

# Investment Strategy

BMO Nesbitt Burns | October 2024

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## Rate Cuts and the Yield Curve Steepening – A Good Omen for 2024/2025

We salute the Federal Reserve (“Fed”) for being bold and cutting interest rates by 0.5%. To us, this is a clear signal that the most important bank in the world is serious about engineering a so-called “soft landing” where the economy avoids a recession. If this is achieved – and our proprietary recession probability model is currently leaning in that direction – the implications for the stock and bond markets will be profound. Simply put, recessions are never good news for risky assets such as equities and high-yield bonds but can, conversely, create increased demand for safer government bonds. On the other hand, our base case calls for additional upside to stock indices, with the S&P/TSX especially well positioned to outperform through year-end given its high concentration of interest rate sensitive stocks (which benefit from lower rates), leverage to global economic growth through natural resources, and its far cheaper valuation than the S&P 500. In this report, we will explore the implications of rate cuts and the steepening of the yield curve we are witnessing. Both have historically been good omens for stocks.

As BMO Economics noted: “The FOMC cut policy rates by 50 basis points, lowering the target range for the Fed funds rate to 4.75%-to-5.00%. Apart from the market pricing in more than half this move, the reason for the large start was clear in the policy statement... inflation had improved, and the labour market had deteriorated sufficiently to warrant a bigger (than 25 basis points) action”. And more cuts are being signaled. The Summary of Economic Projections and its ‘dot plot’ showed the median FOMC projection sported a further 50 basis points of cuts for this year to a 4.375% range midpoint, 100 basis points next year to 3.375%, and 50 basis points in 2026 to 2.875%. In Canada, we also now expect that 3% level to be breached, probably more forcefully, and almost certainly much sooner. We are adding two additional 25 basis point cuts in the first half of 2025, and now see the Bank on a forced march of seven consecutive quarter-point rate cuts (after the cuts at the past three meetings). That combination of 10 consecutive 25 basis point cuts will exactly slice the overnight rate in half from its prior peak of 5.0% to 2.5% by July of next year.

**Figure 1: 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

We recently stated: “Stocks typically post strong gains during easing cycles”. Based on data collected by our research partners at Ned Davis Research (“NDR”), going back to 1928 (encompassing an impressive 22 Fed rate cut cycles), mean U.S. market returns turned positive almost immediately following the first Fed rate cut, with 20% average annualized total 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). Top sectors included Consumer Staples and Discretionary, Healthcare, and Tech. Of course, every cycle is different and contains idiosyncratic drivers. Still, the results make intuitive sense since a lower cost of funds helps

consumers and corporations, and a lower “risk-free rate” increases the value of existing bonds and the present value of corporate free cash flows.

With the Bank of Canada (“BoC”) leading the charge with 3 rate cuts already, we also wanted to include Canadian figures (with cycles starting in 1996). While the dataset is far more limited than in the U.S., results were also positive when an easing cycle was not accompanied by a recession (again our base case). As shown by the table below, The broader index posts modest 7% returns, on average. Among large sectors, top performers include Financials, Real Estate and Consumer Discretionary. We just happen to have strong conviction ideas for all these sectors. Please contact your BMO Wealth Professional for specific stocks ideas.

Figure 2: S&P/TSX and Sector Performance Over Last 5 Non-Recessionary Rate Cycles (Starting in 1996)

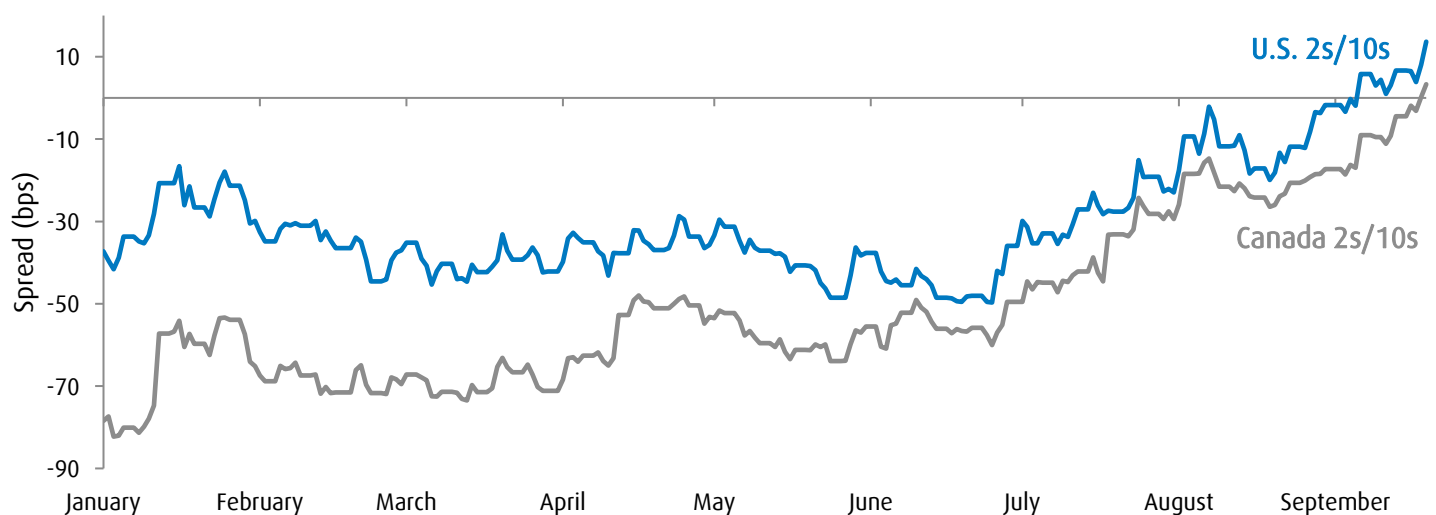
Sector	Average All Cycles	Average Without Recession
Healthcare	12%	21%
Financials	15%	19%
Real Estate	3%	16%
Communication Services	7%	15%
Consumer Discretionary	2%	11%
Information Technology	6%	9%
<b>S&amp;P/TSX Composite</b>	<b>1%</b>	<b>7%</b>
Energy	0%	6%
Consumer Staples	1%	5%
Materials	-1%	5%
Industrials	-1%	3%
Utilities	-2%	-1%

