

Equity and Fixed Income Strategy

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Positive on Canadian stocks and discount bonds, expect more bifurcation

In the spirit of leading with our conclusions:

1. As we enter 2024, we remain overweight equities (with fair values of 25,000 for the S&P/TSX Composite Index and 5,000 for the S&P 500 Index), and find very good value in discount bonds which are quite efficient from a tax perspective (more on this below).
2. The S&P/TSX may outperform the S&P 500 as sector leadership broadens out from “Magnificent 7” type stocks where the U.S. market has a huge advantage. In a nutshell, we see the Canadian market as far cheaper, Canadian sector weights are more favourable in the context of a “soft landing” scenario and eventual upturn in 2024, and we consider the Canadian dollar to currently be substantially undervalued.
3. We think high-quality, low-duration stocks (i.e., reasonably valued versus profitability and growth, and paying growing dividends) remain the place to be.
4. If we are correct in stating that interest rates are unlikely to substantially spike from current levels, then defensive/interest rate-sensitive sectors like Pipelines/Utilities, Multi-Family REITs, Financials, and Telecoms should continue their recovery from a difficult 2023. In fact, the recently expressed dovish view from the U.S. Federal Reserve (the “Fed”) makes the prospect of short-term interest rate cuts more likely.

We are already seeing some optimistic signals. First, far from deteriorating, our recession probability model has shown improvement with the odds of a recession ticking down to about 40%. As our readers know well, securities markets are primarily influenced not by absolute numbers but by the trajectory of key macro variables. On that front, the situation has already improved massively for inflation

and the 2%+ range is now in our sights for 2024. The key missing ingredients have been an improvement in growth and housing momentum, and that’s what we think will happen in the new year as rates further stabilize/decline. As always, the stock and bond markets will discount these improvements well before we see the evidence in the “real world.”

But that was last year’s story. History has shown that chasing past performance can be a dangerous endeavour for investors and we believe this time will be no different.

A simple argument for this is that the five biggest stocks in the S&P 500 (Apple, Microsoft, Google, Amazon, and NVIDIA) now have an aggregate value of over US\$10 trillion, representing over 25% of the total value of the biggest stock index in the world. This is not a trivial share and is, in fact, a record in recent memory based on our data (top five weighting during the Tech bubble peaked at 18%). While these companies undoubtedly have dominant business models and are highly profitable, they are staring down the barrel of the “Law of Large Numbers.” At the very least, slowing growth will act to compress their very high trading multiples (price to earnings or price to free cash flow, whichever you prefer).

A numerical example should help illustrate. Investors who are paying 30-40x expected earnings per share for these companies implicitly expect at least a 10% return on their investment as compensation for the risk. To attain that goal, and all things being equal, these five companies would have to add the market cap equivalent to PepsiCo, Bank of America, Coca-Cola, and Merck & Co. in 2024. To continue that compounding trend, they would then have to add the equivalent of Oracle, Adobe, Costco, and Chevron in 2025, and J.P. Morgan, Walmart and Johnson & Johnson in 2026. Anything is possible, but is that a likely scenario? We think not.

Updated fair value estimates

We continue to see better upside from Canadian stocks, with updated fair value estimates of approximately 5,000 for the S&P 500 and 25,000 for the S&P/TSX. While our numbers may strike some as being on the bullish side, we reiterate that we see a strong recovery happening in the second half of 2024, particularly with the prospect of potential rate cuts both in the U.S. and Canada. Also worth noting, we expect a strong recovery trade in Canadian Banks, Industrials, Energy Infrastructure, some parts of Consumer Discretionary, Multi-Family REITs and Healthcare in the U.S. We believe in maintaining an underweight positioning in expensive “FANGish” stocks in the Technology and Communication Services areas.

Lessons from history

With the help of our research partners at NDR, we conducted several long-term historical studies to help with our market and sector positioning. We referred back to several decades to find out whether dividend payers and reasonably valued stocks are poised to outperform after a very difficult 2023, and which sectors have traditionally rebounded in a similar inflation and interest rate environment.

The conclusions were as we predicted. Namely, dividend-paying and “value” stocks (there is considerable overlap in these two categories) do tend to outperform meaningfully 12 months after the Fed pauses rate increases and following a minimum 2% increase in 10-year bond yields, as is the current situation. From a sector perspective, it has been a mix between defensive and economically sensitive stocks, but many of them generated double-digit returns in seven of the eight “Fed cycles” since 1973.

Technical analysis

The S&P/TSX Composite and the S&P 500 have just completed their best eight-week rallies in more than a year, and given the state of our medium-term timing model, there’s plenty more to come. For example, weekly momentum gauges are fully bullish again for all of the major averages after giving new buy signals at various points in November, which by itself suggests that the bias for equities should remain to the upside into late Q1 of 2024.

