Monthly Market Monitor

NEI

May 2024

Equities continue the rally, but economic paths diverge

After a brief respite in April, global equities resumed the rally to find higher ground in May, as ongoing moderation of inflation and resilient economic trends continue to boost investor optimism. The S&P 500 Index returned 4.1% driven by optimism on rates outlook, better than expected corporate earnings, and the strength in growth trajectory in the information technology (IT) and communication services sectors. The utilities sector in the U.S. also rebounded dramatically, benefitting from renewed investor interest from compressed valuations and the potential to benefit from lower interest rates on the horizon. Gains were more muted in Canada and Emerging Markets at 2.6% and -0.2% respectively, both primarily due to the relative lag in the IT sector. Europe also had a strong month returning 4.0% in CAD terms, partly due to currency fluctuations.

Canadian and global fixed income also generated positive performance of 1.8% and 0.8% for the month, with significant movements on yields during the month as markets speculate on divergence in the timing of rate cuts between the major central banks.

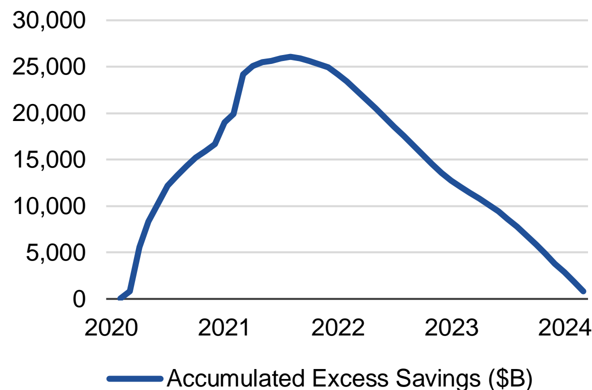
Greater scope for Europe and Canada to catch up on growth

Since the pandemic, the U.S. has been exceptionally strong, diverging from the rest of the developed markets in economic growth trajectories as other countries including Canada, have lagged behind. However, the tides may be turning as the U.S. slows and other countries catch up on growth.

U.S. economic growth slows down

While the U.S. economy remains in solid shape, the latest data in May pointed to some signs of moderation. The U.S. economy grew at an annualized rate of 1.3% in Q1 2024, revised lower from last month's estimate of 1.6% and significantly lower than the 3.4% annualized growth in Q4 2023. This slowdown was primarily driven by a larger-than-expected deceleration in consumer spending, as pandemic era accumulated savings are largely depleted due to inflation and strong spending over the last few years. Economists continue to point to a more moderate level of growth at 1.7% and 1.6% for Q3 and Q4 of this year.

Consumer spending becomes headwind for growth as excess savings run out



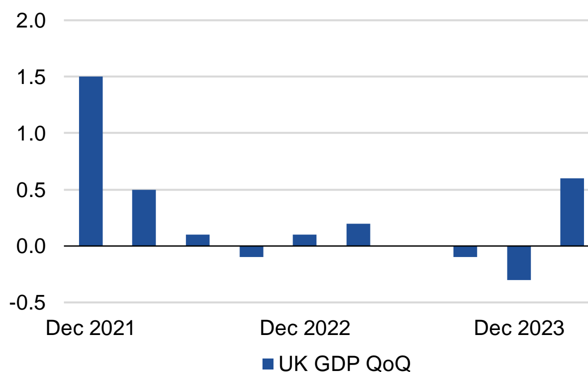
Source: Bloomberg.

Europe showing early signs of recovery

In Europe, PMI data released during the month confirmed that economic activity is improving, with the services sector acting as the key pillar of strength and sign of recovery in manufacturing. Q1 GDP showed positive growth, and corporate profits surprised positively.

In the U.K., the economy also started growing again in Q1, thus exiting a technical recession in the past two quarters. Q1 growth came in at 0.6%, improving from a contraction of 0.3% last quarter, surpassing expectations of 0.4%.

U.K. comes out of a technical recession



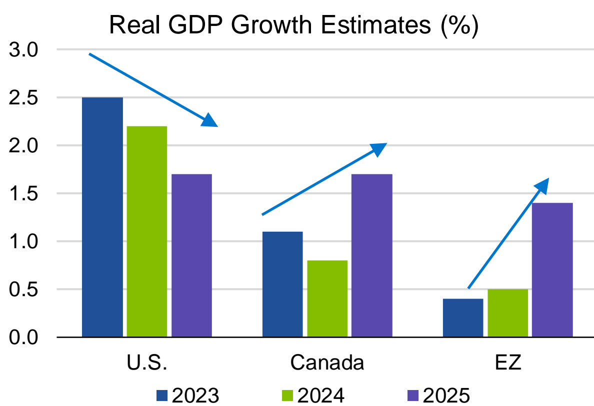
Source: Bloomberg.

