Portfolio Management

November 2017

Equity Strategy

Potential Tax Reform + Accelerating Corporate Earnings = Increasing Fair Value for S&P 500 & S&P/TSX

Stéphane Rochon, CFA, Equity Strategist

The S&P 500 has now surpassed our long standing 2,400 fair value estimate by quite a bit and we believe there is additional earnings per share upside from corporate tax reform which is now more likely (more details below). To be conservative, we are assuming the tax rate goes down to 25% not 20% and is phased in over several years. Accordingly, we believe that the current consensus of $140 for the next 12 months is too low, particularly given the acceleration we are seeing in corporate earnings. Tweaking our profit growth expectations slightly higher gets us to a fair value of 2,850 to 2,900 on the U.S. market. We do not view this as particularly aggressive given interest rates (i.e. a key component of the discount rate in our models) remain very low by historical standards. We are also tweaking our fair value to 18,000 from 17,000 for the S&P/TSX Composite Index given the strength we have seen in oil and base metal prices which we expect to persist for at least the next few quarters.

Figure 1: 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 (October 31, 2017)	$ **2,575**				Long Bond	2.5%
					Historical Equity Risk Premium	4.5%
Upside Potential	**11%**				Additional Risk Premium	2.0%
					Total discount rate	9.0%

Source: Bloomberg, BMO Nesbitt Burns

Figure 2: S&P/TSX Fair Value

	Present value	% of value	Earnings per share growth	Discount rate		
Period 1 (2018-2021)	$3,424.30	19.0%	7%	9.0%		
Period 2 (2022-2026)	$3,725.80	20.7%	5%	9.0%		
Period 3 (2027 -)	$9,720.86	54.1%	2%	9.0%		
Rounded Fair Value	$ **18,000**	93.8%			Next 12 month consensus	970
					Implied terminal mult.	14,1 X
Current Price (October 31, 2017)	$ **16,026**				Long Bond	2.5%
					Historical Equity Risk Premium	4.5%
Upside Potential	**12%**				Additional Risk Premium	2.0%
					Total discount rate	9.0%

Source: Bloomberg, BMO Nesbitt Burns

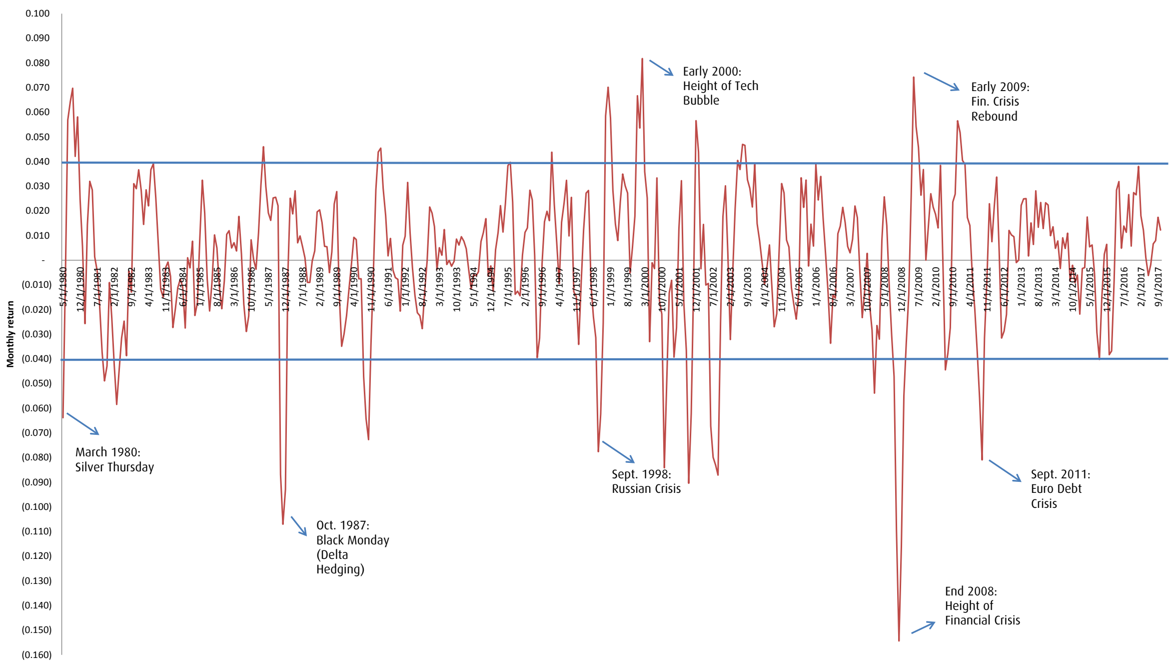
Figure 3: BMO Nesbitt Burns Investment Strategy Committee's Recommended Asset Allocation (%)

	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

Source: FactSet

Looking at our proprietary BMO North American Risk Appetite Index, the good news is that despite daily records in many stocks indices, risk appetite is not especially elevated from a historical perspective. We continue to think that given the amount of skepticism prevalent in the market, this increases the probability that the path of least resistance for equities may be a continued grind higher through year end. Should a market pullback occur, which is notoriously difficult to forecast, we would advise clients to add to high quality stocks on weakness.

