

Investment strategy

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Sometimes the best offense is good defense

Defensive stocks serve an important purpose in portfolios, providing ballast in more volatile periods. We are referring to companies that are less exposed to economic fluctuations (particularly of the downward kind) and, therefore, have more visible and predictable revenue and earnings streams. While they tend not to go up as much in good times, these characteristics typically make them less vulnerable to market pullbacks. We believe it is the right time to look at these companies given “sticky inflation” and our Technical Analyst’s call that the market is due for a minor correction over the next few months. We hasten to add that we still believe the long-term market trend is upward, so all we are talking about here is a pause. Within the broad “defensive stock” category, we also include actual “defense” or weapon manufacturing companies which are well positioned right now given the geopolitical context and rising global defense budgets, combined with relatively low valuations. However, fully realizing that missiles and jet fighters may not be aligned with every investor’s personal values, we also point to other, more prosaic areas which could be interesting, including Consumer Staples, Health Care, Pipelines, and traditional Utilities. The latter two sectors, in particular, should benefit once interest rates stabilize, given the expected significant increases in North American power demand. Most importantly, these sectors currently offer good value, making long-term capital appreciation prospects that much better.

Sticky inflation (especially in the U.S.) is a big reason as to why the market could struggle to make headway in the short term. Specifically, the recently-reported core Consumer Price Index was unchanged year-over-year at 3.8%, much better than 18 months ago but still far above the 2% target. This lowers the odds and magnitude of potential rate cuts by the U.S. Federal Reserve (“Fed”) as the world’s most important central bank looks to finish its fight against higher prices.

The net result has been higher long-term rates which lower the fair value of most equities, especially higher duration (i.e., highly valued) ones. The silver lining for Canadian investors is that the BMO Economics team still expects the Bank of Canada (“BoC”) to make its first cut this summer, providing a tailwind to the S&P/TSX.

Interestingly, BMO’s Chief Economist Doug Porter notes that: “the closest historical parallel to modern Fed policy appears to be the mid-to-late 1990s. After a fierce 300 bps of rate hikes in 1994/95, the economy did indeed manage to pull off a rare soft landing, and rates began to come off over the next year. However, the cuts stalled out at just 75 bps, and the Federal funds rate then bounced around within a 125 bps range over a five-year period.” We agree with this view and – given the epic bull market witnessed in those years – think that it supports our long-term bullish stance on markets, particularly if U.S. productivity continues to accelerate (hopefully Canada eventually gets its act together from that perspective).

Election cycles support the move to value/defensives

With the U.S. Presidential Election looming in November, we wanted to flag an electoral cycle analysis from our data partners at NDR. It shows that — from a historical perspective — we should soon be seeing better performance from sectors/stocks with value and defensive characteristics. Obviously, every cycle is different and history is not always predictive, but we believe this is due to the inherent uncertainty surrounding electoral outcomes. In the current case this uncertainty is magnified by tight polls and Trump’s mercurial stance on foreign relations and global trade, for example. When one adds this analysis to the work we have done on rate and economic momentum cycles, the weight of the evidence suggests that fresh money should be allocated toward defensive and value sectors which have languished for a number of years.

Power demand rising

Power demand in particular is set to accelerate in North America (and globally), driven by the massive investments in artificial intelligence/data centers along with the growth of electric vehicles and manufacturing reshoring (to strengthen supply chains). By some credible estimates, U.S. power demand could grow at a compound annual growth rate of approximately 2.5 to 3% through the end of the decade after being essentially flat the last 10 years. This may not sound like a huge number, but given the enormous size of this market already it will require tens of billions of dollars in new power generation, transmission and distribution across U.S. states and Canadian provinces. A good example of the predicament some regions face is Hydro-Québec — which for years has enjoyed substantial surplus production — which is now expected to face a power shortage of over 100 terawatt-hours as early as 2027, a May study by the Montreal Economic Institute found.

We will address this theme in more detail in a future report, but the investment implications are profound since the power will have to be generated from a combination of baseload nuclear power (good for uranium producers), natural gas (energy and pipeline companies) and renewables which is preferred by most Tech companies. Of course, companies like Hydro One in Ontario (100% electricity, one of the only ones in North America) and other traditional Utilities will benefit from incremental demand assuming regulators allow acceptable rates of return on their investments, which is likely.

Some recent corporate examples help illustrate the opportunity. Northland Power is building an offshore wind project in Taiwan for semiconductor manufacturing under contract for 30 years. TransAlta just commissioned a wind farm in Oklahoma with Amazon as a counterparty, and TC Energy is building a natural gas pipeline in the U.S. Northwest to help Bloom Energy/gas power plants in the area.

NextEra, a large U.S. utility company with a longstanding focus on renewable energy recently noted robust demand from data centers with 3.5GW currently in operation and another 3 to 3.5GW of backlog with technology providers. Importantly, management highlighted that they see a ~15% CAGR for data center demand through 2030.

