September 2023

Highlights

By Stéfane Marion / Matthieu Arseneau / Alexandra Ducharme

- The MSCI ACWI is currently posting a negative return for the quarter. It seems that the recent pessimism in global equity markets may be short-lived, with analysts expecting a strong rebound in earnings growth over the coming year. In our view, slowing economic growth, combined with declining pricing power and restrictive monetary policy, is not conducive of a bounce back in corporate earnings.

- We believe further weakness is ahead for the S&P 500 as we remain skeptical of the soft landing thesis and continue to see the economy in a three-quarter technical recession starting at the turn of 2024. Historically, the U.S. economy enters a recession 5 to 16 months after the yield curve inverts. It has now been 10 months since the current inversion. Adding to our concerns, the S&P 500 continues to trade at a rich valuation of just over 18 times forward earnings, a ratio that has never been this high when the U.S. yield curve is this inverted.

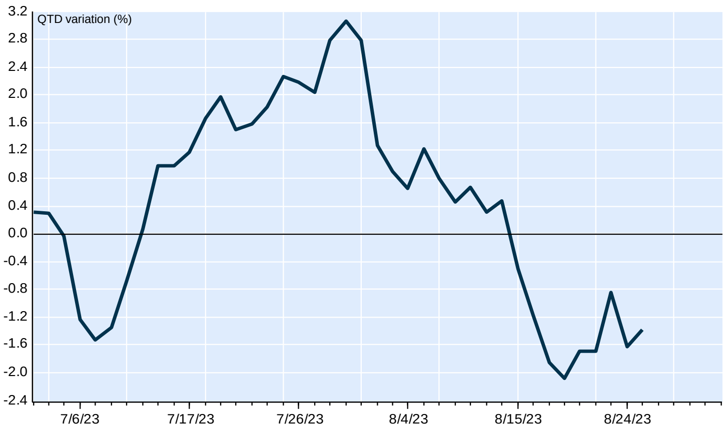
- Like most equity indices, the S&P/TSX is struggling in Q3, with all sectors except consumer staples and energy down. The benchmark's weakness is due to concerns about the exposure of Canadian households to higher interest rates, as well as the fact that the Chinese economy is slowing rapidly. Some of these concerns are already reflected in the low valuation of the S&P/TSX. At just under 13 times forward earnings, the Canadian benchmark trades six points below the P/E of the S&P 500.

- Given our view of a rapidly slowing economy, we are keeping our defensive asset mix this month. Our sector rotation remains unchanged this month, with a preference for more defensive sectors (consumer staples, communications services, and utilities), an appropriate positioning when the earnings yield is below the return on cash.

World: A tougher Q3

When we last published this Monthly Monitor, the global equity market was struggling as negative economic surprises dampened optimism. While positive surprises in the second half of July resulted in renewed momentum in global equities, this was rapidly reversed in August, mainly on worrying economic news coming from China. As a result, the global equity market is currently showing a negative return in the quarter (chart).

World: Short-lived optimism in global equities in Q3
Quarter-to-date performance in % (as of August 25, 2023)



NBF Economics and Strategy (data via Refinitiv)

Losses in August were broad-based, but, unsurprisingly, particularly pronounced in Asia. This translated into negative QTD returns in almost all regions of the world. Nevertheless, equities remain positive on a year-to-date basis in all regions but the Pacific excluding Japan (table).

MSCI composite index: Price Performance

	Month to date	Quarter to date	Year to date
MSCI ACWI	-4.3	-1.4	11.3
MSCI World	-4.1	-1.4	12.4
MSCI USA	-4.2	-1.0	15.0
MSCI Canada	-4.1	-1.7	2.6
MSCI Europe	-3.9	-2.5	5.6
MSCI Pacific ex Jp	-6.5	-3.5	-3.8
MSCI Japan	-2.9	-1.7	20.3
MSCI EM	-5.8	-1.2	2.8
MSCI EM EMEA	-4.1	0.9	4.4
MSCI EM Latin America	-5.2	-1.9	2.0
MSCI EM Asia	-6.2	-1.5	2.7

8/25/2023

NBF Economics and Strategy (data via Refinitiv)

It appears that the recent pessimism in global equity markets is expected to be short-lived, with analysts expecting earnings growth for the year ahead to remain positive (table).

