Investment Strategy

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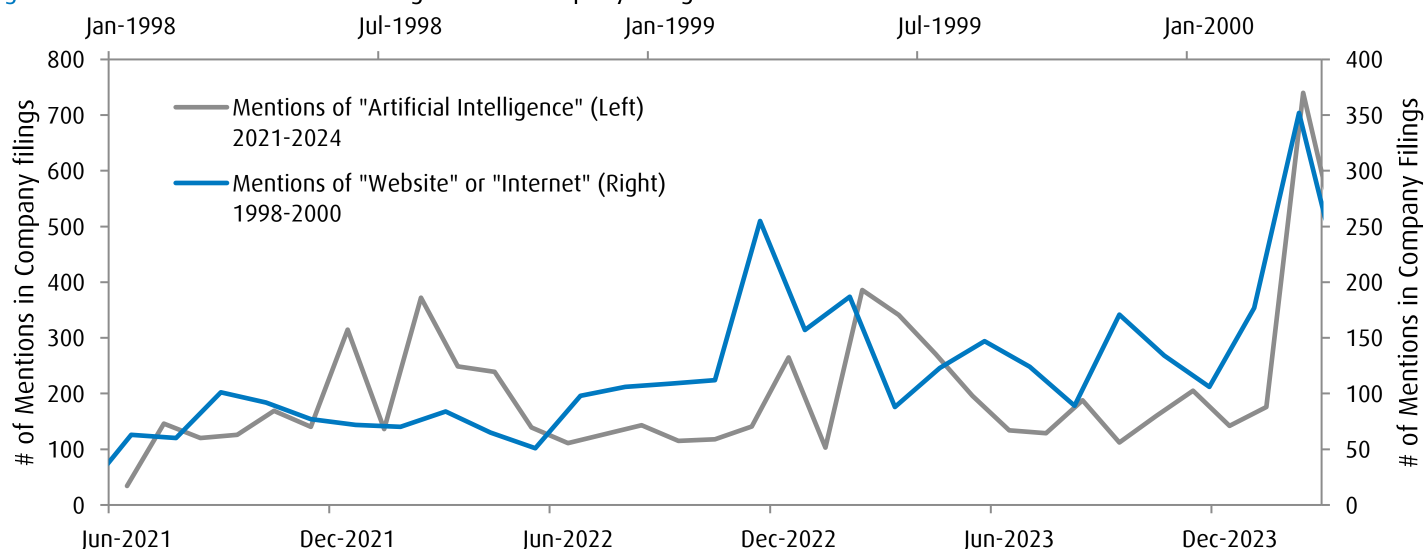
AI & The FOMO (Fear of Missing Out) Market

"Anyone who believes exponential growth can go on forever in a finite world is either a madman or an economist."

- Kenneth Boulding, American Economist.

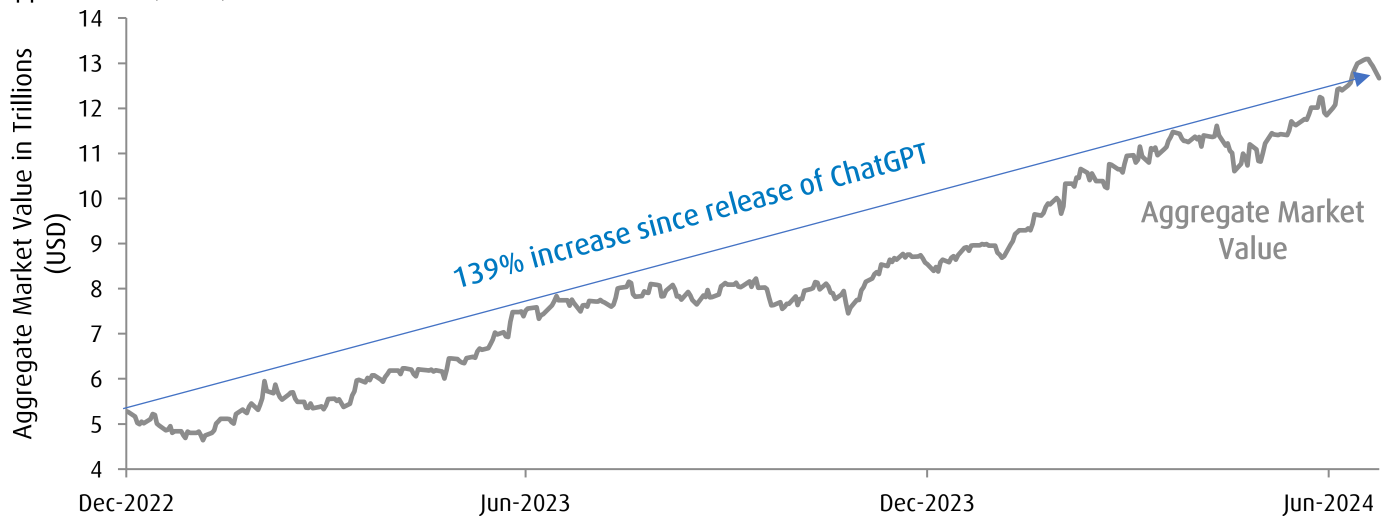
Most people tend to be rational and value conscious. Case in point, Costco, a favourite retailer of ours, has built an empire by providing great quality products at excellent prices. Consumers clearly like that business model. In the case of investments however – and particularly stock investments – there are times when investors forget those instincts and decide to buy shares simply because they keep going up. Right now is one of those times in our opinion, and we believe Artificial Intelligence "arms dealers" are forming a classic investment bubble as shown by their extremely high price-to-sales valuation multiples (by arms dealers, we mean semiconductor companies such as ARM Holdings, Nvidia, and Broadcom who provide the chips to train large language models). Now a spoiler alert: investment bubbles NEVER end well. This is true whether one looks at tulips in the 17th century, railroads in the 19th century, or early internet plays at the start of the 21st century. That being said, asset prices can continue inflating for far longer than many expect and that is particularly true of emerging themes that capture traders' collective imaginations. In the final analysis though, while AI stocks may go higher still, the long-term risk/reward is looking decidedly less compelling at current valuation levels. Using real estate as an example, overpaying for a house lowers expected long-term gains; the same is true for shares of companies. A few charts and numbers will help us illustrate.

Figure 1: Mentions of "Artificial Intelligence" in Company Filings Mimics Dot Com Bubble



Source: BMO Private Wealth Portfolio Advisory Team, Factset

Figure 2: Aggregate Market Value of Top AI-Related Tech Stocks Has Increased by $7 Trillion Since Release of ChatGPT Against an Approximate $150-$200 Billion Global Total Market Size in 2024



Note: Companies used to calculate aggregate market value include Nvidia, Broadcom, AMD, Microsoft, Meta, Amazon, and Alphabet.
Source: BMO Private Wealth Portfolio Advisory Team, Factset, Statista

