Portfolio Advisory Team

Portfolio Management

September 2017

Equity Strategy

The Evolving Investment Climate

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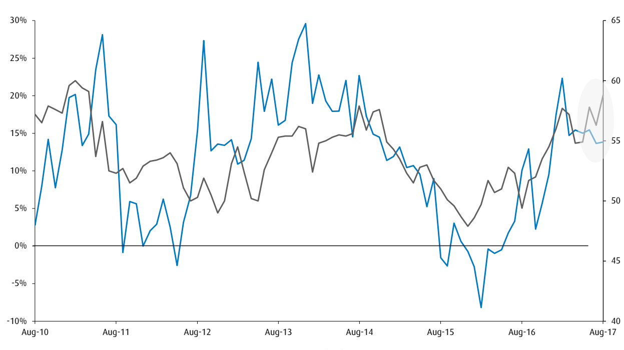
This quarter we are not making any changes to our asset allocation recommendation. Broadly, we think it is still appropriate to be overweight equities relative to bonds –given continued robust global economic momentum, accelerating corporate earnings, palatable valuations and still benign inflation trends. We continue to have a preference for more defensive and high quality stocks with good dividend growth potential. Also, as we discuss in the coming pages, our proprietary BMO Private Client North American Risk Appetite Index (RAI) is still just above the neutral range and is far from euphoric levels. Given the amount of skepticism prevalent in the market and the number of pundits calling for an imminent correction, this increases the probability that the path of least resistance for equities may be a continued grind higher in our view.

Economic Momentum

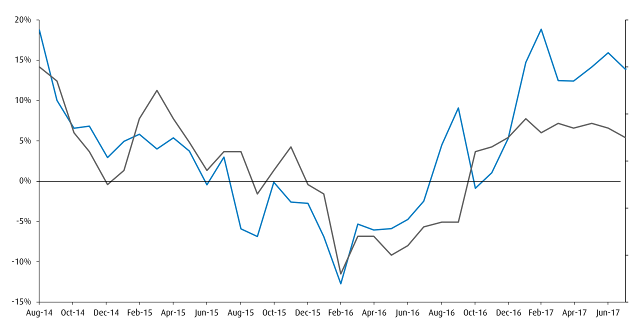
The Purchasing Managers Index (PMI) or Institute for Supply Management (ISM) in the U.S. provides the first indication each month of global business conditions, based on data collected from thousands of purchasing executives. In other words, it is a reflection of "real world" current and expected business conditions and has become one of the best macroeconomic data series to get an early read of where we are in the economic cycle. Typically, stocks and other risky assets do well when these data series are trending higher since it is a leading indicator of future corporate profitability.

Figure 1: S&P 500 Monthly Returns (Year over Year) versus ISM Manufacturing Index



Source: Bloomberg

Figure 2: MSCI World Monthly Returns (Year over Year) versus JP Morgan Global Manufacturing ISM



Source: Bloomberg

Figure 3: BMO Nesbitt Burns Investment Strategy Committee's Recommended Asset Allocation (%)

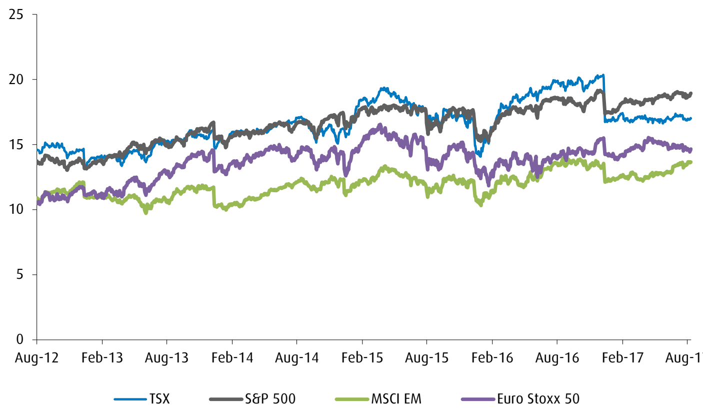
	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	5	5	5	5	5	5	0	5
Fixed Income	70	70	40	45	20	25	5	0
Equity	25	25	55	50	75	70	95	95
Canadian Equity	15	15	25	25	35	35	40	40
U.S. Equity	10	5	25	15	25	20	35	30
EAFE Equity*	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

