

## Canadian Strategy Snapshot

### Our View on Yield Sectors and Interest Rate Regimes

#### Bottom Line

Against the backdrop of rising long-term interest rates year to date, ALL the Canadian yield-heavy sectors have underperformed. However, from our perspective each of these areas are excessively oversold and are extremely overdue for a sharp reversal to the upside once interest rate concerns stabilize. While we do subscribe to the “higher-for-longer” interest rate narrative (please see our recent [US Strategy Comment: Rate Worries Resurface Yet Again](#)), our work shows that these sectors can post solid absolute returns and, in some cases, even outperform when long-term interest rates are in a range. Indeed, the **Real Estate** sector typically posts its best absolute and relative performance when interest rates are range bound and is historically one of the least interest rate sensitive high-yielding sectors in the TSX. While the **Communication Services** sector is interest rate sensitive, we believe the sector should be doing much better on an absolute basis given we are likely at or near peak long-term interest rates. **Utilities** is historically the most correlated with interest rates, but typically sees a clear inflection of performance once long-term interest rates peak and is generally a Market Perform in range-bound rate environments. Lastly, **Canadian banks** have become too interest rate sensitive in our view. Historically, while there IS a relationship, particularly on the tails of interest rate moves, the sector can outperform in most interest rate environments and typically posts its best absolute performance when interest rates are range bound or rising gradually. Overall, while we continue to urge income investors to focus on dividend growth, we believe many of these sectors are oversold and can rebound sharply when interest rate concerns subside.

#### Overview:

- **Real Estate Sector Performance Best in Range-Bound Rate Environments**
- **Communication Services Underperformance Is Beyond Interest Rate Concerns**
- **Peak in Long-Term Interest Rates Are Key for Utilities Sector**
- **Banks Can Outperform in Most Rate Environments**

#### Investment Strategy

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#### CDN Strategy – S&P/TSX Targets

S&P/TSX Price Target	
2024 Calendar Year End	23,500

S&P/TSX EPS Target	
2024 Calendar Year End	\$1500

Source: BMO Capital Markets Investment Strategy.

#### CDN Strategy – Recommended S&P/TSX Sector Weightings

Sector	Opinion	Tgt. Wgt.
Communication Services	OW	4.5%
Consumer Discretionary	OW	4.5%
Consumer Staples	UW	3.5%
Energy	MW	18.0%
Financials	OW	31.5%
Health Care	UW	0.0%
Industrials	UW	12.0%
Information Technology	OW	9.0%
Materials	MW	11.0%
Real Estate	MW	2.0%
Utilities	MW	4.0%

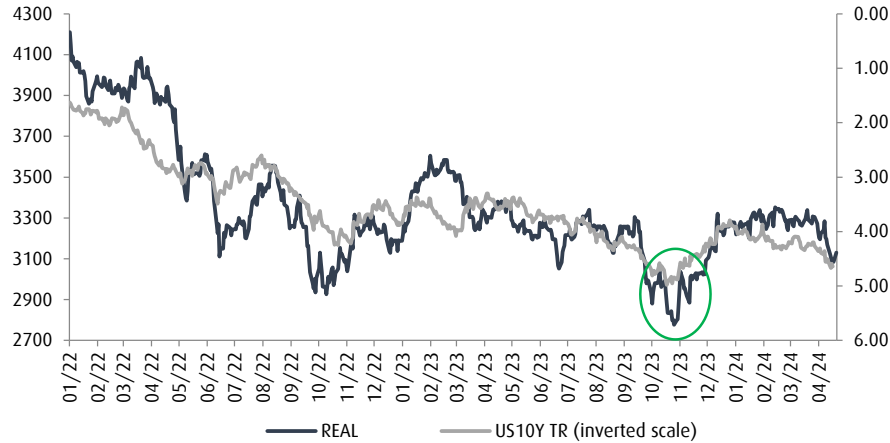
Source: BMO Capital Markets Investment Strategy.

