Investment Strategy

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U.S. economy, consumers, and Magnificent 7 feeling more shaky. Rates declining; while Defense and China stocks starting to shine.

As we publish this report, some U.S. tariffs on Canada and Mexico have been postponed (again) until April 2. The nascent U.S.-instigated trade war is clearly negative for the entire North American economy as it increases inflation and lowers economic growth. The silver lining is that the Canadian economy has shown surprising strength of late, meaning that a recession in 2025 is not a foregone conclusion. It is also possible trade tensions will de-escalate. Regardless, a more defensive investment stance is fully warranted in our view.

It may surprise some investors that only one of the so-called "Magnificent 7" stocks is outperforming year-to-date in 2025. That stock is Meta, the artist formerly known as Facebook. But even this stock is starting to roll over. Tesla, for its part, is actually down an eye-watering 32% year-to-date (as of March 4), given deteriorating sales trends and its CEO's (none other than Elon Musk) attention being focused elsewhere, to put it mildly. The net result of this is that those "magnificent" stocks are lagging the S&P 500 considerably and the overall impact is not trivial since they represent a full third of the value of the index. Therefore, most global markets are outperforming U.S. stocks, including the Canadian S&P/TSX (despite constant tariff threats). We expect this trend to continue and despite weakening U.S. economic momentum, we still see attractive investment opportunities, particularly in defensive sectors and Chinese tech stocks. More on this below.

Inflation rising, consumer confidence dropping

Inflation trends are becoming less constructive in the U.S. and other major economies. This is significant on two fronts for equities, and particularly high-multiple (or high-duration) stocks. First, it erodes the present value of future cash flows (i.e., a dollar earned in five years is worth considerably less today when inflation is higher). Second, it may force the Federal Reserve ("Fed") and other central banks to pause rate cuts to make sure price levels are contained. We are already seeing this effect. A related headwind concerns consumer confidence which has clearly begun to slip in the first quarter of 2025.

Our BMO Economics team put it best: "Even with generally quiet markets, one common theme was the stickiness of inflation in many economies." A key takeaway from the latest FOMC Minutes was some underlying concern that U.S. inflation risks are tilted to the upside, especially given uncertainty surrounding immigration and trade policies. A key nugget: "Business contacts in a number of Districts had indicated that firms would attempt to pass on to consumers higher input costs arising from potential tariffs." As well, officials cited the uptick in inflation expectations. The implied inflation breakeven rate in 10-year Treasuries has pushed up to around 2.45%, a level that has rarely been topped in the past two years and compares with its median of little more than 2% over the past decade.

From the consumer perspective, the University of Michigan found that five-year inflation expectations bumped up to 3.5% in February, the highest reading in 30 years. This upswing was almost certainly the driving factor behind a big drop in overall confidence reported for this month, with sentiment sliding to a 15-month low of 64.7 from 71.1 in January, and a post-election high of 74.0. Amid the non-stop news flow from Washington, the majority of U.S. consumers may be more focused on the fact that egg prices are up 53% year-over-year (due to avian flu). The Conference Board's Consumer Confidence survey also confirmed the decline with a drop to an 8-month low of 98.3 in February, which was worse than expected.

Manufacturing new orders also weakening

Adding to the general slowdown, the Institute for Supply Management ("ISM") New Orders Index plunged by the most since April 2020, to 48.6, suggesting demand may be waning again after a nice rebound in Q4 (mostly due to the short-lived optimism regarding Trump's victory). Notably, a measure of prices paid galloped to 62.4, the highest level since June 2022. That's certainly not good news for the inflation picture and suggests price pressures are stirring again in the production pipeline.

Global Economic Policy Uncertainty Index reaches a new high

Financial markets dislike uncertainty. Therefore, the negative trend we are seeing could act as a more pronounced headwind to stock performance in the next few months at least. For those less familiar with this index, the Economic Policy Uncertainty group constructs an index from three types of underlying components: 1) newspaper coverage of policy-related economic uncertainty; 2) the number of federal tax code provisions set to expire and disagreement among economic forecasters; and 3) the dispersion between individual forecasters' predictions about policy-related macroeconomic variables.

