Equity and Fixed Income Strategy

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The amazing resilience of the U.S. economy and AI trade

The long-promised U.S. recession is not even close to materializing. Case in point, and as noted by the excellent BMO Economics team, "Q4 GDP data showed yet another year of solid activity, while price pressures eased (which strengthens the case for interest rate cuts later this year). Growth in the fourth quarter came in much stronger than expected, at 3.3%, providing a nice handoff to Q1, and setting the stage for the expansion to continue in 2024. But, with the mighty consumer still fueling economic activity, we're not expecting a pivot any time soon and are comfortable with our July rate cut call." Higher-than-expected growth and lower-than-expected inflation! That, in our experience, is not a recipe for a major market pullback. Quite the opposite, in fact.

We have often stated that looking at GDP figures is akin to reading ancient history as far as financial markets are concerned, but we find this economic resilience remarkable, and it certainly argues for further increases in consensus growth expectations for 2024, with very positive implications for corporate earnings and the stock market. While Canada's performance has been weaker, the fact that our largest trading partner (by far) is still so strong should help boost our own economic momentum.

As our Technical Analyst, Russ Visch, noted on January 23, "The best part of (Monday's) action was how broad-based the price strength was (greater than 3:1 advancers to decliners on the NYSE), where small- and mid-cap stocks actually outperformed the S&P 500. Overall, the broadening out of the rally is the best confirmation of the sustainability of last week's breakouts." We could not agree more and note that while the market has had a strong run, last year's very narrow focus on the "Magnificent 7" and AI-related stocks has left many investment opportunities in less sexy, more prosaic areas.

Among these are Financial stocks, particularly strong banks with cost cutting/margin expansion potential. Also interesting are Railroad stocks which should benefit from an inflection point in volumes this year and an associated acceleration in EPS trends. Other interest-sensitive stocks which should act well in 2024, include Pipelines, Telcos, Utilities, and REITs. While still a bit early, copper and oil also seem poised to recover with the prospects of increased demand in the back half of the year.

Artificial intelligence mania

Taking a step back, while the concept of AI has been around for over 50 years, we are at a pivotal point for its adoption today, due to the availability of big data, high-powered computing, and advances in algorithms – all of which make AI cheaper and faster to implement. In simple terms, AI is the simulation of human intelligence by machines. It is the development of computer systems with human-like capabilities such as visual perception, speech recognition, decision making, and language translation. In practice, AI is a group of technologies that help facilitate the discovery and analysis of information for the purpose of making predictions and recommendations, support decision making, facilitate interactions, and automate certain processes. (We note this in our recent report, *AI Primer*. Please contact your BMO Nesbitt Burns Investment Advisor if you would like a copy.)

Undeniably, the growth curve for AI is very steep with chip makers such as NVIDIA, AMD, and Broadcom being early beneficiaries of business enthusiasm for this compute-intensive technology. The stock market has already rewarded those stocks handsomely, discounting a very optimistic scenario in a very short time. Having witnessed the 2000 Tech Bubble first-hand, we note that this follows the historical script for sexy emerging themes – stocks moving well ahead of fundamentals – and certainly argues for being selective and not overpaying for "hype."

That said, we still see investment opportunities in AI with some reasonably valued stocks that are clear leaders in developing the technology. Amazon and Google come to mind, while other inexpensive Tech stocks such as Qualcomm and IBM also stand to benefit as shown by recent management comments and the positive increase in order trends.

Taking a more macro view, we are enthused about the growth and productivity implications of AI. This could be very significant because we believe sustained productivity growth is the Holy Grail in economics as it increases the potential growth rate of the economy while keeping inflation in check. In trying to quantify this impact, consulting firm McKinsey recently stated that current GenAI and other technologies have the potential to automate work activities that absorb 60-70% of employees' time today, and that it could enable labour productivity growth of 0.1 to 0.6% annually through 2040, depending on the rate of technology adoption and redeployment of worker time into other activities.

Using another methodology, McKinsey also suggests that AI adoption could raise global GDP (through direct and indirect effects) by as much as US$13 trillion by 2030, about 1.2% additional GDP growth per year. Their survey respondents expect significant business disruption from GenAI with companies predicting meaningful changes to their workforces. They anticipate workforce cuts in certain areas and large reskilling efforts to address shifting talent needs.

Technical analysis

As we gathered our thoughts at the end of January, the S&P 500 was on the cusp of completing its best three-month rally in nearly four years. In fact, there have only been two other instances of bigger three-month rallies in the past 15 years: 1) the lift-off from the pandemic bear market low; and 2) the lift-off from the credit crisis low in early 2009. So, we've experienced something truly special and rare. Of course, now that the S&P 500 is at an all-time high it has prompted many to ask if there's much more upside left in this rally. While the sample size is much too small to make any strong statistical inferences, the 2009 and 2020 rallies can still provide a decent guide as to how the next few months are likely to play out. For example, the average three-month return in the S&P 500 following those big gains in 2009 and 2020 is +14.41% and the average six-month return is +21.23%.

Despite the big run-up from the late October low, it's entirely possible that the S&P 500 continues to power higher in the months ahead. The good news is that's exactly what our medium-term timing model is telling us: weekly momentum gauges for all the major averages remain bullish and supportive of more upside, breadth oscillators are also improving after giving their first combined buy signals since 2020, and seasonality remains constructive well into the second quarter.

In terms of upside potential, the recent close above the July peak at 4,607 opened an upside swing target of 5,111 for the S&P 500. Here in Canada, the S&P/TSX Composite broke out of a year-long sideways trading range in late December. The all-time high of 22,213 will provide some resistance but the swing target on the close above 20,843 measures to 22,995. Favorite 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.

Is an early U.S. rate cut even probable?

One of the main drivers behind the lower U.S. interest rates these past few months has been the combination of the optimism surrounding a soft landing and lower inflation. This led the market to place higher odds of a March U.S. Federal Reserve ("Fed") rate cut, which is not surprising if we consider that, on average, the Fed has historically cut rates approximately six months after its final hike; the latest hike was last summer. We admit that if inflation measures alone were driving the monetary policy decision, the strong indication of the metrics moving toward 2% would support an earlier cut. With Core Personal Consumption Expenditure ("PCE") – the preferred Fed inflation measure – trending close to, or below 2% over the last three-to-six months, the door would be open for the Fed to start normalizing its policy toward the neutral rate.

However, other data may not yet align with an early pivot that could risk pushing inflation back above target. Growth, for one, continues to surprise to the upside, with Q4 2023 GDP showing a faster pace than initially anticipated and prompting many to even revise 2024 expectations higher, including our BMO Economists. Reports of tighter bank credit standards and higher credit card loan delinquencies are worth monitoring, but are normal signs of the impact of higher interest rates and should help moderate economic growth. The labour market also continued to surprise with the January report showing another strong job creation trend at a time when we expected a more normalized report, considering we are seeing more layoffs announced. If we combine the strong wage gains (above 4%), the rebound in job openings above nine million (still higher than pre-covid levels), and the low unemployment rate (3.7%), the data is far from being all in for an early pivot.

Despite our views, we see no end in sight to the rate cut debate and history has shown that volatility tends to be higher at inflection points as we await the first cut. While this may complicate investment decisions, we find it prudent to remain focused on portfolio duration target over yields. A neutral to slightly defensive duration compared to an investor's benchmark should combine high income and reduced exposure to volatility, but still maintain enough exposure to longer-term bonds if conditions change. As for U.S. yields, they may be off last year's highs, especially when driven by rate cut hopes, but when the whole Treasury yield curve is offering a minimum of 4%, they remain attractive.

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