NEI

2023 MARKET OUTLOOK

Balancing short-term volatility
with long-term opportunity

2022 REVIEW

No place to hide

INVESTORS IN A DANGEROUS TIME

No shelter from the storm

(Opinions as of December 9, 2022)

If markets and investors had any say in determining Merriam-Webster's 2022 word of the year it would surely be 'Inflation'. From January 2022 onward the monthly U.S Consumer Price Index (CPI) release dominated headlines as investors digested the data to gauge the response of the Federal Reserve. The U.S CPI showed inflation above 7.5% for the first time since the early 1980's and it continued to accelerate through most of the year, with headline inflation peaking in June and core inflation peaking in September. Inflation remains stubbornly high despite the extraordinary pace of tightening which has taken a toll on economic growth and asset values.

While the old saying "during a market a crisis all correlations go to 1" may not be precisely accurate, the spirit of the saying rang true this year. Equity and bond markets both saw steep declines as the US Aggregate Bond Index and the S&P 500 showed an increasingly positive correlation throughout the year. To put it in perspective, on a real return basis the traditional balanced portfolio of 60/40 US stocks/bonds had one if its if worst performances (possibly the worst depending on how December ends) in over a decade.

Outside of the U.S, international markets also didn't offer investors any shelter from the storm, as developed and emerging markets also faced inflation in addition to other idiosyncratic risks.

Europe felt the knock-on affects of the Russian-Ukraine Invasion, the U.K produced its own home-grown currency crisis and China continued to sacrifice economic growth to pursue its covid-zero policy.

The combination of high inflation, aggressive monetary tightening, war in Europe and the knock-on effects of a global pandemic presented a challenging year where investors had no place to hide. In most cases the market took no prisoners, as returns were negative regardless of geography, sector, factor exposure or investing style. Even the alternatives like crypto, gold or commodities offered no respite from a down market. The lone sources of positive returns were only in the US Dollar, Natural Gas and Oil.

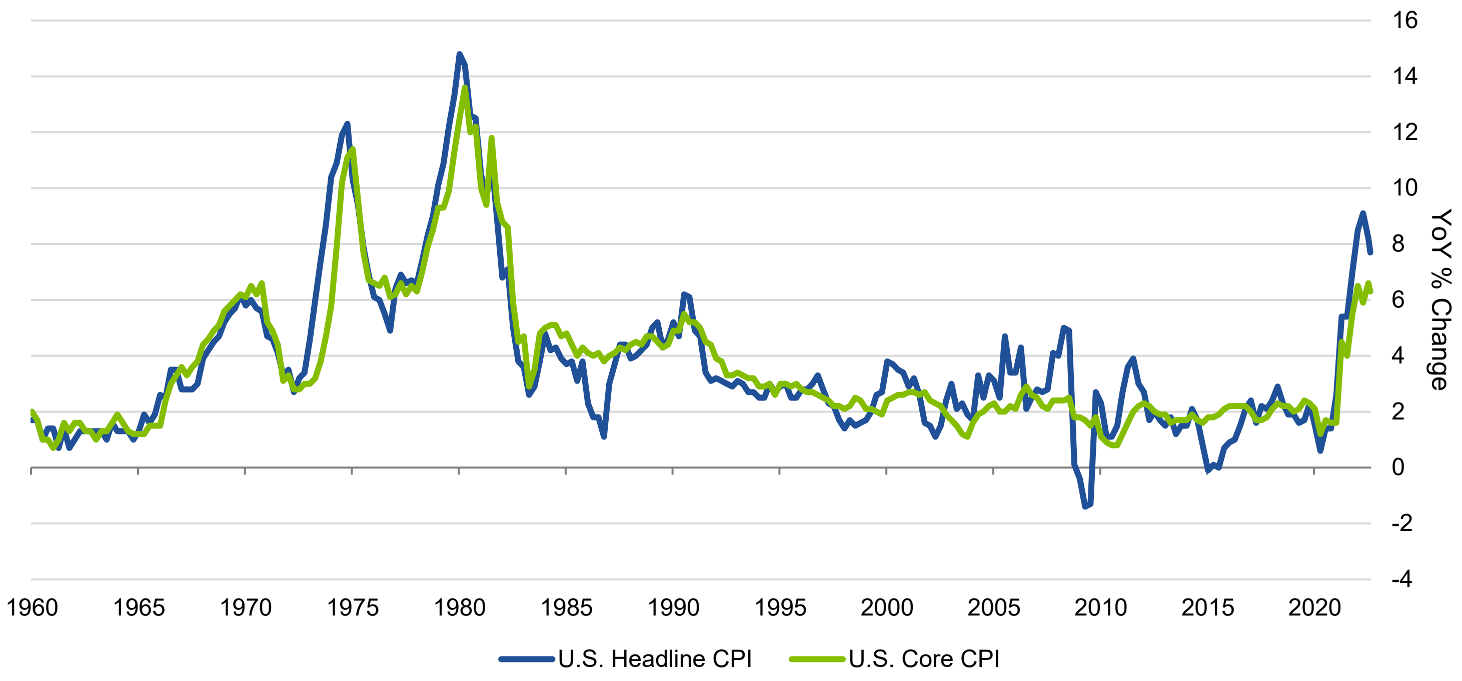
In many ways 2022 was a perfect storm, so it was no surprise this year marked one of the worst years for balanced investors. The silver lining is that active managers who are willing to weather the volatility will likely find long-term opportunity ahead. These ideas are outlined in the next few sections.

John Bai, CFA
SVP and Chief Investment Officer

HISTORICAL LEVELS OF INFLATION

Moderating, but still at highest levels since 1982

U.S. Headline and core inflation



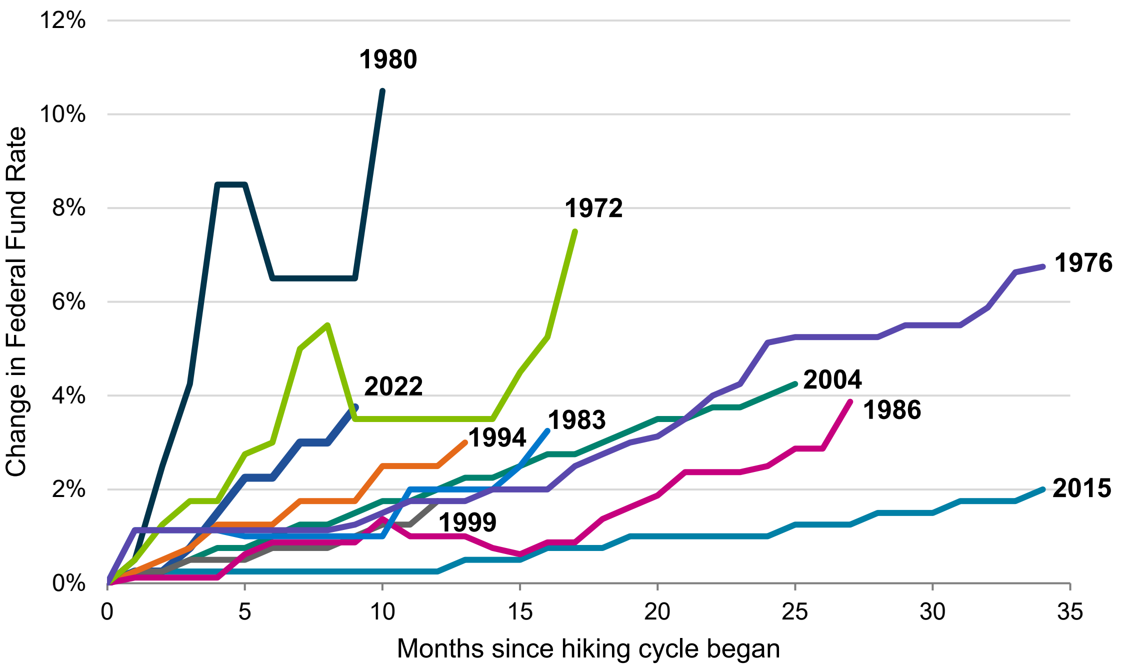
- Inflation continued to increase since the beginning of 2020. Headline inflation peaked at 9.1% in June this year and core inflation at 6.7% in September
- Both measures have begun to ease, as commodity prices continue to retreat and inflationary pressure on wage gains have also shown signs of easing
- Market forecasts continue to suggest inflation will moderate sharply in 2023, towards 2.0% - 3.0% both in Canada and the U.S.

Source: NEI Investments, Bloomberg. Data as of November 25, 2022.

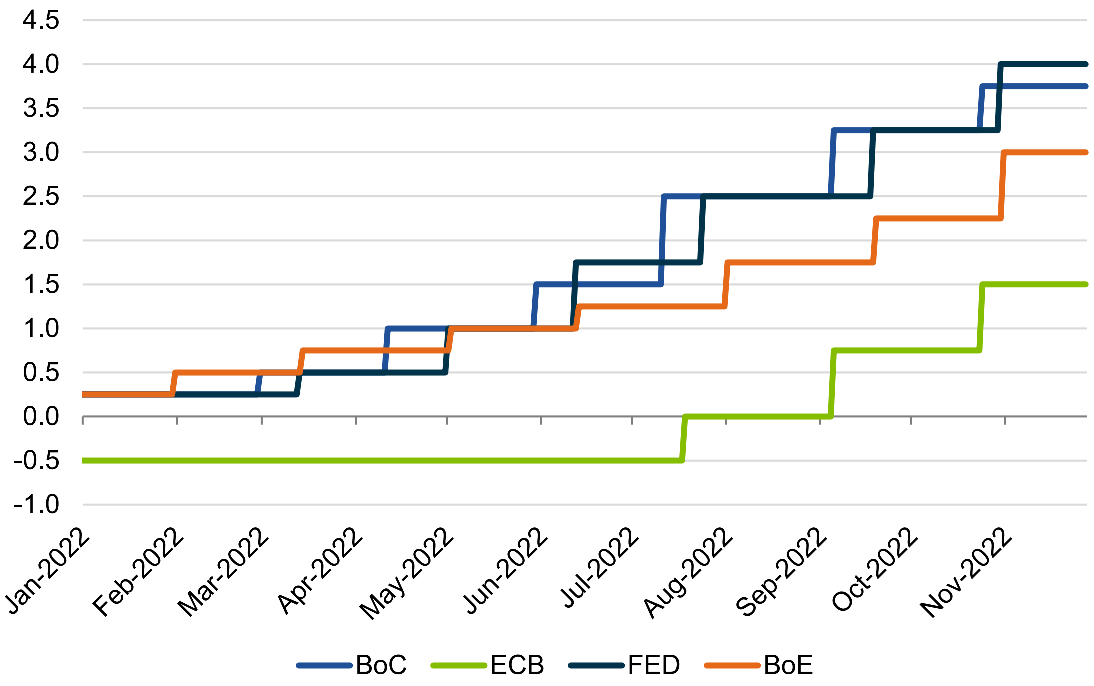
EXTRAORDINARY PACE OF TIGHTENING IN 2022

Synchronized global rate hikes weigh on economic growth and asset values

Pace of historical U.S. FED rate hikes



Global policy rates since January 2022

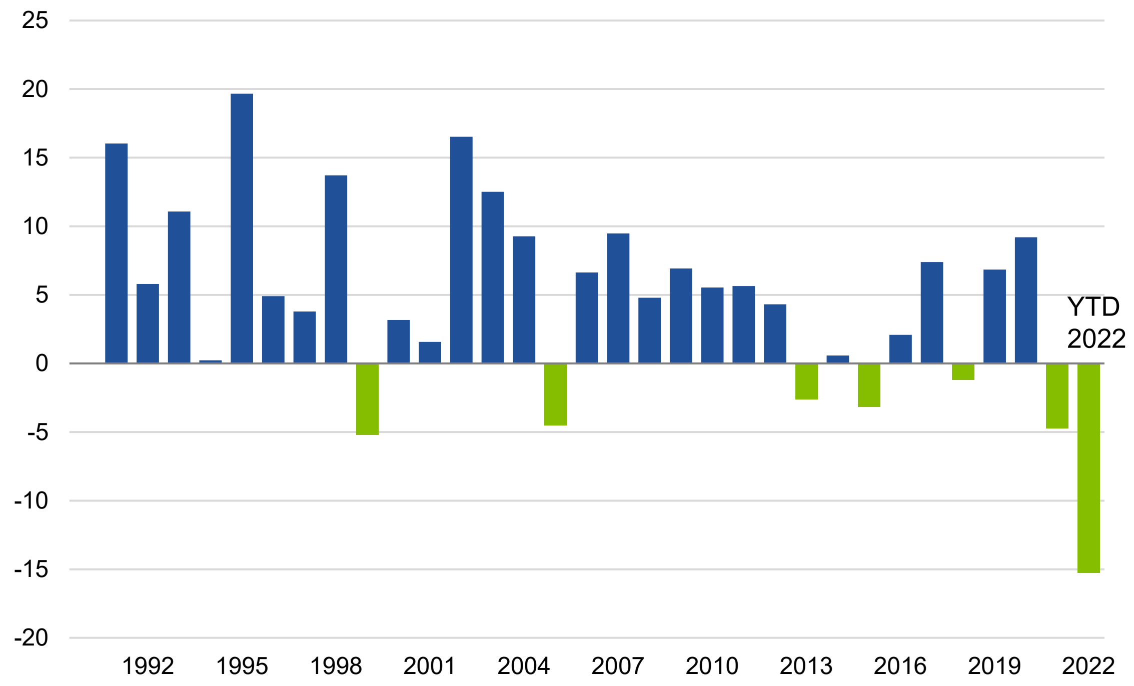


Source: NEI Investments, Bloomberg. Data as of November 25, 2022.

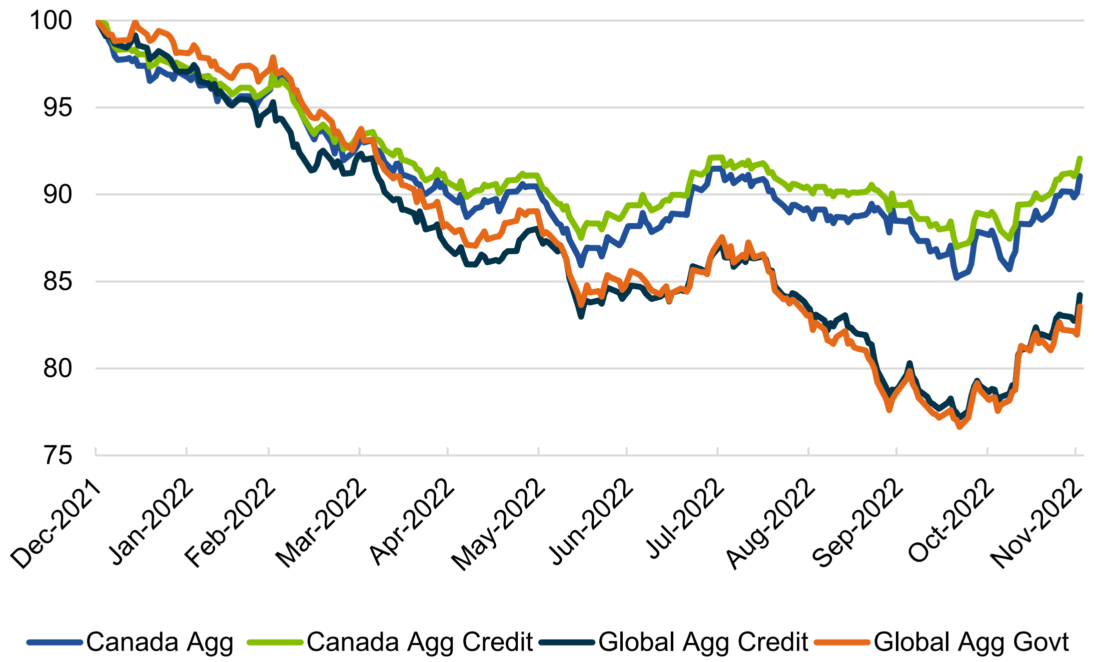
RISING YIELDS ACROSS DEVELOPED MARKETS

Bond prices declined sharply as bond yields rallied across major markets

Annual returns of Global Fixed Income Index



YTD Returns Canada versus global indices



Source: NEI Investments, Bloomberg. Data as of December 2, 2022.