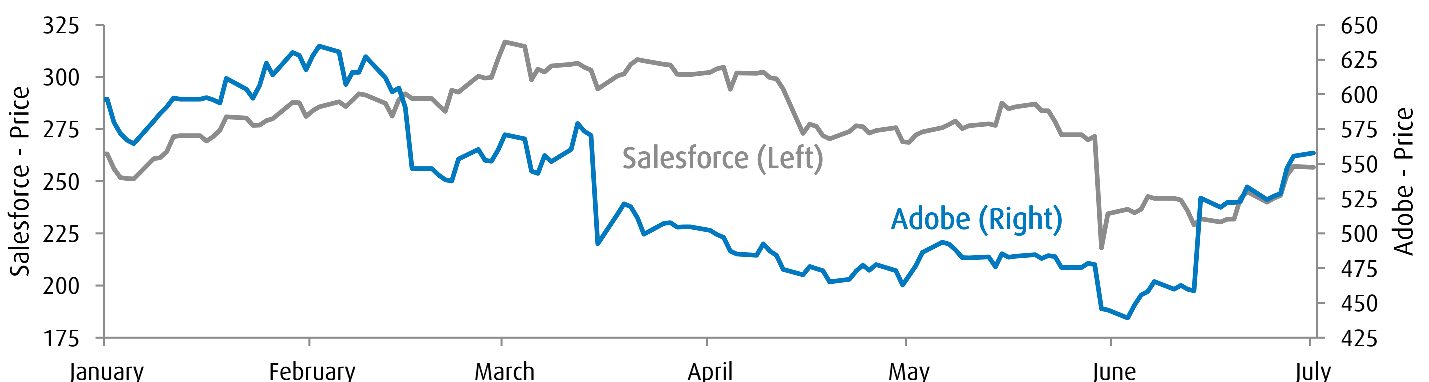
Figure 3: BMO Nesbitt Burns Investment Strategy Committee's Recommended Asset Allocation (%)

	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	0	5	0	5	0	5	0	5
Fixed Income	70	70	40	45	20	25	0	0
Equity	30	25	60	50	80	70	100	95
Canadian Equity	25	15	35	25	45	35	50	40
U.S. Equity	5	5	20	15	20	20	30	30
EAFE Equity	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

Source: BMO Nesbitt Burns Private Client Strategy Committee

The Wall Street Journal recently cited a study which notes that more than $50 billion has been invested in Nvidia's chips since ChatGPT was launched in November 2022 (the unofficial start of the AI boom). However, Generative AI startups have only brought in $3 billion in sales so far. While this number should rise, the discrepancy appears unsustainable, not to mention that the world may not actually need a dozen different large language models. There are of course other commercial and defense uses for Artificial Intelligence, but so far, the vast majority of profits have accrued to the aforementioned arms dealers. At some point, the business case must improve for software companies, or else they may become disinclined to continue growing their datacenter/AI spending at current rates.

Figure 4: The Market May be Losing Patience With Software AI Giants Adobe and Salesforce



Source: BMO Private Wealth Portfolio Advisory Team, Factset

This brings us back to a great quote from Sun Microsystems founder Scott McNealy in a 2002 interview as the tech bubble was melting down:

"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"

- Scott McNealy, Business Week, 2002

The retort to this statement is that high growth and barriers to entry which protect high profit margins can make valuation multiples look more reasonable down the road. Fair enough, but in the case of chip design darling ARM Holdings for example, the stock trades at 42x expected 2024 sales. Even if it meets very bullish growth consensus forecasts, it will still trade at 22x expected 2028 sales. The history of finance clearly shows us that no country, industry, or company can escape the "law of large numbers" where growth rates invariably come down.

Figure 5: Canadian Stocks Trading at Over 10x Price-to-Sales (Excluding Royalty and Holding Companies) as of July 2, 2024

Ticker	Name	GICS Sector Name	Market Value ($M)	Price/Sales	FY1 P/E	Dividend Yield	52-Week Total Return
DSG	Descartes Systems Group Inc.	Information Technology	8,494	15.0	60.3	0.0	28.4
CCO	Cameco Corporation	Energy	21,572	11.6	59.0	0.2	64.1
SHOP	Shopify, Inc. Class A	Information Technology	85,003	11.6	67.9	0.0	5.5
TPZ	Topaz Energy Corp	Energy	2,565	11.5	75.9	5.2	24.7
TRI	Thomson Reuters Corporation	Industrials	75,667	11.1	45.6	1.2	30.4

Source: BMO Private Wealth Portfolio Advisory Team, Factset

Figure 6: Top 20 U.S. Stocks Trading at Over 10x Price-to-Sales as of July 2, 2024

Ticker	Name	GICS Sector Name	Market Value ($M)	Price/Sales	FY1 P/E	Dividend Yield	Total Return
NVDA	NVIDIA Corporation	Information Technology	3,017,682	38.3	46.9	0.0	190.1
CRWD	CrowdStrike Holdings, Inc. Class A	Information Technology	93,706	29.3	96.9	0.0	162.2
FICO	Fair Isaac Corporation	Information Technology	37,792	24.0	64.7	0.0	89.0
LLY	Eli Lilly and Company	Health Care	861,742	22.8	65.0	0.5	94.8
MPWR	Monolithic Power Systems, Inc.	Information Technology	40,337	22.2	63.7	0.5	54.5
ISRG	Intuitive Surgical, Inc.	Health Care	155,649	21.6	69.0	0.0	28.3
CDNS	Cadence Design Systems, Inc.	Information Technology	86,298	21.3	53.4	0.0	35.1
ANET	Arista Networks, Inc.	Information Technology	111,874	18.8	45.9	0.0	120.3
AVGO	Broadcom Inc.	Information Technology	771,538	18.7	35.9	1.2	94.5
NOW	ServiceNow, Inc.	Information Technology	162,793	17.4	58.3	0.0	41.3
MA	Mastercard Incorporated Class A	Financials	413,354	16.2	31.3	0.6	13.7
V	Visa Inc. Class A	Financials	536,728	16.0	27.0	0.7	13.8
PANW	Palo Alto Networks, Inc.	Information Technology	110,235	15.5	61.2	0.0	33.2
SNPS	Synopsys, Inc.	Information Technology	93,410	15.3	47.0	0.0	40.0
MSCI	MSCI Inc. Class A	Financials	38,932	14.9	33.7	1.2	5.9
MSFT	Microsoft Corporation	Information Technology	3,413,510	14.5	39.0	0.6	35.9
VRSK	Verisk Analytics Inc	Industrials	38,859	14.3	41.4	0.5	21.2
PLD	Prologis, Inc.	Real Estate	107,412	13.5	43.2	3.2	-4.9
AXON	Axon Enterprise Inc	Industrials	22,125	13.5	65.4	0.0	50.3
ANSS	ANSYS, Inc.	Information Technology	28,556	12.9	34.8	0.0	-1.0

Source: BMO Private Wealth Portfolio Advisory Team, Factset

Looking at these lists of stocks a few conclusions stand out:

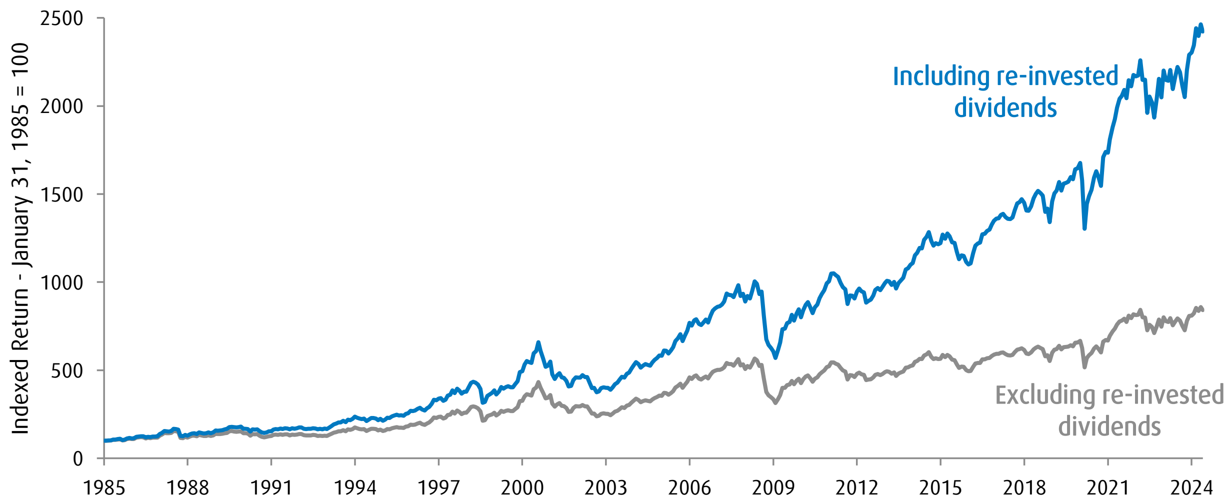
1. This elite valuation club is concentrated in Technology stocks or other companies with strong tech attributes (e.g. Thomson Reuters, Visa, Mastercard, Intuitive Surgical which makes robots for surgery, Eli Lilly which makes obesity drugs etc.).