This reacceleration, coupled with relatively low valuations, has started to attract investors' attention. In May, European equities excluding the U.K. returned 4.6% while U.K. equities returned 2.8% in CAD terms.

Canada

Although the Canadian economy grew at a slower pace of 1.7% annualized in the first quarter of 2024, weaker than Bank of Canada's (BoC) forecast of 2.8%, the data indicates that underlying strength in consumption was much stronger than expected at 3.0% annualized. Despite the downside surprise in GDP, robust consumer spending and positive signals from other components like business investment and trade indicate the economy remains resilient.

Canada and Europe to catch up on growth in 2025



Source: Bloomberg.

Bottomline: Economic growth in the U.S. is expected to decelerate, towards similar levels as the accelerating growth rates in other regions. This convergence, coupled with the more reasonable valuations in Canada and Europe, could pave the way for a pickup in investor interests in Canada and Europe, presenting attractive investment opportunities for investors.

Central bank policies diverge

In addition to the increasingly divergent path of regional economies, the inflation trajectories in the U.S., Canada and Euro area are also causing central bank policy responses to be less synchronized.

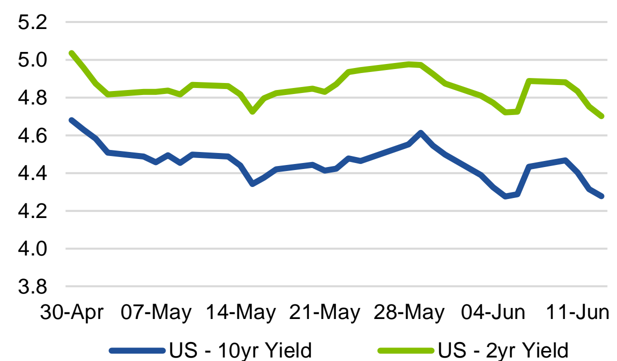
Canada's disinflationary momentum continued, as April's 2.7% headline CPI and moderation in core measures like CPI-Trim and CPI-Median pointed towards an imminent easing cycle by the BoC. On June 5th, the BoC led the major central banks to kick off this easing cycle and cut overnight rates by 0.25% to 4.75%.

Contrastingly, the Euro area saw an upside surprise in core inflation, with core HICP accelerating to 2.87% year-over-year in May, driven by a notable pickup in services price growth. Despite this uptick in core inflation, the European Central Bank (ECB) also kicked off the long-awaited easing cycle on June 6th, cutting rates by 0.25% to 3.75%.

The U.S. exhibited signs of easing inflationary pressures, with core CPI rising a muted 0.16% month-over-month in May, the slowest pace since August 2021. This softening has raised expectations of the U.S. Federal Reserve (Fed) to potentially to able to initiate rate cuts as soon as September.

In response to fluctuating rate cut expectations, U.S. bond yields were on a rollercoaster ride in May. Both 2-year and 10-year yields in the U.S. fell by 40bps since the end of April. A weaker-than-expected April jobs report fueled speculation of an economic slowdown, causing bond yields to decrease as investors anticipated earlier interest rate cuts by the Fed. However, yields rebounded in mid-May as persistent inflation and stronger data, such as the flash PMI readings, reminded investors that the Fed might need to maintain higher rates for longer to tame inflation, with markets now pricing in one rate cut by year end, from a previously expected two.

Volatility in bond yields in May 2024



Source: Bloomberg.

Strong earnings of mega-cap companies lead to highest market concentration

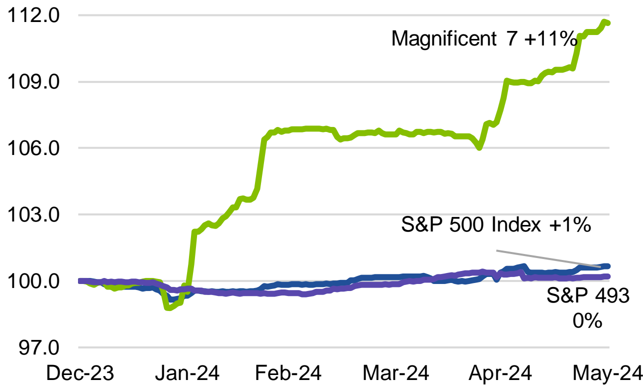
78% of S&P 500 companies reported Q1 results that exceeded consensus estimates. The S&P 500 reported earnings growth of 6.0%, the highest year-over-year since Q1 of 2022.