Without recession: 1) 2/22/1996; 2) 9/24/1998; 3) 1/23/2001; 4) 7/15/2003; 5) 1/20/2015  
 Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

### The Yield Curve is Steepening – A Positive Sign

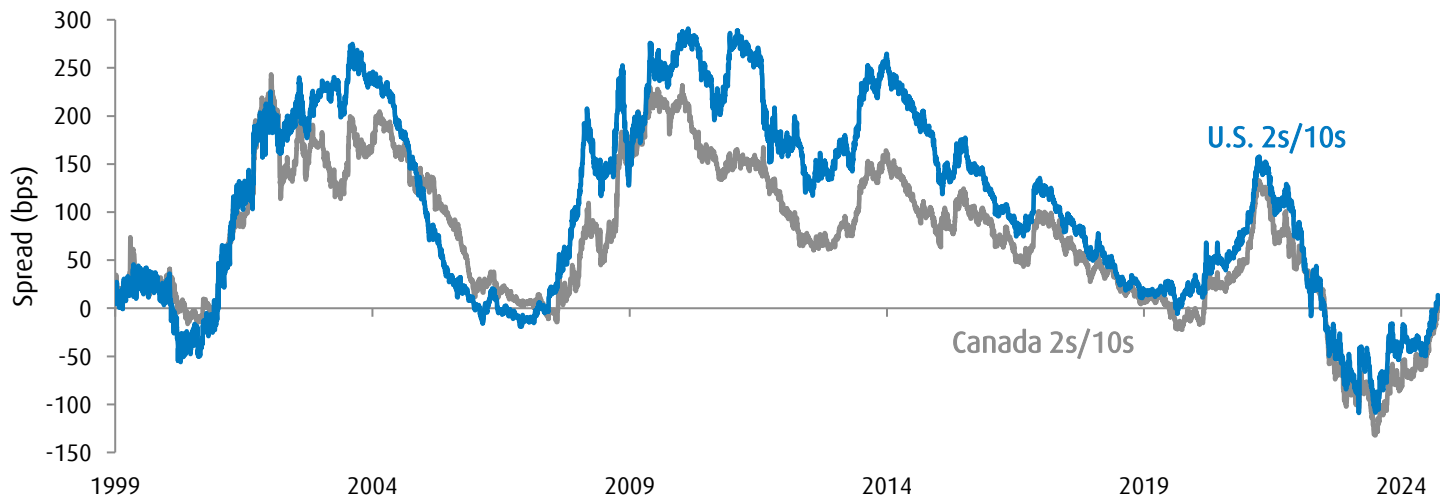
The charts below show just how much steeper the curves in Canada and the U.S. have gotten year-to-date (a positive number on the left axis shows how much higher 10-year rates are vs. 2-year rates). We also include a longer-term chart for perspective.

Figure 3: Year-to-Date Government of Canada and U.S. Treasury 10/2 Spread



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 4: 25-Year Government of Canada and U.S. Treasury 10/2 Spread



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

This is good news since the market historically tends to perform well when the curve is steepening. The reason for this is that this structure has long been seen as a harbinger of future economic strength. From that perspective, the inverted yield curve (when short-term interest rates are higher than longer-term rates) we experienced since mid-2022 caused investor anxiety since it has often been a 12-to-24-month leading indicator of recessions in the last fifty years. There have also been exceptions to this rule, however. We think the current cycle could be one of those times given the remarkable resilience of the labour market (even with the recent softening), corporate spending and, more importantly, the fact that inflation trends have vastly improved in North America and globally.

We updated our historical analysis looking at the impact of the yield curve on the stock market. Going back to the late 1970s, the S&P 500 and S&P/TSX have done better during cycles when the yield curve was steepening with average median annualized price returns of 16.6% and 8.6% respectively vs. 5.5% and 4.7% when the yield curve was flattening.