** Within EAFE, we specifically recommend Continental European equity. Source: BMO Nesbitt Burns Private Client Strategy Committee*

Market Valuations have increased, but are not absurd given the Benign Inflation and Low Interest Rate Environment

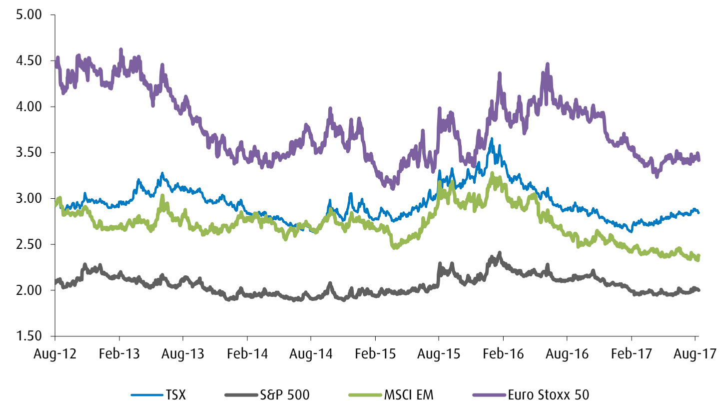
Europe and Emerging Markets continue to offer better value than North American markets given generally improving inflation trends and declining unemployment rates. We show simple forward looking price to earnings ratios in Figure 4 below. The S&P 500, S&P/TSX Composite Index (TSX), EuroStoxx 50 (European blue chip companies) and Emerging Markets stocks trade at 18.8x, 16.9x, 14.6x and 13.5x forward earnings respectively (at the time of writing this report). Dividend yields are also far higher in Europe and Emerging Markets, especially compared to very low bond yields globally.

Figure 4: Price to Earnings Ratio – Next Fiscal Year



Source: Bloomberg

Figure 5: Dividend Yield



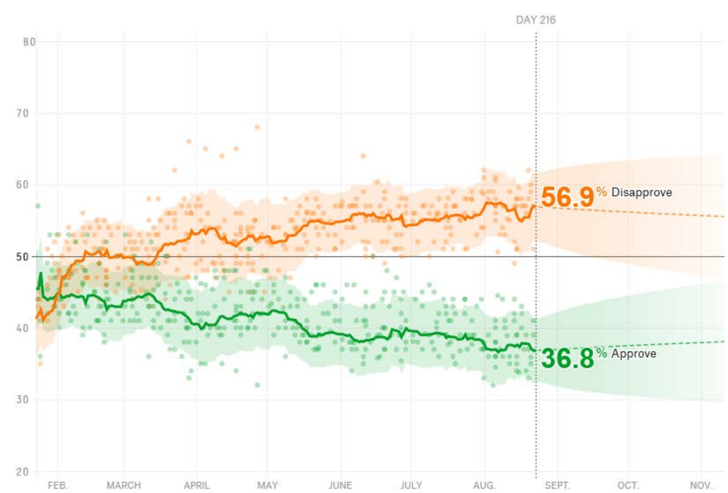
Source: Bloomberg

The Investment Climate has changed over the Last Year

Figures 7 through 11 illustrate the shifts that have taken place since Trump's November 2016 election. Early enthusiasm about Trump's pro-growth promises (corporate tax cuts, infrastructure spending, financial deregulation etc) has been replaced by deep skepticism about his ability to get things done. Congress' recent failure to replace Obamacare has only exacerbated this trend. The conclusion for stocks is not necessarily sinister but, for the sake of conservatism, investors should not bank on any equity-friendly measures passing in Washington. In fact, the market has been discounting progressively lower probabilities of major positive reform being enacted. The silver lining is that at this point, any progress toward a major tax cut could actually act as an upside catalyst for stocks.

First, the President's disapproval rating is the highest of any president since World War Two. Also, betting sites are showing an almost 50% chance of Trump getting either impeached or resigning before 2020 (as reported by British paper The Telegraph). This matters because the lower the President's approval rating, the less leverage he will have over members of Congress (particularly Republicans who disagree with him) to push through his agenda.

