Monthly Market Monitor

March 2021

HIGHLIGHTS

Turmoil in the bond market

The bond market rout continued as the Treasury yield curve steepened, driven largely by rising real yields. This is a sign of encouraging economic conditions and a warning that markets may be pricing in a sooner-than-expected Fed rate hike.

Equity rotation continues

The impact of higher yields carried over to the equity market as well, which reversed its gains in the first half of February. Under the surface, value stocks continued their outperformance and beat growth stocks by nearly 7%.

Policy support remains in place

We believe the Fed will remain accommodative and that it still has tools at its disposal to intervene if necessary. Also, more stimulus cheques are coming to Americans.

ASSET ALLOCATION OUTLOOK SUMMARY

	Negative		Neutral	Positive	
Equity					
Canada Equity			Last month	This month	
U.S. Equity			This month		
International Equity			This month	Last month	
EM Equity				This month	
Fixed Income					
Government Bonds		This month			
Corporate Bonds			This month	Last month	
High Yield Bonds			This month		
Overall equity				This month	
Overall fixed income		This month			

This month / Last month

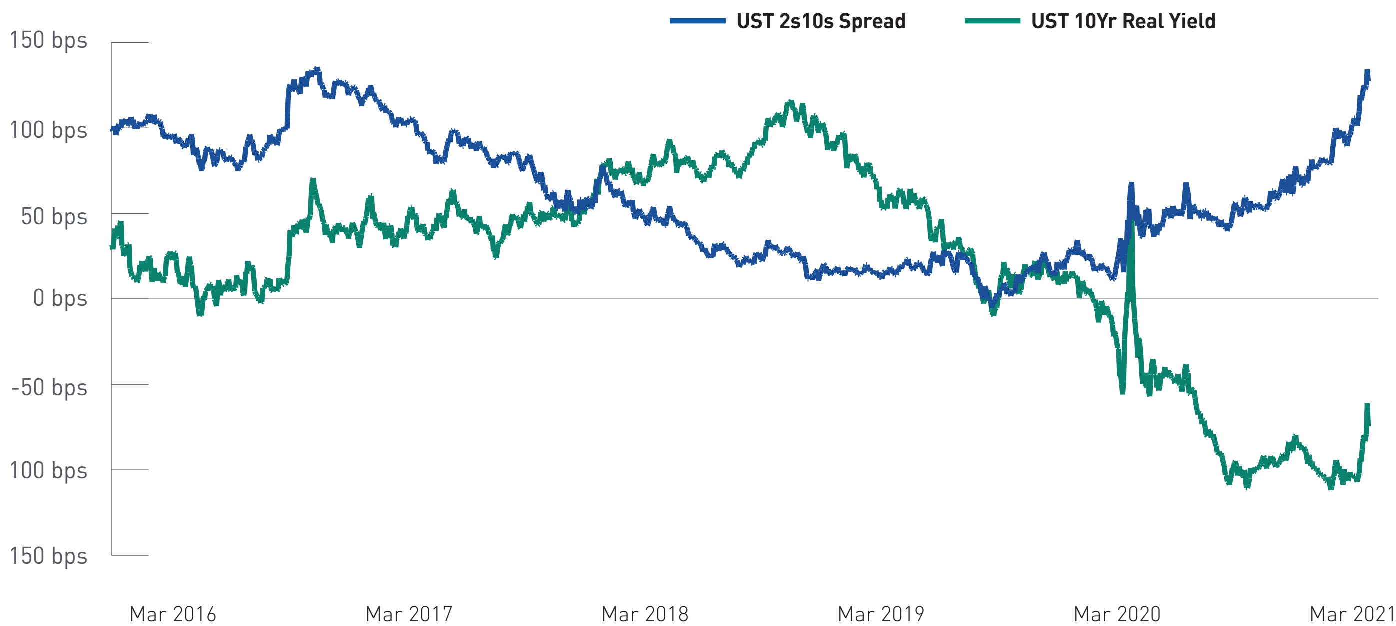
This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of February 28, 2021. If an asset class has a blue box in its row and no green box, it means this month's outlook is the same as the prior month's.