Figure 4: Risk Appetite Index



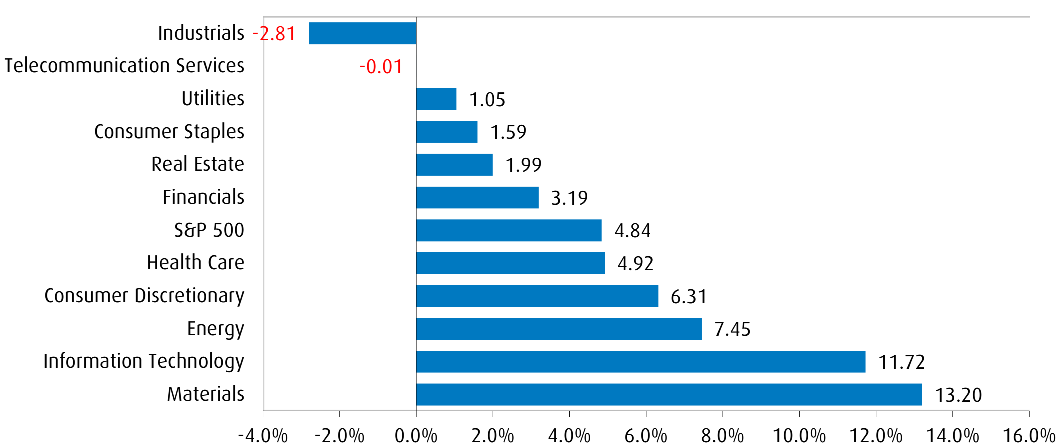
Source: Bloomberg, BMO Nesbitt Burns

Corporate Earnings Accelerating – Especially on the Technology Side

This is one of the main reasons the market keeps grinding higher. We saw spectacular strength in some of the core technology stocks we have recommended to clients for a long time – namely, Amazon.com (AMZN), Alphabet (GOOG) and Intel (INTC) – following much better than expected results. We also continue to like other tech giants such as Oracle (ORCL) which has lagged peers and trades at 17x forward earnings per share (EPS), a steep discount to the market and peers (Microsoft now trades at ~25x forward earnings). It even sports a 1.5% yield and the dividend has doubled in the last five years.

According to FactSet, for Q3 2017, 76% of S&P 500 companies have reported positive EPS surprises and 67% have reported positive sales surprises. The percentage of companies reporting EPS above the mean EPS estimate is above the one-year average (71%) and above the five-year average (69%). At the sector level, the Information Technology (91%) and Materials (85%) sectors have the highest percentages of companies reporting earnings above estimates, while the Telecom Services (50%) sector has the lowest percentage of companies reporting earnings above estimates.

Figure 5: S&P 500 Sector Level Earnings Surprise (Q3 2017)

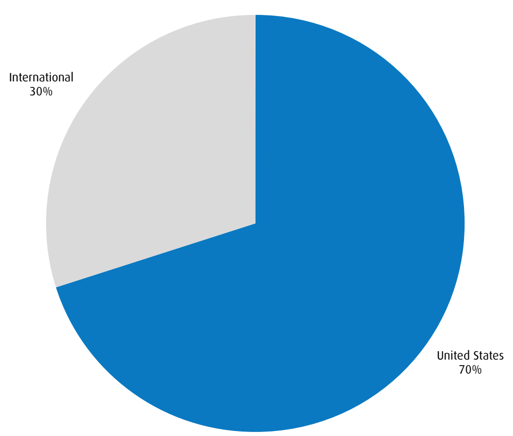


Source: FactSet

In terms of revenues, 67% of companies have reported actual sales above estimated sales and 33% have reported actual sales below estimated sales. The percentage of companies reporting sales above estimates is above the one-year average (61%) and above the five-year average (55%). At the sector level, the Information Technology (85%) and Materials (85%) sectors have the highest percentages of companies reporting revenues above estimates, while the Utilities (22%) sector has the lowest percentage of companies reporting revenues above estimates.

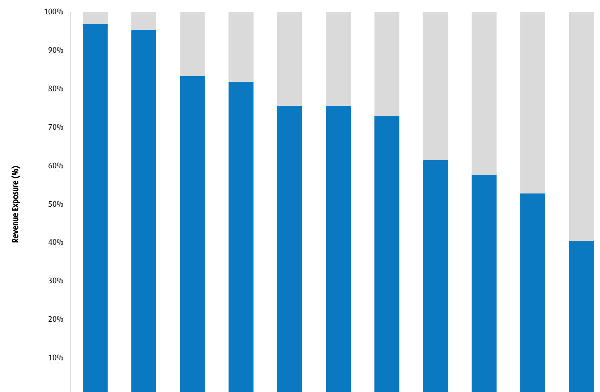
The general weakness in the U.S. Dollar this year has been a contributor to the positive earnings trajectory, since on average, S&P 500 companies generate 30% of their sales outside the U.S. This is beneficial as stronger foreign currency sales and profits are translated into more U.S. dollars. For tech firms, the most international sector of the market, that percentage is a whopping 60%.