OW: Overweight  
MW: Market Weight  
UW: Underweight

## Real Estate Sector Performance Best in Range-Bound Rate Environments

### Real Estate Performance Driven by Movements in Interest Rates

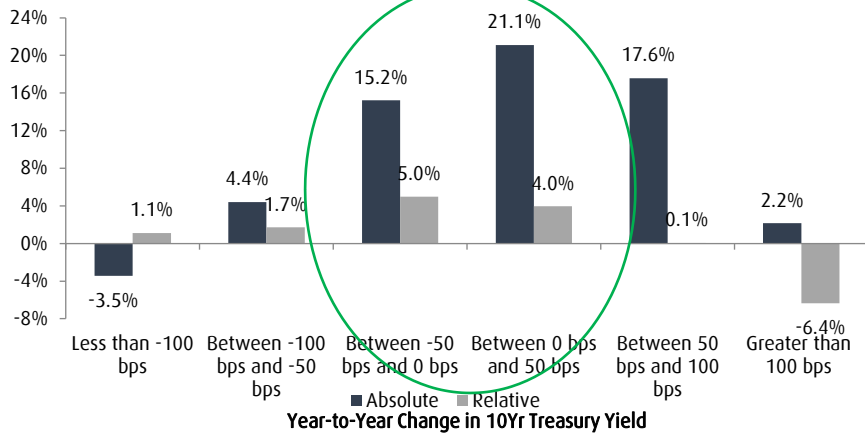
S&P/TSX Real Estate vs US 10-Year Treasury Rate



Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB

### Best Absolute & Relative Performance When Rates Are Range Bound

S&P/TSX Real Estate Absolute and Relative Average Rolling 1Yr Total Return Based on Year-to-Year Change in US 10Yr Treasury Yield monthly data, beginning 2002



Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB

### Real Estate Can Outperform Around Peaks in Interest Rates

Real Estate US Interest Rate Peaks	Absolute Total Return		Relative Total Return	
	t-6m	t+12m	t-6m	t+12m
6/29/2007	5.7%	-18.2%	-3.1%	-23.4%
4/30/2010	19.0%	28.6%	4.9%	9.8%
12/31/2013	5.3%	22.8%	-7.6%	11.1%
11/8/2018	5.6%	16.0%	7.3%	2.3%
10/19/2023 - To date	-12.7%	10.8%	-8.2%	-4.2%
	8.9%	12.3%	0.4%	-0.1%

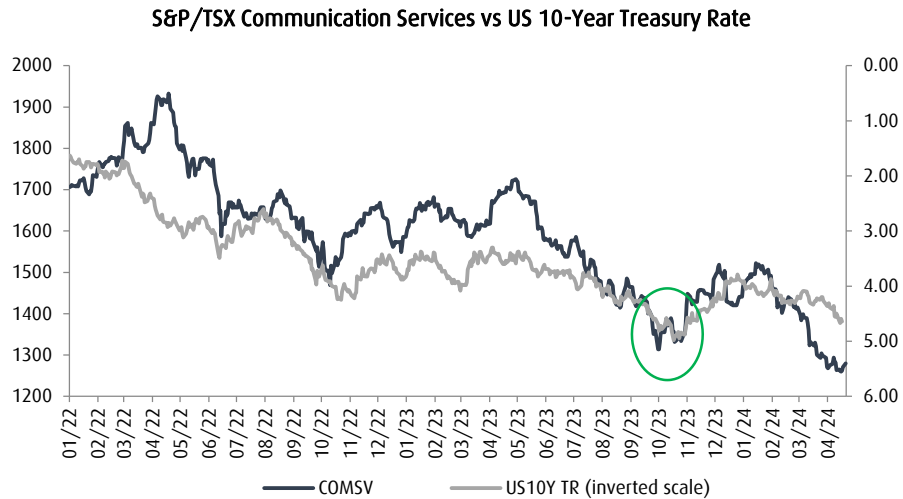
Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB.