Figure 6: Approval Rating

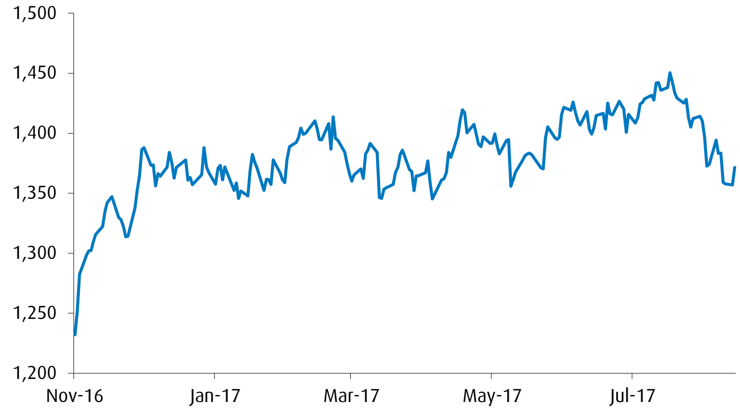


Source: The Telegraph

Small cap stocks, as represented in Figure 7 by the Russell 2000 Index, have pulled back significantly lately. Since many of the companies in this index are domestically focused they will disproportionately benefit from a large tax cut. Therefore we think this index is a good barometer of investors' expectations regarding the successful passage of fiscal reform.

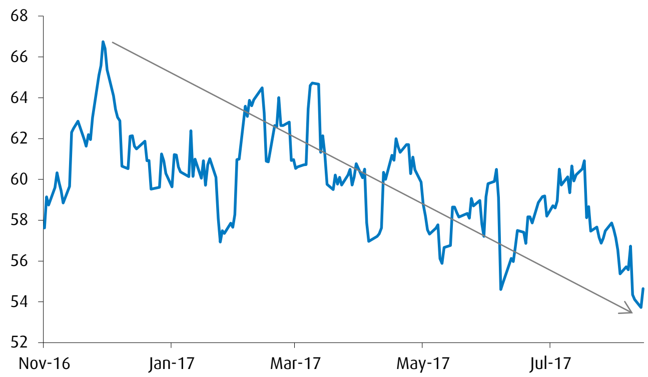
Steel stocks, which are prime beneficiaries of increased infrastructure construction, jumped after the election but have given back all of their gains. Figures 8 and 9 show the stock charts for Nucor (NUE) and U.S. Steel (X).

Figure 7: Russell 2000 Index



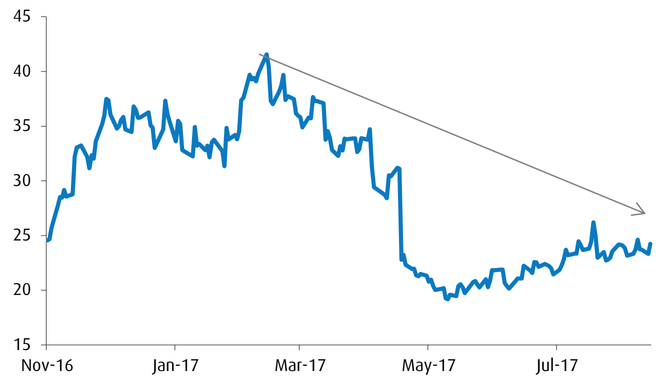
Source: Bloomberg

Figure 8: Nucor



Source: Bloomberg

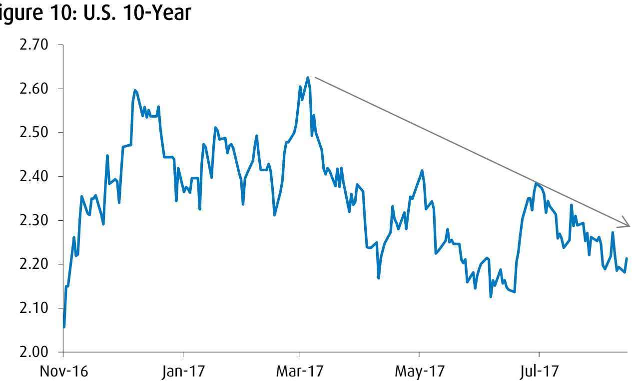
Figure 9: U.S. Steel



Source: Bloomberg

The US 10-year interest rate, the most important benchmark in the world of finance, jumped after the election on fears that Trump's agenda would be inherently inflationary. However, since peaking at over 2.6%, it has been drifting down; and the U.S. Trade Weighed dollar continues to weaken:

Figure 10: U.S. 10-Year



Source: Bloomberg

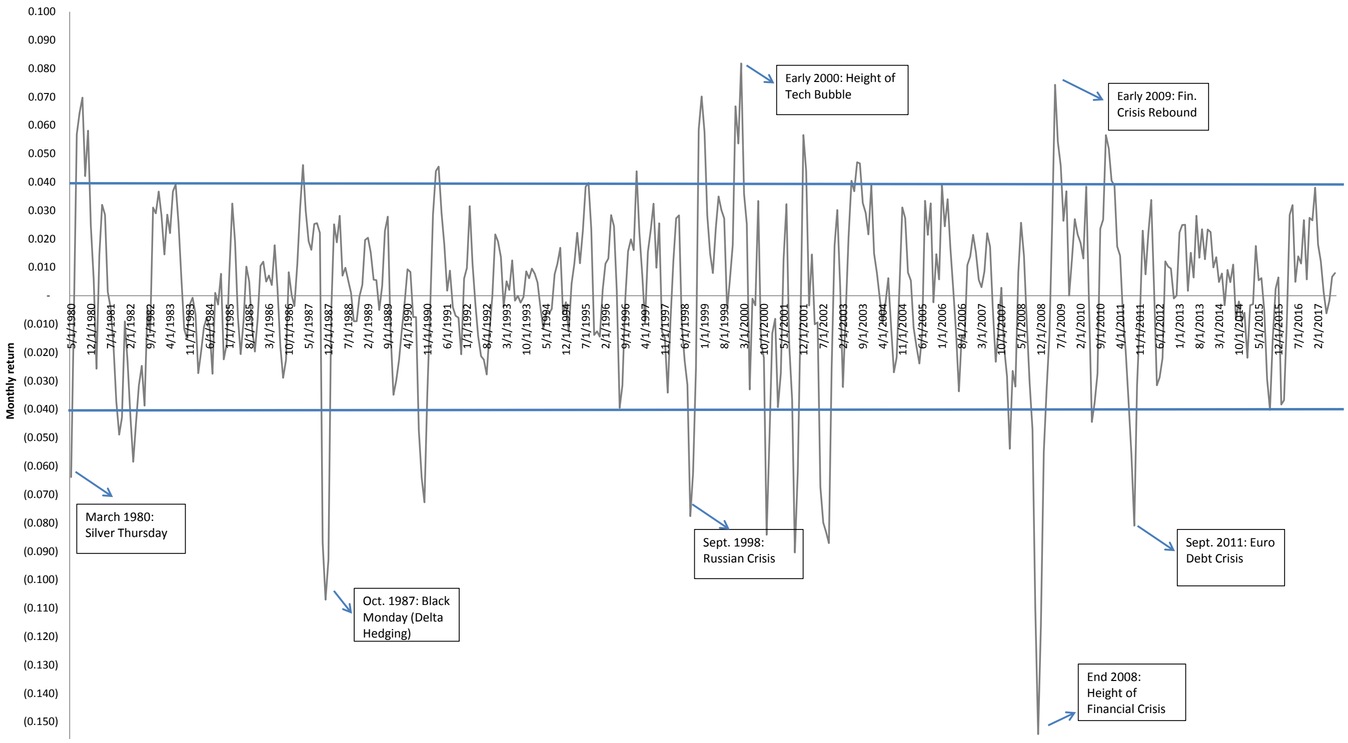
Figure 11: U.S. Trade Weighted Dollar

Source: Bloomberg

In August, we launched our proprietary BMO Private Client North American Risk Appetite Index (RAI)[1] to get a sense for how "stretched" stocks are relative to bonds as we flirt with all-time highs for many indices. Given the market is inherently "mean reverting," being able to know where we are on the risk appetite continuum can help investors optimize portfolios and boost long term returns in our view.

The punchline – and good news – is that while risk appetite continues to move up, we are still just above the neutral range and far from euphoric levels. Given the amount of skepticism prevalent in the market and the number of pundits calling for an imminent correction, this increases the probability that the path of least resistance for equities may be a continued grind higher in the short term.

