August 2018

Equity Strategy

Still Bullish but Beware of High Duration Stocks when Rates Really Start to Rise

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Despite the somewhat ominous title of this missive, we underline that we remain bullish on stocks and maintain the overweight stance on equities we have held for the last 6+ years. The reason for this continued bullishness – which may seem incongruous given trade and geopolitical tensions – is that economic and earnings momentum remain very strong. And as we always point out, the economic cycle almost always trumps (pun intended) politics when it comes to market returns. In short, corporate profitability in the U.S. is rising at the fastest rate since 2010, primarily because of continuing strong economic momentum and the U.S. corporate tax cuts that were enacted at the beginning of the year. In Canada, continued strength in the financial sector and the rebound in oil prices have been a helpful tailwind.

That being said, we *do* recommend a more selective approach to sectors and stocks going forward. However 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. The so called FAANG (Facebook, Amazon.com, Apple, Netflix and Alphabet, mostly known as Google) stocks have been the poster children for this phenomenon over the last two years. As an aside, Alphabet (GOOG) and Amazon.com (AMZN) have been "core" technology stocks in our Guided Portfolios over the last several years and remain our favourites among the FAANG names. Figures 2 and 3 below show the massive outperformance these stocks have experienced since the beginning of 2017 and 2018. Specifically, just Alphabet, Amazon.com, Apple and Netflix have accounted for 40% of the S&P 500's total return this year.

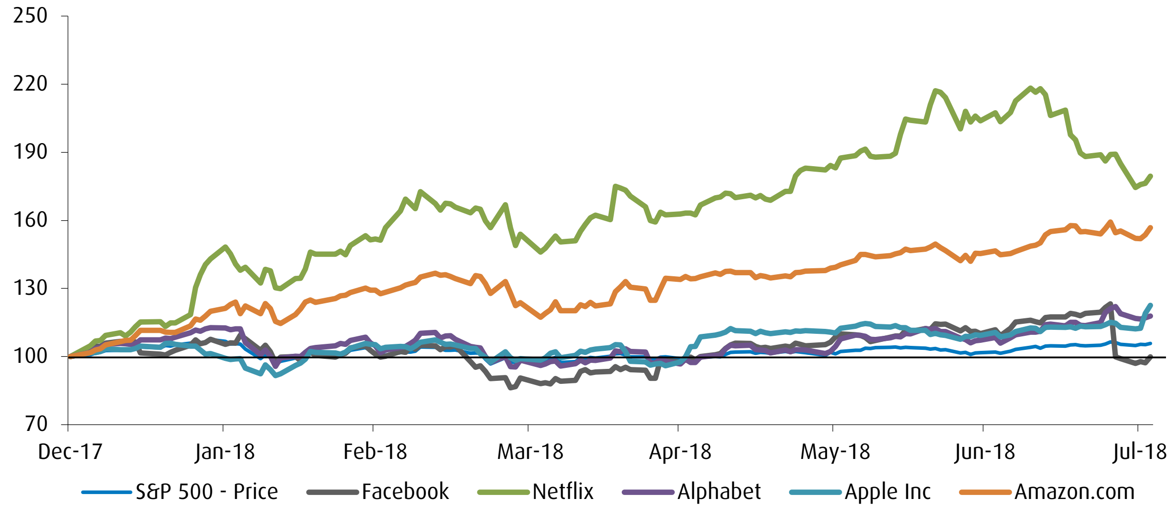
Figure 1: BMO Nesbitt Burns Investment Strategy Committee's Recommended Asset Allocation (%)

