Monthly Equity Monitor

Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

May 2024

Highlights

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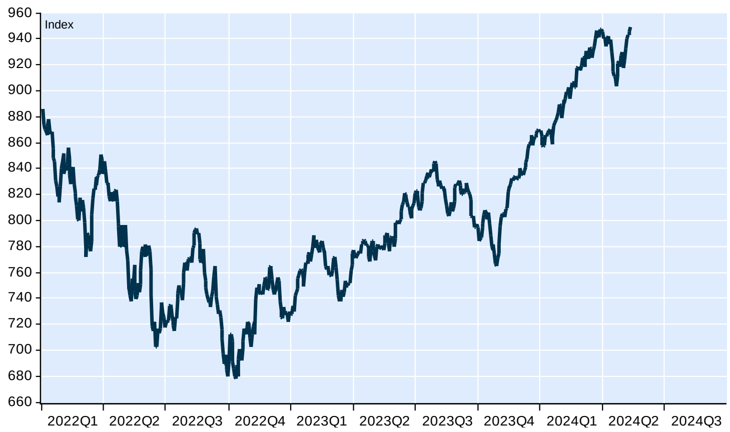
- Equities fell almost 5% in from their peak in April as questions were raised about the proximity of the start of the easing cycle, particularly in the US. However, this dip was short-lived and the MSCI ACWI has now fully recovered from April's slump.
- In the US, a strong first quarter earnings season has brought some optimism to the S&P 500. At the time of writing, almost 80% of companies that have reported have delivered positive surprises, with consumer staples, information technology, healthcare and industrials leading the way. Now that household excess savings have been fully exhausted and full-time employment is weakening, we do not believe that this earnings momentum can continue for much longer.
- Trailing earnings growth for the S&P/TSX has been negative for three consecutive quarters and the outlook doesn't suggest improvement, given the deterioration in the Economic Surprise Index. The economic weakness is being reflected in the labour markets. In the Greater Toronto Area, which accounts for 20% of Canada's GDP, the unemployment rate is already close to 8%, the highest level since 2014.
- Unsurprisingly, this weakening in employment conditions has led to significant downward revisions in earnings estimates in consumer-related industries. For its part, the energy sector is in a better position to beat expectations in the coming quarters. For one, the start of commercial operations of the Trans Mountain pipeline (TMX) in May should allow for both an increase in oil exports and a narrowing of the WCS-WTI spread. As far as natural gas producers are concerned, their earnings should benefit from the increased demand for electricity, which is starting to grow again after 15 years of stagnation.

World: Recovering from a bad month

With the start of the easing cycle by major central banks still awaited, global equities had a difficult start to the second quarter. In the first half of April, equities fell almost 5% from their peak as recent data from the U.S. seemed to postpone the first rate cut. However, this dip was short-lived and the MSCI ACWI has now fully recovered from April's slump - chart.

World: Equities back to a record high despite a difficult month of April
MSCI ACWI



NBF Economics and Strategy (data via Refinitiv)

As a result, on a quarter-to-date basis, global equities edged up 0.1%, with declines observed in the U.S. and Japan. On year-to-date basis, however, these two markets continue to fare well - table.

MSCI composite index: Price Performance

	Month to date	Quarter to date	Year to date
MSCI ACWI	3.1	0.1	9.2
MSCI World	3.3	-0.2	9.4
MSCI USA	3.7	-0.7	9.3
MSCI Canada	2.7	0.6	6.7
MSCI Europe	3.2	1.9	9.6
MSCI Pacific ex Jp	2.1	1.2	1.8
MSCI Japan	-0.9	-2.0	15.9
MSCI EM	2.0	3.2	7.4
MSCI EM EMEA	0.6	0.2	2.2
MSCI EM Latin America	1.2	-0.3	-3.3
MSCI EM Asia	2.3	4.1	9.6

