Monthly Market Monitor

NEI

June 2024

Political uncertainty stokes volatility, but markets continue to rally

It has been two years since the start of the monetary tightening cycle, and it has been a full year where rates are at or above 5% in both Canada and U.S. While economic growth in both countries is starting to moderate, markets have been remarkably resilient. Despite tightening monetary policies, financial conditions remain incredibly easy. Equities, by far led by the U.S., continue to see strong gains in the first half of 2024 with major indices reaching new record highs. Despite some volatility and brief selloffs, such as Nvidia's three-day, 13% plunge, the overall market sentiment remains bullish.

The rally in the U.S. has been narrow, with a few mega-cap companies dominating the gains. The S&P 500 market cap weighted index returned 18% in USD year-to-date, outpacing the equal weighted index by 11%. This concentration of performance in select stocks has raised some concerns about market breadth. Additionally, while U.S. markets thrived, the returns of other global markets were much more subdued, with Euro Area equities and the EUR/USD experiencing heightened volatility due to political events. The S&P/TSX Index has lagged this year, and June was no exception. The index returned 9% YTD, and was down -1.5% in June, weighed down by financials, utilities, energy, communications, and materials.

Bond markets finished the month higher with FTSE Canada Universe Bond Index up 1.3%, bringing the year-to-date return to almost breakeven, only down -0.4%. The Global Aggregate Bond Index also rose 0.8% over the month, the index is also nearly flat YTD, down just -0.2%.

Bank of Canada kicked off the monetary easing cycle

Rate cut despite inflation upside surprise in May

The Bank of Canada (BoC) became the first G7 central bank to initiate the monetary easing cycle by cutting its benchmark interest rate by 25 bps to 4.75% in June. Officials signaled that additional cuts are likely if inflation shows further signs of slowing. However, inflation reaccelerated to 2.9% in May, up from 2.7% in April, driven by higher service prices, challenging the likelihood of an additional cut in July. This increase, exceeded economists' expectations and was the first uptick in core inflation this year, suggesting underlying price pressures remain. On the GDP front, April saw a solid 0.3% month-over-month growth, with both goods and services sectors contributing equally.

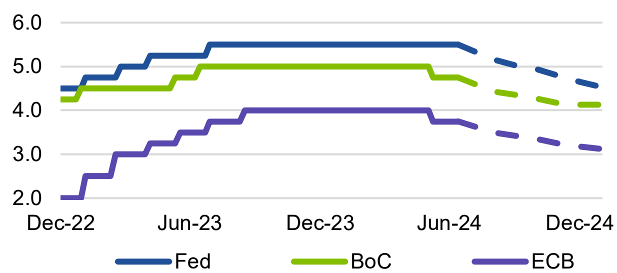
European Central Bank cuts rates but hikes inflation forecast

Similar to the BoC, the European Central Bank (ECB) also delivered on a widely expected 25bps rate cut in June despite upside surprise on inflation data. In response to that, they also revised upwards its inflation forecast for end of the year, in both core and headline inflation projections. Despite the rate cut, ECB President Christine Lagarde emphasized that monetary policy remains restrictive and that the central bank will maintain a data-dependent approach. The ECB views this move as a moderation of monetary policy restriction rather than a pivot to easy policy, and Lagarde stressed that the path for further rate cuts remains uncertain.

Fed holds rates steady and signals one cut in 2024

In a widely expected move, the U.S. Federal Reserve (Fed) kept its benchmark rate steady with projections indicating only one rate cut for 2024. However, Fed Chair Jerome Powell emphasized a cautious, data-dependent approach, leaving room for more cuts. The core consumer price was down by 0.1% to 3.3%, from 3.4% in May, showing some progress towards the Fed's 2% inflation target. Other data also supported the idea that the Fed could cut rates more than once this year, with the Fed's preferred inflation measure, the core personal consumption expenditures (PCE) price index, lower by 0.2% in May.

Interest rate expectations as of mid-July



Source: Bloomberg.

Bottomline: The upside surprise on inflation in Canada is a monthly volatility that is unlikely to repeat, therefore should not affect the BoC's path of easing in the face of falling GDP per capita, rise in unemployment rate, and decline in corporate profits. We expect the BoC to continue its easing policies.

In contrast, the Fed is taking a much more reserved approach and tries to lower expectations of rate cuts given the strength in the economy. The widening rate differentials will likely cause further weakness in the CAD versus the USD.

