Portfolio Management

November 2018

Equity Strategy

Mense Horribilis

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October was indeed a horrible month for equity investors and there were seemingly few places to hide, barring the most defensive of utility, health care and consumer staple stocks. Also causing some uncertainty is the upcoming U.S. midterm elections on November 6th, where Democrats seem highly likely to gain control of the House of Representatives (more on this below). Our objective in this report is not to try to time the end of this market correction, which we consider a fool's errand, but rather to provide our perspective on what has led us to this point and where the best opportunities lie for long term investors.

So what exactly does this stock market pullback (the S&P TSX Composite Index was down 6.3% and the S&P 500 was down 6.8% in October) mean for investors? As we wrote in our "The October Effect" missive from earlier this month, October has been characterized by sizable losses. For example, October 1929 (during the depression), and Black Monday (October 19, 1987) which still holds the record for the largest one day percentage drop in history (22.6%). But behind every sizable pullback lurks more fundamental reasons than seasonal effects ahead of Halloween. In fact, we think this pullback is being driven by the combination of 1) higher interest rates, which increase the discount rate for future corporate free cash flows (meaning their present value is lower) and 2) a synchronized slowdown in economic momentum. This phenomenon has historically been associated with significant underperformance for cyclical stocks which are more exposed to the business cycle, and therefore experience a disproportionately negative impact on their profitability.

There are still some positives however. First of all, our models still show a low probability of a U.S. (and Canadian) recession in the next year which tells us that the current pullback, while painful, is more likely a resetting of expectations (which translates into a pullback in the 15-20% range) rather than a "run for the hills moment" associated with a protracted downturn in the economy (down 25-30%+). Also important is that corporate profitability and cash flow generation remain very strong, particularly in the U.S. Even if we have peaked at 20% year over year earnings per share (EPS) growth, a deceleration to the 10% range next year (current consensus) would still be quite strong by historical standards and, in our view, enough for stocks to stabilize to more reasonable valuation levels and embedded expectations in stocks.

Given our belief that interest rates will continue to rise (albeit slowly) over the next several years, we have updated our fair value estimates for the S&P/TSX Composite Index and S&P 500 to incorporate a higher 10 year bond risk free rate (we now use 4% to be conservative). We have also updated the models with 2019 consensus EPS estimates but used lower growth estimates for the next few years to incorporate the risk of an economic slowdown. Our fair value estimates stay roughly the same given higher corporate profitability largely offsets the rise in interest rates.

Figure 1: 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. Canadian Equity = S&P TSX; U.S. Equity = S&P 500; Cash = Cdn T Bills; Fixed Income = Cdn Bond Universe; EAFE = MSCI EAFE Index; Emerging Equity = MSCI Emerging Markets; Source: BMO Nesbitt Burns Private Client Strategy Committee*

Figure 2: S&P/TSX Fair Value Estimate Goes to 17,600 from 18,000

	Present value	% of value	Earnings per share growth	Discount rate
Period 1 (2018-2022)	4,333.11	24.7%	5%	10.0%
Period 2 (2023-2027)	4,159.37	23.7%	3%	10.0%
Period 3 (2028 -)	9,062.49	51.6%	2%	10.0%

Rounded Fair Value	**17,600**	100.0%	Next 12 month consensus	1,160
			Implied terminal mult.	12.5 X
Current Price (October 31, 2018)	**15,027**		Long Bond	4.0%
			Historical Equity Risk Premium	4.5%
Upside Potential	**17%**		Additional Risk Premium	1.5%
			Total discount rate	10.0%

Source: FactSet, BMO Nesbitt Burns

Figure 3: S&P 500 Fair Value Estimate is Still Approximately 2,900

	Present value	% of value	Earnings per share growth	Discount rate
Period 1 (2019-2022)	616.26	21.3%	6%	10.0%
Period 2 (2023-2027)	634.60	22.0%	5%	10.0%
Period 3 (2028 -)	1,638.57	56.7%	3%	10.0%

