Portfolio Advisory Team

Portfolio Management

November 2019

Equity Strategy

November 2019: Recession Probabilities Have Increased but 1990s Parallels Keep us Positive

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An interesting disconnect is developing between the stock market and the seemingly never-ending refrain of bad news coming from the wires: global slowdown, trade uncertainty, Middle Eastern tension and more and more pundits trying to convince investors that a recession is on the way. And yet, major North American stock indices are at or close to record highs. What gives?

To provide clients some perspective and to try to separate fact from emotion, we created a proprietary recession probability model in the last year. Admittedly, odds of a North American recession occurring in the next year have increased to over 40% in the last few months but we are still below the dangerous 50% threshold. Interestingly, as the chart below shows, our model also went above 40% on a few occasions in the 1990s and the odds subsequently receded. We believe we could be looking at a similar scenario in 2019 as well. We argue that there are many similarities between the current expansion and the one from the 90s, which was of course characterized by one of the longest uninterrupted U.S. economic expansions and was associated with very high equity returns. Low inflation and interest rates (and associated very easy monetary conditions) and vast technological innovation which resulted in productivity acceleration are the most important similarities in our opinion. The 1990s bull market eventually culminated in the tech bubble but reassuringly, we are still far from that type of market "euphoria" based on our models. Recall that we raised our fair value estimates for the S&P 500 and TSX to 3,300 and 19,000 back in July. If the parallel with the 1990s holds, these numbers could be quite conservative.

Figure 1: Recommended Asset Allocation by Investor Type

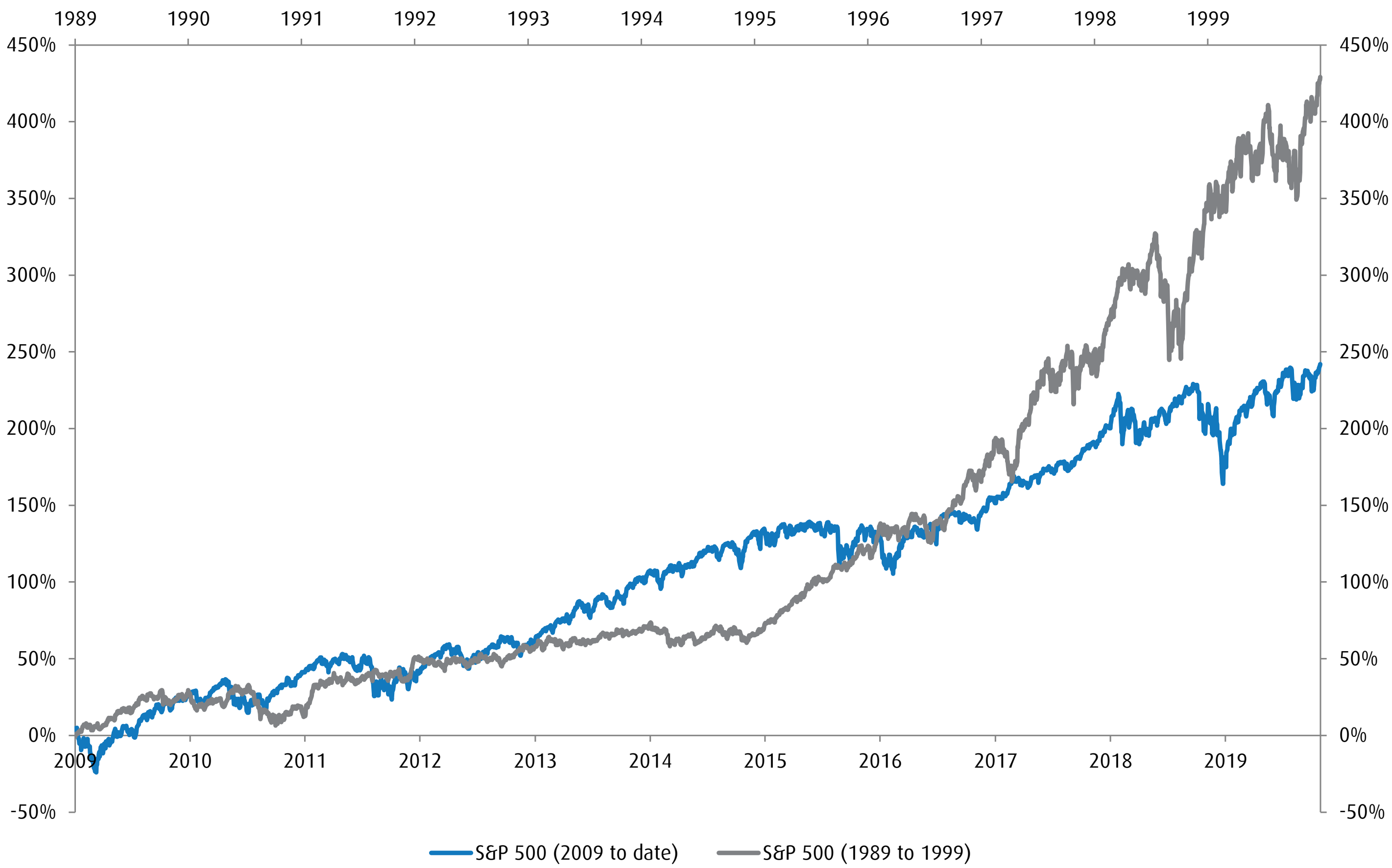
	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	5	5	5	5	5	5	0	5
Fixed Income	65 ↓	70	35 ↓	45	15 ↓	25	0 ↓	0
Equity	30	25	60	50	80	70	100	95
Canadian Equity	20 ↑	15	30 ↑	25	40 ↑	35	45 ↑	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.

Parallel with the 1990s

The recession of 1990 has been largely attributed to restrictive monetary policy (i.e. higher interest rates) enacted by the Federal Reserve along with the **1990** oil price shock which was caused by the first Gulf War. The following decade, however, became associated with one of the strongest periods of sustained economic growth and prosperity on record.