We believe recent interest rate moves and speculation has significantly bullied the Real Estate sector to being one of the worst-performing sectors year to date. However, from our perspective this relationship is way overdone, and we believe the Real Estate sector could see sharp improvement when interest rate concerns stabilize. In fact, our work shows the Real Estate sector typically posts its best absolute and relative performance when interest rates are range bound and is historically one of the least interest rate sensitive high-yielding sectors in the TSX.

- Interest rates have been a key driver of both absolute and relative performance of the Canadian Real Estate sector over the last few years. In fact, the recent rise in US treasury yields back to near-cycle highs is likely the primary reason the sector has struggled year to date.
- While long interest rates may set a new cycle high this year, our work shows the Real Estate sector can post solid absolute and relative performance around peaks in long-term interest rates.
- More importantly, our work shows the Real Estate sector posts its best absolute and relative returns in more range-bound interest rate environments. In fact, since 2002 the best absolute return for the Real Estate sector was when rates were rising modestly.

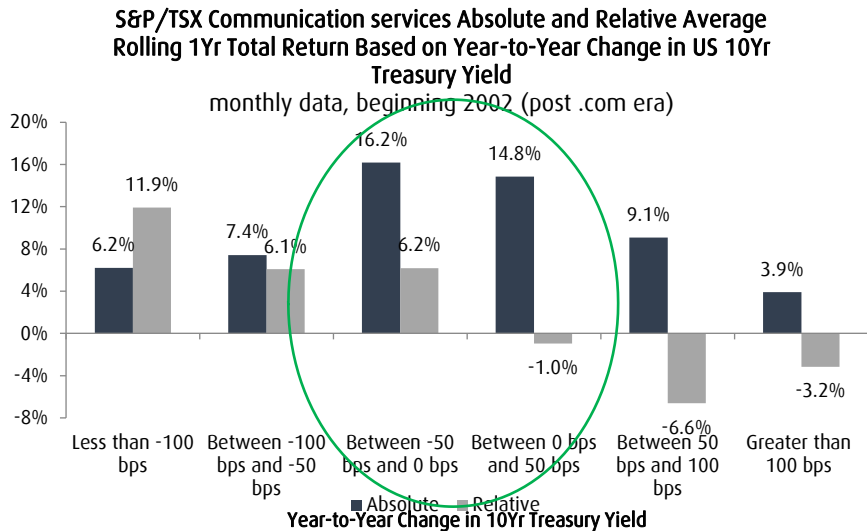
## Communication Services Underperformance Is Beyond Interest Rate Concerns

### Communication Services Performance Beyond Interest Rates



Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB

### Best Absolute Performance When Rates Are Range Bound



Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB

### Historically Mixed Relative Performance Around Peak in Interest Rates

Communication Services	Absolute Total Return		Relative Total Return	
US Interest Rate Peaks	t-6m	t+12m	t-6m	t+12m
6/29/2007	26.7%	-14.6%	16.2%	-20.0%
4/30/2010	16.2%	19.7%	2.4%	2.2%
12/31/2013	13.3%	15.5%	-0.6%	4.5%
11/8/2018	5.4%	13.9%	7.1%	0.4%
10/19/2023 - To date	-17.6%	-1.9%	-13.4%	-15.2%
	15.4%	8.6%	6.3%	-3.2%

Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB.