Rounded Fair Value	**2,890**	100.0%	Next 12 month consensus	179
			Implied terminal mult.	14,2 X
Current Price (October 31, 2018)	**2,732**		Long Bond	4.0%
			Historical Equity Risk Premium	4.5%
Upside Potential	**6%**		Additional Risk Premium	1.5%
			Total discount rate	10.0%

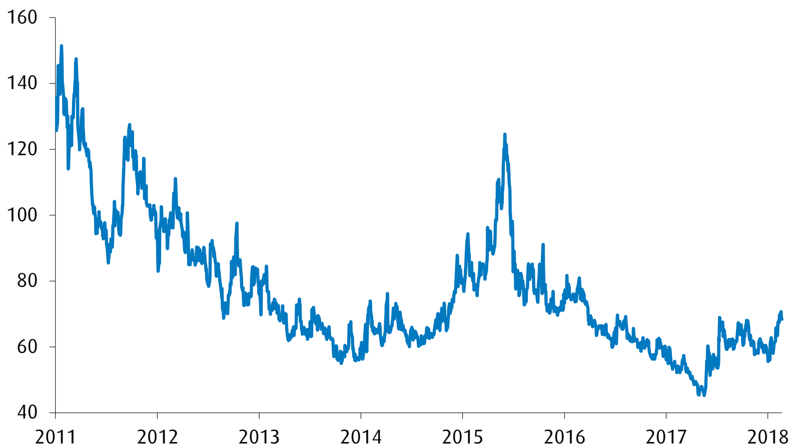
Source: FactSet, BMO Nesbitt Burns

Credit and money markets, often the proverbial "canary in the coal mine" for more dangerous market action to come, remain relatively well behaved, indicating that the fixed income market does not see a big deterioration in creditworthiness. It is true that spreads have widened out over the last few weeks (bad news directionally) but getting some longer term perspective is important. The multiyear charts in Figures 4 and 5 show that the recent widening is still nowhere near the levels of stress experienced in 2011, 2013 and 2015.

Figure 4: China Corporate Default Spreads (Higher is More Risky)

