Monthly Market Commentary

Equity Strategy

With the emergence of electric vehicles and the global emphasis on renewable power, it may have seemed as though within a few years, we would be living in an oil-free world. Energy stocks certainly seemed to be discounting this outcome. While the BMO Nesbitt Burns Portfolio Advisory Team believes continued investment in renewable power is critical to combat global warming, they also believe we are far from weaning off crude oil. Accordingly, the Team believes the Energy sector presents investors with an uncommon value opportunity for the balance of 2018, and perhaps longer.

The implications for Canadian equities are profound. Despite the strength in oil and other commodities, and a robust Canadian economy, the S&P/TSX has underperformed the U.S. market (as represented by the S&P 500), since the start of 2017. This is a disconnect, since Canada typically does well later on in the cycle, particularly as inflationary pressures start building and 10-year interest rates begin to rise. There is a performance catch-up opportunity for high quality Canadian stocks, certainly in the Energy sector (e.g., Canadian Natural Resources, Suncor, Encana), but also in such sectors as Financials and Basic Materials.

This view is backed up by the Portfolio Advisory Team's historical work, which shows that over the last 25 years, the S&P/TSX actually outperformed the S&P 500 when the consumer price index was rising. In this rising rate environment, the Basic Materials, Energy and Financials sectors had average annual returns of 13%, 14% and 10%, respectively.

No oil-free world anytime soon

The fundamental driver of oil prices is supply/demand, and both factors have been positive. As of March 2018, the Organization of Petroleum Exporting Countries ("OPEC"), and 10 non-OPEC nations led by Russia, had curtailed supply by 2.4 million barrels per day, and even hinted at prolonging the cuts into 2019. On the demand side, while economic momentum is currently slowing in North America and Europe, it is doing so from an elevated level. The global economy should manage to post robust growth of almost 3.8% in 2018, according to BMO Economics. There are clear positive implications for oil demand, since a growing economy leads to more consumption of jet and industrial fuels.

Longer-term, electric vehicle sales and tighter fuel economy standards will have a negative impact on oil demand growth. However, motor vehicle demand represents 45% of total global oil consumption – a critical driver. According to CNBC, global electric vehicle sales in 2017 grew 58% to 1.2 million units, which is still a small 1.4% of totalmarket share. IHS-Markit notes that in the last year, electric vehicle and light trucks, including hybrids, displaced only about 50,000 barrels a day of oil in a world that is using 100 million barrels a day. According to the International Energy Agency's World Energy Outlook 2017, "Oil demand continues to grow to 2040, albeit at a steadily decreasing pace."

The current oil market setup is bullish

Russ Vich, the Portfolio Advisory Team's Vice President and Technical Analyst, noted that "West Texas Intermediate ("WTI") crude oil recently broke out of a medium-term triangular consolidation pattern. The reversal of a declining trend line near US$66 signaled a resumption of the long-term uptrend, in effect since mid-2017, and opened a new upside target that measures to US$75.25."

Energy stocks look very cheap

In mid-April, the BMO Capital Markets Oil & Gas Research Team reported that since the end of 2017, crude oil prices appear to have settled into a new, higher trading range, due to improving market fundamentals, coupled with heightened geopolitical risk. However, the strength in oil prices has not translated to better oil and gas equity performance. The North American Large-cap group is trading at the largest valuation discount to the overall market in more than a decade. Further, group valuation multiples are now roughly in line with 10-year average levels. At the same time, the

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financial position of the group is changing dramatically, and the BMO Capital Markets Oil & Gas Research Team expects the North American Large-cap group to generate roughly US$41.5 billion in free cash flow over the next three years.

Fixed Income Strategy

3% Treasury Yields – why now?

The U.S. treasury 10-year yield was again one of the main stories in April, as it briefly crossed paths with the 3% mark, reigniting all fears of a major breakdown in fixed income markets. Even Canada 10-year yields flirted with a four-year high on the back of stronger inflation in the first quarter.

Why higher rates now? In fact, why has it not happened earlier this year as highly anticipated? The combination of better economic forecasts, strong corporate earnings, record quarterly U.S. treasury issuances and, interestingly, the cycle-high short interest in treasury bonds and futures could not even push 10-year yields above 3%. Yields also struggled to move higher, perhaps due to a slight shift in sentiment about global economic growth from optimism to caution. With signs that North American and European economic growth have decelerated, along with slower job growth, it is becoming more difficult to find a catalyst that would push the 10-year yield even higher. The lack of a catalyst seems to be partly responsible for the more muted response in long-term yields, leaving the yield curve to continue flattening despite signs of rising inflation. This should not yet deter the U.S. Federal Reserve (“the Fed”) and the Bank of Canada (“BoC”) from preemptively tightening policy, as the counter arguments to growth are the wage gains and inflation that have undeniably been on a rising path.

Wage gains and inflation could also be late cycle indicators, putting into question whether the aggressive policy expectations for 2018 and 2019 are still warranted, despite central banks’ softer growth and inflation forecasts. While the focus remains on central banks targeting higher neutral rates, recent economic data seems to be gradually weakening the case for tighter policies. The Portfolio Advisory Team isn’t convinced of the need to be as aggressive for the remainder of the year, if only for the fact that real short-term rates remain negative.

The focus has been on longer-term rates when the bigger story has been unfolding in the short-term sector. Over the last year, two-year U.S. Treasury and Government of Canada yields have more than doubled, reaching their highest levels in 10 years, as the central banks raised rates.

Despite lower allocations to longer-term securities to reduce interest rate sensitivities, fixed income portfolios have continued to underperform, especially in recent quarters. What further exacerbated the issue is that private investors have favored shorter maturities that rarely exceed 10 years to maturity.

Before thinking about selling your fixed income investments, it is important to put things in perspective. There is a difference between losses from price variation and default. While the former is market-based and normal in a rising interest rate environment, it does not result in an actual loss, like a default if the security is held until maturity. Price erosion from rising interest rates only serve as shifting greater cash flow distribution in the later years of the life of a bond as the expected yield is rising. A default, however, is the result of an issuer no longer able to service the debt and/or repay the loan at maturity, leaving investors with unrecoverable losses. Fortunately, corporate credit markets have remained strong and default rates are low.

Even if a security has lost value in the wake of the recent rise in rates, the Portfolio Advisory Team continues to expect to receive the regular coupon payments and our principal unless the credit quality of the investment has deteriorated.

From a reinvestment perspective, we think this is a good thing as we look forward to both income and maturities to benefit from higher yielding investments. This may not yet be the case for longer-term securities, but we are now seeing more attractive short-term Guaranteed Investment Certificate (“GIC”) rates and better opportunities in the provincial, municipal and corporate bond sectors with a three- to five-year term to maturity. This is where investors stand to gain the most as yields often exceed cash and cash equivalent rates by over 100 basis points.

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

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