Figure 6: S&P 500 Aggregate Geographic Revenue Exposure



Source: FactSet

Figure 7: S&P 500 Aggregate Sector Geographic Revenue Exposure



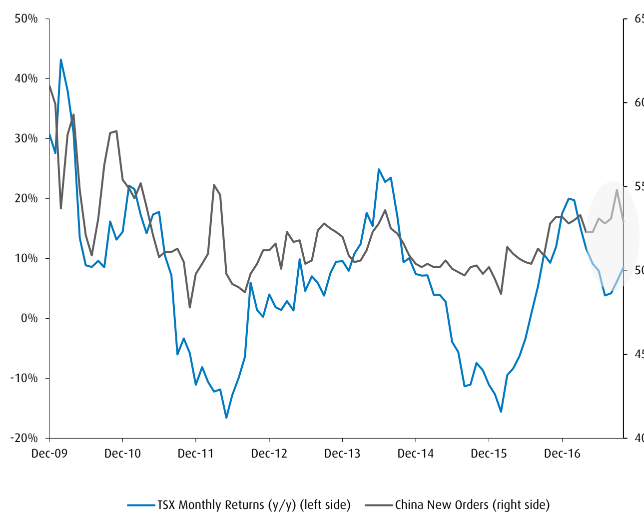
	Telecom Services	Utilities	Real Estate	Health Care	Financials	Consumer Disc.	Consumer Staples	Industrials	Energy	Materials	Info. Technology
International	3%	5%	17%	18%	24%	24%	27%	39%	42%	47%	60%
United States	97%	95%	83%	82%	76%	76%	73%	61%	58%	53%	40%

Source: FactSet

Economic Momentum Continues to Improve Globally

Of course, corporate profitability does not go up in a vacuum. It is driven by economic momentum, which happens to be in a "sweet spot" right now with the globally synchronized recovery. In other words, the four largest economies: the U.S., Eurozone, China and Japan are all on a positive trajectory. It is therefore not surprising that companies – especially those in some of our favorite cyclical sectors such as technology and financials – are reaping the benefits of this environment in the form of better than expected sales and earnings.

Figure 8: S&P/TSX Monthly Returns (year over year) versus China PMI New Orders

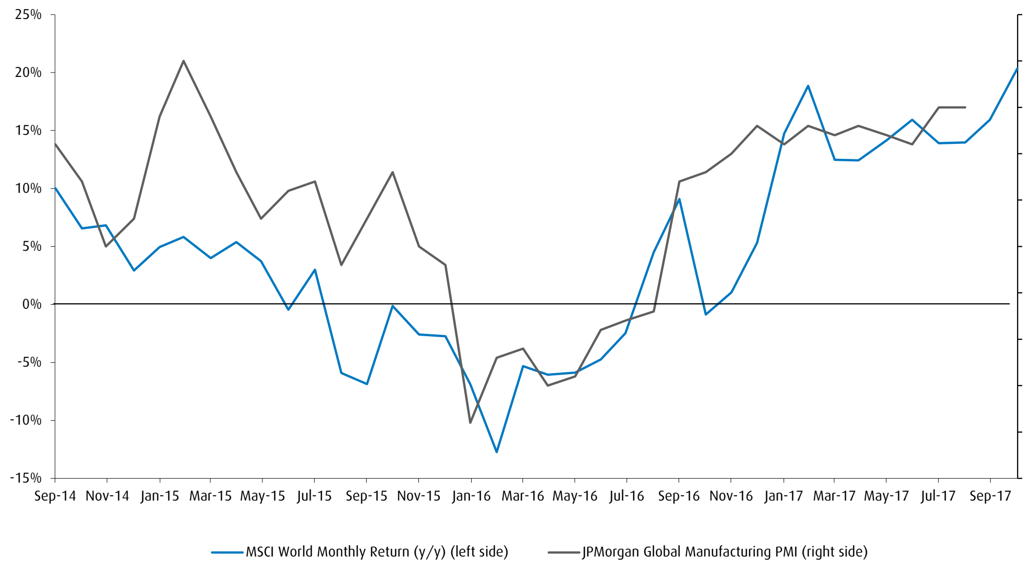


Source: Bloomberg, BMO Nesbitt Burns

As BMO's Chief Economist Doug Porter recently said: *"The Dow whistled by the 30-year anniversary of Black Monday this week by soaring to yet more records above the 23,000 mark. And, it's certainly not just U.S. stocks getting into the act, as Japan's Nikkei hit a 20-year high, European stocks are thriving and emerging markets are on fire. The global economy has broken a six-year span of serial disappointment, perking up this year to a 3.5% growth rate, with all major economies finally in expansion mode. While the U.S. economy is far from spectacular, it continues to grind along at a solid pace, and now looks headed for roughly 2½% growth in the second half of 2017 despite the hurricane disruptions. And while many fret about too-low inflation, the reality is that slow and steady price gains are almost an ideal backdrop for financial markets."*

We could not agree more. Looking at some recent data examples, Figures 8 through 12 show these trends are highly correlated to stock market performance. In other words, the bull market, which we expect to continue, is not a random event. It is strongly rooted in fundamentals. Figure 8 shows how closely the Canadian market follows the Chinese economic trajectory as measured by the China PMI New Orders Index. In fact, the S&P/TSX Composite Index is more closely correlated to Chinese economic trends than Canadian ones!