Figure 12: Risk Appetite Index



Source: Bloomberg, BMO Nesbitt Burns

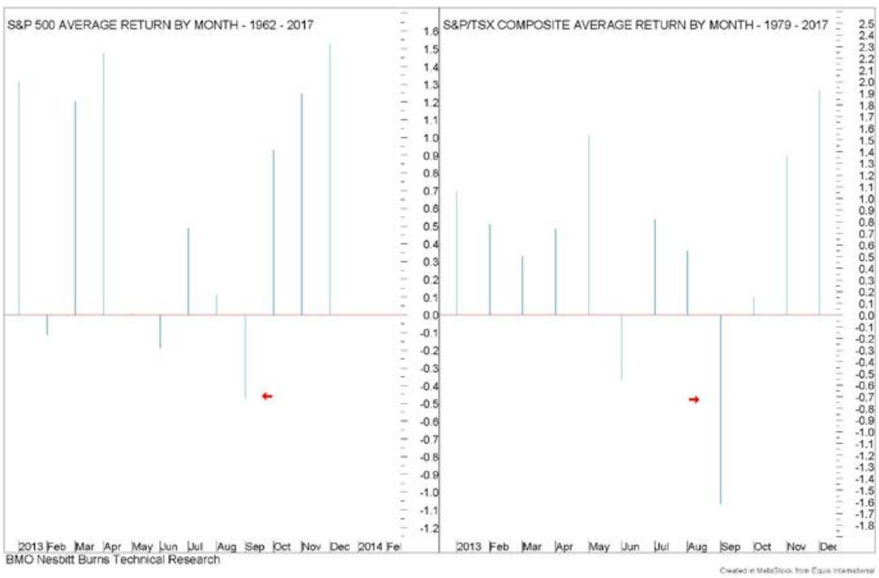
[1] To build the index, we use exclusively market price data and compare the relative performance of risky assets (a composite of the S&P 500, TSX, Philly Semiconductor Index, Nasdaq Biotech Index and several other indices) vs. safe assets (several Canadian and U.S. Government, provincial and municipal bond indices). Simply put, when stocks are outperforming bonds, the RAI goes up and when bonds outperform stocks (which is typical when investors fear an economic slowdown for example), the RAI goes down.

The Technical Picture— September Weakness is a Buying Opportunity

Russ Visch, CMT, Technical Analyst

We last reviewed our medium-term equity model in the July issue of this publication. At the time, we noted that all aspects of this model – momentum, breadth, and sentiment – were deteriorating which suggested there was risk of some corrective action during the summer, in line with seasonal tendencies. Since that report, these same indicators have done nothing but get worse which suggests this September could live up to history and be the worst performing month of the year.

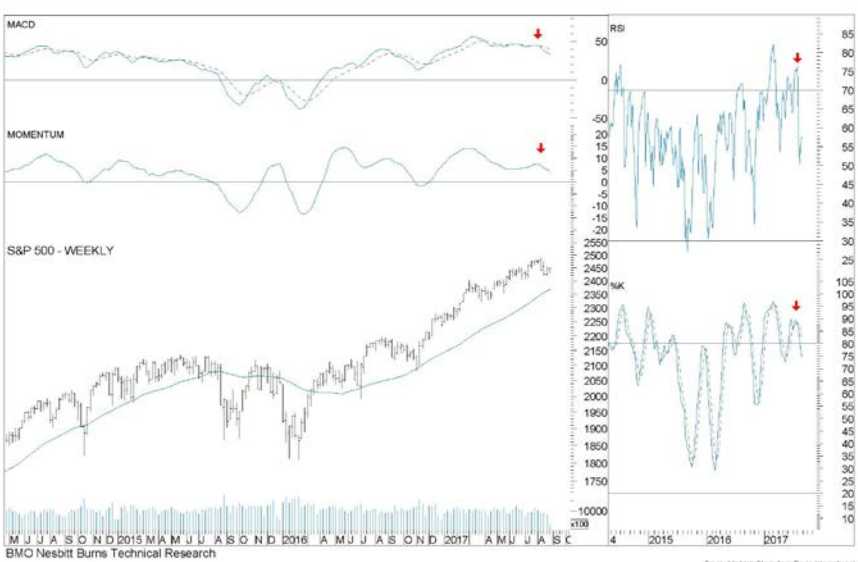
Figure 13: S&P/TSX Composite & S&P 500 Monthly Returns



