Investment Strategy

Stéphane Rochon, CFA
Equity Strategist
BMO Nesbitt Burns
Portfolio Advisory Team

Richard Belley, CFA
Fixed Income Strategist
BMO Nesbitt Burns
Portfolio Advisory Team

Russ Visch, CMT
Technical Analyst
BMO Nesbitt Burns
Portfolio Advisory Team

Eric Yoo
Associate
BMO Nesbitt Burns
Portfolio Advisory Team

Ernad Sijercic
Associate
BMO Nesbitt Burns
Portfolio Advisory Team

Let the Rate Cuts Begin & Commodities Showing Signs of Life

Lest you think you missed some major local news, the rate cuts to which we refer are not from the Bank of Canada ("BoC") or the U.S. Federal Reserve ("Fed"). At least not quite yet. Rather, it was the Swiss National Bank – which punches above the country's demographic weight in financial circles – and the Bank of Mexico which eased very recently. Why does this matter for investors? Simply put, rate cuts boost future economic growth (primarily through better consumption and housing strength), and equity markets anticipate this well in advance of official economic data. It is therefore no surprise that stocks have performed admirably during "easing cycles". While we have been consistently bullish on stocks since the end of 2022, we do concede that markets feel a little stretched at this point, especially among high flying AI-related stocks. In our view, a minor 4-5% pullback would present an attractive opportunity in lagging sectors. We hasten to add that the numerous models and indicators we track show a very low likelihood of a more painful 10-15%+ correction at this point. Our Technical Analyst, Russ Visch, believes one area that looks very promising for new money are commodity stocks (Energy, Base and Precious Metals), where we've seen several breakouts in underlying commodities. More on this later.

Rate Cuts Starting

As noted by BMO Chief Economist Doug Porter, the Swiss National Bank became the first central bank in the developed world to trim, slicing its policy rate 25 bps to 1.5%, as the combination of slow growth and 1% inflation has chopped Switzerland's nominal GDP growth to just 1.3% y/y. Soon after, the Bank of Mexico also delivered its first cut of 25 bps to 11.0%. Mexico was a leader on the way up – first lifting rates in June 2021 – and the full cycle saw 725 bps of hikes, outdoing the Fed by 200 bps in total. But Brazil has truly been in the vanguard, first tightening in March 2021 – a full year before the Fed – and hiking rates by a staggering 1175 bps (from 2.0% to 13.75%). Brazil began cutting rates last August, and chopped another 50 bps at the end of March to 10.75%. The point of this brief trip abroad is that the Emerging Markets that sniffed out the inflation trouble early on, and responded accordingly, are now beginning to send out the almost-all-clear signal.

As we have noted before, stocks typically post very strong gains during easing cycles. Based on data collected by our research partners at NDR, going back to 1933 (post-depression), mean returns turned positive almost immediately following the first Fed rate cut, with 20% average annualized returns 12 months after the first rate cut. This represents more than 10% better performance vs. the market's historical return (i.e., including non-easing cycles).

Commodities Perking Up – Great News for Canada

After a difficult 2023, commodities have been acting much better of late. In fact, we see positive signs from a number of different perspectives. Should this trend continue, which we expect, it would be a great omen for Canadian stocks and, potentially, even the Loonie (should the historically very strong correlation between the Canadian dollar and oil/copper reassert itself).

Investors need look no further than sector weights to see why the S&P/TSX Composite would benefit. The Canadian market has by far the highest exposure to oil and Basic Materials at approximately 30% of the market vs. 6-7% for the S&P 500 and MSCI World Index. Even Emerging Markets only have about 13% exposure to those sectors; a massive

change from a few decades back (given the importance of Tech, Financials and Consumer stocks in contemporary China and India in particular).

Newly-released manufacturing data from the world's largest purchaser of commodities, China, shows a large uptick in manufacturing, signalling increased macroeconomic stabilization and overseas demand. The Caixin/S&P Global China Purchasing Manager's Index ("PMI") came in above expectations at 51.1 in March, its strongest reading since February 2023. This bodes well for commodities. An index value of above 50 puts China in expansion territory which means demand for commodities are high, underpinning Canadian stocks which, as we noted, are exposed to commodity prices. The U.S. is seeing similar progress, with March ISM PMI at a hotter-than-expected 50.3. PMI is generally correlated to EPS growth which provides us comfort in our bullish call for equities.

Technical Analysis

In technical analysis there are basically two types of indicators: 1) general barometers of market health; and 2) timing. The former give you a sense of what the risks are for a real bear market (15-20%+) occurring. As we wrap up the first quarter of 2024, these structural "canaries in the coal mine" are about as healthy as they ever get. NYSE advance-decline lines recently made new all-time highs and bond market indicators (credit spreads and credit default swap indexes) are either at 52-week or multi-year lows.