2. Generally, these stocks have had great returns over the last year. This is a bottoms-up look at where investor money has been flowing in the market.
3. The vast majority of these stocks have negligible dividend yields.
4. This last point is especially interesting since historically, dividends have accounted for the majority of equity returns. Depending on the study one looks at, approximately 60% of North American total stock returns over the last century have come from dividends (and even more when dividend reinvestment is factored). The upshot is that it is the current low-yielding situation which is anomalous. We expect the historical trend to reassert itself eventually and for dividend-paying stocks, and especially dividend growers to regain their luster with investors. The recent extra tax on share buybacks in the U.S. and a more normalized (i.e., higher) interest rate environment could eventually help change corporate behaviour and investor preference in that regard.

Dividends Play an Important Role in our Portfolios

Dividends are distributed to shareholders by companies as a sign of financial stability. Many dividend-paying stocks are those that have reached a point in their growth where their free cash flow can sufficiently cover strategic commitments – it makes more sense to distribute excess earnings as opposed to reinvesting in the company. Although not every dividend-paying stock is mature and stable[1], companies that pay stable, growing dividends provide a significant advantage to portfolios. Comparing the S&P/TSX Composite's return with and without dividends from January 1985 to June 2024, we found that re-investing dividends led to triple the return relative to price performance.

Figure 7: Dividends Play a Crucial Role in Amplifying Portfolio Returns



Source: BMO Private Wealth Portfolio Advisory Team, Factset

Relative to growth stocks, these high-yielding dividend stocks haven't seen as much love recently (see figure 8 below), so we believe that there are good value plays in the space. Companies such as Verizon (6.5% yield), Canadian Natural Resources (4.3% yield), and Medtronic (3.5% yield) have all paid stable, growing dividends over the past 20 years and operate in industries with relatively high barriers to entry.

Figure 8: Average Total Return (%)

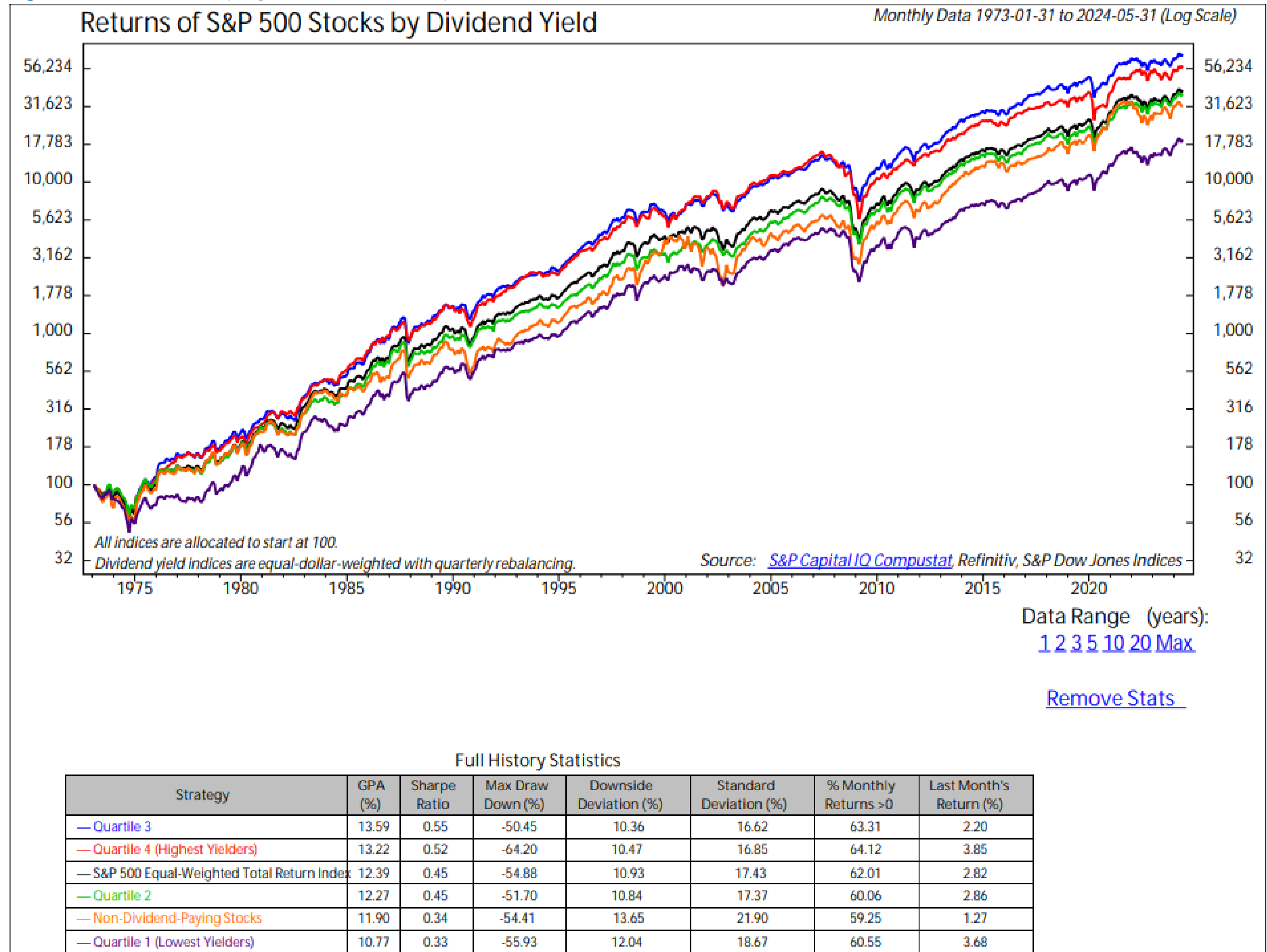
Dividend Yield Over 2%			Dividend Yield Under 2%		
6-Month	1-Year	2-Year	6-Month	1-Year	2-Year
4.6	10.6	12.9	11.2	24.8	62.4

Source: BMO Private Wealth Portfolio Advisory Team, Factset

[1] Remember, dividends are not obligations, and companies have the right to cut or completely stop paying dividends. A prime example is the Great Financial Crisis when nearly all banks cut or completely eliminated dividend payments.

Going back to 1973, higher-yielding stocks have done much better with lower volatility and downside on average. The recent outperformance of non-dividend paying stocks is the anomaly.