NO PLACE TO HIDE

Broad based declines except for U.S. dollars and energy

2022 year-to-date USD denominated returns

Assets		Equities		Sectors	
U.S. Dollar	10.8%	U.K. Equities	-6.3%	S&P Energy	70.2%
High Yield Bonds	-15.9%	Canada Equities	-7.4%	S&P Financials	-5.6%
DM Equities	-20.3%	Europe Equities	-13.7%	S&P Materials	-7.1%
Global Bonds	-16.7%	U.S. Equities	-13.1%	S&P Info Tech	-21.6%
EM Equities	-13.6%	China Equities	-28.6%	S&P Cons. Disc.	-29.0%

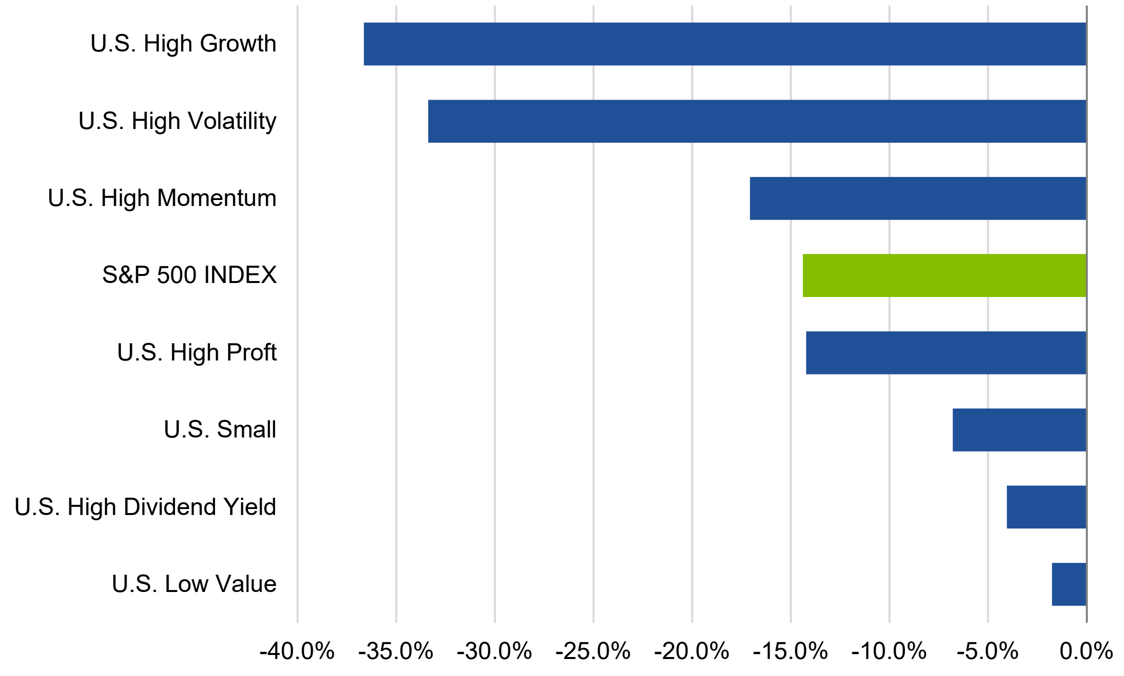
Fixed income		FX vs. USD		Commodities	
Canada Aggregate	-10.2%	Canadian Dollar	-5.9%	Natural Gas	86.5%
U.S. High Yield	-11.1%	Euro	-8.5%	WTI Oil	7.0%
U.S. Aggregate	-13.1%	Chinese Renminbi	-10.9%	Gold	-3.3%
Euro Aggregate	-14.0%	British Pound	-9.8%	Copper	-15.4%
EM Bonds	-16.4%	Japanese yen	-16.6%	Bitcoin	-63.2%

Source: NEI Investments, Bloomberg. Data as of November 30, 2022

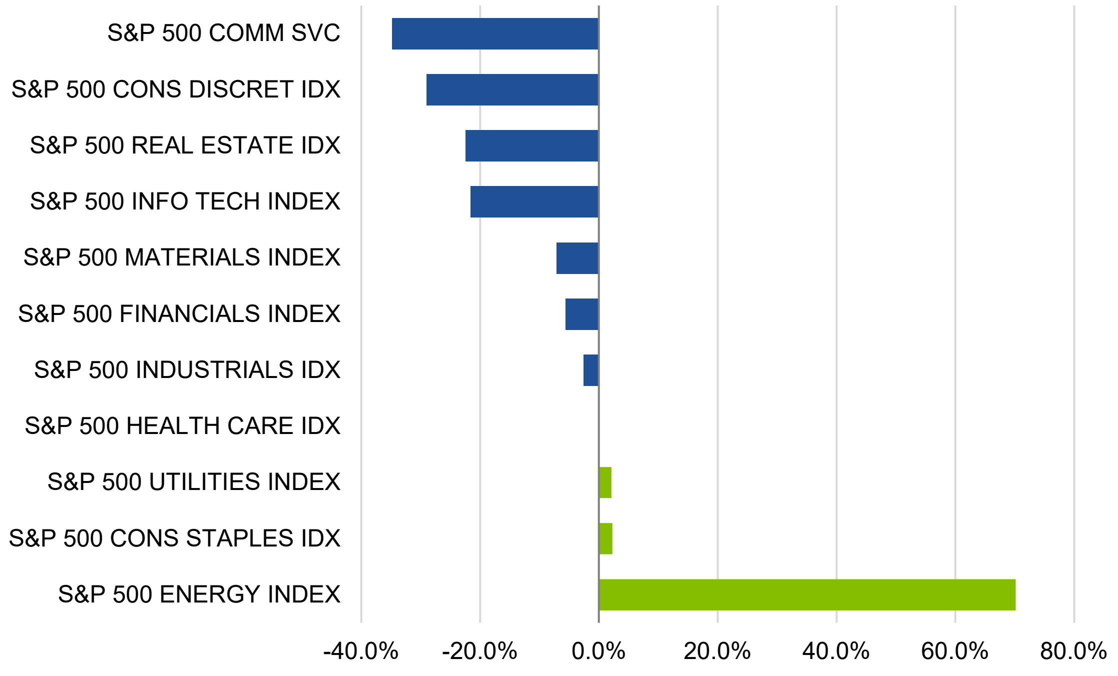
BROAD BASED DRAWDOWN

Wide divergence by factors and sectors

YTD Return by factors



YTD Return by sectors



Source: NEI Investments, Bloomberg. Data as of November 30, 2022

A YEAR OF EXTREME VOLATILITY

More frequent drawdowns of higher magnitude across bonds & equities

S&P 500 Index declines

1/3/1928 – 11/1/2022	>5% dip	>10% correction	>15% correction	>20% correction
Number	326	101	46	26
Average per year	3.4	1.1	0.5	0.3
YTD 2022	7	3	2	1
Last occurrence	10/4/22	8/16/22	8/16/22	1/4/22

- 2022 has been characterized by extremely high volatility in U.S. equity markets
- Hyper-aggressive monetary tightening in the U.S., looming recessions and war in Europe fueled algorithmic trading that created exaggerated swings
- As higher interest rates weigh on economic activity, inflationary pressures should begin to ease providing space for a more dovish approach, and this extreme volatility should abate

Source: Ned Davis Research Group; River Road Asset Management.

SHORT-TERM VOLATILITY

Recession risk weighs

A BUMPY START TO 2023

Expect volatility to persist in the short term

Markets in a restrictive monetary regime

- Markets will likely be volatile in the first half of 2023 as central banks continue their path of tightening and will likely not reach their peak rate until closer to the middle of the year
- Current projections have rates peaking in May in the U.S. and even earlier in Canada. However, the recent trend of slower rate hikes may push peak rates later into the year as dictated by how quickly inflation tempers
- Regardless of when and where rates do top out, they will be firmly in restrictive territory that will impact economic growth
- The current forecasts for global economic growth look anemic with negative GDP in most regions in the first half of the year as markets adjust to tighter financial conditions
- Earnings growth has already been revised down, but likely don't reflect a recession and could be revised further

Dark clouds

- A very narrow path for central banks to tame inflation without driving the economy into a recession
- The risk of recession is affecting the labour market with job openings starting to fall, but higher wages will likely continue to provide inflationary pressure
- Valuations are fair but can be further compressed if recessionary fears increase. This would lead to more downward pressure on prices

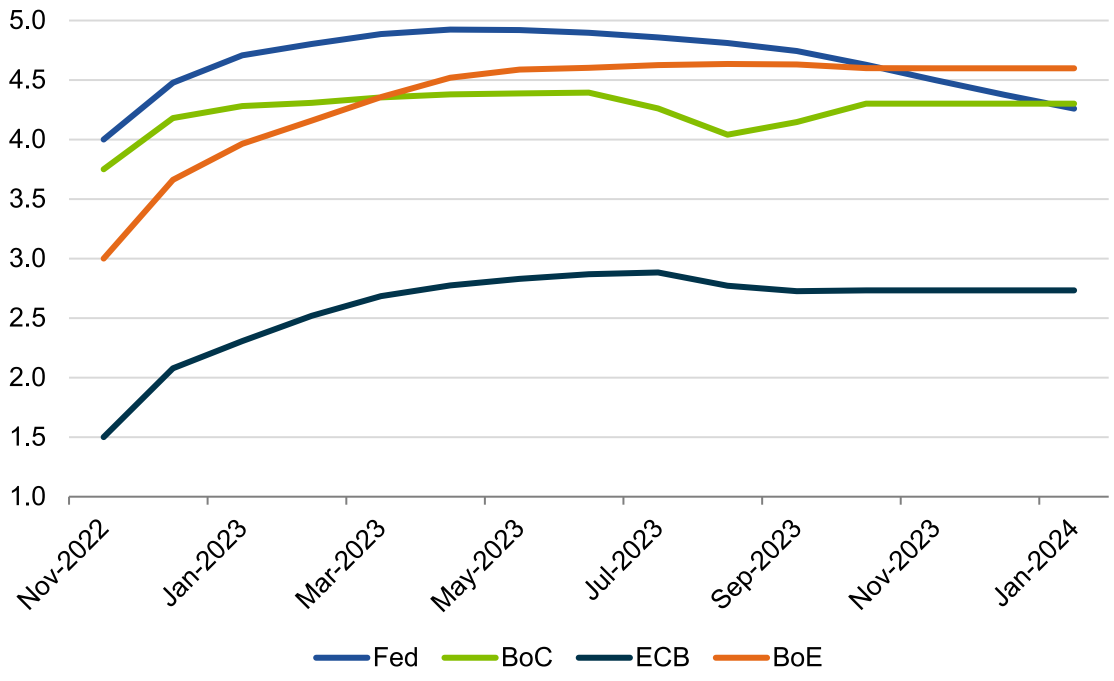
Silver linings

- Global supply chain pressures have mostly eased, which should point to cheaper goods that also help pull down inflation
- Higher rates are impacting the housing market which is starting to see rents fall and house prices roll-over from their recent peaks

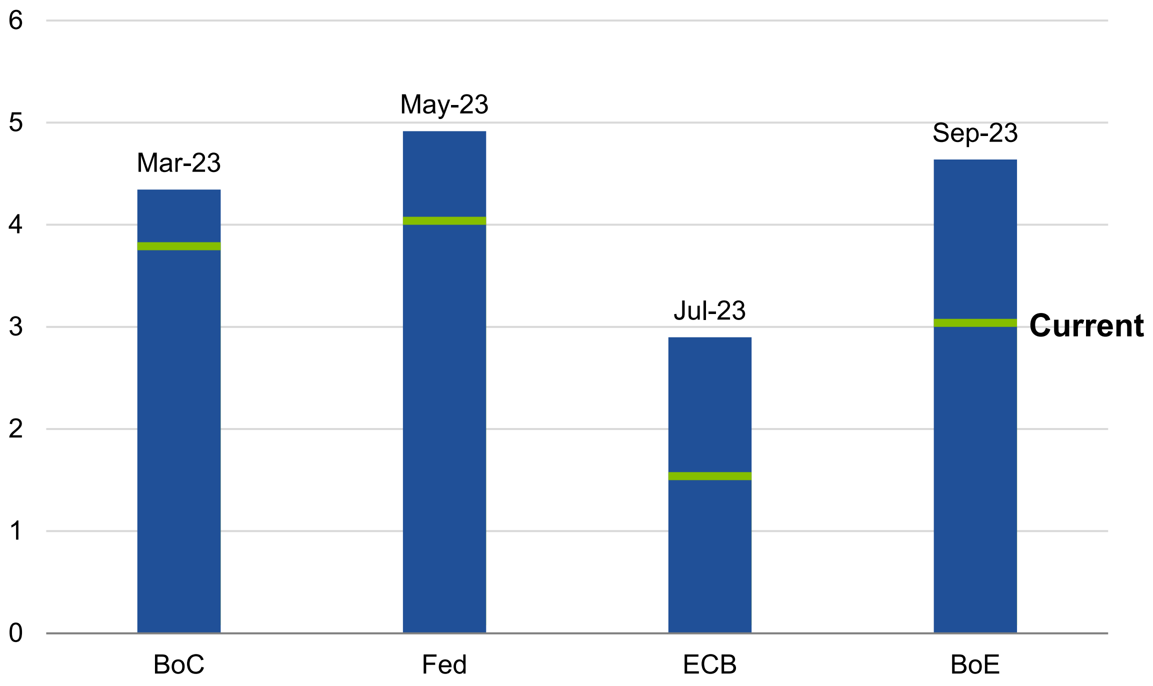
CENTRAL BANK RATES APPROACHING PEAK

Timing and level of peak rates dependent on inflation

DM reference rate – Market implied



Peak Rates as implied by swaps market

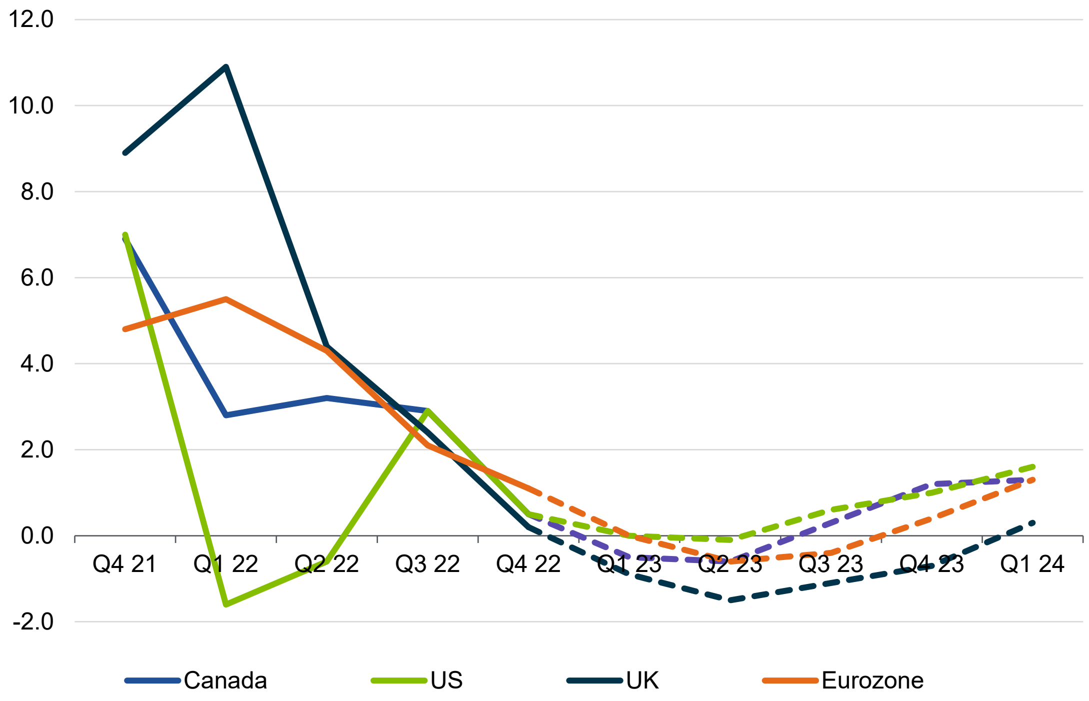


Source: NEI Investments, Bloomberg. Data as of November 30, 2022.