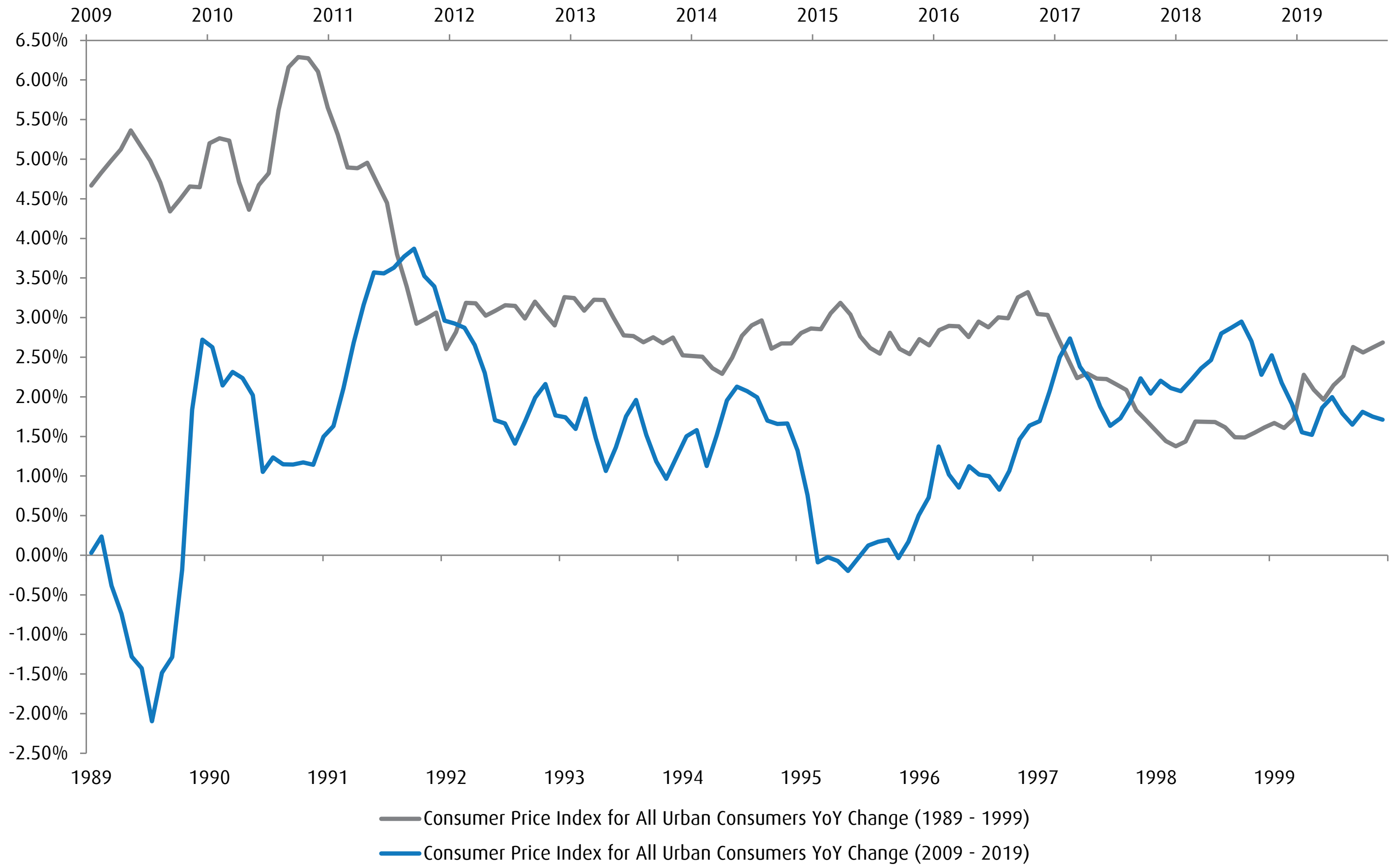
Figure 2: S&P 500 1989 to 1999 versus 2009 to 2019 – Stock gains accelerated along with productivity in the mid-90s. This could bode well for future returns in the next few years.



Source: FactSet; data from January 01, 1989 to December 31, 1999 and January 01, 2009 to October 29, 2019

As the New York Times describes it: “Back then, technological advances that had been building for years finally started to translate into higher rates of productivity growth economy wide. Some feared inflation, but Alan Greenspan, the Federal Reserve chairman, decided not to move pre-emptively to choke off the expansion. Instead, he advocated patience to see just how hot the economy could get without setting off a spiral of rising prices”.

Figure 3: Inflation Has Systematically Been Lower in the Last 10 Years Than in the "Goldilocks" 1990s Era

