Investment Strategy

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In the Blue Corner: Ms. Harris. In the Red Corner: Mr. Trump.

As the U.S.A will decide if a woman will become President for the first time in history or if Donald Trump will get a second term in office, the contrast between the two candidates could not be more stark. The purpose of this missive is not to try to handicap the potential winner – although Trump has been gaining strength of late both in polls and predictive betting markets. Rather, we want to briefly discuss the potential impact of this choice on the North American economy and sectors. Ironically, the U.S. economy continues to defy skeptics with its strength and inflation has been largely tamed yet Democrats do not seem to be getting much credit for it. So, in very simplistic terms, Kamala Harris represents a level of continuity with the current administration while Trump brings more uncertainty to the table given his propensity for iconoclastic statements. We have often stated that the economic cycle matters far more to markets than the party in power, however, in the present case, divergent trade and tax policies could have an outsized impact.

But first, a bit of history. From 1926 to 2023, the U.S. stock market did considerably better when a Democrat was President with a material 5% annual advantage. The timing of elections relative to recessions or strong economic expansions surely played a significant role in this, but, interestingly, Democrats retained their advantage (albeit a smaller one) even when excluding the Herbert Hoover (Depression) and George W. Bush (Financial Crisis) periods. The key point here is that conventional wisdom (Republicans are better for the economy and markets) is often refuted by the data.

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

While current proposals must be taken with a big grain of salt (since campaign promises can easily be derailed by Congress depending on its composition[1]) our research partners at NDR estimate that Harris' corporate tax rate hike proposal could decrease S&P 500 after-tax EPS by 9%, while Trump's tax cut could increase EPS by 5%. Harris has also proposed an increase to capital gains taxes which historically has lowered expected returns for the market. NDR notes that returns in the year of the tax hikes have been below average, with a median gain of 3.7%. So, while already partly discounted, a Trump victory could boost the stock market in the short term. However, once cooler heads prevail, some investors may question the wisdom of further increasing the deficit and debt load for the largest economy in the world.

From a macro perspective, neither party has been fiscally responsible over the last several years. Case in point, the U.S. is still projected to have a 5%+ deficit to GDP ratio in 2024, despite the economy expanding. Call us old fashioned, but times of

[1] The makeup of Congress will also matter enormously since pushing through domestic legislation is notoriously difficult when the White House, House or Senate are controlled by different parties. Even with a Republican or Democratic sweep, increasing political polarization doesn't guarantee easy legislative wins.

economic expansion should be used to pay back debts, not add to them. Keeping some dry powder for stimulus when it – unavoidably – becomes necessary seems like the right approach to us, but this has not been in vogue with politicians for a long time.

Should he win, it is reasonable to expect Trump to continue ratcheting up trade tariffs[2] - which are inherently inflationary – particularly if other countries engage in tit-for-tat tactics (think of those as a tax on consumers). Tariffs also tend to reduce potential growth rates over time which is not helpful for corporate profits, particularly those of multinationals which derive a high percentage of sales from outside the U.S. (approximately 40% of S&P 500 profits come from overseas). From a Canadian perspective, this is a key risk since a third of our GDP comes from exports and 70% of those go to the U.S. While we are a key buyer of U.S. exports, they matter to us far more than we matter to the American economy. The BMO Economics team adds that under a Republican sweep, while Canada's economy might benefit initially from stronger U.S. growth and Canadian energy producers would rejoice if the Keystone XL pipeline was resurrected, the country could be one of the hardest hit (along with China and Mexico) because of a possible trade war with its largest trading partner.

From an interest rate perspective, the combination of growing deficits and trade protectionism under Trump is the greater risk. Republican tax cuts and less regulations would be positive for credit spreads, but the significant risk of higher inflation and rising government funding needs would pressure interest rates higher. An environment that would likely complicate the Federal Reserve's ability to further normalize its monetary policy.

From a sector perspective, key Republican winners should include sectors/companies that benefit from increased tariffs (e.g. steel stocks, autos), deregulation (financials, health insurers, big pharma), lower environmental scrutiny (energy, mining), more defense spending and continued lax gun regulations. Trump is a big proponent of fossil fuels and would presumably encourage the construction of more LNG plants which should be long-term bullish for natural gas prices. BMO Industrials analyst Devin Dodge notes that in the event a Republican-led Congress emerges from the U.S. federal elections, greater protectionism may further the ongoing reshoring trends and add to the domestic manufacturing and industrial capacity base over time. This would also benefit U.S. railroad and logistics companies along with factory automation companies.

