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

After a fantastic year, market still well supported…but keep a close eye on tariffs and the unemployment rate

The year 2024 brought very strong performance for stock investors in the U.S., Canada, and foreign markets. We believe the market remains well supported for now.

Our key conclusions are as follows:

1. As we enter 2025, we remain overweight equities with a fair value of 29,000 for the S&P/TSX and 6,500 for the S&P 500, implying a better return potential – in local currency terms – for the Canadian market despite Trump's tariff threats which are undoubtedly a risk (more on this below). The key pillars of this positive stance are: a) a low probability of recession in the next year; b) strong corporate earnings momentum (double-digit growth projected in the U.S. and Canada); c) a relatively favourable inflation and interest rate environment; and d) still reasonable valuation and dividend growth potential for a number of sectors and individual stocks (especially in Canada).
2. At the same time, investors should not underestimate the risks of a Trump-led tariff war and the high valuation for the U.S. stock market (particularly in the Tech and Communication sectors), along with the extreme concentration we are seeing with the top 10 largest U.S. companies comprising more than a third of the S&P 500's value (a level only matched during the 1970s "nifty-fifty period").
3. While both markets did well in 2024, the U.S. once again managed to outperform given the country's huge edge in productivity growth and the S&P 500's much higher exposure to the Artificial Intelligence theme which has captured investors' imagination. However, we are seeing sector leadership broaden out and the S&P/TSX remains far cheaper, and the sector weights are more favourable in the context of a "soft landing" scenario (Financials, Industrials and Energy Infrastructure, in particular). Also, the prospect of a new Government with a more sensible economic vision could act as an important catalyst for foreign and domestic investors.
4. We think high-quality, lower-duration stocks (i.e., reasonably valued and paying growing dividends) will regain their luster in the not-too-distant future. An example of such stocks are large pharmaceutical companies which have rarely traded this cheaply vs. the market in the last 20 years (currently at 70% of the S&P 500 forward price/earnings multiple).
5. Defensive/interest rate sensitive sectors like Utilities, REITs, and Financials should continue their recovery if we are right in our view that long-term interest rates are unlikely to spike up significantly from current levels. As for shorter-term rates, both the Bank of Canada ("BoC") and the U.S. Federal Reserve ("Fed") remain in easing mode which has historically been a good tailwind for equities. We believe this is true despite the Fed recently indicating a slower path of interest rate cuts in 2025 relative to overly optimistic trader expectations. Also helpful is that the yield curve is steepening (meaning 10-year rates are now higher than the 2-year rate) which has historically been a good omen for stocks. Drilling down a little deeper, we conducted a study of the last 10 "steepening cycles" going back to 1984 and found that returns were very strong at almost 20% after a year. Dividend payers slightly outperformed non-payers and always had positive returns. This was not the case for growth-oriented, non-dividend payers which got hit very hard following the Tech bubble crash post March 2000.
6. On balance, our macro driver "dashboard" shows that key variables are still flashing a positive picture for equities. Historically, market returns in the U.S. have been better when inflation is coming down (the picture is more mixed for the S&P/TSX since Energy and Basic Material stocks tend to benefit from higher inflation). Also helpful are the steepening yield curve – as mentioned below – and the

rising ISM New Orders Index[1]. Just-released December ISM results came in above consensus, with new orders rising a further 2.5% to 52.5%. This is the fourth straight month of increases, finally pushing through the key level of 50.

Strong corporate earnings

A related positive factor is rising corporate earnings estimates. Recent datapoints continue to confirm the strong growth in earnings expectations for the S&P 500 in 2025 (+13%) and for the S&P/TSX (+12%). Best of all, these do not yet factor a possible corporate tax cut in the U.S. in 2025 or deregulation benefits. Financials, Utilities and Health Care continue to have solid EPS growth rates and are home to a number of reasonably valued stocks, especially after recent pullbacks.