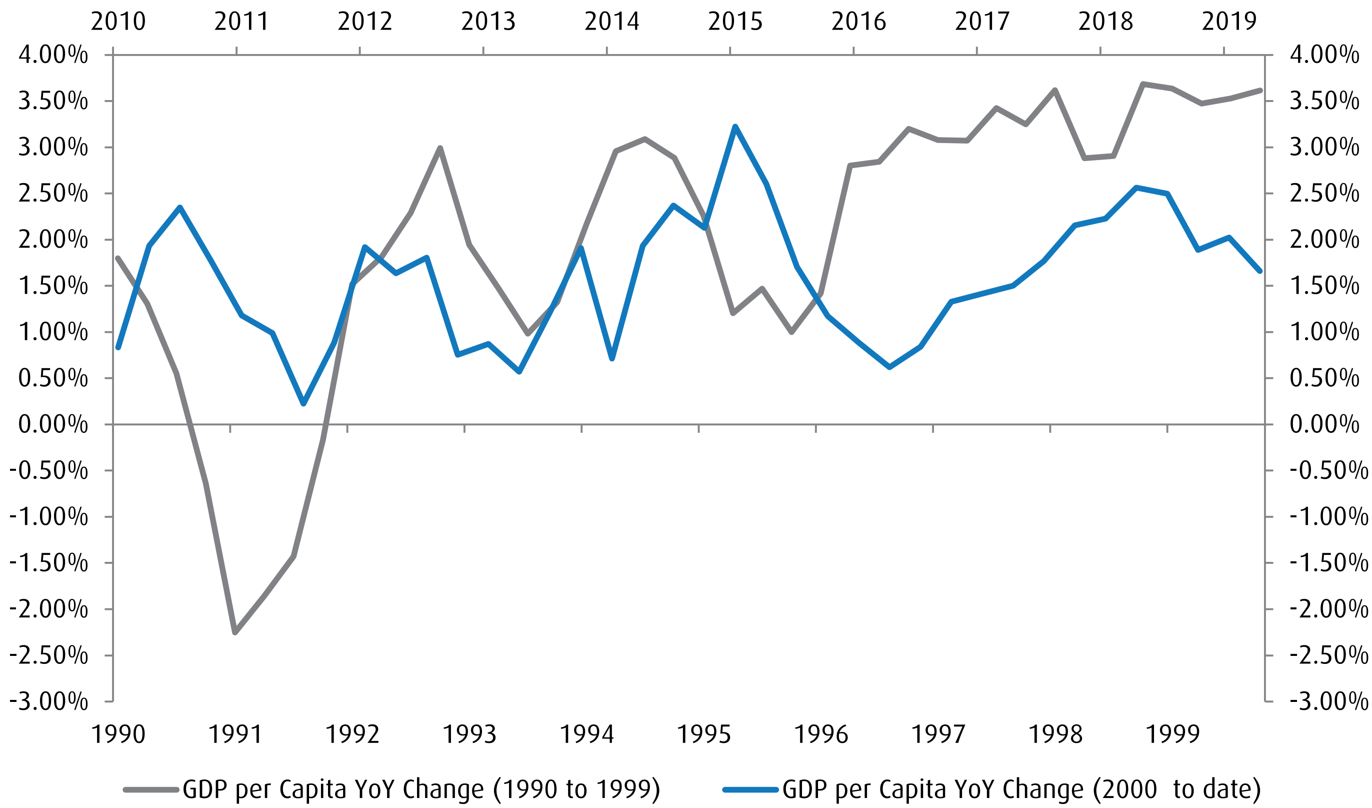


Source: FRED; data from January 1989 to December 1999 and January 2009 to September 2009

The bet paid off (at least for while) as annual productivity rose an average of 1.8 percent from 1991 to 1995, then leapt to a 3 percent annual rate from 1996 to 2000 which allowed the economy (and corporate profits) to grow faster with triggering an inflationary spiral.

In a recent study, consulting firm McKinsey believes "digitization" could be about to unleash a second wave of productivity acceleration. They see productivity growth "of at least 2 percent per year over the next decade, with about 60 percent coming through digitization. That's below the roughly 2.5 percent annual rate achieved by the United States in the late 1990s and early 2000s, but well ahead of the 0.5 percent annual average in recent years".

Figure 4: Productivity Growth Accelerated in the Mid 90s; We Have Yet to See This In the Current Expansion



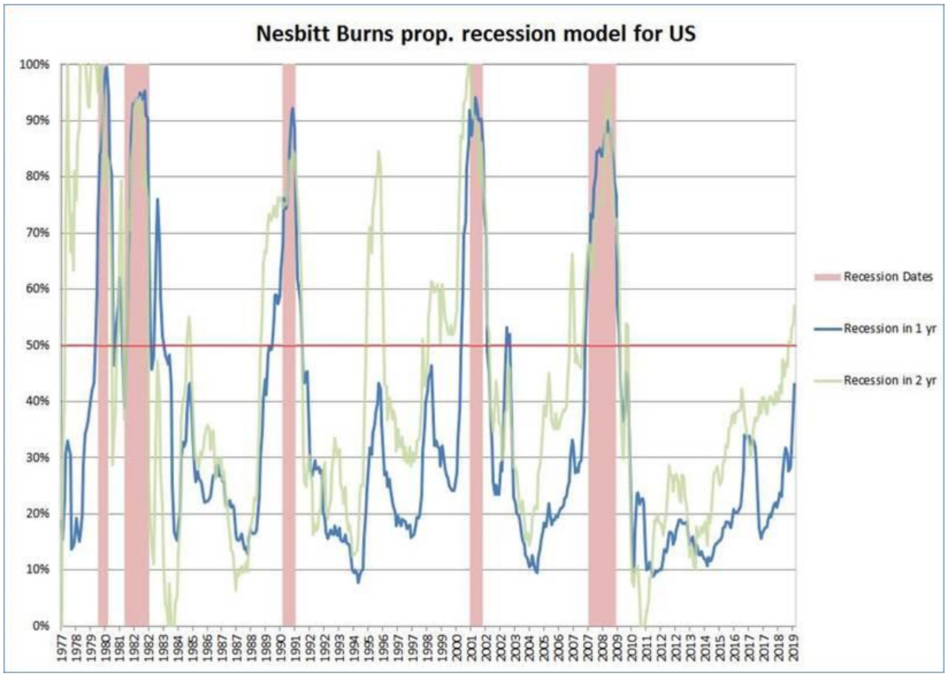
Source: FRED; data from January 1990 to December 1999 and January 2010 to September 2009

By digitization, McKinsey refers to "the latest digital technology—such as cloud computing, e-commerce, the mobile internet, artificial intelligence, machine learning, and the Internet of Things—that is moving beyond process optimization to fundamentally transform business models, alter value chains, and blur the borders of industries".

Some examples they use are illuminating. "In retail, while online sales are twice as productive as offline, they account for only about 10 percent of total sales today in the United States and Western Europe, according to data from Euromonitor International. Transition costs abound in the realization of productivity benefits, starting with the impact of declining foot traffic in traditional retail stores and malls. Behind the headlines about drone delivery and workerless distribution centers, retailers are working overtime to strike the right "Goldilocks" balance between offline and online retail; their quest will take time.

In the utilities sector, some estimates suggest that digital opportunities such as smart meters and grids, digital productivity tools for employees, and automation of back-office processes could boost profitability by as much as 20 to 30 percent. Investments in digital technologies are still subscale, though, and come with a learning curve. Renewables, too, tend to be more productive—however, wind and solar energy, for example, still comprise less than 10 percent of power generation in the United States and less than 20 percent in Europe".

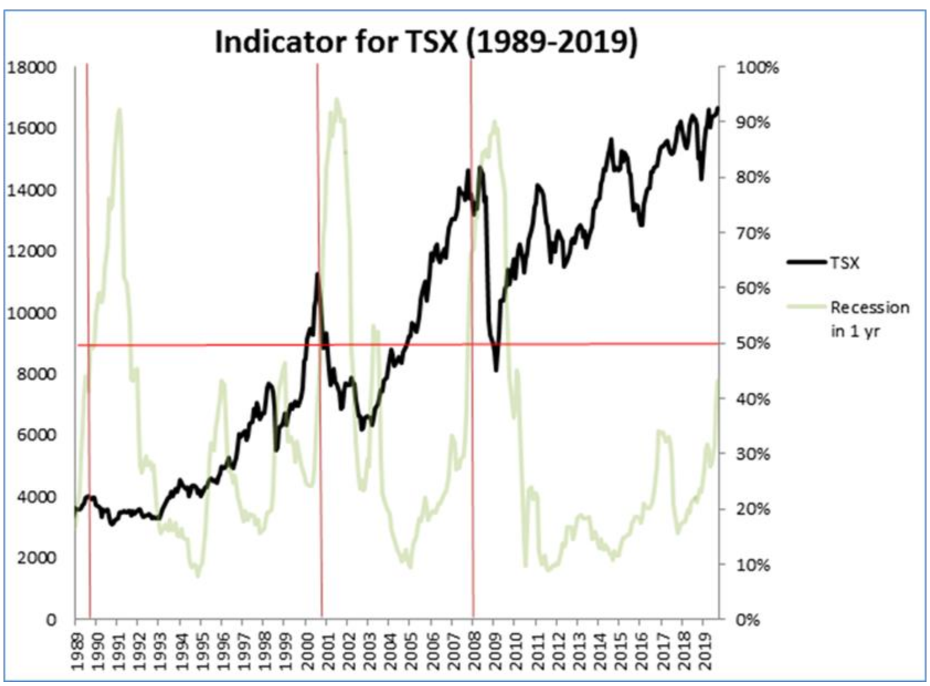
Figure 5: BMO Private Client Recession Probability Model: Odds Rising But Not Ominously Yet