Traditional Democrat-favoured sectors include renewable energy and infrastructure related companies. BMO Internet analyst Brian Pitz sees the most positive outcome for his sector as a Democrat majority but no sweep since companies in his coverage have revenue and operating expense levers to ensure that higher tax rates will be muted for overall earnings potential. Further, geopolitical stability will prove bullish given relatively unchanged qualitative events. From a software perspective, BMO analyst Keith Bachman adds that infrastructure spending has been a tailwind to select vertical and design software companies, and a Democratic administration is potentially more supportive for increases in spending beyond 2026.

In Household Wealth We Trust

There has been a lot of talk about increases in debt at the government and individual level and how it represents a major threat to the economy and markets. While we do agree that a continued increase in debt represents a material long-term risk and that governments should become less profligate (particularly in an economic expansion), we wanted to shift the focus to the asset side of the balance sheet.

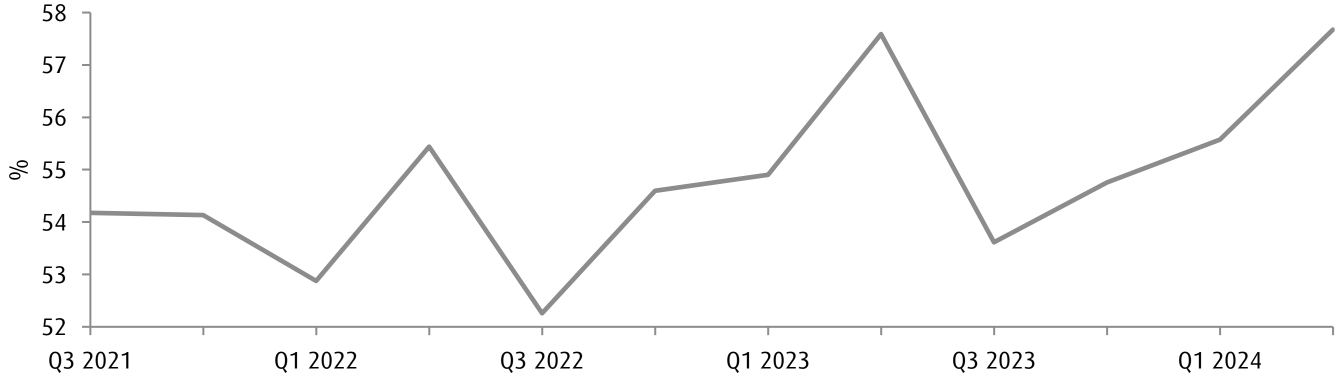
More specifically, household net worth in both Canada and the US is at historic highs with levels of $17 trillion and $163 trillion respectively. Put another way, this level of net worth represents 8x Canadian GDP and almost 6x U.S. GDP. We believe these assets should help cushion blows to the North American economy and it continues to be a tailwind for consumption and the market. The key reason for this is the so-called "wealth effect" which holds that part of the increase in wealth is typically spent by households (e.g. a Bank of Canada study from the early 2000s showed a 2 cent increase in consumption for every dollar increase in stock market wealth). Other studies have shown that this effect is more pronounced for increases in real estate values which are seen as more "permanent" in nature. The good news is that both financial and real estate assets have been rising strongly in tandem.

Interestingly, net worth gains have been broad based across wealth quintiles in the U.S. this cycle (source: NDR). This matters greatly since this should have the effect of delinquency rates subdued, which is a tailwind to credit growth, the economy, and

[2] So far, Trump has promised to 1) raise tariffs 10-20% across the board on all imports and by at least 60% on Chinese products, 2) levy punitive tariffs on manufacturers that shift domestic production to Mexico, such as 100-200% on automakers and 200% on John Deere, 3) levy tariffs of up to 200% on vehicles produced by foreign (non-NA) transplants in Mexico.

