it vulnerable for corrections.

Canadian Equity – neutral: Attractive valuations offset by lower growth. Economy weighed by higher sensitivity to interest rates.

U.S. Equity – neutral: Strong job market and falling inflation provide boost for disposable income and consumer spending. Valuations not reflecting recessionary risks.

International Equity – neutral: Falling gas prices and warm winter are positive for the region, coupled with low valuations, but inflation still rising, and more tightening required.

Emerging Markets Equity – neutral: China's re-opening is tampering off and boost to equity market not as strong as expected.

Overall Fixed Income – underweight: Rates rally overdone, reflecting too dire an economic picture. Yields may rebound in the near term, seek safety of shorter-term bonds or cash.

Government Bonds – overweight: Defensive position to overweight higher quality government bonds at the expense of high yield bonds. However recent rally may be overdone causing yields to rise in the near term.

Investment Grade Corporate Bonds – neutral: Attractive yields while spreads expect to remain stable.

High Yield Bonds – underweight: Favour government bonds as risk off hedge.

Cash: Offers attractive yield while waiting for better clarity.

Asset allocation outlook summary

	Negative		Neutral		Positive
Equity					
Overall Equity		This month	Last month		
Canada Equity			This month		
U.S. Equity			This month		
International Equity			This month		
EM Equity			This month		
Fixed Income					
Overall Fixed Income		This month			
Govt		This month		Last month	
IG Corp			This month		
U.S. HY Corp		This month			
Cash				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 March 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	2.20	0.15	3.07	3.34	3.07	-1.84	-3.18	-1.69
Bloomberg Global Aggregate TR Hdg CAD	2.18	0.49	2.76	3.70	2.76	-4.34	-4.12	-2.34
Bloomberg US HY 2% Issuer Cap TR Hdg CAD	1.03	-0.32	3.41	7.63	3.41	-4.08	-2.43	5.42
Equities								
MSCI World NR USD	2.48	2.04	7.60	16.47	7.60	0.74	5.00	14.46
MSCI World Growth NR USD	6.30	6.43	14.97	18.72	14.97	-2.29	2.99	14.00
MSCI World Value NR USD	-1.27	-2.21	0.80	14.04	0.80	2.88	6.33	13.97
MSCI Canada NR CAD	-0.53	-2.95	4.19	10.37	4.19	-5.83	6.07	16.53
MSCI USA NR USD	2.89	2.42	7.47	13.37	7.47	-1.32	5.57	15.99
MSCI EAFE NR USD	1.87	1.77	8.34	25.36	8.34	6.86	3.65	11.10
MSCI Europe NR USD	1.76	3.18	10.43	29.96	10.43	9.85	6.30	13.09
MSCI Japan NR USD	3.35	1.40	6.06	18.42	6.06	2.69	-2.31	5.60
MSCI Pacific Ex Japan NR USD	-0.05	-4.61	2.04	16.43	2.04	0.33	1.75	12.07
MSCI EM NR USD	2.42	-2.28	3.83	12.32	3.83	-3.25	-7.68	6.03
World Currencies								
US Dollar	1.74	-0.90	-0.98	7.12	-0.98	-1.19	-5.45	-8.29
Euro	1.84	1.46	1.68	9.23	1.68	5.80	-0.23	-1.99
Pound Sterling	1.52	1.86	2.67	9.09	2.67	1.75	-1.77	-1.76
Yen	1.74	-0.90	-0.98	7.12	-0.98	-1.19	-5.45	-8.29

Source: Morningstar data as of March 31, 2023