ISM New Orders	Yield Spread (10yr/3mo)	Real Manufacturing & Trade Sales	Manufacturing Employment	Initial Claims	CFNAI	Economic Policy Uncertainty

Source: BMO Private Client Strategy, Bloomberg

Figure 6: Recession Probability Model: Historically Market has Corrected When Odds Rise Above 50% For an Extended Period



Source: BMO Private Client Strategy, Bloomberg

In our latest update, the odds of a recession in the next year increased to over 40% from 35% 6 months ago. This was mainly due to 2 factors: 1) lackluster manufacturing employment (it has been rolling over of late), and 2) increased Economic policy uncertainty (trade war, upcoming election etc).

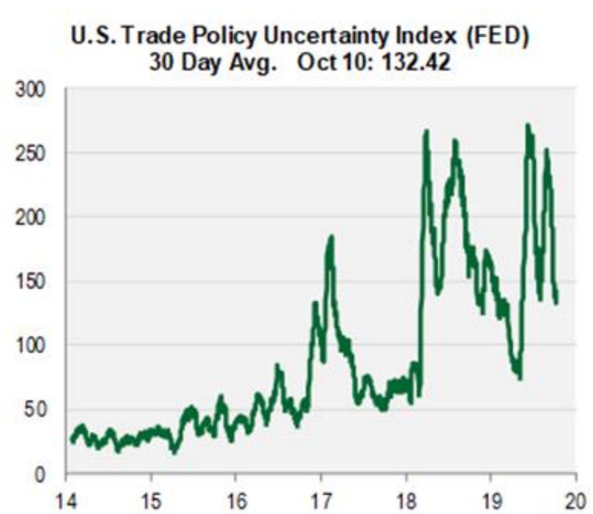
So what are the Silver Linings?

The key silver linings from our perspective are that some manufacturing indicators are starting to improve globally (particularly in China, Europe and the U.S.), Trade Policy Uncertainty is receding (a bit) with talk of a "Phase 1" trade deal with China, and that the U.S. and Canadian yield curves are starting to steepen again indicating that the bond market is expecting stronger growth in the future.

Cornerstone Macro is of this view as well, and adds that U.S. manufacturing is gaining strength because:

1. The lagged impact of lower corporate bond yields is kicking in (i.e. lower cost of financing for companies).
2. U.S. inventory drag is fading. In 2018/early 2019, inventories were built in anticipation of the higher tariffs, and then drawn down, weakening manufacturing activity. Markit manufacturing inventories averaged roughly 52% in 2018, and then dropped to less than 47% in mid-2019. October's reading of 48% is still low, but the measure appears to have stabilized.
3. The U.S. export drag is ending. They'd been brought forward in anticipation of the tariffs, and then weakened significantly. Markit's manufacturing new export orders index plunged from 52% in mid-2018 to less than 46% in mid-2019. In October, it rebounded to 51%.
4. Trade Policy Uncertainty is fading. About a month ago, the Fed introduced their Trade Policy Uncertainty index (TPU[1]). It rose sharply in 1H 2019, but then dropped into October. With a trade truce now appearing to unfold, the November reading is likely to decline even further.

Figure 7: Trade Policy Uncertainty



Source: Cornerstone Macro

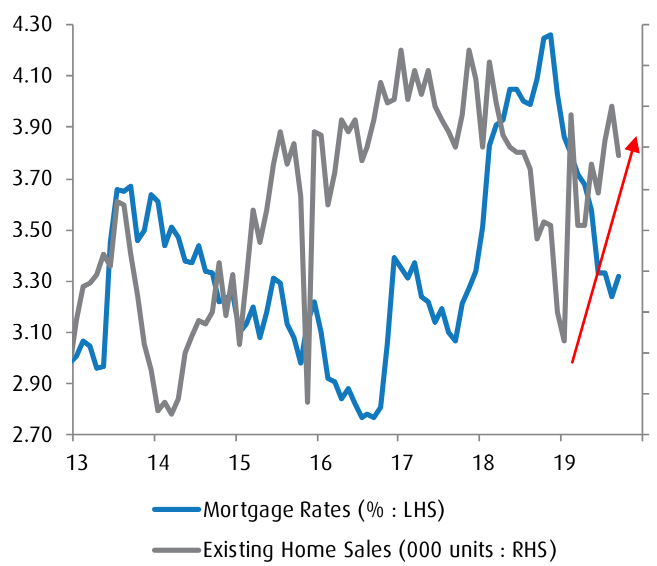
[1] Our first measure of TPU is based on searches of newspaper articles that discuss trade policy uncertainty. We run automated text searches of the electronic archives of seven newspapers: Boston Globe, Chicago Tribune, Guardian, Los Angeles Times, New York Times, Wall Street Journal, and Washington Post. We select articles that discuss TPU by searching for terms related to uncertainty--such as risk, threat, uncertainty, and others--that appear in the same article as a term related to trade policy--such as tariff, import duty, import barrier, and anti-dumping. Our news-based measure of TPU is the monthly share of articles discussing trade policy uncertainty, rescaled to equal 100 for an article share of 1 percent. Source: Fed.