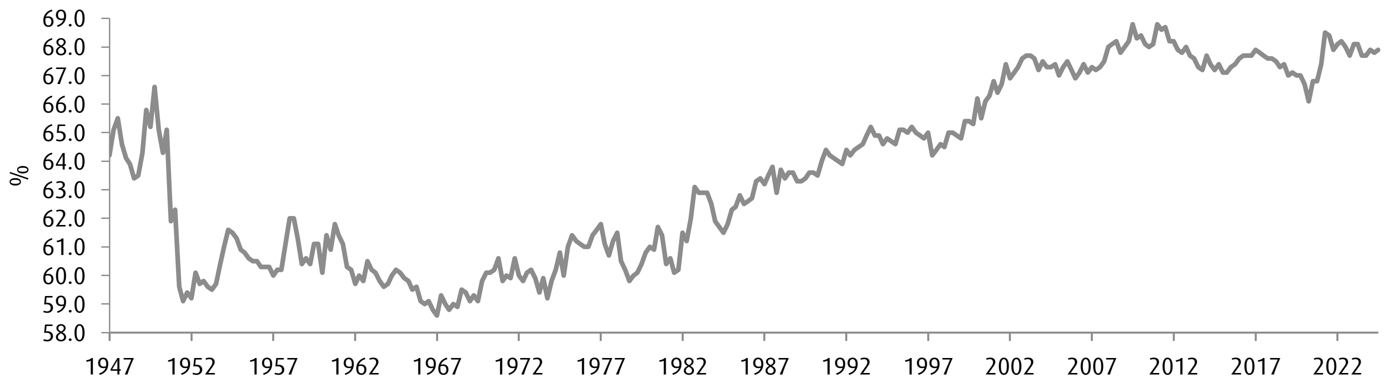
the corporate bond market. This more "equitable" increase in wealth growth amplifies the increased consumption associated with the wealth effect since less-well-off consumers have a higher marginal propensity to spend (as a % of income).

Figure 2: Canada Personal Consumption as % of GDP



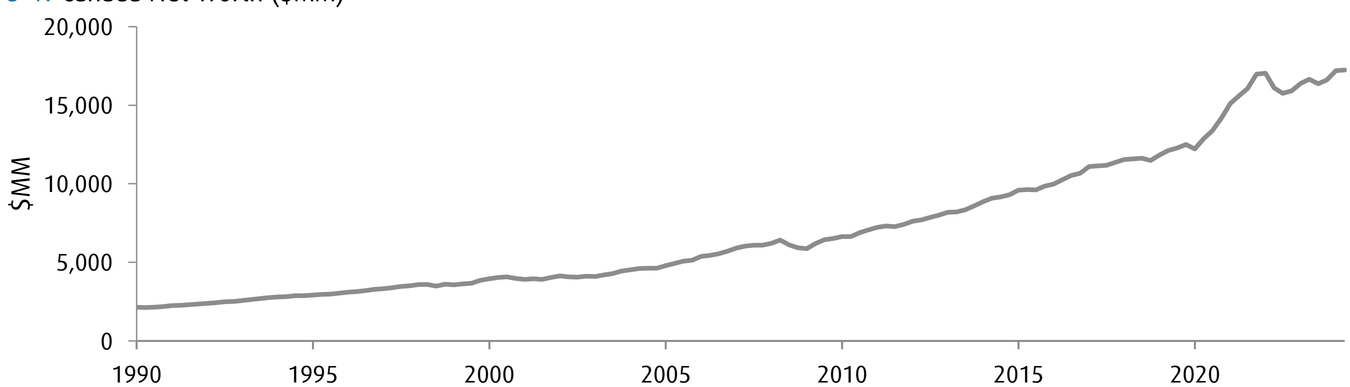
Source: BMO Private Wealth Portfolio Advisory Team, CEIC

Figure 3: U.S. Personal Consumption as % of GDP



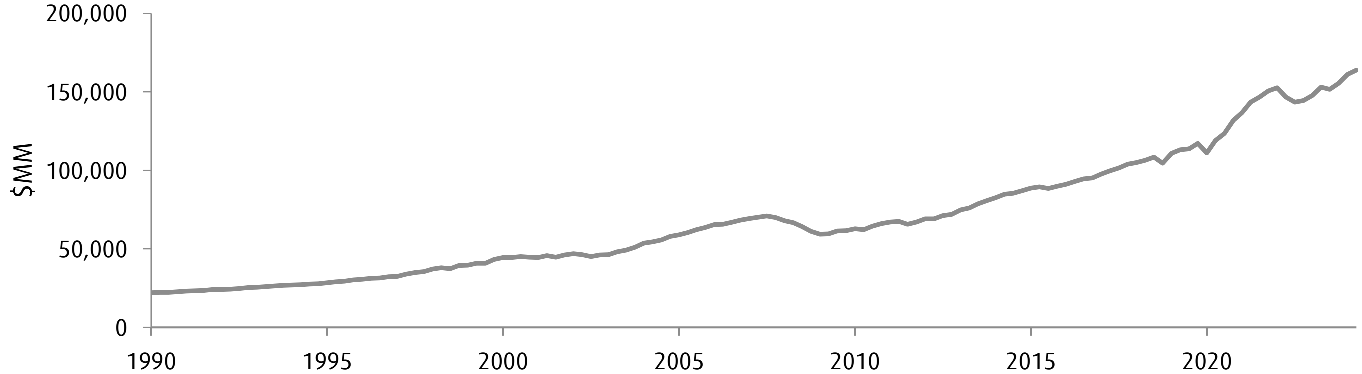
Source: BMO Private Wealth Portfolio Advisory Team, FRED

