Equity and Fixed Income Strategy

BMO Nesbitt Burns | October 2023

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Winter is coming (for expensive growth stocks)

Between another averted U.S. government shutdown and strikes across different industries, investors have had plenty of risks to consider. However, the risk to rule them all has to do with interest rates. In fact, traders have become fixated with U.S. long-term interest rates – the cornerstone of all financial markets – which went above the psychologically important 4.5% level (we were at 3.5% as early as May of this year). We are now at the highest level in over 15 years. This matters because bond prices move inversely with interest rates, and long-term bonds (i.e., 10+ years in maturity) are most vulnerable of all. These are known as high-duration bonds and we have already seen some carnage in long bond ETFs.

Similarly, very expensive stocks – many of which reside in the tech-heavy Nasdaq – are very vulnerable to higher rates because higher rates makes the present value of years out cash flows less valuable. For example, when interest rates are close to zero, a dollar of profits expected to be earned by Artificial Intelligence ("AI") darling NVIDIA Corp. in 10 years is worth close to the same as a dollar earned today. That is no longer the case when rates have increased significantly.

NVIDIA Corp. has been a phenomenal success story and is building "must-have" processors for AI. They have shown outsized growth and have been rewarded by an eye-watering price to sales multiple of 32x (that compares to about 2.2x for the S&P 500 Index). Using consensus estimates and simply adjusting the assumed 10-year risk free rate in our model, we concluded that an increase of 2% in long-term rate assumptions **lowers** the fair value for the stock by about 25%, all things equal.

But not all is lost. Recent weakness has created some value in stocks although our modus operandi is still very much to be selective. With the likelihood of a North American recession in the next year steadily decreasing on our models (now below 45%), we believe the setup for Canada — which has a more economically sensitive market than the U.S. — and oil equities, in particular, is quite positive. Backing up this view, important industrial indicators have started to stabilize and even turn up in some cases. More specifically, Colin Hamilton, BMO's Commodity Strategist, notes that while still weak in absolute terms, "at the margin there is sequential improvement in the data points, while metals and bulks have been stable and energy prices rising over the past month. Moreover, the data improvement is cross-regional." Corporate earnings estimates have followed suit, rising for the first time in over a year. All this makes us quite comfortable with our current fair value estimates for the S&P 500 Index and S&P/TSX Composite Index.

We studied the impact of higher interest rates on historical sector performance. The most important conclusion is that two years after a 3% increase in long rates (this has only happened on five occasions since the 1970s), the market typically shows healthy returns, albeit with a wide variation of returns among sectors. The top performers have been defensive sectors such as Consumer Staples and Healthcare, along with more cyclical areas like Financials, Consumer Discretionary and Energy. The one sector which has systematically underperformed is Technology and we expect this cycle to be no different. We do not recommend avoiding the entire tech sector, but rather to be particularly sensitive to barriers to entry and valuations.

Growth/value vs. Fed Funds cycle

A related conclusion concerns investment style performance following a "pause" in rate hikes (with the caveat that there may be one final rate increase) by the U.S. Federal Reserve (the "Fed"). Our work has shown that the market tends to act well with interest rate stability and that "value" stocks (e.g., banks and oil producers), tend to outperform growth equities (e.g., tech) 12 months after interest rate stability is achieved.

Earnings themes and insights

Analyst earnings estimates have started moving back up for 2023 and 2024, after consistently coming down since 2022. Thematically, more companies than ever are citing AI in their conference calls and less companies are citing inflation as CPI and producer prices have come off the boil.

In terms of estimate revisions, analysts have increased earnings estimates for Q3 2023 for the first time since Q4 2021. On a per-share basis, estimated earnings for the third quarter have increased by 0.4% since June 30. In terms of revenues, analysts have also increased their estimates during the quarter. We expect the S&P 500 Index to report (year-over-year) revenue growth of 1.6%, compared to the expectations for revenue growth of 1.2% on June 30.

Technical analysis

The U.S. 10-year yield is what's "driving the bus" for North American equities. Since last month's commentary, the U.S. 10-year yield definitively closed above key resistance at 4.34%, effectively signaling a resumption of the long-term uptrend following a year-long consolidation and opening a new upside target of 5.37%.