Further evidence of power demand is shown through Brookfield Renewable Partners' recent agreement with Microsoft to deliver 10.5GW of renewable capacity globally, between 2026 and 2030, in an effort to fuel data center demand. The agreement incentivizes Brookfield to build a large portfolio of renewable energy projects in the coming years.

Technical analysis

In our last strategy comments, we were concerned with how overbought equity markets were, noting that we were looking for a short-term pullback which brought the major indexes back to their rising 50-day moving averages. While there was a bit of an overshoot with the S&P 500 and NASDAQ Composite, that's essentially what came to pass through the first half of April. While we had a bit of a relief rally in the second half of the month, the main problem is that the weakness in the first half had a materially negative impact on our medium-term timing model. Weekly breadth and momentum oscillators have rolled over and gone negative from some of the deepest overbought readings in years and bullish sentiment is contracting sharply as well.

The latter will ultimately be a healthy development for equity markets. As of right now, it's telling you that investors across the spectrum — everyone from retail investors to professional derivatives traders — are scaling back risk. This suggests the recent short-term pullback is likely developing into a more pronounced medium-term pullback, similar to what occurred last summer. Back then, we saw the major averages sell off 8 to 10% over a three-month period from late July to early October. If that's the case, then a test of 200-day moving averages is likely at some point in late Q2 or early Q3 (S&P/TSX: 20,611 and S&P 500: 4,690). At face value, that doesn't seem great, but it's basically a partial retracement of the rally since last October and would bring the major averages back to where they were at the beginning of the year. Another way of looking at it is this: the S&P 500 just underwent the best five-month rally since the lift-off from the pandemic bear market low four years ago. Before that, you had to go all the way back to the lift-off from the credit crisis low in early 2009 to see a similar sized five-month rally. So, all we are talking about here is a healthy breather following a historic rally and should be followed by further new highs as part of this otherwise healthy cyclical bull market.

Generally speaking, investors are cautioned to refrain from making significant changes to portfolios during pullbacks of this magnitude since they're essentially "speed bumps" within bigger multi-year bull markets. However, anyone looking to scale back risk a bit might want to look at more defensive areas such as Utility stocks. As an example, the S&P 500 Utility Index recently reversed a multi-year trend of underperformance and broke out of a base pattern, potentially signaling the beginning of a new long-term uptrend with an initial upside target that could measure 17% higher.

Here in Canada, Pipeline stocks (as measured by the S&P/TSX Composite Oil & Gas Storage & Transportation Index) look set to challenge the upper end of a yearlong base pattern as well. A breakout would signal the beginning of a new long-term uptrend with an initial upside target that could measure nearly 20% higher.

Bond portfolios can also be more defensive

Fixed income investments are defensive in nature, but even within a bond portfolio there is a time when a more defensive positioning is preferred. There are three primary ways to be defensive: 1) maintain a shorter portfolio duration; 2) increase allocation to better-quality sectors (i.e., more government exposure); and 3) reduce exposure to higher beta corporate issuers/sectors, including the lower-rated credits.

Shorter duration – or lower interest rate sensitivity – helps mitigate the short-term impact of rising rates. This is particularly important as sticky inflation leads to greater uncertainty around the easing cycle and risks maintaining upward pressure on rates. Being defensive, however, does not necessarily mean increasing cash allocation. While the inverted yield curve and high policy rates make cash yields attractive, it may not last with the BoC expected to start reducing its policy rate soon. Instead, shorter duration may be achieved by increasing bond allocation to the two- to three-year term sector. Compared to cash, the short-term bonds, like longer bond holdings in the portfolio, will offer the potential for capital

gains should the BoC cut in June/July. In addition, with many low-coupon bonds still trading at deep discount prices, the short-term bond solution offers an added benefit of being more tax efficient compared to interest earned on cash.

For the sector and credit allocation, a restrictive monetary policy will continue to negatively impact economic growth and risks, reducing the potential for further credit spread tightening. The corporate bond market has been particularly strong over the last six months, significantly outperforming government bonds, and not all credit sectors may continue to offer the same return potential. From a defensive credit perspective, investors might consider reducing portfolio allocation to corporate bonds in favour of governments, including targeting short-term Government of Canada and provincial bonds.

Within the corporate allocation, lower beta issuers, primarily the Senior Banks, Autos, Infrastructure, and Utility sectors will likely offer greater stability of income and less spread/yield volatility should credit markets come under pressure in the near term. Within the Senior Banks, we prefer the Big Six bail-in bonds, and for Autos, our top picks are Honda and Toyota. For the Infrastructure/Utility sectors, many issuers fit our criteria, but we favour 407 ETR, Hydro One, and Toronto Hydro.

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



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