Figure 4: Canada Net Worth ($MM)



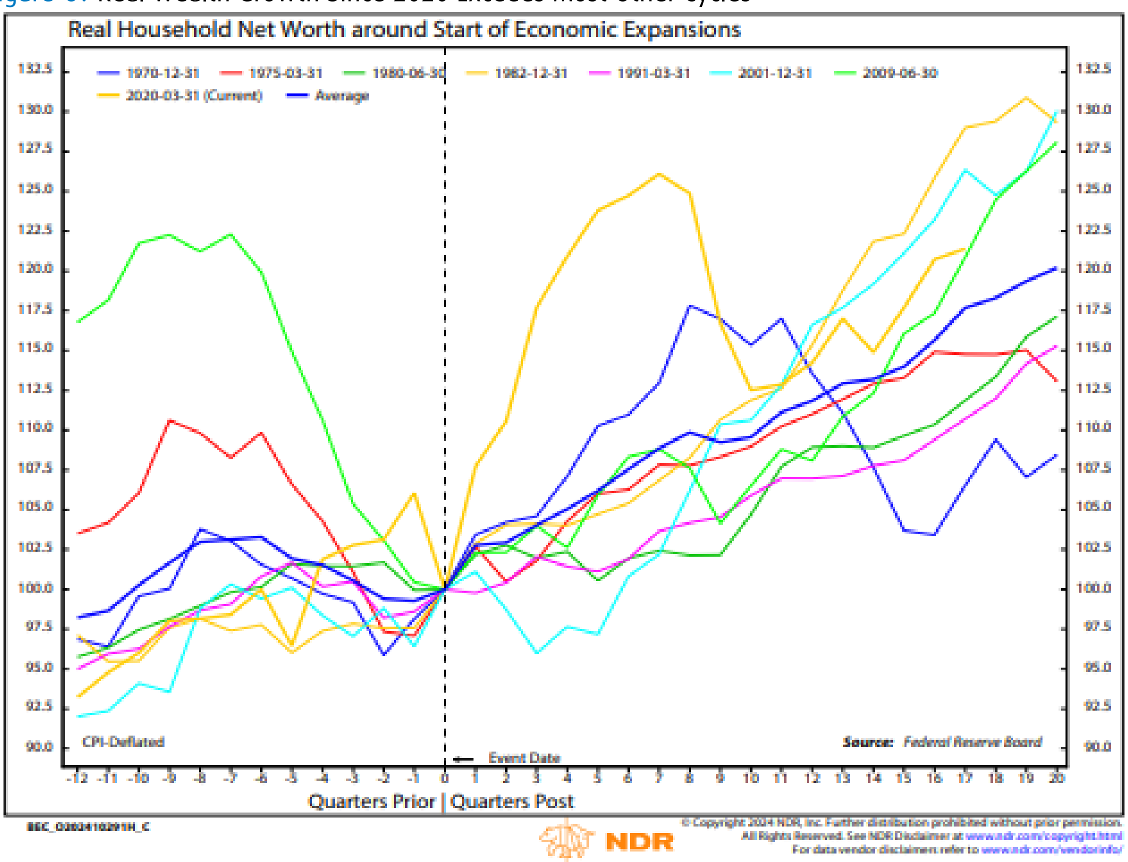
Source: BMO Private Wealth Portfolio Advisory Team, StatCan

Figure 5: U.S. Net Worth ($MM)



