Monthly Equity Monitor

Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

November 2022

Highlights

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- Recent developments in the U.S. offer hope that central banks may soon declare a ceasefire and halt their tightening campaign to limit the collateral damage to the economy and profits. Three-month annualized core goods inflation, which was a record 26.3% in June 2021, was only 0.4% in October 2022. This improvement is much faster than in the stagflation era when it took more than a decade of high unemployment to bring goods inflation down to current levels.

- The better-than-expected trend in inflation paved the way for USD depreciation and a significant recovery in global stock markets. The MSCI ACWI is already up 10.2% since the start of the fourth quarter, with half of those gains coming in the five days leading up to November 11.

- The S&P 500 Q3 2022 earnings reporting season is ending on a positive note. As of this writing, nearly 70% of companies had reported better-than-expected earnings. The outlook, however, remains challenging. Downward revisions were widespread, with just over 20% of S&P 500 companies revising upward their earnings per share estimates for the coming year, the worst since the COVID recession.

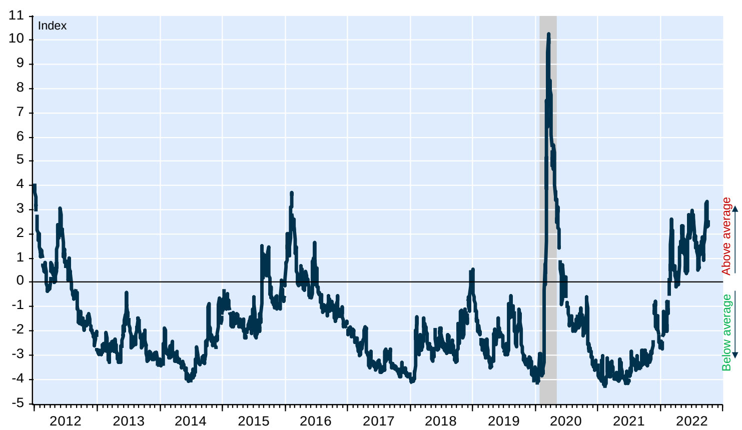
- The third quarter 2022 reporting season is also ending in Canada, with earnings per share for the S&P/TSX as a whole beating expectations by a larger margin than for the S&P 500. But this is mostly due to the energy sector, where companies reported earnings 25.4% above expectations. The key for a tangible expansion in the PE of energy companies will depend on their ability to deploy carbon capture, utilization and storage (CCUS) technologies that would significantly extend the life of fossil oil extraction while reducing CO_2 emissions.

- Our asset allocation is unchanged this month. Equities remain underweight, fixed income retains its market weight and cash is slightly overweight. Despite the improving inflation backdrop in the U.S., the Fed has yet to commit to a pause in its interest rate tightening campaign. This obstacle must be overcome before we can become more constructive on the profit outlook.

World: Central banks ceasefire?

Inflation remains stubbornly high around the world, forcing the hand of central banks to continue to raise their policy rates. Against this backdrop, since the last publication of this report, global financial tensions have essentially not moved from their elevated levels (chart). As we have argued in our recent Economic Monitors, this is consistent with slower economic growth ahead. Whether central banks continue to tighten financial conditions further and push the economy over the edge will depend on inflation.

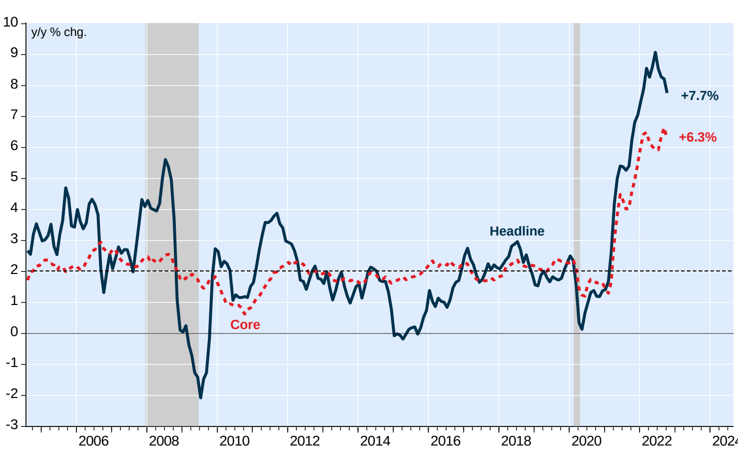
World: Financial stress is mounting
Global financial stress index



NBF Economics and Strategy (data via OFR)

Fortunately, recent developments in the U.S. offer hope that central banks may soon declare a ceasefire and halt their tightening campaign to limit the collateral damage to the economy and profits. CPI data came in below consensus expectations in October for just the second time in the past 8 months. Year on year, headline inflation clocked in at 7.7%, down from 8.2% the prior month and two ticks below the median economist forecast - chart.