Figure 5: Yield Curve Cycles and Market Returns

Yield Curve Flattening		U.S. Market				
Period	S&P Return Dates	Yield Curve Shape Starting Level	Yield Curve Shape Ending Level	No. of Months	S&P Annualized Price Return	TSX Annualized Price Return
1	Feb 77 - Feb 80	1.7	-2.02	37	4.3%	28.6%
3	Aug 80 - Aug 81	0.18	-1.33	13	0.3%	-1.7%
5	Jul 85 - Mar 89	1.52	-0.39	45	12.3%	7.0%
7	Oct 92 - Dec 94	2.41	0.12	27	4.2%	10.9%
9	Oct 99 - Aug 00	0.24	-0.44	11	12.4%	61.3%
11	Aug 03 - Nov 06	2.5	-0.15	40	10.4%	17.2%
13	Feb 11 - Jul 12	2.75	1.26	18	2.6%	-12.0%
15	Jan 14 - Jun 16	2.32	0.89	30	6.8%	1.1%
17	Oct 17 - Aug 19	0.78	-0.01	23	6.9%	1.3%
19	Apr 21 - Jun 23	1.47	-1.06	27	2.8%	2.4%
271						
Average					6.3%	11.6%
Median					5.5%	4.7%

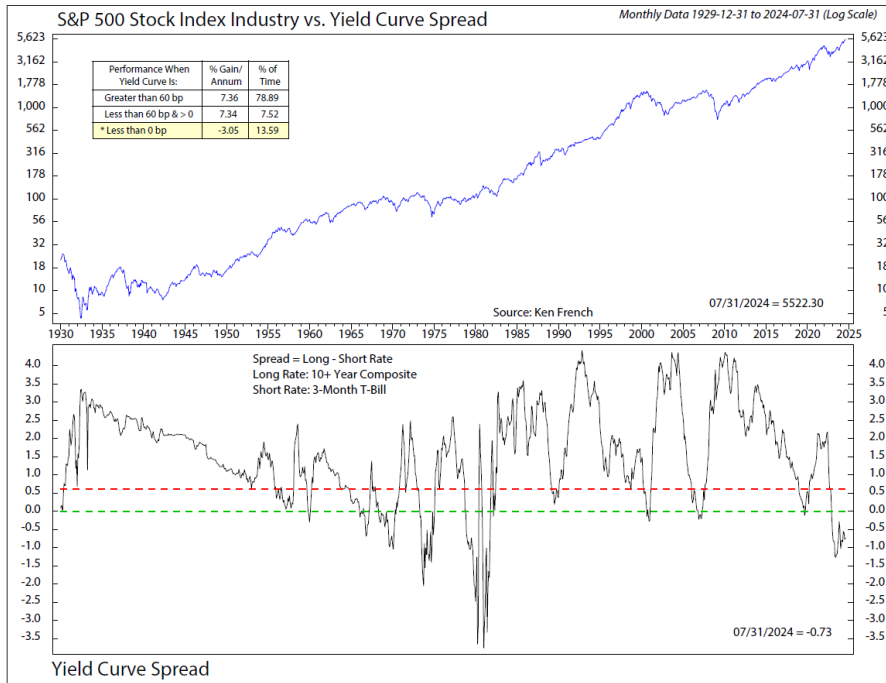
Yield Curve Steepening		U.S. Market				
Period	S&P Return Dates	Yield Curve Shape Starting Level	Yield Curve Shape Ending Level	No. of Months	S&P Annualized Price Return	TSX Annualized Price Return
2	Mar 80 - July 80	-2	1.03	5	52.4%	61.9%
4	Sep 81 - June 85	-0.86	1.57	46	14.0%	10.0%
6	Apr 89 - Sept 92	-0.22	2.56	42	8.9%	-2.7%
10	Sep 00 - Jul 03	-0.18	2.67	35	-12.0%	-11.5%
12	Dec 06 - Jan 11	-0.11	2.81	50	-2.3%	1.2%
14	Aug 12 - Dec 13	1.33	2.65	17	21.3%	9.7%
18	Sep 19 - Mar 21	0.04	1.58	19	20.0%	7.6%
20	Jul 23 - Aug 24	-0.92	-0.01	14	19.5%	11.2%
228						
Average					15.2%	10.9%
Median					16.7%	8.6%

Source: BMO Private Wealth Portfolio Advisory Team, FactSet

### The Shape of the Yield Curve and Sector Performance

Since our data only went back to the 1970s, for greater historical perspective we asked NDR to analyze data going back to 1929 for the U.S. stock market. The results are very consistent with our bullish conclusions. NDR finds that the average annual gain has been over 7% when long rates were higher than short-term rates (yield curve flat or positive) and negative when the yield curve was inverted. The good news is that the yield curve is back to a flattish position so further steepening should be seen as a tailwind for risky assets.

Figure 6: S&P 500 Performance and the Yield Curve Spread



Source: NDR

At the industry level, the results are also interesting. It is true that sectors, industries, and individual companies have changed considerably over the last century, but the market has consistently reacted to the same great macro variables including inflation, interest rates, as well as economic and corporate earnings momentum. Historically, top sectors in a “flattish curve” environment which currently prevails have been a mix of defensive sectors such as Consumer Staples and Healthcare along with more economically sensitive ones such as Tech and Construction.

