Monthly Market Commentary

Equity Strategy

Corporate tax cuts + Commodities moving higher = Advantage North America

The BMO Nesbitt Burns Portfolio Advisory Team begins 2018 with a most patriotic and bullish report – at least for Canadian and U.S. investors. The economic cycle almost always trumps politics when it comes to asset returns, but the U.S. corporate tax cut to 21% from 35% is a big tailwind for stocks. There are also potential derivative impacts from the U.S. tax bill, such as higher economic growth (through increased corporate and consumer spending) and repatriation of foreign cash, which could further drive merger and acquisition activity. This boost to growth could also prompt the U.S. Federal Reserve (the "Fed") to raise rates a little faster, but this is viewed as only a minor risk at this point in the cycle, especially given how low the Fed Fund's rate is by historical standards. The impact of the tax cut will vary greatly by industry but, generally speaking, profitable and U.S.-focused companies will benefit most. Financials are expected to be one of the top beneficiaries. The positive impact will also be felt by Canadian companies with substantial U.S. operations such as railroads, equipment manufacturers, banks and insurance companies.

Commodities

As we begin the new year, commodities look to be a solid tailwind for Canadian equities for at least the first half of 2018. Oil and copper prices have the highest correlation with the Toronto Stock Exchange ("TSX") and Canadian dollar at over 90%, meaning that when they go up, typically so do Canadian stocks and the loonie. Oil and base metals have been trending higher for the last several months based on improving supply/demand fundamentals. This has been driven by the synchronized global economic upturn – particularly the stabilization of Chinese economic momentum – and by supply curbs and falling inventories (finally) in the case of crude oil. The Portfolio Advisory Team believes that oil prices are well supported in the low- to mid-US$60 range, given increasing demand and supply curbs. It is true that heavy Canadian oil ("WCS") currently trades significantly below the frequently quoted WTI price, but even with this discount high quality Canadian producers can still generate high levels of profitability, particularly if they have refining capacity and firm pipeline access to get their production to the U.S. market. BMO's outlook on base metals is also constructive.

Risk appetite remains muted – There is still room for stocks to go up

Looking at the BMO North American Risk Appetite Index, the good news is that despite daily records in many stocks indices, risk appetite continues to be muted from a historical perspective. Consequently, the path of least resistance for equities may be a continued grind higher through to year end.

Fixed Income Strategy

Looking forward: Interest rate forecasts

Overall, 2017 income returns in Canada and the U.S. were positive and above expectations. With the prospects of rising interest rates and volatility, investors focused on reducing term exposure in anticipation of greater tightening from global central banks. We saw benchmark interest rates rise, especially in the short term, but this was done in a very orderly fashion. Bond volatility reached record lows which, along with stronger economic growth, provided an excellent landscape for credit markets to outperform.

The year also marked the beginning of a more synchronized global monetary tightening which contributed to shifting global yield curves. This is a trend that is expected to continue as the improved economic environment is making it more difficult for central bankers to justify negative real rates.

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Before jumping to conclusions, let's put things in perspective: global economies are doing better, in general, still inflation remains low. Central banks will continue to be supportive of financial markets with accommodative monetary policies for a bit longer.

So, what should we watch for in 2018? The Portfolio Advisory Team considers strengthening economies, rising inflation and volatility as major risks for interest rates; however, they believe U.S. political uncertainty and being later in the economic cycle will continue to mitigate the rise in interest rates. While Americans were granted a holiday gift in the form of new tax cuts, the focus will be on the economic impact from the additional liquidity from both corporations and individuals. Economists in general expect marginal economic gains with most, if not all, of the impact already priced in markets. However, what may not be factored in is the overall political uncertainty as the U.S. is still without a new debt ceiling, and the Republicans may face strong opposition leading to the mid-term elections; potentially shifting the balance of power in Washington. In fact, uncertainty and low inflation are potentially the reasons why the message from the bond market still seems to conflict with the bullish equity and credit markets.

The balance of risks should still provide enough support for the Canadian fixed income market to generate positive returns, barring any negative inflationary surprises with the exception of the long-term sector. The Portfolio Advisory Team recommends keeping expectations low – similar to 2017. It is difficult to assess how global interest rate markets will react to another year of multiple rate hikes and a synchronized global reduction in quantitative easing. Investors must be conscious of volatility risk which can be seen as an opportunity to generate value, but could also lead to higher costs and risks not properly compensated, especially in credit markets. The Portfolio Advisory Team starts the year with a neutral recommendation in terms of duration (interest rate volatility) of around 4.50 to 4.75 years, in line with their benchmark.

Both Canadian and U.S. yield curves are expected to flatten again in 2018, but definitely not at the same speed and magnitude that we saw in 2017. This environment supports a more conservative approach to the interest rate sensitivity of fixed income portfolios, but the Portfolio Advisory Team continues to advocate for investors to remain invested in the market and to gradually take advantage of higher yields.

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

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