5/10/2024

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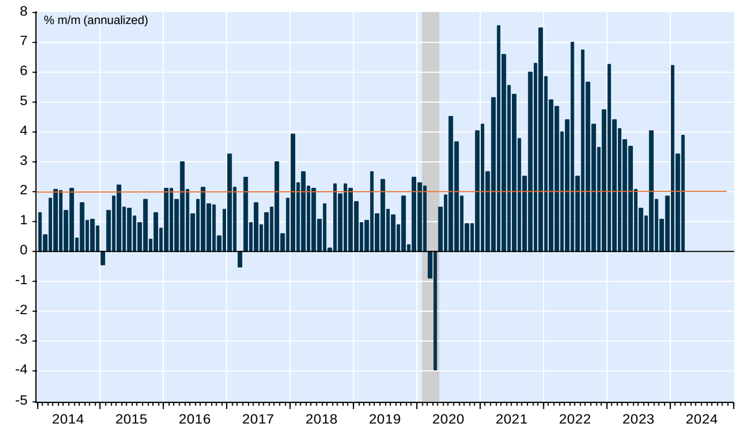
S&P 500: A good earnings season

The U.S. economy continued to impress in the first quarter of the year. While output slowed somewhat, domestic demand remained resilient, especially considering the level of interest rates the economy is operating under. Had inflation continued to normalize towards the 2% target as it did up until the end of 2023, this could have meant a realization of the immaculate disinflation or perfect economic soft- landing scenario that many anticipate. But over the last three months, inflation has rather shifted gears and started to rise again - chart.

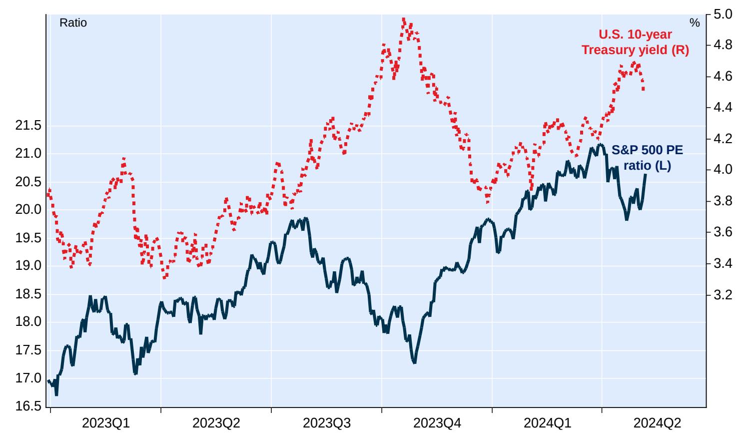
U.S.: Inflation refuses to stay down
Core PCE deflator



NBF Economics and Strategy (data via Fred)

This pick up in price pressures led to a reassessment of expectations regarding the timing of the Federal Reserve's first cut, with some observers even wondering whether the next move might be a hike rather than a cut. Although these expectations receded somewhat after Chairman Powell took a less hawkish stance than expected in his latest decision, they weighed on the S&P 500 through lower valuations - chart.

U.S.: Fed repricing weighs on valorisations
U.S. Treasuries (10-year yield) and PE ratio of the S&P 500



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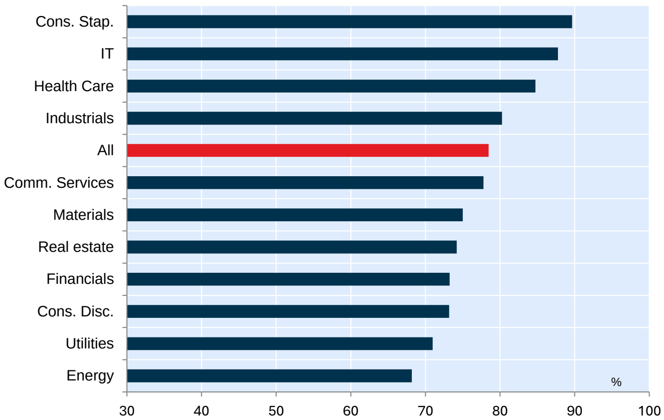
Counterbalancing this pressure, a good first-quarter earnings season brought some optimism to the equities markets. At the time of writing, almost 80% of companies that have reported their results have posted positive surprises, with Consumer Staples, IT, Health Care and Industrials leading the way. The Energy and Utilities sectors, meanwhile, lagged behind - chart.