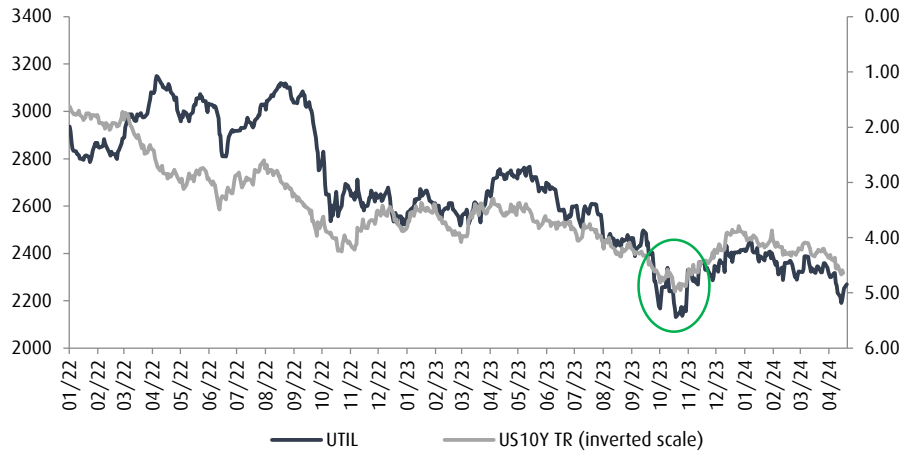
Yes, Communication Services is historically correlated with movements in interest rates and can struggle around peak interest rates. However, we believe the depth and breadth of recent underperformance is overdone. In fact, we believe the sector should be doing much better on an absolute basis given we are likely at or near peak long-term interest rates.

- In our opinion, the recent move in both the absolute and relative performance of the Canadian Communication Services sector has moved well beyond just interest rate concerns. In fact, year-to-date performance has been one of the worst on record for the sector and has decoupled from its historical interest rate relationship.
- Yes, peaks in long-term interest rates are not a clear turning point for the Communication Services sector. However, the sector does typically post positive absolute returns around peaks in US interest rates.
- Yes, Communication Services typically underperforms when interest rates are rising and outperforms sharply when interest rates start to decline. However, its best absolute performance is when interest rates are more range bound (+50 to -50 bps range).

## Peak in Long-Term Interest Rates Are Key for Utilities Sector

### Utilities Performance Tracking Movements in Interest Rates

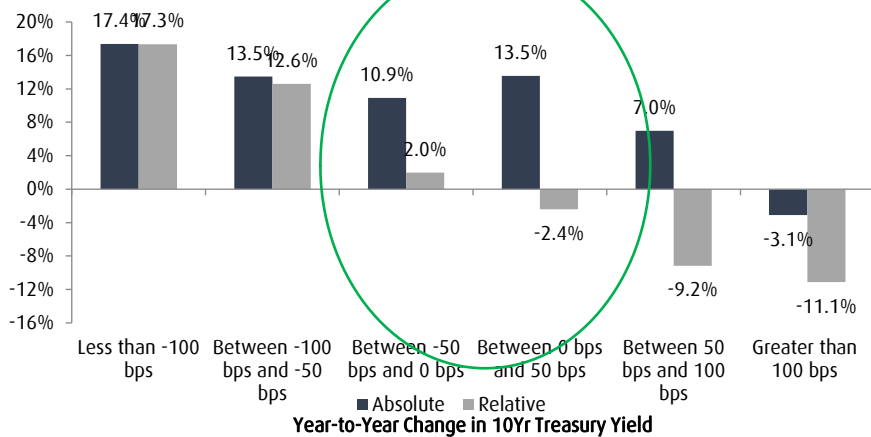
S&P/TSX Utilities vs US 10-Year Treasury Rate



Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB

### Utilities Are Market Perform in Range Rate Environments

S&P/TSX Utilities Absolute and Relative Average Rolling 1Yr Total Return Based on Year-to-Year Change in US 10Yr Treasury Yield monthly data, beginning 1990



Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB

### Peak Interest Rates a Clear Turning Point for Utilities

Utilities US Interest Rate Peaks	Absolute Total Return		Relative Total Return	
	t-6m	t+12m	t-6m	t+12m
6/29/2007	0.1%	12.7%	-8.2%	5.5%
4/30/2010	13.5%	21.6%	0.0%	3.8%
12/31/2013	-0.1%	16.1%	-12.4%	5.0%
11/8/2018	-0.2%	31.2%	1.4%	15.6%
10/19/2023 - To date	-18.6%	7.8%	-14.4%	-6.8%
	3.3%	20.4%	-4.8%	7.5%