	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*

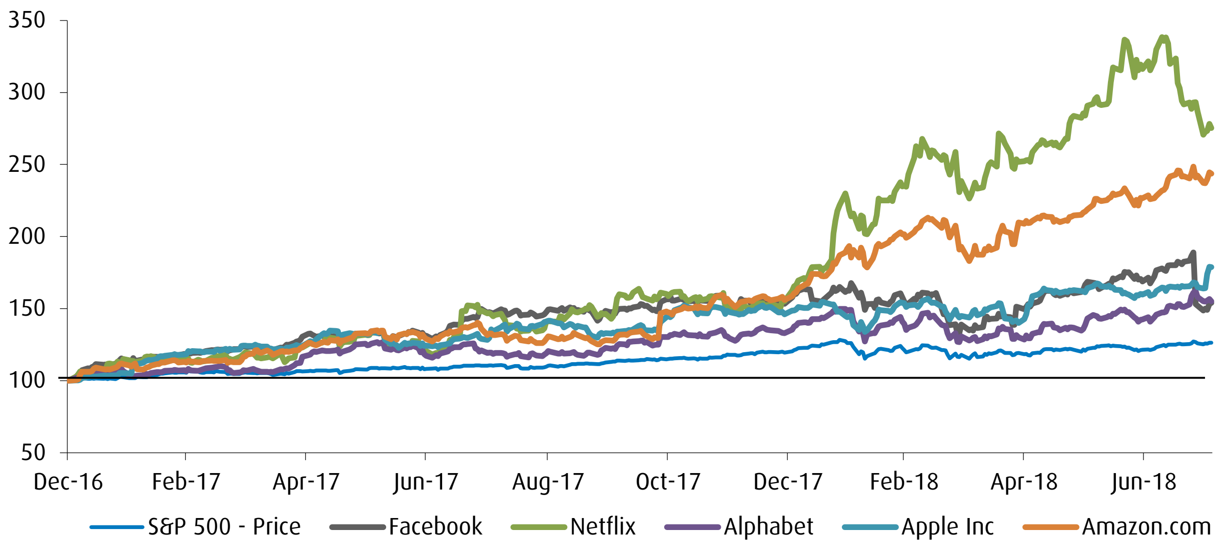
Source: BMO Nesbitt Burns Private Client Strategy Committee

Figure 2: FAANG Stocks versus S&P 500 in 2018



Source: FactSet

Figure 3: FAANG Stocks versus S&P 500 since 2017



Source: FactSet

The Drivers of Stock Returns

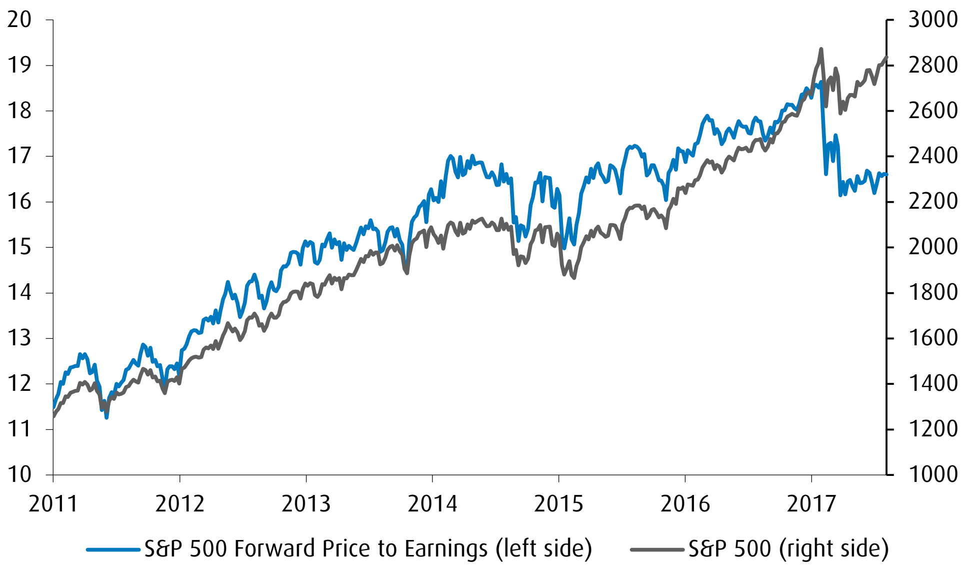
While multiple expansion[1] was the key driver of market returns up to the beginning of 2018, the baton has been passed on to earnings growth. And boy did companies run with it! More specifically, so far this earnings season, profit growth is approximately 20%, the highest level since 2010. And, we believe that profit growth is expected to continue to improve for the balance of 2019. Forward looking guidance – which is even more important to investors than reported numbers (since these are after all backward looking) – has also been very strong. According to Factset, "the number of companies issuing negative earnings per share (EPS) is below the 5-year average while the number of companies issuing positive EPS guidance is well above the 5-year average. At the sector level, the Information Technology and Health Care sectors have the highest number of companies issuing positive EPS guidance for the

[1] We will discuss valuation multiples frequently in this report. A valuation multiple is simply a ratio of the market value of a stock or the market relative to a key metric. While imperfect (i.e. we prefer using free cash flow), in stock trading, one of the most widely used multiples is the price-earnings ratio (P/E ratio). The price/earnings ratio is the ratio of a company's stock price (or the market level) to the company's earnings per share (or the market's overall earnings). The higher the ratio, the more expensive are stocks and vice-versa.

quarter." Incidentally, these have been two of our favourite sectors all year with many high quality names such as Alphabet (GOOG-US), Medtronic (MDT-US), and AstraZeneca (AZN-US) included in our Guided Portfolios.

