Monthly Equity Monitor

Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

November 2021

Highlights

By Stéfane Marion / Matthieu Arseneau

- Global equities hit a new record high in early November, despite rising new COVID cases in Europe and China. At this point, the MSCI ACWI is already up 7% in Q4 and 21.3% in 2021 on a total return basis. The emerging market index continues to struggle with ongoing uncertainty related to Covid, inflation, and Beijing's regulatory framework amidst a challenging environment for some of China's major property developers.
- In the U.S., where 80 percent of S&P 500 companies reported earnings above analysts' expectations in the third quarter, pricing power is at its highest level in several years. The stock market is also supported by the persistence of negative real interest rates, which keep the equity risk premium essentially in line with its average of the past five years.
- The S&P/TSX hit a record high in November, led by new highs in Financials, Materials, Information Technology, Real Estate and Industrials. The Canadian benchmark is already up 8.7% in the fourth quarter and 27.7% in 2021 on a total return basis. Foreigners continue to play an important role in supporting the index. Should we fear an outflow? We don't think so given still attractive valuations and a strong economic recovery.
- Our asset allocation remains unchanged this month. We remain underweight fixed income and overweight equities, with a preference for value stocks over growth stocks, given our expectation of rising long-term interest rates and a relatively steep yield curve. Even if QE tapering accelerates in the coming months, we doubt the Fed will want to rush rate hikes given that its employment mandate is still far from being fulfilled. While it is true that GDP may weaken in the coming months, we still believe this is primarily due to supply constraints. If we are right, businesses should maintain their pricing power in an environment where long-term interest rates continue to drift higher.
- Our sector allocation is unchanged this month. We continue to favour cyclicals such as Energy, Materials and capital goods – sectors that have historically done well during an economic expansion when inflation is above trend and the slope of the yield curve is relatively steep.

World: Pricing power!

Global equities hit a new record high in early November, despite rising new COVID cases in Europe and China. At this point, the MSCI ACWI is already up 7% in Q4 and 21.3% in 2021 on a total return basis (table). The emerging market index continues to struggle with ongoing uncertainty related to Covid, inflation, and Beijing's regulatory framework amidst a challenging environment for some of China's major property developers. The MSCI EM Asia has a paltry 0.8% return so far in 2021.

MSCI composite index: Price Performance (Total return)

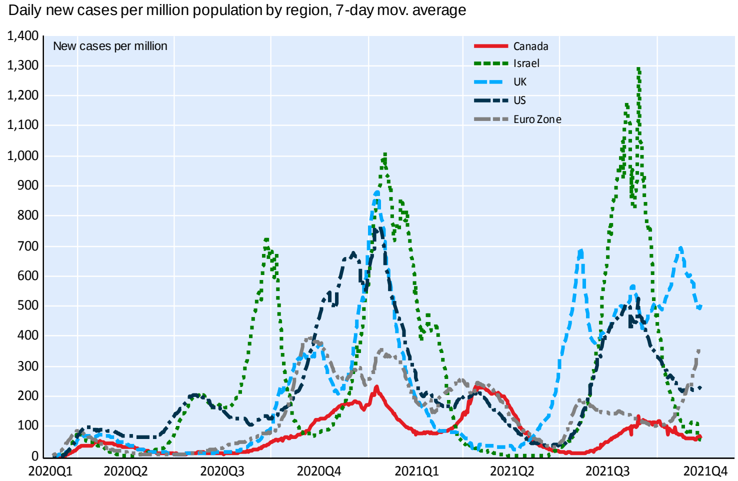
	Month to date	Quarter to date	Year to date
MSCI ACWI	1.9	7.0	21.3
MSCI World	2.0	7.6	24.0
MSCI USA	1.7	8.8	25.5
MSCI Canada	3.5	9.0	28.1
MSCI Europe	2.7	6.6	23.3
MSCI Pacific ex Jp	0.9	1.5	11.3
MSCI Japan	2.3	1.0	15.9
MSCI EM	1.7	2.6	3.6
MSCI EM EMEA	1.3	3.7	26.9
MSCI EM Latin America	1.9	-1.5	-2.4
MSCI EM Asia	1.8	2.8	0.8

11/12/2021

NBF Economics and Strategy (data via Refinitiv)

On the pandemic front, things are getting murky again. While the situation has improved in the United States in recent weeks, the European continent is facing an upsurge in new cases of Covid-19, which are nearing record levels (chart).