Figure 9: Dividend-Paying Stocks Historically Provide Better Returns



Full History Statistics

Strategy	GPA (%)	Sharpe Ratio	Max Draw Down (%)	Downside Deviation (%)	Standard Deviation (%)	% Monthly Returns >0	Last Month's Return (%)
— Quartile 3	13.59	0.55	-50.45	10.36	16.62	63.31	2.20
— Quartile 4 (Highest Yielders)	13.22	0.52	-64.20	10.47	16.85	64.12	3.85
— S&P 500 Equal-Weighted Total Return Index	12.39	0.45	-54.88	10.93	17.43	62.01	2.82
— Quartile 2	12.27	0.45	-51.70	10.84	17.37	60.06	2.86
— Non-Dividend-Paying Stocks	11.90	0.34	-54.41	13.65	21.90	59.25	1.27
— Quartile 1 (Lowest Yielders)	10.77	0.33	-55.93	12.04	18.67	60.55	3.68

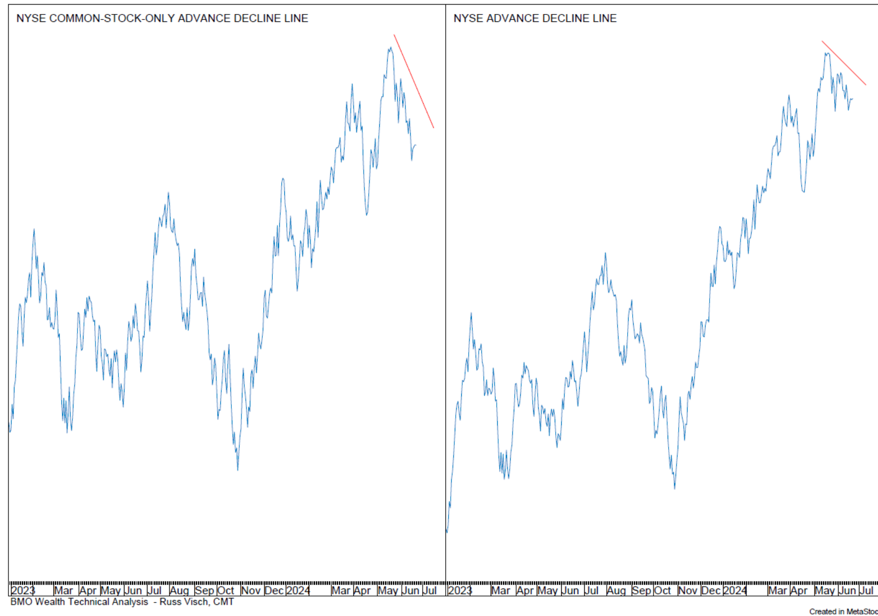
Source: NDR

Technical Analysis

In last month's report we discussed our "canaries in the coal mine" – the indicators that warn of real bear markets. Credit spreads, credit default swaps, market-based measures of economic activity and the performance of "risk on" vs. "risk off" sectors. They're all healthy and mostly all at/near all-time highs which suggests the threat of a real bear market happening in the second half of the year is virtually nil. As such, the upside targets of 23,224 for the TSX and 5,575 for the S&P 500 remain in effect and we expect the indexes to achieve those targets, or get pretty close to them, at some point in the weeks ahead.

Where it gets interesting is that there has been some deterioration underneath the surface in breadth indicators as of late which would suggest markets are teeing up for a medium-term pullback in the third quarter in line with traditional and presidential election year seasonality. For example: while the S&P 500 and Nasdaq Composite made new all-time highs recently, they were not confirmed by any of the advance-decline lines we follow (traditional NSYE A-D line, common-stock-only A-D line and the S&P 500 A-D line).

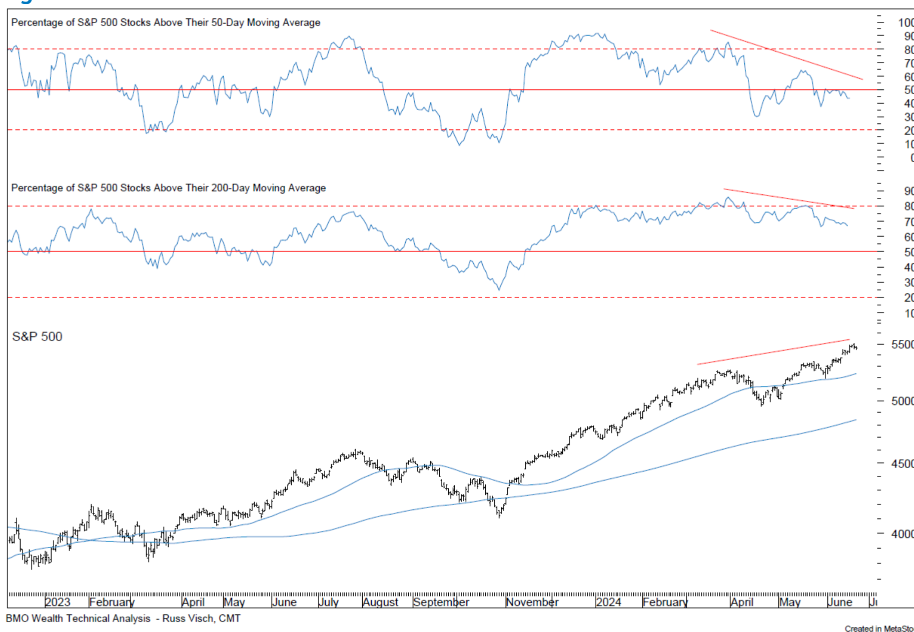
Figure 10: Advance-Decline Lines



Source: BMO Private Wealth Technical Analysis

In fact, NYSE breadth has actually been negative more often than not for two weeks now (i.e., more decliners than advancers most days) despite the persistent new highs in the S&P 500. At the same time, the percentage of S&P 500 stocks trading above their 50-day moving averages is at a lowly 44%.

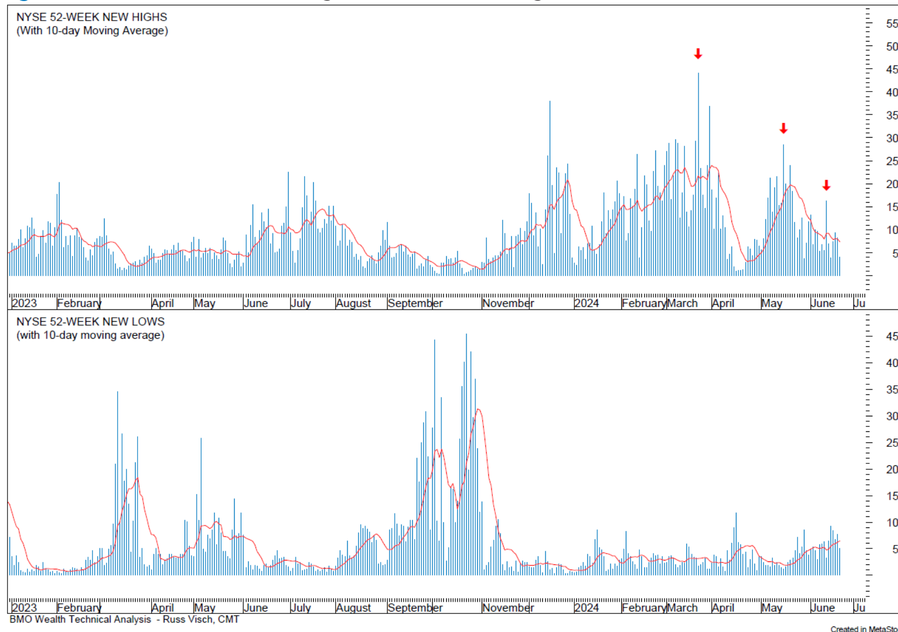
Figure 11: Breadth



Source: BMO Private Wealth Technical Analysis

A pullback to or slightly underneath a 50-day moving average is a fairly standard short-term pullback, which means the majority of the stocks in the index are already in corrective mode to some degree. Finally, the number of individual stocks on the NYSE making 52-week new highs has also shrunk dramatically.

