Equity and Fixed Income Strategy

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Canadian banks starting to look very good

Sometimes in the world of investments, the best longer-term risk-reward vehicles are found on the road less travelled. Case in point, since the start of 2022, Canadian banks have been very much out of favour with investors (despite their stellar long-term track record of dividend increases and shareholder value creation). While timing is always tricky, we see this as an opportunity for long-term investors (i.e., day traders need not apply). The contrast with mega-cap technology stocks this year is particularly stark. In fact, while the S&P 500 Index is up an impressive 13% year-to-date, excluding the top 10 performers (virtually all tech giants) turns this into a far more pedestrian, low single-digit gain. Still, as noted in our technical analysis on the following page, participation among smaller stocks and across sectors is really starting to broaden out which is an encouraging sign for some sectors that have been left behind, like Financials.

We have consistently made the point that a near-term recession is not a foregone conclusion, and last month we stated that we believe the housing market in North America has bottomed. There are a number of investment possibilities related to this view; however, we believe large-cap banks should be prime beneficiaries given their high economic and housing exposure.

Recent data continues to strengthen our conviction in this view. First and foremost, inflation continues to slow. The implications for this trend are profound. Not only will this reduce the likelihood of seeing too many more rate increases, but it will boost the fixed income and equity markets; historically, stocks have benefitted from a 30% multiple expansion on average when CPI slows. In Canada, the latest data was quite encouraging. Specifically, consumer prices (CPI) rose 0.4% and 3.4% year-over-year in May, with headline inflation slowing a full percentage point from the prior month. On a seasonally-adjusted basis, CPI rose a mere 0.1%, the smallest increase of the year. South of the border, inflation expectations for a year out slipped for the third consecutive month. The U.S. economy continues to steadily defy the bears who have been assuring us that a recession is imminent.

BMO Capital Markets recently conducted a detailed analysis of credit trends and loan reserves for Canadian banks and concluded that, "allowances for credit loss levels are generally higher than pre-pandemic levels. Our review of credit risk and reserve levels at Q2/23 end leads to no changes to our provision for credit loss forecasts… If our credit quality, reserve adequacy, and provision cost conclusions hold, one important risk to our earnings forecasts is more or less eliminated, suggesting to us there is limited downside risk to lower forward P/E valuation multiples; the path to re-rating higher would need to include a more favourable revenue environment. Once sentiment toward the banks improves (tied to the macro outlook), we expect the "cheaper" valuation names to be relative outperformers…"

From our perspective, this lowers the primary risk which looms over bank equities: insufficient bad loan provisions which can severely impair profitability. In particular, Canadian banks all continue to have excess reserves. With the recovery in economic momentum we foresee in 2024, and the improvement in housing, revenues should accelerate over the next several quarters leading to continued steady dividend increases.

History is also on our side when it comes to bank performance vs. inflation trends. Financials have been among the top performing sectors when inflation came down by at least 2.5% year-over-year (this is clearly the case), and also following a U.S. Federal Reserve (the "Fed") pause in raising interest rates (we are very close to that).

Finally, valuations are very attractive. History shows us that buying Canadian banks when they are on "sale" has yielded outsized returns.

Technical analysis

In recent weeks, there has been some concern in the media and elsewhere about how narrow the participation had been in U.S. equity markets. At the time, only a handful of mega-cap technology stocks were responsible for the lion's share of the gains in the S&P 500 Index. While the weight of those stocks in the Index means they will almost always have an outsized impact on the performance of the Index, there is plenty of evidence the rally is beginning to broaden out. For example, in June, we saw the biggest five-day rally in mid-cap stocks since October, the biggest five-day rally in small-cap stocks in more than two years, the percentage of NYSE stocks trading above their 50-day moving averages undergoing the biggest five-day spike since late 2020 (just after the U.S. election), and the number of individual stocks making 52-week new highs jumped to the highest reading in more than four months. In addition, the 10-day moving average of the total value of U.S. securities traded is very near to making a three-month high.

S&P/TSX Financials Index – A close above resistance at 3,560 would signal the beginning of a new long-term uptrend, with an initial upside target that is measurable to 3,965. New buy signals in short-term momentum gauges suggest the next major move will be to the upper end of the base. By itself a trade to the upper end of the base would represent a 25% gain from the late June level, but given the bullish macro call a breakout of the base is the expected outcome.