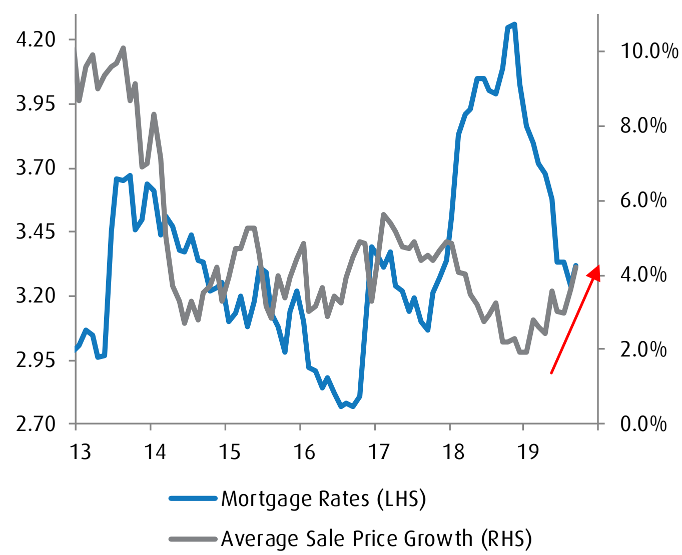
Housing Continues to be a Major Source of Strength and Household Net Worth Keeps Hitting New Highs

The biggest purchase a consumer can make is a house, and with the 30-year mortgage rates in the U.S. falling to 3.80% (from 4.90% a year ago), and close to all-time lows, that is going to be supportive for the consumer and the stock market longer-term, given housing's economic importance. Put another way, the reduction in mortgage rates has improved housing affordability by over 10% in the U.S. and Canada since the start of the year. Sure enough, homebuilders and even lumber stocks are acting very well which is inconsistent with an economy on the edge of the proverbial cliff.

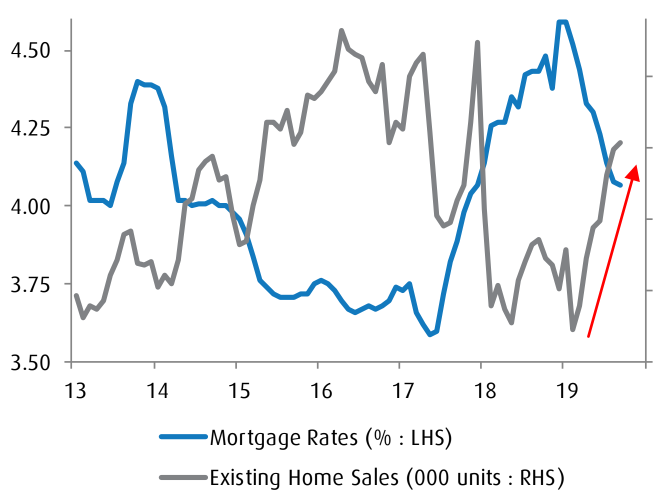
Figure 8: The Charts Below Clearly Show That The Reduction in Mortgage Rates is Boosting Sales and Home Prices in North America