Source: Bloomberg

Figure 5: Markit CDX North America Investment Grade Index



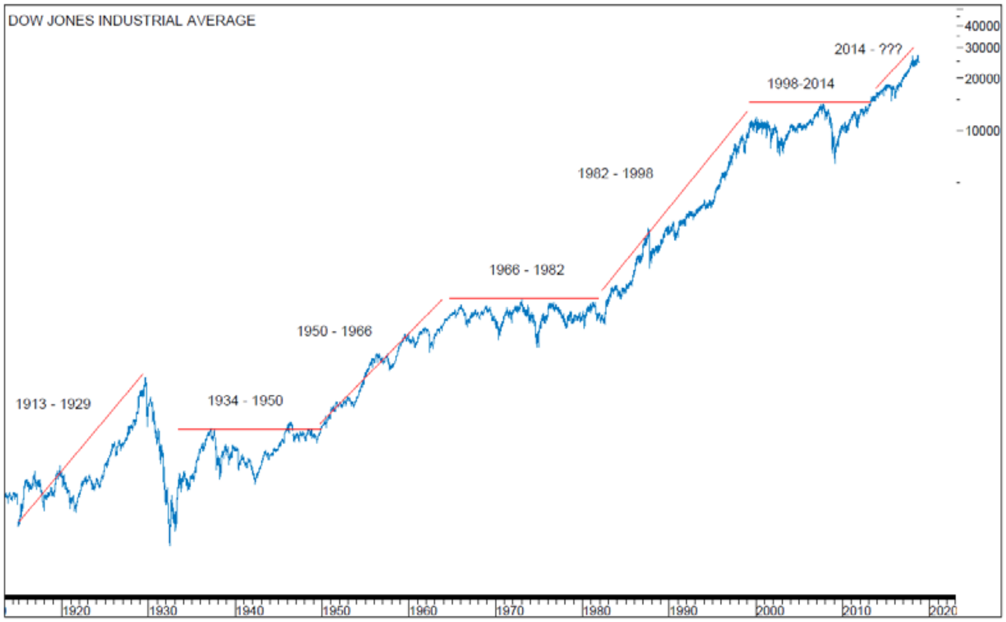
Source: Bloomberg

The Markit CDX North America Investment Grade Index is composed of 125 equally weighted credit default swaps on investment grade entities, distributed among 5 sub-indices: High Volatility, Consumer, Financial, Industrial, and Technology, Media & Telecommunications. Markit CDX indices roll every six months in March & September.

BMO Nesbitt Burns' technical analyst Russ Visch also provides a very long term perspective which supports our view that this is not the beginning of a secular bear market. He notes that:

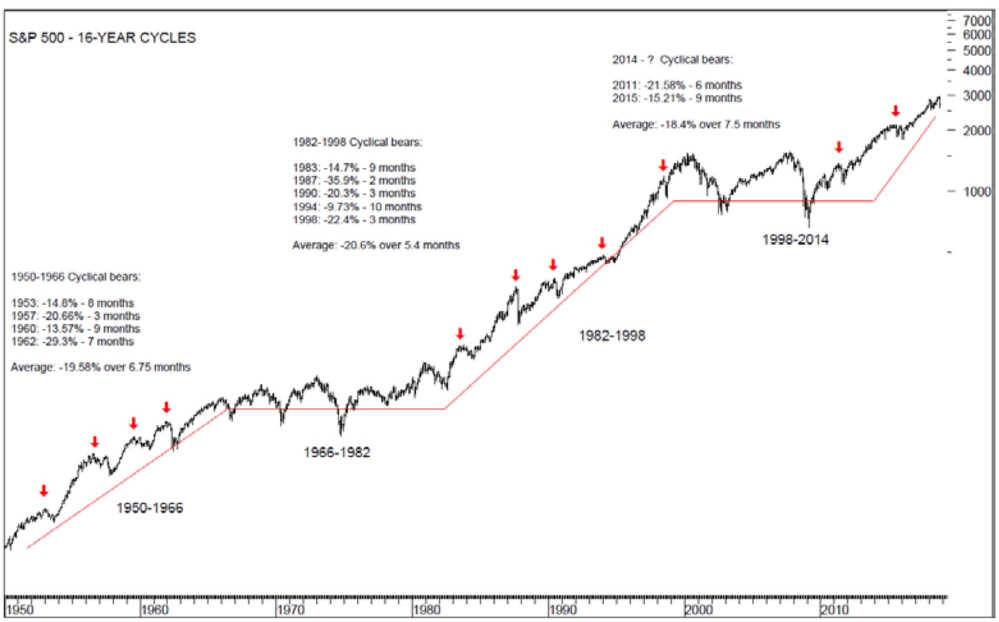
> "The secular (multi-year/multi-decade) trend for equities remains bullish and based on the 32-year cycle that stretches back more than 100 years, the bias should remain to the upside at least for the next 10-12 years. Within those big multi-decade secular bull markets, bear markets of lesser degree (cyclical bears) develop from time to time though, and we appear to be in the early/mid stages of one right now. Historically, they tend to last about 6-8 months on average with peak-to-trough losses of 18-20% in the S&P 500. Obviously, that's not fun to ride out, but during the two cyclical bear markets we've had since the credit crisis (2011 & 2015) the S&P 500 broke to new all-time highs above those bear market peaks less than 12 months later. Additionally, the average gain for the S&P/TSX Composite in the 12 months following the bear market lows in 2011 and 2016 is 25%. The average gain for the S&P 500 in the 12 months following those bear market lows is an astounding 32.5%! Investors should focus on accumulating stocks aggressively in early 2019, which will most likely represent the best buying opportunity since the last cyclical bear market low in February 2016."