Figure 4 below shows the S&P 500 progression (grey line) over the last 7 years, overlaid with the market's valuation as represented by the price to earnings (P/E) ratio (blue line). This graphically shows that the market's P/E valuation has expanded from just under 12x in 2011 all the way to a little more than 19x at the beginning of 2018. The multiple then compressed in February 2018, leading to a pronounced pullback in stocks. Our contention is that it was nascent inflation fears which led to this compression since, as our work has shown, a surge in inflation has always been associated with lower valuation multiples going all the way back to the early 1960s (and even earlier). The reason for this is simple in our view. Since the value of a stock is the present value of all future free cash flows, a dollar generated 10 years hence is worth less today when inflation is rising. The same principle applies to the market, only on a larger scale.

Figure 4: S&P 500 versus Forward Price to Earnings Ratio (based on Consensus Estimates)



Source: FactSet

Inflation Fears and Long Term Interest Rates

Wage inflation – partly offset by productivity growth – is one culprit for inflation fears. Another is Trump's trade policies. As BMO Economics recently noted: "we estimate that the combination of tariffs on washing machines (20% to 50%) and solar panels (30%), steel (25%) and aluminum (10%), and on US$50 billion of Chinese goods (25%), will add a tenth to U.S. headline inflation. The proposed 10% tariff on a further US$200 billion of Chinese goods could tack on another tenth. While these inflation impacts might appear small, keep in mind that goods imports are still only a bit above 12% of U.S. GDP and the net negative economic impact of tit-for-tat tariffs will be disinflationary. Further escalation of this trade war to tariffs on more Chinese goods and all imported vehicles could easily vault the cumulative impact on inflation above a full percentage point… Clearly, if the rate is now 25% instead of 10%, this would potentially ramp up the additional figure by 0.2-to-0.3%". And of course, historically, higher inflation eventually leads to higher interest rates.

With U.S. 10 year rates – the single most important benchmark in the world of finance – flirting with the 3% level again, pundits are pondering whether we are on the cusp of seeing a more sustainable move higher. The implications of course are nothing short of enormous across all asset classes. When this does happen – and to be clear, we are firmly in the "when" not "if" camp – it will require an important shift in the way investors manage portfolios and risk.

While 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 high single digit range (the S&P has historically struggled once the 10-year goes above the 6-8% level).

As we noted a few months back: "However, the changing inflation and interest rate landscape provides some interesting geographic allocation opportunities. In Canada specifically, the market has reacted quite differently, posting far better median gains when interest rates were rising, likely because these periods coincided with inflationary pressure and associated strong commodity price cycles. We remind our readers that approximately a third of the S&P/TSX market capitalization is in the Energy and Materials sectors versus less than 10% in the U.S."

Rising 10 year interest rates directly impact the price of bonds as higher rates mathematically lead to lower bond prices. The longer the maturity of the bond, the more pronounced the impact. They also have a significant impact on equity sector valuations and performance. It is well understood that rising interest rates have a nefarious impact on the performance of defensive, lower growth sectors such as Utilities, Telecommunications and REITs since 1) these sectors are typically very capital intensive so as interest rates rise, their costs of funds go up and 2) it makes the typical dividend yield advantage of these sectors less attractive relative to bond alternatives.

From High Duration Bonds to High Duration Stocks

Perhaps less well understood however is the impact to "high duration stocks". In simple terms, these are typically very high multiple stocks (e.g. a stock trading at a forward P/E of 50 to 100 times), where the bulk of the value comes from expected future growth in cash flows. In other words, while the stock may seem extremely expensive based on current profits, investors expect such strong growth in the future, that the current price still seems attractive.

Getting back to some of the previously mentioned FAANG stocks: Netflix trades at a 126x forward P/E and Amazon trades at 106x.