ECONOMIC OUTLOOK CONTINUES TO WEAKEN

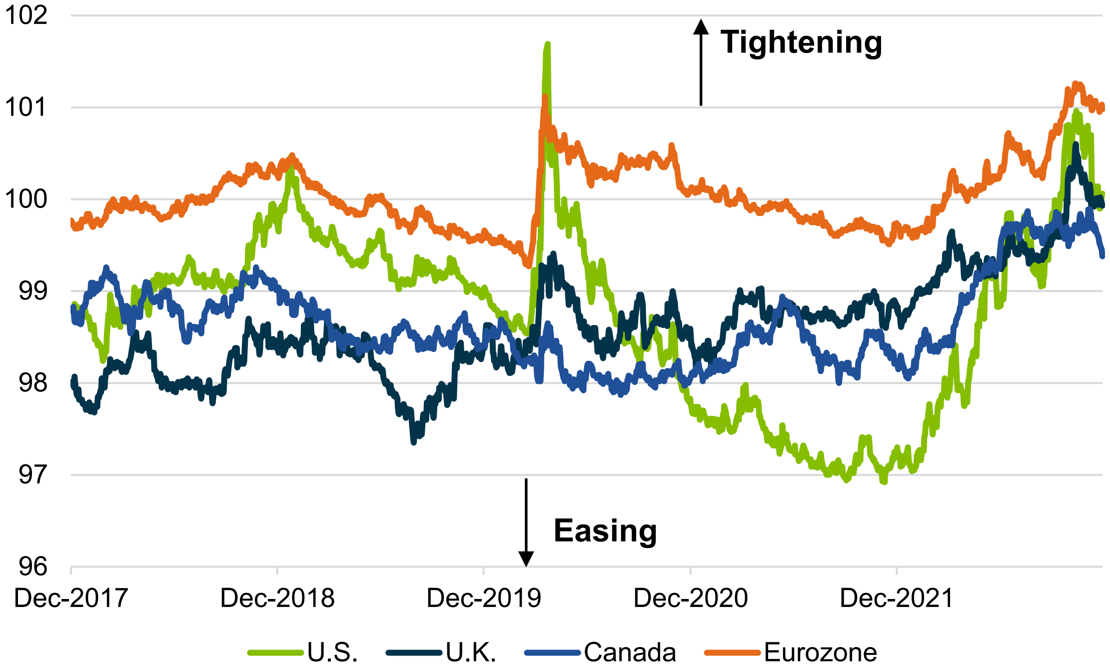
Growth estimates lowered and activities slowed amidst tightening financial conditions

GDP growth and forecast



Source: NEI Investments, Bloomberg. Data as of December 02, 2022.

Financial conditions index

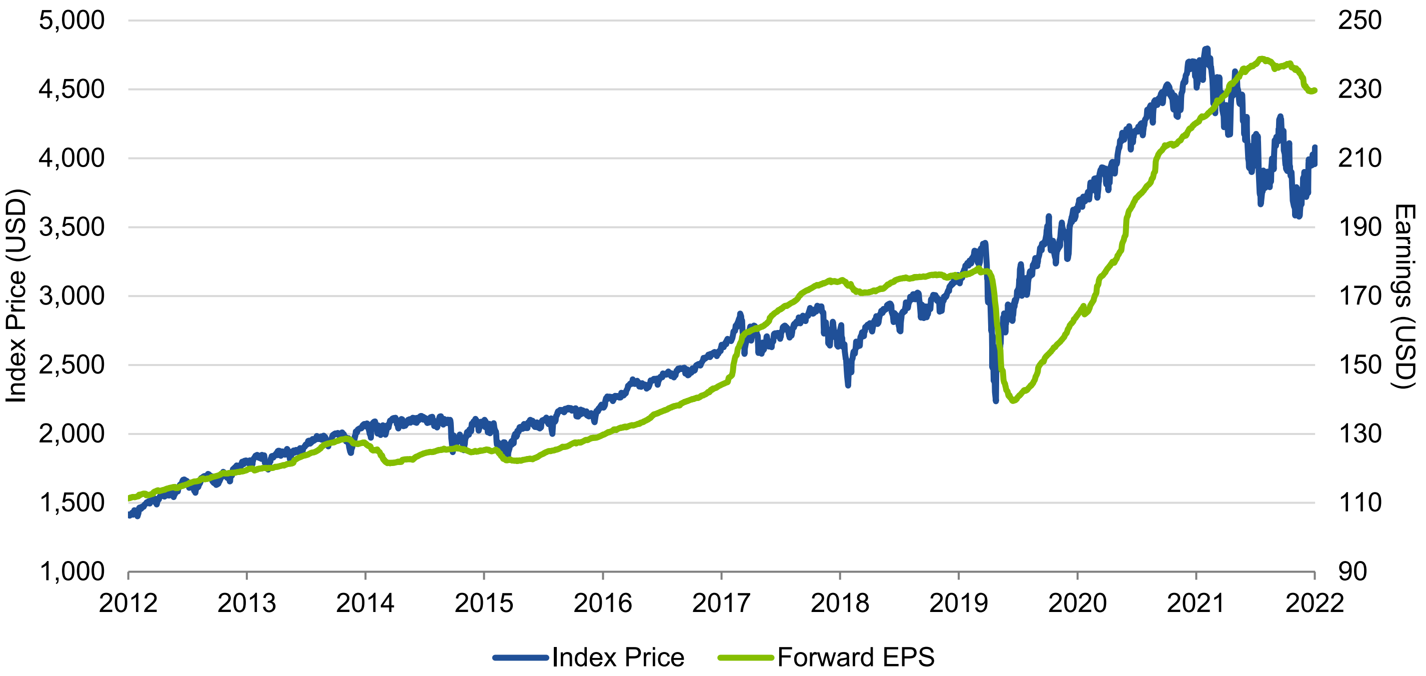


Source: Bloomberg, NEI Investments. Data as of November 30, 2022.

HOW WILL SLOWING ECONOMY IMPACT EARNINGS?

S&P 500 earning estimates are starting to slip

S&P 500 vs 12-month forward earnings estimates



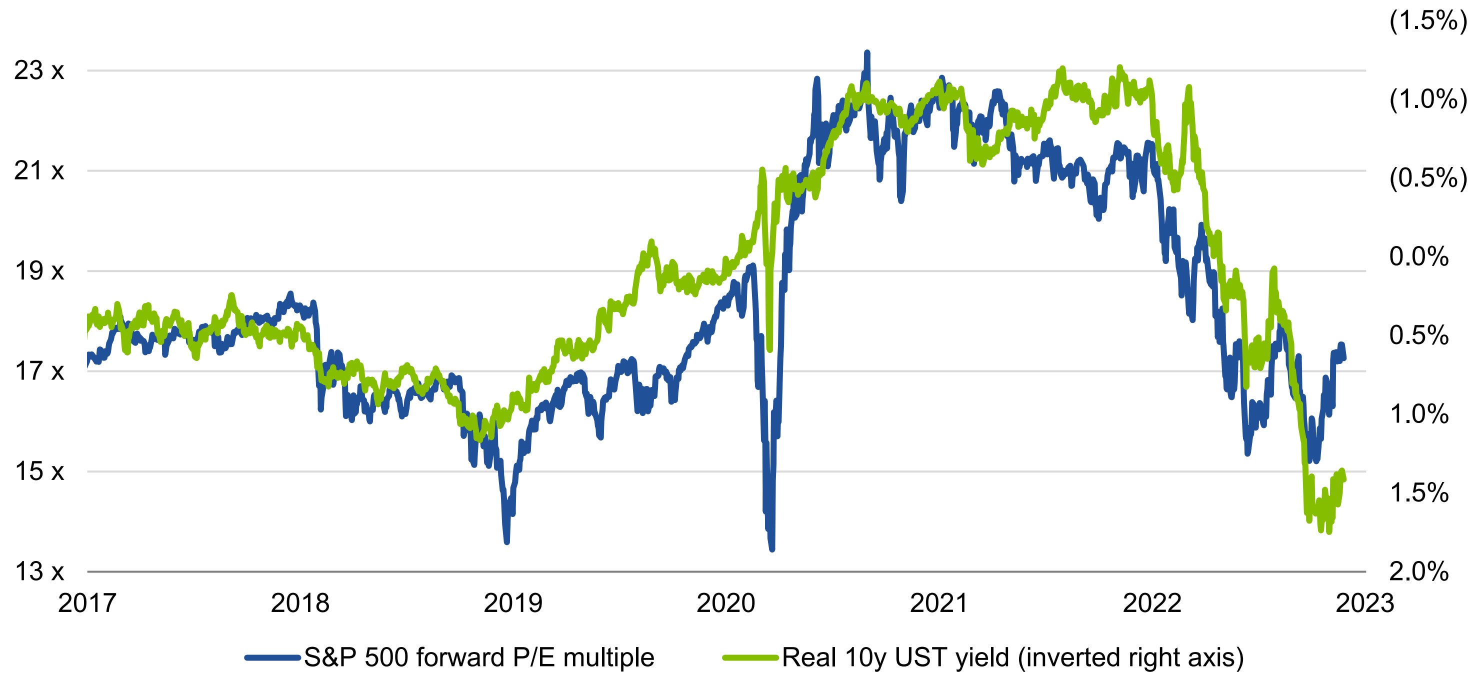
- As the economy continues to decelerate, earnings estimates are more likely to be revised downward
- Q3 earnings season was not as negative as feared. Investors will be watching Q4 earnings season, which kicks off in mid-January 2023, for further guidance on earnings for 2023.
- 2023 earnings growth estimates have slipped from 8.2% on Sep. 30th to 5.6% today. With recessionary risks on the horizon, there is room for earning estimates to move lower

Source: NEI Investments, Bloomberg. Data as of November 30, 2022. Bloomberg 12-month forward earnings estimates uses next four quarter consensus earnings forecast.

VALUATIONS NOT REFLECTING RECESSION FEARS

The rise of long-term real yields negatively impacting equities

S&P 500 forward P/E vs 10-year real bond yield



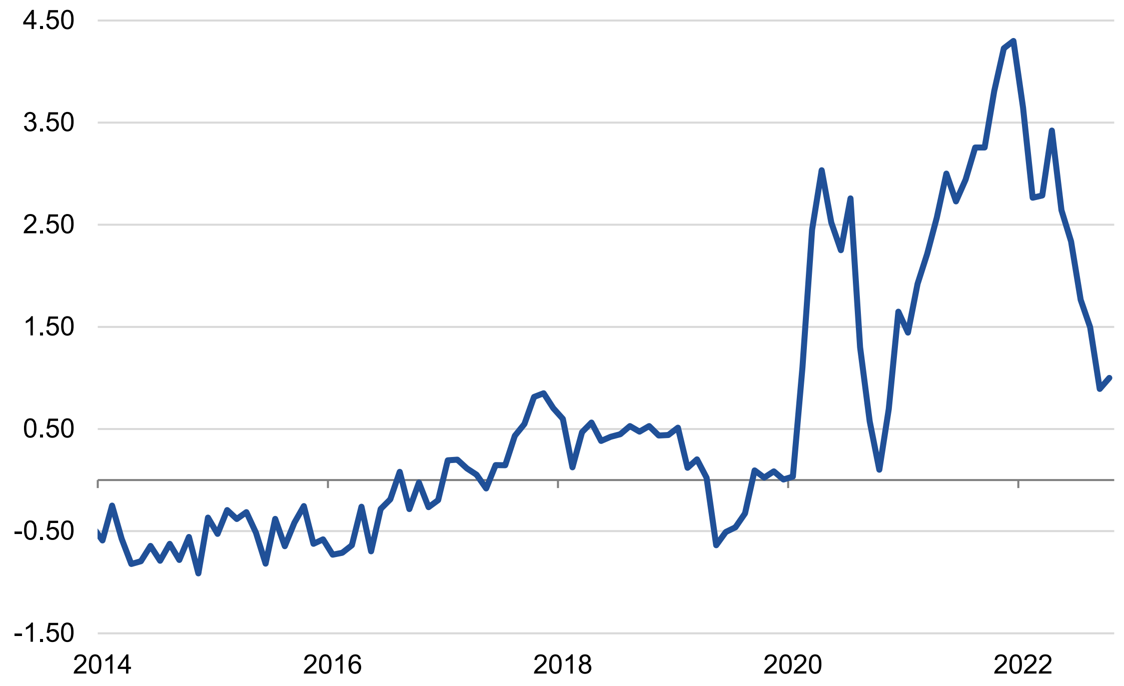
- Equity valuations are inversely impacted by real bond yields
- As real bond yields rose in 2022, equity valuations compressed causing falling stock prices
- The recent rise in equities has increased the gap between bond yields and forward P/E ratios
- We can see more downward pressure for valuations in the future

Source: IMPAX Asset Management, Bloomberg. Data as of November 28, 2022.

GLOBAL SUPPLY CHAIN PRESSURES HAVE EASED

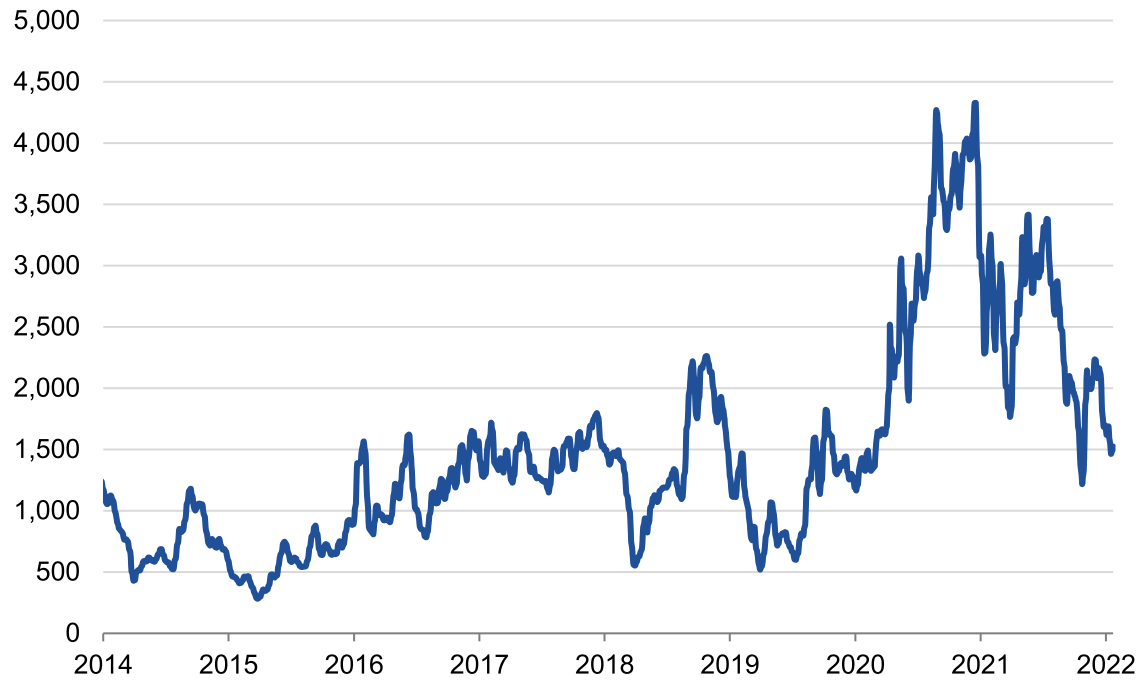
Providing relief to goods price inflation

Global Supply Chain Pressure Index



Source: Federal Reserve Bank of New York, Global Supply Chain Pressure Index, https://www.newyorkfed.org/research/gscpi.html.