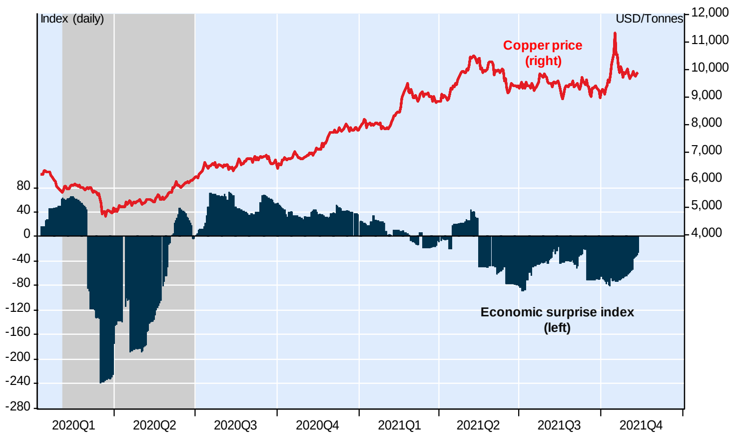
World: Evolution of the pandemic
Daily new cases per million population by region, 7-day mov. average



NBF Economics and Strategy (data via Johns Hopkins CSSE)

In China, the country is also beset by a wave of outbreaks related to the Delta variant. The Middle Kingdom is one of the last jurisdictions in the world to cling to a zero-tolerance virus response, a policy that is being reinforced by the approach of the Beijing Olympics, which will be held from February 4 to 20, 2022. This means that extremely stringent distancing measures are bound to cripple economic activity and lengthen the transition period to a normalized global supply chain (recall that China accounts for about 30% of global manufacturing output).

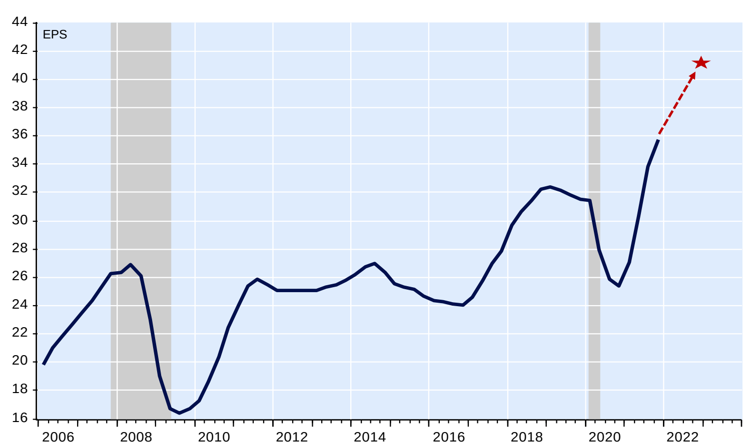
China: Negative economic surprises put a lid on commodity prices
China CITI economic surprise index and the price of copper



NBF Economics and Strategy (data via Bloomberg and Refinitiv)

So why are equity markets in developed economies still trending higher despite the renewed uncertainty over Covid, which will likely have a negative impact on growth? First of all, corporate earnings continue to exceed expectations and pricing power is impressive. For the MSCI ACWI, earnings per share (EPS) hit a record high in the third quarter, and the consensus of equity analysts expects 7% growth in 2022 (chart).

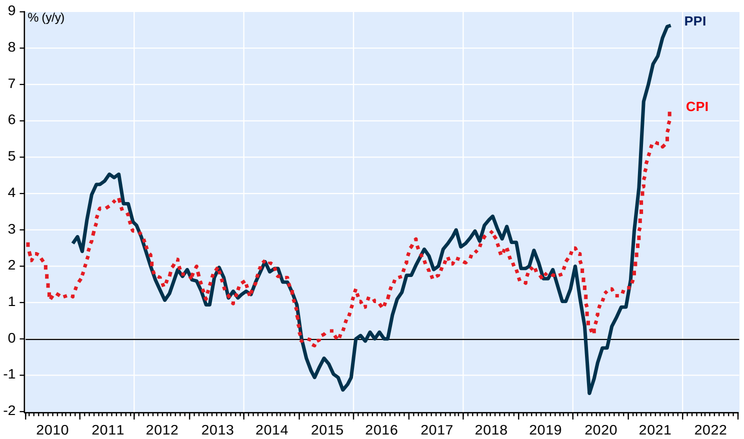
World: More growth is expected for corporate earnings
Trailing earnings for the MSCI ACWI and 12-month-forward expectations



NBF Economics and Strategy (data via Refinitiv)

In the U.S., where 80 percent of S&P 500 companies reported earnings above analysts' expectations in the third quarter, pricing power is at its highest level in several years. The Producer Price Index (PPI), which measures the selling price received by domestic producers of goods and services, rose 8.5% from its year-ago level in October. By comparison, growth in the consumer price index (CPI), a measure that includes several items unrelated to business profits (such as owners'-equivalent rent), was 6.25.