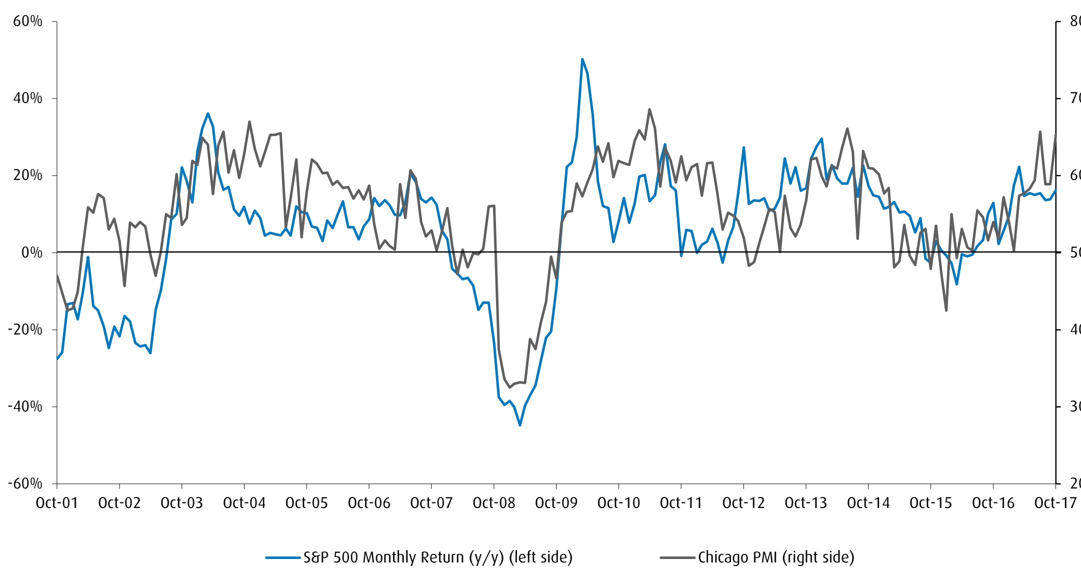
Figure 9: MSCI World Monthly Returns versus JPMorgan Global Manufacturing PMI



Source: Bloomberg, BMO Nesbitt Burns

The Chicago PMI[1] jumped 1 point to 66.2, the highest reading since March 2011, which is encouraging news for the factory sector.

Figure 10: S&P 500 Monthly Returns versus the Chicago PMI



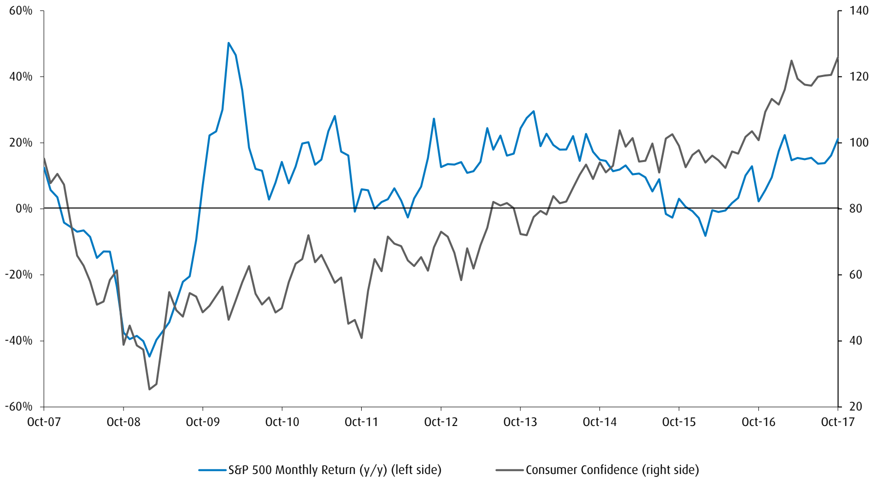
Source: Bloomberg, BMO Nesbitt Burns

U.S. consumer confidence rose to a 17-year high. According to the Conference Board, confidence jumped 5.3 points to 125.9, a level not seen since December 2000. Besides soaring stock prices, the strong job market (with higher wages, beckoning) is likely driving confidence higher. More survey respondents nodded when asked "are jobs plentiful?" and fewer felt that jobs were hard to get. The net labor differential widened to 18.8, the highest since July 2001, pointing to a further tightening labor market and potentially an even lower jobless rate from the current reading of 4.2. Good news for consumer spending.

[1] The Chicago Purchasing Managers' Index (PMI) determines the economic health of the manufacturing sector in Chicago region. A reading above 50 indicates expansion of the manufacturing sector; a reading below indicates contraction. The Chicago PMI can be of some help in forecasting the National ISM manufacturing PMI.