Baltic Exchange Panamax Index

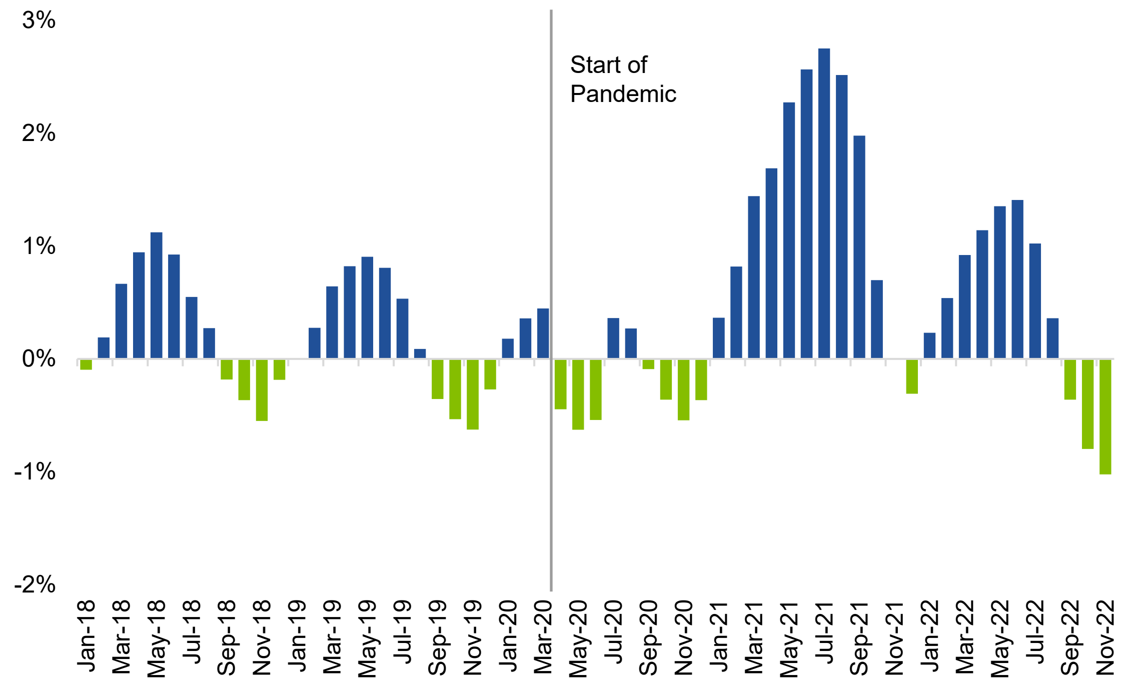


Source: NEI Investments, Bloomberg. Data as of November 30, 2022.

HOUSING PRICES ROLLING OVER

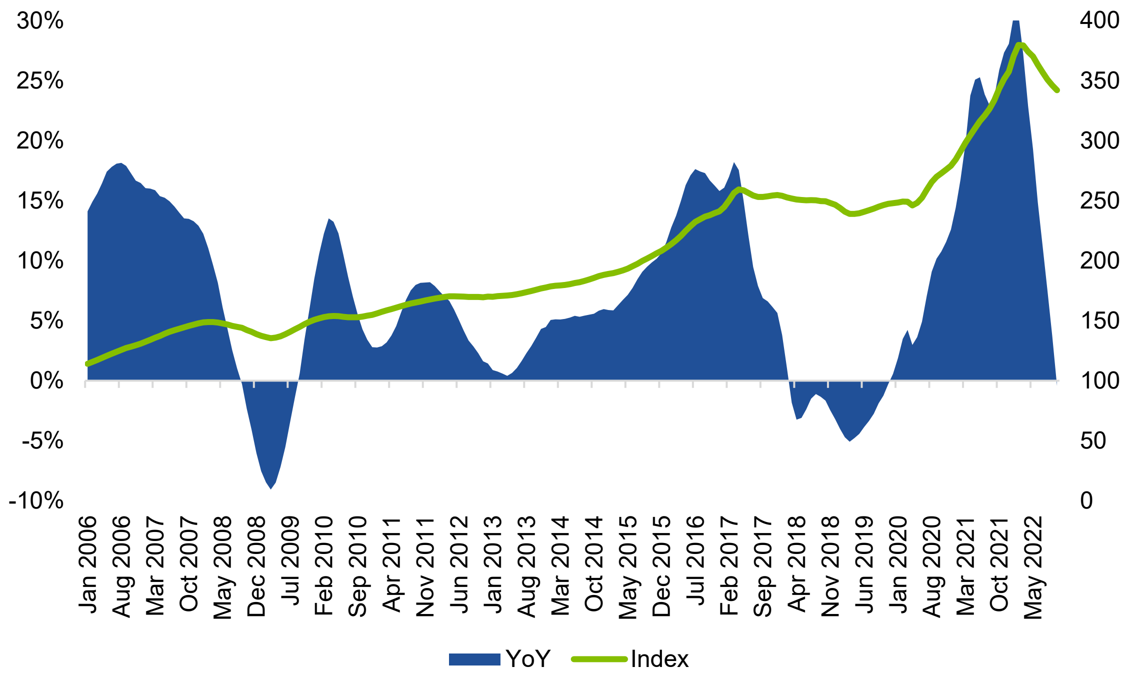
U.S. rents fell three months in a row. Canadian housing prices down 10% from February highs

U.S. National Rent Index (MoM Change)



Source: https://www.apartmentlist.com/research/national-rent-data; Updated Nov 30, 2022.

Canadian House Price Index (MoM & Price)

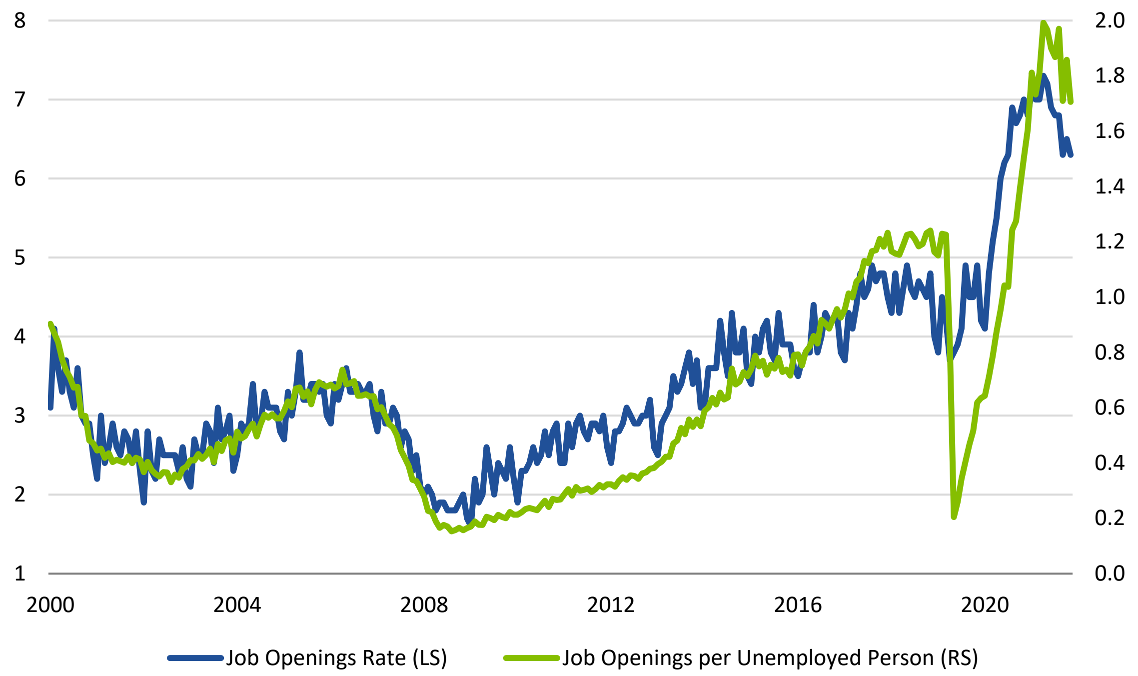


Source: https://stats.crea.ca/en-CA/; Updated Nov 30, 2022.

LABOUR MARKET STARTING TO TURN

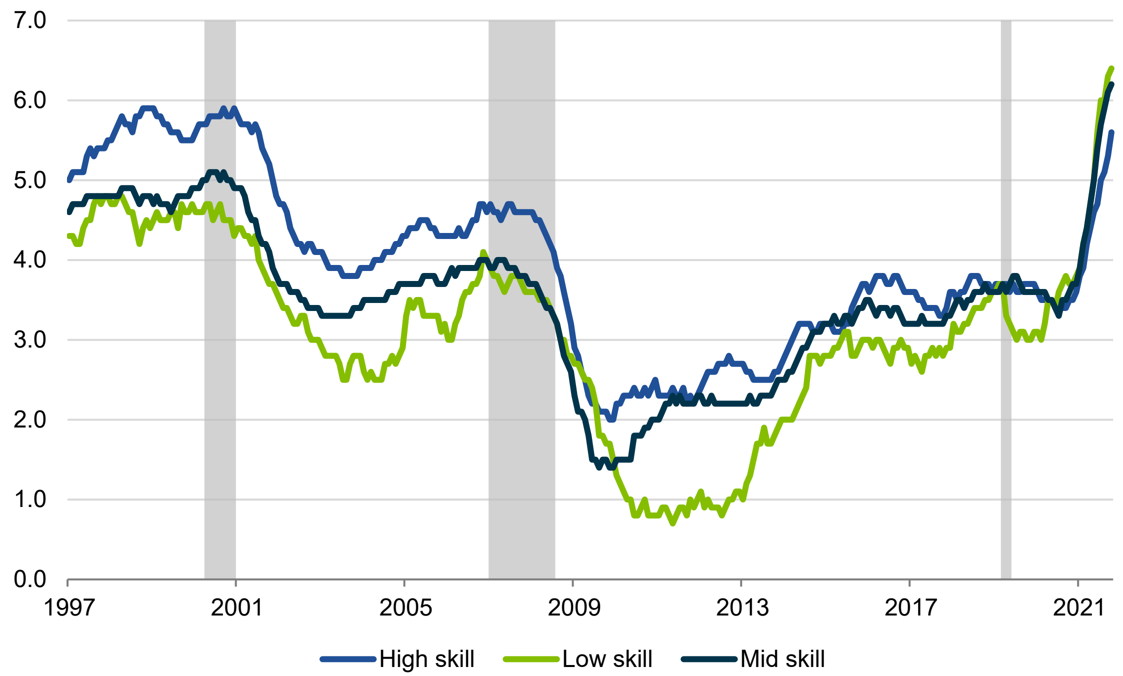
Less pressure on wage gains ahead

U.S. Job Openings per unemployed person



Source: NEI Investments, Bloomberg. Data as of December 02, 2022

U.S. Atlanta FED Wage Tracker by Occupation



Source: Federal Reserve Bank of Atlanta. Data as of October 25, 2022

LONG TERM OPPORTUNITIES

Attractive entry points

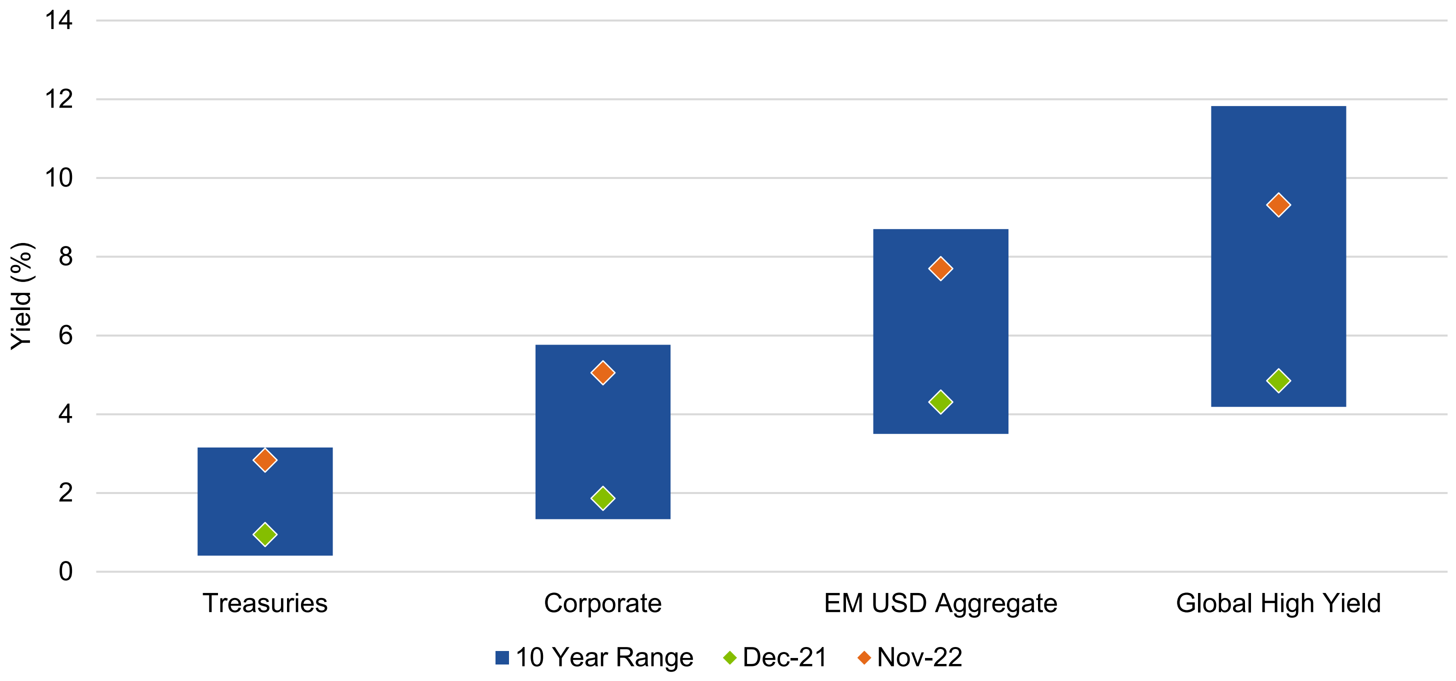
FIXED INCOME

Bonds are back

BOND YIELDS AT MORE ATTRACTIVE LEVELS

Bond yields now near the top of the 10-year range

Current yields relative to historical 10-year range



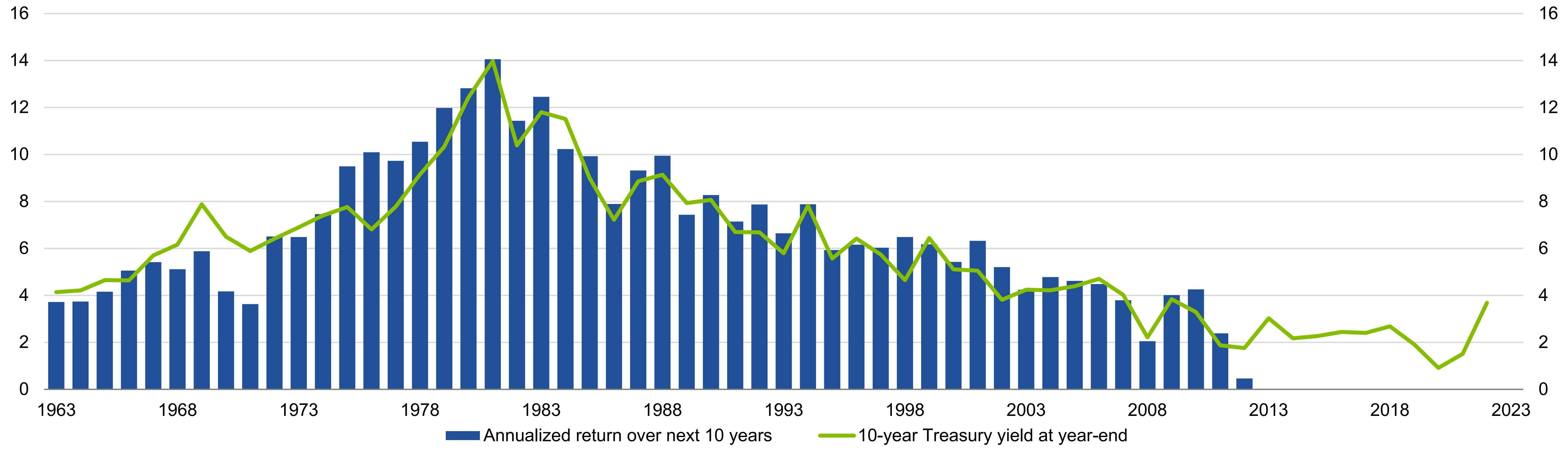
- Across the fixed income spectrum, yields are close to their 10 year highs
- Great opportunity to take advantage of higher yields, and greater potential for capital gains
- Possibility of capital gains when interest rates peak and start a new cycle in the years ahead

