JULY 19, 2021

On the Radar

FAQS ON THE MARKETS AND ECONOMY

Why is CNR still underweight in European equities?

Progress on vaccinations, recovering economic activity and recent political developments have been encouraging, but Europe's outlook still faces a number of short- and long-term headwinds, and we expect any potential outperformance to be short-lived.

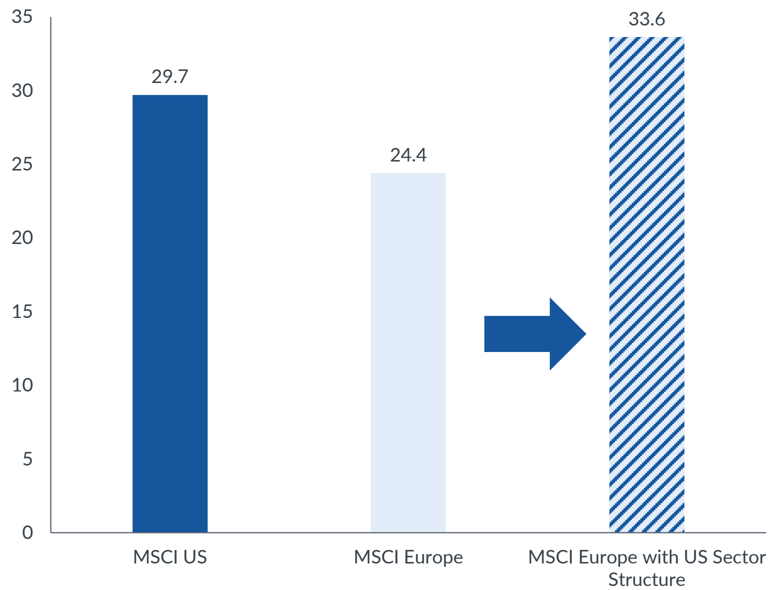
Our concerns have been the region's historically weak domestic growth compared to the U.S., higher exposure to global headwinds, negative yields that affect banks' profitability, a less favorable sector representation in the market structure and the politics that hinder market/economic reforms. These issues, which led to underperformance in the past, are unlikely to ease going forward.

In the short-run, overall European growth looks set to meaningfully trail the U.S. recovery. Although economic activity should be strong over the next few quarters as more EU economies reopen, much of Europe is still expected to take nearly three years to recover from the pandemic.

For investors, euro corporate earnings have also significantly lagged the U.S. recovery, and longer-term expectations remain lower. U.S. companies have historically generated higher earnings growth compared to their European counterparts due to a number of factors including differences in corporate management, cost competitiveness and innovation.

Meanwhile, much of the difference in valuations between the U.S. and Europe can be explained by different sector structure of the equity markets. In fact, euro equities are more expensive than U.S. equities when viewed on a sector-adjusted basis.

Trailing P/E Ratios



Source: MSCI, Ned Davis Research.

Longer term, our 4Ps framework analysis continues to indicate the outlook for European economies remains hamstrung by structural barriers to growth, including an aging population, declining productivity, high unemployment and diminished global competitiveness.

KEY QUESTIONS

What was Fed Chair Powell talking about when he testified in front of Congress?

Is the consumer roaring back?

Is a market correction possible?

What was Fed Chair Powell talking about when he testified in front of Congress?

Twice a year, the Fed chair is required to testify in front of Congress. In the past, it was a way for Fed watchers to get insight into the workings and thinking behind many of the Fed's decisions. But in the past few years, the Fed started giving press conferences after each FOMC meeting, so Fed watchers have received their information then. That said, it is always good to listen to these Congressional testimonies for a chance to get more information.

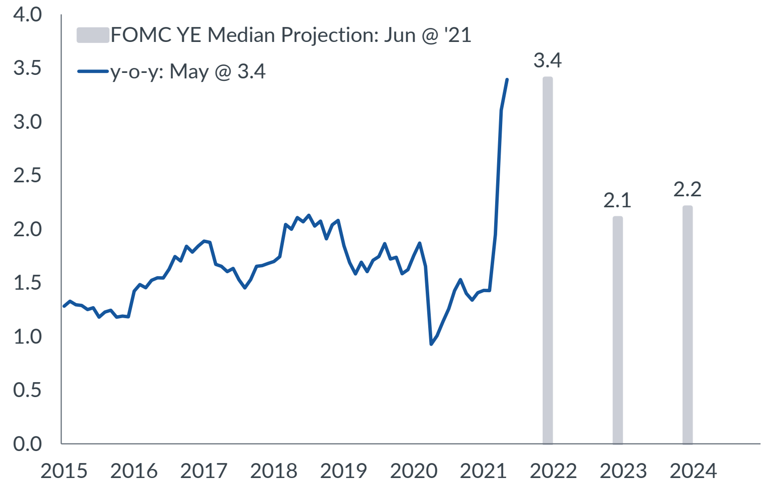
This past week, Powell answered many questions on the economic recovery and the recent increase in inflation.