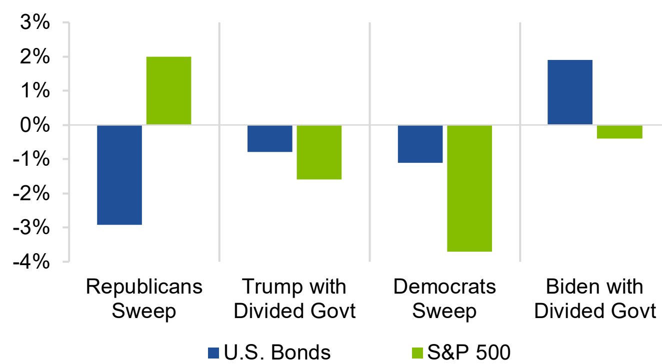
Political regime changes caused volatility

June was a busy month on the political front as elections in Mexico, India, France, the U.S., and the U.K. have had some surprising outcomes and varying market reactions:

- In France, President Emmanuel Macron's decision to call a snap election has unsettled markets, and the French equity index had its worst week in two years following the decision. The French equity market fell -9.0% since a recent high in mid-May and hampered broader European returns. The uncertainty surrounding the elections has raised fears of prolonged fiscal deficits and prompted credit rating downgrades, contributing to market volatility and weakening the Euro. The election's impact extends beyond France, potentially complicating the implementation of new EU fiscal rules and affecting the broader European economic landscape
- In Mexico, the markets reacted negatively to the surprise election results and the extent of Morena party's victory, raising concerns about potential constitutional changes that could weaken institutions and create a less favorable business environment. The peso has suffered its largest fall against the USD since the outbreak of the pandemic, after having been one of the best-performing major currencies against the USD over the past couple of years
- In India, the surprise election result with Prime Minister Modi's party losing its parliamentary majority initially caused significant volatility in the Indian stock market, as it created uncertainty about the continuation of Modi's pro-business agenda and concerns about the party's ability to form a stable government and continue economic reforms. However, the market showed resilience in the days following the initial shock. Indian stocks rebounded, with both major indexes recovering within a couple of days. Analysts remain optimistic about India's long-term market prospects, citing favorable demographics and ongoing geopolitical tensions between major powers as supporting factors
- The U.K. election, which resulted in a Labour victory after 14 years of Tory rule, had a muted impact on markets, as the outcome was largely anticipated and priced in by the markets. Labour's economic agenda is viewed as moderate and prudent, not signaling significant policy shifts
- And lastly, the biggest one of all, the upcoming U.S. election has been dominating headlines with shifting poll predictions and almost daily developments, and is likely to lead to increasing market volatility leading into the November election. The odds have changed since the first presidential debate between Joe Biden and Donald Trump, with the Republicans widening their lead after the debate. The divergent policy approaches of former President Trump and President Biden in areas such as international trade, taxation, immigration, and green energy initiatives could have varying implications for the economy and financial markets. Based on campaign rhetorics, a Republican sweep would likely be positive for the equity markets due to tax cuts, and negative for the bond markets due to inflationary impact of trade policies, while a Democratic sweep would be more positive for the bond markets and negative for equity markets. Canada and Mexico would be most affected by potential trade actions in the case of a Republican sweep given their dependence on the U.S. market

Asset market shifts in four scenarios

Baseline estimates of impact on asset prices from policy shifts



Source: Goldman Sachs Global Investment Research.

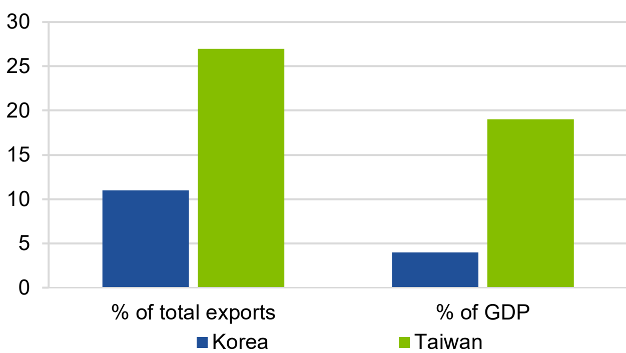
Bottomline: While political rhetoric can create short term noise in the markets, it continues to be corporate earnings and fundamentals that are the real drivers of long term returns. Historical data demonstrates that markets have shown resilience and indifference under both Republican and Democratic administrations. Investors may want to take advantage short-term market volatilities as entry points but should not position their portfolios any differently based on election outcomes.

Semis push emerging markets higher

Emerging market equities have had a strong month of June and second quarter, outperforming developed markets. Chinese authorities have been rolling out policies to support the real estate market, which provided a boost to Chinese equity markets. Continued strength in demand for semiconductors is also supporting the Taiwanese equity market, buoying Taiwan Semiconductor Manufacturing Company Limited's (TSMC) market cap to be over 51% of the MSCI Taiwan Index's overall market cap. Exports of high-end semiconductors is also boosting Taiwan's economic growth, where sales of AI-related products account for 27% of Taiwan's total exports and 19% of GDP in Taiwan.

AI-related products account for a significant share of Korean and Taiwanese economies

AI exports (%)



Source: Capital Economics.

Economy – goldilocks for now but some signs of slowing in the U.S.

The U.S. economy has been delivering one upside surprise after another since the pandemic but that has started to show signs of slowdown recently as retail sales and consumer confidence are starting to miss expectations.