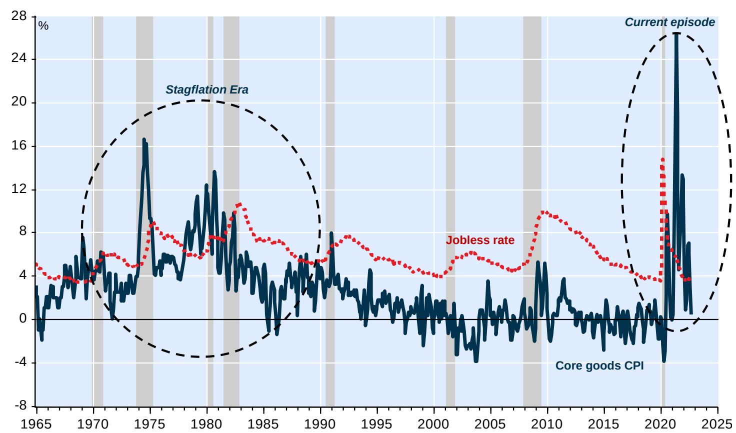
U.S.: Inflation eased more than expected in October
Consumer Price Index



NBF Economics and Strategy (data from Bloomberg)

While these figures remain unacceptably high, there are signs of a more significant turnaround, particularly in the consumer goods segment where price cuts are now being made. After a stable reading in September the core goods CPI fell 0.4% in October. As a result, three-month annualized inflation, which was a record 26.3% in June 2021, was only 0.4% in October 2022. This improvement is much faster than in the stagflation era when it took more than a decade of high unemployment to bring inflation down to current levels - chart.

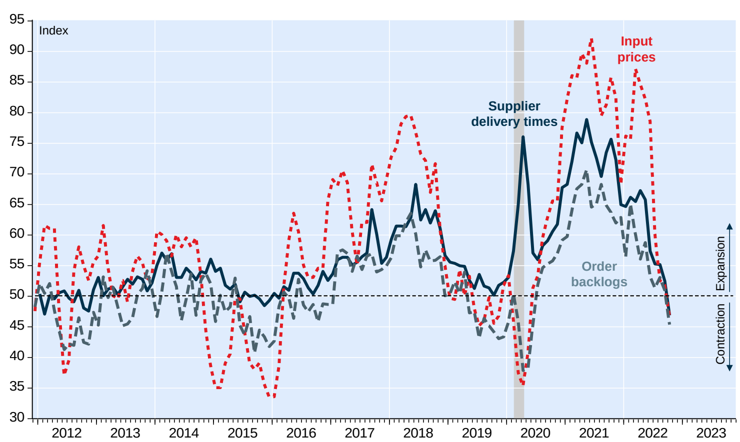
U.S.: Goods inflation falling much faster than in the stagflation era
Three-month annualized change in the core goods CPI vs unemployment rate



NBF Economics and Strategy (data via Refinitiv)

It is important to note that this trend is likely to continue judging by the current setbacks in the manufacturing sector, where input prices, order backlogs and supplier lead times are all declining - chart.

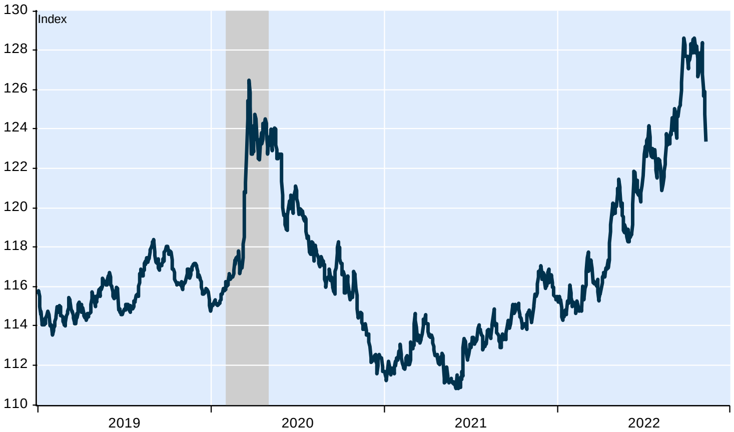
U.S.: Manufacturing supply chain rapidly becoming more fluid
ISM Manufacturing PMI