When the going gets tough in global financial markets, bond market participants sell their "riskier" corporate bonds in favour of the "safer" government bonds, which sends credit spreads soaring. They also pile into credit default swaps, which are essentially an insurance policy against corporate bankruptcies. The fact that these gauges are at multi-year lows shows that bond market participants are not worried about the global economy right now and, as we always like to say: if the bond guys aren't worried, then we're not worried. At the same time, market-based measures of the economy (semiconductors, South Korean Kospi Index and industrial/commercial commodities) continue to improve as well. Most of these gauges begin to deteriorate 6-12+ months ahead of major declines, so the fact they're all still improving suggests the threat of a real bear market in 2024 is virtually nil.

Timing indicators, on the other hand, give you an idea of what the probabilities of a pullback occurring are, and that's where there is a problem. For example, negative divergences have been building in short-term breadth and momentum gauges for all of the major averages for the better part of two months now.

At the same time, sentiment (as measured by our proprietary Composite Sentiment indicator) is now stretched into multi-year highs. A bit of a "breather" to calm this overly bullish sentiment would be a healthy development. In terms of downside risk, there are multiple support levels in the 21,200 zone for the S&P/TSX which should contain any weakness, while the 50-day moving averages for the S&P 500 and the Nasdaq Composite (S&P: 5,026 and Nasdaq: 15,828) will likely be as bad as it gets for those indexes. That would represent a fairly benign 4-4.5% pullback from recent intraday highs. Viewed through the lens of how constructive our general barometers of market health look, we view any weakness that develops in the second quarter as nothing more than a healthy pause following the huge run-up that's occurred since last October, and could be used as a buying opportunity.

One area that looks great for new money right now are commodity stocks, where we've seen a number of breakouts in underlying commodities. Medium-term momentum gauges for crude oil (WTI contract) continue to improve and the recent close above interim resistance, at US$79.50, cleared the way for the rally to extend back to US$95. Gold also broke out of a massive multi-year trading range. The recent close above resistance at US$2,072 shifted the long-term trend for gold back to bullish and opened a new upside target of US$2,475. Given the size of the pattern it broke out of though, higher targets are likely. Copper cleared an important hurdle at US$4.02 recently. That breakout clears the way for the rally to extend to the upper end of the base pattern at US$4.30. A close above US$4.30 would shift the long-term trend back to bullish and open new upside targets of US$5.05 then US$5.46.

Fixed Income – 'Tis The Rate Cut Season!

The surprise cut by the Swiss National Bank, the first of the major central banks, is leading a global shift from pause to easing that is starting to be felt in North America, with expectations for rate cuts to start this summer.

For the BoC, with two consecutive benign inflation reports that brought down CPI back within the bank's acceptable range of 1-to-3%, the door for less restrictive policy is opening. Our BMO Economists expect the BoC to likely start cutting rates as early as June, with the potential for up to four cuts of 25 bps in 2024 that would bring the policy rate down to 4%. This is slightly more aggressive than the 75 bps cuts expected by the market. The stronger-than-expected January GDP report likely played a role in casting doubt upon the need for lower rates (for now), but it may not be enough to delay further policy re-normalization as growth is expected to continue trending below potential.

For the Fed, after pricing almost seven rate cuts (25 bps each) at the start of the year, the market expectations have come down, closer to three cuts in 2024, better aligning with the Fed's/economists' average forecast. While this better reflects the current strong U.S. macroenvironment, it remains questionable as to why the Fed would not wait further. Admittedly, the last year's progress on lowering inflation, the slowing economy, and a better-balanced labour market likely no longer need the policy to be as restrictive. However, despite the progress, wages and inflation remain elevated and may not be low enough by June or July to justify a cut.

Instead of inflation, could the Fed be worried about negative surprises in the labor market? Or could it be a potential credit event brought on by the lagged effect of tightening? Could the growing concerns over commercial real estate loans and the delinquency rate in the leverage loan markets rising to 6% - double the average of the last 25 years – be on the Fed's radar when they continue to forecast three cuts this year despite sticky inflation?

One thing for sure, the inflation story has helped remove the exuberance in the U.S. Federal Funds (policy rate) pricing and explains the back-up in yields in the quarter, a trend that could persist a bit longer until we see further confirmation that conditions are better aligned for less restrictive policy. Until then, the risk is that a continued Fed dovish bias may add pressure – especially at the longer end of the yield curve – if the market believes the Fed may be willing to accept above-target CPI. Barring any credit events, the risk to the easing call, especially in the U.S., is for less cuts, not more. Considering 2024 is an election year in the U.S., it may interfere with the Fed's willingness to remain politically neutral. Therefore, the policy rate re-normalization story may be a late 2024, if not a 2025 story. This may be a bit early to call with a lot more data to flow before decision day, but it supports our slightly defensive recommended duration while we continue to gradually earn our coupons.

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

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