As for the economy, the Fed will remain very accommodative until there is significant additional employment improvement before they consider removing any accommodation. They remain dovish.

In regard to inflation, with consumer prices rising at the fastest pace in 13 years, the Fed admits inflation is higher than expected and a little more persistent. Prices are higher due to several special factors; there has been a perfect storm for high demand meeting low supply. The Fed expects the bottlenecks should reverse themselves and inflation will trend back toward 2.0% next year (chart).

Inflation and FOMC Projections (%)

Core Personal Consumption Price Deflator



Source: Bureau of Economic Analysis, Federal Reserve as of June 2021.

Is the consumer roaring back?

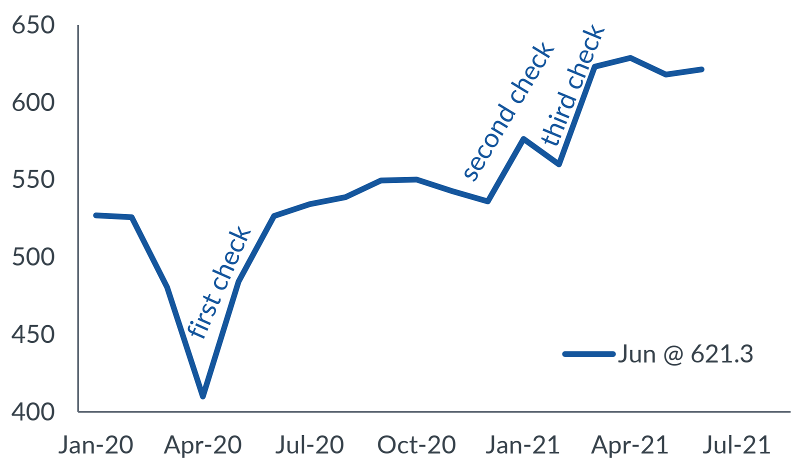
Consumer spending has been on a notable upward trend, with retail sales increasing 18.0% in the past year. Along the way there have been ebbs and flows, heavily influenced by stimulus checks (chart).

Consumers are responding to the reopening of the economy. They have a significant amount of cash due to the stimulus checks and savings from reduced spending on many services. As a result, they are excited to be out and about for the first time in over a year. This is most notable in sales at restaurants, which jumped 2.3% in June and now stand 6.6% above February 2020, the pre-pandemic peak.

A few of the strong 2020 sectors within retails sales showed some weakness of late. For example, last summer, sporting goods sales grew at a robust pace as parents tried to find activities for their kids as summer camps were canceled due to COVID-19. But this year, most camps are open, and families are taking vacations. As a result, sporting goods sales have fallen for three consecutive months. In addition, vehicle sales have fallen for two straight months, but that is due to supply chain problems related to semiconductors.

Retail Sales

$, billions, seasonally adjusted



Source: U.S. Census Bureau as of June 2021.

Is a market correction possible?

In our minds, the fundamental outlook for equities remains favorable, and we think the market's high degree of optimism is not entirely misplaced. The U.S. economy is poised to deliver its best rate of growth in nearly 40 years, S&P 500 earnings are expected to reach all-time highs, and the combination of central-bank and government stimulus will remain a tailwind.