MSCI composite index: EPS Performance

	2022	2023	2024	2025	12 months forward
MSCI ACWI	9.5	-0.1	10.9	11.5	7.7
MSCI Energy	131.7	-27.7	0.3	3.2	-10.9
MSCI Health Care	6.4	-8.6	12.8	12.5	5.4
MSCI Industrials	16.9	4.1	10.9	12.4	7.3
MSCI IT	8.2	0.2	14.4	16.5	12.5
MSCI Utilities	11.6	12.3	2.6	5.1	7.1
MSCI Banks	-4.2	16.0	0.0	7.0	4.8
MSCI Consumer Staples	6.9	2.1	8.3	8.6	6.8
MSCI Financials	-7.3	13.3	7.6	9.4	9.4
MSCI Consumer Disc.	4.2	-27.6	7.5	7.3	-5.9
MSCI Real Estate	10.1	26.1	12.6	14.1	17.1
MSCI Communication Svc.	13.8	5.1	1.8	10.1	3.1

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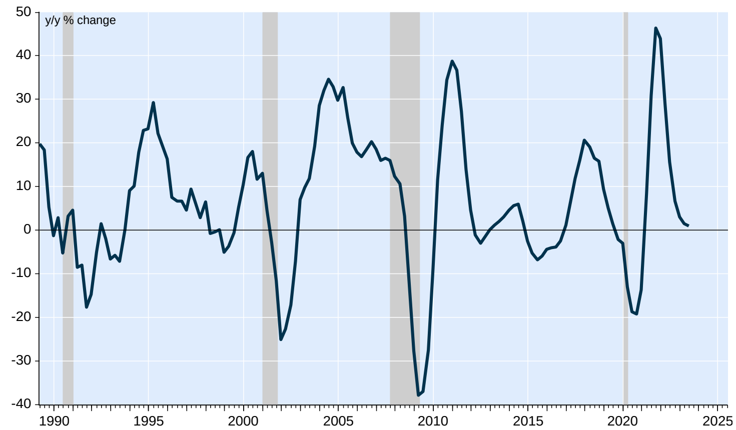
NBF Economics and Strategy (data via Refinitiv)

We disagree with this assessment and believe that corporate earnings expectations will have to be revised downwards. Trailing EPS for the MSCI ACWI are currently flatlining and stand only about 1% above their year-ago level (chart).

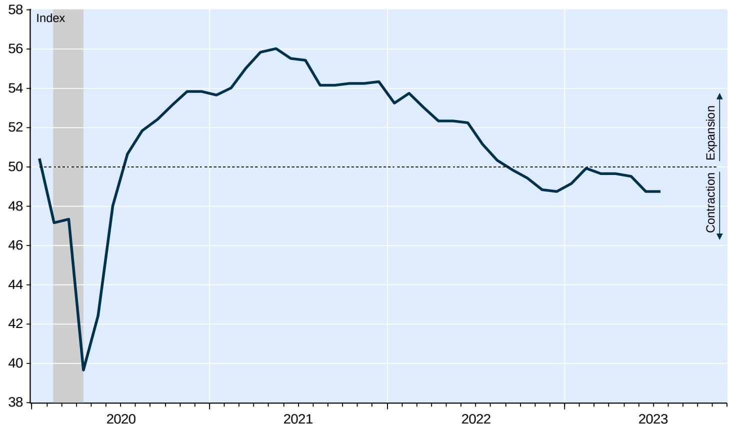
World: Earnings are flatlining
Trailing earnings per share (EPS)



NBF Economics and Strategy (data via Refinitiv)

The loss of momentum in earnings occurs as the manufacturing side of the World economy has contracted for the eleventh consecutive month in July. In our view, slower economic growth combined with declining pricing power and restrictive monetary policy do not support a rebound in corporate earnings (chart).

World: Global factory activity contracted for eleventh month running
JPMorgan/Markit Global Manufacturing PMI. Last observation: July 2023



NBF Economics and Strategy (data via Refinitiv)

S&P 500 composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P 500	-4.0	-1.0	14.7
ENERGY	-0.4	6.8	-0.9
HEALTH CARE	-0.6	0.2	-2.1
INDUSTRIALS	-3.7	-1.0	8.2
FINANCIALS	-4.0	0.5	-1.0
TELECOM	-4.3	2.2	38.6
CONS. STAP.	-4.3	-2.4	-2.4
REAL ESTATE	-4.7	-3.3	-1.9
CONS. DISC.	-4.7	-2.4	29.1
IT	-5.4	-2.9	37.9
UTILITIES	-5.6	-3.3	-10.3
MATERIALS	-5.8	-2.7	3.8

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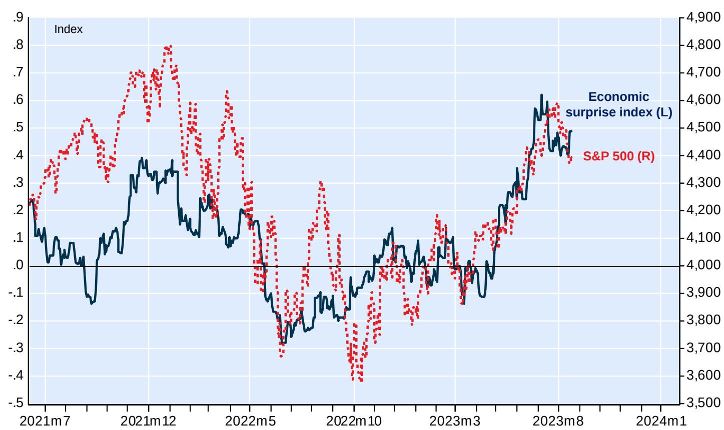
NBF Economics and Strategy (data via Refinitiv)

S&P 500: Soft landing or not?