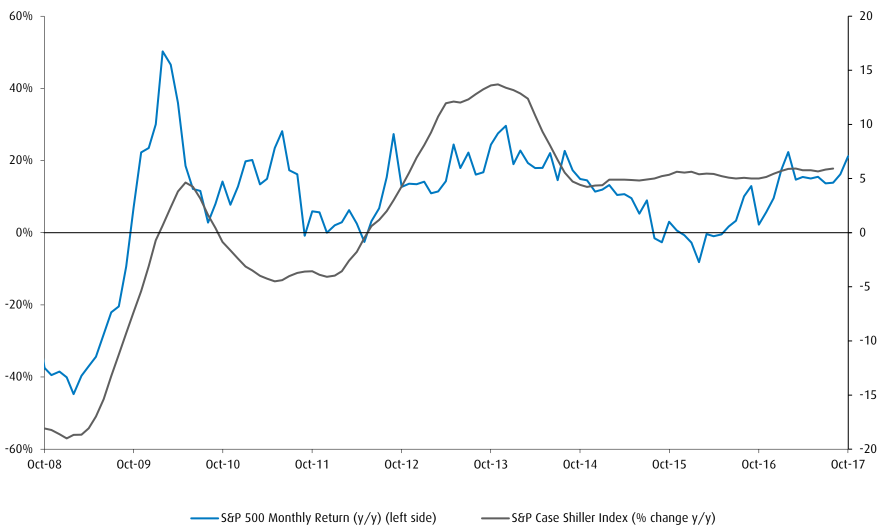
U.S. home prices continue to climb skyward. S&P CoreLogic Case-Shiller's home price index rose 0.5% in August for the country's 20 largest metropolitan cities, and was up 5.9% year over year, matching the spring's three-year high.

Figure 11: S&P 500 Monthly Returns versus Consumer Confidence



Source: Bloomberg, BMO Nesbitt Burns

Figure 12: S&P 500 Monthly Returns versus S&P Case Shiller



Source: Bloomberg, BMO Nesbitt Burns

Tax Reform Update

Political specialist Andy Laperriere from our research partners at Cornerstone Macro notes that:

The indictment of Paul Manafort and his aide, Rick Gates, as well as the guilty plea by former Trump campaign advisor George Papadopoulos are likely to have little bearing on the legislative outlook in the near term. If anything, it puts more pressure on Republicans to deliver on the tax bill. If Mueller drops a bombshell that could impact the legislative outlook, it probably won't come for months and most likely it would be after the tax bill is resolved one way or the other.

Press reports suggest that the corporate rate may be phased in over five years. So the rate, which is 35% today, would be 32% in 2018 and drop three percentage points each year until hitting 20% in 2022. The 5-year phase-in is a bit longer than we would have guessed, but our best bet would have been no reduction in the corporate rate in 2018 (which is still possible if the bill doesn't end up *being signed until early 2018). We have been of the view that many of the key provisions will be phased in. House Ways and Means Committee Chairman Kevin Brady (R-TX) said that no firm decisions have been made on this issue, but investors should expect the bill that becomes law will phase in the reduction in the corporate rate.*

There have been press reports that the House tax bill will allow companies to deduct 70% of their net interest expense. That's a more restrictive proposal than capping interest costs at 30% of EBITDA, which seemed like the leading idea for a while. Allowing businesses to deduct 70% of their interest costs raises a lot more money (perhaps $600 billion or more over 10 years) than tying it to EBITDA, and we have argued for months that they need to raise significant dollars by limiting this deduction to make the numbers add up.

Risk Appetite Index

In July, we launched our proprietary BMO Private Client North American Risk Appetite Index (RAI) 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. This month, the RAI actually went down slightly given the very strong bond market performance.

So, the good news is that despite daily records in many stocks indices, risk appetite is not especially elevated from a historical perspective. We continue to think that given the amount of skepticism prevalent in the market, this increases the probability that the path of least resistance for equities may be a continued grind higher in the short term. Should a market pullback occur – which can happen at any time – we would advise clients to add to high quality stocks on weakness.

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 13: S&P 500 Fair Value Model

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Figure 14: S&P/TSX Fair Value Model