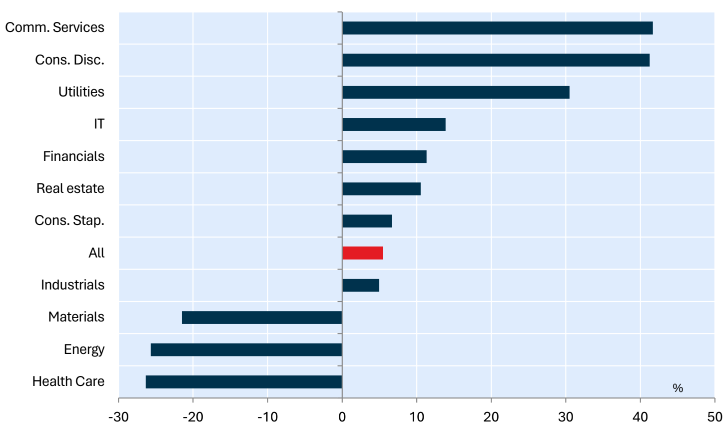
S&P500: Earnings surprised on the upside in Q1
% of companies reporting higher than expected benefits (as of May 9, 455/500 companies reported)



NBF Economics and Strategy (data via Bloomberg)

These surprises have translated into aggregate earnings growth of 5.5%. The most impressive increases were seen in the Communication Services, Consumer Discretionary and Utilities sectors, while Health Care, Energy and Materials registered declines - chart.

S&P500: Resilient growth in earnings in Q1
Average earnings growth (as of May 9, 455/500 companies reported)



NBF Economics and Strategy (data via Bloomberg)

The bottom-up consensus of analysts is expecting earnings to remain solid in the year ahead, as it anticipates a 12% growth in earning per share - table.

S&P 500 composite index: EPS analysts expectations

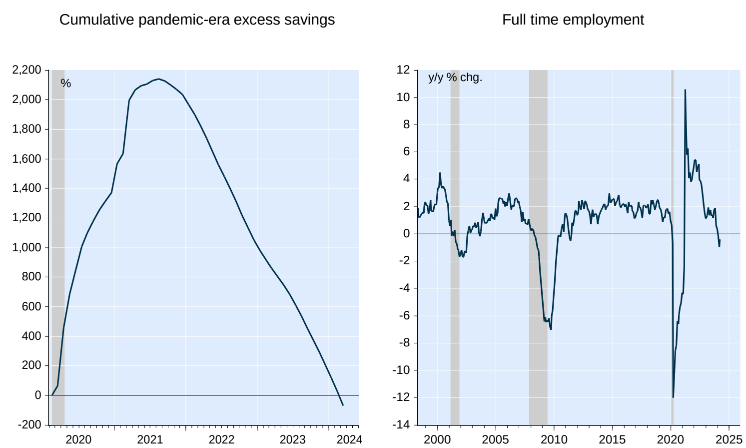
	Earnings per share					EPS % growth		
	2023	2024	2025	12m Trail.	12m Forw.	2024	2025	12m Forw.
S&P 500	217	239	272	227	255	10	14	12
ENERGY	58	56	61	57	58	-3	9	2
MATERIALS	27	27	31	27	28	-2	15	6
INDUSTRIALS	45	47	54	46	50	6	15	11
CONS. DISC.	50	57	65	53	60	13	15	14
CONS. STAP.	38	39	42	39	41	4	8	6
HEALTH CARE	76	83	98	79	89	9	19	13
FINANCIALS	40	43	48	42	45	8	11	9
IT	108	126	149	118	140	17	18	18
TELECOM	12	15	17	14	16	23	12	18
UTILITIES	18	20	22	19	21	12	8	10
REAL ESTATE	7	7	7	7	7	-2	8	2

5/10/2024 N.M.=Not meaningful

NBF Economics and Strategy (data via Refinitiv)

While we admit to being surprised by the current resilience, especially given the level of interest rates and the length of time they have remained at this level, we continue to disagree with this optimism. It is important to recall that the recent tightening cycle occurred against an unusual backdrop where consumers had plenty of pandemic-related savings to deploy, delaying the transmission of tighter rates to the economy. Now that this reserve is fully depleted and that the labour market seems to be rapidly losing steam, we do not think that this momentum can last much longer.