Figure 6: Dow Jones – 16 Year Cycles



Source: BMO Nesbitt Burns Technical Analysis

Figure 7: S&P 500 – Cyclical Bear Markets



Source: BMO Nesbitt Burns Technical Analysis

Circling Back to the Reasons for the Current Pullback:

1. Higher Interest Rates

Higher interest rates have forced investors to adjust the discounting algorithm for future corporate free cash flows (higher) leading to lower stock prices, particularly for more cyclical and more expensive stocks. In August, we warned that high duration[1] stocks were vulnerable to higher rates. In simple terms, these are typically very high multiple stocks (e.g. a stock trading at a forward price to earnings multiple of 50 to 100 times), where the bulk of the value comes from expected future growth in cash flows. At the time, we noted that, "We do recommend a more selective approach to sectors and stocks going forward, given we are later in the cycle and inflationary pressures are building. Another reason for this is the massive disparity in performance and valuations we have seen over the last few years."

While the popular perception is that rising interest rates are negative for stocks, our analysis shows that this is not necessarily the case, at least at first. While the median annual return for the S&P 500 has in fact been better when interest rates are declining, our analysis of interest rate cycles going back almost 60 years shows that the market can absorb interest rate increases as long as they are gradual and do not go much above the middle single- digit range. Ultimately, the best portfolio defense against higher rates is to emphasize companies with very high quality balance sheets (i.e. very low debt levels), outsized dividend growth potential and very high quality defensive business models (less competitive businesses). Examples of such companies include Johnson & Johnson, Medtronic, Enbridge, Pembina, Accenture, CP Rail and Coca Cola among others.

2. Slowdown in Economic Momentum:

Over the last few months we have seen a broad slowdown in economic momentum (proxied by International PMI[2] data, particularly in China and Europe). This has spooked investors and the reaction of selling more cyclical stocks (i.e. Technology, Industrials, Financials, Consumer Discretionary, Basic Materials and Energy) aggressively has followed the historical script. By our numbers, since the early 2000s, when the ISM is above 50 and declining (consistent with the current environment), cyclical sectors have declined approximately 4% on average while defensive sectors (Utilities, Telecom, Healthcare and Consumer Staples) have gained about the same amount on average.

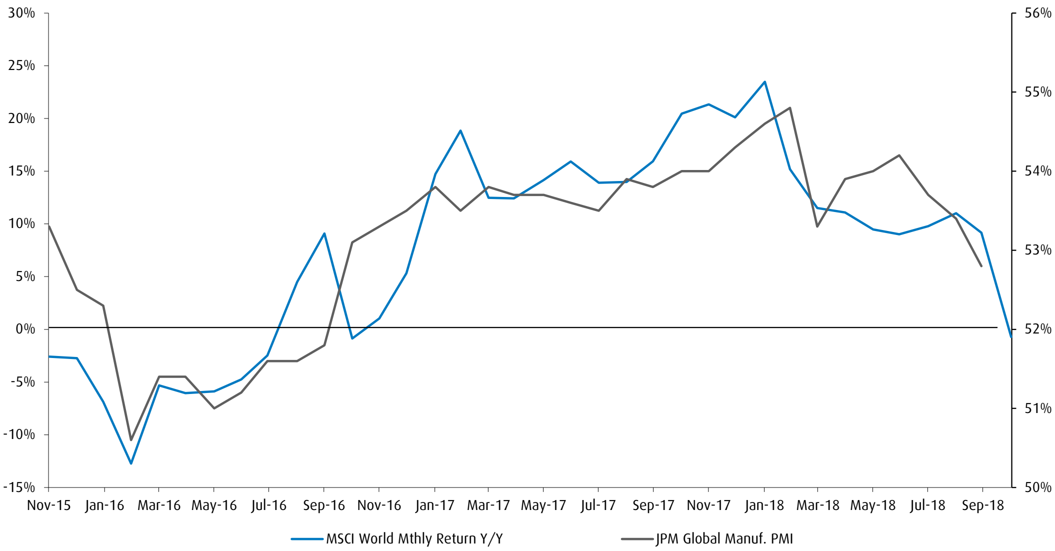
While a negative trajectory on the economy hits risky assets such as stocks, we want to stress that we are still well above recession territory. Our BMO Economics team still forecasts 3.5% global GDP growth next year down only slightly from 3.6% in 2018. Supporting this view are increasing reports that the Chinese government is now considering further simulative measure to help support the economy.