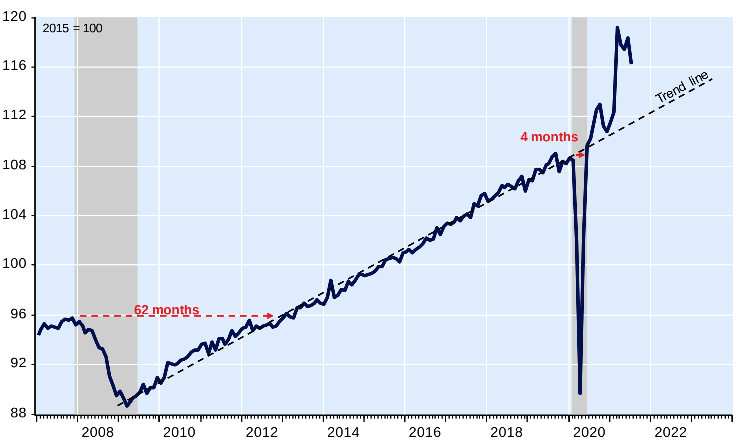
U.S.: Corporations have pricing power
PPI for final demand and headline CPI



NBF Economics and Strategy (data via Fred)

Businesses can raise prices thanks to strong demand. As our latest Economic Monitor shows, retail sales volumes in the 38 OECD member countries remain well above the pre-pandemic trend, a sign of consumer strength in the developed economies. We note that after the 2008-09 recession, it took no less than 62 months for this indicator to fully recover. This time, it took four months (chart). With labour markets improving in most developed economies, demand for manufactured goods, combined with the current disruptions in the global supply chain, should preserve producers' pricing power and profit margins longer than we had assumed.

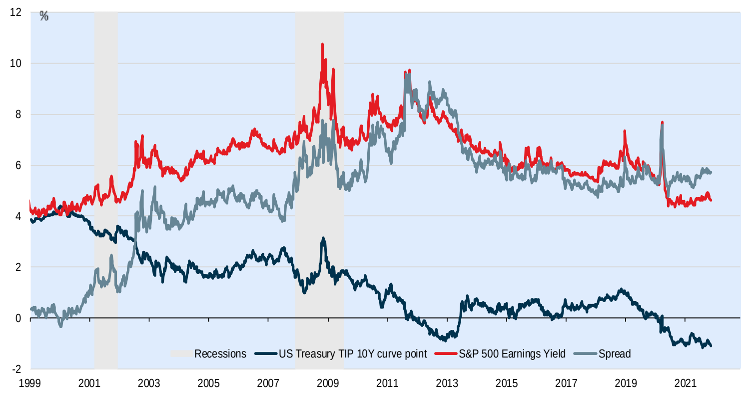
OECD: Excess demand persists for retail sales
Volume retail sales



NBF Economics and Strategy (data from Refinitiv)

As we mentioned last month, equity markets are also supported by the persistence of negative real interest rates, which keep the equity risk premium essentially in line with its average of the past five years (chart).

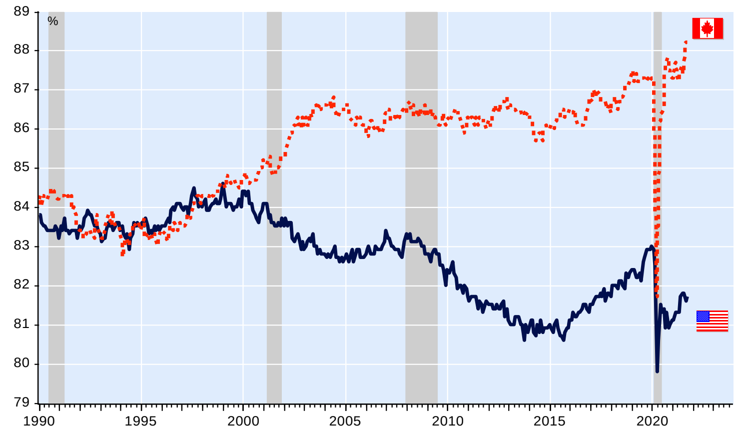
U.S. : Perspective on valuation
S&P 500 earnings yield and 10 years U.S. treasury yield TIP