OVERVIEW

Markets were rocked in February by bear steepening of the Treasury yield curve. Ever since the November vaccine announcements, nominal bond yields had been steadily rising, largely driven by rising inflation expectations which have acted as a strong tailwind for equities. In periods of moderate inflation, companies are usually able to pass on higher costs to their end customers, and thus act as a decent inflation hedge.

Treasury curve continues to steepen into February

U.S. Treasury Curve



Source: Bloomberg. Data as of February 28, 2021.

Contrary to the last couple of months, the Treasury curve steepening in February was predominately attributed to an increase in real yields, which may have different implications. Not only does it reflect better economic conditions ahead, it reflects the tighter monetary policy that goes with those conditions. Any expectations of premature tightening could spell trouble for equities.

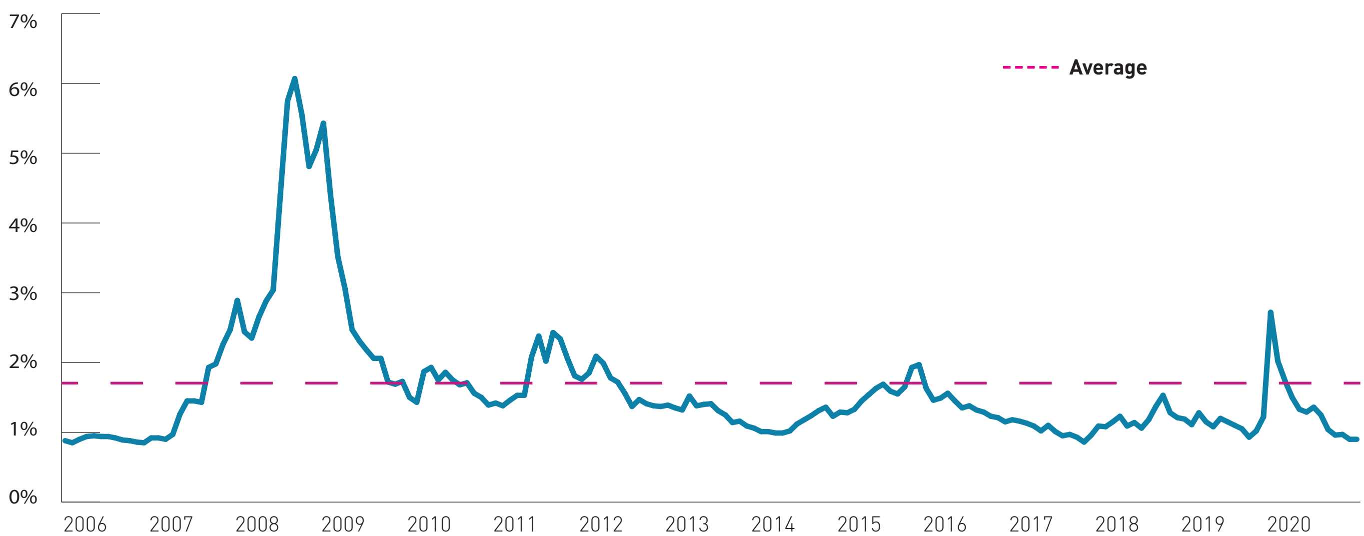
That said, we don't expect the trend of rising real yields to continue much longer, as the Fed has committed to keeping rates low until at least 2024. The run-up in yields reflects a strengthening economy, however longer-term inflation risks remain skewed to the downside and employment is still far from a full recovery. There is also speculation the Fed could still announce some form of yield curve control. Seeing as they have already successfully used this tool before in the form of Operation Twist back in 2012, it's hard to see why they wouldn't deploy it again should long-term Treasury yields get out of hand.