Defensive stocks should not be ignored

As we have mentioned several times in the past, defensive stocks serve an important purpose in portfolios, providing ballast in more volatile periods. We are referring to companies that are less exposed to economic fluctuations (particularly of the downward kind) and; therefore, have more visible and predictable revenue and earnings streams. While they tend not to go up as much in good times, these characteristics typically make them less vulnerable to market pullbacks. We believe it is the right time to look at them given "uptrending inflation in the U.S." And within the broad "defensive stock" category we also include actual "Defense" or weapon-manufacturing companies which are well positioned right now given the geopolitical context and rising global defense budgets combined with relatively low valuations. However, fully realizing that missiles and jet fighters may not be everyone's investment cup of tea, we also point to other more prosaic areas which could be interesting, including Consumer Staples, Healthcare, Pipelines and traditional Utilities. Best of all, these sectors offer good value currently, making long term capital appreciation prospects that much better.

Chinese tech stocks are quite attractive

The BMO Family Office recently increased its recommended exposure to Chinese equities, a decision we fully support. Our team continues to recommend adding exposure to China tech giants such as Alibaba (BABA), JD.Com (JD) and Tencent (TCEHY) along with Asian gaming play Las Vegas Sands (LVS). All these stocks are very liquid and have been gaining significant investors interest thanks to: 1) an apparent bottoming in certain important China macro indicators; 2) A marked shift in Chinese policy in favour of tech companies which are now seen as part of the solution to reignite growth; 3) technological advances such as Deepseek which show that Chinese innovation – especially in AI – has been underestimated; 4) far more tame inflation trends in the Middle Kingdom; and 5) very attractive valuations, especially relative to U.S. tech leaders.

As our strategists noted, China's economy and stock market appear to be at an inflection point. Consumer spending and housing prices show signs of bottoming and Lunar New Year holiday spending was strong. Property sales have improved in recent months, and China's tier 1 and 2 cities are seeing price growth and stabilization. Consumer spending has improved even without the bulk of expected government support having yet arrived. Even the broader real estate climate has seen eight straight months of improvement. While not all economic indicators in China have turned up decisively, we believe the worst of the downturn has passed and prospects for continued equity market gains are underappreciated.

China leads the world in numerous technologies and has strengthened ties with Asia, South America, and Africa. President Xi recently (February 17) held a symbolic meeting with China business and technology leaders, which is indicative of the pro-growth shift that Beijing has taken over the past few months. Stock market valuations in China are attractive, including for the Tech sector, even as major developments and innovations are taking place. Beijing's shift to a pro-growth tone last September has echoes of a "whatever it takes" mentality to stabilize growth. The regulatory environment on businesses and the housing market has improved, the People's Bank of China ("PBOC") has a clear easing bias, and small business sentiment is improving. Finally, we believe that President Trump and President Xi are inclined to reach a deal on tariffs and that trade negotiations will benefit China. President Trump has made numerous statements and overtures pointing in this direction.

Technical Analysis

In our last strategy comments, we noted there was risk of "a more pronounced/prolonged medium-term correction later in the first quarter," based on the deterioration that was evident in the indicators in our medium-term timing model. At the time, weekly momentum oscillators had just given their first sell signals since last summer, breadth oscillators such as the percentage of stocks trading above short- and long-term moving averages were deteriorating, and bullish sentiment was contracting across all segments of the market as well. Now, just four weeks later, the S&P 500 is down 6% from the recent all-time high and the Nasdaq Composite is down more than 10% (as of early March).

The good news is that most of the conditional elements are now in place for a trading low to develop any time now. For starters, short-term momentum oscillators for both the S&P 500 and the Nasdaq Composite are stretched into oversold extremes.

In addition, bearish sentiment is ticking up sharply as evidenced by the steep drop in the number of bulls in a recent AAII survey of U.S. retail investors. (In the last week of February, U.S. retail investors suffered the biggest one-week contraction in the number of bulls in more than two years. It was also the biggest 4-week drop since 2013.)

