Equity and Fixed Income Strategy

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A Light at the end of the tunnel

The light we are referring to is a peak in inflation, which we believe is now finally and thankfully behind us. We concede that the Consumer Price Index remains too high for comfort, however, the trend should improve in the coming months and possibly more quickly than many bearish investors believe. This is part of the reason the stock market has been behaving better very recently. Vast improvements in supply chains largely explain this. Anecdotally, the cost of shipping a full container from Asia is currently around US$4,000 compared to US$20,000 last year. Also encouraging is that consumer inflation expectations are coming back down to trend, which mean that individuals still have confidence in Central Banks' abilities to break the cycle of price increases. This, in turn, means that we are unlikely to enter a wage growth spiral like we saw in the seventies (annual double-digit salary increases) which is far harder to contain.

The open question is how much does economic momentum deteriorate from here. No one knows for certain but – at least from a stock market perspective – we feel that a considerable amount of bad news is already priced into the market. Call it a sharp slowdown or mild recession. All that said, we continue to recommend a selective approach to investing as we have all year. In particular, beaten down Technology stocks are still a no-go zone for us in general (still too expensive with deteriorating earnings trends in many cases) while there are great opportunities in certain Industrials and Consumer Discretionary stocks.

The Bank of Canada ("BoC") delivered a pleasant surprise on October 26, announcing a more modest than expected 50 basis point rate hike, 25 basis points less than expected. The BoC's decision shows that policy makers are noticing the economic deceleration and are at least trying to avoid a very deep recession. This move may not sway the all-important U.S. Federal Reserve (the "Fed") one iota but, even South of the border, the tone is softening slightly indicating rate increases are closer to the end than the beginning. This, in turn, should help long-term interest rates stabilize.

As we have often stated, history has proven that absolute numbers matter far less than the trajectory for asset performance. In other words, even if current conditions are still poor in absolute terms (i.e., inflation remains much too high for comfort), as long as things start to improve, then stocks and bonds generally perform far better since the market anticipates conditions in the real world several months in advance. Case in point, going back to the 1960s the U.S. market has benefitted from an average 30% multiple expansion when inflation was in a long-term downtrend. So, while earnings estimates are still generally coming down, stocks will get a tailwind from this effect (i.e., run rate profits will be multiplied by a greater factor meaning that stock market returns will be – thankfully – less dependent on pure earnings growth).

Technical analysis – A brighter future

Our macro call for equity markets right now is that the August to October sell-off represented a successful test of the June low, effectively completing a "low, rally, re-test" bottoming sequence which is the most common way that bear markets end. If that turns out to be the case, then there's a basic playbook for sector positioning which we like to refer to as "All offense, no defense." Historically, pro-cyclical/economically sensitive sectors tend to lead the markets out of the low which makes a lot of sense since they're usually the ones that get beaten up the most in an economic downturn, and are the most levered to a recovery

Tightening cycle: The end is near

Historically speaking, interest rate markets perform well when central banks end tightening cycles; a period that normally coincides with slower economic growth. There is no reason to believe this time would be any different and the recent strength in the rates markets would suggest the time is near, especially for the Bank of Canada. The BoC's governor made it clear that while more rate hikes would be necessary as inflation remains elevated, we are getting closer to the end. After being the earliest and the most aggressive of the major central banks so far, the BoC will likely become the first one to end its cycle. With inflation trending lower and the unemployment rate higher than in the U.S., it helps justify the need to become less aggressive compared to the Fed. The fact is that our resource-heavy and more interest-rate-sensitive economy is showing earlier signs of the negative impact from rising policy rates, something the BoC acknowledges.

Whether December or January marks the end or a pause is uncertain, but this is nonetheless encouraging news for investors. BMO Chief Economist, Doug Porter, believes that the BoC will hike by 75 basis points in total over the next couple of meetings and lift its key interest rate to 4.50% – but the job is not done yet. While there are positive signs on the inflation front, we have yet to see significant improvement on core measures (i.e., excluding food and gasoline). More importantly, never have we seen the BoC or the Fed end a tightening cycle while short-term real rates were negative. If history repeats itself, slowing inflation and rising short-term rates crossing paths (or soon expected to) should offer the BoC and the Fed the opportunity to stop raising rates.

While the focus slowly shifts to the economy and away from inflation concerns, investors are getting paid attractive yields awaiting the end line for this cycle. In fact, after the significant upward adjustment in interest rates this year, the total return prospects for Canadian investment grade bonds are some of the best in years. Using the latest BMO Economics interest rate forecast (October), we calculated the expected 1-year total returns and attribution for select government and corporate securities. Considering that the carry yields (expected income from both coupon income and price amortization) of short- to mid-term investment grade bank bonds nears 6%, this means investors will earn on average 0.50% monthly, more than double income levels from a year ago.

More importantly, in our opinion, is the developing investment theme: tax efficient fixed-income strategies. Rarely have bonds been associated with tax efficiency, but months of rising yields and declining prices is offering an attractive opportunity. The combination of low coupons (result of years of historically low interest rates) and deeply discounted prices, means future income will be composed of a mix of coupons and capital gains as prices amortize back toward a maturity value of $100. After years of bonds selling at a premium, a market composed primarily of discounted bonds and the introduction of discounted bond ETFs provides interesting income opportunities and tax loss selling strategies. So, not only are the nominal yields attractive, but for a rare time, so are the after-tax return prospects.

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

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