The first will be last and the last will be first

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Escalator up, elevator down. This old trading cliche aptly describes recent stock market action in our view. After a relentless ascent led by the "Nifty AI Five" (Nvidia, Microsoft, Meta, Amazon, and Google) and a few other names, market volatility has shot up and prices have come down quickly over the last week. It is important to note, however, that this negative price action has seen enormous variance. The worst performers (by far) have been expensive mega cap tech stocks and cyclical sectors (Consumer Discretionary, Industrials, Energy, and Basic Materials), which are more exposed to the economic cycle. On the other hand, defensive sectors such as Healthcare, Consumer Staples, Utilities and REITs, have so far weathered the storm quite well. Lower interest rates have also acted as a tailwind for them as it makes their higher dividend yields all the more attractive.

As our colleague Brent Joyce, Chief Investment Strategist, BMO Private Investment Counsel, points out: Corrections in equity markets are a normal part of investing. It's good news that pockets of overvaluation saw weakness and other areas saw strength. However, we are in the volatile, low attendance, and low liquidity part of the calendar year, so more rocking and rolling may lie ahead.

Once again this is a reminder that portfolio diversification across sectors is an essential risk management tool. As difficult as it was for many to watch only a handful of stocks go up over the last 18 months, it was, and remains crucial not to put all eggs in one basket. The implosions of the so-called "Nifty Fifty" stocks (early 1970s) and internet tech bubbles (early 2000s) are but two historical examples which back up the soundness of this approach. In both cases, former market darlings vastly underperformed the market for years after they peaked.

The proximate causes of this pullback were a weakening labour market south of the border and underwhelming results from the bluest of the blue-chip tech stocks, such as Microsoft, Amazon, and Google (and a few other friends). We hasten to add that their numbers were far from disastrous, but they failed to meet elevated expectations. This brings us back to the importance of stock valuations. While a notoriously poor timing tool, valuations (e.g., how expensive stocks are based on price to earnings, cash flow or sales ratios) do provide insights on embedded expectations. The higher they are, the higher the bar for companies when they report quarterly results. Conversely, inexpensive stocks face considerably lower downside risk even in the face of mediocre results.

One of the key issues facing the market is that hedge funds collectively own many of the same momentum stocks. So, when any bad news hits the tape they tend to stampede out of similar equity positions. This is exactly what seems to be happening right now. Further hurting investor morale was the news that the Oracle of Omaha, Warren Buffet, had liquidated a substantial portion of his stake in Apple. While this move does reduce Berkshire Hathaway's portfolio risk and could be construed as a negative call on the market, another plausible explanation could also be that their investment team felt Apple was fully valued and that the timing was right to take profits. No one ever went broke taking a profit as the old adage states.

As noted above, a weakening labour market also acted as a catalyst for the weakness with many bears dusting off the old "Sahm Rule," which is based on the view that an increase of over 0.5% in the unemployment rate from its 12-months low has preceded every recession since the 1970s. We find this conclusion overly simplistic since the jobs market has been amazingly

strong with the unemployment rate still close to its historical low. So, a normalization – far from a sinister turn of events – was to be expected and will, in fact, make the Fed's fight against inflation that much easier. It could also accelerate the pace of interest rate cuts which has historically been a tailwind for equities and other risky assets.

Modern economies, and particularly the U.S. economy, are just too complex to be reduced to a single variable in our view. Accordingly, we updated our multi-factor recession probability model (which has proven its worth over the last several years) and found that there is still a lower than 50 percent probability of a North American recession in the next 12 months. Things can change of course, but we are not detecting a looming financial torpedo as we write this missive. In fact, public companies in Canada and the U.S. are still expected to deliver double-digit earnings per share growth in the next year.

The bottom line is that the current bout of weakness is likely to yield attractive buying opportunities. Being selective will be crucial, however, and financial history has proven that leading sectors and stocks can change considerably depending on the economic and interest rate cycle. Our focus will continue to be on identifying companies with strong competitive advantages, excellent management teams, fortress balance sheets and proven track records of growing cash flow and dividends.

As always please contact your BMO Private Wealth professional if you have any questions, and to discuss your portfolio and specific security recommendations.

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