Source: NEI Investments, Bloomberg. Data as of November 29, 2022

SUPPORTIVE ENVIRONMENT FOR FIXED INCOME INVESTING

Starting yield a key determinant of future returns

Current 10-year U.S. Treasury yield vs annualized returns over next 10 years



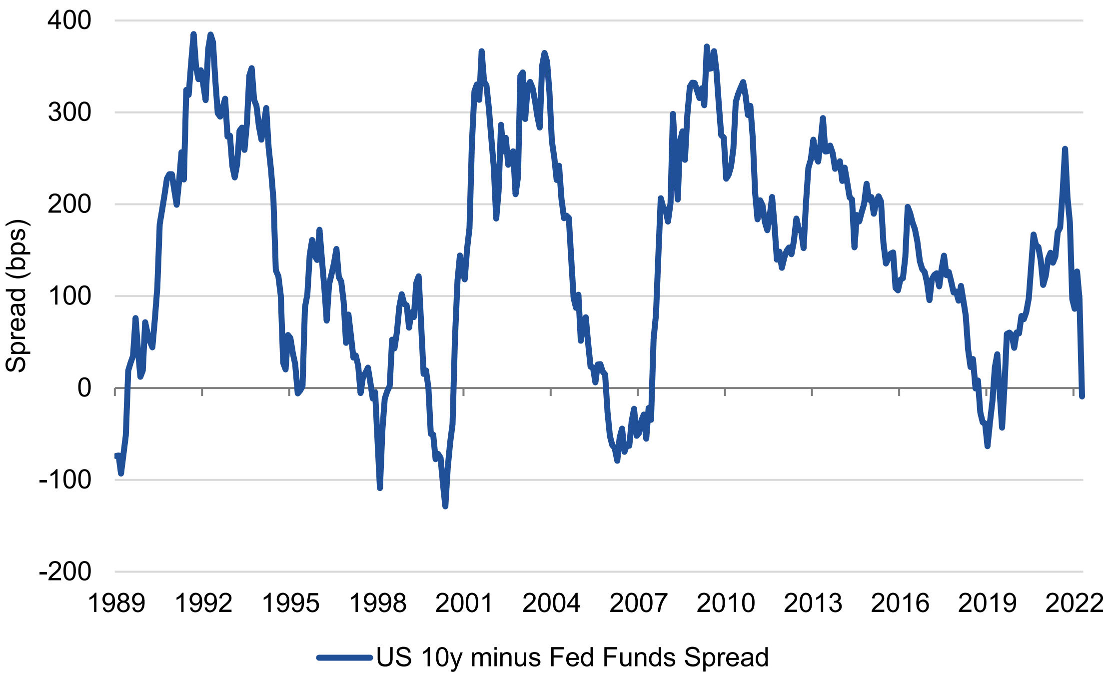
Source: NEI Investments, Bloomberg. Data as of November 28, 2022.

CREDIT SPREADS ARE ATTRACTIVE

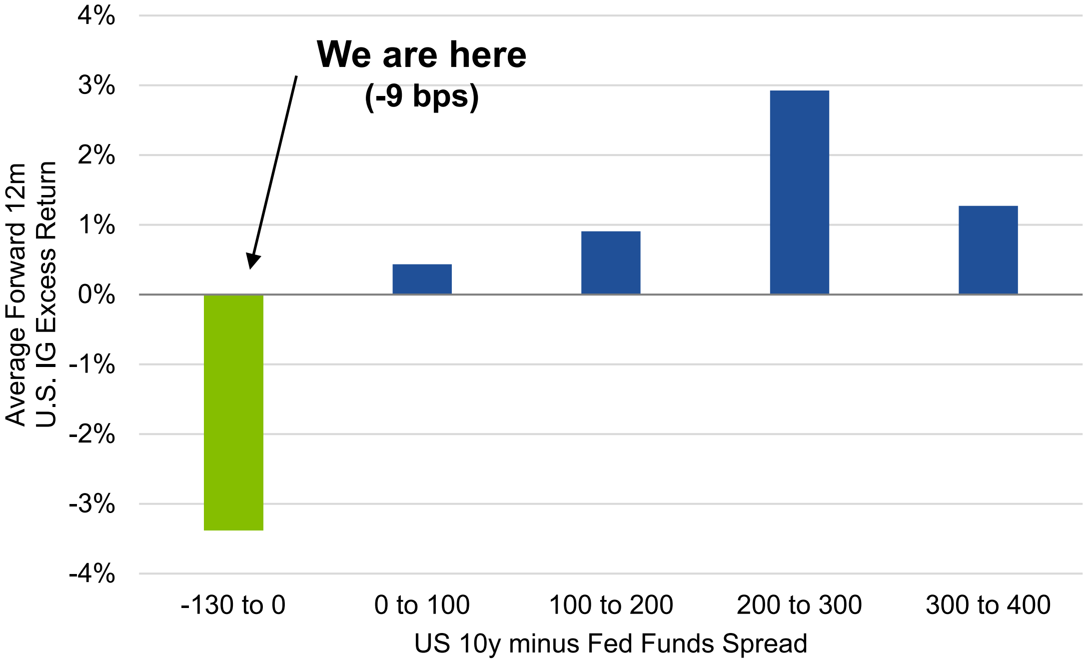
WELLINGTON MANAGEMENT®

May remain subdued in the near term

Yield curve slope



IG 1-yr excess return by Fed Funds Spread



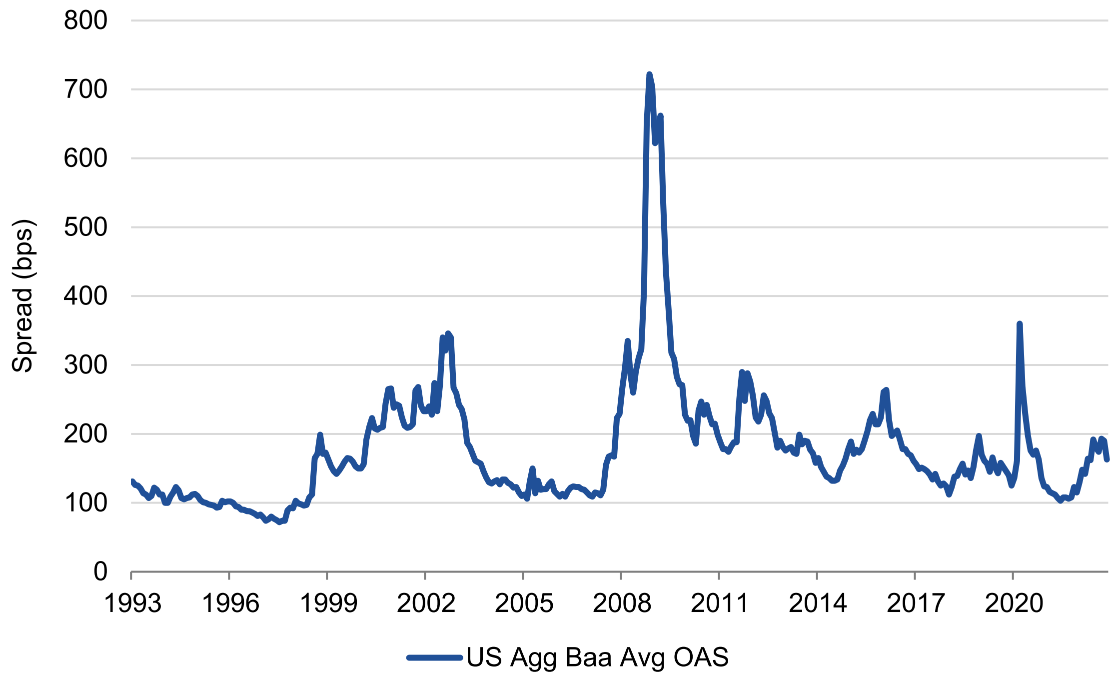
Source: Wellington, NEI Investments, Bloomberg. Data as of November 29, 2022.

CREDITS SPREADS ARE ATTRACTIVE

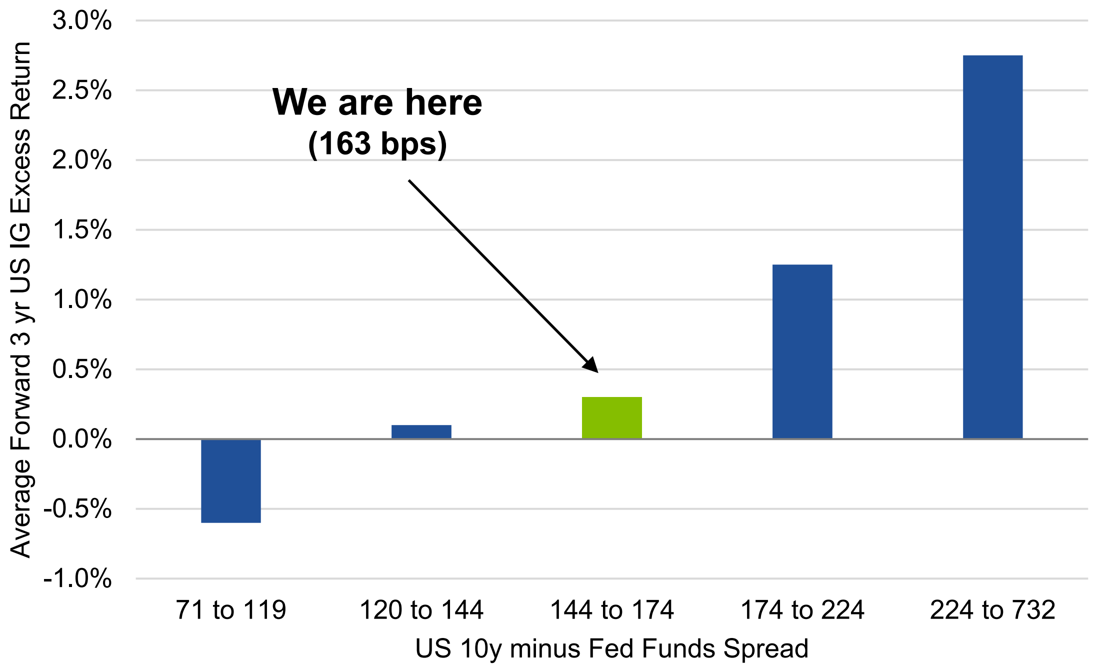
WELLINGTON MANAGEMENT®

Presenting long term opportunity relative to sovereigns

U.S. Aggregate Baa Spread



IG 3-yr excess return by Fed Funds Spread

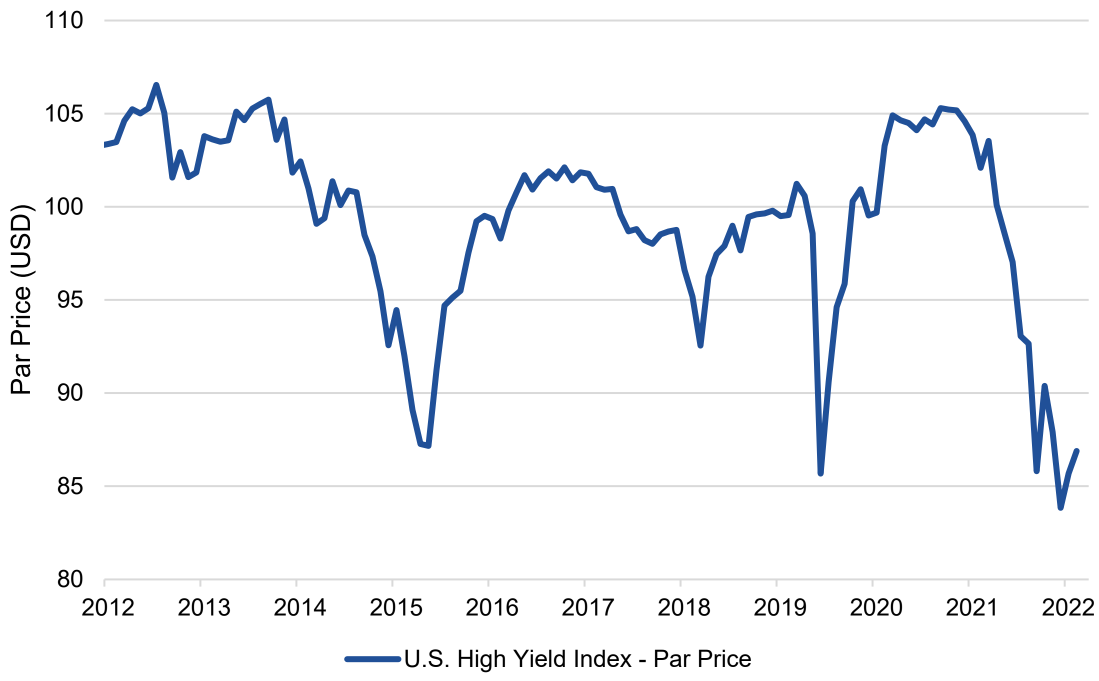


Source: Wellington Asset Management, Bloomberg. Data as of November 28, 2022.

ATTRACTIVE ENTRY POINT IN HIGH YIELD CREDITS

Equity-like returns in fixed income asset class

U.S. High Yield Index – Par Price



U.S. High Yield Index – Yield

Source: Principal Asset Management, Bloomberg. Data as of November 29, 2022.

EQUITIES

Attractive valuations

EQUITY VALUATIONS MUCH MORE ATTRACTIVE

Valuations are cheaper than at the end of 2021

Equity valuations by region vs historical averages

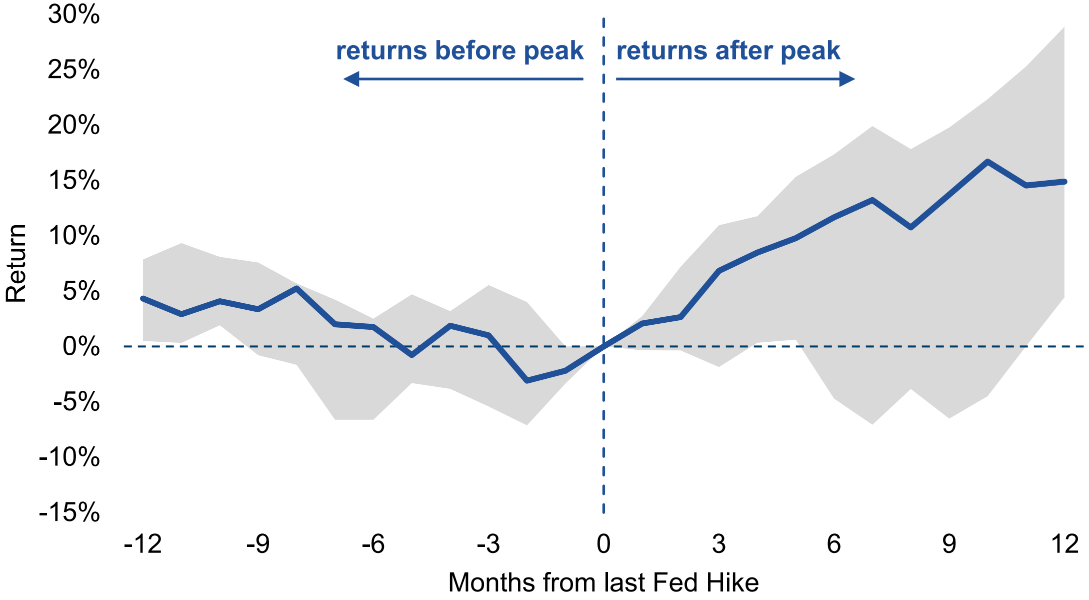
- Valuation multiples across regions have contracted since the beginning of this year
- Low multiples reflect bearish investor sentiment at the onset of recession in global economies likely in 2023
- Current valuations are at or below their respective 10-year averages, providing more attractive entry points for long term investors

Source: NEI Investments, Bloomberg. Data as of November 29, 2022.