The S&P 500 has also displayed strong enthusiasm in the summer. Indeed, U.S. economic data coming in better than expected has fueled optimism about the probability of a soft landing and given steam to equities (chart).

U.S.: A summer of positive economic surprises
Bloomberg economic surprise index and S&P 500



NBF Economics and Strategy (data via Bloomberg)

True, the S&P 500 was also cooled by negative surprises coming from China. Plus, the flip side of positive economic surprises is the prospect of higher-for-longer interest rates, which has also dampened the growth in U.S. equities (table).

But despite the recent negative returns, we believe that further weakness lies ahead for the S&P 500. As discussed in our forthcoming Monthly Economic Monitor, we remain skeptical of the soft landing thesis and continue to see the economy in a three-quarter technical recession starting at the turn of 2024. Our forecast is supported by economic indicators that tend to lead the economic cycle, which, as reported in our weekly U.S. recession dashboard, continue to send red flags (table).

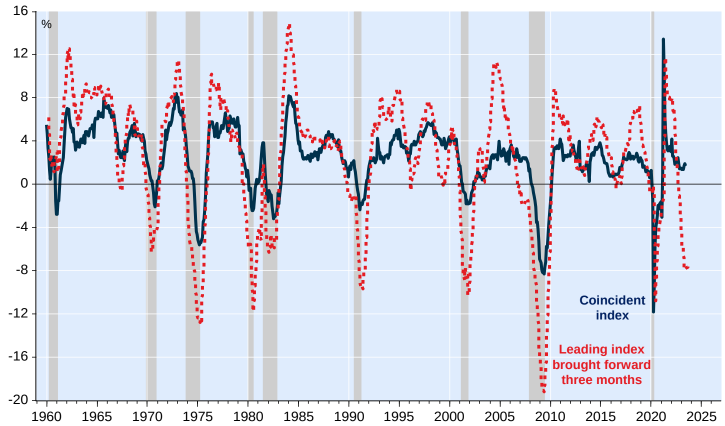
U.S.: Economic and financial indicators 3 months before recessions
As of August 25, 2023

		Last reading	Prior reading*	Median
Financial/commodity	S&P 500 (% drawdown from past year max)	-4.0%	-4.4%	-7.7%
	BBB spread (increase from past year min, bps)**	2.7	11.4	32.0
	Copper price (% drawdown from past year max)	-10.8%	-10.7%	-5.9%
	Oil price (% drawdown from past year max)	-17.7%	-17.2%	-4.0%
	U.S. Dollar (% increase from past year min)	3.0%	2.7%	4.5%
	Yield curve (10-year minus 3-month, bps)	-126	-115	-18
Soft data	Consumer sentiment (Michigan)	69.5	71.6	83.7
	SME optimism	91.9	91.0	96.9
	CEO confidence (quarterly data)	48.0	42.0	43.5
	ISM manufacturing	46.4	46.0	51.2
	ISM services	52.7	53.9	53.5
Hard data	UI Claims 4-week ave. (% increase from past year min)	24%	23%	9%
	Temp. help services jobs (% drawdown from past year max)	-5.4%	-4.7%	-3.2%
	Average hours worked (% drawdown from past year max)	-0.9%	-0.9%	-0.6%
	Building permits (% drawdown from past year max)	-13%	-15%	-24%
	Real consumption (3-month, % ann)	2.9%	1.2%	2.1%

*Previous Friday for financial data, previous month for hard and soft data (quarter for CEO confidence)
** As of Thursdays
NBF Economics and Strategy (data via Refinitiv, Bloomberg)

How can this weakness coexist with positive economic surprises? The answer lies in the sharp disconnect between leading and coincident economic indicators as reported by the Conference Board. While the leading indices have turned sharply downward on a 12-month basis, the corresponding coincident gauge has remained in positive territory, a historically unusual situation (chart).