NBF Economics and Strategy (data via Refinitiv)

So how long will this environment of negative real interest rates persist? With U.S. CPI inflation exceeding 6% and with improving momentum in the labour market, our fixed income strategists see a very distinct possibility that the QE taper that began in November gets accelerated early next year (see here). But when it comes to actual rate hikes, we do not expect a move before Q3 of 2022. Recall that headline nonfarm employment remains more than 4 million jobs below where we stood pre-pandemic, as labour force participation has remained stubbornly low – unlike Canada (chart).

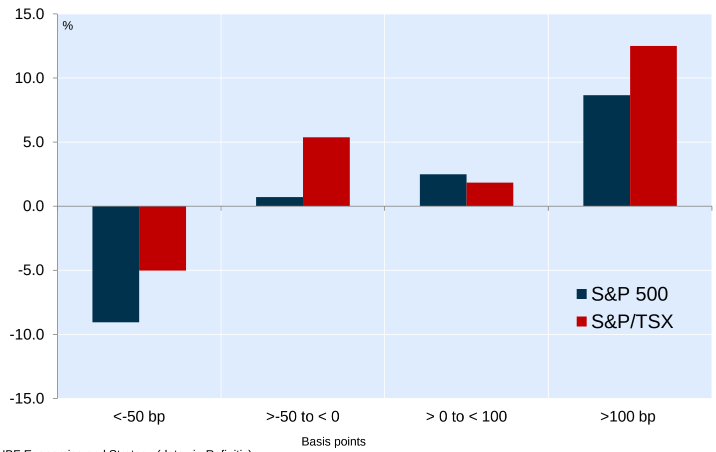
U.S.: Participation rate remains a concern
Labour force participation rate of people aged 25-54 (as of October 2021): Canada and the U.S.



NBF Economics and Strategy (data from Statistics Canada, Bureau of Labour Statistics)

If the Fed remains as patient as we currently expect, negative real interest rates should prevail through 2022 with a yield curve slope (10-year Treasury yield minus 3-month Treasury bills) that remains relatively steep. As the chart below shows, a slope that exceeds 100 basis points in the mature phase has historically implied robust returns for the stock market.

Mature phase: Return of equities based on slope of the yield curve
Slope of the U.S. yield curve during the mature phase and average 6-month return following



NBF Economics and Strategy (data via Refinitiv)

S&P/TSX: Record earnings!

The S&P/TSX hit a record high in November, led by new highs in Financials, Materials, Information Technology, Real Estate and Industrials. The Canadian benchmark is already up 8.7% in the fourth quarter and 27.7% in 2021 on a total return basis (table).

S&P/TSX composite index: Price Performance (Total return)

	Month to date	Quarter to date	Year to date
S&P TSX	3.5	8.7	27.7
HEALTH CARE	10.4	3.7	2.0
IT	8.8	13.3	36.1
MATERIALS	7.5	13.8	6.9
CONS. DISC.	7.2	7.1	17.7
CONS. STAP.	6.5	5.0	19.2
BANKS	3.2	9.1	36.3
FINANCIALS	2.9	8.2	35.0
TELECOM	1.8	1.7	21.1
INDUSTRIALS	1.3	10.2	22.3
REAL ESTATE	0.5	6.9	34.5
UTILITIES	0.3	0.8	6.9
ENERGY	-0.5	8.2	52.4

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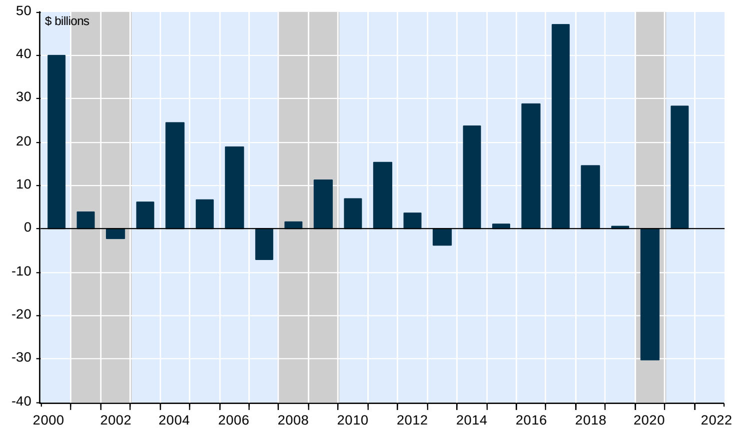
NBF Economics and Strategy (data via Refinitiv)

Foreigners continue to play an important role in supporting the index. According to the latest available data, net foreign purchases of Canadian equities were already nearly $30 billion in the first eight months of 2021, the best such performance in four years (chart).