Figure 12: Less Stocks Making 52-Week New Highs

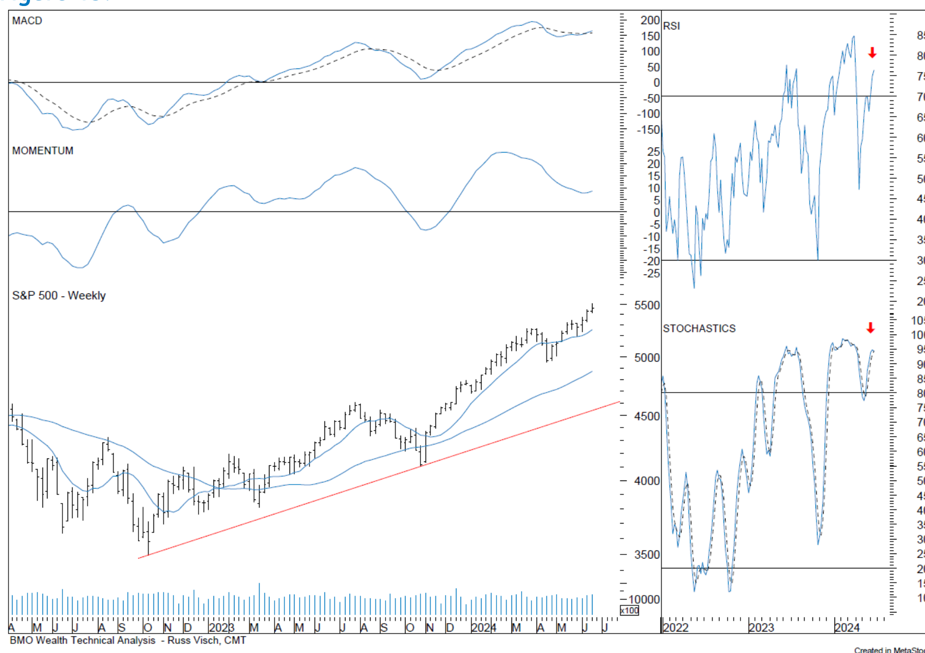


Source: BMO Private Wealth Technical Analysis

Back in February and March it was common to see 350-400 issues making 52-week highs. For most of the second half of June it's been less than 50. Essentially what's been happening is that a few of the mega-cap Tech names (AAPL, MSFT, and NVDA in particular) have been propping up the markets (driven by the persistent weakness in long-term interest rates) while mostly everything else has been flat lining or correcting.

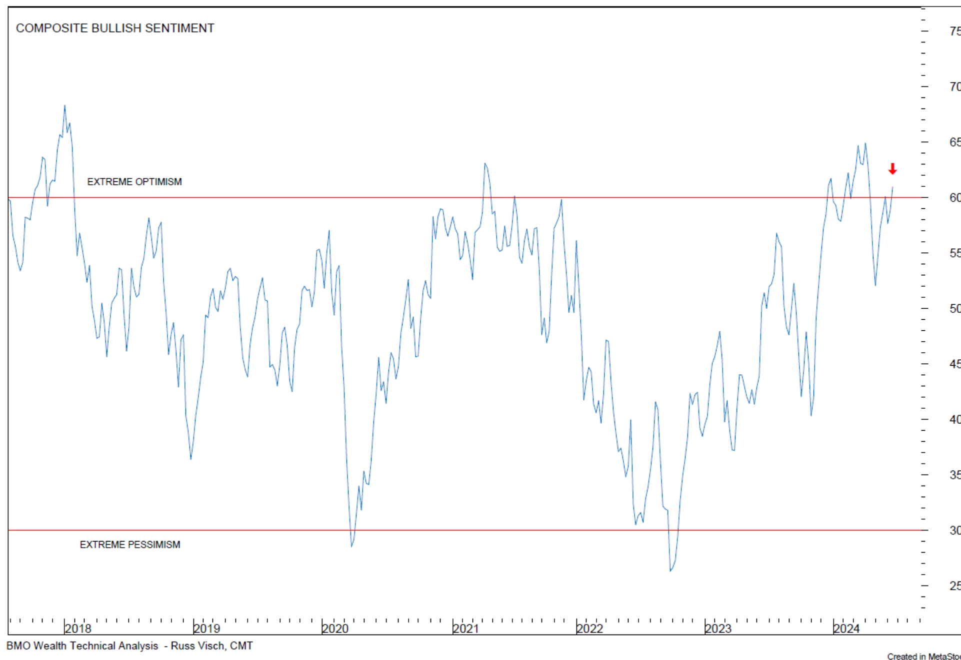
At the same time, most of the indicators in our short- and medium-term timing models are stretched into deep overbought extremes. Momentum gauges in particular, but also sentiment gauges where our Composite Sentiment Indicator is now back up into overly bullish extremes.

Figure 13: Momentum



Source: BMO Private Wealth Technical Analysis

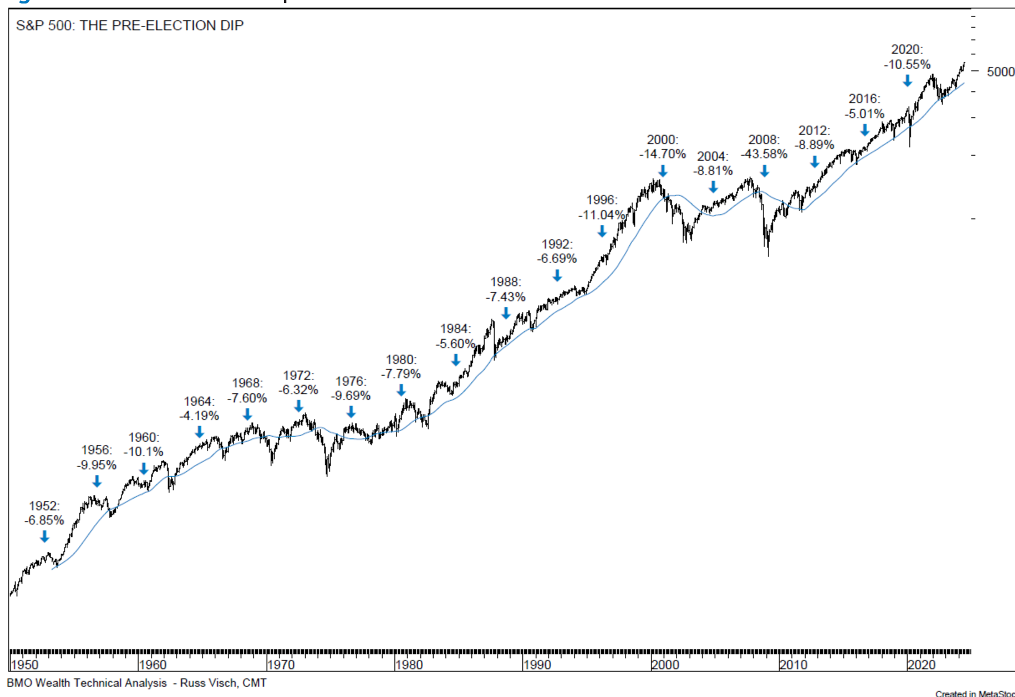
Figure 14: Composite Sentiment



Source: BMO Private Wealth Technical Analysis

In a lot of ways, this is exactly what we saw happen ahead of last summer's 10% decline in the S&P 500 from July to October. We've noted in prior reports that during presidential election years medium-term pullbacks tend to get underway in August, last about 5-6 weeks with a decline of around 8% and usually bottom before the election.