S&P/TSX REIT Index – The S&P/TSX Composite REIT ("Real Estate Investment Trust") Index is currently rebounding from the deepest oversold readings since the pandemic low in early 2020. The minimum expectation should be for a rally back to the upper end of the year-long base pattern of 3,620. That alone would represent a gain of nearly 20% from the late June level. A breakout at that point, given the bullish macro call, would shift the long-term trend to bullish and open an initial upside target that measures to 4,340, which is more or less in line with the late 2021 all-time high.

Testing higher boundaries

The surprise Bank of Canada ("BoC") rate hike early in June confirmed that in the face of stubborn inflation, central bankers are growing impatient. Rarely have we seen the BoC having an impact on global bond markets. Combined with surprise hikes from Australia and the UK, it led a repricing of global monetary policy expectations and pressured short-term rates higher. The Fed did pause to let the last rate hike sink in, but that did not slow the 2-year U.S. Treasury yield which marched higher towards 5% as tough talks from Fed officials continue to indicate that a least one more hike, if not two, are a possibility this year.

Just two quarters ago many economists had pencilled in a mild contraction in Canada for the summer. Instead, the labour market remains strong, which combined with above average population growth, continues to support consumption and economic growth. Not only has the expected contraction been delayed, but so too has inflation returning to its target. This helps explain why interest rates are generally back close to levels prevailing before the first U.S. bank failure (Silicon Valley Bank on March 8), and even higher for Canada and the UK, as investors brace for more tightening and remove any traces of potential policy reversal for 2023.

This economic resilience also helps explain the overall strength in risk assets and, in particular, credit markets. While the most recent back up in government yields negatively impacted year-to-date performance, the corporate bond sector continued to outperform. A combination of higher income and tightening credit spreads – in part supported by slower financing activities – provided the edge over government bonds. In addition to strong economic data, the waning bank crisis and the debt-ceiling deal cleared the way for spreads to return to pre-March levels (with the exception of the Financials sector), and in many cases, close to their tightest levels in over a year.

Digging deeper though, some diverging trends are emerging, in particular in the U.S. Strong labour, low unemployment rate and growth reports continue to feed into the inflation story. However, comparing the trend of leading indicators, like surveys of purchasing managers, average work week and initial claims to the more coincident and lagging ones, clear signs of economic deceleration can be observed which should help inflation slow further.

This is encouraging; but likely more work, and surely more time will be needed. Hence the expectations for still higher terminal policy rates and, more importantly, higher rates for longer. As bond investors re-price higher short-term expectations, their optimism is not similarly reflected at the longer end of the yield curve. Since the resiliency of the economy is expected to be met by central bankers' resolve, long-term rates continue to price in slower growth/inflation ahead; leading to further curve inversion, the widest since the early eighties. To note, inverted yield curves have preceded every recession in recent history.

Bottom line: The job is not done, but we are definitively closer to the end of the tightening cycle. Our BMO economists expect both the BoC and the Fed could deliver

at least one more hike this quarter. This should maintain upward pressure on short-term rates while long-term rates continue to consolidate at the higher end of the range until confirmation of the end of this cycle.

We believe a neutral duration offers a good balance between attractive income and protection against upside economic/ inflation surprises that could add volatility at the longer end of the yield curve.

As for the credit market's risk pricing, we believe it is fair and some sectors remain attractive, supporting an overweight allocation. The yield curve may indicate weaker days ahead but a relatively strong corporate bond market is at worst a vote for a mild contraction. A notable exception has been the underperformance of Financials which continue to suffer from the aftershock of U.S. regional bank issues.

Whether this game of chicken between inflation and central bankers leads to a soft or hard landing has yet to be determined. Some may already be giving up on the idea of a recession due to today's different set of circumstances. We would caution, however, against dismissing too quickly the predictive nature of the yield curve. Considering the quality of Canadian bank issuers in general, their wider spreads reflecting expected risks, we see yields between 4.5% and 6% for short- to mid-term issues as attractive compensations to add to portfolios until the results are in.

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

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