Keep a close eye on the unemployment rate

On the other side of the ledger, investors must keep a close eye on the unemployment rate. While it has only risen a little from historically low levels, a more pronounced increase would force us to revisit our bullish call on stocks. In fact, going back to 1962, the market has had negative price returns when the unemployment rate was rising consistently. Our rule of thumb is that the unemployment rate becomes more problematic when it rises above five percent in the U.S.

Specifically, the unemployment rate in the United States went up to 4.2% in November of 2024, from 4.1% in the prior month and in line with market expectations. In Canada, the unemployment rate rose to 6.8% in November, from 6.5% in October.

Trump tariff's threats

The elephant in the room for the Canadian economy is clearly Trump's threat to impose a blanket 25% tariff on all Canadian imports.

BMO's Chief Economist Doug Porter notes: "Big picture, the financial markets simply do not believe that this is going to come to pass," but cautioned that Canada still needs to approach this situation as though the tariffs will be enacted. From a Canadian perspective, the risk to this important trade relationship, even if a scaled-back version of the tariffs were to be imposed, is too big to be dismissed.

Tariffs could have an inflationary impact on both sides of the border, said Porter. Even though there is some debate about how inflationary tariffs could be, at the very least, they throw sand in the gears of trade, he added.

Porter said the Canadian Chamber of Commerce estimates that a 25% tariff would also carve about two percentage points from Canada's expected GDP growth in the first year of implementation. The Bank of Canada would then have to slash rates to between 1.5% and 2.5% from its current 3.75%. The tariffs would also likely cause the Canadian dollar to pull back by 5% to 10% from its current levels, he added. Of note, none of the scenarios factor in any retaliatory actions by Canada or the chill it would put into business investment.

Technical analysis

The "big picture" macro call for North American equities remains bullish. For example: seasonality remains a strong tailwind for equities all the way out to February, and all of the indicators in our short-term timing model continue to improve from the deep oversold readings that developed mid-December. This includes daily momentum gauges and breadth indicators such as the percentage of stocks trading above short- and medium-term moving averages.

Sentiment is pushed into overly bullish extremes, of course, but that's been the case throughout most of 2024, and probably won't be a headwind for equity markets until we start to see signs of deterioration in the indicators we refer to as our "canaries in the coal mine."

Speaking of the canaries, they're all in great shape too: Credit spreads remain super tight, credit default swap indexes are at/near 52-week lows, and "risk on" sectors such as Consumer Discretionary continue to outperform "risk off" sectors like consumer Staples.

Recall that these are the indicators that typically roll over 6 to 12+ months ahead of major bear markets, so the fact that they're all good right now suggests there's no risk of a bear market happening until the second half of 2025, at the earliest. (Maybe a better way of saying that is that as of the start of the year, there is no risk on the horizon of a bear market occurring at all in 2025.)

In terms of upside potential, our technical targets of 6,219 for the S&P 500 and 26,257 for the S&P/TSX remain in effect. Now, that may not seem too exciting since the indexes are reasonably close to them right now, but those numbers are still well below historical averages in terms of how cyclical bull markets play out. An average bull market in the S&P 500, for example, carries it 86% higher. If you apply that to the October 2022 low, that would give you a target of 6,494. Here in Canada, the average cyclical bull market in the S&P/TSX since the credit crisis is 61.85%. If you apply that number to the October 2022 low, it would give you an upside target of 30,253 which is more than 5,000 points away from where it's at now. So, we still have lots of runway just to get to historical averages.

The only caveat to those statistics is that if you look at the entire history of the S&P 500 all the way back to 1950, cyclical bull markets tend to last about 30 months on average with a median value of 33 months. If you apply that to the October 2022 bear market low, that gives us a window of April to June of 2025 where a bear market could begin. We want to stress that this is simply statistics, and not our market call. There are multiple examples of cyclical bull markets lasting 40 months or more, so it's entirely possible we don't get a bear market at all this year. At any rate, our "canaries in the coal mine" indicators should give us plenty of warning ahead of time if things begin to go southbound, but as of right now they all look great.