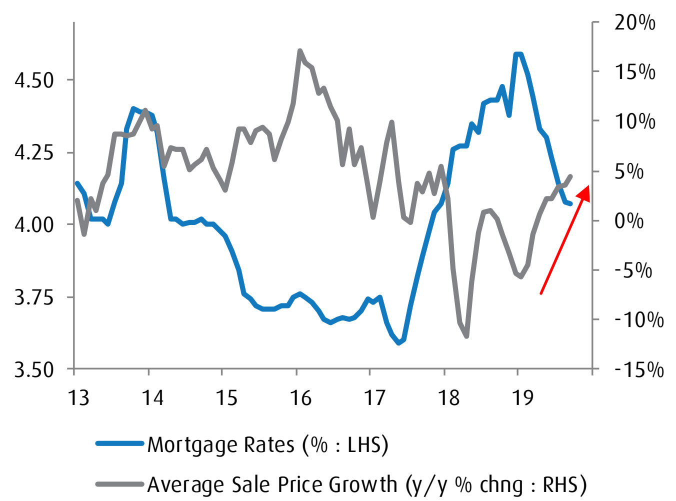
United States

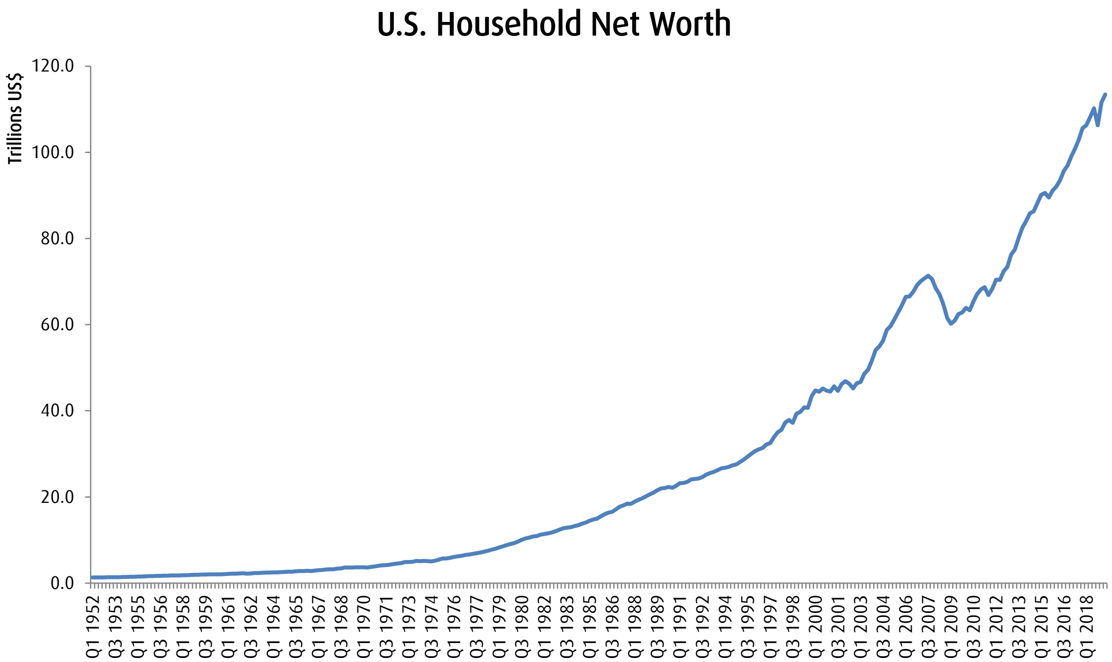


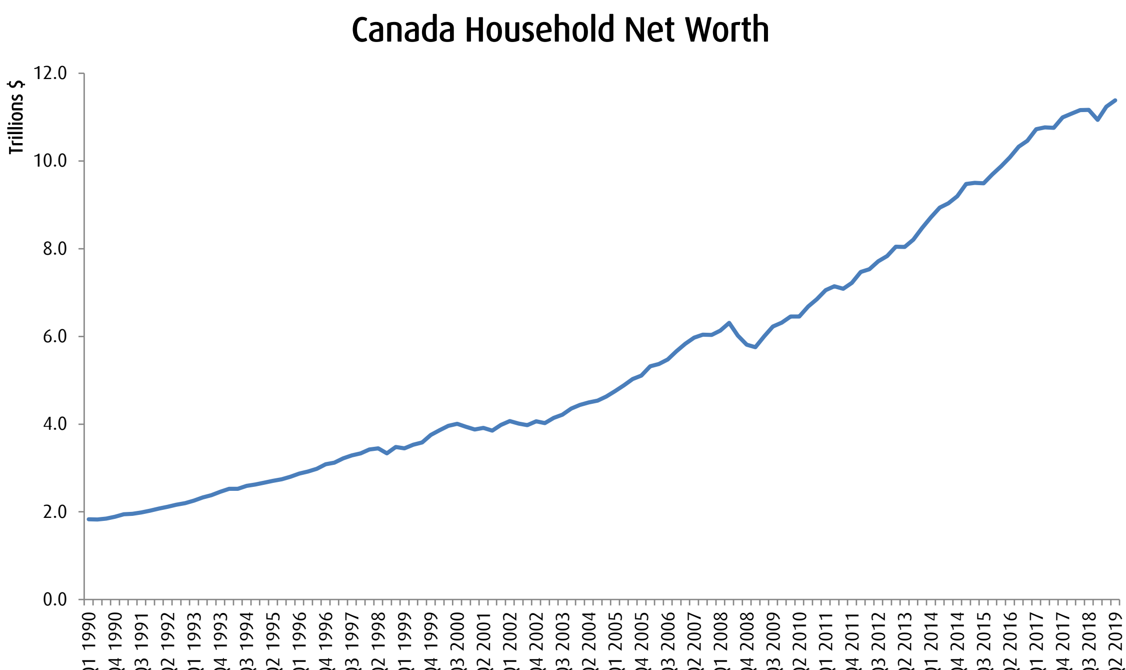


Canada







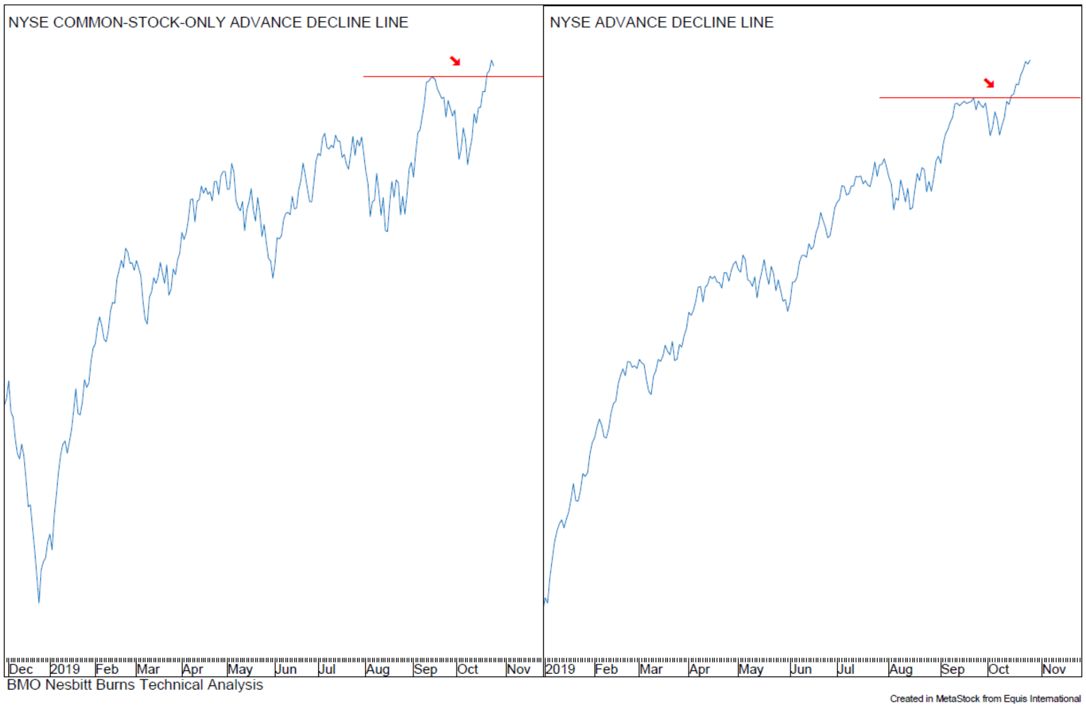


Source: FRED, Statistics Canada; the U.S. mortgage rate is the 15-year fixed rate; the Canada mortgage rate is the conventional 5-year term mortgage lending rate