President Biden's US$1.9 trillion stimulus bill just passed the House and now awaits Senate approval, so it's only a matter of time before many Americans receive another $1,400 cheque. Combine that with improving vaccine logistics (which includes approval of a third Johnson & Johnson single-dose vaccine) and an accommodative central bank, and there is ample reason to continue to be bullish on equities over bonds, despite the short-term market weakness.

In our asset allocation solutions, we have adjusted our outlook to a more neutral view on investment grade corporate credit, compared to overweight from last month. The compression of investment grade spreads since the March 2020 selloff has benefitted our asset allocation solutions where we were overweight in this sector relative to government bonds. However, spreads today sit below pre-pandemic levels, and just 5 basis points above their all-time lows reached in April 2006 and February 2018. Moreover, the short interest on LQD, the most popular U.S. investment grade corporate bond ETF, has reached an all-time high. For large institutional investors worried about the effects of rising rates and inflation, shorting LQD is a way for them to hedge against rising yields given its relatively high duration and given today's narrow spread levels.

U.S. investment grade corporate bond spreads now below pre-pandemic levels

Bloomberg Barclays U.S. Aggregate Corporate OAS



Source: Bloomberg. Data as of February 28, 2021.

CANADA

We have a slightly more positive view on Canadian equities. No, it's not because we are seeing meaningful improvements on the vaccine front, where Canada still ranks lowest among the G7. Rather, we believe Canada should benefit from the continued cyclical upturn and commodity rally. Crude oil has rallied over 18% in February to over US$60/barrel. Copper, a better gauge of global industrial activity and in particular demand from China, also rallied over 16%. We may look to further increase our overweight should vaccine logistics improve.

U.S.

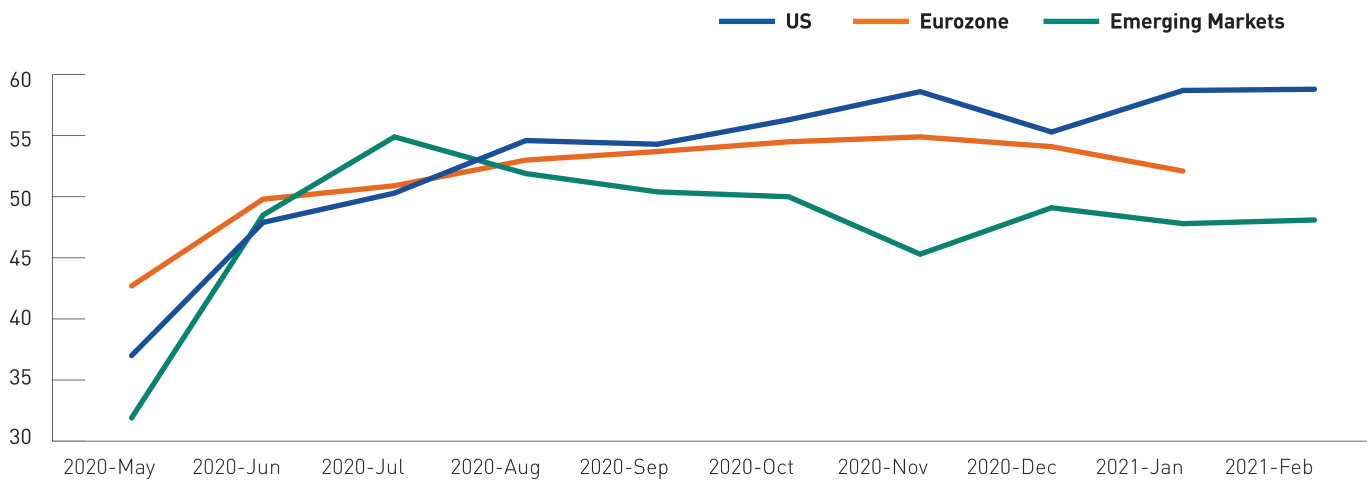
Our view on U.S. equities remains neutral relative to the broad market. While we don't believe this to be a concerning issue yet, at some point, rising long-term rates will start to create a headwind for U.S. equities. The technology sector, which accounts for more than a third of U.S. equity market cap, will likely see the largest impact from rising rates. Though posting positive returns, the S&P 500 technology sector has been lagging the broad market since November. Although, in the event of a market pullback and/or disappointments in the economic recovery, U.S. equities may still be able to help cushion the blow due to the safe haven nature of the U.S. dollar and the defensive nature of mega-cap technology stocks, and therefore we do not expect to go too far underweight.