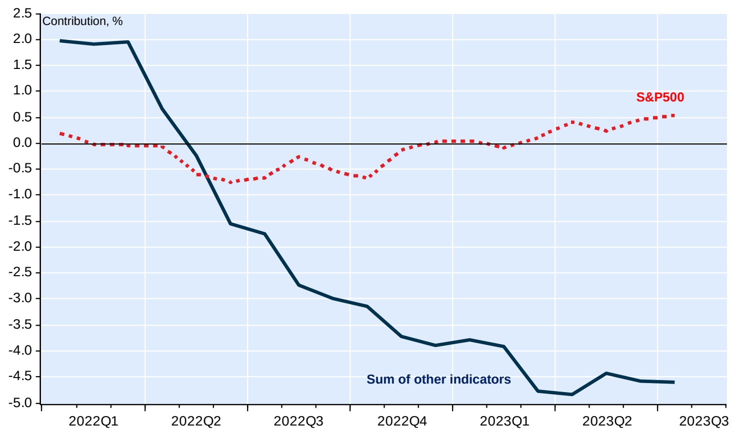
U.S.: Disconnect between leading and coincident economic data
Annual change in the Conference Board's coincident and leading economic indices



NBF Economics and Strategy (data via Conference Board)

As a result, the S&P 500 has parted ways from other leading economic indicators (chart).

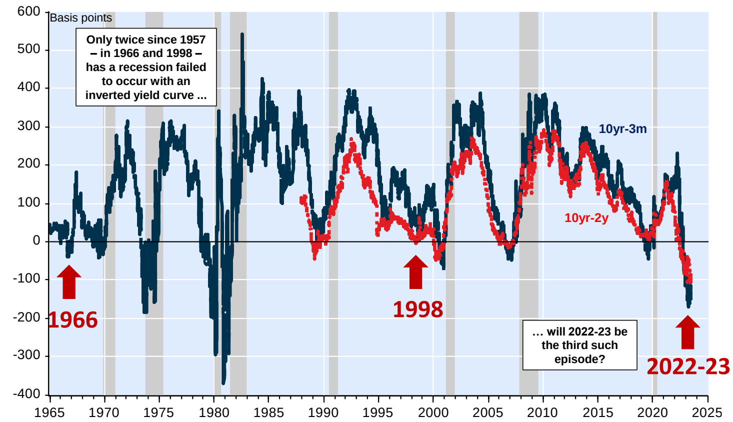
S&P500: A justified optimism?
Contribution to the Conference Board Leading Economic Index, 6-month moving sum, %



NBF Economics and Strategy (data via Bloomberg)

Amid components tracked by the Conference Board's leading economic index, we view one as particularly worrying from an equity standpoint. Indeed, the spread between the 10 year and 3-month treasuries is deeply negative, something that has historically tended to precede an economic downturn (chart).

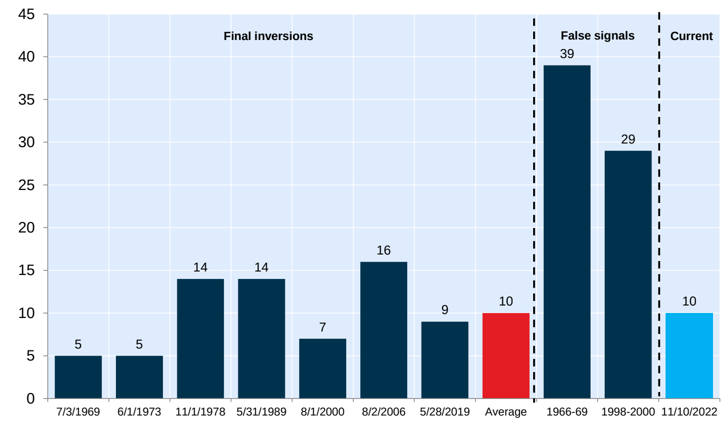
U.S.: Yield curve and business cycles
10-year Treasury yield minus 3-month T-bill and 2-year Treasury yields



NBF Economics and Strategy (data via Refinitiv)

While some might argue that this inversion could end up being the third false signal ever sent by this indicator, it is important to keep in mind that a leading indicator, as the name says, precedes the business cycle. As such, it is not unusual (and in fact, it is typical) for the economy to remain in expansion for a few months following the inversion of the yield curve. On average, the U.S. economy falls in recession 10 months after the inversion of the 10 year – 3-month yield curve (YC). It is now 10 months since the current inversion took place (chart).

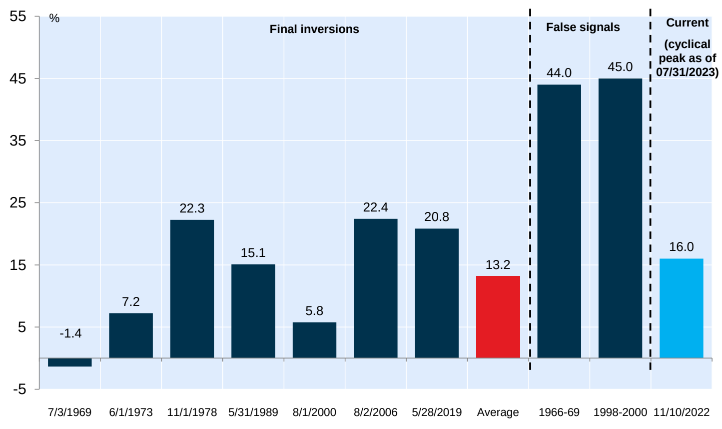
U.S.: Yield curve inversions and recessions
Months until recessions following the inversion of the yield curve (10y-3m)



NBF Economics and Strategy (data via FRED, NBER)

It is also typical to see positive returns for the stock market following a YC inversion. These have historically averaged 13.2%, roughly in line with the recent rebound of the S&P 500 of 16% (chart).