Figure 15: Pre-Election Dips



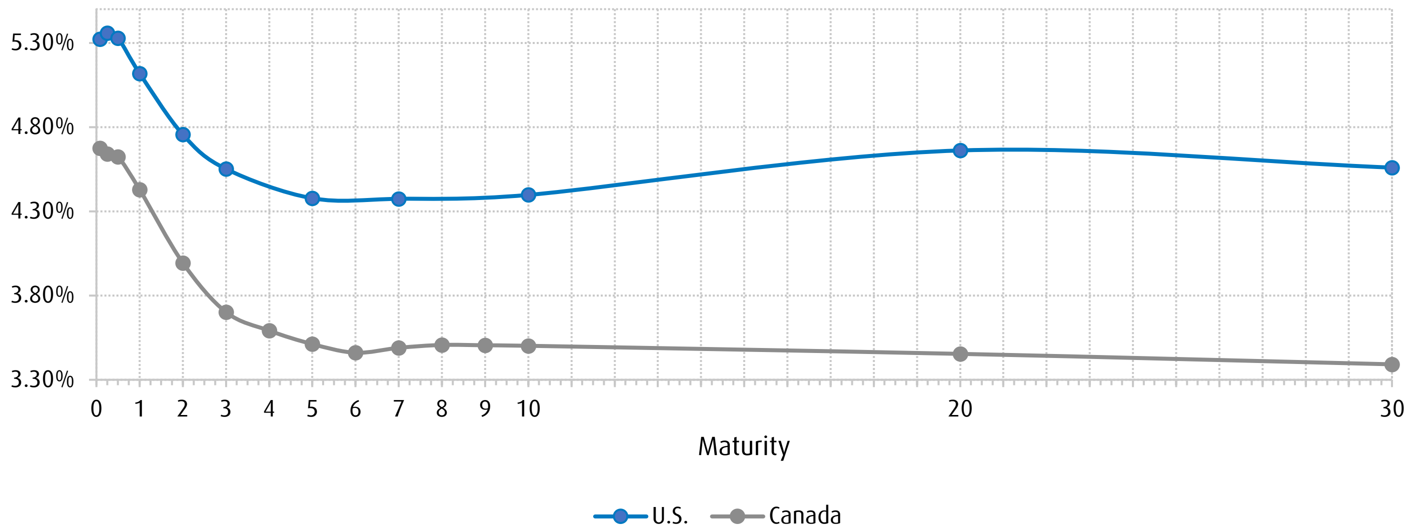
Source: BMO Private Wealth Technical Analysis

So don't be surprised it equity markets go squishy late in the summer. It's generally a temporary thing and given the state of our "canaries in the coal mine" the expectation should be for further new highs once we get past the election.

Are the Highest Canada-U.S. Interest Rate Differentials in Recent History Still Justified?

The Bank of Canada ("BoC") finally initiated its easing cycle in June with a 0.25% cut in its overnight rate to 4.75%. The move, which had been widely anticipated, came ahead of the U.S. Federal Reserve ("Fed"), which is not expected to move on rates before September, if not waiting until after the November 5 U.S. election. The move was positive for interest rates, especially at the shorter end of the yield curve where the term sector tends to be more sensitive to monetary policy decisions and helped Q2 performance recover after a more challenging start of the year. The expected move by the BoC helped maintain the Loonie close to its weakest against the U.S. Dollar, but it also pushed down further the Canadian yield curve relative to the U.S.

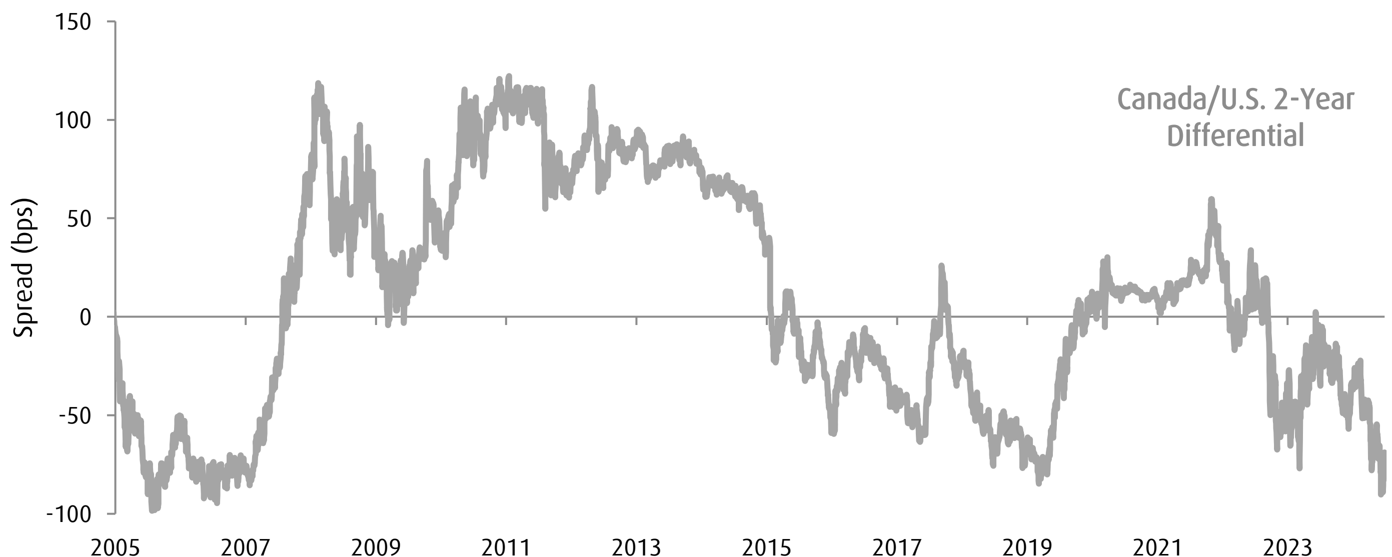
Figure 16: Canada Yield Curve Well Below the U.S. Curve