Figure 7: Industry Performance and the Yield Curve Spread

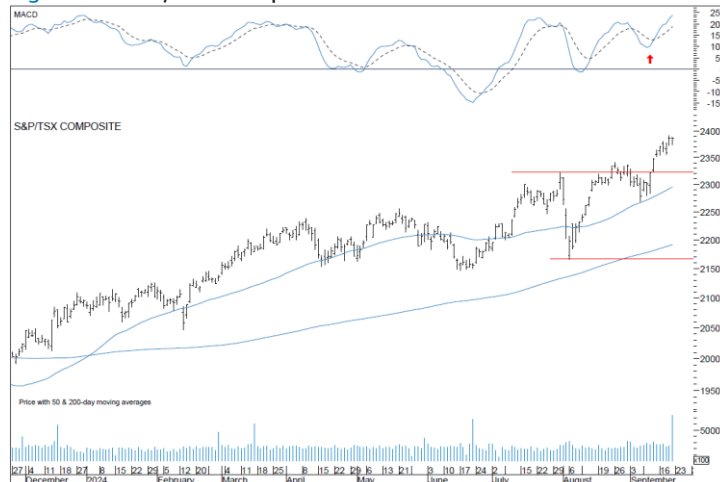
Industry	1929-12-31 to 2024-07-31		
	Annualized Returns When Spread Is:		
	<0 bp	0 to 60 bps	>60 bps
S&P 500	-3.05	7.34	7.36
Toys - Recreation	-11.31	27.68	4.06
Computers	-7.71	21.78	10.40
Lab Measuring and Control Equipment	0.32	19.06	9.57
Medical Equipment	2.16	16.57	8.36
Construction	-2.48	15.78	6.30
Drugs - Pharmaceutical Products	1.64	15.63	8.67
Household Consumer Goods	-4.90	15.09	6.85
Electrical Equipment	-4.40	14.56	8.00
Chips - Electronic Equipment	-8.10	13.79	11.06
Smoke - Tobacco Products	-8.71	13.43	5.47

Source: NDR

Technical Analysis

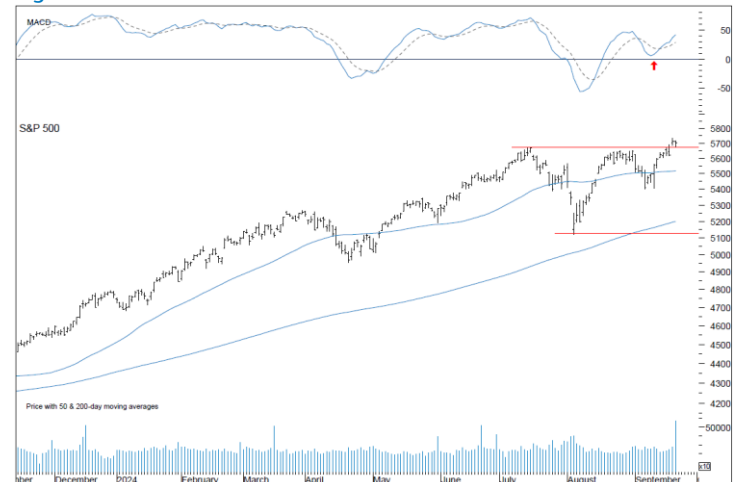
It's "all systems go!" for equity markets as we start the fourth quarter. Both the S&P/TSX Composite and S&P 500 recently broke out of medium-term consolidation patterns, which opened upside targets of 24,759 and 6,219 respectively.

Figure 8: S&P/TSX Composite



Source: BMO Private Wealth Technical Analysis

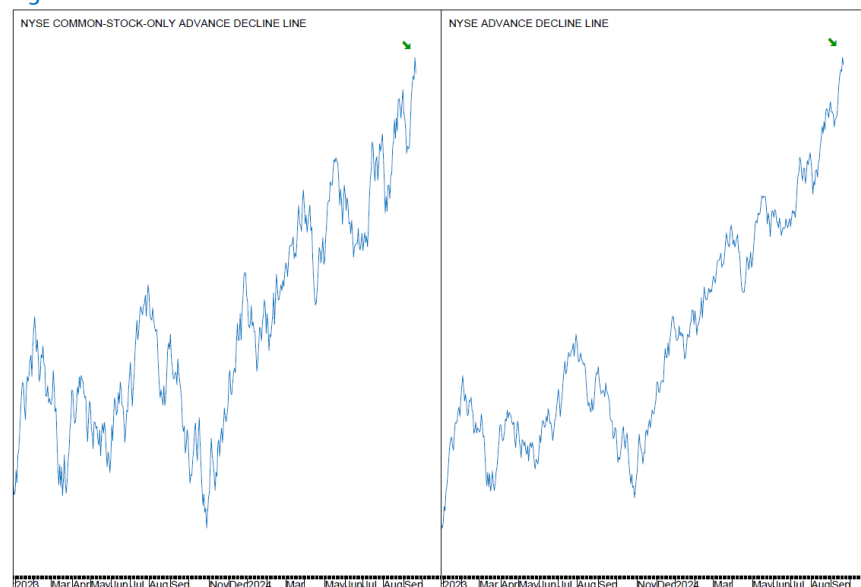
Figure 9: S&P 500



Source: BMO Private Wealth Technical Analysis

At the same time, key barometers of market health such as the various advance-decline lines we follow as well as other broad-based measures of stock performance such as the NYSE Composite and Russell 2000 indexes are either at 52-week or all-time highs, i.e., the market is really firing on all cylinders up and down the capitalization curve.