NBF Economics and Strategy (Refinitiv data)

The better-than-expected trend in US inflation paved the way for the greenback's biggest weekly decline since 2009 and a significant recovery in global stock markets. A wave of major corporate layoffs, accompanied by forced deleveraging, could still be avoided to get inflation back to normal.

U.S.: Greenback finally weakens
Nominal trade-weigthed U.S. dollar index against 26 currencies



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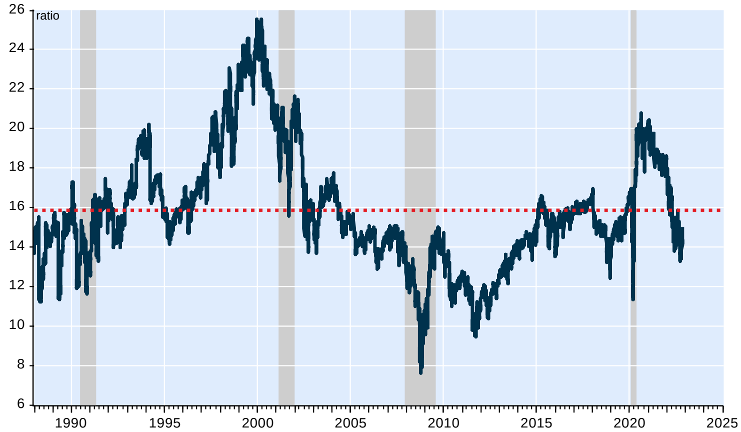
World: Forward PE near historical average
12-month forward PE for the MSCI ACWI



NBF Economics and Strategy (data via Refinitiv)

The MSCI ACWI is already up 10.2% since the start of the fourth quarter, with half of those gains coming in the five days leading up to November 11. As shown in the table below, all major regions except for Latin America are posting strong increases in November, with a particularly solid performance by EM Asia (+9.8%) thanks to the expected easing of COVID restriction in China.

MSCI composite index: Price Performance

	Month to date	Quarter to date	Year to date
MSCI ACWI	4.0	10.2	-15.0
MSCI World	3.6	10.9	-14.5
MSCI USA	3.1	11.2	-17.4
MSCI Canada	3.3	9.0	-5.5
MSCI Europe	4.9	11.2	-10.0
MSCI Pacific ex Jp	7.0	7.7	-7.9
MSCI Japan	2.9	8.8	-1.4
MSCI EM	7.7	4.8	-19.0
MSCI EM EMEA	2.0	6.8	-20.0
MSCI EM Latin America	-0.5	6.5	1.5
MSCI EM Asia	9.8	4.3	-20.5

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NBF Economics and Strategy (data via Refinitiv)

After its recent rebound, the MSCI ACWI is trading at a PE ratio of 15x forward earnings. This ratio is in line with its historical average of 15.8x since 1988 (chart).

That's not cheap considering major central banks have yet to announce a pause in their tightening and earnings are still being revised downward (table).

MSCI : change in 12-month forward earnings

	3-month change		1-month change		1-month diffusion (% up)	
	3-month change	10 year historical average	1-month change	10 year historical average	1 month diffusion	10 year historical average
MSCI ACWI	-3.2	-0.4	-2.5	-0.4	34%	45%
MSCI World	-3.0	-0.4	-2.5	-0.4	35%	47%
MSCI USA	-4.7	-0.3	-3.5	-0.3	27%	48%
MSCI Canada	-2.0	-0.4	-2.3	-0.4	19%	45%
MSCI Europe	0.3	-0.7	-0.5	-0.7	41%	43%
MSCI Pacific ex Jp	-2.0	-0.4	-0.8	-0.4	32%	42%
MSCI Japan	0.7	0.0	-0.2	0.0	51%	51%
MSCI EM	-4.8	-0.5	-2.6	-0.5	33%	42%
MSCI EM EMEA	2.3	-0.3	-0.4	-0.3	43%	45%
MSCI EM Latin America	-3.8	-0.6	-0.9	-0.6	56%	42%
MSCI EM Asia	-6.2	-0.5	-3.3	-0.5	30%	41%