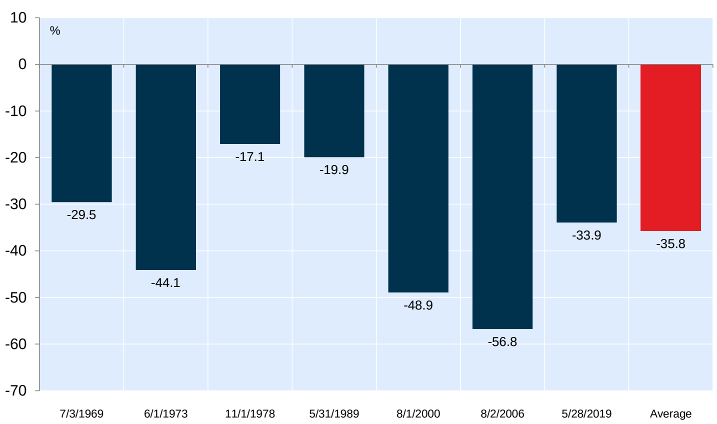
S&P 500: Historical performance following yield curve inversion
Cumulative returns of the S&P 500 until its cyclical peak after an inversion of the yield curve



NBF Economics and Strategy (data via Bloomberg)

But historically, these gains are short-lived if a recession is confirmed. In fact, the S&P 500 tends to quickly post deep negative returns from its cyclical peaks (chart).

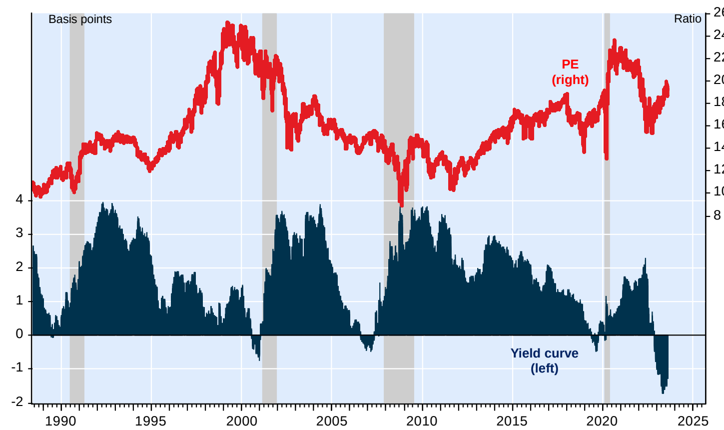
S&P 500: Sharp declines when yield curve inversion signals recession
Cumulative returns of the S&P 500 from its cyclical peak to its through following an inversion of the yield curve



NBF Economics and Strategy (data via Bloomberg)

Adding to our concerns, the S&P 500 continues to trade at a rich valuation of just over 18 times forward earnings. The S&P 500's P/E ratio has never been this high when the U.S. yield curve is this inverted (chart).

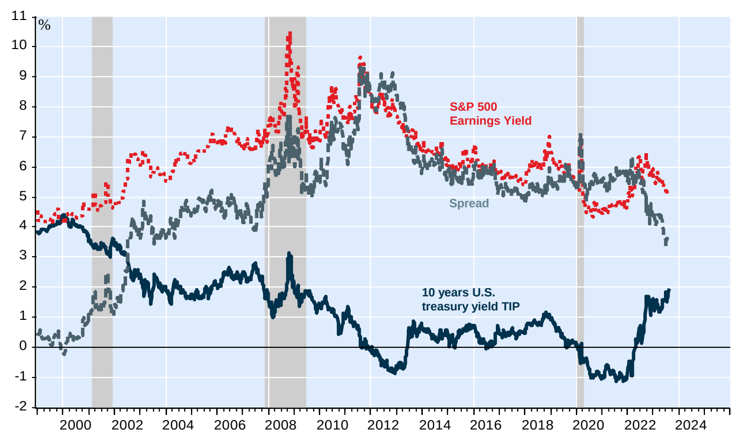
S&P 500: Trading at over 18x despite one of the most inverted YC ever
12-month forward PE vs yield curve (10-year Treasury yield minus 3-month T-bill)



NBF Economics and Strategy (data via Refinitiv)

This valuation seems particularly optimistic in an environment where 10-year real rates are approaching 2% for the first time in 15 years. The spread between the earnings yield and the 10-year TIPS (a measure of the equity risk premium) is the narrowest since 2003 - chart.