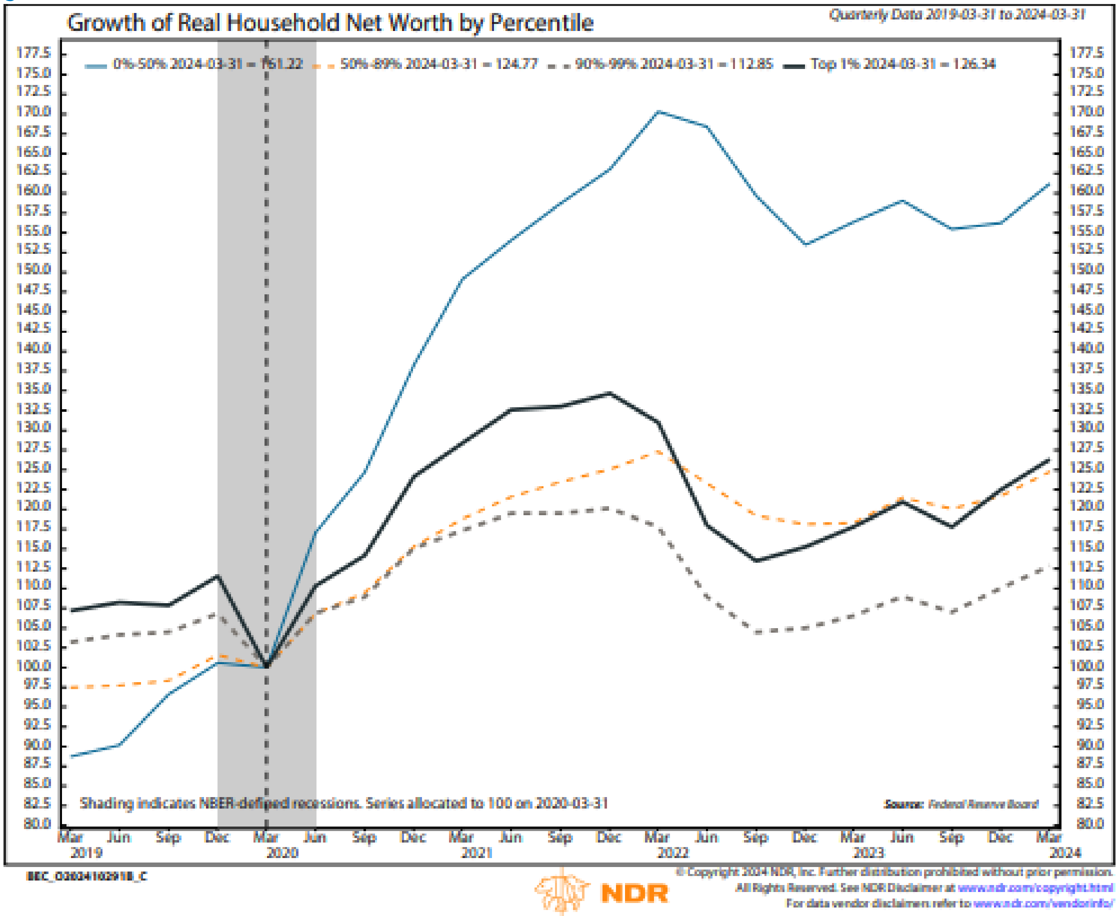
Source: BMO Private Wealth Portfolio Advisory Team, FRB

Figure 6: Real Wealth Growth Since 2020 Exceeds Most Other Cycles



Source: NDR

Figure 7: Broad-Based Increase in Wealth Since The Pandemic

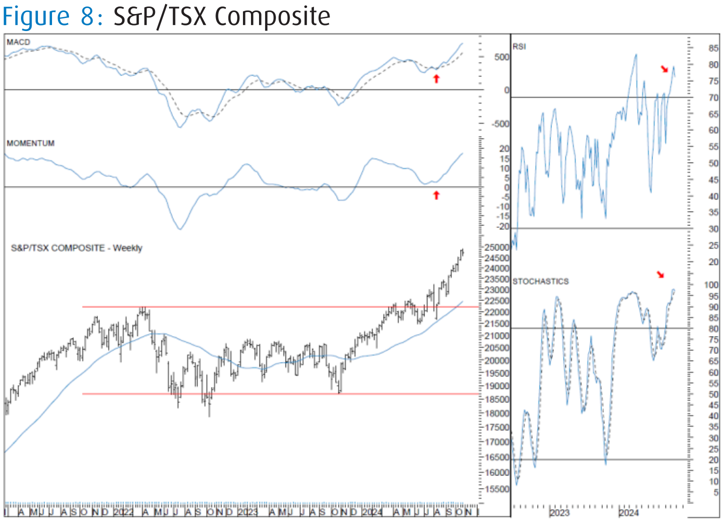


Source: NDR

Technical Analysis

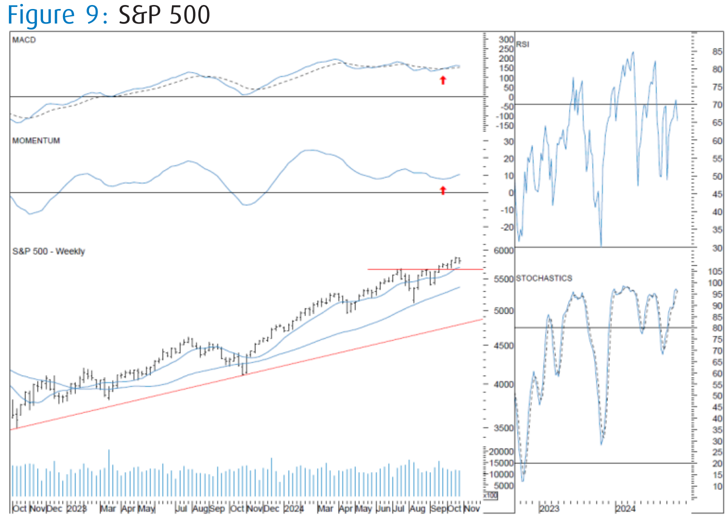
In last month's commentary we noted that it was "all systems go!" for equity markets as we started the fourth quarter, and the story remains the same as we begin November.