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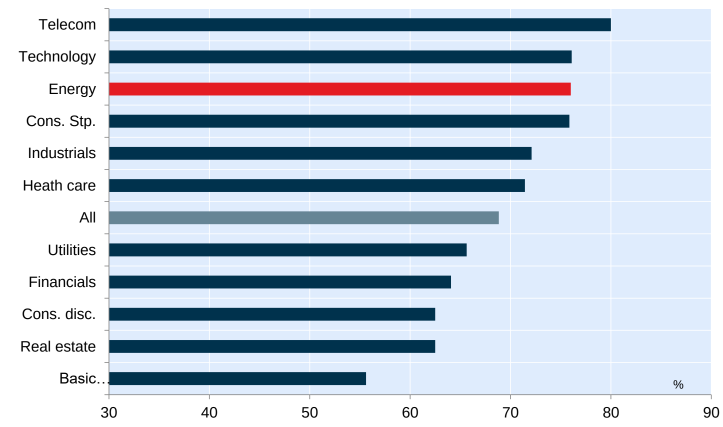
NBF Economics and Strategy (data via Refinitiv)

U.S.: A good earnings season, but...

The S&P 500 Q3 2022 earnings reporting season is ending on a positive note. As of this writing, nearly 70% of companies had reported better-than-expected earnings. The energy sector did particularly well this earnings season with profits up a whopping 150% compared to the same quarter last year. Close to 80% of companies reported earnings that surprised to the upside (chart).

S&P500 : Energy earnings surprised on the upside in Q3
Share of companies reporting higher than expected benefits (as of November 12)



NBF Economics and Strategy (data via Bloomberg)

This performance has been extremely gratifying for the sector, with energy stocks already up a whopping 29.6% since the start of Q4 (table). Industrials (+20%) and materials (+19.4%) have also gained quarter-to-date, but both sectors remain in the red in 2022. Only energy is showing a positive year-to-date return.

S&P 500 composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P 500	3.1	11.4	-16.2
MATERIALS	9.6	19.4	-10.3
FINANCIALS	5.6	18.1	-8.4
INDUSTRIALS	5.4	20.0	-6.0
REAL ESTATE	5.4	7.4	-25.3
IT	3.8	11.9	-23.8
ENERGY	3.8	29.6	69.4
TELECOM	2.8	2.7	-37.8
UTILITIES	1.8	3.8	-5.1
CONS. STAP.	1.1	10.1	-4.8
CONS. DISC.	0.5	0.7	-29.8
HEALTH CARE	0.2	9.9	-5.7

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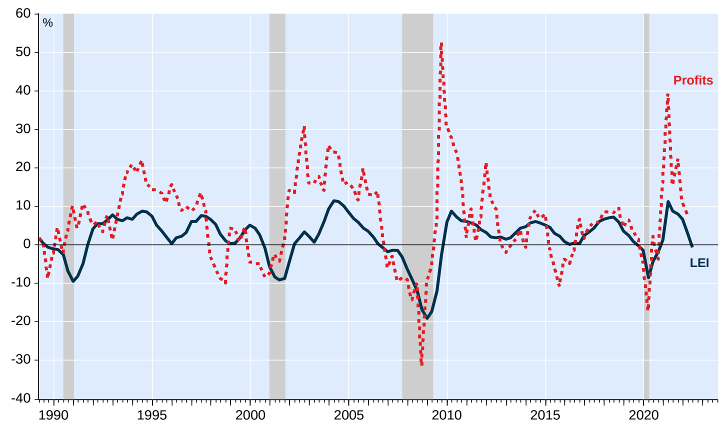
NBF Economics and Strategy (data via Refinitiv)

The earnings outlook remains challenging. On a year-over-year basis, the Conference Board's leading economic indicator has just turned negative, which is normally a sign of earnings contraction – chart.