U.S.: Perspective on valuation
S&P500 earnings yield and 10 years U.S. treasury yield TIP



NBF Economics and Strategy (data via Refinitiv)

S&P/TSX: Many challenges

Like most equity indices, the S&P/TSX is struggling in Q3, with all sectors except consumer staples and energy down (table). Materials have been hit particularly hard by the headwinds for gold stocks from the recent strengthening of the USD and the rise in real interest rates. Banks and consumer discretionary stocks are also notable underperformers. The benchmark's weakness is due to concerns about the exposure of Canadian households to higher interest rates, as well as the fact that the Chinese economy is slowing rapidly.

S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	-3.8	-1.6	2.3
CONS. STAP.	2.6	0.2	4.6
ENERGY	1.5	5.6	0.5
INDUSTRIALS	-1.8	-1.2	6.8
TELECOM	-2.3	-8.5	-9.0
REAL ESTATE	-2.5	-1.0	-0.1
UTILITIES	-4.3	-5.5	-2.8
HEALTH CARE	-4.8	15.3	15.5
FINANCIALS	-6.0	-3.0	-1.5
MATERIALS	-6.8	-0.9	-1.2
BANKS	-7.3	-4.0	-5.4
CONS. DISC.	-7.5	-6.9	2.5
IT	-8.0	-6.2	38.2

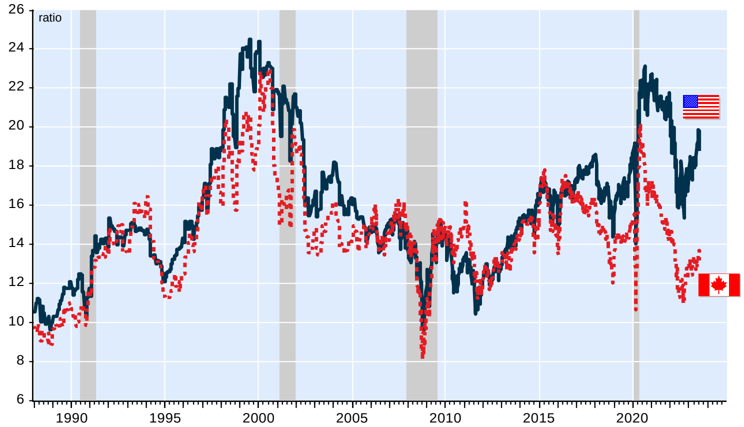
8/25/2023

NBF Economics and Strategy (data via Refinitiv)

Some of these concerns are already reflected in the low valuation of the S&P/TSX. At just under 13 times forward earnings, the Canadian benchmark trades six points below the P/E of the S&P 500. This compares to a historical average gap of 1.4 points (chart).

S&P/TSX: Trading at a steep discount to the S&P500

12-month forward PEs for the S&P500 and the S&P/TSX



NBF Economics and Strategy (data via Refinitiv)

Low P/E ratios are the norm across the major sectors of the S&P/TSX, with only industrials showing a valuation above its 10-year average. At the other end of the spectrum, energy, health care, materials and financials are the most depressed relative to their average over the past decade (table).

S&P/TSX : Price to 12-month forward earnings

	8/25/2023	A year ago	10 year ave.	5 year average
S&P TSX	12.9	12.2	15.1	14.5
ENERGY	11.0	8.6	33.3	36.1
MATERIALS	16.3	11.2	18.4	16.0
INDUSTRIALS	21.2	24.5	19.7	23.0
CONS. DISC.	13.6	13.3	14.2	14.1
CONS. STAP.	15.6	16.6	17.0	16.7
HEALTH CARE	6.5	29.4	16.3	20.8
FINANCIALS	9.3	9.9	11.2	10.5
BANKS	9.2	9.5	10.8	10.3
IT	30.4	32.4	31.2	41.6
TELECOM	15.7	17.8	16.5	17.1
UTILITIES	19.1	24.0	20.7	22.3
REAL ESTATE	13.9	NA	NA	NA

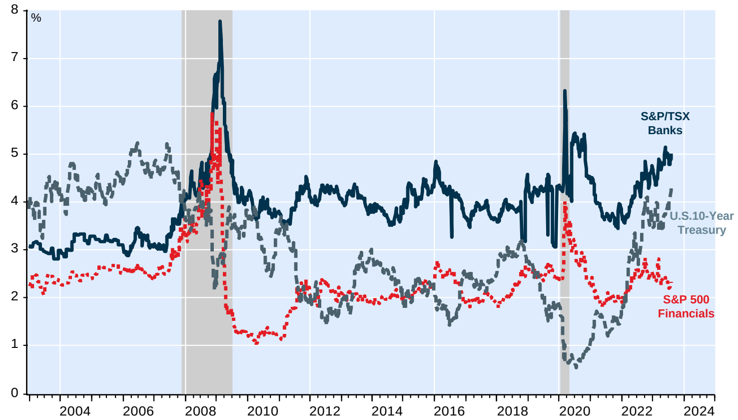
8/25/2023

NBF Economics and Strategy (data via Refinitiv)

Within financials, it is interesting to note that the dividend yield (DY) of S&P/TSX banks is above 5%, which is very rare outside of recessions. This compares to a DY of 2.3% for the S&P 500 financials and about 4.2% for the yield on the 10-year U.S. Treasury (chart).