U.S.: A vulnerable consumer

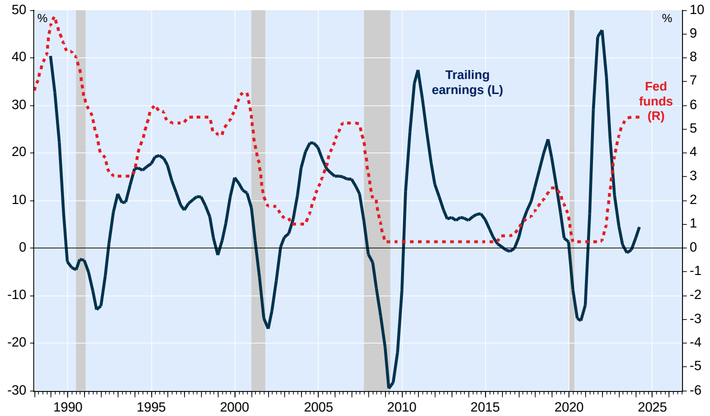


NBF Economics and Strategy (data via Datastream)

Looking ahead, we continue to believe that earnings face headwinds. As we approach the Fed's easing cycle, let's examine the historical behavior of earnings in the face of loosening financing conditions. This exercise shows that the last four easing cycles have always been accompanied by a slowdown or contraction in earnings as they normally occur in deteriorating economic conditions. We expect this time to be no different.

S&P500: No precedent for EPS acceleration at the end of a tightening cycle

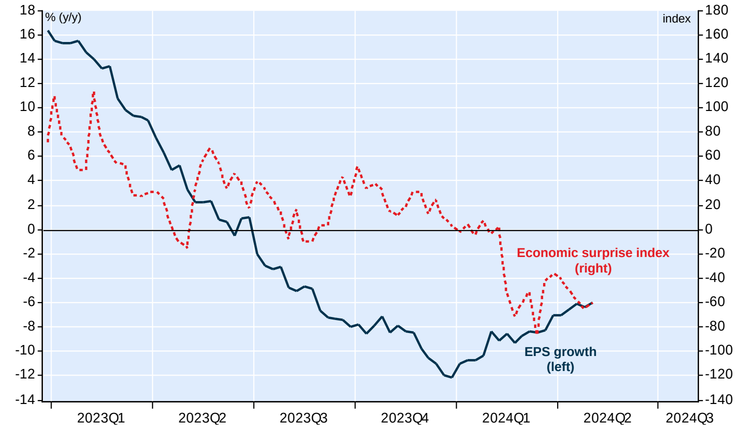
Annual change in 12-month trailing earnings and Federal Reserve policy rate



NBF Economics and Strategy (data via Refinitiv)

S&P/TSX: Earnings hit by weak economy

S&P/TSX 12-month trailing EPS vs CITI economic surprise index for Canada



NBF Economics and Strategy (data via Refinitiv and Bloomberg)

S&P/TSX: A positive outlook for energy

Despite significant declines in Health Care and IT, the S&P/TSX continues to post a small positive return almost halfway through the second quarter, led by Utilities (+7.2%), Materials (+5.6%), and Industrials (+4.1%) - table.

S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	2.7	0.6	6.4
UTILITIES	7.2	3.4	1.0
MATERIALS	5.6	11.8	17.8
INDUSTRIALS	4.1	-2.3	8.2
FINANCIALS	3.6	0.1	4.5
REAL ESTATE	3.2	-4.1	-3.4
ENERGY	2.6	3.7	15.9
BANKS	2.6	-1.6	0.4
TELECOM	2.3	0.4	-9.6
CONS. STAP.	1.9	1.0	4.7
CONS. DISC.	-0.5	-1.4	2.5
IT	-6.3	-11.7	-7.5
HEALTH CARE	-11.7	-16.5	-1.7

