Investment Strategy

Stéphane Rochon, CFA
Equity Strategist
BMO Nesbitt Burns
Portfolio Advisory Team

Richard Belley, CFA
Fixed Income Strategist
BMO Nesbitt Burns
Portfolio Advisory Team

Russ Visch, CMT
Technical Analyst
BMO Nesbitt Burns
Portfolio Advisory Team

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.

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 three 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). Among large sectors, top performers include Financials, Real Estate and Consumer Discretionary. We just happen to have strong conviction ideas for all these sectors.

This is good news since the market historically tends to perform well when the yield 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, versus 5.5% and 4.7% when the yield curve was flattening.

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.

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.

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.

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).

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.

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.

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 two 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.

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. The current cycle trajectories for the U.S. 10-year Treasury yield and the credit spreads between BBB and AAA rated issuers are tracking more closely to the average trajectories of previous Fed rate cut cycles **outside of recessions** 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.

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.

Please speak with your BMO Nesbitt Burns Investment Advisor if you have any questions, or would like to discuss your portfolio.

General Disclosure

If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. The information and opinions in this report were prepared by BMO Nesbitt Burns Inc. Portfolio Advisory Team ("BMO Nesbitt Burns"). This publication is protected by copyright laws. Views or opinions expressed herein may differ from the views and opinions expressed by BMO Capital Markets' Research Department. No part of this publication or its contents may be copied, downloaded, stored in a retrieval system, further transmitted, or otherwise reproduced, stored, disseminated, transferred or used, in any form or by any means by any third parties, except with the prior written permission of BMO Nesbitt Burns. Any further disclosure or use, distribution, dissemination or copying of this publication, message or any attachment is strictly prohibited. If you have received this report in error, please notify the sender immediately and delete or destroy this report without reading, copying or forwarding. The opinions, estimates and projections contained in this report are those of BMO Nesbitt Burns as of the date of this report and are subject to change without notice. BMO Nesbitt Burns endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Nesbitt Burns makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Nesbitt Burns or its affiliates that is not reflected in this report. This report is not to be construed as an offer to sell or solicitation of an offer to buy or sell any security. BMO Nesbitt Burns or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Nesbitt Burns, its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. BMO Nesbitt Burns or its affiliates may act as financial advisor and/or underwriter for the issuers mentioned herein and may receive remuneration for same. Bank of Montreal or its affiliates ("BMO") has lending arrangements with, or provides other remunerated services to, many issuers covered by BMO Nesbitt Burns' Portfolio Advisory Team. A significant lending relationship may exist between BMO and certain of the issuers mentioned herein. BMO Nesbitt Burns Inc. is a wholly owned subsidiary of Bank of Montreal. Dissemination of Reports: BMO Nesbitt Burns Portfolio Advisory Team's reports are made widely available at the same time to all BMO Nesbitt Burns investment advisors. Additional Matters TO U.S. RESIDENTS: Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. ("BMO CM") and/or BMO Nesbitt Burns Securities Ltd. ("BMO NBSL") TO U.K. RESIDENTS: The contents hereof are intended solely for the use of, and may only be issued or passed onto, persons described in part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001. BMO Wealth Management is the brand name for a business group consisting of Bank of Montreal and certain of its affiliates, including BMO Nesbitt Burns Inc., in providing wealth management products and services.

BMO Private Wealth is a brand name for a business group consisting of Bank of Montreal and certain of its affiliates, including BMO Nesbitt Burns Inc., in providing private wealth management products and services. BMO Nesbitt Burns Inc. is a wholly-owned subsidiary of Bank of Montreal. BMO Nesbitt Burns Inc. is a Member – Canadian Investor Protection Fund and is a Member of the Canadian Investment Regulatory Organization. Please contact your BMO Nesbitt Burns Investment Advisor if you have any questions.

"BMO (M-bar roundel symbol)" is a registered trademark of Bank of Montreal, used under licence.

PW2692 (10/24)