[1] Duration is an approximate measure of a bond's price sensitivity to changes in interest rates. If a bond has a duration of 10 years, for example, its price will rise about 10% if its yield drops by a percentage point (100 basis points), and its price will fall by about 10% if its yield rises by that amount (source: www.thestreet.com).

[2] As our readers know, we very much like ISM (or PMI data internationally) since it correlates very well with market returns as shown by the chart below. Recall that ISM data is a real world survey of hundreds of companies in multiple industries. A lower reading indicates conditions are slowing which is a good leading indicator for a slowdown in sales and profitability.

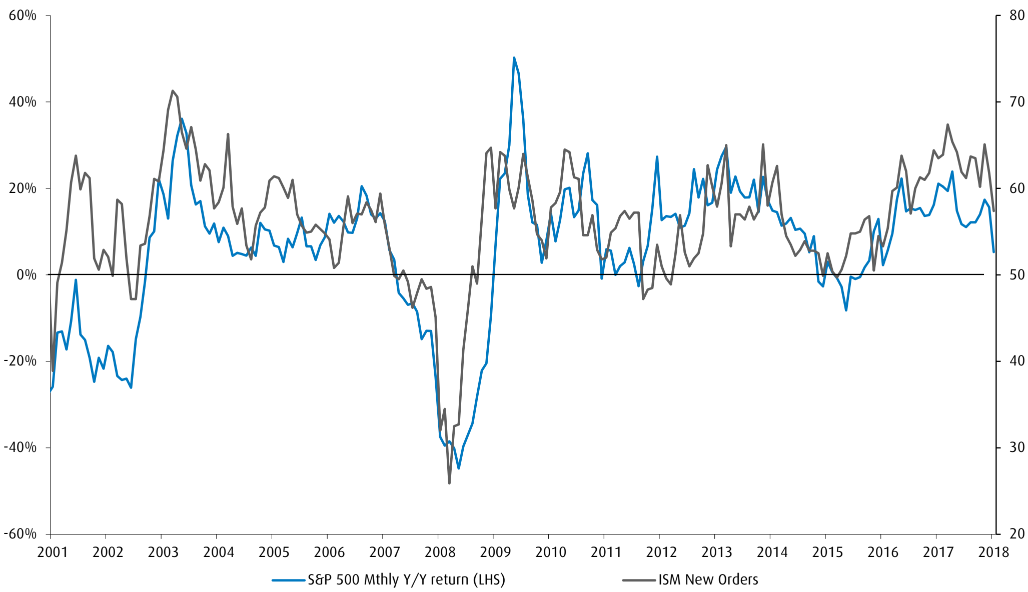
Stocks Seem to Be Overreacting to the Downside

Figure 8: MSCI Monthly Returns (year over year) versus JP Morgan Global Manufacturing ISM



Source: Bloomberg

Figure 9: S&P 500 Monthly Returns (year over year) versus ISM New Orders Index



Source: Bloomberg

Upcoming U.S. Mid-Term Elections

According to the excellent political website FiveThirtyEight, Democrats have an 86% chance of taking over the House of Representatives while Republicans have an 85% chance of retaining control of the Senate. With this in mind going into the November 6 election, we wanted to flag historical market returns around U.S. Mid-Term elections from our research Partner Ned Davis Research's extensive database going back to 1900.