U.S. economic surprise index turned negative

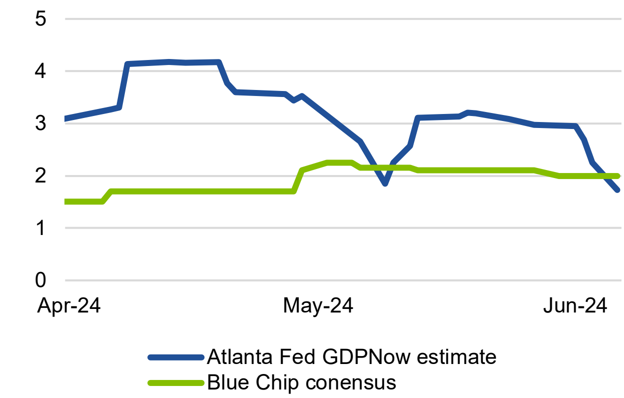
Source: Bloomberg.

The depletion of excess savings, particularly among lower-income groups, is starting to dampen consumer spending, a key driver of the U.S. economy.

The Federal Reserve Bank of Atlanta (Atlanta Fed) GDPNow forecasting model, a higher frequency measure of economic growth, for Q2 has fallen from 4.2% to 1.8% in 4 weeks. It is now below the consensus estimate for the first time in a long time. Weak manufacturing data fueled speculation that the economy is slowing.

Evolution of Atlanta Fed GDPNow real GDP estimate for Q2 2024

Percentage change quarter-over-quarter



Source: Bloomberg. Atlanta Fed Nowcast.

Additionally, the gradual rebalancing of the labour market may further contribute to this slowdown. Data releases on job openings and labour market turnover survey is lagged by a month, but they are important inputs to assess labour market tightness. The April Job Openings and Labor Turnover Survey (JOLTS) data pointed to a continued easing in the labour supply/demand imbalance. This should give the Fed tentative confidence that the labour market is rebalancing and in turn, inflation pressures overall will continue to subside.

NEI Investment Team

Asset class outlook

Asset class	Current View	Change from last month	Rationale
Equities	OW	–	Momentum to continue with strong earnings growth, 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	–	Divergent trajectories of growth by country. Selective opportunities exist, but continue to be structurally bearish in China.
Fixed Income	UW	–	Yields already reflecting disinflation in soft landing scenario, few catalysts 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	UW	↓	Spreads tighter than historical average, especially in the U.S., may widen moderately. Absolute yield levels remain attractive.
HY Bonds	UW	–	Fundamentals remain strong, but spreads may widen from historically tight levels. Keep quality bias for good 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 June 30, 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	1.29	0.92	-0.42	-0.42	3.79	-1.69	-0.06	1.88
Bloomberg Global Aggregate Index	0.81	-0.06	-0.20	-0.20	3.39	-2.03	-0.14	1.74
Bloomberg US High Yield Index	0.89	0.92	2.26	2.26	9.55	1.01	3.17	3.71
Equities								
MSCI World Index	2.42	3.78	15.96	15.96	24.29	10.47	12.81	11.93
MSCI World Growth Index	5.22	7.53	21.66	21.66	30.68	11.06	16.34	14.98
MSCI World Value Index	-0.50	-0.10	10.20	10.20	17.78	9.15	8.55	8.48
MSCI Canada Index	-1.65	-1.05	5.59	5.59	12.30	5.72	8.42	6.27
MSCI USA Index	3.94	5.10	18.97	18.97	28.33	12.32	15.47	14.99
MSCI EAFE Index	-1.24	0.69	9.31	9.31	15.34	6.38	7.45	6.98
MSCI Europe Index	-1.87	1.67	9.80	9.80	15.48	7.39	8.13	6.80
MSCI Japan Index	-0.33	-3.20	10.28	10.28	17.00	5.75	7.60	8.22
MSCI Pacific Ex Japan Index	0.67	3.61	4.50	4.50	10.48	2.09	3.38	5.85
MSCI EM Index	4.34	6.17	11.54	11.54	16.38	-1.85	4.05	5.40
World Currencies								
US Dollar	0.38	1.12	3.77	3.77	3.41	3.38	0.93	2.54
Euro	-0.90	0.34	0.68	0.68	1.58	-0.04	-0.29	0.06
Pound Sterling	-0.34	1.18	2.90	2.90	2.82	0.37	0.79	-0.51
Yen	-1.94	-4.87	-9.05	-9.05	-7.09	-8.64	-6.85	-2.10
Commodities								
Bloomberg Sub WTI Crude Oil Index	6.70	2.30	23.57	23.57	33.87	19.57	5.28	-6.27
Bloomberg Sub Brent Crude Index	5.94	2.39	21.51	21.51	31.15	26.45	16.35	0.83
S&P GSCI Gold Spot Index	0.12	5.69	17.19	17.19	25.39	13.43	11.62	8.56
Bloomberg Sub Copper Index	-3.72	11.79	19.02	19.02	23.64	6.26	11.97	5.68

Source: Morningstar data as of June 30, 2024.

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