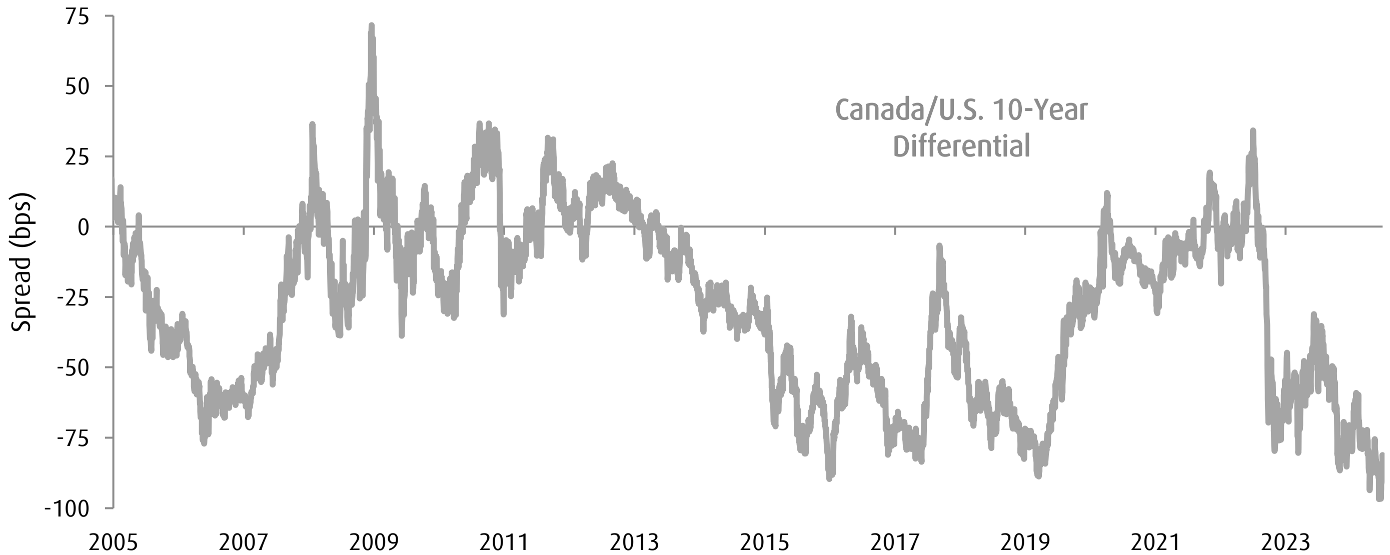


Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Objectively, different growth / inflation paths led to different monetary policy targets with the BoC ending its rate tightening at 5% last year, short of the Fed's 5.25-5.50% range. That difference alone helps justify the lower yield curve and when combined with the current softer economic environment, it explains the outperformance of the Canadian bond market so far this year. However, it does not justify, in our opinion, the widest Canada-U.S. yield differentials seen in recent history.

Figure 17: Canada-U.S. Government Yield Differentials

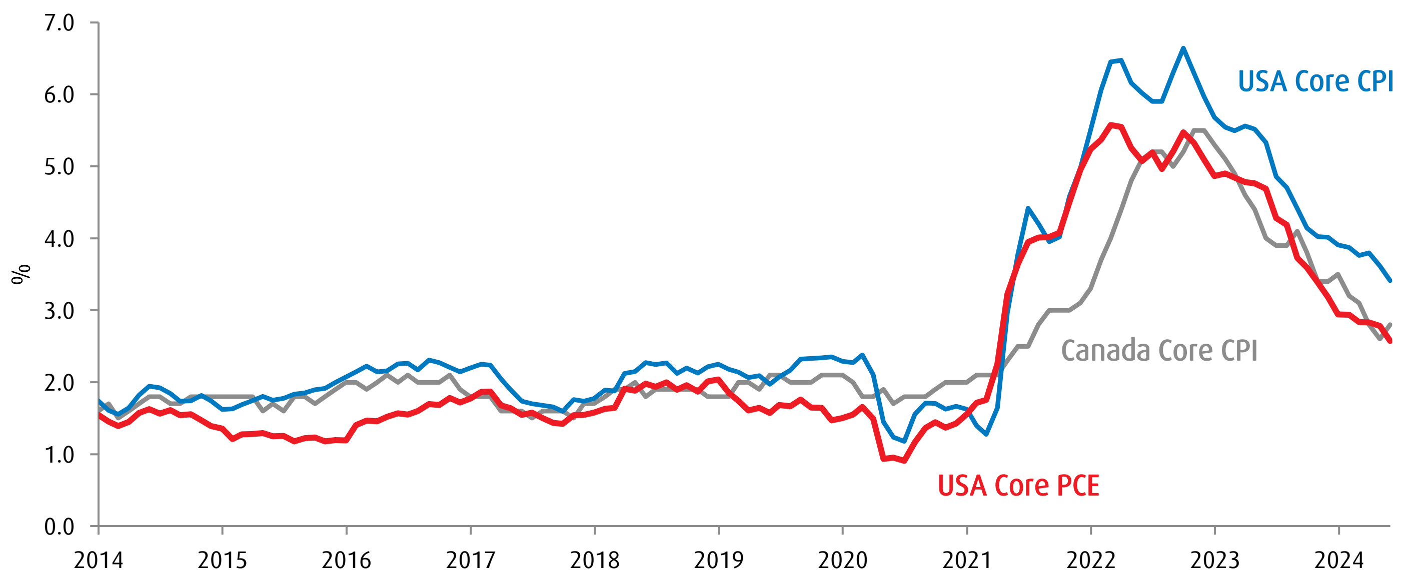




Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

First, early Q2 readings on Canada's economic growth are more encouraging while the U.S. has definitively slowed. In addition, our BMO economists expect Canadian growth to slowly pick up and gradually close the gap with the U.S., with the expectations of stronger results on this side of the border in 2025 – BMO expects 2025 GDP growth in Canada and the U.S. to expand at 2.0% and 1.8%, respectively. Second, after consecutive months of softer inflation readings, Canadian CPI in May surprisingly jumped higher, with its core measure settling just shy of 3% and close to the U.S. core measure of 3.4%. Interestingly, while lower than the U.S. level, it is higher than the Fed's preferred measure of core Personal Consumption Expenditure ("PCE")[2] price index which dropped to 2.6%. On top of this, monetary policy expectations on both side of the border are fairly similar with our economists' call for the BoC and the Fed to deliver 125 basis points of cuts before year-end 2025, leaving a policy rate differential of 50-75 basis points ("bps"), smaller than the widest historical differences (over 200 bps).

Figure 18: Canada-U.S. Core CPI



Source: BMO Private Wealth Portfolio Advisory Team, Factset

[2] Core PCE and CPI are both measures of inflation, but they differ in their methodology and the items they include. CPI measures prices at the end user level, while PCE measures the prices producers pay at the wholesale level. Core CPI strips out food and energy prices, while core PCE does not. Core CPI tends to show higher inflation than core PCE. The PCE's weighting and source material make it the Federal Reserve's preferred inflation measure (source: Brittanica Money).

Granted that productivity gains in Canada remain more muted, our economy is more interest-rate sensitive, and that market rates may be more attuned to the better long-term U.S. economic prospects, nonetheless these have been the conditions for years. We admit that long-term U.S. rates may also be pressured higher lately by increased odds of Trump winning back the White House in November. We debate however if this would be sufficient for the yield differentials to be maintained or even widened at this time. We believe instead that the current outlook leaves limited room for wider differentials and would argue for the cheapening of the Canadian yield curve vs the U.S. (smaller yield differences). This means that in the near term and barring any central bank surprises, there is little room for Canadian rates to move lower unless it is driven by a similar move in the U.S. rates market. In fact, we tend to believe that the risk is for reduced differentials leading to the Canadian market likely underperforming its U.S. counterpart.

For investors, underperformance does not necessarily mean negative returns, it means instead potentially less attractive returns than what could be achieved South of the border. It also means that after years of being accustomed to capital gains, they may be more limited in the near term as we settle in a more normalized environment where the bulk of a bond portfolio's returns will be generated by coupon income. Despite the volatility risk from labour and inflation surprises – as we have experienced in June – we continue to recommend taking advantage of market rate pullbacks to extend term and move toward neutral duration.