INTERNATIONAL AND EMERGING MARKETS

Within our asset allocation solutions we are revising our international equity overweight back to neutral. Perhaps we were too early on our call, but our view was that the reflation trade should benefit eurozone equities as well. However, eurozone Purchasing Managers' Indices have not been able to move out of contractionary territory and the vaccine rollout has only been marginally better than Canada's.

As business activity improves in U.S. and emerging markets, eurozone remains challenged

Composite Purchasing Managers' Indices



Source: Bloomberg. Data as of February 28, 2021.

We believe the recent emerging market equity weakness on the back of the surge in Treasury yields is probably a chance for some needed consolidation. The bigger picture here is that the global recovery should continue to drive long-term U.S. dollar weakness, and the resulting emerging market currency appreciation can act as an offset to inflationary pressures. With the exception of China and South Korea, many emerging economies remain in a fragile state relative to developed economies, which means monetary policy will need to remain accommodative and if emerging market yields do rise, we could see central banks step in.

All of these forces mean emerging market yields will likely stay relatively low, which should be good for emerging market equities. There are other points of consideration as well. Like the U.S., emerging markets also have a large technology sector exposure. As rising U.S. Treasury yields create headwinds for U.S. technology stocks, investors that continue to seek technology exposure may increasingly look to emerging markets instead, where these same types of companies may benefit from long-term structural tailwinds.

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 Barclays Canada Aggregate	-2.48	-3.25	-2.74	-3.54	0.91	4.48	3.17	4.09
Bloomberg Barclays Global Aggregate ($C Hdg)	-1.55	-1.83	-0.94	-2.09	0.04	4.19	3.07	4.13
Bloomberg Barclays US HY 2% Issuer Cap ($C Hdg)	0.36	2.52	5.84	0.68	7.90	5.45	8.06	6.26
Equities								
MSCI World (Developed Markets)	1.64	3.41	8.56	0.91	21.99	10.33	12.57	12.31
MSCI World Growth	-0.50	1.92	4.74	-1.20	33.20	16.81	17.01	15.27
MSCI World Value	3.76	4.85	12.82	2.99	10.10	3.57	7.88	9.19
MSCI Canada	4.62	5.65	9.91	3.77	12.37	7.05	9.17	4.60
MSCI USA	1.65	3.29	7.35	0.95	25.81	13.96	15.19	15.97
MSCI EAFE	1.33	3.41	11.09	0.52	15.49	4.17	8.25	7.83
MSCI Europe	1.53	3.27	9.63	0.33	13.46	3.74	7.38	7.45
MSCI Japan	0.60	2.23	13.65	-0.13	21.08	4.77	9.77	8.87
MSCI Pacific Ex Japan	1.95	6.55	13.62	2.95	14.68	4.85	10.30	7.95
MSCI EM (Emerging Markets)	-0.14	8.92	18.85	3.20	28.31	5.92	13.69	7.17
World Currencies (relative to CAD)								
US Dollar	-0.90	-2.31	-2.84	-0.63	-5.69	-0.40	-1.34	2.65
Euro	-0.99	-0.87	-1.39	-1.42	4.22	-0.56	0.87	1.33
Pound Sterling	0.90	2.31	1.46	1.64	3.23	0.08	-1.28	1.11
Yen	-2.61	-4.38	-3.29	-3.70	-4.51	-0.35	-0.20	-0.01

Source: Morningstar. Data as of February 28, 2021.

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