Equity and Fixed Income Strategy

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Advantage Canada, commodities and low duration stocks

The year 2022 was volatile and difficult to navigate with seemingly very few places to hide both for equity and bond investors. This created an understandable general feeling of anxiety and pervasive bearishness among investors. While we were unabashedly bearish and recommended a very defensive positioning all year, we are now looking "over the cliff" and are moving portfolios to benefit from the unavoidable recovery we foresee in 2023. This being said, we expect the next few months to remain volatile, but economic momentum should pick up (from low levels) in the second half of the year with an associated far stronger performance from risky assets and stocks in particular. Securities markets are primarily influenced not by absolute numbers but by the trajectory of key macro variables. On that front, the situation is already improving for inflation – though it will be a slow, painful slog to get back down to the 2% to 3% range. The missing ingredients are an improvement in growth and housing momentum, and that's what we think will happen in the year ahead. As always, the stock and bond markets will discount these improvements well before we see the evidence in the real world.

As we begin 2023, we remain very slightly overweight equities and also find good value in bonds. Interestingly, in the Canadian market, approximately 75% of bonds now have a price of less than $100. Since these bonds will mature at $100 (assuming they are high quality), investors have a rare opportunity to increase the tax efficiency of their portfolios. Specifically, for an average 5-year bond – on an after-tax basis – 30% of the total return is a far more attractive capital gain and the remaining 70% is interest income.

In the spirit of leading with our conclusions: 1) We expect continued strong relative performance from the S&P/TSX Composite Index vs. the S&P 500 Index following a better than 10% outperformance in 2022; 2) We believe high-quality, low-duration (i.e., reasonably valued vs. profitability and growth) stocks remain the place to be invested; 3) We continue to see room for Energy and Materials (especially Agriculture plays) to do well, along with some oligopolistic Industrial and Consumer Discretionary stocks (e.g., Honeywell, Finning, Home Depot, Raytheon and CN Rail); and 4) Defensive but interest-rate-sensitive sectors like Utilities, REITs and Telecoms should recover nicely from a difficult 2022, if we are right in our view that interest rates will be rangebound and may even potentially drift lower (i.e., we do not see another huge spike from current levels).

The **U.S. Conference Board's Consumer Confidence Index** brightened for the first time in three months, up 6.9 points to an 8-month high of 108.3 in December, with support from both components: the **present situation** (+8.9 points); and **expectations** (+5.7 points). As noted by BMO Economics, "This particular survey is based more on the employment environment and that's where one can find the positive influence. Those who found that jobs were more plentiful picked up again, while there were fewer respondents who found it more difficult to land a decent gig. So, **on net, the "jobs plentiful" component rose**, which suggests that the jobless rate may tick lower after staying at 3.7% for the last two months."

Our Currency Strategy team notes that, "Canadian dollar (CAD) outperformance was a noteworthy feature for much of 2022, but a late-year decline in oil prices narrowed its divergence from other G10 currencies over the last couple of months of the year. For 2023, we look for a mild rebound in crude prices to anchor the loonie in Q1. Our 3-month outlook for USD/CAD is 1.35, which is little changed from the average of Q4 2022. We expect moderate CAD appreciation in the latter half of the year on the back of recovering Canadian and global growth. We see USD/CAD at 1.30 on a 12-month horizon."

We continue to see better upside from Canadian stocks and we foresee a strong recovery in the second half of the year. Also worth noting, we expect continued strong relative performance from Energy, Materials, Industrials, some parts of Consumer Discretionary, Utilities, REITs and Healthcare. We would continue to underweight expensive "FANGish" stocks in the Technology and Communication Services areas. Note that we do see great long-term value in oil stocks but they could remain under pressure over the next few months with the economic slowdown we are experiencing.