Source: BMO Nesbitt Burns Technical Analysis

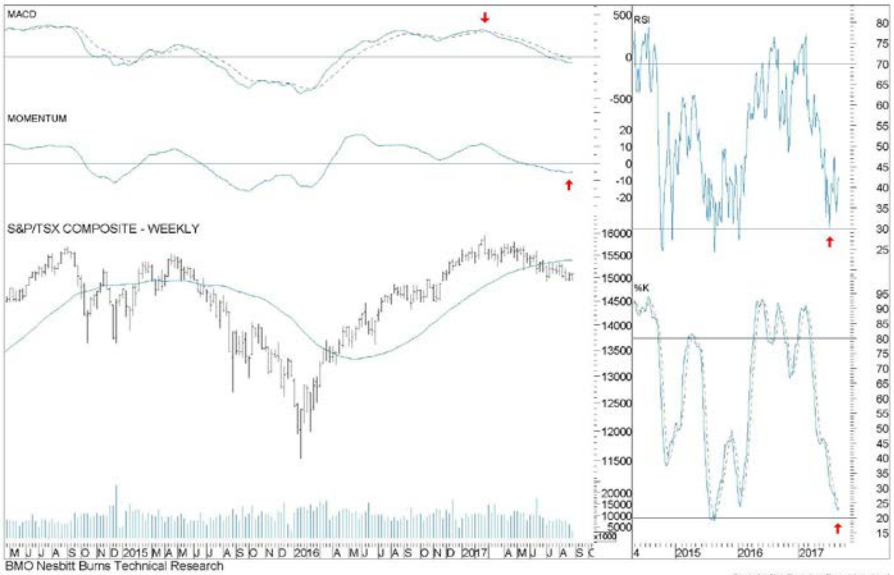
For example, weekly momentum gauges for the S&P 500 are fully negative again since last Spring, which suggests the index could remain under pressure well into the third quarter. Here in Canada, we are seeing the earliest signs of improvement in weekly momentum gauges for the S&P/TSX Composite, but they remain mostly negative as well.

Figure 14: S&P 500 Index Weekly Momentum Indicators



Source: BMO Nesbitt Burns Technical Analysis

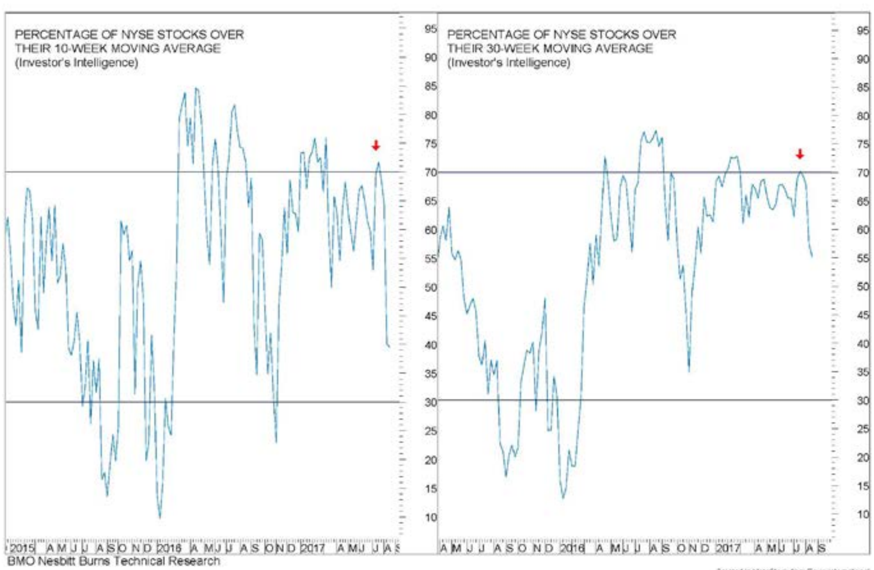
Figure 15: S&P/TSX Index Weekly Momentum Indicators