S&P/TSX: Dividend yield exceeds 5% for banks

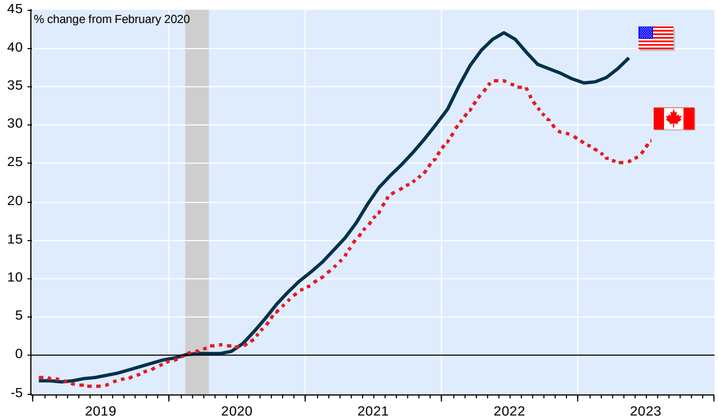
Dividend yield for S&P/TSX Banks and S&P500 Financials versus yield on 10-year U.S. treasury



NBF Economics and Strategy (data via Refinitiv)

Canadian bank valuations are being driven by concerns that an impending payment shock could cause a number of homeowners to default and weaken the mark-to-market value of the mortgages held by the banks. This is not our baseline scenario at this point. Despite higher interest rates, house prices are rising again. The Teranet-National Bank national house price index rose by 2.4% between June and July, the fourth consecutive increase and the second highest monthly gain on record. Canadian house prices have already recovered half of what they've lost since peaking in April 2022 (chart).

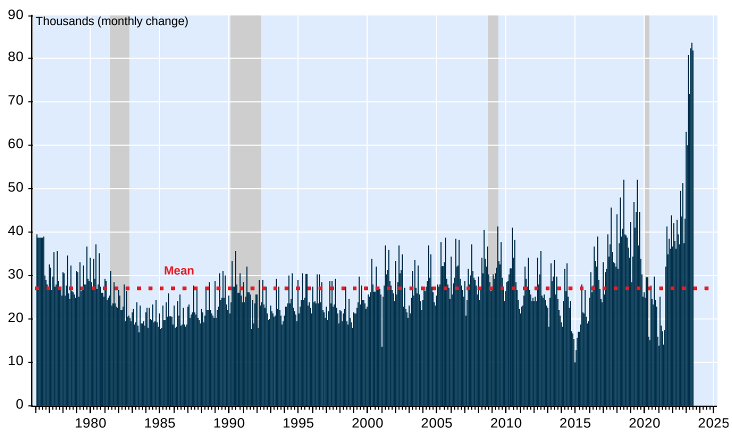
Canada-U.S.: Historical perspective on real estate prices
Teranet-National Bank House Price Index (composite-11) and Case-Shiller index (composite-20)



NBF Economy and Strategy(data via Teranet-National Bank and Refinitiv)

The biggest driver of this increase is Canada's unprecedented demographic boom. Since the beginning of the year, the working-age population has been growing by 80,000 a month. This is three times the historical average of 27,000 (chart).

Canada: Surging population growth
Working-age population (aged 15+)



NBF Economics and Strategy (data via Statistics Canada, U.S. BEA and Federal Reserve)

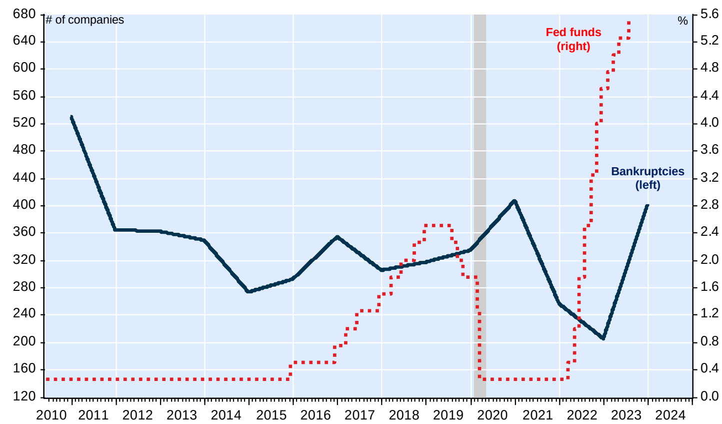
As long as Ottawa does not announce a major U-turn on its immigration policy, we do not expect home prices to revisit recent troughs.

