Investment Strategy

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We Continue to Like the Market Setup Going Into 2025

Our title is shamelessly self-referential since we essentially copied the one from the December 2024 Investment Strategy report and changed the year to 2025. To mix metaphors, why reinvent the wheel when the shoe still fits? Going into 2024, we noted that, "We think the market can power higher through year-end and beyond, in spite of the pervasive negativity surrounding the geopolitical environment as well as the interest rate and economic outlook. Interest rates have come off the boil which is a significant tailwind for equities and, not surprisingly, the market has been led by so-called high duration (i.e., high multiple) Tech stocks. Still the participation in the market has broadened to include other sectors and stocks beyond these. That is an encouraging signal and a good omen for better performance to come from the very undervalued Canadian stock market, which is not blessed with many sexy Technology stocks (Shopify being one exception)."

All this continues to be true with the added tailwind that the Bank of Canada ("BoC") and U.S. Federal Reserve ("Fed") are well into their rate easing campaigns, which has historically been a significant tailwind for stocks. It may surprise some investors to learn that the S&P/TSX has been the best performing developed market over the last one, three and six months. At the same time, the yield curve (difference between short- and long-term rates) continues to steepen from deeply inverted levels with positive implications for future growth prospects and some of the more cyclical sectors within the S&P/TSX and S&P 500 (think Industrials and Consumer Discretionary as well as parts of the Materials and Energy super sectors). This makes intuitive sense since traders and investors at large have historically rewarded visibility and stability with higher valuations. The shift to more "value" parts of the market (e.g., banks, utilities, pipelines) has already begun and, if historical trends hold, we expect this to continue well into 2025.

We expect Artificial Intelligence to be an enduring investment theme and industries outside of the "compute arms dealers" (i.e., Nvidia, Dell, etc.) to continue gaining prominence. An example of this is the enormous incremental electricity generation that will be required to power data centers over the next several years. By some credible estimates, U.S. power demand could grow at a compound annual growth rate of approximately 2.5 to 3% through the end of the decade after being essentially flat the last 10 years. This may not sound like a huge number, but given the enormous size of this market already, it will require tens of billions of dollars in new power generation, transmission, and distribution across U.S. states and Canadian provinces. Traditional utilities, along with power equipment manufacturers, nuclear/uranium companies, renewable power/natural gas producers and pipeline operators (to transport the gas) will all benefit from this for a long time. Canada just happens to have several investable companies in these fields.

A related positive long-term tailwind for markets will be continued productivity growth led by the U.S. (as usual), but we also see Canada benefitting from this in time, assuming better policies and incentives to increase capital investments (particularly in Technology). While productivity acceleration gets less attention than other major macro variables (because it moves slowly and with a considerable lag following investments), we believe it is crucial as it increases long-term economic and corporate margin growth potential without creating dangerous inflationary pressures. In the current context, we believe enormous investments in Artificial Intelligence, cloud computing, autonomous vehicles, etc., is bound to have an outsized and durable real-world impact.

Another theme that we have discussed often is the re-industrialization of America where hundreds of companies have either moved factories back to the U.S. or decided to build new factories there. Trump's tariff threats could accelerate this trend and "encourage" more U.S. based manufacturing with positive implications for factory automation companies, railroads, and housing plays among several others.

Asset Allocation

From an asset allocation perspective, we maintain our overweight recommendation on equities in general with Canada (given the potential for a new Government in 2025, which could improve business confidence, better commodity prospects, and low valuations), and the U.S. in particular. While Trump's tariff threats pose a real risk, we believe that this represents an extreme opening move in what will be protracted negotiations. Additionally, we do not see material risk to Financials since they are mostly domestic with sizable U.S. businesses (unless the Canadian economy really tanks which we do not expect over the next year), and Energy (no clear alternative to Canadian heavy oil), the two largest sectors of the S&P/TSX. More on this below. Importantly, household net worth in both Canada and the U.S. 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.