PEAK FED RATE AN IMPORTANT INFLECTION POINT

Unless economy slips into recession

S&P Price Return Around Last Fed Hike (Median trajectory since 1974)



S&P Price Return Around Last Fed Hike

	SPY Change (%)			
Date	3m before	3m after	6m after	12m after
May 1974	10.2%	-17.3%	-19.8%	4.4%
Mar 1980	5.7%	11.9%	22.9%	33.2%
May 1981	-1.0%	-7.4%	-4.7%	-15.6%
Aug 1984	-9.7%	-1.9%	8.7%	13.2%
Feb 1989	-5.2%	11.0%	21.7%	14.9%
Feb 1995	-6.9%	9.4%	15.3%	31.4%
May 2000	-3.8%	6.8%	-7.4%	-11.6%
Jun 2006	1.9%	5.2%	11.7%	18.4%
Dec 2018	16.2%	13.1%	17.3%	28.9%
Median	-1.0%	6.8%	11.7%	14.9%
Average	0.8%	3.4%	7.3%	13.0%
SD	8.1%	9.7%	13.9%	16.8%
# Positive	4	6	6	7
# Negative	5	3	3	2

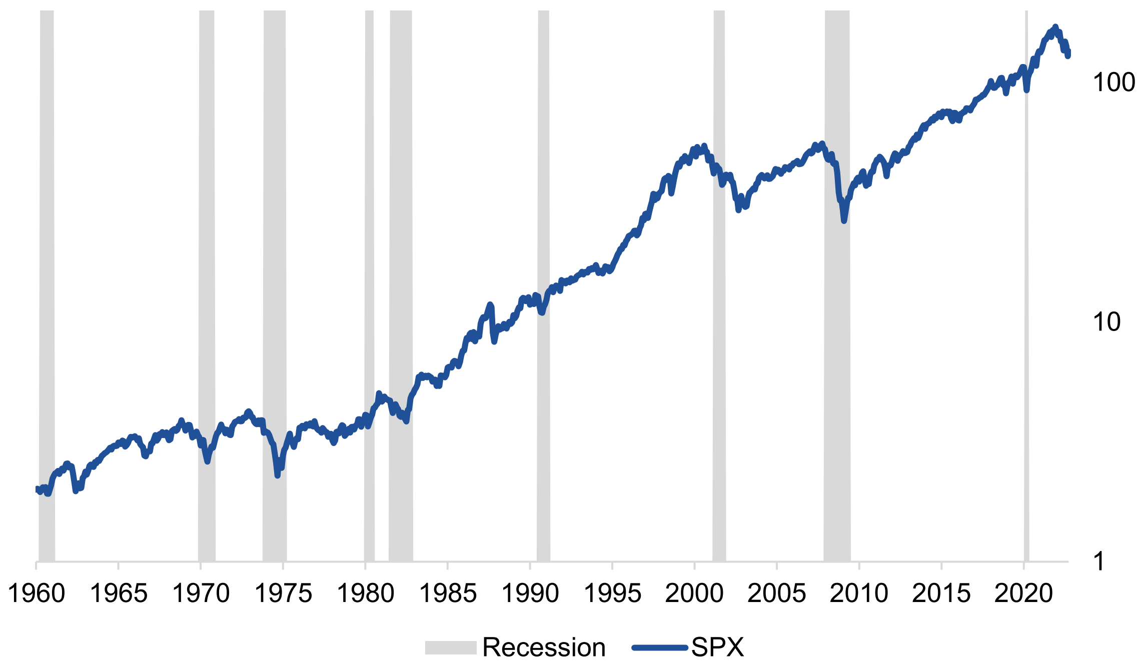
Recession

Source: NEI Investments, Bloomberg. Data as of October 25, 2022.

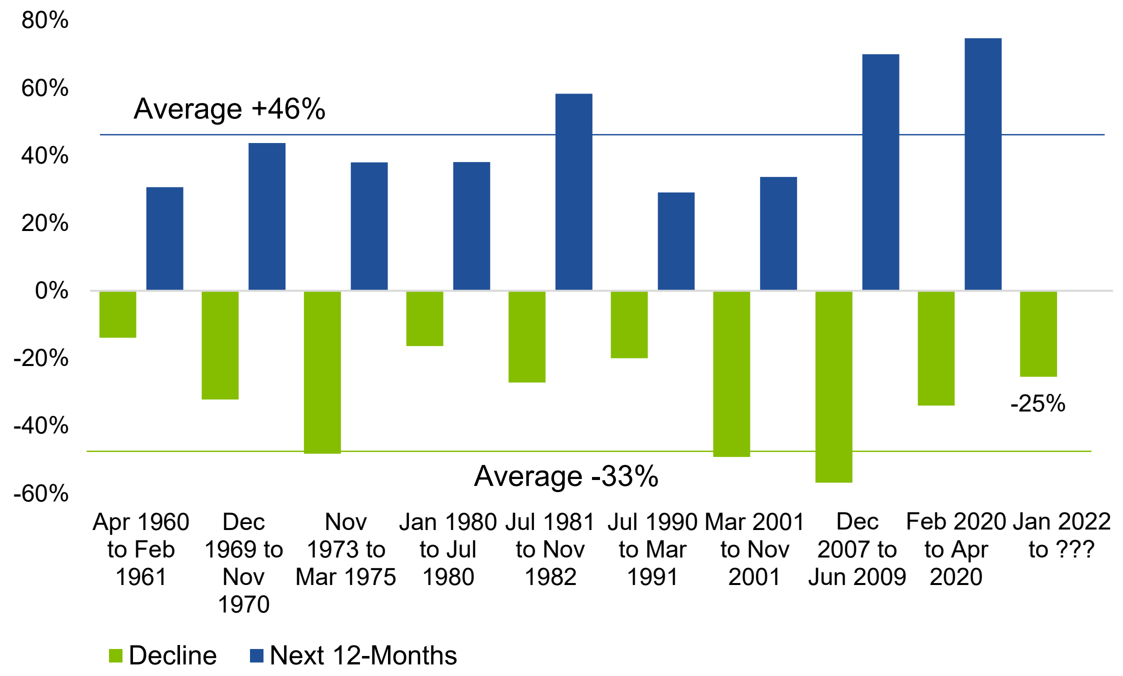
RECESSION DECLINES AND RECOVERIES

Average decline in recession is 33%. Average recovery over the next 12-months is about 50%

S&P 500 return (1960 to Sep. 2022)



Recession declines vs next 12-month recovery

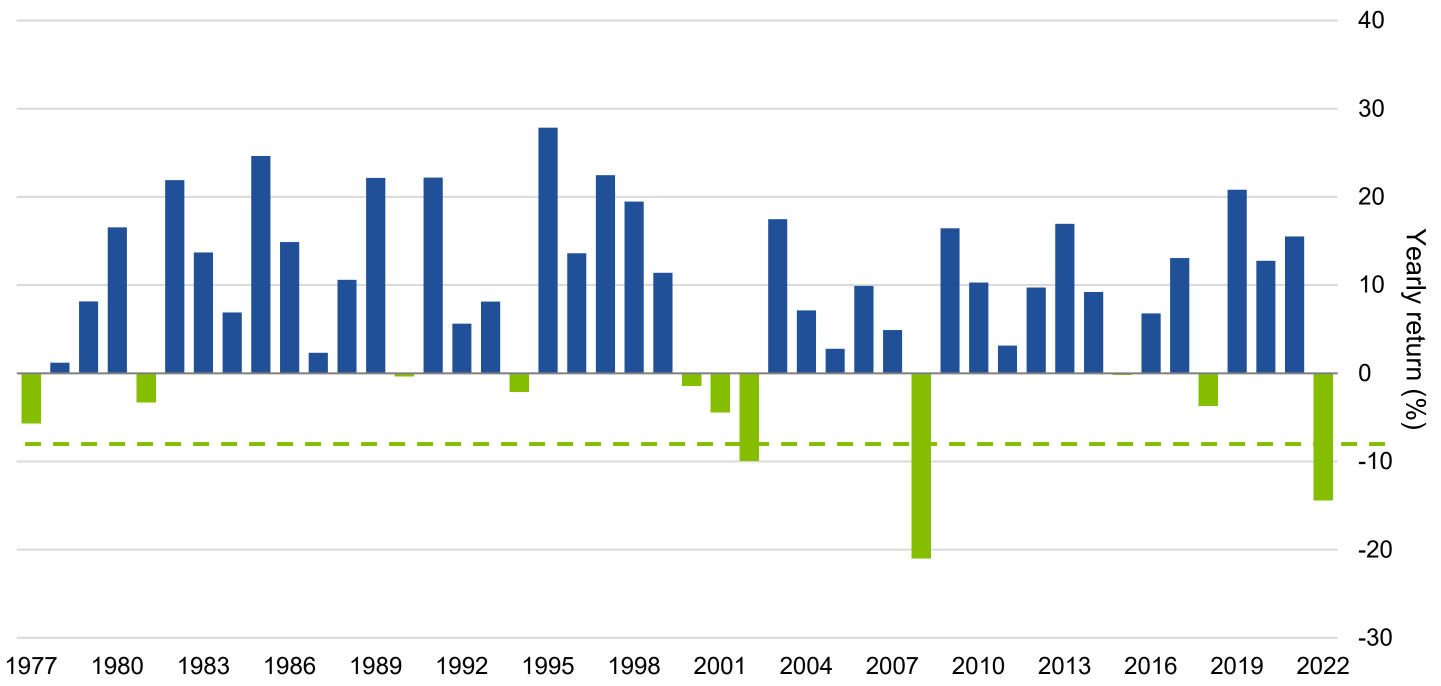


OPPORTUNITIES FOR THE 60/40 PORTFOLIO

EXCEPTIONAL YEAR FOR THE 60/40 PORTFOLIO

Worst return in 60/40 portfolios since the financial crisis

Annual returns of 60/40 portfolio[1] denominated in USD



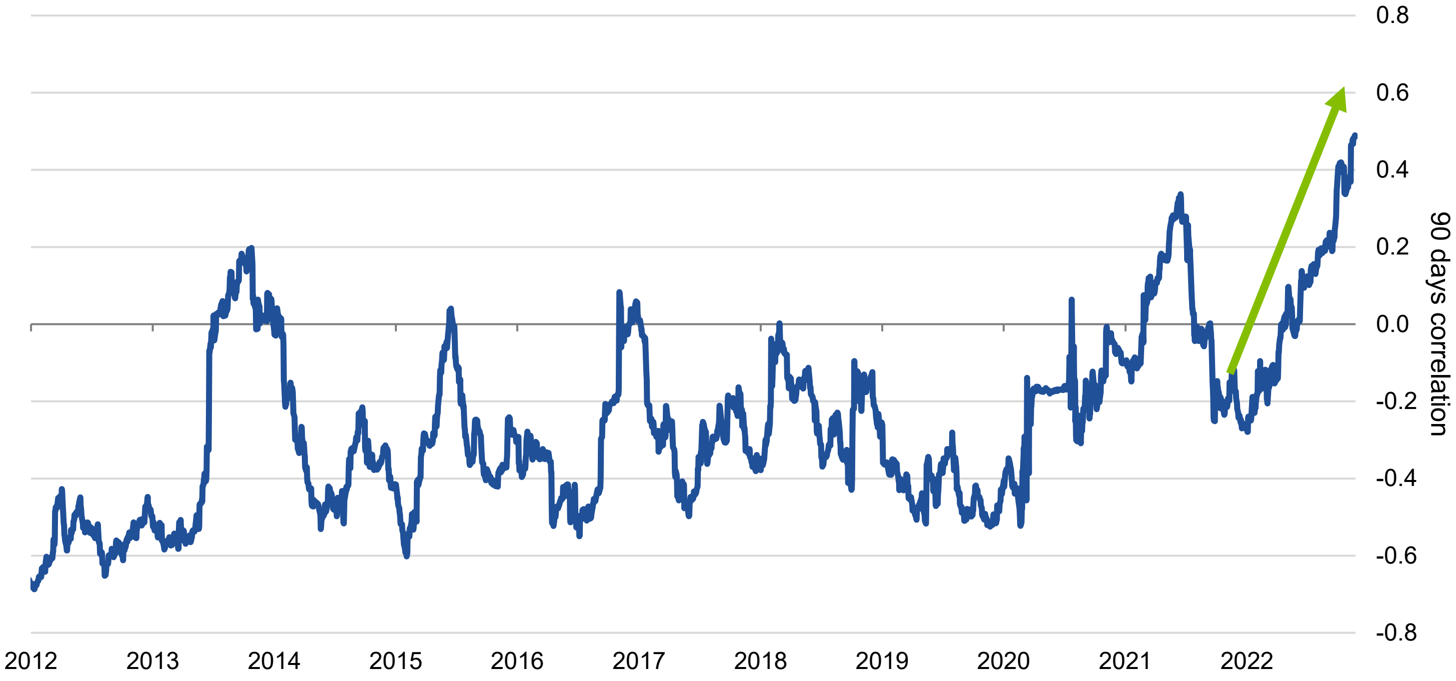
- Using the S&P 500 Index as a proxy for equities and the Bloomberg U.S. Agg Index and a proxy for bonds, balanced portfolio was down nearly 20% this year
- Both equities & fixed income started the year with rich valuations
- Both asset classes struggled in the higher-inflation, higher-interest rate environment

Source: NEI Investments, Bloomberg. Data as of November 25, 2022. [1] Comprised of 60% S&P500 Index and 40% U.S. Aggregate Bond Index.

EQUITIES AND BONDS FALL IN TANDEM

Bonds not able to offset stock declines as correlations turned positive in 2022

Rolling 90-day correlation between U.S. Aggregate Bond Index and S&P 500 Index



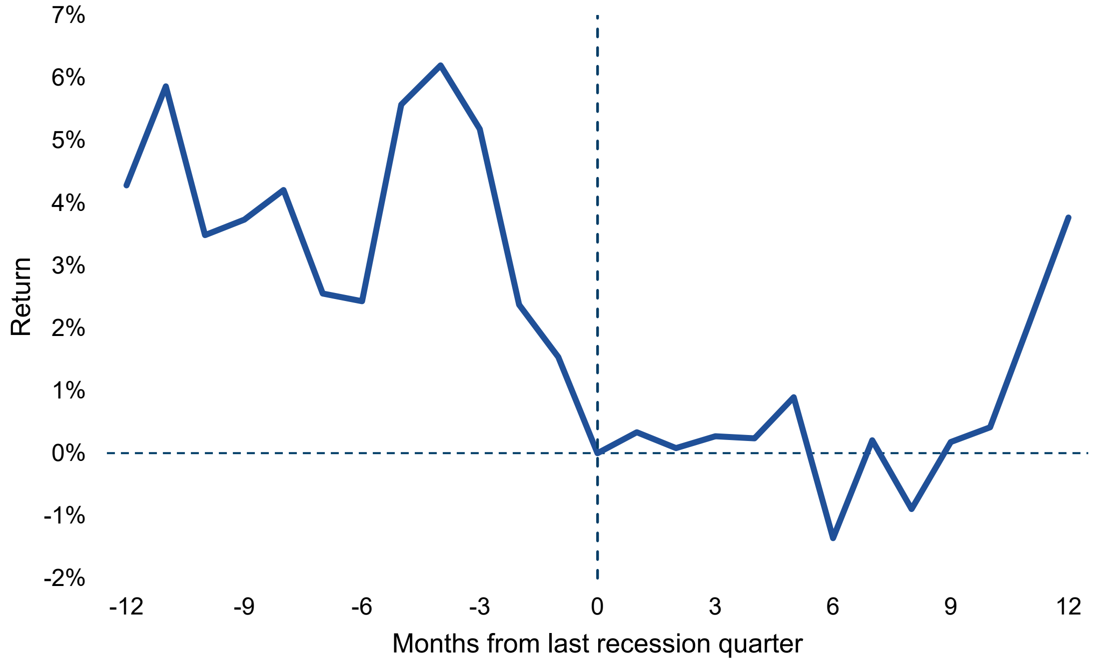
- In 2022, the fixed income portion of a balanced portfolio has failed to provide traditional role of downside protection in equity bear market
- Periods of positive correlation between bonds and equities are rare and often short lived
- We expect bonds to offer more diversification and stabilization benefits as inflation moderates and recession fears pick up in early 2023

Source: NEI Investments, Bloomberg. Data as of November 25, 2022.