Using Amazon.com as an example is instructive. In our view, this company has a dominant business model and as such it is a "core holding" that we have been recommending. It is BMO Capital Markets analyst Dan Salmon's top pick and he recently raised his price target to US$2,250. By conducting a simple discounted cash flow analysis that uses consensus free cash flow estimates, applies a reasonable growth rate to the future and discounts those cash flows at a rate of 9.5% (including a 10 year bond "risk free" rate of 3%), we get a fair value output that is very close to our analyst's price target and implies a very attractive upside of almost 30% from current levels.

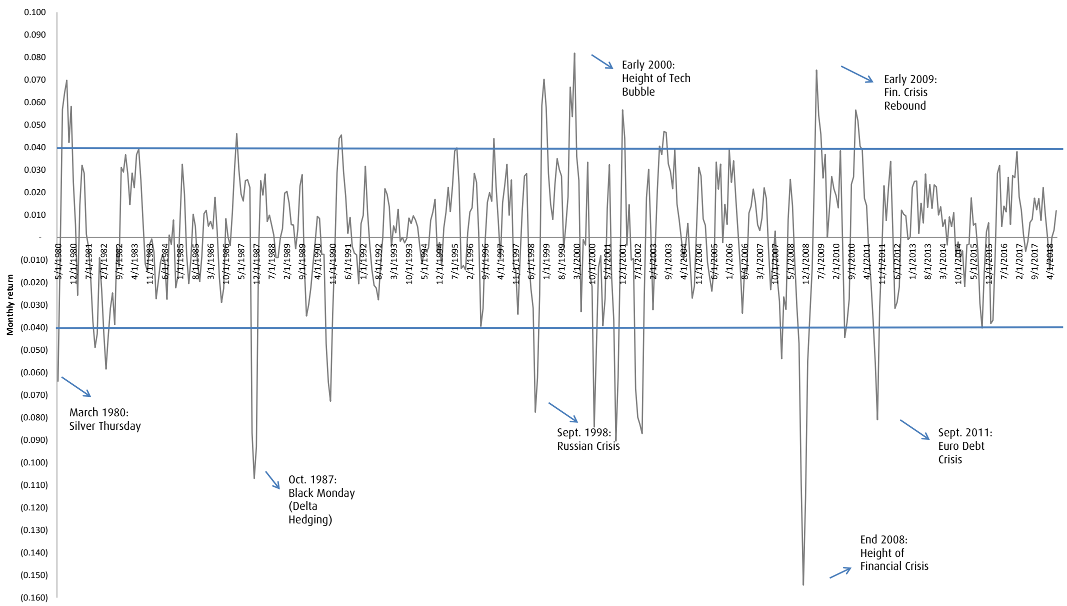
However, if the market factors that the long term bond rate increases by 1% (i.e. by increasing the 10 year bond rate assumption to 4%), this will increase the discount factor from 9.5% to 10.5% and REDUCE the fair value for the shares by almost 20%. The good news in the case of Amazon, is that there would still be some upside under this adverse scenario, but that is not the case for many other "high duration" stocks where the downside risk could be very significant.

BMO Risk Appetite Index: Continues to Move Up

Looking at our proprietary BMO North American Risk Appetite Index (which we introduced last year), the continued earnings-led recovery in stocks has helped risk appetite rise for the last 3 months. While we are above average at this point we are still a long way from a more dangerous "euphoria zone" which has historically been followed by sharp pullbacks.

By way of background, we created the BMO Private Client North American Risk Appetite Index (RAI) to get a more rigorous and less anecdotal sense for market sentiment. In order to do this, 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 do better than stocks (which is typical when investors fear an economic slowdown for example), the RAI goes down. 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.

Figure 5: Risk Appetite Index



Source: Bloomberg

Stock Fair Value Update

Our fair value discounted cash flow models for the S&P/TSX and S&P 500 yield fair values of ~18,000 and 2,850 to 2,900 respectively.