5/10/2024

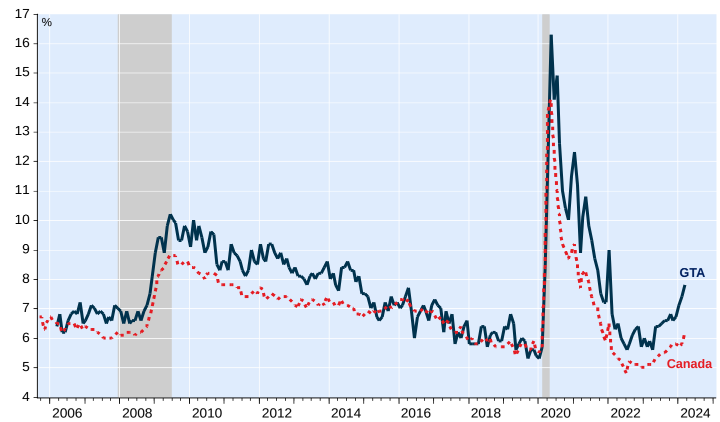
NBF Economics and Strategy (data via Refinitiv)

The lacklustre performance of other sectors reflects the weakness of the Canadian economy. Trailing earnings growth has been negative for three consecutive quarters and the outlook doesn't suggest improvement, given the deterioration in the Economic Surprise Index - chart.

The economic weakness is being reflected in the labour markets. At 6.1%, the national unemployment rate has already returned to levels last seen in 2018 (excluding the COVID recession). In the Greater Toronto Area, which accounts for 20% of Canada's GDP, the unemployment rate is already close to 8%, the highest level since 2014 – chart.

GTA: Jobless rate already near 8%

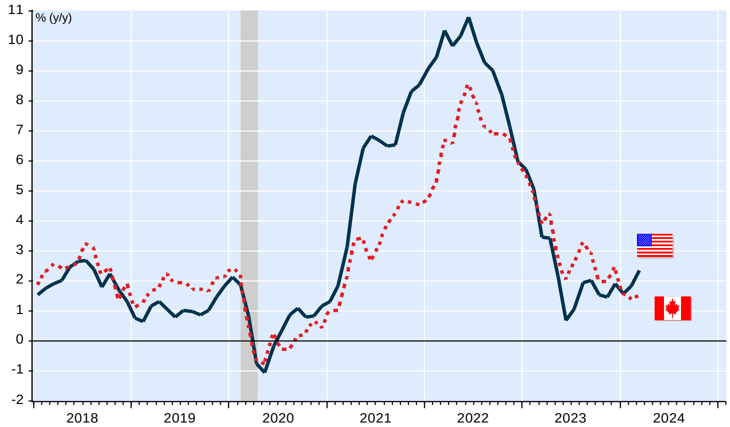
Unemployment rate: Greater Toronto Area (GTA) and Canada



NBF Economics and Strategy (data via Statistics Canada)

Unsurprisingly, this weakening in employment conditions has led to significant downward revisions in earnings estimates in consumer-related industries, where pricing power is also eroding faster than in the US - chart.

Canada: Less pricing power for retailers
CPI excluding shelter: Canada and the U.S.



NBF Economics and Strategy (data via Statistics Canada)

S&P/TSX: Oil price differential improves for producers
WCS-WTI spread

NBF Economics and Strategy (data via Bloomberg)

But even after the latest revisions, earnings per share (EPS) for the consumer discretionary sector are still expected to grow by 12% over the next twelve months, a forecast that may be difficult to achieve without a more robust labour market - table.