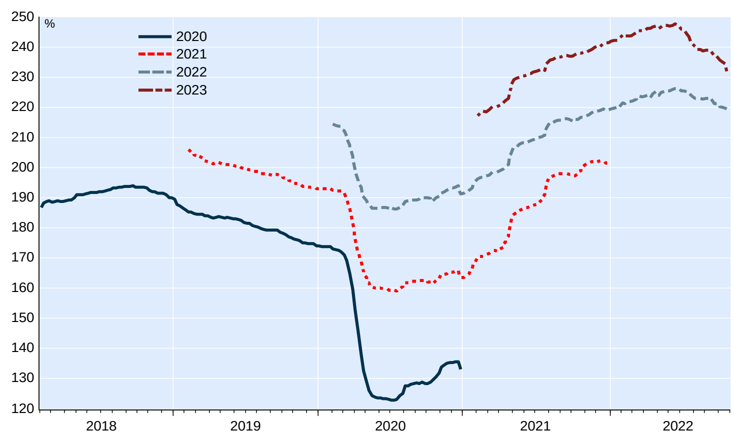
United States: Leading indicators signal weaker profits ahead
Leading Economic Indicator and profits, annual % change. Last observation: 2022Q3 for LEI, 2022Q2 for profits



NBF Economics and Strategy (Source: Conference Board via Refinitiv)

In-line with this scenario, earnings per share forecasts for 2023 have been falling steadily after peaking in late June - chart.

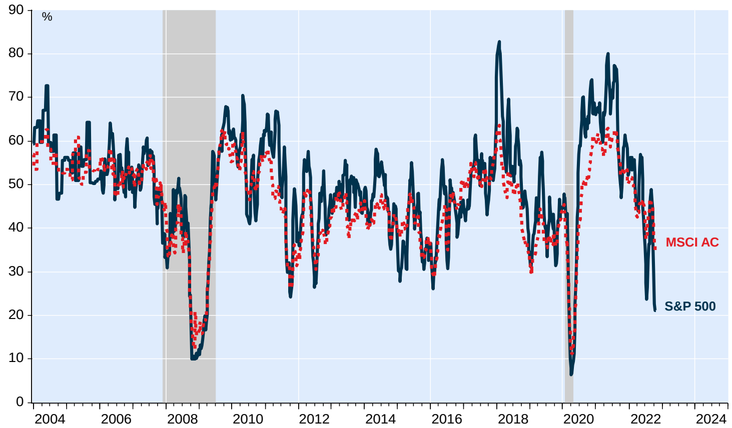
S&P 500: EPS expectations for 2023 are softening
EPS expectations by year



NBF Economics and Strategy (data via Refinitiv)

In addition, downward revisions were widespread, with just over 20% of S&P 500 companies revising upward their earnings per share estimates for the coming year in the past month. This diffusion, the worst since the COVID recession, is also well below that of the MSCI ACWI (35%) - chart.

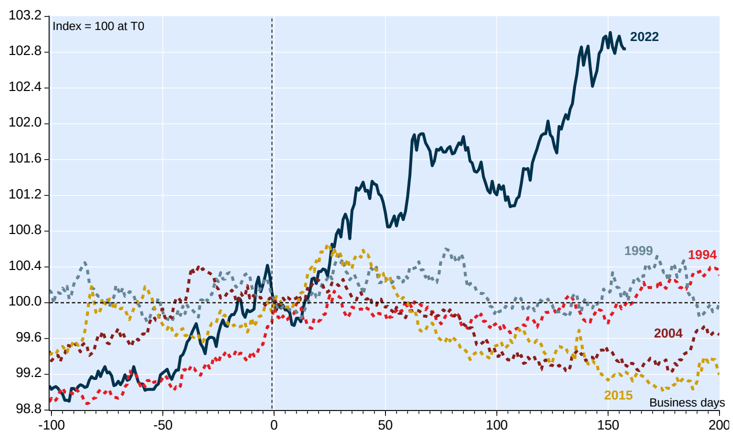
S&P 500 and MSCI AC: Diffusion of positive earnings revisions
Number of corporations revising earnings upward/Number of corporation revising earnings (November 1st)



NBF Economics and Strategy (data via Refinitiv)

The most dramatic tightening of financial conditions in a generation at this point in the Fed's tightening cycle is about to hit corporate profits. Mr. Powell will soon have to pause in raising interest rates to avoid further weakening the economy.