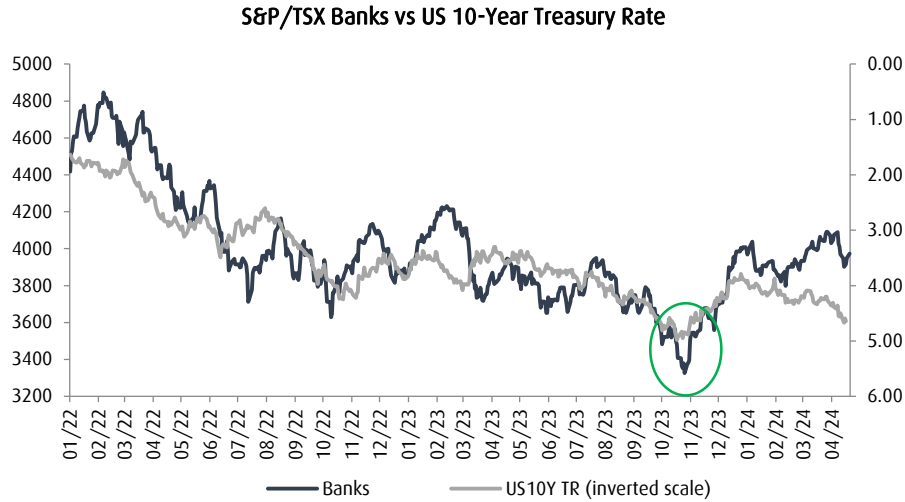
Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB.

Like all the other high-yielding sectors, the Utilities sector has underperformed year to date. However, from our perspective this sector is still tracking its historical relationship with interest rates closely. As such, we believe a clear peak in long-term interest rates will be key to a stabilization in returns. Overall, we see this sector is a clear Market Perform in periods of range-bound interest rates.

- The Canadian Utilities sector has been tracking movements in US interest rates very closely this year, with a near -90% correlation year to date, suggesting to us that a stabilization in interest rates will be key for this sectors' performance in the quarters ahead.
- Indeed, our work shows that historically peaks in long-term interest rates are a clear turning point for the sector. In fact, Utilities typically struggle on an absolute and relative basis heading into peak US interest rates and consistently outperforms 12 months after the peak in interest rates are set.
- According to our models, Utilities are the most interest sensitive of the high-yielding sectors. Historically, the sector posts it best absolute and relative performance when interest rates are declining by over 100 bps year over year, and typically posts its worst absolute and relative performance when interest rates are rising by over 100 bps year over year. Furthermore, we see the sector as a clear Market Perform when interest rates are range bound.

## Banks Can Outperform in Most Rate Environments

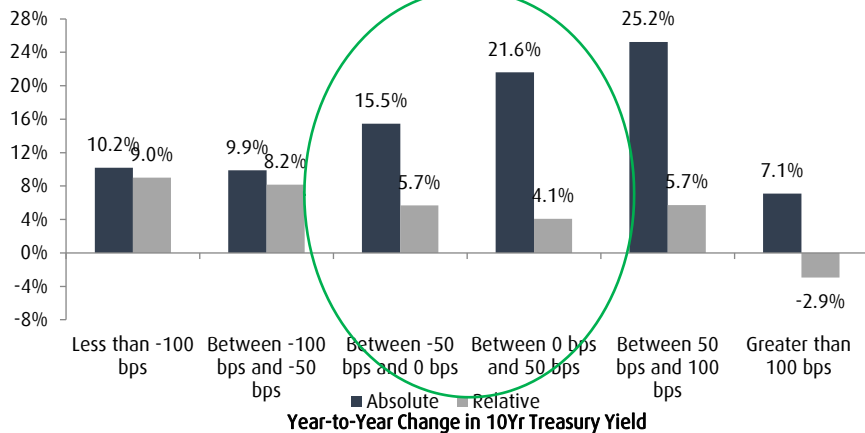
### Banks Are starting to Break Away From Shifts in Interest Rates



Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB

### Banks Can Post Solid Returns in Most Rate Environments

**S&P/TSX Banks Absolute and Relative Average Rolling 1Yr Total Return Based on Year-to-Year Change in US 10Yr Treasury Yield**  
monthly data, beginning 1990



Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB

### Peak Interest Rates NOT a Key Factor for Banks

Banks US Interest Rate Peaks	Absolute Total Return		Relative Total Return	
	t-6m	t+12m	t-6m	t+12m
6/29/2007	2.4%	-17.8%	-6.1%	-23.0%
4/30/2010	19.8%	9.7%	5.5%	-6.3%
12/31/2013	20.1%	13.5%	5.3%	2.6%
11/8/2018	-0.6%	11.1%	1.1%	-2.1%
10/19/2023 - To date	-9.6%	17.5%	-4.9%	1.6%
	10.4%	4.1%	1.5%	-7.2%

Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, IBES, FRB.

From our perspective, Canadian banks have become too interest sensitive. Historically, while there is a relationship, particularly on the tails of interest rate moves, the sector can outperform in most interest rate environments and typically posts its best absolute performance when interest rates are range bound or rising gradually. Indeed, if we are now in a more range-bound interest rate environment, which we believe, banks should be doing much better in our opinion.

- The correlation between banks and interest rates have been elevated over the last few years, with bank performance bottoming in line with peak US interest rates. While this correlation has started to decline year to date, we believe it remains too high given its historical relationship.
- From our perspective, the relationship of commercial banks and peak interest rates is not strong with an inconsistent historical return profile.
- When we examine the bank industry versus changes in long-term interest rates, our work shows that commercial banks can perform well in most interest rate environments. In fact, historically banks post their best absolute returns when interest rates are rising between 0 and 100 bps. It is only more extreme tail event moves higher in interest rates where banks tend to underperform.

## Recent Canadian Strategy Research Reports

Date	Title
<b>Canadian Strategy Snapshots</b>	
4/9/2024	<a href="#">Canadian Strategy Snapshot: Canadian Advantage During Periods of US Volatility</a>
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2/15/2024	<a href="#">Canadian Strategy Snapshot: Canadian YARP Opportunities</a>
2/7/2024	<a href="#">Canadian Strategy Snapshot: Our Overweight Canadian Consumer Discretionary</a>
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5/17/2023	<a href="#">Canadian Strategy Snapshot: Factor Performance Observations of the TSX</a>
5/10/2023	<a href="#">Canadian Strategy Snapshot: Downgrading Consumer Staples to Underweight</a>
4/26/2023	<a href="#">Canadian Strategy Snapshot: Canadian GARP Opportunities</a>
<b>Monthly Reports</b>	
4/3/2024	<a href="#">Canadian Strategy: Canadian Chartbook – April 2024</a>
4/3/2024	<a href="#">Canadian Strategy - Canadian Factor Profiles – April 2024</a>
<b>Investment Strategy Snapshots and Special Reports</b>	
11/27/2023	<a href="#">2024 Market Outlook: The Year Ahead for the US and Canada</a>
<b>US Strategy</b>	
<i>Please call or e-mail us to be added to our standalone US Strategy research</i>	

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Buy	Outperform	49.6 %	19.6 %	48.4 %	55.8 %	58.4 %	57.7%
Hold	Market Perform	48.1 %	20.6 %	49.5 %	42.7 %	40.8 %	37.5%
Sell	Underperform	2.4 %	18.2 %	2.2 %	1.4 %	0.9 %	4.8%

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