Of course, historical observations on market performance under different political regimes must be taken with a large grain of salt given the massive changes that have occurred in the last century in the composition of the economy, stock market and the evolving ideologies of the Democratic and Republican parties (particularly under the current President). Still, given the historical record, we would say the implications for the current market are mixed.

On the negative side, a split congress has historically led to the weakest market returns when the President is Republican, while on the positive side, there have often been rallies in Q4 of a mid-term year after corrections earlier in the year and Mid-term years have been stronger than average under new Republican presidents.

Key Historical Market Conclusions (From Ned Davis Research):

Mid-term years have been the weakest of the four-year presidential cycle for the stock market, on average (so far this is happening). One of the reasons mid-term years have been weak is that the government has tended to remove stimulus during mid-term years following and to increase stimulus going into the Presidential election. Importantly, Trump and the Republican Congress' decision to increase stimulus (cutting taxes) with unemployment already so low means that we have diverged from the historical then this time.

Figure 10: Presidential Cycle for Dow Jones Industrial Average

Cycle Year	Since 1900 Median % Change	Since 1948 Median % Change
Post Election Year	11.8	11.9
Mid Term Year	4.1	7.5
Pre Election Year	14.4	16.4
Election Year	7.6	7.3

Source: Ned Davis Research

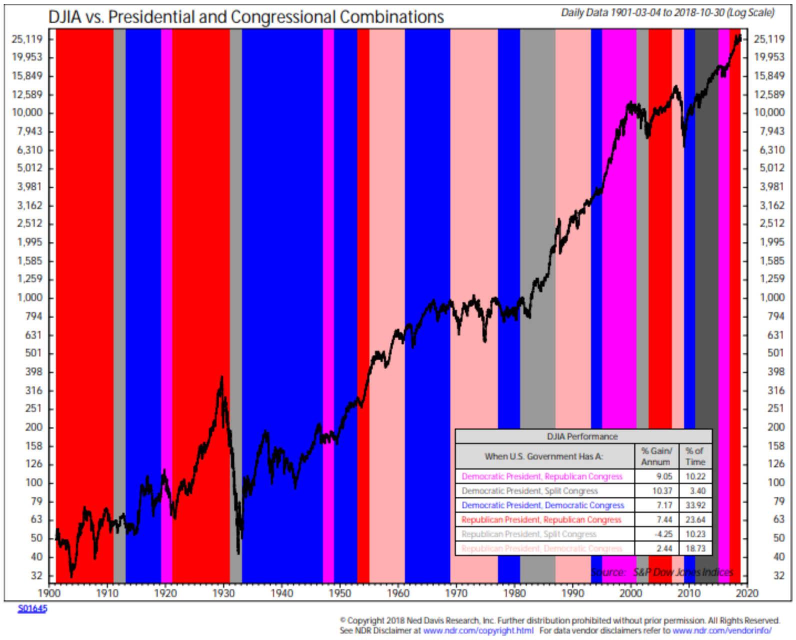
Mid-term years have tended to endure elongated corrections in Q2 and Q3 before a Q4 rally (this appears to be the case so far, we'll see about a Q4 rally).

Mid-term years have been stronger than average under new Republican presidents.

The president's party has tended to lose Congressional seats, especially in the House of Representatives. If Republicans lose the House or Senate (which appears likely for the House), historical trends suggest the stock market could come under pressure.

Leadership trends during mid-term years have reflected low-beta strength: large over small, Value over Growth, High Quality over Low Quality, Dividend Payers over Non-Payers, and High Dividend Yielders over Low Dividend Yielders.

Figure 11: Dow Jones versus Presidential and Congressional Combinations



Source: Ned Davis Research

Stock Fair Value Update

Our fair value discounted cash flow models for the S&P/TSX and S&P 500 yield fair values of ~17,600 and 2,800 respectively.

