Monthly Market Commentary

Equity Strategy

Introducing the BMO Private Client North American Risk Appetite Index

The BMO Nesbitt Burns Portfolio Advisory Team has created the proprietary BMO Private Client North American Risk Appetite Index (RAI), which attempts to minimize the emotion and bias prevalent in a number of market indicators. In order to do this, the Portfolio Advisory Team uses exclusive market price data and compares the relative performance of risky assets versus safe assets. Simply put, when stocks outperform bonds, the RAI increases. When bonds outperform stocks (which is typical when investors fear an economic slowdown, for example), the RAI decreases.

The good news is that despite the strong stock returns experienced over the last year, the RAI is only slightly above a neutral reading. This is encouraging as it contradicts the common refrain that the market has "run too far too fast." While there are no guarantees in investments, the RAI is indicating there is still room for stocks to extend gains before we reach a dangerous, overly optimistic zone, which tends to precede sharp stock underperformance. This supports the Portfolio Advisory Team's overweight stance on stocks, albeit with a defensive, high quality tilt (i.e., preference for dividend growing Healthcare stocks as opposed to the hyper-cyclical Energy sector).

So far, it's been a slow (some would say boring) summer from a stock market perspective. Volatility remains near record lows, which is historically a good omen for the market, and trading volumes are muted. But still, the stock market keeps grinding higher in a slow, deliberate way. This may seem puzzling given the political gridlock in the U.S. with the Republicans seemingly incapable of advancing the Trump agenda, despite controlling Congress. There is also this nagging Russian collusion investigation, which is not going away and further hampers the White House's ability to get things done. This illustrates that the business cycle — and economic and earnings momentum, in particular — is almost always a more important market driver than politics, especially for risky assets such as stocks. While earnings season is still young, early results are encouraging with quarterly profit growth of over 9% for S&P 500 companies. What's more encouraging is that three-quarters of companies that have reported to date are beating both earnings and sales estimates, according to FactSet, a financial research and analytics firm. Incidentally, this is the highest percentage of companies reporting sales above estimates for a quarter since FactSet began tracking the data in the third quarter of 2008. Looking at sectors, there are particularly strong profit trends from Healthcare, Technology, Industrials, Financials, and Energy (which is rebounding from extremely depressed levels).

Fixed Income Strategy

Is it too early to talk about another rate hike in Canada?

The Canadian bond market took another step back in July as the Bank of Canada (BoC) hiked rates and investors priced in further monetary policy tightening. The Portfolio Advisory Team believes that portfolios, in general, will start to gradually benefit from higher interest rates. However, considering the strong performance of corporate bonds and the insatiable appetite for yields that has driven corporate credit spreads tighter, a gradual shift toward better quality securities is warranted. Lately, the focus has been on rising interest rates; however, monitoring credit risk is also recommended.

Canadian interest rates continued to ride higher in July, despite further indications of limited inflationary pressure, significantly underperforming the U.S. and European markets. The Canada/U.S. interest rates differentials tightened

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significantly, with the two-year spread moving from 60 basis points in May to practically flat at the end of July, as investors priced in greater chances of further tightening in Canada. However, on a real yield basis, Canada has recently moved above the U.S., reflecting the better economic landscape on this side of the border.

With limited wage growth, this does not bode well for spending growth and in part, helps explain why consumer prices have remained stubbornly below the BoC's target of 2%. This also helps explain the fact that on average, long-term rates have been underreacting to the recent shift in monetary policies and forecasts. In particular, the U.S. yield curve has flattened; long-term yields moved lower this year despite the U.S. Federal Reserve (the Fed) hiking rates three times since December, and its discussion of starting to shrink its balance sheet. With limited inflationary pressure, it's difficult to see long-term rates significantly higher. BMO Economist Doug Porter reported that over the past five major Canadian tightening cycles (over 20 years), core inflation (consumer prices which exclude the most volatile items like food and energy) was below 2% for the vast majority of the cycle or for its entirety. He provides the example that during the most recent cycle in 2004 to2007, the core consumer price index moved above 2% at the ninth (and last) interest rate hike in 2007. Interestingly, while the core average over the last 20 years is 1.7%, below the bank target, it rose above 2% after the hikes ended in four of the five cycles. Clearly, we cannot exclude the possibility of inflation turning around yet.

U.S. monetary policy and political uncertainty may start playing a larger role in the direction of Canadian long-term interest rates. A recent Bloomberg survey shows that economists are now increasingly concerned over the recent slowing of inflation, something that the Fed Chair, Janet Yellen, acknowledged. The market currently expects the Fed to announce the timing of its balance sheet unwinding in September, but to delay further rate tightening to December. If we combine the low inflation (which is an issue both in the U.S. and Canada) with the current political drama surrounding healthcare, and uncertain fiscal policy and its potential impact on the economy, it could delay further action from the Fed and lead interest rates lower.

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

General Disclosure

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