Higher for longer

Another good year for Canadian fixed income markets, but unlike 2023, the FTSE Canada Universe Bond Index returns were primarily generated at the shorter end of the yield curve. The return to target for the Consumer Price Index ("CPI") and the BoC delivering 175 basis points ("bps") of cuts helped lower short-term rates significantly compared to longer-term rates, which ended the year higher. It is a different story in the U.S. where stronger economic growth, sticky inflation, and rising deficits limited the Fed to 100 bps of easing and negatively impacted performance as upward pressure was maintained on mid- to long-term rates. Credit markets in general performed relatively well on both sides of the border and, in particular, the U.S. high yield market outperformed in the risk-on environment, returning over 8%.

With higher longer-term U.S. rates to start the year compared to 2024, and historically wide positive spreads above Canadian rates, the U.S. market is positioned to potentially surprise and outperform our Canadian rate market. Having said that, the changing political landscape, starting with a new U.S. administration this month and a potential spring Canadian election, could foster greater uncertainty. This, added to the current volatility, could potentially drive markets to deviate from fundamental valuations. Considering the risks and opportunities, our main conclusions are as follows:

1. We remain underweight fixed income assets. Higher U.S. rates remain attractive and a 10-year Treasury yield above 4.50% offers a compelling risk-return profile. Canadian rates, however, are starting the year at much lower levels than the U.S., already pricing in much of the current rate cut expectations, lower CPI, and slow economic growth.
2. Easing from the BoC and the Fed is expected to continue but certainly not at the same pace, and policies will likely continue to diverge further. Our BMO Economists forecast the Fed will cut another 100 bps which is slightly more aggressive than current market expectations of 0.50%, and we admit there is downside risk to this call considering the resilient economy and sticky inflation environment. As for the BoC, after a more aggressive 2024 easing campaign, it is expected that it will deliver another 75 bps of cuts to bring down the bank rate to 2.50%.
3. While year-end targets for Canadian and U.S. rates are lower, the odds of long-term rates remaining higher for longer in the near term is a strong possibility. Combining sticky inflation, resilient growth, and larger government funding, we believe the odds are high that the 10-year Treasury yield could re-test the 5% mark. In Canada, improving growth prospects led by stronger consumption could surprise and have a more negative impact on long-term rates especially if inflation fails to stabilize around its target. Under this scenario, we would expect yield curves to steepen further and support a more defensive portfolio duration (a portfolio that is less sensitive to changes in interest rates compared to a fixed income index).
4. Finally, barring any significant trade war, we remain constructive on fixed income investment. Our base case scenario is for rates to remain relatively rangebound with the Canada 10-year likely hovering between 2.80% and 3.65%, with a year-end target of 3.10%. In the U.S., we see an even wider range of trading between 3.75% and 5.10%, ending 2025 at 4.00%. This means we expect the Canada-U.S. yield differential to narrow from the current historical record wide.

Total return expectations

In this environment, Canadian bonds should continue to earn their coupons but experience more 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.

Using the latest BMO Economics interest rate forecast (from mid-December) which calls for Canada 5- and 10-year yields to top 2.75% and 3.00% (slightly lower than our call), respectively, by the end of 2025, we calculated the expected total returns for select government and corporate securities over the next 12 months.

Considering current market risks and the potential for these forecasts to materialize, we believe a target of 4% to 4.25% total return for a diversified core Canadian bond portfolio is reasonable. One of the greatest risks to our base-case scenario is the looming trade war that could cloud the outlook, be inflationary, and negatively impact the Canadian economy forcing a more aggressive response from the Bank of Canada. As a result, we could experience a much wider trading range in Canadian yields as uncertainty and volatility increases. While bond investments are meant as the conservative anchor to an investor's asset allocation, this environment may offer greater opportunities to have a more tactical approach to portfolio sensitivities and sector allocation.

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

[1] As our readers know, we very much like the Institute for Supply Management Index ("ISM" or PMI data internationally) since it correlates very well with market returns. Recall that ISM data is a real-world survey of hundreds of companies in multiple industries. A higher reading indicates conditions are improving which is a good leading indicator for a pickup in sales and profitability (and vice-versa).

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