Figure 8: S&P/TSX Composite



Source: BMO Private Wealth Technical Analysis

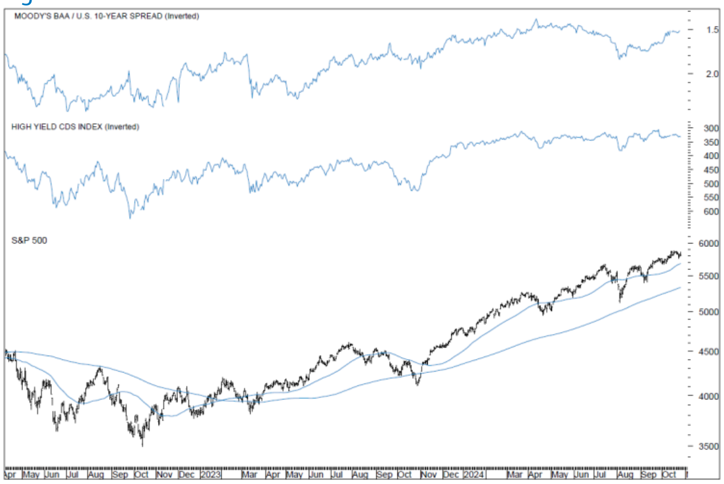
Figure 9: S&P 500



Source: BMO Private Wealth Technical Analysis

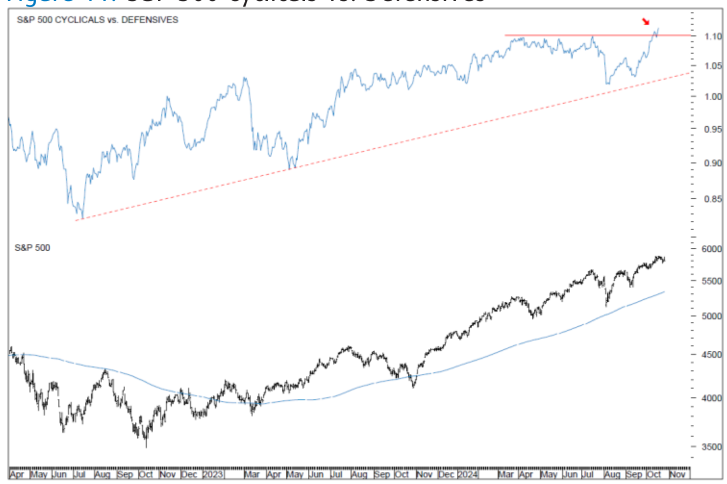
Our medium-term timing model, which measures 3-6+ month trends, remains bullish and supportive of more upside, credit market sentiment remains sedate ("if the bond guys aren't worried, we're not worried" is a motto we live by) and "risk on" sectors continue to outperform "risk off" sectors.

Figure 10: Credit Market Sentiment



Source: BMO Private Wealth Technical Analysis

Figure 11: S&P 500 Cyclicals vs. Defensives



Source: BMO Private Wealth Technical Analysis

In addition, November kicks off the strongest consecutive three-month period for equities both here and in the U.S. with average returns of 4.30% for the S&P 500 and 4.33% for the TSX. In terms of upside potential, the S&P/TSX Composite broke out of a massive two-year trading range earlier this year, which opened an upside target that measures to 26,257. That would represent a 46.9% gain from the October 2022 low and while that might seem ambitious it's still well below the 61.85% average of the five cyclical bulls since the credit crisis. South of the border, the recent breakout in the S&P 500 above resistance at 5,669 opened an upside target of 6,219, which remains in effect. Favorite sectors include Consumer Discretionary, Industrials, Financials, and REITs, 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 over the past week or two.