Technical analysis

The second half of December was certainly much weaker than we expected given the strong historic seasonality and the state of our Medium-term Timing Model (which was fully bullish) coming into the month. Still, the 5.90% decline in the S&P 500 Index had no material impact on those weekly gauges. Momentum gauges remain mostly positive after giving new, medium-term buy signals earlier in the fall; there was minimal deterioration in breadth oscillators such as the percentage of S&P 500 Index stocks trading above 50- and 200-day moving averages and there was only the slightest of dips in our Composite Sentiment indicator.

Perhaps the most telling aspect of December's action is the performance of economically-sensitive, pro-cyclical areas, such as Industrials, which just made a three year high in relative performance versus the S&P 500 Index. It's also teetering on breaking out of a massive "double bottom" reversal pattern with an upside target that measures 22% higher than the December 30 close. The Equal Weight S&P 500 Consumer Discretionary Index (which removes the AMZN/TSLA "skew") also recently achieved an 8-month high in relative performance vs. the S&P 500 Index. Drilling into that group further, we see that housing stocks such as DHI, PHM, and TOL are outperforming the S&P 500 Index and already in new long-term uptrends. This is essentially the polar opposite of what we would expect to see if the economy was tilting into a major recession next year (i.e., the markets are telling a very different story than the doom and gloom we see in the news these days). It's also in line with how these groups have performed coming out of every bear market since (and including) the credit crisis.

Fixed income update

Good news for bond investors: The year 2022 is now in the rear-view mirror! This will be one for the history books. The rising inflation, significant monetary policy response and the sharp increase in global interest rates combined with weak risk asset performance led to the worst portfolio performance in years. Even balanced portfolios which normally tend to provide some stability in times of global market volatility underperformed significantly; never in the last 50 years had we seen both the U.S 10-year treasury and S&P 500 Index generate negative returns in the same year.

Leaving the gloom behind, investors can take comfort in much-improved prospects for fixed income returns. Interest rates start the year at much more attractive levels than early 2022, providing higher income potential and a greater buffer against price volatility. Government of Canada 2- and 10-year yields are at their best levels in 15 and 10 years, respectively.

Monetary policy rate expectations contrast greatly. Twelve months ago, the U.S. Fed Funds rate was expected to reach an average of 1% by the end of 2022 – not 4.5% where it is today – as rising inflation was perceived as temporary. Today, some upward policy adjustment is expected in the early months of 2023, but the bulk of the tightening is most likely behind us, mitigating upside surprise risk in interest rate markets.

Slowing economic activity and moderating inflation, after hitting historic highs, should also help limit the upside risk for long-term interest rates. Not only have investors rarely seen two consecutive years of negative bond performances like the one delivered in 2021/22, but for markets to turn negative again for a third year, fundamentals for interest rates would need to deteriorate significantly. However, the list of positive scenarios for geopolitics, inflation, the economy and rates can be matched with an even longer list of things that can go wrong in the next six to 12 months. These uncertainties will continue to lead to higher-than-normal market volatility, forcing investors to remain vigilant, but most scenarios would lead to range bound to lower interest rates.

Whether we look in the UK, Europe or even Japan, major central banks around the world are actively fighting inflation by tightening financial conditions. The Fed may have downshifted from 75 basis points to 50 basis points in December but the rhetoric remains hawkish. Policymakers haven't even shifted to being 'cautiously hawkish' yet and continue to see the need for more tightening. The BoC seems to be closer to a pause with the potential for one more 25 basis points hike in Q1. In both cases; however, the issue remains that not only is the headline Consumer Price Index elevated but core prices also; while goods price pressures are slowly abating, services are stickier along with wages. This may take more than one or two quarters to improve and open the door for rate cuts which are expected to be more a 2024 story. This is not well reflected in markets.

For the month ahead, we continue to see upward pressure on the front-end of the yield curve but not so much on longer rates. The current inverted yield curve – which has historically been a good predictor of recessions – should persist a while longer. While we expect volatility to remain elevated, we see the potential for longer-term rates to drift lower with expectations for the 10-year U.S. yield to move closer to 3% while the Canada 10-year could venture below 3%.

Please contact your BMO Nesbitt Burns Investment Advisor if you have any questions or would like to discuss your investments.

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