Figure 6: S&P 500 Fair Value

	Present value	% of value	Earnings per share growth	Discount rate	
Period 1 (2018-2021)	$535.49	18.7%	7%	9.0%	
Period 2 (2022-2026)	$582.64	20.3%	5%	9.0%	
Period 3 (2027 -)	$1,750.42	61.0%	3%	9.0%	
Rounded Fair Value	**$ 2,870**	100.0%	Next 12 month consensus		140
			Implied terminal mult.		16.2 X
Current Price (July 31, 2018)	**$ 2,816**		Long Bond		2.5%
			Historical Equity Risk Premium		4.5%
Upside Potential	**2%**		Additional Risk Premium		2.0%
			Total discount rate		9.0%

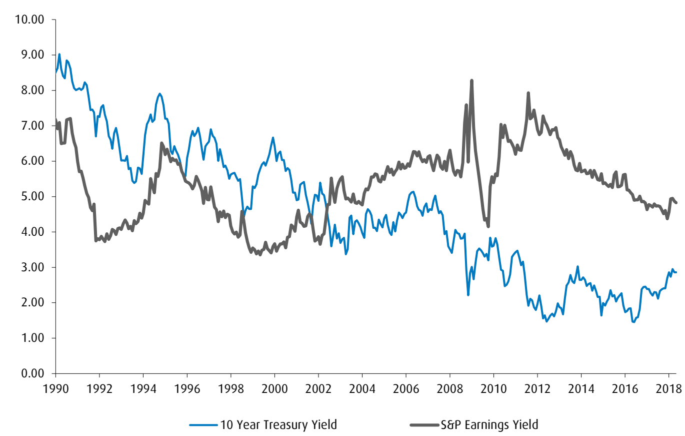
Source: Bloomberg, BMO Nesbitt Burns

Figure 7: S&P/TSX Fair Value

	Present value	% of value	Earnings per share growth	Discount rate	
Period 1 (2018-2021)	$ 3,774.51	21.0%	7%	9.0%	
Period 2 (2022-2026)	$ 3,993.85	22.2%	5%	9.0%	
Period 3 (2027 -)	$ 10,214.43	56.8%	2%	9.0%	
Rounded Fair Value	**$ 18,000**	100.0%	Next 12 month consensus		970
			Implied terminal mult.		14,1 X
Current Price (July 31, 2018)	**$ 16,434**		Long Bond		2.5%
			Historical Equity Risk Premium		4.5%
Upside Potential	**10%**		Additional Risk Premium		2.0%
			Total discount rate		9.0%

Source: Bloomberg, BMO Nesbitt Burns

Figure 8: S&P 500 Earnings Yield versus 10-year Treasury Yield



Source: Bloomberg

Figure 9: S&P/TSX Earnings Yield versus 10-year Canada Bond Yield

Source: Bloomberg

Figure 10: S&P 500 Index Sector Total Returns to June 2018

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Cons. Discretionary	1.83	13.56
Info. Technology	2.09	13.19
Health Care	6.61	8.57
Energy	**1.42**	**8.32**
S&P 500 Index	3.72	6.47
Industrials	7.32	2.29
Utilities	1.86	2.19
Financials	5.27	0.97
Real Estate	1.00	0.03
Materials	2.96	-0.21
Consumer Staples	4.07	-4.83
Telecom. Services	2.33	-6.22

As of July 31, 2018

Source: Bloomberg

Figure 11: S&P/TSX Composite Sector Total Returns to June 2018

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Info. Technology	-2.07	19.72
Industrials	4.77	11.69
Energy	1.04	5.92
Real Estate	1.58	4.42
Cons. Discretionary	-0.24	3.28
S&P/TSX Composite Index	1.15	3.12
Financials	**2.61**	**1.09**
Materials	-3.99	-0.85
Telecom. Services	3.80	-1.34
Consumer Staples	0.86	-1.78
Utilities	0.84	-5.46
Health Care	-8.81	-9.85