However, rather than excitement based on the strong Q1 results, investors focused on forward-looking earnings guidance. 80 companies issued negative EPS guidance and they typically lagged the index despite beating expectations on actual results, while firms that raised guidance outperformed.

Despite the softening macroeconomic backdrop in the U.S., analysts have been revising the Q2 2024 EPS estimates upwards after the Q1 results. It has been better than usual due to rosy forward guidance from

the largest firms. Analysts typically reduce earnings estimates as the year progresses, by a median of 4%. This year, however, analysts have lifted their full year 2024 EPS estimates for the Magnificent 7 companies by 11% while the estimates for the other 493 companies remained flat, leaving the aggregate 2024 S&P 500 EPS forecast revised up by 1%.

Revisions to 2024 S&P 500, Magnificent 7 and remaining 493 S&P EPS

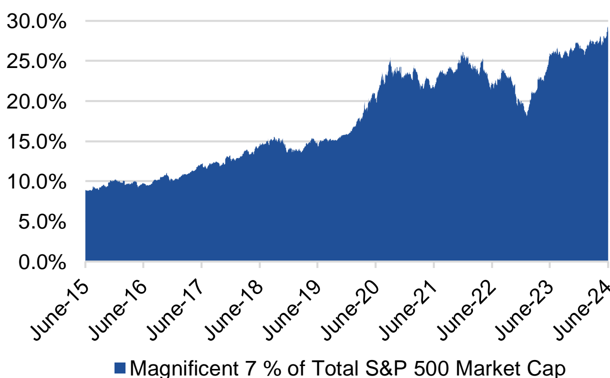


Source: FactSet, Goldman Sachs Global Investment Research.

In line with their strong earnings and revisions, the mega-caps have continued to dominate market performance resulting in highest levels of market concentration in recent history, with the largest 10 stocks now representing 35% of S&P 500 index market capitalization.

The most significant contributor was Nvidia. Nvidia surged after the first quarter earnings, reporting a 260% increase in overall revenue and 500% increase in operating income driven by the company's dominance in the AI chip market catering to the surging demand from major tech giants like Google, Microsoft, Meta, Amazon, and OpenAI.

U.S. market concentration reaches a new high



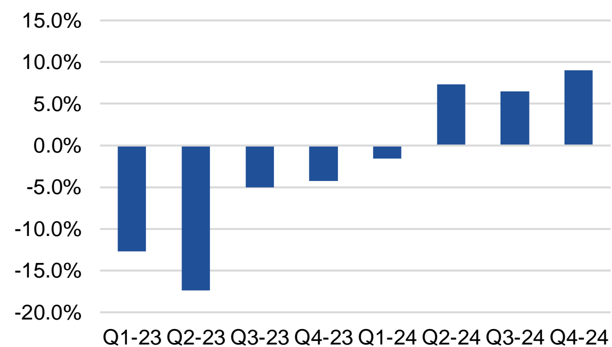
Source: FactSet, Goldman Sachs Global Investment Research.

Recovery in Canadian earnings growth expected in Q2

In Canada, year-over-year earnings growth has been negative for five consecutive quarters, weighed by weakness in materials and utilities sectors.

The TSX has also lagged in performance year-to-date relative to other regional markets. It was largely driven by the lackluster performance of Shopify, which represents about 3% of the S&P/TSX Index. Shopify shares dropped 19% following their earnings announcement as the e-commerce firm gave second quarter guidance that included a drop in its gross margin, although it reported revenues that beat the average analyst estimate.

TSX earnings growth back in black by Q2 2024



Source: Bloomberg.

Another detractor was financials, affected by a mixed quarter in earnings in the sector, with Royal Bank of Canada performing quite well while others struggled, most notably Bank of Montreal. Bank of Montreal shares fell as much as 5.4%, after the bank's second quarter adjusted earnings per share missed expectations due to higher provisions weighing on the bank's domestic segment, and margin compression as well as muted loan growth created headwinds in the U.S.

Looking ahead to the next quarter, earnings in the TSX are expected to rebound to positive year-over-year growth for the first time in 18 months, buoyed by recoveries in materials, energy, and continued strength in technology sectors.

Bottomline: The inflection point in earnings growth trajectory, coupled with undemanding valuations, makes the S&P/TSX index relatively more attractive.