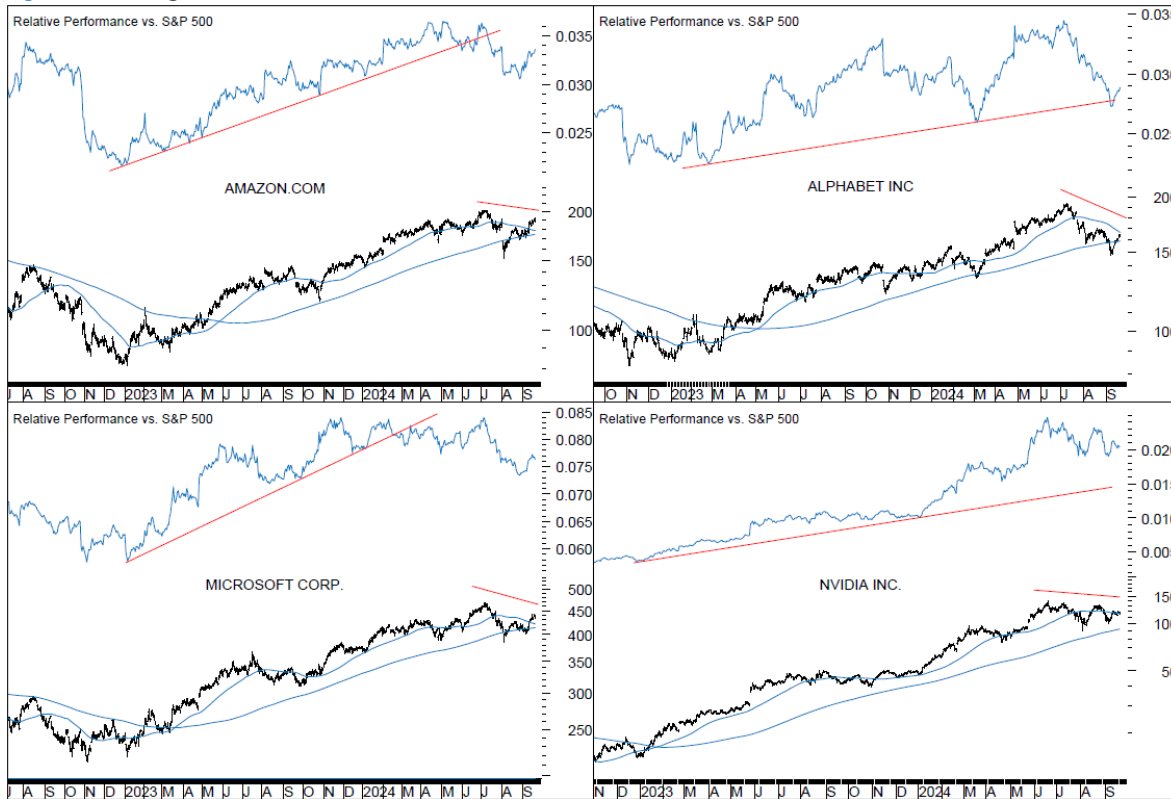
Figure 10: NYSE Advance-Divide



Source: BMO Private Wealth Technical Analysis

Seasonality is also a strong tailwind all the way into the first quarter of 2025 so the general bias for equities should be to the upside into the new year. Favorite sectors include Industrials, Financials, REITs, Utilities, and Healthcare, all of which continue to benefit from the trend of lower interest rates and have made new highs on an absolute and/or relative basis in recent days. Of course, this outperformance has come at the expense of the Technology stocks which, while they remain in bullish long-term uptrends, most are still well below their mid-summer peaks.

Figure 11: Mega-Techs vs. S&P 500



Source: BMO Private Wealth Technical Analysis

Going forward, we expect this trend of underperformance to continue to focus on the new leadership areas for new money in the fourth quarter and beyond. With respect to interest rates, the expectation for the U.S. 10-year yield is still for a test of its early 2023 lows at 3.25% at some point later this year.

Figure 12: U.S. 10-Year Yield



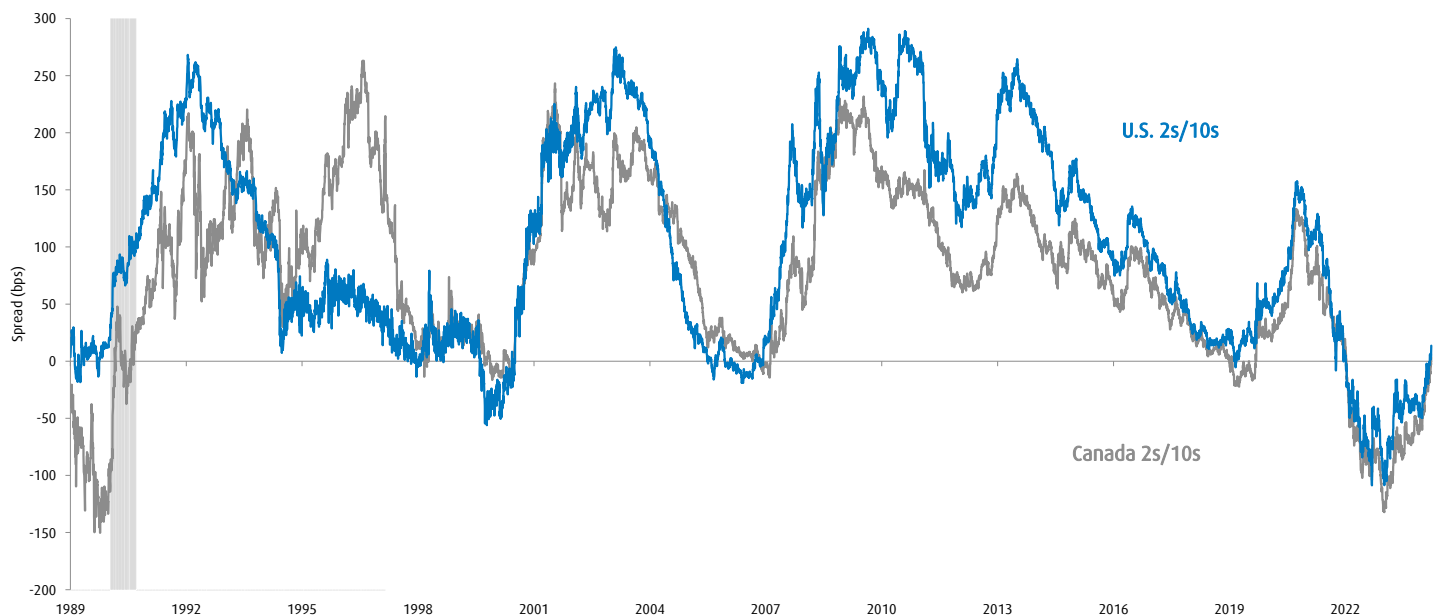
Source: BMO Private Wealth Technical Analysis

