Equity and Fixed Income Strategy

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Stock markets can continue to climb the wall of worry

For the better part of the last 12 months, numerous pundits have assured us that a recession was at hand or had already begun. Well, here we are, a third of the way through 2023, and still no recession in the U.S. or in Canada. Could one occur before the end of the year or in early 2024? It is certainly possible, but it is still not a foregone conclusion in our view. We caution against using "official" Gross Domestic Product ("GDP") figures to inform us on the direction of securities markets since they are ancient history by the time they are published, and the stock and bond markets are forward looking (i.e., the stock market tells us what is going to happen in three to six months). Still, GDP data has its uses. In this case, to debunk the notion that we were already in a recession at the start of the year. Case in point, the recently released Real U.S. Q1 GDP showed a slowdown (fully expected) but still grew 1.1% annualized (down from 2.6% in Q4) as inventories shrank meaningfully, offset by continued strong consumer spending. Clearly, companies are being cautious as shown by their focus on cash conservation and cost cutting through multiple layoff announcements. The upside of this corporate behaviour is that profit margins should remain robust and that the unavoidable economic reacceleration will be further helped by inventory restocking.

The political rhetoric is intensifying regarding the U.S. debt ceiling standoff and it does present a risk to markets and may lead to increased volatility in the coming months. Still, the political expert of our research partners at Piper Sandler notes that, "Our base case is Democrats and Republicans will reach a deal at the eleventh hour, avoiding an outcome where the Treasury won't have sufficient funds to pay all the federal government's bills. To get the votes to raise the debt ceiling in both the House and Senate, Democrats are probably going to have to offer a modest policy concession to Republicans, which may or may not have anything to do with the budget. We put about 10% to 15% odds there is no deal by June. The political pressure to reach a deal will be immense, so even if Congress goes past the deadline a deal is likely to be reached within hours or days of cheques not going out. To be clear, this may put rating agencies on alert, but bondholders get paid in any scenario".

The silver lining from the recent banking scare is that 10-year interest rates – the cornerstone of financial markets – fell by about 50 basis points. The combination of slower growth, slower inflation, uncertainty surrounding U.S. regional banks, and the U.S. Federal Reserve (the "Fed") likely pausing its tightening after hiking in early May, contributes to lower long-term yields. Given our long-held view that inflation has peaked, we believe rates will stay range-bound which has a positive impact on the fair value of stock markets. The fundamental question for stock investors – and unfortunately, there is no definitive answer on this – is how much economic slowdown is currently priced in? Our view is that a mild recession is priced in at this point but a severe one is not. This is also reflected in short-term markets pricing in easier Bank of Canada and Fed monetary policies by Q1 next year (rate cuts of between 0.25% to 0.50%). Thankfully, our base case falls in the former category which leads us to the view that investors should make moderately positive returns from both stocks and bonds this year. However, it will continue to be a bumpy ride.

We believe the S&P/TSX Composite Index and the S&P 500 Index could rise to 24,000 and 4,300, respectively, in the next year or so. Clearly, this provides far more upside for the Canadian market which had underperformed the S&P 500 Index in the last decade (until last year). Market composition has a lot do with it. Our market has a far greater proportion of cyclical and value stocks (think Energy, Mining, and Financials stocks which trade at low multiples of earnings) than the U.S., which is strong in Technology, Healthcare, and Consumer stocks. We happen to believe that prospects and risk/reward is very attractive for several Canadian Financials, Energy, Mining and Industrial heavyweights (e.g., CP Rail, Canadian National Railway, Finning, Toromont, Royal Bank of Canada and Canadian Natural Resources).

Corporate credit spreads are key fixed income indicators that currently point to a relatively benign environment[1]. Despite signs of tightening bank credit conditions, credit spreads continue to behave relatively well, having tightened, not widened, in the last month. While counterintuitive to the current market environment, it shows that corporations came into 2023 with strong cash/balance sheet positions that were well-funded from years of low interest rates.

History is also on our side relative to inflation coming down. When inflation declined materially – irrespective of the starting point – the S&P 500 Index was up double digits, on average, with notable outperformance from sectors we recommend such as Consumer Discretionary and Financials. Technology has bounced back impressively year to date, but very expensive valuations and declining growth prospects keep us cautious for the time being.

Technical analysis

In early 2022, the S&P/TSX Composite Index reversed a 10-year trend of underperformance versus the S&P 500 Index and hasn't looked back. Yes, there have been minor pauses along the way but the S&P/TSX Composite Index has been outperforming consistently since then, and there is no sign of that trend changing. The expectation is that this should remain the case throughout 2023, at least.

The TSX Industrials Index broke out from a massive 18-month trading range. The recent close above the resistance at 5,010 signaled a resumption of the long-term uptrend and opened a new upside target of 5,940. The Index has also been consistently outperforming the S&P/TSX Composite Index since the low of last October. This is consistent with how pro-cyclical, economically sensitive sectors tend to perform as markets shift from bear markets to bull markets.

The TSX Bank Index is reversing back to the upside from a successful test of the mid-2022 low, accompanied by new buy signals in short-term momentum gauges (from the steepest oversold reading since the pandemic low, no less). There is at least a trade back to the upper end of the base at 4,280. A breakout there would shift the long-term trend to bullish and open a new upside target of 4,975, essentially in line with the late 2021 all-time high.

The TSX Diversified Mining and Metals Index broke out from a massive 10-year base pattern. The close above resistance, near 7,500, shifted the secular (multi-year/multi-decade) trend to bullish and opened a new upside target that measures to 13,300. Currently reversing back to the upside from a successful test of the breakout, a close above the early 2022 peak of 9,990 would open an additional target of 14,000.

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

[1]Corporate credit spreads are the difference in yield between a corporate bond and a government bond with the same maturity.

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