Utilities emerge as top performers

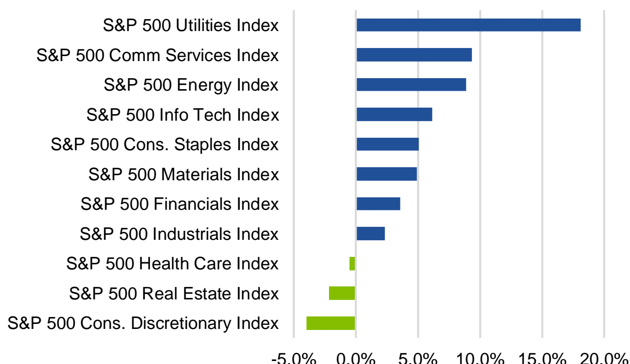
As elevated valuation and increasing market concentration poses additional risks in the U.S. markets, not to mention geopolitical risks given the upcoming election, investors have started to look outside of mega-cap technology for diversification into

other more defensive sectors. Over the last few months utilities have been a beneficiary of that.

Utilities stocks have emerged as the top-performing sector over the past three months, which have experienced an expansion of multiples from very compressed levels. Tailwinds for further runway include easing monetary policies, slowing economic growth in the U.S., and the rising demand for electricity from the growth of artificial intelligence and data centers.

The rapid advancement of AI technology has led to a significant increase in the need for data centers, which consume vast amounts of electricity. As major tech companies ramp up their investments in AI and data centers, the demand for power from utilities, especially those focused on clean energy and nuclear power, is expected to surge. This has made utilities an attractive play on the AI boom.

S&P 500 Three month sector performance



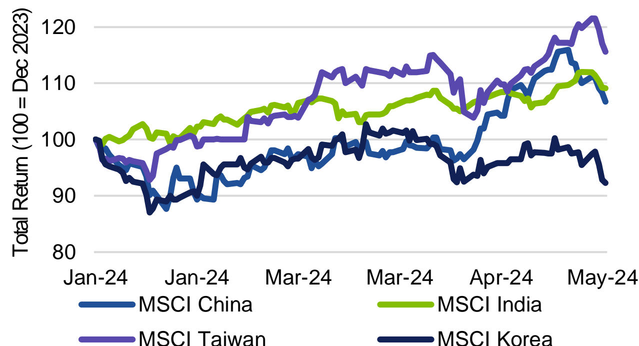
Source: Bloomberg.

Additionally, utilities' traditional defensive characteristics have also contributed to their outperformance, with concerns about slowing economic growth and potential rate cuts.

China's rally supports emerging markets, but could be short lived

Over the last few months the vast majority of emerging markets have been exhibiting strength, with their indices trading above rising 200-day moving averages. China, especially given its 40% weight in the MSCI Emerging Markets Index, has been one of the most significant contributors to the emerging markets rally.

Emerging market performance YTD

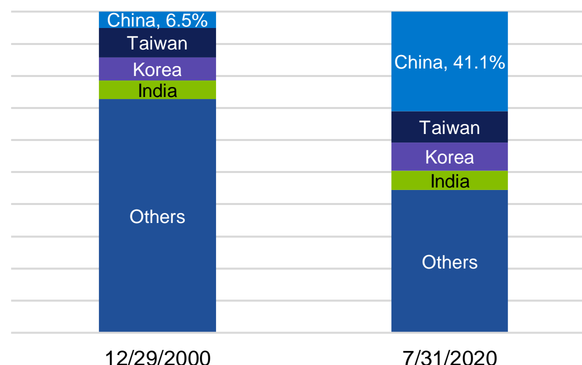


Source: Bloomberg.

One of the key drivers for China's recent rally was the recently released policy guideline by China's State Council known as the "Nine Measures", which could mark a new chapter of development in Chinese capital markets. This policy guideline shifts the focus from previous emphases on reform, opening up and development, to prioritizing the strengthening of supervision and high-quality growth.

In addition, China's first quarter GDP growth was stronger than expected, at 5.3% growth from a year ago, mainly thanks to the robust growth in high-tech manufacturing. Much of the good news in manufacturing comes from China's "new three" industries: Electric Vehicles (EVs), solar panels and batteries. However, this is not without risk as China's overcapacity in these areas could lead to further price reductions, which can trigger additional tariffs from the U.S. Other challenges facing China include a slower long term growth outlook, limited stimulus measures, lack of foreign investment interests due to low economic confidence, regulatory concerns, government controls, and geopolitical tensions – casting a shadow over the sustainability of the rally.