As of July 31, 2018

Source: Bloomberg

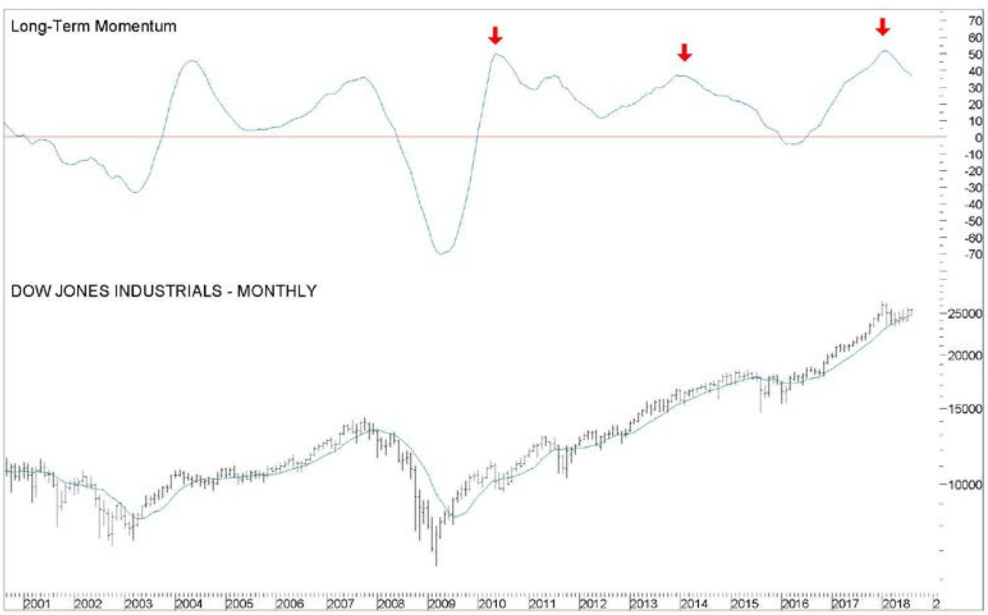
The Technical Picture— The Wayback Machine

Russ Visch, CMT, Technical Analyst

We treat this report as an ongoing dialogue covering the medium to long-term technical outlook for North American equities. As part of that we regularly review past comments for continuity and accuracy. This month the Wayback Machine jumped to September of 2016 where we highlighted the fresh (at the time) new buy signals in our Long-Term Momentum Model. At the time we noted:

> "…this model has a near-perfect record of catching important long-term turns in equity markets. Three signals – May 1941, April 2001, and January 2002 – provided sub-par/early signals, but every other signal since 1930 produced gains in the Dow Industrials of more than 10%, with 15 of the 22 signals providing returns of 30% or greater. The 22 signals over the past 80 years average out to about 23 months for the uptrend, with an average return just over 58%. If history is any guide then we're in for quite a ride over the next two years."

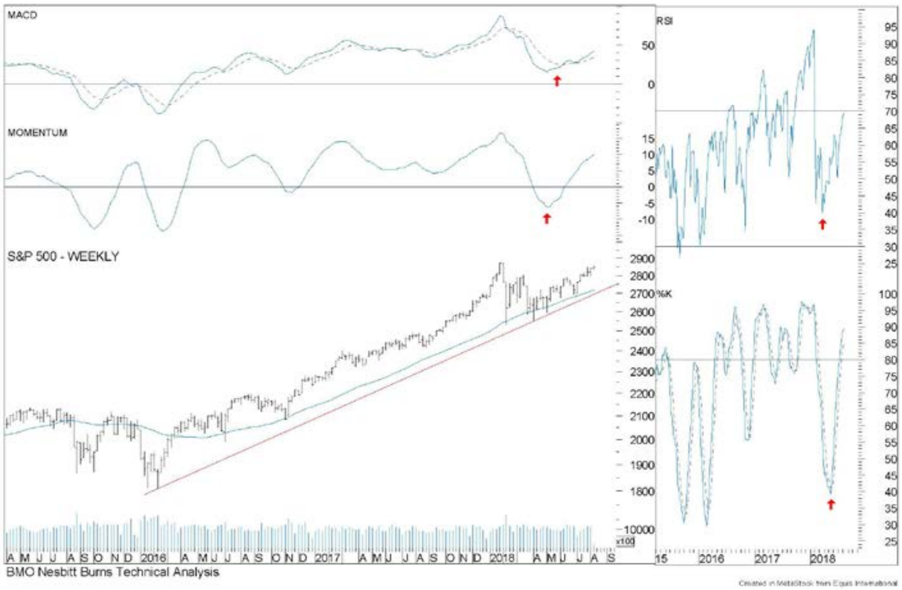
Figure 12: Long Term Momentum Indicator



Source: BMO Nesbitt Burns Technical Analysis

In the intervening two years the Dow Industrial Average is up more than 45% which is below the historical average for our model, but impressive nonetheless. Unfortunately, the current medium/long-term outlook is a bit more uncertain this September since this same indicator is now decidedly negative for the first time since 2014 and other market-based measures of economic activity noted in last month's report (base metals and important emerging market indexes such as the South Korean Kospi index) have broken down. We have endured two cyclical bear markets since the credit crisis ten years ago, and in each instance these indicators diverged an average of 6-12 months ahead of the cyclical peak in stocks.