We would allow for a bit of a bounce as we begin the month to alleviate a short-term oversold condition, but overall, the bias for rates remains to the downside and should be a continued tailwind for interest sensitive stocks (banks, REITs, pipelines, and Utilities in particular) for the foreseeable future.

## Return to Normal!

After more than 2 years of inversion the Canada and U.S. yield curves are gradually turning positive as short-term rates fall faster than long term ones. The return to normal is good news, but despite all the recent positivity exhibited in risk assets, recession concerns initially associated with the 2022 curve inversion have not yet dissipated and for good reason: despite the historical relationship between the two, the lag between an un-inversion and recession have been much shorter in the U.S. over the last 3 occurrences – on average between 2 and 6 months.

Figure 13: Inversions and n-inversions of Canada and U.S. Yield Curves Over Economic Cycles

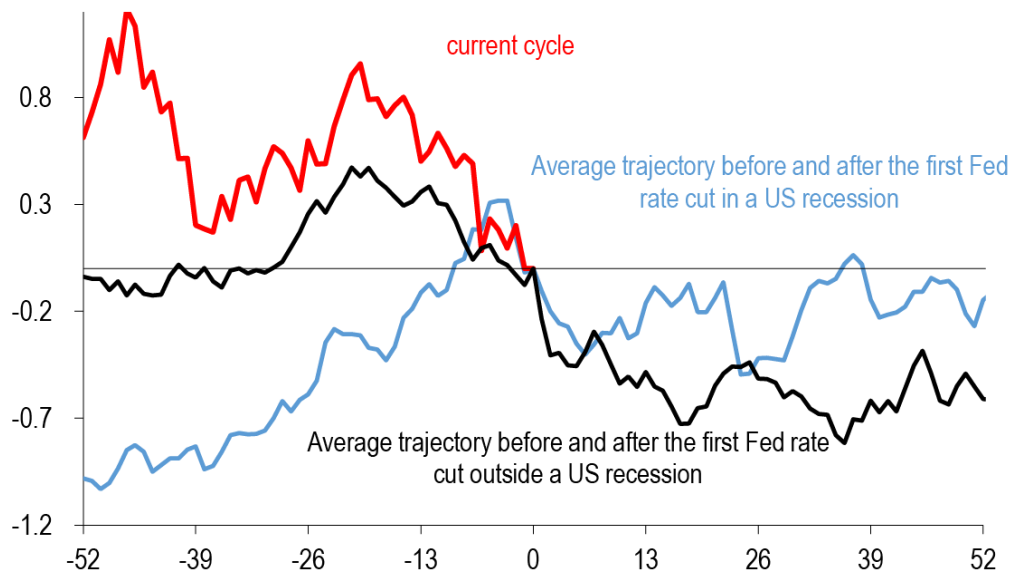


Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Intuitively, un-inversions have been driven by central banks reducing their policy rates from restrictive levels to help support a slowing economy and reduce recession risks. But not all easing cycles have been associated with recessions and early indications would suggest this could be the case again as the Fed starts reducing its policy rates. The cooling of the U.S. labor market conditions does indicate slower economic growth and is worth monitoring, but a closer look to indicators like job openings, layoffs and unemployment claims would hardly be associated, in our opinion, with a recession. Instead, the current economic landscape, combined with the expectation for central banks to remain on the easing path well into 2025, support our base case scenario of a soft landing.