Figure 12: S&P 500 Fair Value

	Present value	% of value	Earnings per share growth	Discount rate	
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Figure 13: S&P/TSX Fair Value

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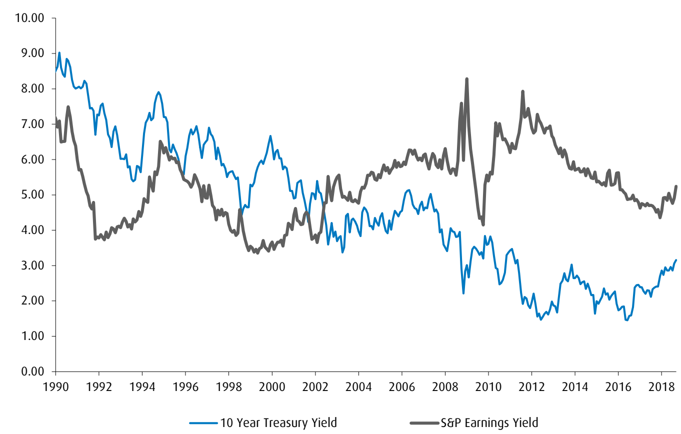
Upside Potential	**17%**		Additional Risk Premium		1.5%
			Total discount rate		10.0%

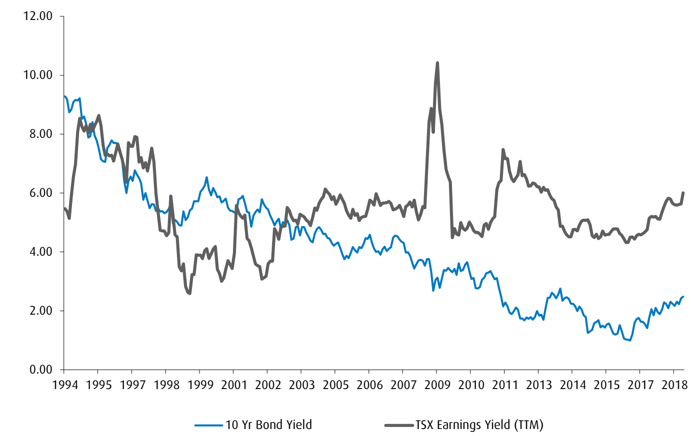
Source: Bloomberg, BMO Nesbitt Burns

Figure 14: S&P 500 Earnings Yield versus 10-year Treasury Yield



Source: Bloomberg

Figure 15: S&P/TSX Earnings Yield versus 10-year Canada Bond Yield



Source: Bloomberg

Figure 16: S&P 500 Index Sector Total Returns to October 2018

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Info. Technology	-7.97	11.02
Health Care	-6.69	8.83
Cons. Discretionary	-11.27	7.04
Utilities	1.96	4.72
S&P 500 Index	**-6.84**	**3.01**
Consumer Staples	2.31	-1.11
Real Estate	-1.73	-2.69
Energy	-11.26	-4.64
Financials	-4.73	-4.65
Telecom. Services	-5.75	-5.04
Industrials	-10.81	-6.50
Materials	-9.47	-11.95

As of October 31, 2018

Source: Bloomberg

Figure 17: S&P/TSX Sector Total Returns to October 2018

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Info. Technology	-8.13	15.72
Health Care	-17.62	6.99
Industrials	-5.85	6.02
Real Estate	-3.31	2.01
Consumer Staples	-0.71	-4.22
Financials	-6.33	-4.23
Telecom. Services	-2.06	-4.72
S&P/TSX Composite Index	**-6.27**	**-5.00**
Utilities	-2.55	-10.11
Energy	-9.10	-10.17
Cons. Discretionary	-6.35	-10.76
Materials	-4.63	-14.25

As of October 31, 2018

Source: Bloomberg

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