Figure 12: S&P/TSX Composite Total Returns

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Materials	3.67	32.17
Financials	0.79	22.98
Energy	4.83	21.92
Canada S&P/TSX Composite	**0.85**	**18.24**
Healthcare	4.78	17.68
Utilities	-1.80	13.46
Information Technology	-0.56	12.27
Consumer Staples	-2.77	11.59
Consumer Discretionary	0.22	11.24
Real Estate	-5.68	11.17
Industrials	-1.49	8.55
Communication Services	-4.32	-6.57

31-Oct-24
Source: Bloomberg

Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

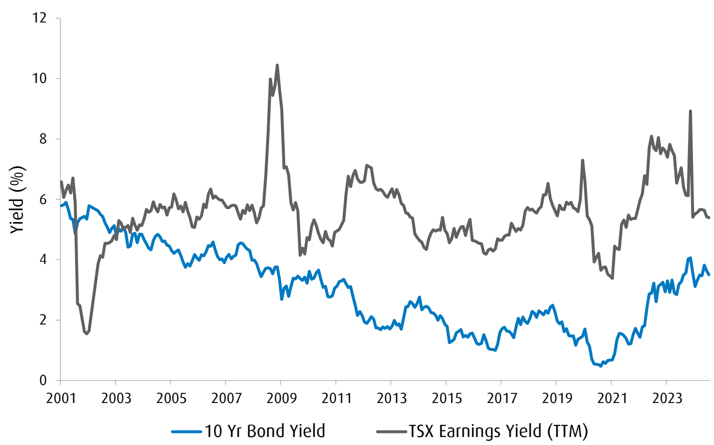
Figure 13: S&P 500 Sector Total Returns

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Communication Services	1.94	31.31
Utilities	-1.02	29.30
Information Technology	-0.97	29.04
Financials	2.69	25.19
S&P 500	**-0.91**	**20.97**
Industrials	-1.25	18.70
Consumer Staples	-2.80	15.42
Consumer Discretionary	-1.55	12.14
Real Estate	-3.28	10.56
Materials	-3.49	10.16
Energy	0.79	9.22
Healthcare	-4.62	9.07

31-Oct-24
Source: Bloomberg

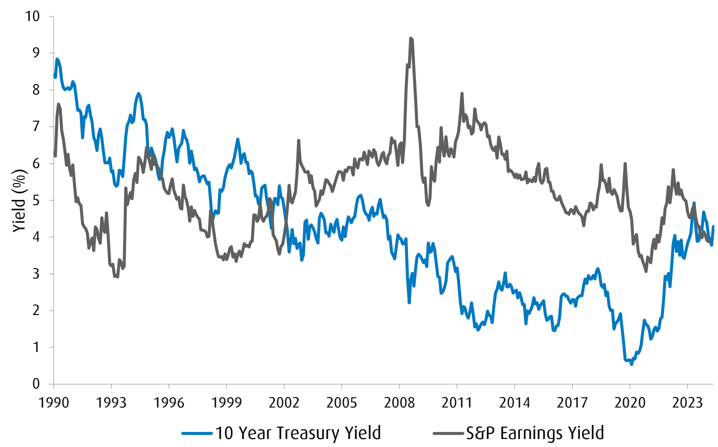
Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 14: S&P/TSX Composite Earnings Yield vs 10-Yr GoC Yield



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

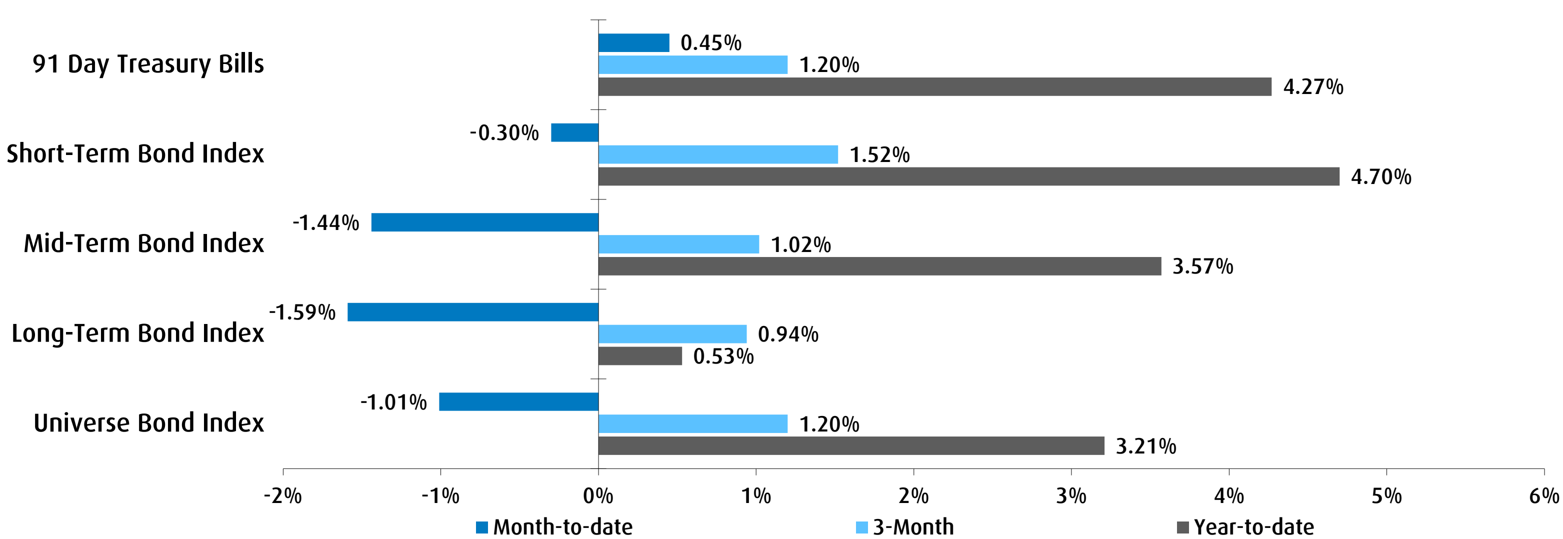
Figure 15: S&P 500 Earnings Yield vs 10-Year Treasury Yield