China grew tremendously in MSCI Emerging Markets Index representation



Source: MSCI.com.

NEI Investment Management Team.

Asset class outlook

Asset class	View	Changes from last month	Rational
Equities	OW	↑	Strong earnings support, crucial to have high quality bias given wide divergence of performance
Canada Equity	Neutral	–	Earnings back to positive growth rates in Q2, better clarity on path of rate cuts may provide relief.
U.S. Equity	OW	↑	Strong earnings growth to continue despite delays on rate cuts. Rich valuation gives investors pause and limits upside.
International Equity	OW	–	Macroeconomic data showing signs of recovery, and along with disinflation leading to rising expectations of rate cuts, can provide boost to investment sentiment at attractive valuations.
EM Equity	UW	–	Continue to be structurally bearish, but near-term downside could be overdone and easing policies can lead to short term rebounds.
Fixed Income	UW	–	Yields already reflecting disinflation in soft landing scenario, little catalyst to move lower in the near term, making equities more attractive.
Govt Bonds	OW	–	Yields to remain relatively steady at current levels, relatively more attractive than corporate credit in the short term.
IG Bonds	Neutral	–	Spreads tighter than historical average, especially in the U.S., may widen moderately. Absolute yield levels remain attractive.
HY Bonds	UW	–	Fundamentals remain strong. Spreads may widen from historically tight levels. Keep quality bias for attractive absolute yields.
Cash	Neutral	↓	High opportunity cost when macro environment remains supportive for risk assets.

This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of May 31, 2024. "UW" refers to an Underweight position, "OW" refers to an Overweight position. Symbols indicate the change in outlook from the prior month's outlook. The arrows indicate the change in outlook from last month. An upward arrow indicates a positive change on outlook, a downward arrow indicates a negative change on outlook and a dash indicates unchanged outlook.

Market performance

Percent return in Canadian Dollars

Returns less than 1 year are not annualized	1 Mo	3 Mo	6 Mo	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs
Fixed Income								
Bloomberg Canada Aggregate Index	1.78	0.19	1.77	-1.69	2.44	-1.83	-0.12	1.78
Bloomberg Global Aggregate Index (CAD Hedged)	0.83	-0.02	2.03	-1.00	2.42	-2.13	-0.04	1.70
Bloomberg US HY Index (CAD Hedged)	1.04	1.17	5.00	1.36	10.28	1.17	3.43	3.71
Equities								
MSCI World Index	3.65	4.34	15.51	13.22	25.27	11.05	12.94	11.64
MSCI World Growth Index	4.87	3.85	17.44	15.62	28.31	11.71	15.92	14.37
MSCI World Value Index	2.37	4.86	13.51	10.75	22.09	9.72	9.24	8.53
MSCI Canada Index	2.60	4.51	11.48	7.36	18.41	7.17	9.32	6.86
MSCI USA Index	3.92	4.06	16.52	14.46	28.17	12.81	15.36	14.57
MSCI EAFE Index	3.06	5.07	13.36	10.69	18.86	7.30	8.23	7.01
MSCI Europe Index	4.03	7.24	14.26	11.89	20.05	8.47	9.21	6.79
MSCI Japan Index	0.55	-0.17	12.31	10.65	18.96	6.64	7.74	8.60
MSCI Pacific Ex Japan Index	2.62	4.01	10.05	3.80	11.35	2.16	3.81	5.58
MSCI Emerging Market Index	-0.22	4.04	8.03	6.90	12.71	-2.38	3.72	5.03
World Currencies								
US Dollar	-0.78	0.50	0.54	3.38	0.28	4.11	0.17	2.30
Euro	0.74	0.82	0.03	1.60	2.12	0.06	-0.36	-0.01
Pound Sterling	0.89	1.16	1.11	3.25	3.02	0.35	0.37	-0.48
Yen	-0.64	-4.28	-5.42	-7.26	-10.84	-7.73	-6.97	-2.05
Commodities								
Bloomberg Sub WTI Crude Oil Index	-5.59	3.15	6.29	15.81	27.38	22.11	4.97	-6.72
Bloomberg Sub Brent Crude Index	-5.46	3.25	7.10	14.70	25.91	28.78	15.59	0.44
S&P GSCI Gold Spot Index	1.07	14.74	14.64	17.05	18.68	11.58	12.53	8.98
Bloomberg Sub Copper Index	0.49	21.16	22.00	23.62	29.43	5.35	12.71	6.16

Source: Morningstar data as of May 31, 2024

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