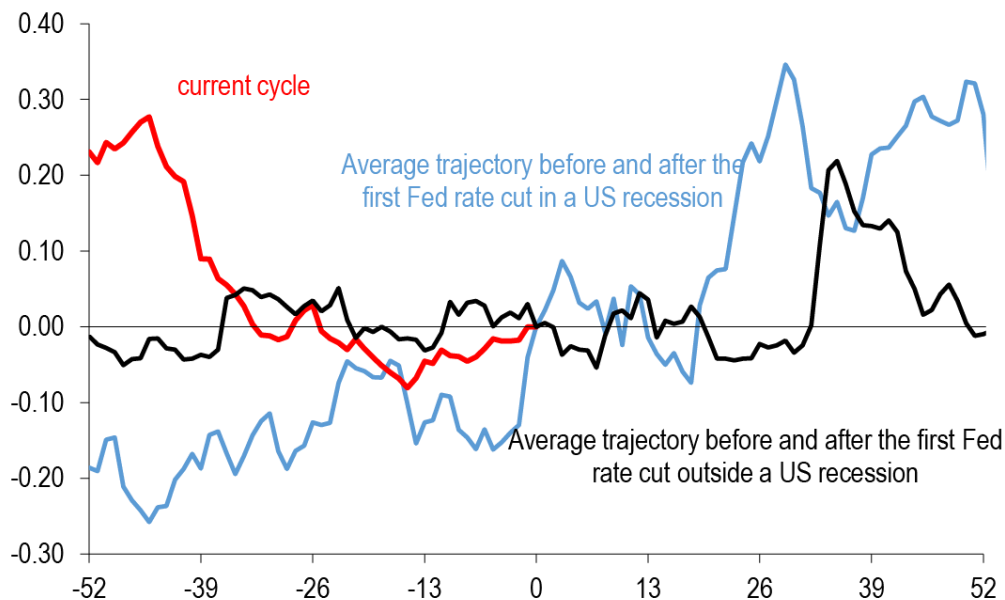
A recent JP Morgan study that looked for patterns in market pricing across asset classes during different easing cycles offers the same conclusions. As shown on the figures 14 and 15 below, the current cycle trajectories for the US 10-year Treasury yield and the credit spreads between BBB and AAA rated issuers (red line) are tracking more closely the average trajectories of previous Fed rate cut cycles **outside of recessions** (Black lines) and more consistent with a U.S. economic soft landing scenario. Again, the strength in the corporate bond sector, a leading bond performer YTD, would hardly be associated with concerns of an economic contraction in the near term.

Figure 14: Average Trajectory of the 10y U.S. Treasury Yield Weeks Before and After the Start of Fed Rate Cuts



Source: J.P. Morgan

Figure 15: Average Trajectory of the BBB-AAA Moody's Spread Weeks Before and After the Start of Fed Rate Cuts



Source: J.P. Morgan

We cannot ignore that economic risks remain especially considering the heightened geo-political risks, the upcoming U.S. election and the potential for a Canadian election to be called in the near term that could potentially change the political landscape. This time however, unlike previous years, bonds can play an important role in investment portfolios as they continue to offer attractive yields and offer some downside protection against weaker risk asset markets. Assuming a soft landing scenario, we expect short- to mid-term yields to continue to be well supported especially if inflation continues trending closer to its target, which could lead yields lower in the near term. However, considering the strong gains so far this year, and the current market expectations for rates cuts over the next 12 to 18 months, we should expect more normalized returns led primarily by coupon income as investors earn their yield.

Figure 16: S&P/TSX Composite Total Returns

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Materials	3.17	27.49
Financials	5.86	22.01
<b>S&amp;P/TSX Composite Index</b>	<b>3.15</b>	<b>17.24</b>
Energy	-1.62	16.30
Utilities	6.18	15.54
Consumer Staples	1.24	14.77
Real Estate	5.29	14.62
Info. Technology	4.83	12.90
Health Care	14.46	12.31
Cons. Discretionary	2.04	11.00
Industrials	1.30	10.19
Telecom. Services	3.16	-2.35

30-Sep-24  
 Source: Bloomberg  
 Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 17: S&P 500 Sector Total Returns

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Utilities	6.60	30.63
Info. Technology	2.49	30.31
Telecom. Services	4.63	28.81
<b>S&amp;P 500 Index</b>	<b>2.14</b>	<b>22.08</b>
Financials	-0.54	21.91
Industrials	3.39	20.20
Consumer Staples	0.90	18.74
Health Care	-1.68	14.35
Materials	2.64	14.14
Cons. Discretionary	7.09	13.91
Real Estate	2.77	11.48
Energy	-2.68	8.36

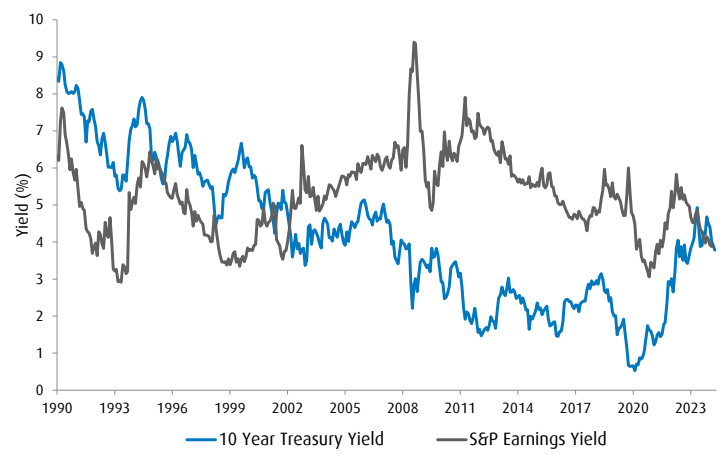
30-Sep-24  
 Source: Bloomberg  
 Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 18: S&P/TSX Composite Earnings Yield vs 10-Yr GoC Yield



