Equity and Fixed Income Strategy

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Growing evidence of inflation peaking supports market stabilization

Notwithstanding the recent relief rally, the market has been mired in negativity for the entire year. No single factor has been more damaging to financial assets – both bonds and stocks – than inflation, which has pushed up interest rates dramatically and lowered equity valuations. The BMO Nesbitt Burns Portfolio Advisory Team has previously likened inflation to a cancer for financial assets, eroding the present value of interest coupons (hurts bonds) and of corporate free cash flows (bad for stocks, especially high multiple, high duration equities).

However, history has proven that absolute numbers matter far less than the trajectory for asset performance. In other words, even if current conditions are still poor in absolute terms (i.e., inflation remains much too high for comfort), as long as circumstances start to improve, then stocks and bonds generally perform far better since the market anticipates conditions in the real world several months in advance. That is why recent evidence that inflation has peaked is a big deal in our view, and a key reason for the nascent rally witnessed in both markets. Of course, we are not out of the woods quite yet and the next big problem to deal with will be the magnitude of the growth slowdown and whether it will bring an actual recession. We shall see, but any good news is worth highlighting in the current universally bearish context.

Our data analysis going back to the 1960s shows that stocks generally perform better when inflation is declining. This makes intuitive sense since the value of future corporate cash flows is worth more in today's dollars when inflation and interest rates are low. In Canada, however, the performance has actually been slightly better when inflation was rising – no doubt because of our market's very high exposure to basic materials and energy which offer good inflation protection.

Periods of generally rising inflation have led to approximately 23% multiple compression for U.S. and Canadian equity markets. The good news is that the valuation compression witnessed so far this year is even greater than the historical average. The price-to-earnings ratio for the S&P 500 Index (expected profits for the next 12 months) has fallen from >23 times to about 16 times currently. The S&P/TSX Composite Index, which we believed would outperform in 2022, has in fact held on much better (down 8% vs. 14% for the S&P 500), but has seen even greater multiple compression. How can this be? Well, in this case it is a function of fast rising earnings per share estimates, which is a net positive.

Conversely, and encouragingly, the U.S. market has benefitted from a 30% multiple expansion when inflation was in a long-term downtrend.

Signs inflation has peaked

BMO Chief Economist Doug Porter recently noted that: "There are a variety of encouraging signs that inflation may be at an inflection point, and that some of the initial underlying drivers are now backing off. Most obviously, commodity prices are simmering down broadly. A basket of key commodity prices has melted almost 20% in the past six weeks alone from the early June peak, and is now almost precisely right back to levels prevailing in the days prior to the invasion of Ukraine. Perhaps most notably is that even with a rebound..., U.S. wholesale gasoline prices have dropped more than $1/gallon (or roughly 25%), reversing more than two-thirds of the post-invasion spike. As well, grain prices are backing down amid an improving outlook for the North American crop and a reported deal between Russia and Ukraine on getting food shipments through the Black Sea. Wheat futures are now a bit below pre-invasion levels, and down about 30% from the average levels reached in May.

Beyond those clear signals, there are a variety of more subtle signs that the tide may be turning. Previously feverish demand for all sorts of goods is now calming globally, reducing pressures on supply chains. Freight rates thus continue to climb down the mountain, with the Baltic Container Index now down from its year-ago levels (it was up more than 100% year-over-year just three months ago). Retail inventories are climbing, leading to discounting in some sectors. Meantime, the previously roaring housing market has turned from lion to kitty cat in a matter of months in both the U.S. and Canada, and is set to undercut price pressures after fueling them for the past year.

And just as inflation has grown – literally – like a weed in the past year, it is entirely possible that it can retreat almost as quickly. We have not seen inflation ramp up so rapidly as it has in 2022 since pre-Elvis days. Picking Canada as an example, the 8.1% June headline Consumer Price Index ("CPI") result compares with a 3.0% pace in June 2021. That 5.1 percentage point leap is the largest rise in inflation in a year since 1951. The only other episode that came remotely close to this kind of dramatic acceleration was in the mid-1970s, when oil and grain prices were also on a rocket ride. However, the good news, such as it is, is that even in that high-inflation environment, the headline rate did retreat heavily after firing higher.

Financial markets are certainly becoming believers that the worst is over for inflation, if not this minute then at least in the very near future. Bond yields came down across the board last week…"

Fixed income market senses inflation is slowing

Since the CPI is slow to respond, perhaps the most telling indicator that inflation and the economy is slowing are the Purchasing Managers' Indexes. U.S. consumer survey of long-term inflation expectations took a big nosedive in July to 2.8%. Market expectations for inflation have also come way down. The Canada 5-year breakeven rate, which has declined to 2.2% from 2.5% last month, and is well below the peak of 2.9% in the first quarter. Looking at Canada CPI data, the best indicator of inflation rolling over is the Homeowners Replacement Cost which is a relatively high 6.4% weight in the CPI basket.

Technical analysis – Close to a green light

We previously noted that all of the indicators in our medium-term trimming model were 100% of the way towards where they land at the end of cyclical bear markets. Since the last report, we have seen nothing but improvement. For example, weekly momentum gauges have recently turned positive for the S&P 500 and have just given their first "4 for 4" buy signals since April of 2020.

Some of the gauges in this model were more oversold than where they landed at during the worst of 2020, which is really quite astounding considering the pandemic bear market was one of the worst one month sell-offs in the past 100 years. Our medium-term timing model for the S&P/TSX is not quite fully bullish yet – but it is close.

On the breadth front, oscillators such as the percentage of stocks in the S&P 500 trading above their 50- and 200-day moving averages (which recently matched the deep oversold reading that occurred in early 2020) have also given new buy signals.

These indicators suggest the sort of broad-based improvement underneath the surface that you normally see at the beginning of new cyclical bull markets. Last but not least, is sentiment – which we think is the most compelling part of the argument. Our Composite Sentiment indicator is an aggregation of a number of surveys that poll market participants to determine if they are bullish or bearish. There are only two other instances of people being this fearful in the past 15+ years: at the credit crisis low in 2009; and at the pandemic low in 2020.

Think about how crazy that is for a moment. People are very near to being as bearish as they were at the end of the credit crisis, when the S&P 500 had dropped nearly 60% over an 18-month period. Warren Buffett is famous for saying: "Be fearful when others are greedy, and greedy when others are fearful."

Bottom line: All of the indicators in our medium-term timing model have begun to turn positive from deep oversold extremes, which suggests we are in the final phase of this bear market. We would still allow for some sort of capitulative wash-out at some point, which is typically how cyclical bear markets end, but you should either be buying aggressively into any weakness that occurs, or be prepared to buy stocks once we see that washout.

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

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