Asset allocation

We have been arguing since our May publication that a deeply inverted yield curve did not bode well for the economy. We also said that we didn't think the Fed would live up to market expectations, which at the time were calling for rate cuts as early as this summer. Our views have not changed. If anything, our dashboard continues to suggest high risks of a U.S. recession at the turn of 2024. On the interest rate front, it doesn't look like the Federal Reserve is going to change course anytime soon.

Indeed, Fed Chairman Jerome Powell recently acknowledged in Jackson Hole that the current stance of U.S. monetary policy is restrictive, but he also said that the precise degree of monetary restraint is difficult to assess because it is difficult to identify with confidence the neutral rate of interest due to uncertainty about the length of the lags with which monetary tightening affects economic activity and, in particular, inflation. This statement implies that the Fed is willing to keep its monetary policy tight and tolerate more bankruptcies until it sees collateral damage in the labour markets. According to S&P Global Market Intelligence, 402 bankruptcies had already been recorded since the start of the year in July. The last time bankruptcies were near or above current levels, the Fed Funds rate was a paltry 0.25% vs. 5.5% this time around (chart).

U.S.: Corporate bankruptcies are surging
Fed funds rate vs. U.S. corporate bankruptcies (year-to-date as of July of each year)*



* Public or private companies covered by S&P global with public debt equal or greater than $2 million ($10 million for private companies)
NBF Economics and Strategy (data via Refinitiv and S&P Global)

Given our view of a rapidly slowing economy, we are keeping our defensive asset mix this month.

NBF Asset Allocation	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	18	
U.S. Equities	20	16	
Foreign Equities (EAFE)	5	3	
Emerging markets	5	3	
Fixed Income	45	51	
Cash	5	9	
Total	100	100	

NBF Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

Sector rotation

Our sector rotation remains unchanged this month, with a preference for more defensive sectors (consumer staples, communications services, and utilities), an appropriate positioning when the earnings yield is below the return on cash. We are keeping resources market weight again this month given the complex geopolitical backdrop and the energy transition policies that limit the downside for metals. We are prepared to change this stance if Beijing is found wanting in its attempt to get its economy back on track.

NBF Market Forecast
Canada

		Actual	*Q4 2023*
Index Level		**Aug-29-23**	***Target***
S&P/TSX		20,290	19,000
Assumptions			Q4 2023
Level:	Earnings *	1453	1415
	Dividend	681	664
PE Trailing (implied)		14.0	13.4

** Before extraordinary items, source Thomson*

NBF Economics and Strategy

NBF Market Forecast
United States

		Actual	*Q4 2023*
Index Level		**Aug-29-23**	***Target***
S&P 500		4,498	4,000
Assumptions			Q4 2023
Level:	Earnings *	216	210
	Dividend	70	68
PE Trailing (implied)		20.8	19.0

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

NATIONAL BANK OF CANADA FINANCIAL MARKETS

NBF Fundamental Sector Rotation - September 2023

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Market Weight**	**17.9%**
Energy Equipment & Services	Market Weight	0.2%
Oil, Gas & Consumable Fuels	Market Weight	17.7%
Materials	**Market Weight**	**11.9%**
Chemicals	Underweight	1.6%
Containers & Packaging	Market Weight	0.4%
Metals & Mining *	Market Weight	3.1%
Gold	Overweight	6.4%
Paper & Forest Products	Market Weight	0.4%
Industrials	**Underweight**	**13.6%**
Capital Goods	Market Weight	2.9%
Commercial & Professional Services	Underweight	3.1%
Transportation	Underweight	7.6%
Consumer Discretionary	**Underweight**	**3.7%**
Automobiles & Components	Underweight	0.8%
Consumer Durables & Apparel	Underweight	0.5%
Consumer Services	Underweight	1.1%
Retailing	Market Weight	1.3%
Consumer Staples	**Overweight**	**4.2%**
Food & Staples Retailing	Overweight	3.6%
Food, Beverage & Tobacco	Overweight	0.6%
Health Care	**Market Weight**	**0.3%**
Health Care Equipment & Services	Market Weight	0.1%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	0.2%
Financials	**Market Weight**	**30.2%**
Banks	Market Weight	19.7%
Diversified Financials	Market Weight	4.0%
Insurance	Market Weight	6.5%
Information Technology	**Market Weight**	**7.6%**
Telecommunication Services	**Overweight**	**3.9%**
Utilities	**Overweight**	**4.2%**
Real Estate	**Underweight**	**2.4%**

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

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