Recall that a “breadth thrust” occurred at the beginning of November as well. A “breadth thrust” is when the New York Stock Exchange breadth goes from heavily negative to heavily positive over a short period of time, and this has a fantastic track record of signaling major rallies. There have been 12 of these signals over the past 60 years, and the

average 12-month return for the S&P 500 following the signal is +24.8%. Since the credit crisis, the signals have been even better. Since 2009, the average return for the S&P 500 in the 12 months following the signal has been +36.76% (we do not include the March 2023 signal in that data since it is still in effect). Finally, bullish sentiment continues to expand for all segments of the market, including everyone from retail investors to professional futures traders.

As an example, we just saw the biggest one-month expansion in our Composite Sentiment indicator in more than 13 years. It’s important to note that sentiment remains below the levels that become a headwind for equities, so no problems there. In terms of upside potential, the S&P 500 recently broke above its July peak at 4,607. The next major target/resistance level from there is its all-time high of 4,818. Of course, the breakout above 4,607 opened an upside swing target that measures to 5,111, so we expect to see an all-time high in that index in early 2024. Here in Canada, the S&P/TSX Composite remains stuck within a year-long sideways trading range, but given the state of our medium-term timing model, we expect an upside breakout above resistance at 20,843 at some point next year as well. The all-time high of 22,213 will provide some resistance, but the swing target on a close above 20,843 measures to 22,995. Favourite spots for new money remain interest-sensitive stocks such as Banks, Pipelines, Telcos, Utilities, and REITs, which should continue to benefit from the persistent slide in long-term interest rates.

The year of the pivot!

After a significant tightening cycle and a very challenging two and a half years in markets, it looks like fixed income investments have turned the corner. The 2023 recession forecast, a failed consensus call, is being quickly replaced by expectations of a soft landing/lower inflation combination that will open the door for central banks to cut policy rates earlier than initially anticipated.

Less than three months ago, investors were bracing for the possibility of a third consecutive year of negative performance. Instead, a clearer indication of the end of the rate tightening cycle and expectations for cuts led markets to aggressively price the Bank of Canada (“BoC”) and Fed policy pivot. As a result, our BMO Economists, like many, recently changed their 2024 forecast, pulling forward some of the 2025 cuts and now expecting a total of 100 basis points (“bps”) easing over the next 12 months, starting in June, with the BoC leading the Fed by one month. The market’s adjustment was even steeper, pricing in

expectations for a cut in Q2 2024. Whether the conditions will be in place by then to start reversing the restrictive measures is debatable, but the trend has definitively turned positive, paving the way for policy rates to start declining next year.

In terms of longer-term interest rates, forecasts interestingly vary greatly despite the strong consensus for a soft landing. Looking at the 10-year Treasury for example, targets for the end of 2024 span from a low of 3% to above 5%, a difference of over 200 bps! This should provide for an interesting trading range for the year, and is likely to maintain volatility at a historically higher level; a reminder that the inflation battle has not been won yet and that not everyone shares the same soft landing definition. In addition, there is a risk that if interest rates decline too quickly along with easing financial conditions and still-elevated wage gains, inflation can re-accelerate as it did in the 1970s, dampening the more aggressive rate cut expectations.

On the more conservative side, BMO Economics expects U.S. 5- and 10-year yields to end 2024 at 3.80% and 3.75% respectively, fairly close to current levels. A similar story is told in Canada, where 5- and 10-year yields are expected to hit 3.20% and 3.00% respectively, remaining well below U.S. rates as a reflection of the better Canadian fiscal position, a weaker economy, and generally lower inflation. BMO's two-year yield forecast is more aggressive, with expectations of rates declining an additional 50+ bps driven by lower policy rates. Under this scenario, the Canada and U.S. 2-year or 10-year yield curve spread is expected to re-steepen (i.e., the spread will become more positive), but risks remaining negative (inverted), a condition that has historically been associated with an increased chance of a recession.

As for credit markets, we admit that this year's performance was much stronger than initially anticipated, especially from the high-yield sector. Stronger economies,

declining inflation, and renewed interest in fixed income investments – arising from a combination of the best yields in years and the tax efficiencies of deep discount bonds – helped support strong demand for corporate bonds. Going forward, however, it raises questions as to whether the current investor's compensation is adequate considering the slower economic scenario and much higher refunding costs for companies that have benefitted from years of low yields. Unfortunately, different study periods yield different expectations. Looking at the last two years of strong economic growth and wider spreads, some would argue that the Q4 2023 spread tightening of over 30% leaves valuation on the expensive side. However, looking at the average from the last 10 years, especially in the high-yield space, the argument would not necessarily confirm overvaluation.

Even if we believe the markets may be ending the year slightly expensive compared to the fundamental background, we remain constructive on fixed income investment return prospects for 2024. Considering the level of yields, bonds will be in a better position to weather higher volatility and economic shocks. Using BMO Economics interest rate forecast, the short- and mid-term part of the yield curve would offer the best return potential over the next 12 months.

Based on these expectations, we maintain our main investment themes of: 1) target a neutral portfolio duration; 2) gradually increase government bond exposure; and 3) maintain a higher-quality bias for our corporate bond exposure. We continue to believe it prudent to add to bond portfolios, gradually investing in liquidities and maturities, and if applicable, taking advantage of the better tax-efficient opportunities the market continues to offer.

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



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