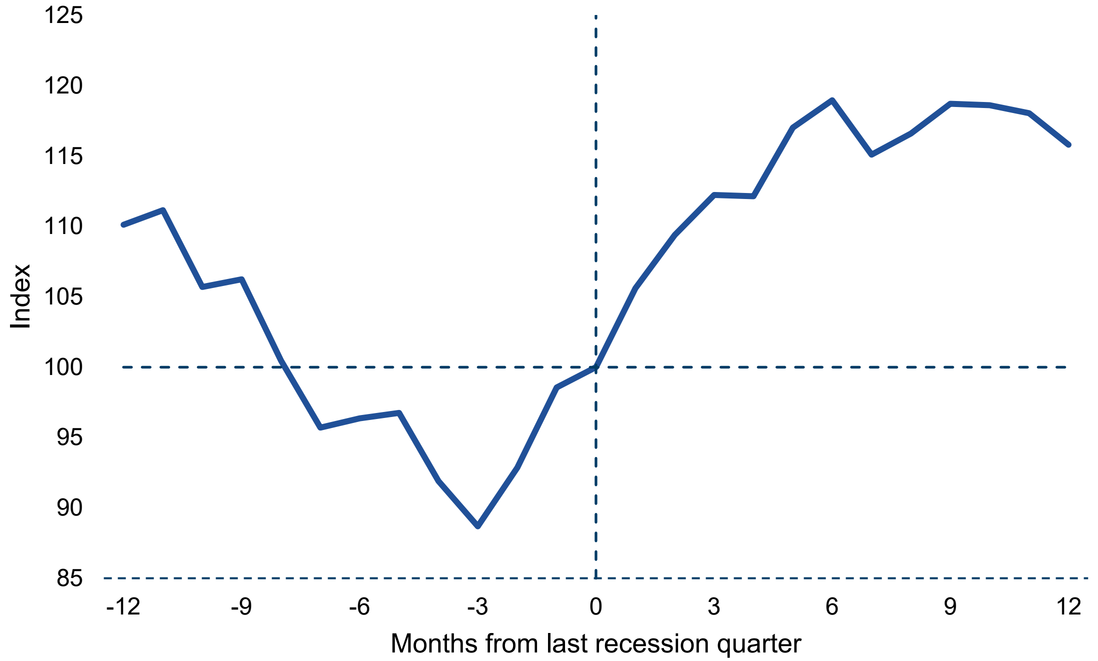
MARKET RETURNS AROUND END OF RECESSION

Bond returns higher during recession. Stocks bottom 3-6 months before end of recession

10y UST price return around recession end



S&P 500 median trajectory since 1974



Source: NEI Investments, Bloomberg. Data as of October 31, 2022.

AREAS OF OPPORTUNITY

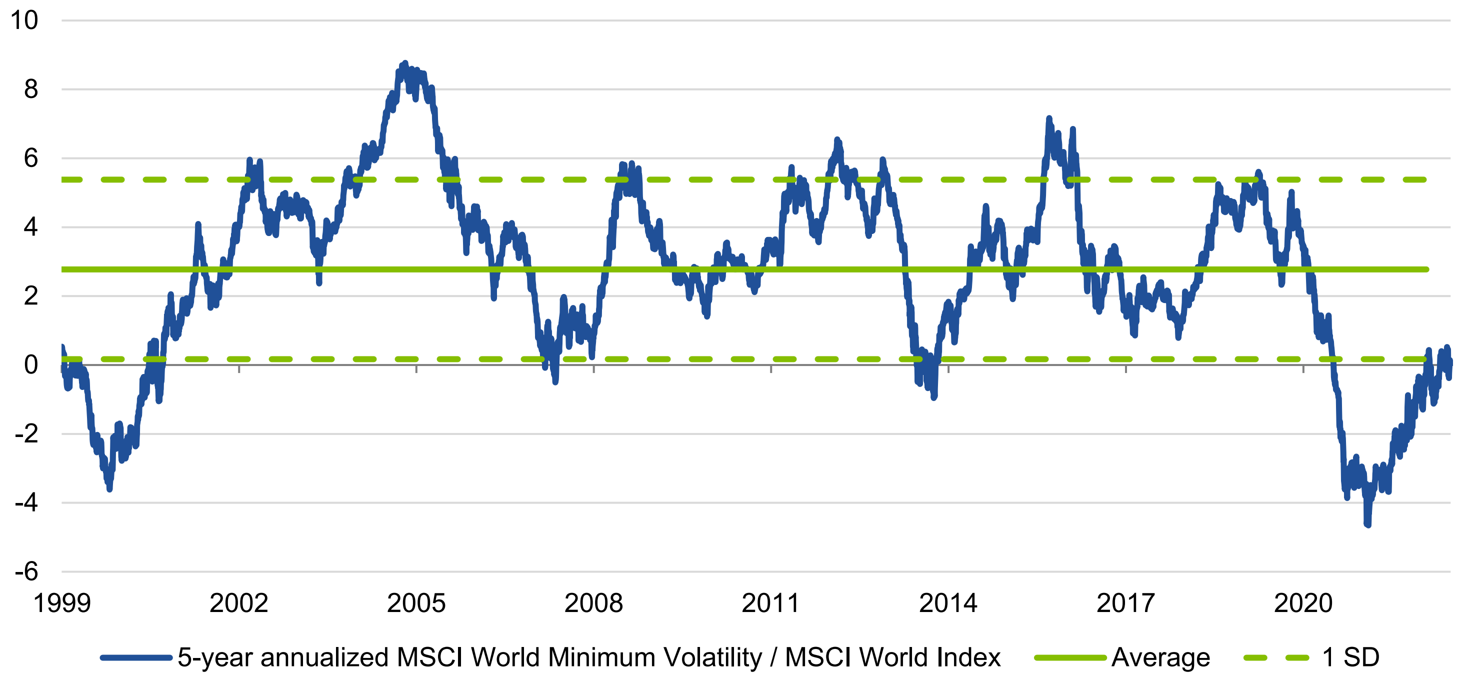
Insights from subadvisors

LOW VOLATILITY EQUITIES ARE STILL ATTRACTIVE

Amundi
ASSET MANAGEMENT

Low volatility equities have upside potential and downside protection

Rolling 5-yr low volatility premium vs MSCI World



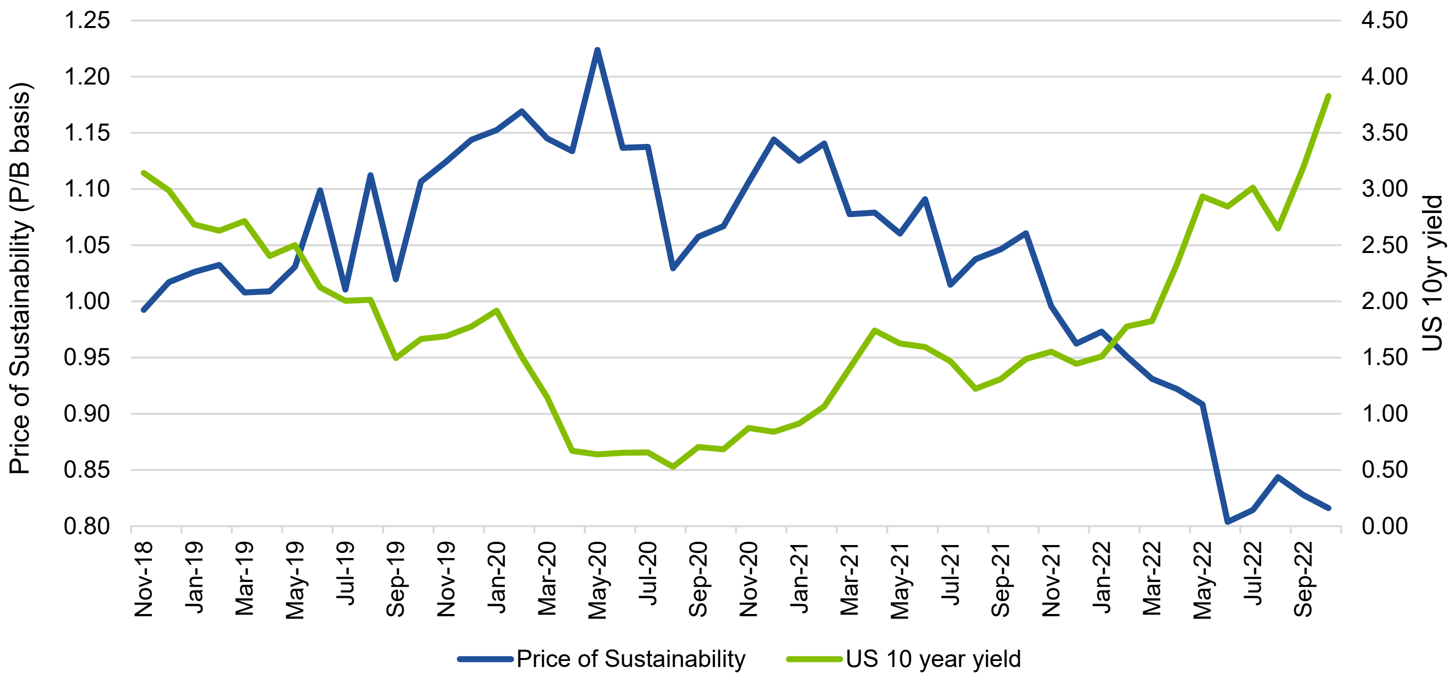
- The Minimum Volatility Index 5-year realized premium has been low since 2020 and has upside potential
- It is well diversified in terms of specific risk or capital concentration especially vs Growth and Quality subsets, thereby providing higher downside protection in the event of equity market downturn
- It provides less volatility with high return potential for equity investors

Source: Amundi Asset Management, Bloomberg. Data as of November 28, 2022.

ATTRACTIVE ENTRY POINT FOR SUSTAINABLE COMPANIES

Sustainable stock valuations are attractive

Price-to-book of sustainable equities vs 10-yr U.S. bond yields



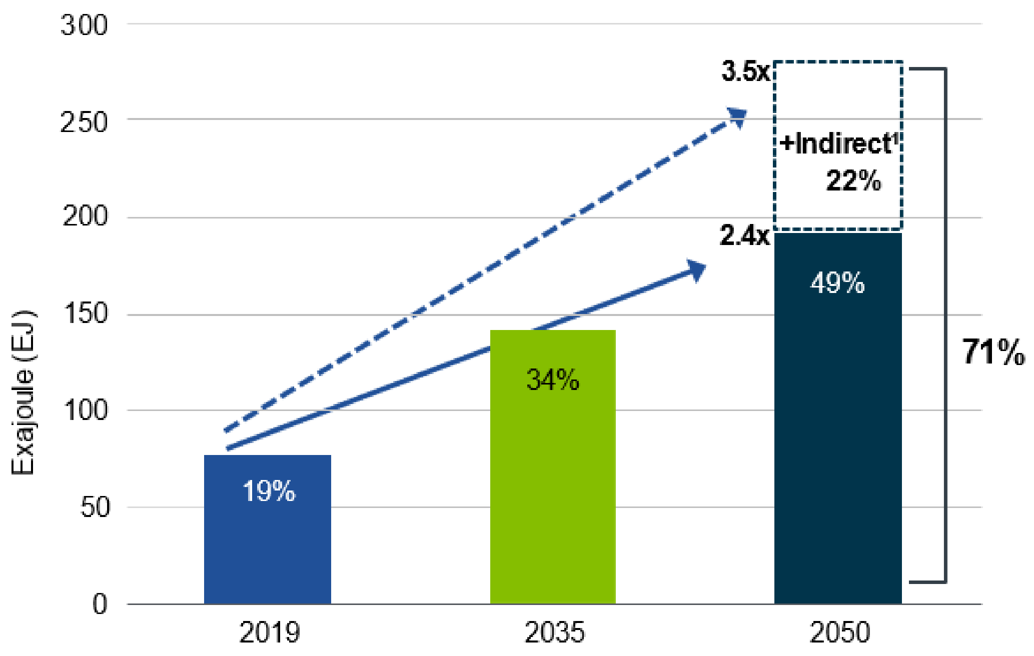
Source: Federated Hermes / Bloomberg as at 31 October 2022.

- Sustainable companies tend to provide goods or services that fulfil an essential need, leading to more durable earnings growth less reliant on the macro environment
- As bond yields have risen, these companies have come under significant pressure as investors have been less willing to pay for growth with greater uncertainty
- This creates an attractive entry point to companies with strong long-term growth that deliver positive outcomes for society

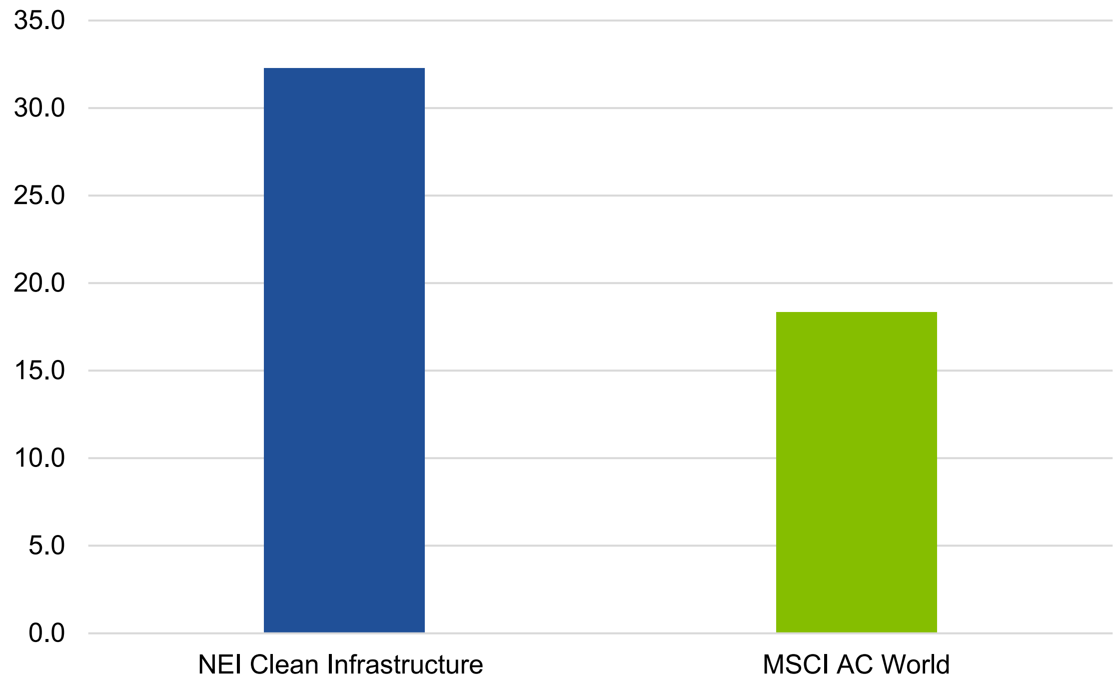
CLEAN INFRASTRUCTURE HAS THEMATIC TAILWIND