The Technical Picture Supports Our Constructive Fundamental Assessment

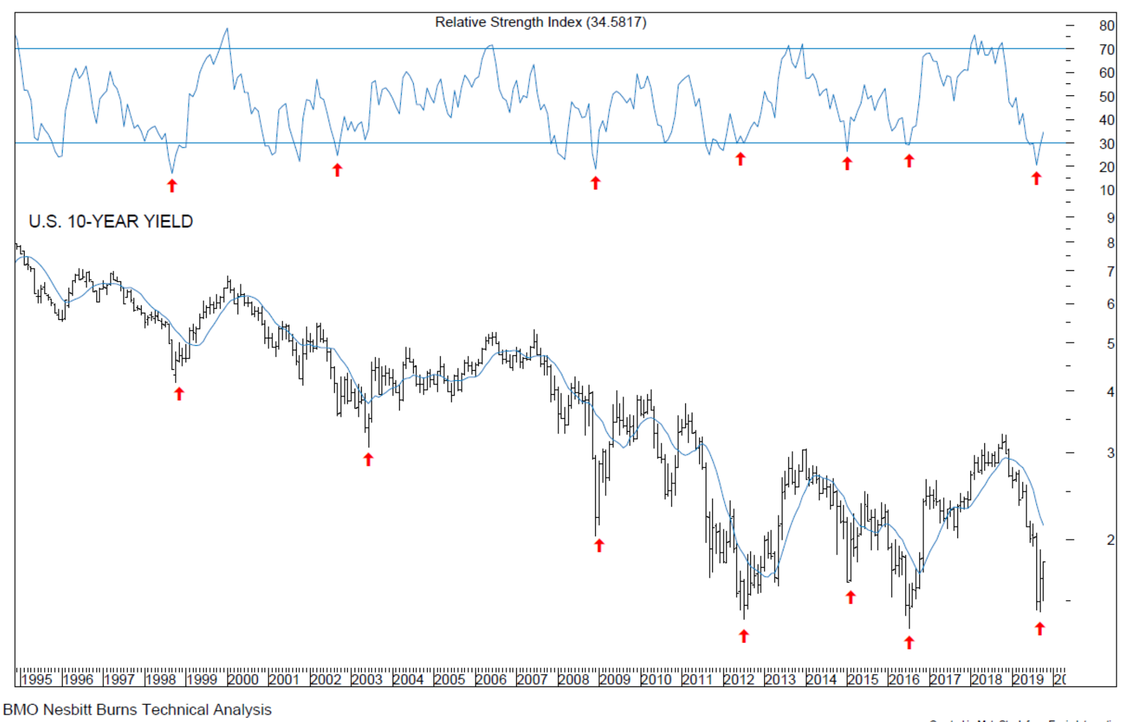
Our technical analyst Russ Visch notes that "A number of significant improvements have occurred in equity markets in recent weeks, all of which suggests the next major multi-month move for equities will be to the upside. This includes the NYSE Advance-Decline lines making new all-time highs, the sell-off in the bond market that now appears to be picking up steam, and the major technical breakouts in bellwether markets such as Germany and Japan. More recently the S&P 500 Equal Weight Industrials index has also broken out of a two year trading range. The performance of the traditional capitalizationweighted index is being dragged down by Boeing's recent woes, so the equal weight index is a truer measure of how the average industrial stock is performing. This sector is just about as economically sensitive as you're going to get, which bodes well for the markets overall".

Figure 9: NYSE Advance/Decline Line



Source: BMO Nesbitt Burns Technical Analysis

Figure 10: U.S. 10-Year Yield

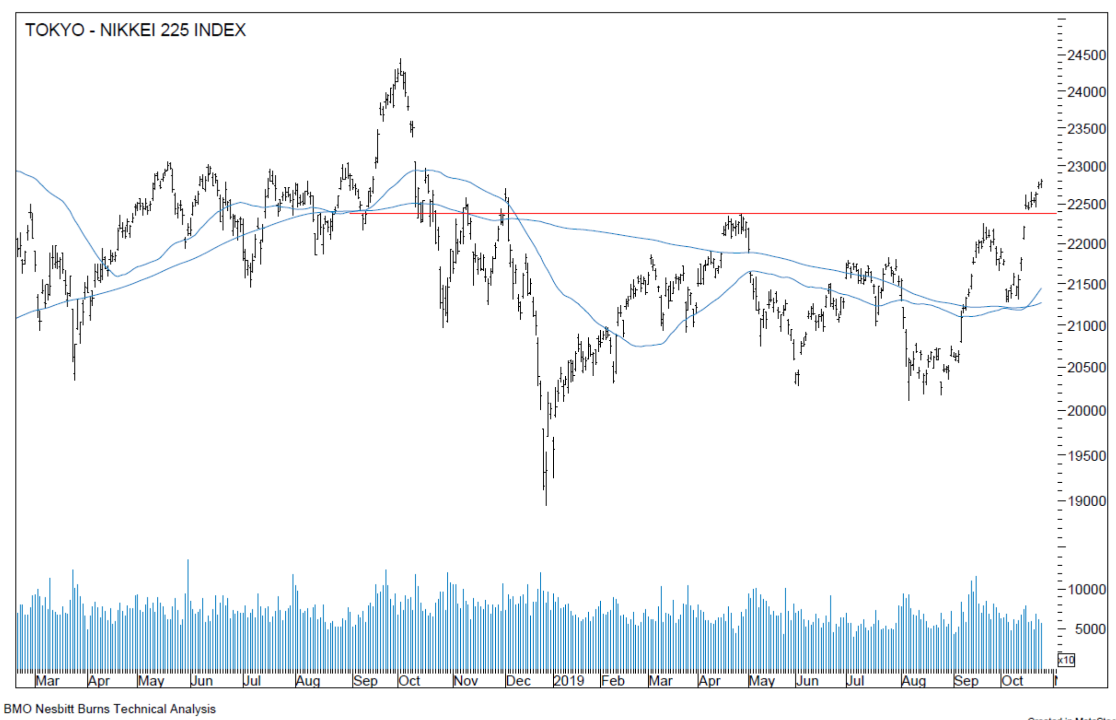


Source: BMO Nesbitt Burns Technical Analysis

Figure 11: Frankfurt DAX Index

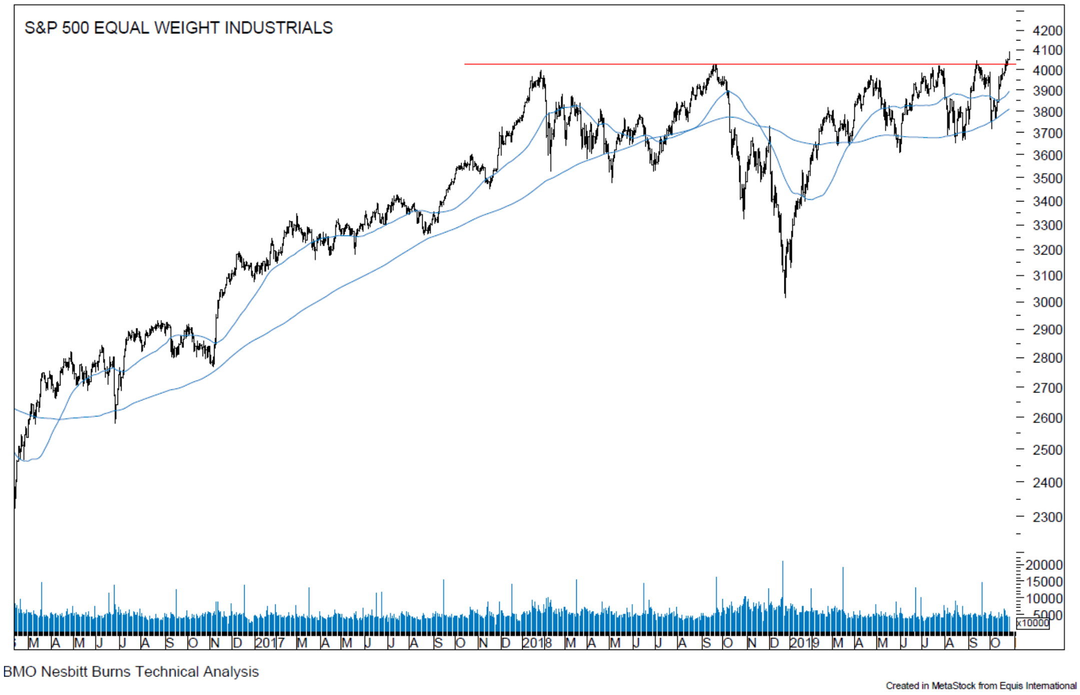
Source: BMO Nesbitt Burns Technical Analysis