We remain underweight Europe given the old continent's chronic growth and productivity problems (especially in Germany, its largest economy). A market weight position in Emerging Markets is still appropriate for most investors, with a preference for India which has outsized growth prospects and continues to tackle longstanding corruption and bureaucratic problems. China, the largest emerging market economy by far, has interesting recovery potential given more serious stimulus and housing recovery measures from authorities and a group of world class tech/internet companies trading at rock-bottom valuations.

Most importantly, our proprietary seven factor North American recession probability model is still not flashing a warning sign even though the odds of a recession in the next 12 months have increased from 40% to slightly below 50% (we typically start to worry when the figure is above 60%). The main culprits for the increase have been some deterioration in manufacturing employment (from very strong levels) and an increase in policy uncertainty, which is not overly surprising given Trump's election.

Trump's Tariff Threats – A Real Risk but Most Likely a Negotiating Tactic at This Point

U.S. President-elect Donald Trump said that he would impose a 25% tariff on all imports from Canada and Mexico in January, unless those countries tighten up their border with respect to drugs and illegal immigration into the U.S. (clearly a bigger issue for Mexico). As BMO Economics noted, while this could certainly be early posturing in order to prompt some changes in Canada and Mexico, markets are in a stir because of the severe level and potential impact. The U.S. market accounts for roughly 75% of Canadian goods exports, and nominal goods exports weigh in at about 25% of Canadian GDP. Indeed, Canada is a small open economy that trades heavily with the U.S.—hence the concern.

There are many moving parts, and much depends on the details, but here are some high-level takeaways: in general, we'd expected the Canadian dollar to see the biggest and most immediate market impact, extending the weakness seen in recent months. Currency adjustments can typically absorb much of the impact in a tariff setting. In this event, we see room for further depreciation from recent levels above $1.41/USD. The ultimate size and coverage of the tariffs will determine the extent of the negative impact on growth. But keep in mind that they would be set against a backdrop of firming domestic demand in Canada in areas like housing and consumer spending.

In the end, tariffs are nothing more than an indirect tax on consumers, which additionally serve to lower economic growth. It is hard to believe that U.S. households will welcome a steep price increase in energy, apparel and a host of other goods given inflation is just now getting to a more acceptable range.

Things are Looking Better for China

For some time now, China's been a significant underperformer. The Shanghai Composite has been lagging global markets for a few years now, with the index consistently unable to reach its recent 5-year highs established in 2021 (~3,700 vs. 3,300 today). Making matters worse, the only other instances where the index passed this level was 2014 (~4,600) and 2007 (~6,000).

However, not all is lost. Recent reports suggest that sentiment for Chinese stocks is at a rock-bottom given record levels of ETF outflows. This – along with Chinese stocks trading at historically low valuations – may point to a solid entry point for investors looking to benefit from momentum in the Chinese stock market. Granted, we still do prefer Western markets as longer-term, core holdings, but we may see China outperform its historical averages.

S&P 500 and S&P/TSX Fair Value Update

We updated our fair value estimates for the S&P 500 and S&P/TSX to 6,500 and 29,000, respectively, implying approximately 8% and 14% upside potential. Given the

huge variance in earnings momentum and valuations between and within sectors however, we continue to advocate a selective approach to stock picking. We fully realize that valuations have not been an important factor over the last several years, likely as a result of the massive inflows in passive ETFs which are agnostic to fundamental factors. Still, history has shown that when investors do start to care about valuations, things can turn quickly, and the trend can take hold for far longer than most expect. A clear historical example we have cited is Microsoft. Had investors bought the stocks at an eye-watering 75x P/E at the peak of the tech bubble in March 2000, it would have taken 15 years to break even on the investment despite annual double digit EPS growth.