Electricity consumption is growing as a % of total final energy consumption

Electricity expected to gain market share



1y Forward EPS growth

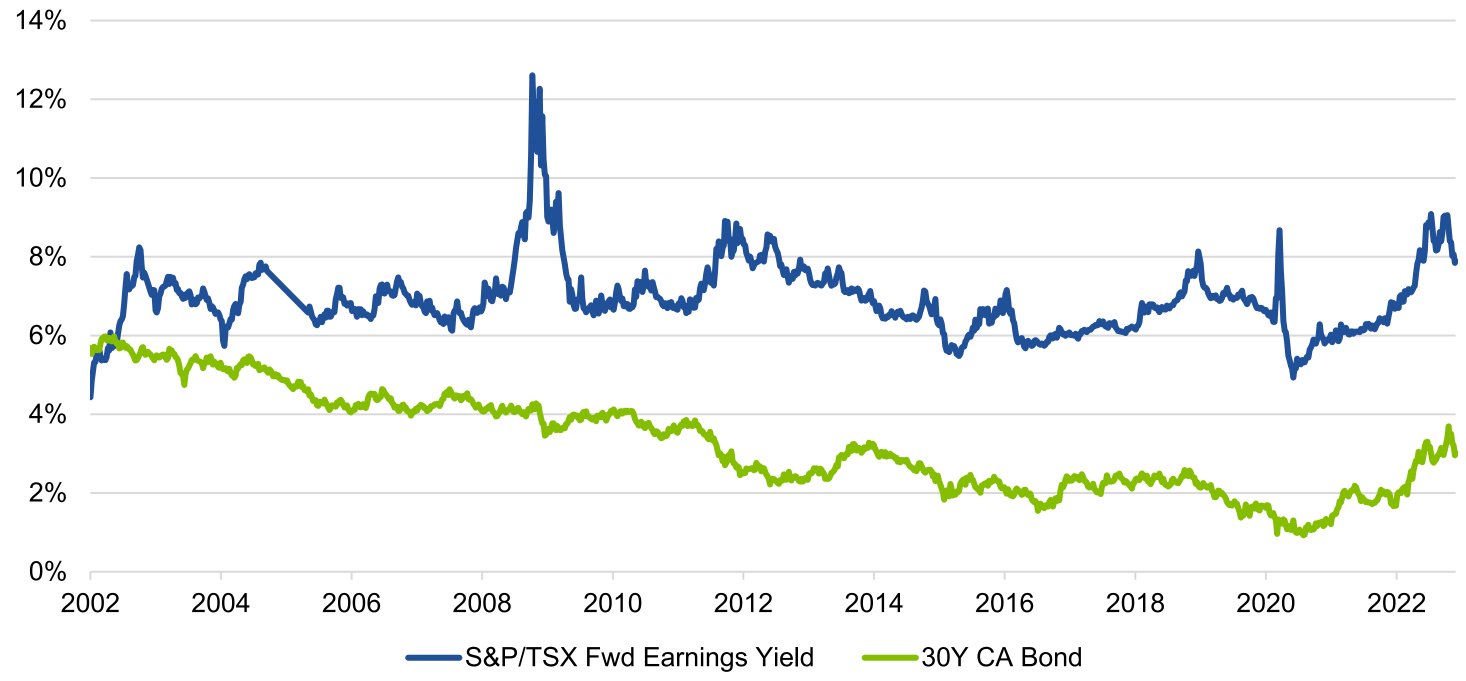


Source: Ecofin

CANADIAN EQUITIES ATTRACTIVE VS. LONG BONDS

Canadian equities at attractive valuations

TSX forward earnings yield vs 30-yr bond yields



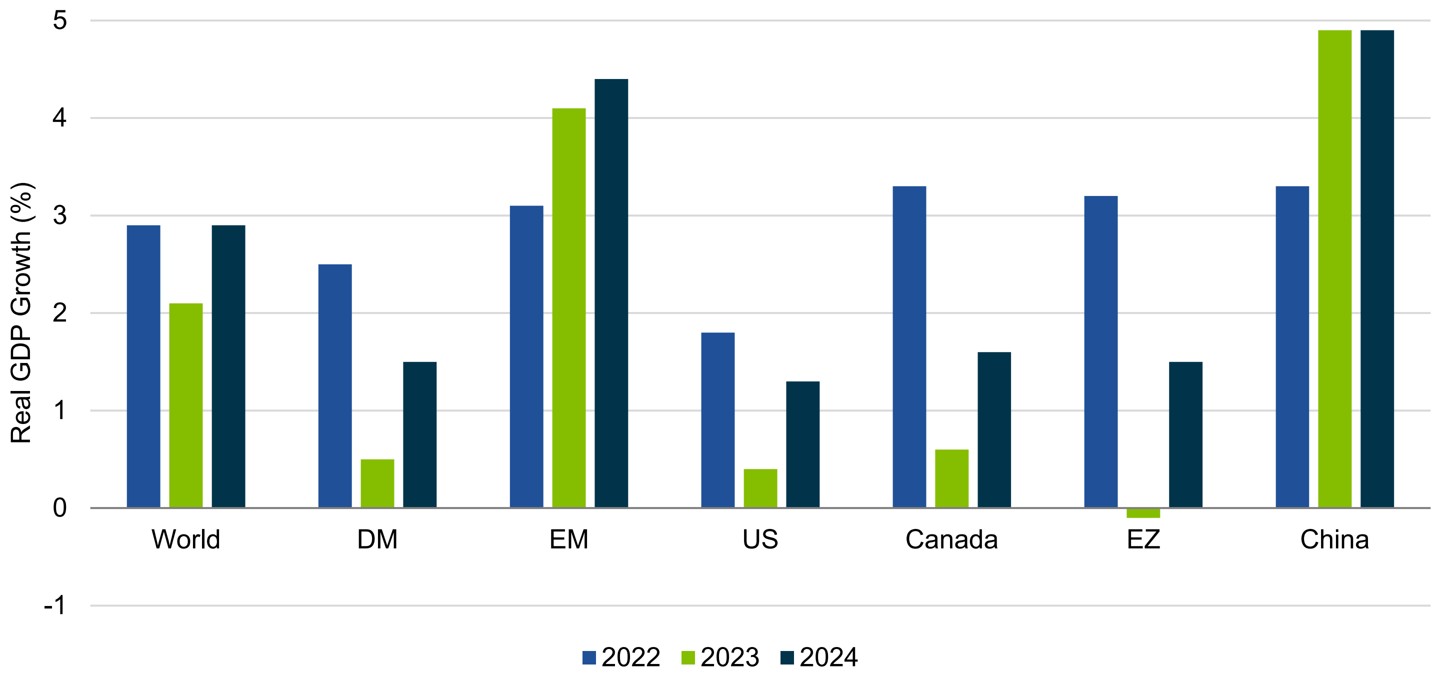
Source: QV Investors, Bloomberg. Data as of November 29, 2022.

- Despite the recent rise in interest rates, earnings yields for equities remain well above Canadian bond yields and, through pricing power, can help to offset inflation
- The earnings yield for the S&P/TSX index is now well above long term averages, increasingly pricing in negative investor sentiment
- Attractive earnings yields provide enhanced valuation support amidst a volatile market backdrop

EM GROWTH TO OUTPACE DEVELOPED MARKETS

Re-opening of China a potential boost to EM growth

GDP forecast to 2024



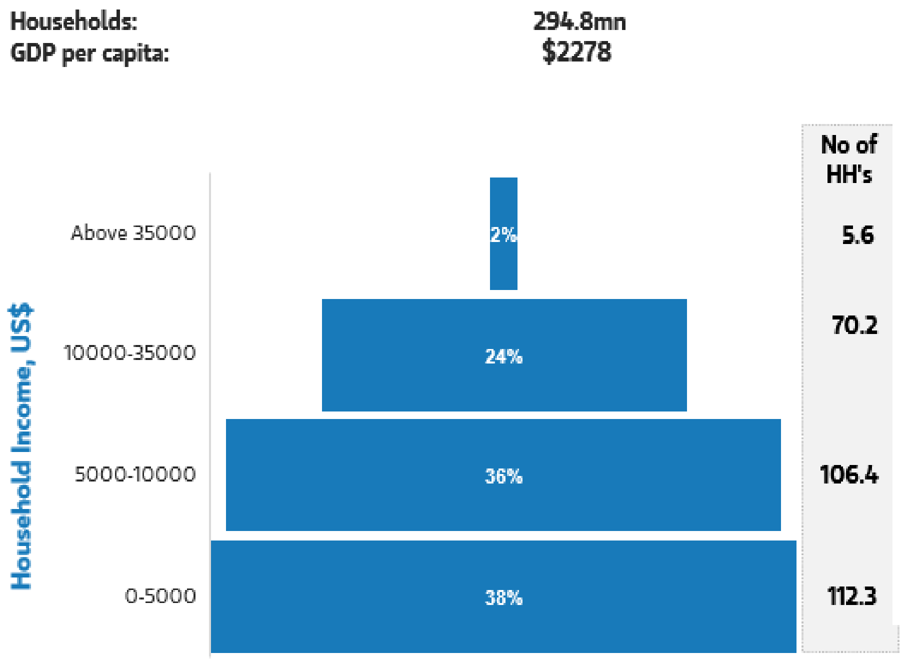
- Despite projections for lower growth in early 2023, expectations are for real GDP global growth to rebound in late 2023 and into 2024
- Expectations for slow growth and a slower recovery in developed markets
- As China's economy reopens it will provide a boost to its own economy and other emerging markets

Source: Amundi Asset Management, Bloomberg. Data as of November 28, 2022.

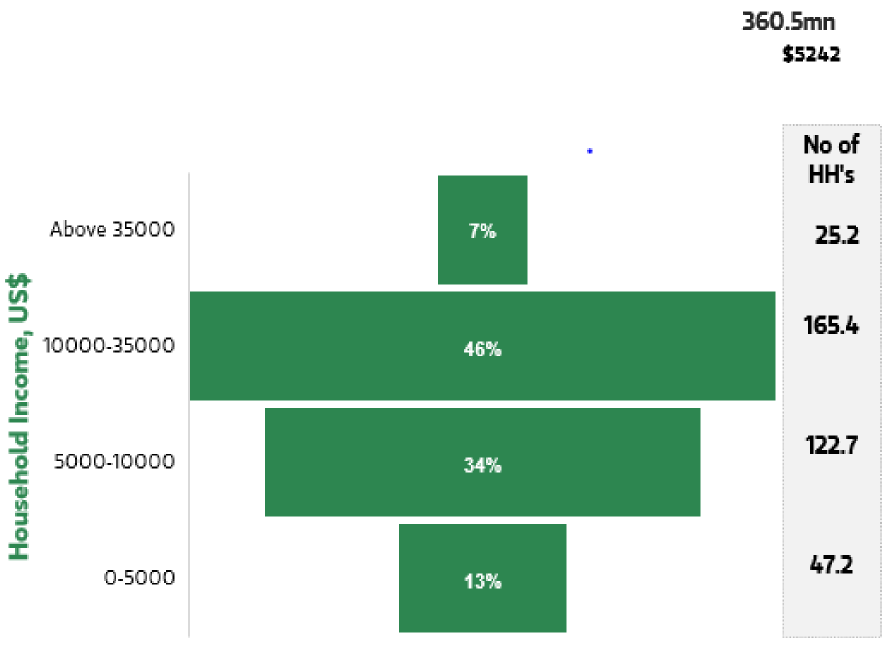
INDIA'S EMERGING MIDDLE CLASS

Discretionary spending boom

2021 Households by income distribution



2031 Households by income distribution



- The number of Indian households earning in excess of US$35,000/year is likely to rise fivefold in the coming decade, to over 25 million
- GDP is likely to cross US$7.5 trillion by 2031, more than double the current level

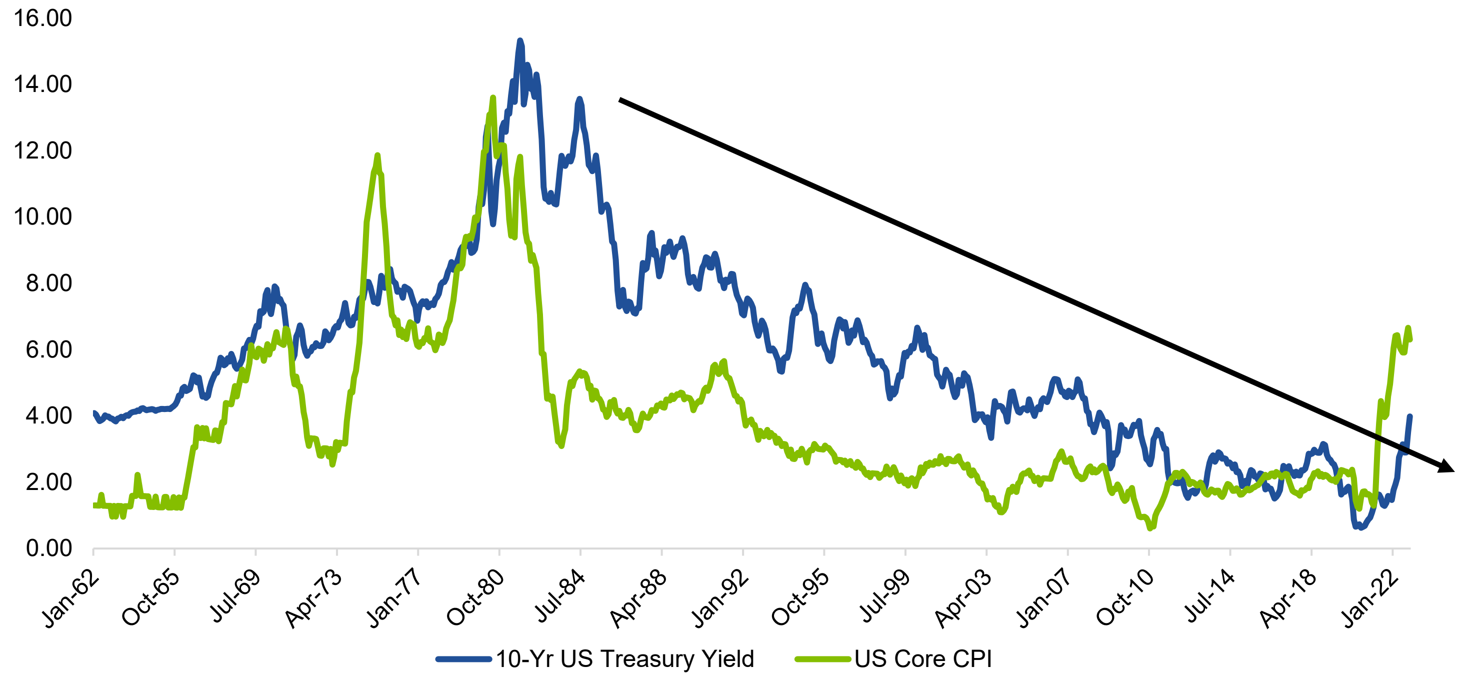
Source: Columbia Threadneedle, WTO, Morgan Stanley Research (E) estimates, as at 31 October 2022.

ENTERING A NEW MACRO ENVIRONMENT

Amundi ASSET MANAGEMENT

Challenging global economic and geopolitical backdrop

Interest rates and Core-CPI from 1962 through 2022



Source: Amundi, Federal Reserve Bank of St. Louis; retrieved from https://fred.stlouisfed.org on Nov 30, 2022.

- The economic environment over the past four decades was supported by a long-term trend of lower inflation, globalization and declining interest rates
- We believe the next few decades will be different
- Going forward, the macro environment will likely have structurally higher volatility with upward inflationary pressures, increased geopolitical tensions and transition to net zero
- Increased volatility provides excellent opportunities for active managers

SUMMARY

Volatility may persist in the short-term but there are long-term opportunities to take advantage of

Bonds are back

- Following a forty-year trend of falling interest rates, the repricing to higher rates marks a great opportunity for fixed income investors in 2023 and beyond. Higher yields provide more attractive income and starting yields are an important predictor of future total returns
- In the likely event of a recession, credit spreads could widen further, which would provide more opportunity for fixed income investors to generate excess returns over the long run
- Between higher income and price appreciation, some parts of the high yield market could provide equity-like returns for patient investors with a long-time horizon

Equity valuations are reasonable

- On a valuation basis, equities are cheaper than they were at the beginning of 2021. The final rate hike of the tightening cycle has been an important inflection point for equities that historically provided an attractive entry point for investors
- While recessions typically result in substantial drawdowns in equity markets, they have been followed by strong recoveries. Taking advantage of drawdowns presents long-term opportunities for outperformance

Don’t give up on the 60/40 portfolio

- The 60/40 portfolio has had one of its worst years in performance in decades due to the positive correlation in fixed income and equities, as both asset classes saw significant declines
- The 60/40 portfolio is well positioned for recessionary environment as fixed income could outperform in a risk-off environment while equities typically hit a bottom and start to recover three months before a recession begins.

Opportunities across regions and asset classes

- Our subadvisors are identifying attractive long-term opportunities in key markets and sectors in low volatility equities, high dividend payers, global clean energy companies, Canadian equities and emerging markets

QUESTIONS

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