The Volatility Strikes Back

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Market volatility has picked up significantly over the last week based on two related factors: (1) the continuing slowdown in global economic growth; and (2) relentlessly lower interest rates. In particular, the brief inversion of the U.S. 10-year / 2-year yield curve (when long-term rates are lower than short-term rates) was clearly the catalyst for the broad equity selloff experienced on Wednesday, August 14. Still, to be fair, overall market returns are more than adequate year to date in North America, with the S&P 500 up 13%, and the consistently lagging S&P/TSX up a respectable 12%. However, the important point is not to look in the rear view mirror, but to try to determine where we go from here. While we don't pretend to have a crystal ball, our objective in this short missive is to frame the risk/reward for bonds and equities for the balance of 2019.

It is true that an inverted yield curve has historically been an ominous sign of a recession, but we remind our readers that the yield curve in isolation is not a perfect predictor. In fact, a negative yield curve did not lead to recessions in the mid-60s, mid-80s and mid-90s. And, importantly, on the several occasions where this was a valid signal, recessions tended to follow 12-24 months later, which means that the stock market typically rose for the next few quarters, even after the inversion. With over 46%[1] of the global bond market, including corporate bonds (ex Canada/U.S.) trading with negative interest rates (a situation that would have been unthinkable just a few years ago), we believe that part of the current downdraft in North American interest rates is being driven by demand for our bonds from overseas, as opposed to the bond market warning of an imminent economic collapse.

It is also true that growth has slowed since the start of the year, a phenomenon exacerbated by Trump's instigated trade wars (at least the White House announced they will delay imposing additional tariffs on a number of imported consumer goods from China until December). Among very large economies, the ones most reliant on manufacturing/exports have been hit disproportionately with Germany and the UK at the forefront of the slowdown. In the case of Britain, a no-deal Brexit would amplify economic pain given the tight integration of supply chains with Continental Europe. So yes, there are a number of risks on the economic and investment landscape, but risks will always exist.

This is why it's so important to keep things in perspective. The silver lining is that lower interest rates – and by extension mortgage rates – are highly supportive for the huge real estate market and consumers. Also, since the present value of future corporate cash flows goes up with consistently lower rates, the relative value of high quality dividend-paying stocks has further improved relative to bonds. The BMO Economics team still forecasts approximately 3% global GDP growth in 2019 and 2020, with China and the U.S. offsetting continued weakness in the Eurozone. These numbers are largely consistent with the conclusion of our BMO Private Client Recession Probability Model. This model shows a relatively low 30% probability for a North American recession in the next year given the strength in employment which supports the consumer economy (far larger than manufacturing). In other words, the odds of a severe economic contraction and associated bear market in stocks have not materially increased since we introduced the Model in May of this year.

[1]Source: Bloomberg/Barclays Global Aggregate Bond Index ex Canada/U.S.

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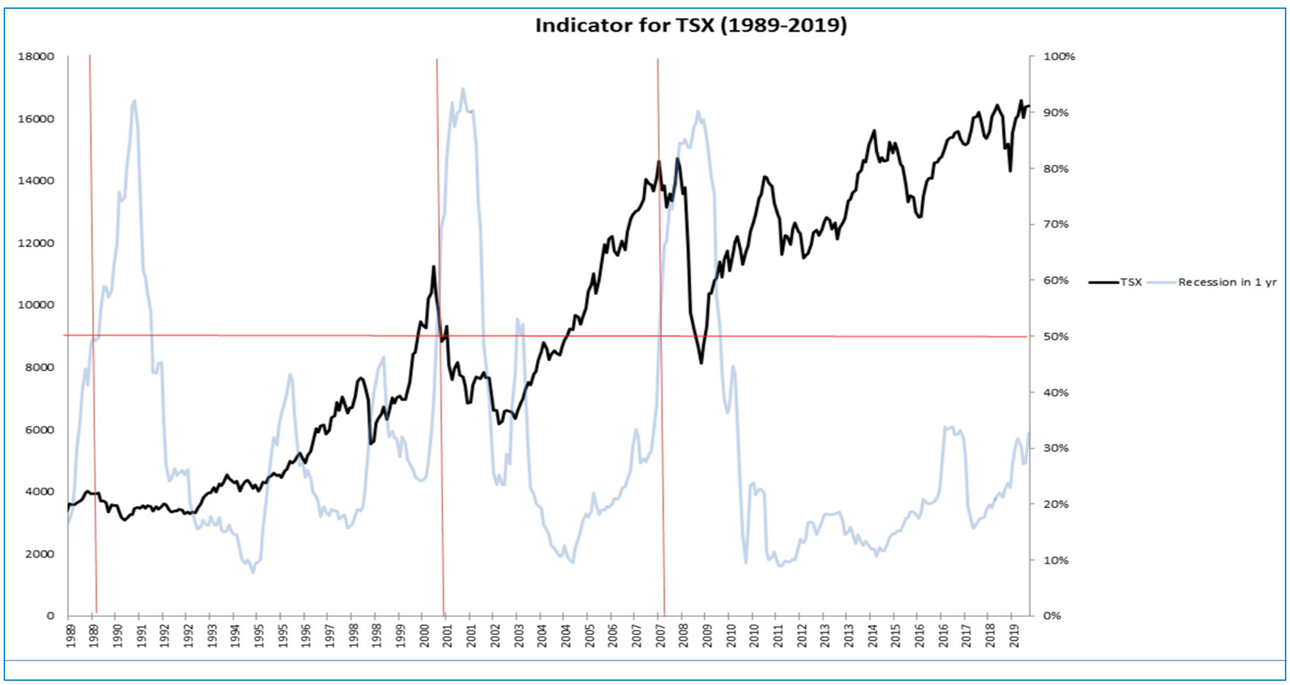
Our Model has provided an important warning on every upcoming U.S. recession (and, by extention, most Canadian recessions) since 1950, with a lead of two to three quarters. This is important because the market is a leading indicator and discounts improving and worsening business cycles in advance. Remember, it is when our one year probability rises above 50% that we get a powerful "risk off" signal that argues in favour of lowering the equity allocation of portfolios. As the chart below shows, since the late 1980s, the S&P/TSX Composite Index started steep declines almost exactly when the Model's probability hit 50%. Clearly, we will be keeping a very close watch on this level as we progress through 2019 and 2020.

We strongly recommend against overreacting to the current bout of volatility. The key is to maintain a well diversified portfolio including bonds, cash and high quality stocks. Of course, since market turbulence could continue for a while longer, the key is to hold on and accumulate the right types of equities. Key characteristics include very high barriers to entry (a competitive advantage), strong balance sheets (low or no debt), and strong consistent dividend growth potential. History has shown that such companies tend to generate outsized profits over a long period of time, and they also act more defensively in tough environments such as the one we are going through right now.



Source: BMO Nesbitt Burns Private Client Strategy

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As a reminder, it is always important to maintain a long-term perspective on your investment strategy. Please contact your BMO financial professonal if you would like to discuss your invesment portfolio.

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