S&P/TSX composite index: EPS analysts expectations

	Earnings per share					EPS % growth		
	2023	2024	2025	12m Trail.	12m Forw.	2024	2025	12m Forw.
S&P TSX	1389	1471	1668	1423	1557	6	13	9
ENERGY	214	228	260	220	241	6	14	10
MATERIALS	142	151	201	146	172	6	33	18
INDUSTRIALS	227	236	278	231	253	4	18	10
CONS. DISC.	181	196	229	187	209	8	17	12
CONS. STAP.	440	491	558	452	510	12	14	13
HEALTH CARE	13	16	19	13	17	22	22	29
FINANCIALS	329	334	361	331	348	1	8	5
BANKS	372	368	394	370	383	-1	7	4
IT	21	26	31	24	29	27	19	20
TELECOM	87	87	95	87	90	1	9	4
UTILITIES	116	121	134	118	126	4	11	7
REAL ESTATE	65	232	244	135	237	256	5	76

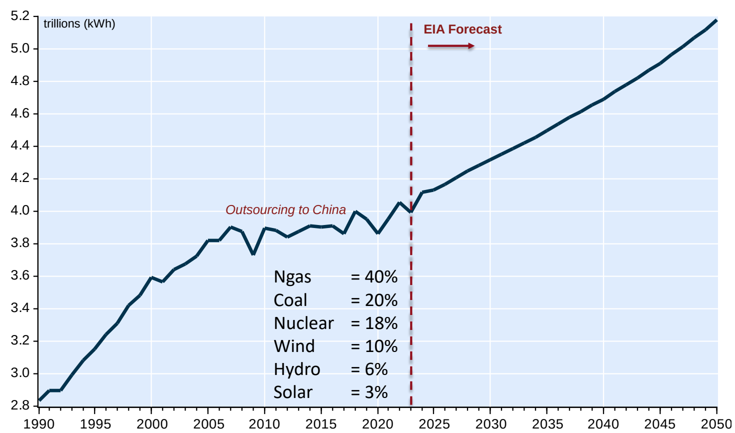
5/10/2024 N.M.=Not meaningful

NBF Economics and Strategy (data via Refinitiv)

For its part, the energy sector is in a better position to beat expectations in the coming quarters. For one, the start of commercial operations of the Trans Mountain pipeline (TMX) in May should allow for both an increase in oil exports and a narrowing of the WCS-WTI spread relative to its 5-year average of USD 15 (chart).

In the case of natural gas producers, earnings should be boosted by an increase in demand for electricity, which is back on the rise after 15 years of stagnation. The combination of population growth, manufacturing reshoring, faster-than-expected AI adoption and increased charging needs for electric vehicles has led to a surge in electricity demand. According to the EIA, this new trend will continue for the foreseeable future. This outlook is particularly supportive for natural gas, which currently accounts for more than 40% of electricity generation in the US and is the cleanest source of non-intermittent energy that is readily available - chart.

U.S.: The demand for electricity is back on an upward trend
Electricity used by all sectors of the U.S. economy



NBF Economics and Strategy (data via EIA)

In Canada, too, demand for electricity is rising, driven by unprecedented population growth. Demographic demand, combined with lower water levels for hydroelectricity even led to Canada's first deficit in at least 16 years in February - chart.

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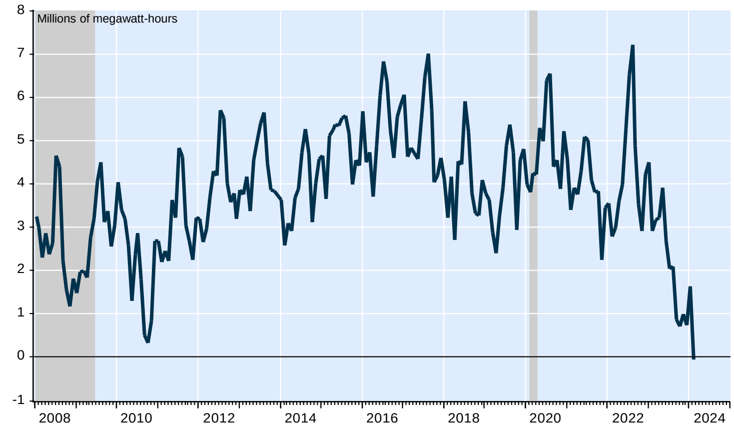
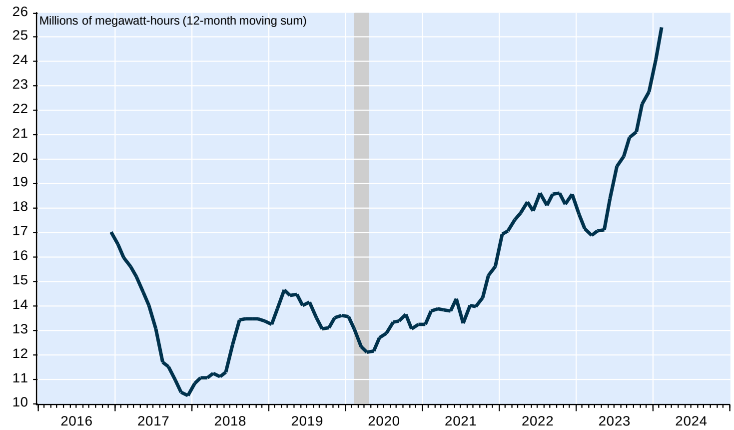
Canada: First electricity deficit on record
Net exports of electricity