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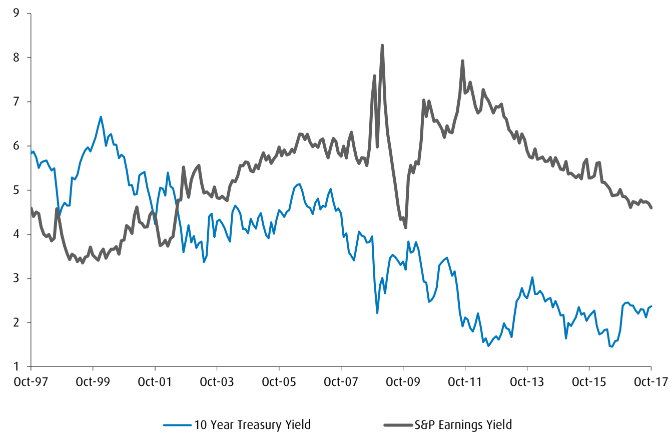
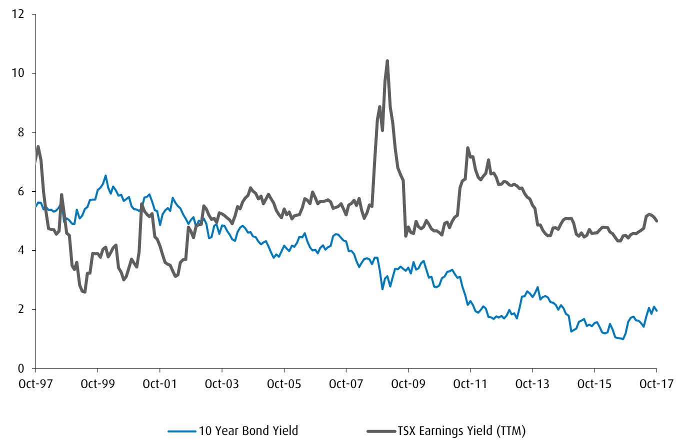
Source: BMO Nesbitt Burns

Figure 15: S&P 500 Earnings Yield versus 10-year Treasury Yield



Source: Bloomberg

Figure 16: S&P/TSX Earnings Yield versus 10-year Canada Bond Yield



Source: Bloomberg

Figure 17: S&P 500 Index Sector Total Returns to October 2017

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Info. Technology	7.76	37.24
Materials	3.87	20.30
Health Care	-0.77	19.39
S&P 500 Index	**2.33**	**16.91**
Utilities	3.90	16.24
Financials	2.93	15.78
Industrials	0.20	14.36
Cons. Discretionary	2.11	14.30
Real Estate	0.68	5.43
Consumer Staples	-1.40	5.08
Energy	-0.66	-7.25
Telecom. Services	-7.62	-11.95

As of October 31, 2017

Source: Bloomberg

Figure 18: S&P/TSX Composite Sector Total Returns to October 2017

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Cons. Discretionary	3.30	21.32
Industrials	3.42	18.64
Info. Technology	2.80	16.09
Telecom. Services	2.95	13.34
Financials	4.58	12.08
Utilities	3.29	11.49
S&P/TSX Composite Index	**2.73**	**7.30**
Real Estate	3.20	4.22
Materials	1.58	4.16
Consumer Staples	2.31	3.84
Energy	-0.35	-7.94
Health Care	-0.19	-8.67

As of October 31, 2017

Source: Bloomberg

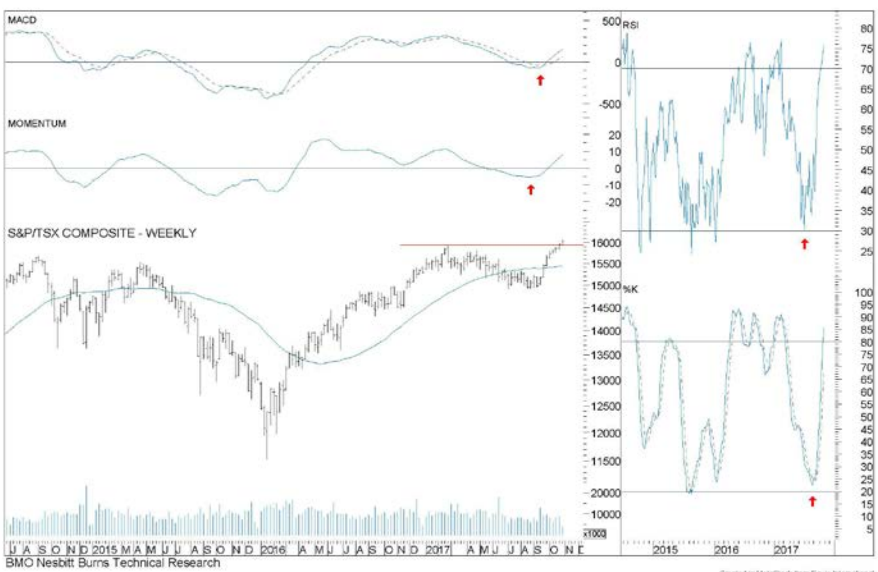
The Technical Picture— Equity Markets are in the "Sweet Spot"

Russ Visch, CMT, Technical Analyst

In recent publications, we noted the potential for a rally in equities that would likely carry the major averages higher into the end of the year. The basis for that outlook was the considerable improvement underway in all aspects in our medium-term equity models. Since our last report, we've seen nothing but continued improvement, increasing the odds that the tone for equities remains positive into the end of the year (and perhaps even into 2018.) For example:

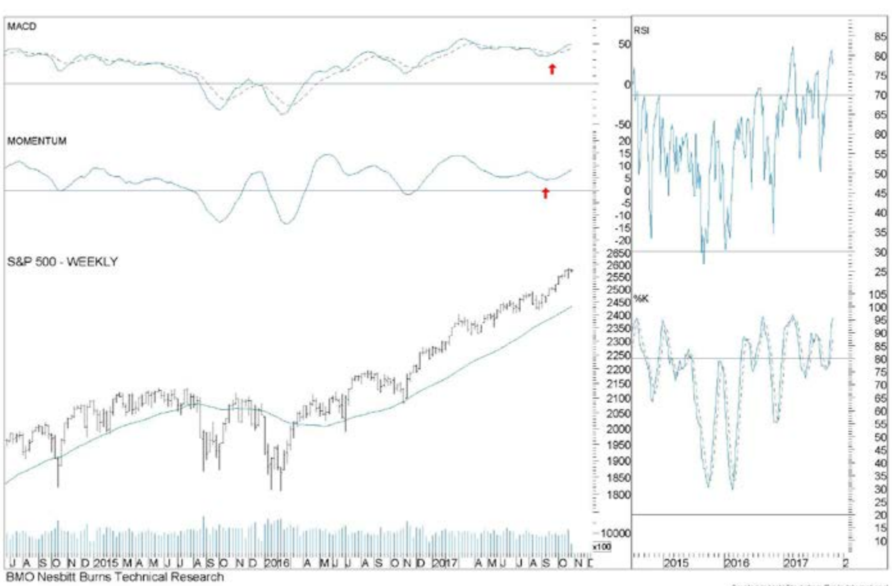
Weekly price momentum models for the S&P/TSX Composite and the S&P 500 remain "4 for 4" bullish after turning positive again late in the third quarter. Historically, buy signals in these indicators typically lead to rallies lasting 3-6 months on average which suggests stocks could remain strong into the beginning of 2018.

Figure 19: S&P/TSX Composite Index Weekly Momentum Indicators



Source: BMO Nesbitt Burns Technical Analysis

Figure 20: S&P 500 Index Weekly Momentum Indicators



Source: BMO Nesbitt Burns Technical Analysis

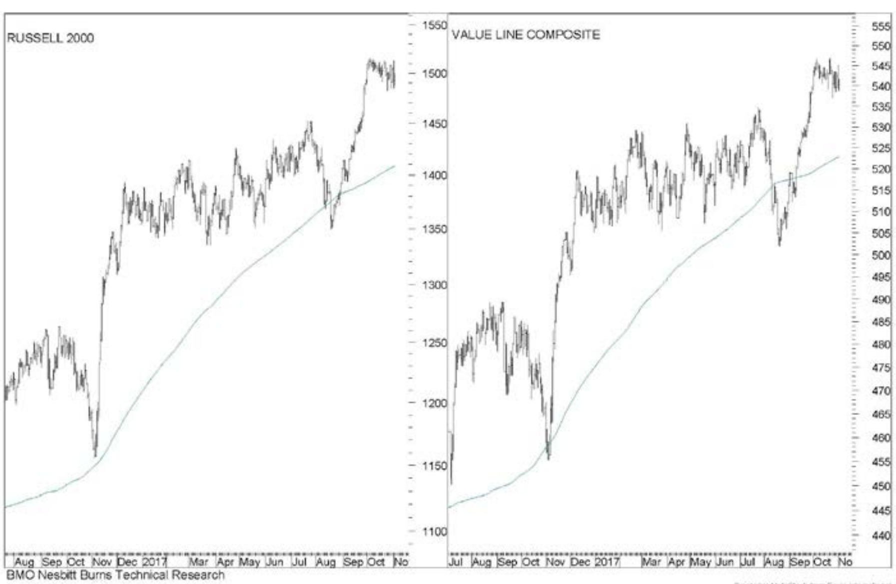
Breadth indicators, the most important barometers of market health, also continue to reflect the sort of healthy economic backdrop in which companies up and down the capitalization spectrum can thrive. For example, all of the various Advance-Decline (A-D) lines we track continue to make new all-time highs, reflecting the sort of broad participation that is the hallmark of healthy bull markets. This includes the traditional NYSE A-D line as well as the NYSE Common-Stock-Only (CSO) A-D line. (The CSO A-D line is different than the traditional Advance-Decline line in that it contains operating companies only and removes things like closed end funds, rate-sensitive preferred shares, etc. As such, it is generally considered to be a better gauge of how actual companies' stocks are performing.)

Figure 21: NYSE Advance-Decline Lines

Source: BMO Nesbitt Burns Technical Analysis

The same is also true for other broad measures of equity participation such as the Russell 2000 and the Value Line Composite indexes. Historically these indicators tend to peak four to six months ahead of a major market top, so there is still no evidence that this bull market is in any real jeopardy.