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

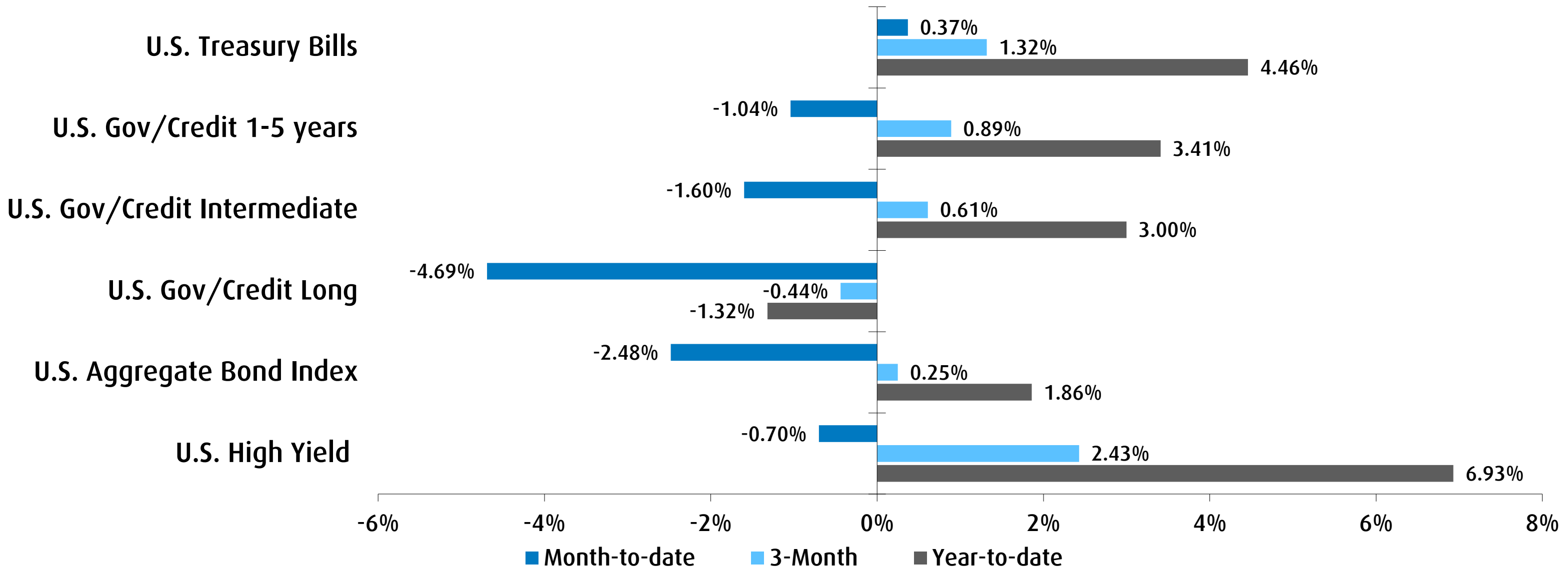
Figure 16: Canada/U.S. Bond Index Total Returns Through October 2024

Canada



Source: BMO Private Wealth Portfolio Advisory Team, FTSE

U.S.



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg Barclays

General Disclosure