Monthly Market Commentary

Equity Strategy

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

The S&P 500 Index has now surpassed the BMO Nesbitt Burns Portfolio Advisory Team's long standing 2,400 fair value estimate and there is additional earnings per share upside from corporate tax reform, which is now more likely. Tweaking profit growth expectations slightly higher produces to a fair value of 2,850 to 2,900 on the U.S. market. The Portfolio Advisory Team does not view this as particularly aggressive, given interest rates (a key component of the discount rate in our models) remain very low by historical standards. The Portfolio Advisory Team is also tweaking its fair value to 18,000 from 17,000 for the S&P/TSX Composite Index, given the strength seen in oil and base metal prices, which is expected to persist for at least the next few quarters.

Looking at the 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. Given the amount of skepticism 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, clients would be advised to add high quality stocks on weakness.

Corporate earnings accelerating – especially on the technology side

This is one of the main reasons the market keeps grinding higher. There has been spectacular strength in some of the long-time recommended core technology stocks – namely, Amazon.com (AMZN), Alphabet (GOOG) and Intel (INTC) – following better-than-expected results. At the sector level, the Information Technology and Materials sectors have the highest percentages of companies reporting earnings above estimates, while the Telecommunication Services sector has the lowest percentage of companies reporting earnings 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 technology firms, the most international sector of the market, that percentage is a whopping 60%.

Economic momentum continues to improve globally

Corporate profitability is driven by economic momentum, which is in a "sweet spot" right now with the globally synchronized recovery. It is therefore not surprising that companies – especially those in favoured cyclical sectors such as Technology and Financials – are reaping the benefits of this environment in the form of better than expected sales and earnings.

Tax reform update

Political specialist Andy Laperriere, from research partner Cornerstone Macro says, "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 five-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 tax bill doesn't end up being signed until early 2018). Cornerstone Macro has been of the view that many of the key provisions of the bill will be phased in."

Fixed Income Strategy

A more dovish message from the Bank of Canada

Two more major central banks became less accommodative in October following the steps of the U.S. Federal Reserve and the Bank of Canada ("BoC"). After hinting at an upcoming policy decision, the Bank of England raised its bank rate by 25 basis points for the first time in more than a decade. The European Central Bank announced it would taper its bond purchase program, while German and French rates, two of

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the largest Euro area bond markets, saw their yields move lower during the month, indicating that while purchases will be reduced, these are only small steps to slow the amount of stimulus to the economy. Conversely, U.S. rates grinded higher, with the increase in the short-term sector, represented by the two-year yield, outpacing the longer-term sector. With the risk of rising long-term rates mitigated by inflation expectations still anchored around 2.5%, the rising short-term rates on the prospect of further tightening contributed to the yield curve, further flattening to levels not seen since 2007.

The BoC adopted a more cautionary approach to its tightening cycle and stated that U.S. trade negotiations, changes to mortgage rules, weaker exports and elevated household debt levels would contribute to economic growth moderating to "a more sustainable pace in the second half of 2017, remaining close to potential over the next two years." This led investors to delay expectations for the next rate hike into the first quarter of 2018, helping the loonie weaken and Canadian bond yields move lower. BMO Economics now forecasts the next rate hike for March 2018.

The flatter U.S. and Canadian yield curves are raising questions. A flattening yield curve is normally linked to an economic expansion that is aging, and as the central bank tightens it may lead to an inverted yield curve, indicating a recession may be closer. However, as BMO's Chief Economist Doug Porter highlighted, while flatter, the curve is not yet flat or inverted and we may have a long way to go before this happens. The flattening trend is expected to persist, especially in the context of central bank tightening policy and persistent low inflation. In this environment, the Portfolio Advisry Team continues to favor a neutral duration compared to investor's benchmark (duration measures interest rate sensitivity of a portfolio). The combination of low inflation and the slow removal of monetary stimulus should contribute to low interest rates and a flattening yield curve.

Improving credit quality: eliminating exposure to the U.S. senior loans sector

The corporate bond sector, both investment and non-investment grade, has generated strong performance since early 2016 as energy markets recovered and credit spreads tightened significantly. The Portfolio Advisory Team reduced its exposure to credits last spring, as spreads tightened on good corporate earnings and as benchmark yields rose. As corporate spreads continued to tighten in October towards levels last seen in 2007, just before the financial crisis, the Portfolio Advisory Team recommended improving the overall credit quality of fixed income portfolios by further reducing exposure to lower investment credits in the mid-term sector, mainly eliminating BBB credit exposure in the five- to ten-year sector. Since the primary objective remains the preservation of capital, the Portfolio Advisory Team prefers to be more conservative at this stage, even at the risk of leaving a bit of yield on the table. As for the proceeds, the Portfolio Advisory Team recommends reinvesting these funds in government or better quality corporate names in the three- to five-year sector.

! Please contact your BMO Nesbitt Burns Investment Advisor if you have any questions or wish to discuss your investments

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