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

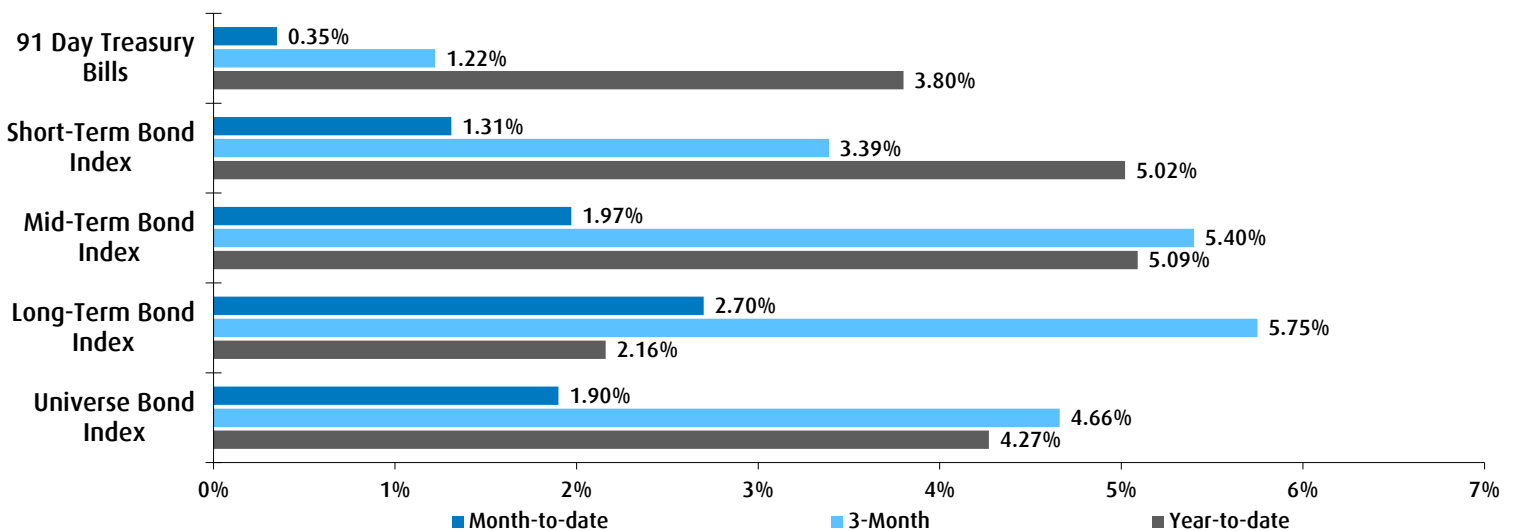
Figure 19: S&P 500 Earnings Yield vs 10-Year Treasury Yield



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

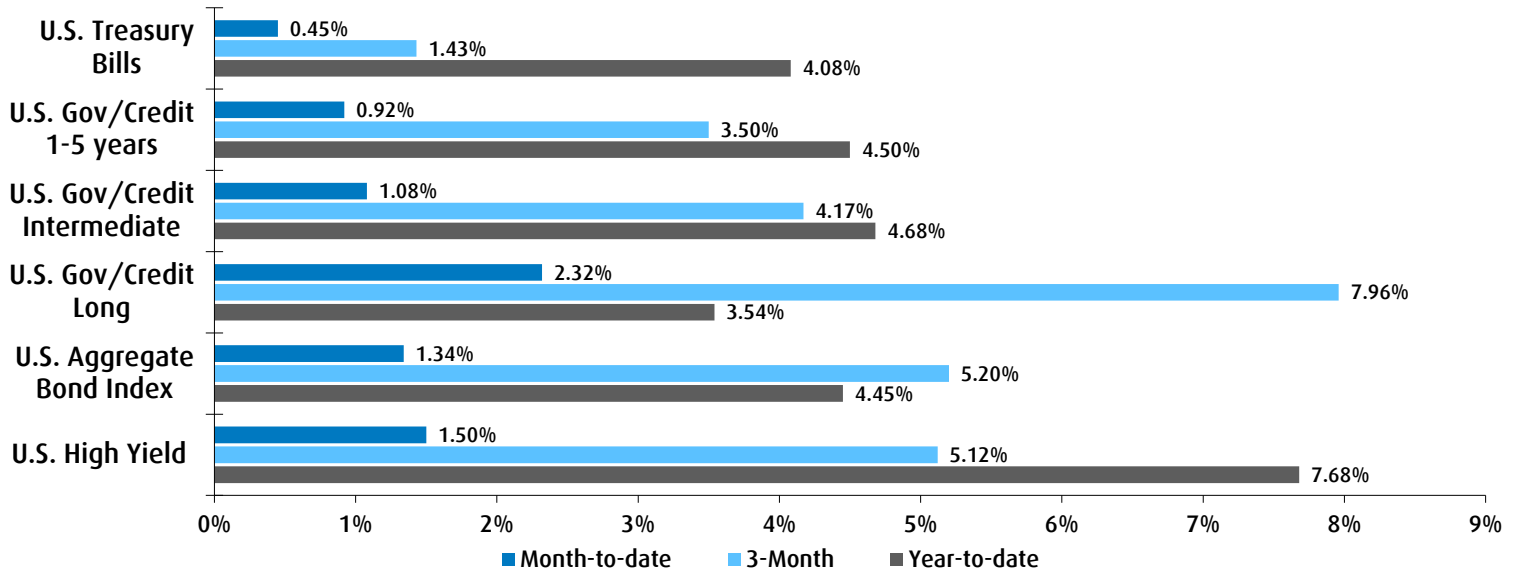
Figure 20: Canada/U.S. Bond Index Total Returns Through September 2024

Canada



Source: BMO Private Wealth Portfolio Advisory Team, FTSE

U.S.



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg Barclays

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