Source: BMO Nesbitt Burns Technical Analysis

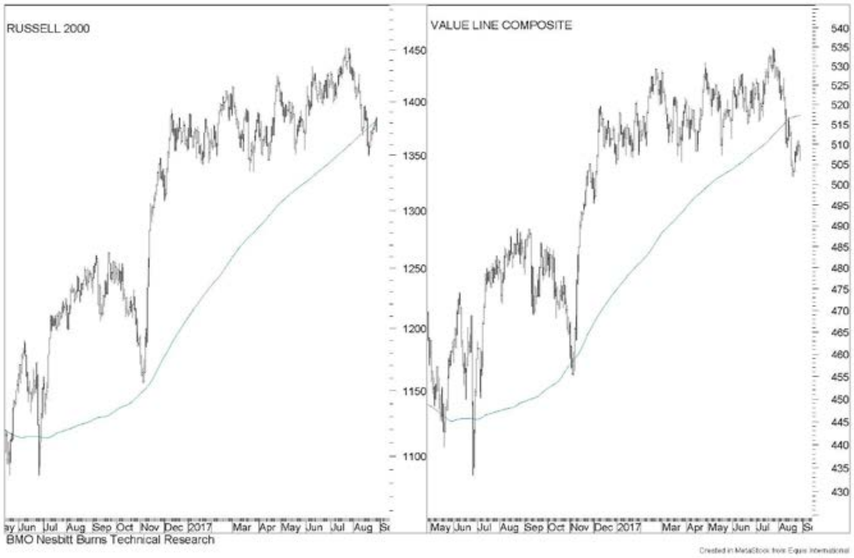
Breadth oscillators such as the percentage of NYSE stocks above their short and long-term moving averages also continues to contract. i.e. - things are deteriorating underneath the surface in a big way. This is plainly evident in other broad measures of equity participation such as the Russell 2000 which has not only been drastically underperforming its large-cap brethren since July, it has already pulled back more than 7% from its mid-summer peak. This sort of erosion in small and mid-cap stocks is a fairly common precursor to weakness in headline indexes such as the S&P 500 and Nasdaq Composite.

Figure 16: Percentage of New York Stocks over their 10 and 30 Week Moving Averages



Source: BMO Nesbitt Burns Technical Analysis

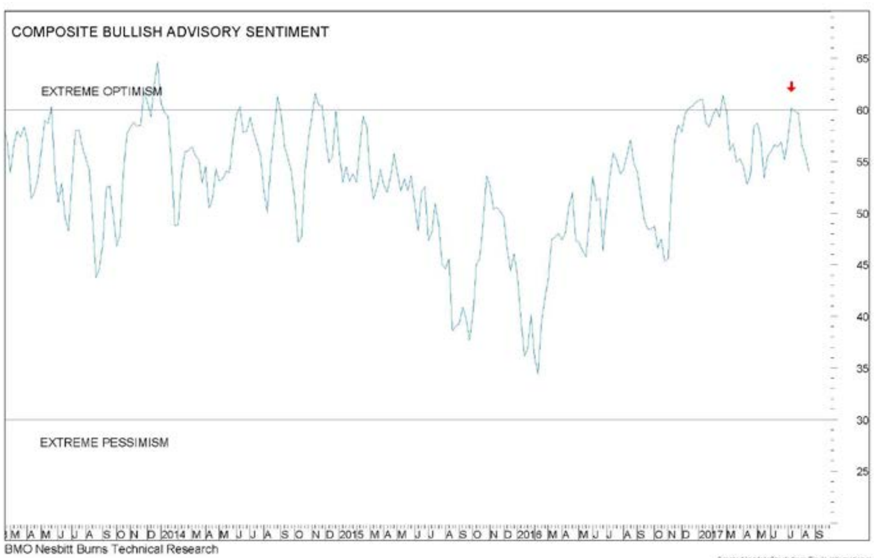
Figure 17: Russell 2000 and Value Line Composite



Source: BMO Nesbitt Burns Technical Analysis

Finally, sentiment continues to contract from the overly enthusiastic extremes which had developed in the first quarter. A cooling off period in equities would ultimately be a healthy development.

Figure 18: Composite Sentiment Indicator



Source: BMO Nesbitt Burns Technical Analysis

In terms of downside risk, first support for the S&P 500 is its July low at 2,405. Realistically though, medium-term corrections typically tend to bring an index back to its rising 200-day moving average which is currently at 2,360. Peak-to-trough, that's a fairly inconsequential 6% pullback, and should be used to accumulate stocks in a big way. There's even less downside risk here in Canada as the S&P/TSX Composite actually appears to be in the late stages of a bottoming process following its own medium-term correction that has been underway since the Spring. (Earlier we noted that medium-term momentum gauges remain mostly negative for the TSX, but they're at/near the oversold extremes which typically mark the end of a correction.) Between the negative outlook for U.S. equities at the moment and weak seasonality, we don't expect the TSX to rip to the upside any time soon, but this is about as good as it gets for a low risk entry point within this ongoing cyclical/secular bull market. Financial stocks and mining stocks in particular look great for new money right now.

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