U.S.: Financial conditions tightening at a blistering pace
Goldman Sachs Index of Financial Conditions, change since the first hike of a tightening phase



NBF Economics and Strategy (data via Bloomberg)

S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	3.5	9.0	-5.2
REAL ESTATE	7.5	10.3	-21.2
MATERIALS	7.3	6.5	-1.3
IT	5.0	16.4	-50.5
HEALTH CARE	4.5	11.9	-52.3
FINANCIALS	4.4	7.0	-8.7
BANKS	3.9	6.3	-8.4
ENERGY	3.4	17.7	36.1
TELECOM	2.1	7.1	-5.0
CONS. STAP.	1.4	6.9	7.3
CONS. DISC.	0.9	8.9	-7.5
INDUSTRIALS	0.5	7.6	0.7
UTILITIES	-0.8	-3.4	-9.3

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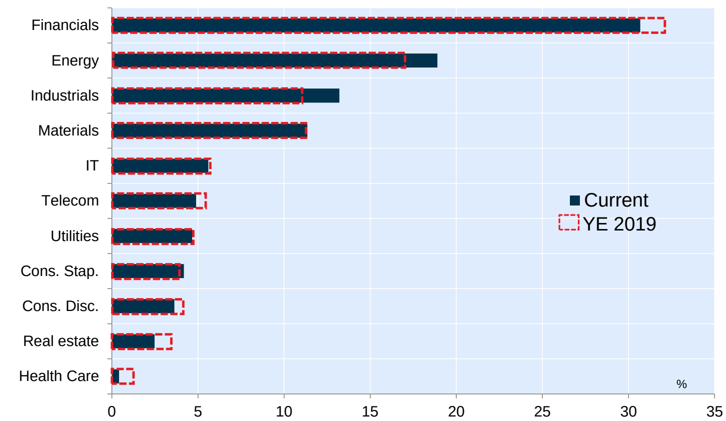
NBF Economics and Strategy (data via Refinitiv)

With a year-to-date gain of 36.1%, the energy sector now represents 19.1% of the S&P/TSX's market capitalization, up from 17% at year-end 2019. In comparison, the financials weighting is currently 31% - chart.

S&P/TSX: Sector weighting in total index
Year end 2019 compared to October 28, 2022



NBF Economics and Strategy (data via Bloomberg)

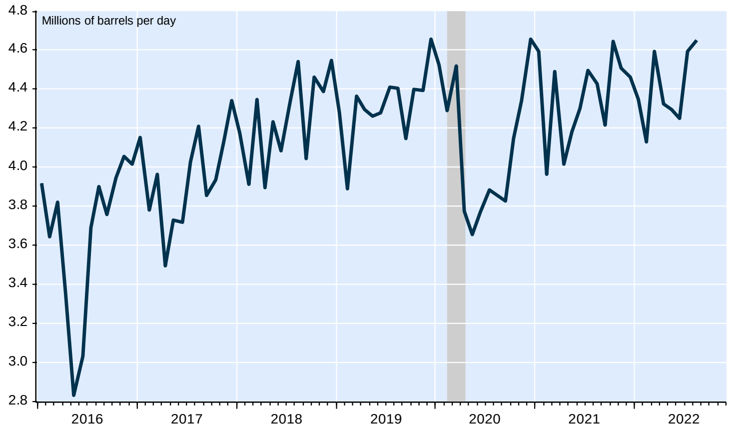
S&P/TSX: Energy boom

The third quarter 2022 reporting season is also ending in Canada, with earnings per share for the S&P/TSX as a whole beating expectations by a larger margin than for the S&P 500 (4 percentage points versus 3 percentage points). But this is mostly due to the energy sector, where companies reported earnings 25.4% above expectations (versus 9.42% for S&P 500 energy companies). Unsurprisingly, Energy companies are leading all other sectors of the S&P/TSX so far in Q4 with a 17.7% gain – table.

Energy could see its weight increase a little further in the coming quarters as Canadian oil production is expected to remain high for the foreseeable future to offset global supply disruptions caused by the war in Ukraine. The key to a larger piece of the S&P/TSX pie would be a tangible expansion in the PE of energy companies. Such an expansion will depend on the ability of companies to deploy carbon capture, utilization and storage (CCUS) technologies that would significantly extend the life of fossil oil extraction while reducing CO2 emissions.