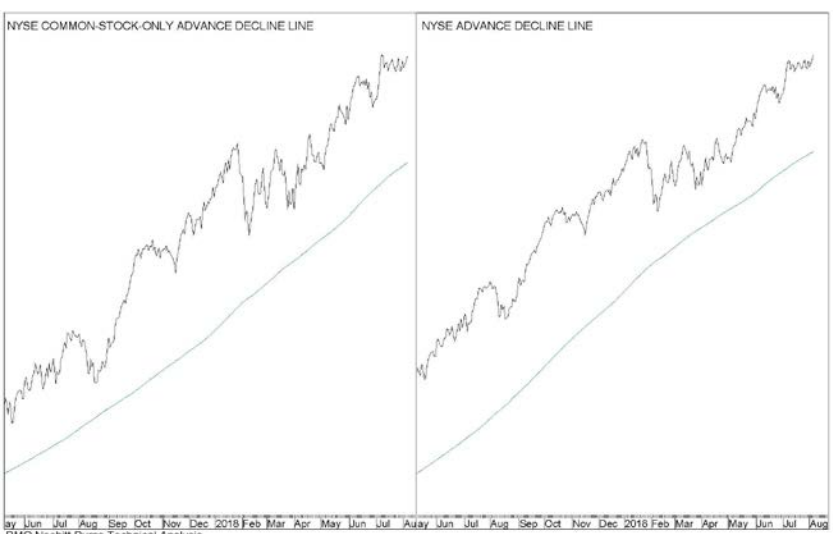
Figure 13: S&P 500 Index Weekly Momentum Indicators



Source: BMO Nesbitt Burns Technical Analysis

It's important to note that a bear market is neither imminent nor a "sure thing" at this point. While many of these "early warning" gauges are flashing bright red, our medium-term timing model for North American equities remains mostly positive and supportive of more upside. For example, weekly momentum gauges continue to improve for the S&P 500, key barometers of market health such as the various Advance-Decline lines we follow continue to make new all-time highs, and bullish sentiment continues to improve within the neutral zone. As such, it's entirely possible that the concerns we have right now may be erased as stocks march higher into the end of the third quarter. i.e. – it's likely that the S&P 500 makes new all-time highs at some point in the weeks ahead, following in the footsteps of the S&P/TSX Composite, Nasdaq Composite, Russell 2000, etc., all of which have already made new all-time highs in recent weeks. They definitely bear monitoring as this rally progresses though.

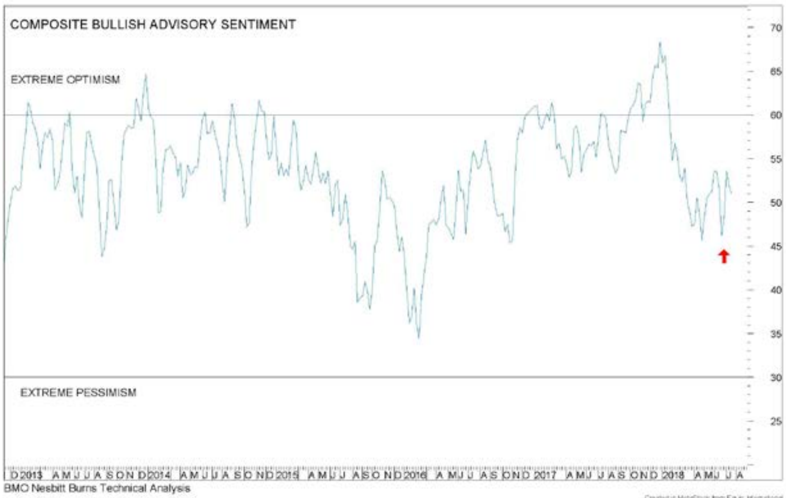
Figure 14: NYSE Advance-Decline Lines



Source: BMO Nesbitt Burns Technical Analysis

In terms of upside potential, the breakout in the S&P/TSX Composite above resistance at 16,421 opened a new medium-term target of 17,850, which remains in effect. Key resistance for the S&P 500 is the early 2018 (all-time) high at 2872. A break above that level – like at some point before the end of the third quarter – would open a new upside target of 3211.

Figure 15: Composite Sentiment Indicator



Source: BMO Nesbitt Burns Technical Analysis

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