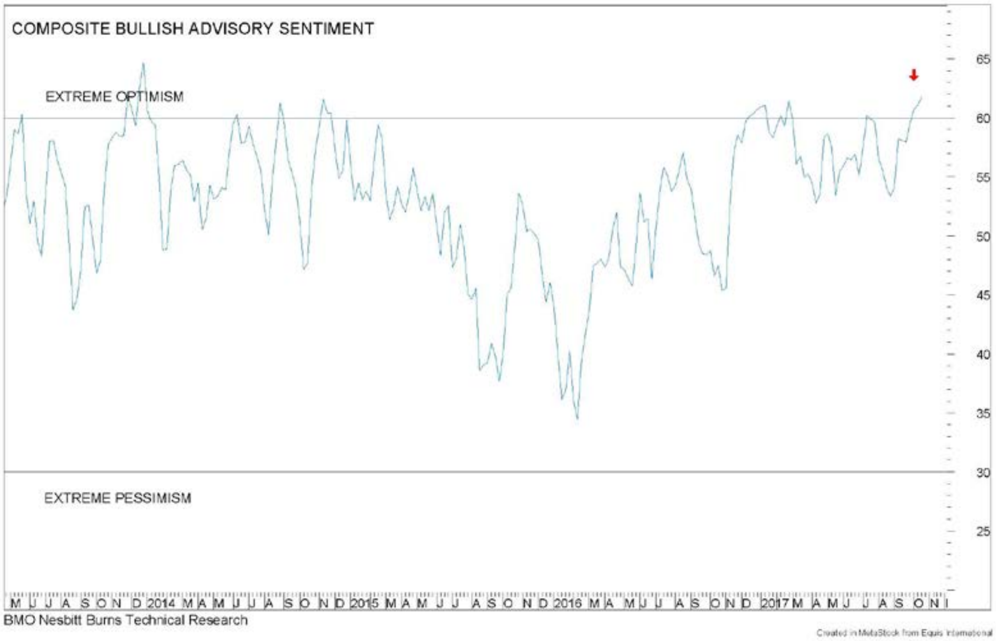
Figure 22: Russell 2000 and Value Line Composite Indexes



Source: BMO Nesbitt Burns Technical Analysis

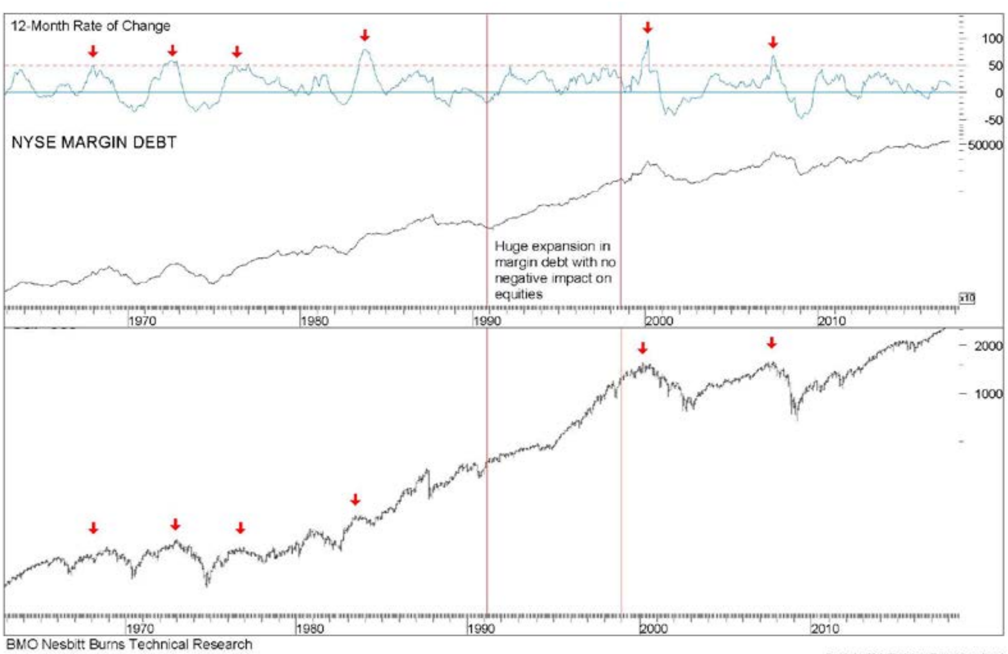
Bullish sentiment also continues to expand for all segments of the market, and while some measures are stretched into overly bullish extremes it's not to a degree that has us concerned at all. i.e. – it's natural to assume people should be bullish with the indexes at all-time highs. However we're not seeing any evidence of "foolish"/overly bullish behaviour in options markets or margin debt data. For example, a 50%+ increase in NYSE margin debt on a rolling 12-month basis has typically been associated with major market peaks. We are nowhere near that right now.

Figure 23: Composite Sentiment Indicator



Source: BMO Nesbitt Burns Technical Analysis

Figure 24: NYSE Margin Debt



Source: BMO Nesbitt Burns Technical Analysis

Figure 25: S&P 500

Source: BMO Nesbitt Burns Technical Analysis

As a result of these developments, we feel there is a very good chance that the general tone for equities should remain bullish all the way into the end of the year. This fits with seasonal tendencies, which are now a strong tailwind for stocks. Over the past 50 years or so, November-January is the strongest consecutive three months of the year with an average gain during that period of 4.25% for the S&P/TSX Composite and 3.75% for the S&P 500.

In terms of upside potential, the S&P/TSX Composite recently broke to a new all-time high above the early 2017 peak at 15,943. That breakout opened a new upside target of 16,971. The S&P 500 continues to trade within a rising channel in effect for nearly two years now. The next upside target/resistance level for it is the upper end of the rising channel currently near 2,670.

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