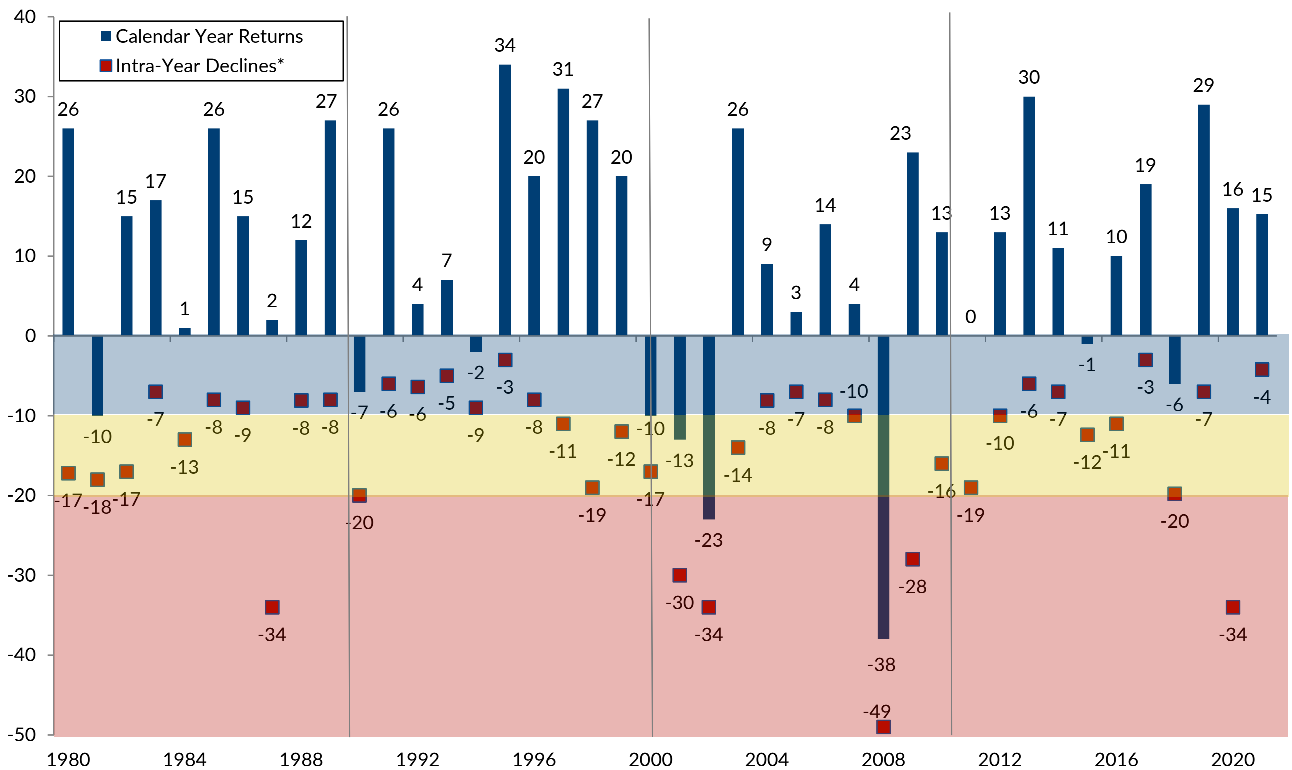
However, equity markets have also been on an unprecedented run since last year's pandemic lows, and much of this robust outlook has already been priced in. Valuations have been stretched somewhat and pockets of euphoria do exist, especially in speculative emerging technology companies.

This means that even small shocks or disappoints have the potential to undermine markets, at least temporarily. While difficult to time, we think a correction in risk assets is probably overdue, with unexpected policy developments, inflation worries and COVID-19-related setbacks among other worries as potential triggers.

Still, it is important to recognize that corrections are not uncommon. Since 1980, the S&P 500 has experienced an intra-year decline of 10% or more 23 times, yet the index has nevertheless finished with a positive return in the vast majority of those years (chart).

Indeed, corrections are often healthy events, helping to eliminate excesses that have built up after extended runs of market optimism and setting a firmer foundation for future gains. Should a correction unfold over coming months, we would view it as a buying opportunity.

S&P 500 Return (%)



Source: FactSet. As of July 2021.

*Intra-year declines are the largest declines within the calendar year.

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Index Definitions

S&P 500 Index (S&P500) is a stock market index that tracks the 500 most widely held stocks on the New York Stock Exchange or NASDAQ. It seeks to represent the entire stock market by reflecting the risk and return of all large-cap companies.

The 4P analysis is a proprietary framework for global equity allocation. Country rankings are derived from a subjective metrics system that combines the economic data for such countries with other factors including fiscal policies, demographics, innovative growth and corporate growth. These rankings are subjective and may be derived from data that contain inherent limitations.