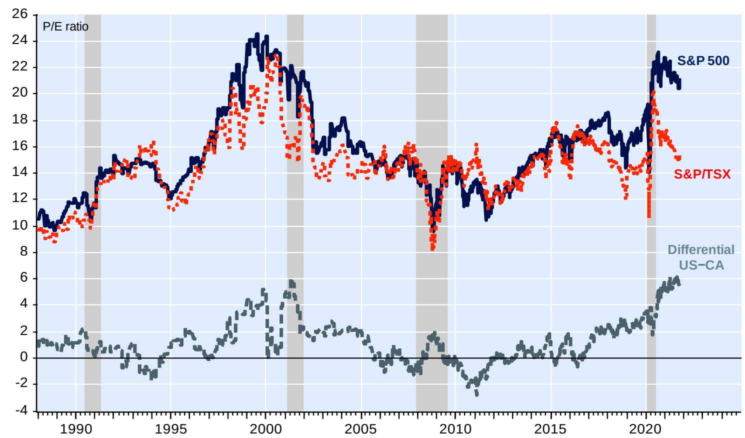
S&P/TSX: Foreigners are attracted to Canada
Net foreign purchases of Canadian equities through the first eight months of every year



NBF Economics and Strategy (data via Statistics Canada)

Should we fear an outflow? We don't think so. Despite being one of the best performing stock markets in 2021, the S&P/TSX still trades at a relatively low PE: 15.6 times forward earnings vs. more than 21.6 for the S&P 500 (chart).

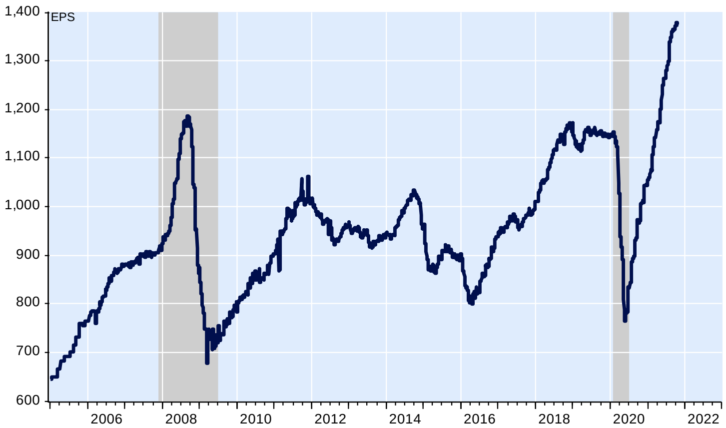
S&P/TSX: Valuation remains attractive
12-month-forward P/Es for the S&P 500 and the S&P/TSX



NBF Economics and Strategy (data via Refinitiv)

It is important to note that TSX earnings forecasts continue to be revised upward as Canada benefits from a strong labour market (employment rose to a record high in October) and improving terms of trade due to surging commodity prices. This year marks the first time in over a decade that the S&P/TSX 12-month earnings per share forecast has exceeded its 2008 peak (chart).

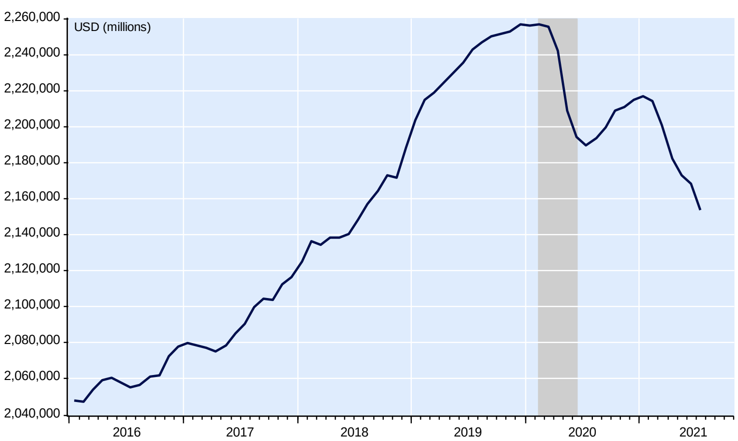
Canada: A bullish outlook
12-month forward EPS estimates for the S&P/TSX