Figure 12: Tokyo Nikkei 225 Index



Source: BMO Nesbitt Burns Technical Analysis

Figure 13: S&P 500 Equal Weight Industrials



Source: BMO Nesbitt Burns Technical Analysis

Stock Fair Value Update

We have updated our fair value estimates for the TSX and S&P to incorporate a lower 10 year bond risk free rate (we now use 3%). 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.

Figure 14: S&P 500 Fair Value

	Present value	% of value	Earnings per share growth	Discount rate	
Period 1 (2019-2022)	629.36	18.9%	6%	9.0%	
Period 2 (2023-2027)	673.34	20.2%	5%	9.0%	
Period 3 (2028 -)	2,022.89	60.8%	3%	9.0%	
Rounded Fair Value	**3,300**	100.0%	Next 12 month consensus		180
			Implied terminal mult.		16,2 X
Current Price (October 31, 2019)	**3,038**		Long Bond		3.0%
			Historical Equity Risk Premium		4.5%
Upside Potential	**9%**		Additional Risk Premium		1.5%
			Total discount rate		9.0%

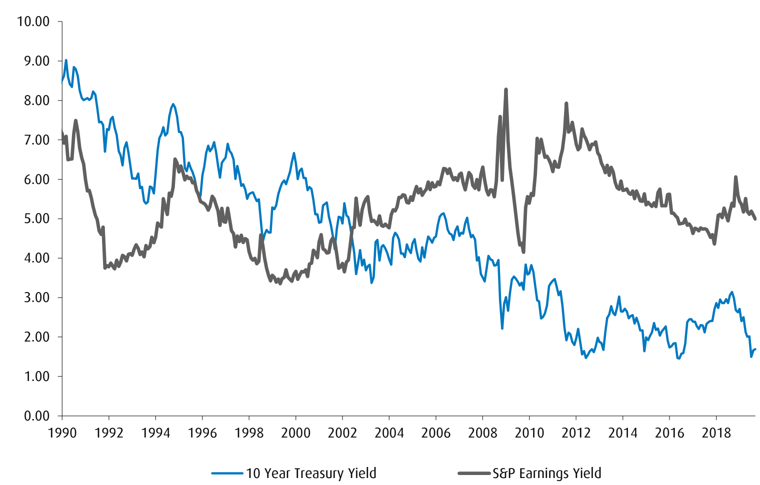
Source: FactSet, BMO Nesbitt Burns

Figure 15: S&P/TSX Fair Value

	Present value	% of value	Earnings per share growth	Discount rate	
Period 1 (2018-2022)	4,115.05	22.2%	5%	9.0%	
Period 2 (2023-2027)	4,113.14	22.2%	3%	9.0%	
Period 3 (2028 -)	10,307.90	55.6%	2%	9.0%	
Rounded Fair Value	**19,000**	100.0%	Next 12 month consensus		1,185
			Implied terminal mult.		14,1 X
Current Price (October 31, 2019)	**16,483**		Long Bond		3.0%
			Historical Equity Risk Premium		4.5%
Upside Potential	**15%**		Additional Risk Premium		1.5%
			Total discount rate		9.0%

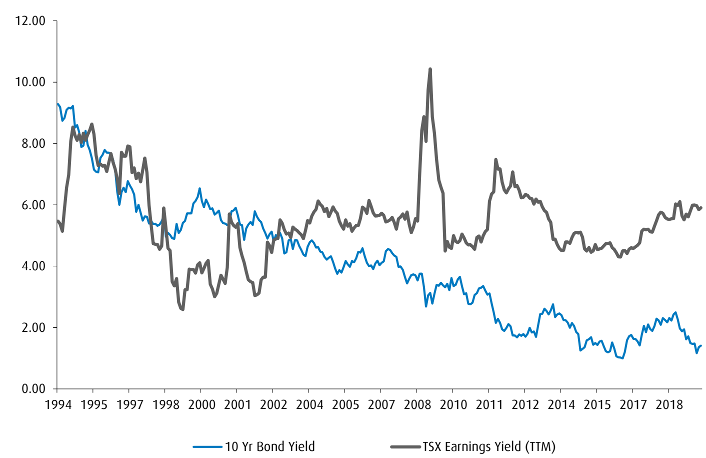
Source: FactSet, BMO Nesbitt Burns

Figure 16: S&P 500 Earnings Yield vs 10-Year Treasury Yield



Source: Bloomberg, BMO Nesbitt Burns

Figure 17: S&P/TSX Earnings Yield vs 10 Year Govt. of Canada Bond Yield



Source: Bloomberg, BMO Nesbitt Burns

Figure 18: S&P 500 Index Sector Total Returns to October 2019

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Info. Technology	3.89	36.48
Real Estate	-0.16	26.44
Telecom. Services	3.02	25.41
Utilities	-0.76	24.44
Industrials	1.08	23.91
S&P 500 Index	**2.17**	**23.16**
Consumer Staples	-0.15	23.10
Cons. Discretionary	0.34	22.88
Financials	2.41	22.49
Materials	0.04	17.16
Health Care	5.12	11.04
Energy	-2.29	3.57

As of October 31, 2019
Source: Bloomberg

Figure 19: S&P/TSX Sector Total Returns to October 2019

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Info. Technology	-1.12	47.16
Utilities	-0.95	33.53
Financials	0.41	20.69
Industrials	0.86	20.40
Real Estate	-2.69	18.33
Materials	2.93	18.24
S&P/TSX Composite Index	**-0.86**	**18.08**
Consumer Staples	-4.48	13.68
Cons. Discretionary	-4.20	13.11
Telecom. Services	-1.49	10.27
Energy	-4.25	8.81
Health Care	-4.53	-9.65

As of October 31, 2019
Source: Bloomberg

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