Figure 19: S&P/TSX Composite Total Returns

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Energy	-3.82	14.06
Materials	-4.59	13.65
Consumer Staples	0.52	8.28
Industrials	1.04	7.34
S&P/TSX Composite Index	**-1.42**	**6.05**
Financials	-1.84	4.31
Cons. Discretionary	-0.87	2.99
Utilities	-2.46	-0.89
Info. Technology	6.83	-1.02
Health Care	1.62	-3.62
Real Estate	0.25	-5.96
Telecom. Services	-4.59	-11.63

28-Jun-24
Source: Bloomberg

Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 20: S&P 500 Sector Total Returns

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Info. Technology	9.32	28.24
Telecom. Services	4.80	26.68
S&P 500 Index	**3.59**	**15.29**
Energy	-1.29	10.93
Financials	-0.89	10.17
Utilities	-5.51	9.44
Consumer Staples	-0.18	8.98
Health Care	1.91	7.81
Industrials	-0.93	7.75
Cons. Discretionary	4.89	5.66
Materials	-3.03	4.05
Real Estate	1.33	-4.14

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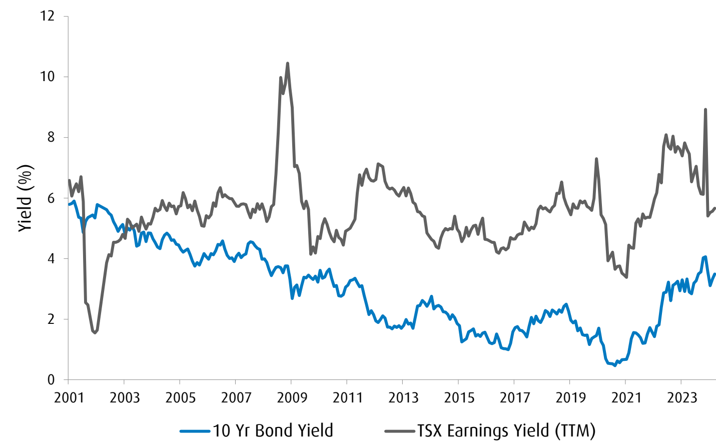
Source: Bloomberg

Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 21: S&P/TSX Composite Earnings Yield vs 10-Yr GoC Yield



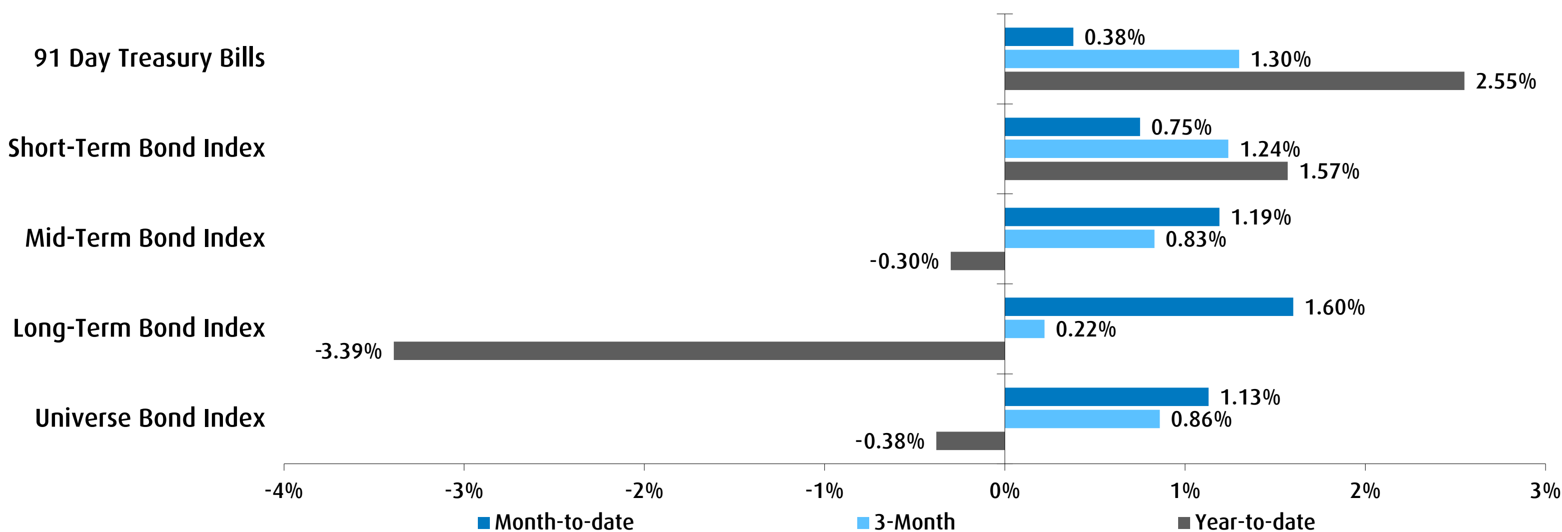
Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 22: S&P 500 Earnings Yield vs 10-Year Treasury Yield

Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

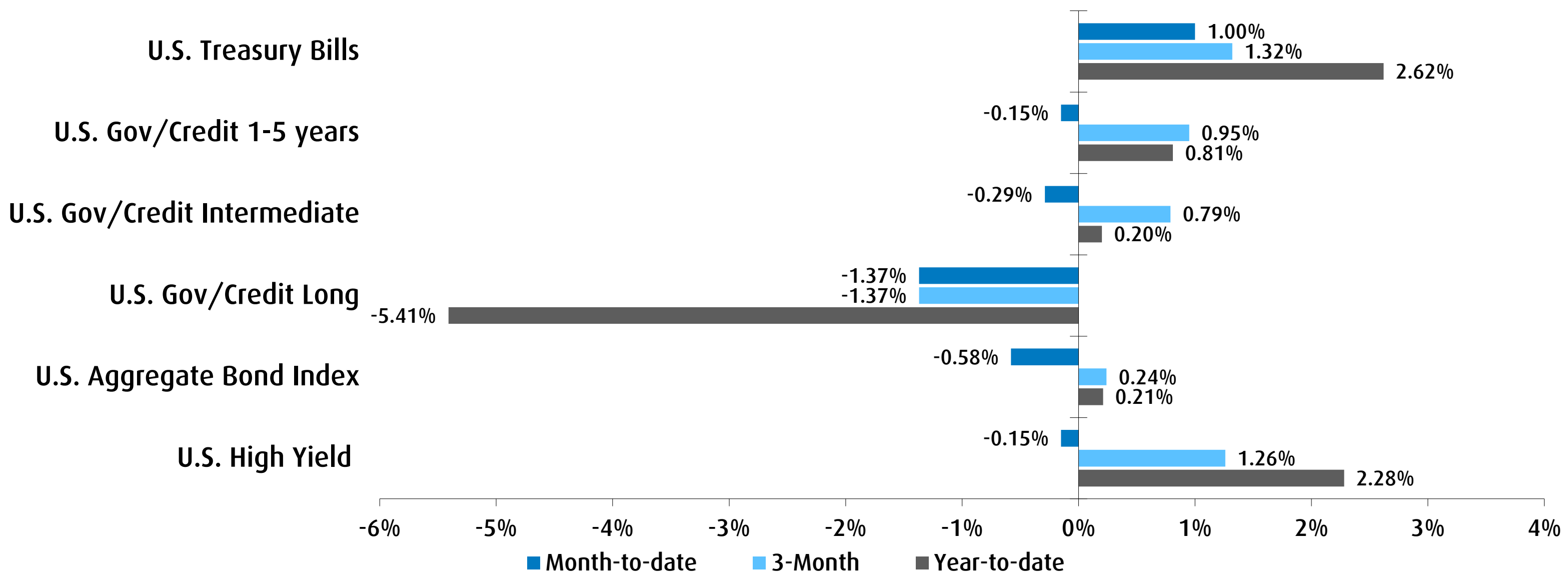
Figure 23: Canada/U.S. Bond Index Total Returns Through June 2024

Canada



Source: BMO Private Wealth Portfolio Advisory Team, FTSE

U.S.



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg Barclays

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