NBF Economics and Strategy (data via Refinitiv)

Notwithstanding an expected slowdown in China in the coming weeks, which could temporarily weaken commodity prices, we maintain our view that a global inventory rebuilding cycle will support industrial production and commodity prices in 2022 (chart).

U.S.: Global restocking activity has yet to begin
Real Manufacturing and Trade inventories



NBF Economics and Strategy (data via Fred)

Asset allocation

Our asset allocation remains unchanged this month. We remain underweight fixed income and overweight equities, with a preference for value stocks over growth stocks, given our expectation of rising long-term interest rates and a relatively steep yield curve. Even if QE tapering accelerates in the coming months, we doubt the Fed will want to rush rate hikes given that its employment mandate is still far from being fulfilled. While it is true that GDP may weaken in the coming months, we still believe this is primarily due to supply constraints. If we are right, businesses should maintain their pricing power in an environment where long-term interest rates continue to drift higher.

NBF Asset Allocation

	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	25	
U.S. Equities	20	18	
Foreign Equities (EAFE)	5	3	
Emerging markets	5	5	
Fixed Income	45	42	
Cash	5	7	
Total	100	100	

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Sector allocation

Our sector allocation is unchanged this month. We continue to favour cyclicals such as Energy, Materials and capital goods – sectors that have historically done well during an economic expansion when inflation is above trend and the slope of the yield curve is relatively steep.

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

NBF Market Forecast *Canada*			
		Actual	***Q42022 (Est.)***
Index Level		**Nov-12-21**	***Target***
S&P/TSX		21,769	22,500
Assumptions			Q42022 (Est.)
Level:	Earnings *	1270	1375
	Dividend	533	577
PE Trailing (implied)		17.1	16.4
			Q42022 (Est.)
10-year Bond Yield		1.68	2.10

** Before extraordinary items, source Thomson*

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NBF Market Forecast *United States*			
		Actual	***Q42022 (Est.)***
Index Level		**Nov-12-21**	***Target***
S&P 500		4,683	4,750
Assumptions			Q42022 (Est.)
Level:	Earnings *	197	212
	Dividend	60	64
PE Trailing (implied)		23.7	22.4
			Q42022 (Est.)
10-year Bond Yield		1.58	2.15

** S&P operating earnings, bottom up.*

NBF Fundamental Sector Rotation - November 2021

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Overweight**	**13.0%**
Energy Equipment & Services	Overweight	0.0%
Oil, Gas & Consumable Fuels	Overweight	13.0%
Materials	**Overweight**	**11.8%**
Chemicals	Market Weight	1.7%
Containers & Packaging	Overweight	0.5%
Metals & Mining *	Overweight	2.5%
Gold	Overweight	6.5%
Paper & Forest Products	Market Weight	0.5%
Industrials	**Market Weight**	**11.6%**
Capital Goods	Overweight	2.3%
Commercial & Professional Services	Underweight	3.2%
Transportation	Market Weight	6.1%
Consumer Discretionary	**Market Weight**	**3.6%**
Automobiles & Components	Underweight	1.1%
Consumer Durables & Apparel	Overweight	0.6%
Consumer Services	Market Weight	0.7%
Retailing	Market Weight	1.1%
Consumer Staples	**Market Weight**	**3.6%**
Food & Staples Retailing	Market Weight	2.9%
Food, Beverage & Tobacco	Market Weight	0.6%
Health Care	**Market Weight**	**1.0%**
Health Care Equipment & Services	Market Weight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	0.8%
Financials	**Market Weight**	**31.6%**
Banks	Market Weight	21.2%
Diversified Financials	Market Weight	4.7%
Insurance	Market Weight	5.7%
Information Technology	**Underweight**	**12.0%**
Telecommunication Services	**Market Weight**	**4.6%**
Utilities	**Underweight**	**4.3%**
Real Estate	**Underweight**	**3.0%**

** Metals & Mining excluding the Gold Sub-Industry for the recommendation.*

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