NBF Economics and Strategy (data via Statistics Canada table 25-10-0016-01)

Canada is also relying more on natural gas to meet increased electricity demand. Electricity generation from combustible fuels in Ontario rose to a record 25 million megawatts (19% of total generation) over the past twelve months - chart.

Canada: Ontario relies more on natural gas
Ontario electricity generation from combustible fuels



NBF Economics and Strategy (data via Statistics Canada table 25-10-0015-01)

Asset allocation

The longer central banks are forced to wait to cut rates, the more likely it is to trigger a liquidity crunch, which has characterized every business cycle since the 1960s when monetary policy is brought to restrictive levels. We maintain our defensive asset allocation, with equities underweight and fixed income and cash overweight (table).

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	

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Sector rotation

Our sector rotation remains unchanged this month, with a preference for Golds, Consumer Staples, Communications Services and Utilities.

NBF Market Forecast
Canada

			Actual	*Q4 2024*
Index Level			**May-10-24**	***Target***
S&P/TSX			22,309	19,000
Assumptions				Q4 2024
Level:	Earnings *		1423	1350
	Dividend		700	664
PE Trailing (implied)			15.7	14.1

** Before extraordinary items, source Thomson*

NBF Economics and Strategy (data via Refinitiv)

NBF Market Forecast
United States

			Actual	*Q4 2024*
Index Level			**May-10-24**	***Target***
S&P 500			5,223	4,300
Assumptions				Q4 2024
Level:	Earnings *		227	210
	Dividend		72	66
PE Trailing (implied)			23.0	20.5

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

NBF Fundamental Sector Rotation - May 2024

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Market Weight**	**18.6%**
Energy Equipment & Services	Market Weight	0.2%
Oil, Gas & Consumable Fuels	Market Weight	18.4%
Materials	**Market Weight**	**12.3%**
Chemicals	Underweight	1.4%
Containers & Packaging	Market Weight	0.4%
Metals & Mining *	Market Weight	10.1%
Gold	Overweight	6.8%
Paper & Forest Products	Market Weight	0.4%
Industrials	**Underweight**	**14.0%**
Capital Goods	Market Weight	3.0%
Commercial & Professional Services	Underweight	3.7%
Transportation	Underweight	7.3%
Consumer Discretionary	**Underweight**	**3.5%**
Automobiles & Components	Underweight	0.6%
Consumer Durables & Apparel	Underweight	0.4%
Consumer Services	Underweight	1.0%
Retailing	Market Weight	1.4%
Consumer Staples	**Overweight**	**4.1%**
Food & Staples Retailing	Overweight	3.5%
Food, Beverage & Tobacco	Overweight	0.5%
Health Care	**Market Weight**	**0.3%**
Health Care Equipment & Services	Market Weight	0.1%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	0.1%
Financials	**Market Weight**	**30.8%**
Banks	Market Weight	19.3%
Diversified Financials	Market Weight	4.2%
Insurance	Market Weight	7.2%
Information Technology	**Market Weight**	**7.5%**
Telecommunication Services	**Overweight**	**3.2%**
Utilities	**Overweight**	**3.9%**
Real Estate	**Underweight**	**2.0%**

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

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