# Equity and Fixed Income Strategy

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## The case for increasing Canadian equity exposure

With our conviction that inflation has peaked and a clear indication that the Bank of Canada has paused interest rate increases (soon to be followed by the U.S. Federal Reserve), this may be an opportune time to put money to work in the S&P/TSX Composite Index, which has a high weighting in attractive sectors and a relatively low valuation. In particular, the China economic "reopening" is a big deal which is not fully priced in yet, in our opinion, with several important economic indicators marking a "V-Bottom" (e.g., Port Container and Subway Traffic, Air Travel, Purchasing Managers' Manufacturing and Services Data).

With both fiscal and monetary stimulus now working together, China's Gross Domestic Product ("GPD") expectations have been raised to the 5% range for the year. This has positive implications for Basic Materials and Energy stocks which account for a third of the total value of the S&P/TSX Composite Index vs. less than 10% for the S&P 500 Index and should, of course, also help the Loonie relative to other developed market currencies and the U.S. dollar in particular. Conversely, we remain negative on Technology, by far the largest sector in the S&P 500, with a 25% weighting, given still-excessive valuations, negative earnings trends, and cost bases that still need to be ratcheted down from COVID-19 excesses (i.e., the slew of layoffs recently announced by Meta, Microsoft, PayPal, Salesforce and Google are not a positive sign for 2023 growth prospects). The S&P/TSX Composite Index also has higher weightings in Financials and Industrials, two of our preferred sectors at this point of the cycle given their earnings momentum recovery potential and attractive valuations.

Another encouraging element is credit trends in North America with bond spreads (the cost to borrow over "risk-free" government bonds) behaving surprisingly well, especially in the high yield sector. This means that fixed income markets are getting less concerned about a severe economic slowdown. By historical standards, the stress level – even at its recent peak – was not even in the same stratosphere as during the Financial Crisis.

## Interest rates moved up fast but are not particularly high by historical standards

BMO Economics note that historically, there have been episodes where rates have risen meaningfully, but economic growth (and corporate profitability by extension) remained resilient. Some examples include the late 1950s, late 1980s, and mid-1990s. That said, none of those episodes saw the same scale of tightening in such a short period of time, and some, for example in 1994, did not see the economy roll over into a recession. However, none of these cycles started from record low interest rates either, which – despite rates normalizing – have not become prohibitive. That is probably the key takeaway – if the economy and earnings can withstand the tightening, equities have a good chance of doing so too with modest damage.

Maybe more important in this particular episode is the inflation dynamic; equities have historically performed very well in periods where inflation is high but falling back toward 2%, and that is the case today with clear evidence that price pressure is cooling. Going back to 1960, the S&P 500 Index averaged annualized total returns of 14% in that environment (versus 7.5% for all years), while the S&P/TSX Composite Index averaged total returns of just over 9% (versus 6.5% for all years). Both markets also outperformed 10-year treasuries and cash. Again, the timing with respect to a possible recession matters in this context too, but from a big picture perspective, the inflation backdrop now looks bullish if trends hold.

Our data analysis work going back to the 1960s clearly shows that stocks, in general, perform better when inflation is declining. This makes intuitive sense since the value of future corporate cash flows is worth more in today's dollars when inflation and interest rates are low.

Our conviction that inflation has peaked has important implications for monetary policy. Clearly, we are nearing the end of the Central Bank tightening cycle. Case in point, Bank of Canada ("BoC") Governor Tiff Macklem, last week stated that rate hikes were on "*conditional pause*" barring an "*accumulation of evidence,*" that flags upside risks to the inflation outlook. BMO Economics expects the BoC to remain on hold for the remainder of the year. South of the border, the U.S. Federal Reserve (the "Fed") downshifted its rate tightening again on February 1, acknowledging the improvement on inflation but, as expected, still noted that more policy adjustments could be required in the near future. With inflation still elevated from a historical perspective, the Fed could not yet tone down its tightening rhetoric. Having said that, it is now becoming more obvious that even if the door remains open for another hike in March, indications are that the Fed is getting much closer to the end of its tightening cycle. Markets even believe that a slower growth path combined with a further decline in inflation could lead to less restrictive policy within the next nine to 12 months.

This will help stabilize the all-important housing market (home building, renovations and associated activities represents close to 20% of Canadian GDP and over 10% of U.S. GDP). Demographics and immigration trends in Canada will provide a long-term demand tailwind for housing. We believe that conditions will begin to stabilize in the second half of 2023.

Further, our work on interest rate cycles going back over 40 years has shown that the best market returns are achieved when policy rates stay unchanged for long periods, something the BoC and the Fed are signaling, "higher for longer." This makes intuitive sense since markets have historically rewarded stability and visibility.

While a North American recession remains a key risk in 2023, our proprietary recession model[1] shows the probability of such an event ticking down (from 60% last year to approximately 45% currently). If we do see a recession, the recent nascent improvement in relevant macro variables strengthens our belief that it will be a very mild one by historical standards.

## Technical analysis

We see nothing but improvement in our Medium-term Timing Model. For example, weekly momentum gauges remain "4 for 4" bullish for both the S&P/TSX Composite Index and the S&P 500 Index after giving new buy signals late last year – the first such combined buy signal since the pandemic low.

Breadth indicators measure the quality of a market rally in terms of the number of stocks participating. There has been continued improvement in the percentage of New York Stock Exchange ("NYSE") stocks trading above 50- and 200-day moving averages, and the latter just registered its highest reading in more than a year. The number of individual stocks making 52-week new highs on the NYSE also just reached its highest reading in more than a year, so the rally is really beginning to fire on all cylinders.

Surveys released the week of January 30 were uniformly higher yet again, resulting in another solid uptick in our Composite Sentiment Indicator. While that marked the fifth week in a row of expanding bullish sentiment, we're still in the middle zone where increases are a tailwind for equities since it means more money is being put to work. Overall, we don't expect sentiment to be a problem for equities at any point this year.

Other conditional elements that are not part of the timing model but are equally important these days is the performance of pro-cyclical, economically sensitive areas of the market such as Industrials, Consumer Discretionary, Financials and Materials, all of which have recently made new multi-month highs on both an absolute and relative basis (versus the S&P 500). A classic "risk on/risk off" metric in technical analysis is the performance of Discretionary stocks versus Staples, where we've recently seen a fresh 52-week new high, which perfectly encapsulates the burgeoning "risk on" environment.

Based on this data, the bias for equities should remain to the upside into Q1 2023. In terms of the price action, we have seen major breakouts in both the S&P/TSX Composite Index and the S&P 500 Index above their December price peaks. For the S&P/TSX Composite Index, that breakout opened an initial upside target that measured to 22,219, which is essentially in line with the early 2023 all-time high of 22,213. For the S&P 500 Index, the close above resistance at 4,100 cleared the way for the rally to extend back to its August peak of 4,325. A breakout there, if it were to occur, would shift the long-term trend back to bullish for the S&P 500 and clear the way for a challenge of its all-time high of 4,818.

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

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[1] Our model results have a good track record. The algorithm has provided an important warning on every upcoming U.S. recession (and most Canadian recessions by extension) since 1950, with a typical lead of two to three quarters. This is important, since the market is a leading indicator and discounts improving and worsening business cycles in advance.



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