Canada: Oil production hovers near a record high

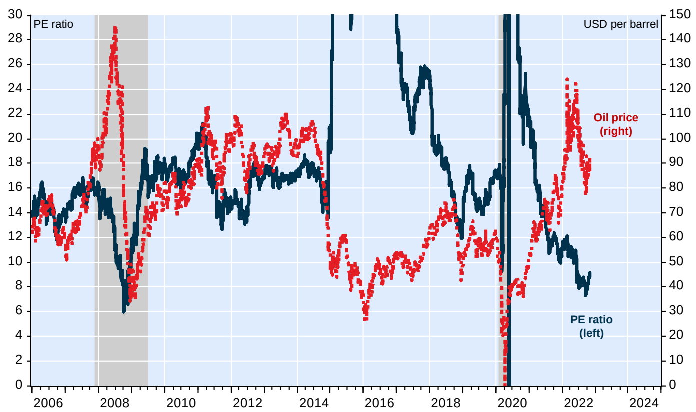
Canadian crude oil production



NBF Economics and Strategy (data via Statcan)

Canada: CCUS is key for PE expansion

Forward PE ratio for the S&P/TSX Energy sector vs. WTI oil price



NBF Economics and Strategy (data via Refinitiv)

Asset allocation

Our asset allocation is unchanged this month. Equities remain underweight, fixed income retains its market weight and cash is slightly overweight. Despite the improving inflation backdrop in the U.S., the Fed has yet to commit to a pause in its interest rate tightening campaign. This obstacle must be overcome before we can become more constructive on the profit outlook.

NBF Asset Allocation

	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	24	
U.S. Equities	20	18	
Foreign Equities (EAFE)	5	3	
Emerging markets	5	3	
Fixed Income	45	45	
Cash	5	7	
Total	100	100	

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Sector allocation

Our sector allocation is unchanged this month. As explained last month, we continue to favour materials and energy, which have historically performed well during the mature phase of the cycle, even when the yield curve is inverted. These sectors also offer protection in the event of stagflation.

NBF Market Forecast
Canada

Index Level	***Actual*** **Nov-11-22**	***Q1 2023 Target***
S&P/TSX	20,112	20,100
Assumptions		Q1 2023
Level: Earnings *	1561	1580
Dividend	636	644
PE Trailing (implied)	12.9	12.7

** Before extraordinary items, source Thomson*

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NBF Market Forecast
United States

Index Level	***Actual*** **Nov-11-22**	***Q1 2023 Target***
S&P 500	3,993	3,850
Assumptions		Q1 2023
Level: Earnings *	218	220
Dividend	65	66
PE Trailing (implied)	18.3	17.5

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

NBF Fundamental Sector Rotation - November 2022

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Overweight**	**19.1%**
Energy Equipment & Services	Overweight	0.0%
Oil, Gas & Consumable Fuels	Overweight	18.9%
Materials	**Overweight**	**11.7%**
Chemicals	Market Weight	2.0%
Containers & Packaging	Overweight	0.4%
Metals & Mining *	Overweight	2.9%
Gold	Overweight	6.0%
Paper & Forest Products	Market Weight	0.4%
Industrials	**Underweight**	**12.9%**
Capital Goods	Market Weight	2.4%
Commercial & Professional Services	Underweight	3.0%
Transportation	Underweight	7.5%
Consumer Discretionary	**Underweight**	**3.5%**
Automobiles & Components	Underweight	0.9%
Consumer Durables & Apparel	Underweight	0.4%
Consumer Services	Underweight	0.9%
Retailing	Market Weight	1.3%
Consumer Staples	**Overweight**	**4.1%**
Food & Staples Retailing	Overweight	3.5%
Food, Beverage & Tobacco	Overweight	0.5%
Health Care	**Market Weight**	**0.4%**
Health Care Equipment & Services	Market Weight	0.1%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	0.3%
Financials	**Market Weight**	**30.9%**
Banks	Market Weight	21.0%
Diversified Financials	Market Weight	4.1%
Insurance	Market Weight	5.9%
Information Technology	**Market Weight**	**5.6%**
Telecommunication Services	**Market Weight**	**4.8%**
Utilities	**Market Weight**	**4.5%**
Real Estate	**Underweight**	**2.5%**

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

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