Of course, the breakout in rates is not solely a U.S. phenomenon. The Canadian 10-year yield also broke out of a massive consolidation pattern above resistance at 3.68%, which signaled a resumption of the long-term uptrend and opened a new upside target of 4.81%.

Currently, the U.S. and Canadian 10-years are overbought (yield basis) on both the short- and medium-term charts, so we expect some consolidative action at some point soon, but the trend for rates through the remainder of the year is now to the upside.

A key takeaway from this is the obvious impact it's going to have on the 11 major S&P 500 sectors. Utilities have suffered the biggest consequences with the S&P 500 Utilities Index breaking down from a massive multi-year topping process. That breakdown shifted the long-term trend for Utilities to bearish and opened a target that measures 15% lower from the recent closing price.

Many breadth oscillators are now stretched into oversold extremes that typically only occur at major turning points, and put-call ratios are beginning to skew heavily bearish. Usually, major lows in the market are accompanied by aggressive put buying as investors make heavily negative (wrong) bets on the market. At the same time, we're not seeing any real deterioration in bond market sentiment gauges such as corporate/treasury credit spreads or credit default swap indexes. In fact, the Moody's BAA/U.S. 10-year yield spread actually just registered a 6-year record for narrowness in late September, so clearly bond traders aren't worried about what's going on in equity markets. We've noted repeatedly over the years that the general rule in technical analysis is that you want to be a buyer when indexes test rising 200-day moving averages. As we started October, the S&P 500 Index is less than 2% from its 200-day moving average, and considering how ridiculously oversold it is, this is easily the best buying opportunity we've had since the March low, and arguably even the best buying opportunity since the bear market low last October.

Higher for longer

Lower yields may have to wait. Not that a quick return to the very low yield regime was forecasted, but after a significant summer increase, some market consolidation was expected. Instead, mid- to long-term rates rose by another 50 basis points on average in September, as central banks remained on the hawkish path, leaving the door open for further rate hikes if needed. As a result, most bond index performances turned negative year to date.

Many will point to the recent CPI uptick, the risk of further upward pressure from rising oil prices (+30% in Q3) and wage negotiations for the late summer push in yields. Interestingly, however, inflation expectations have barely moved over the period. In fact, the latest push higher comes from longer real yields, reflecting the higher for longer narrative from central bankers as markets start to cue in that they mean what they say; committed to bringing inflation back to target.

As a result, the 2- to10-year yield curves are gradually re-steepening, moving away from extreme inversion levels, providing greater incentive for investors to move away from cash and short-term investments. While the expectation was for lower short-term yields to drive the move, it is actually the longer-term sector that is adjusting to the reality that: 1) inflation will be slow to return to 2%; 2) rate cuts are being pushed forward and will likely not come at the same speed and magnitude of the last tightening cycle; and 3) high budget deficits and increased government bond supply combined with reduced buying from central banks and international investors applies pressure on longer-term real rates.

Cooling labour markets, slower economic growth and the lag effect of higher interest rates should help stabilize the short-term impact of higher inflation. Markets remain split as to the next move with odds of another rate hike at around 33% in the U.S. by November, and over 50% in Canada by early 2024.

Even if the Bank of Canada and the Fed do not hike again, the mere threat of it will keep markets on their toes and likely keep volatility elevated. With sticky inflation and a still relatively strong U.S. economy, the upside risk to longer-term interest rates in the near term remains. This supports our recommendation to maintain a neutral duration to benchmark, as we believe it offers a good balance of income and protection.

We admit that experiencing lower bond prices and portfolio values as yield rises to new 15-year highs is concerning, but despite the challenging environment, there are many positive developments. Today's attractive yields provide the combination of a high real yield (net of inflation) and deep discount tax efficient bonds that benefit investors. And, unlike earlier this year, the higher yield offers greater protection against rising interest rates.

In addition, no matter how deeply discounted a bond becomes to reflect higher current rates, it does not change the security's maturity value of par ($100). Lower prices only mean that the expected return will be higher from now until maturity. More importantly, every coupon payment earned in the future will likely be reinvested at higher interest rates, leading the total return of the bond over the holding period to exceed the originally contracted yield.

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

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ID8299 (10/23)