Aside from valuations, one of the key reasons we see less upside in the U.S. is that we are very concerned about the extreme market concentration there, with the top 10 stocks (the usual suspects) accounting for about a third of the market capitalization of the entire S&P 500. This is much higher than during the tech bubble and was only equaled by the "Nifty Fifty" in the 1970s (as a reminder these were "secular growth" household names such as GE, JNJ, PG, IBM, Xerox, MMM, etc.), in recent memory. The massive recession of 1973-75 (fueled by the OPEC oil crisis, Vietnam war debt and the fall of the Bretton Woods System) led to a real GDP contraction of 7% and a steep bear market. While the market fell 14% in 1973 and 26% in 1974, the Nifty Fifty's high valuation (P/E of over 40x) contributed to them doing even worse with respective declines of 19% and 38% in the same period.

Following the tech bubble bust, the S&P 500 went down 10%, 13%, and 23% in 2000, 2001, and 2002, respectively. The NASDAQ (where most of the egregiously overvalued Tech highfliers were listed); however, did far worse with losses of 39%, 21%, and 31.5% in the same period.

History may not repeat but it often rhymes.

Earnings Expectations Continue to be Positive

Encouragingly, EPS estimates have consistently risen both in Canada and the U.S. Additionally, a back-of-the-envelope calculation shows about a five percent increase in S&P 500 earnings per share from Trump's proposal to cut corporate taxes from 21% to 15% for companies that produce goods in the United States. This could also help large Canadian companies with sizable U.S. assets. The prospect of less regulation and potentially more lax antitrust merger enforcement could also add a tailwind to 2025 EPS estimates for the S&P 500.

Technical Analysis

We've been using the term "all systems go!" for equity markets for the past two months no,w and that remains the case following the U.S. election. For example, we're seeing continued outperformance in "risk on" assets such as the relationship between cyclical and defensive sectors.

As an example, Financials, Industrials, and Consumer Discretionary indices continue to make absolute and relative new highs. Other "risk on" assets like Bitcoin have also broken out and the Russell 2000 Index is challenging the upper end of a massive four-year trading range. A breakout would open an upside target that measures approximately 35% higher than the recent closing price.

At the same time, credit sentiment remains benign, and seasonality is a strong tailwind all the way out to February so we think the general bias for equities should remain to the upside for the next 2-3 months at least.

In terms of upside potential, our target of 6,219 remains in effect for the S&P 500. Here in Canada, the S&P/TSX Composite just broke above its October peak at 24,922, which opened a short-term trading target of 25,746, with the longer-term target of 26,257 still in effect as well.

To put those numbers into context, 26,257 for the S&P/TSX would represent about a 47% gain from the October 2022 low. While that may seem ambitious, it's still well below the 61.85% average of the five cyclical bulls since the credit crisis. The same is true for the S&P 500 as well. Over the years we've regularly published a chart which shows how an average cyclical bull market plays out when you're in a bigger secular bull market such as what we're in right now. They tend to last 30 months on average (with a median value of 33 months) with gains of around 86%. If you apply that number to the October 2022 low that would give you a target of 6,493 (i.e., 6,219 is still well below the historical average).

The caveat is that if you extrapolate that 30 to 33-month timeline, it suggests we could possibly run into trouble at some point in the April to July window next year. However, at this point none of the indicators we refer to as our "canaries in the coal mine" are showing any signs of concerns. These are the indicators that tend to roll over 6 to 12+ months ahead of real bear markets. Things like corporate/treasury credit spreads, CDS indices, the percentage of stocks trading above 200-day moving averages and so on. We're definitely going to be paying close attention to them as we get into 2025, but as we mentioned at the beginning, as of right now it's still "all systems go" with no warning signs in any of our key barometers of market health.

Central Banks' Easing Path Continues to be Supportive

The Fed rate cut expectations may have been lowered from relatively lofty levels in the wake of the red sweep, but the easing bias continues to be supportive of risk assets. Our BMO Economics team forecasts another 125 basis points ("bps") over the next 12 months to bring the policy rate in a less restrictive range between 3.25 to 3.50%. This is more optimistic than current market expectations (75 bps) and we admit there is risk to BMO's forecast considering the resilient economy and sticky inflation environment.

Add to this the potential aggressive fiscal and trade policies along with the risk for a continued large deficit and it becomes evident that the Fed's task to further normalize its monetary policy will be complicated. Bond yields could also remain elevated as this would be an environment that supports above-average real yields and inflation expectations. Still too early to speculate on outcomes and the focus cannot be on tariffs alone, but we suspect that policy uncertainty and the odds of inflation upside surprises could keep longer-term rates elevated going into 2025. This is a trend that could help the gradual steepening of the yield curve, a positive for the financial sector.

As for Canadian rates, BMO also expects the BoC to cut by 125 bps through the end of 2025, dropping the policy rate to 2.50%, but unlike the U.S. call we believe there is limited downside risk to this forecast. The economic background of slower growth and lower inflation compared to the U.S. should continue to give greater flexibility to the BoC for further rate adjustments, which justify our lower yields across all terms.

Those yield differentials have also been further reinforced by the threat of U.S. tariffs that could have significant economic impact. Having said that, the combination of stronger consumption lately that could be supported by mild tax relief from Ottawa, a stabilizing housing market as mortgage rates decline, and a personal saving rate at a three-year high of 7.1% could bode well for the gradual recovery of the Canadian economy. Our BMO Economists remain optimistic that growth could exceed 2% in 2025, but admit that trade-related uncertainty is likely to leave the outlook cloudier than normal.

In the near term, it is difficult to see our rates closing the gap with the U.S. The bias is for lower rates, but with most of the rate cuts being priced in, Canadian rates may have little room to move much lower. Our base case scenario is for rates to remain relatively rangebound with the Canada 10-year likely hovering between 2.80% and 3.65%. In this environment, bonds should continue to earn their coupons but experience limited opportunity for capital gains. As for the U.S., many factors could keep bond yields higher than expected, but the bias remains tilted toward lower rates by the end of 2025. The potential for some capital gains combined with the higher carry (higher starting yields) should lead the U.S. market to outperform Canada at least in the first half of 2025.

Positive credit background

Credit trends continue to be positive both in Canada and the U.S. and whether we look at corporate yield spreads or credit default swap spreads (the cost to insure against default risk), we see no signs of concern or stress. Admittedly, with valuation relatively tight compared to recent history, the strong gains of the last two years may not be repeated. Considering that some of the potential gains from Trump's election may have been pulled forward, we would not be surprised to see a period of consolidation in the next few quarters with some temporary pullbacks. From a yield perspective however, the corporate bond sector remains attractive.

Despite the tight spreads, we continue to see pockets of opportunities supported by positive growth forecasts worth exploring into the new year. The prospect for a more business-friendly regulatory environment and a steeper yield curve should continue to support Canadian and U.S. banks whose senior bonds offer an attractive yield with better downside protection compared to lower rated issuers. We also like the major insurance companies (Industrial Alliance, Sun Life, and Manulife) with their ''A'' credit rating and some select REITs that should benefit from lower interest rates. As a good risk diversifier from the financial and diversified financial sectors, we also like the energy midstream sector in Canada with Pembina Pipelines, Altagas, Keyera, and producer Whitecap Resources as some of our top names. Finally, outside the beaten path, we find value in some private equity related names like the better rated Brookfield entities and a lesser know U.S. entity Athene, a leading annuity and retirement services company which is own by Apollo Global Management.

We believe the tax efficiency of the corporate bond market – a main investment theme over the last two years – will continue to be an important contributor to taxable portfolio performance. However, considering how expensive some of these low-coupon discount bonds have become compared to newer current coupon bonds (average 10 to 20 bps), we would recommend eliminating exposure to these securities in non-taxable accounts.

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

Private Wealth

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