Ideally, a big jump in put buying in the days ahead will spike put:call ratios into their historic buy zones as well. In terms of the price action, the Nasdaq Composite continues to stabilize at its rising 200-day moving average and the S&P 500 is just 1% away from its 200-day moving average, so downside is relatively limited from here. Investors are reminded to keep putting their money to work, as the expectation is for further new highs once this corrective process works its way through the system.

One thing to pay attention to going forward are the indicators we refer to as our "canaries in the coal mine." We are keenly aware that we are 29 months into a cyclical bull market in the S&P 500 which have historically lasted 30 months on average. Our "canaries" are the gauges that typically roll over and go negative 6-12+ months ahead of real bear markets, and while we've seen some deterioration in key barometers of market health such as the percentage of stocks trading above long-term moving averages, they generally remain constructive.

Credit market sentiment (i.e., corporate/treasury credit spreads, CDS indexes) remains sedate and "risk on" sectors continue to outperform the "risk off" sectors.

Yes, we have seen an uptick in the performance of traditionally defensive areas like Healthcare, Consumer Staples and Utilities, but generally speaking they're still not outperforming Consumer Discretionary and Financials stocks. Until that occurs it's still "game on" for equity markets.

Slower growth expectation leads real yields lower

Supported by the constant threats – along with the confirmation – of tariffs, Canadian interest rates continued to trend lower as the market shifts focus from upside inflation risk to the downside implications to the economy. Interestingly, the decline in rates has been led by the U.S. as investors are also growing concerned that the uncertainty around trade policies, combined with government layoffs and immigration policies, could have a negative impact on U.S. GDP. Early Q1 data does indicate a weaker backdrop for the economy, but to be fair, adverse weather and the California fires likely weighed heavily in the results. Having said that, recent U.S. sentiment surveys do portray a similar shift in expectations for growth that could start showing more predominantly in hiring and spending in the near future.

Growth forecast models are also downshifting with some more significantly than others. One in particular, the GDPNow from the Federal Reserve Bank of Atlanta, is actually painting a negative trajectory for the economy. The GDPNow Q1 2025 forecast which is updated in "real time" using economic releases was slashed from +2.3% to -2.8% in early March, potentially showing the first U.S. quarterly contraction since Q1 2022. The dramatic change stems from the surprise report of a record trade balance deficit, January personal consumption data surprisingly turning negative, and weaker manufacturing surveys. In comparison, the Bloomberg Nowcast model shows slower expected growth than when Trump took office, but remains fairly close to 3%.

While it is too early to attribute the slowdown directly to Trump's administration, there are signs that policy uncertainty is starting to have an impact which is in large part responsible for the flight to quality in interest rate markets. This is still a very limited set of data, but the trend cannot be ignored. We admit that we underestimated the level of chaos President Trump would be willing to create in a very short period of time, and the risk to the U.S. economy he would be willing to accept. Having said that, risk markets are only starting to show some signs of concern but have yet to reflect the same level exhibited by government bond markets. U.S. corporate bond yield spreads (credit spreads) did hit their widest level in four months, but remained relatively well behave with limited signs of panic yet, and effective yields continue to trend lower.

The risk to growth supports lower real yields and the bond market reaction has been significant with the 10-year yield declining by more than 70 basis points in the last six weeks. This will likely force our expected trading range of the year to decrease – our lower target is currently 3.85%. Markets also expect the Fed to resume its rate cycle cutting in Q2 with three rate cuts (25 basis point each) now priced in for 2025.

Fundamentally, the full impact of policies is not yet known as it is difficult to assess the extent by which the additional cost will be transferred to customers and the impact on demand. While the flight for safety may continue, investors, like the Fed, may need further data confirmation before it can support further gains. At the same time, we cannot ignore the fact that inflation remains stickier, and while the tariffs could more or less translate into a one-time impact to CPI, it will nonetheless slow down the return to target which, in turn, could delay the Fed from moving aggressively to reduce policy rates. The key to the Fed becoming more dovish and cutting policy rate will lie – in our opinion – with the health of the labor market. This could potentially signal the next leg down for rate markets.

For Canada, this is different. The longer the tariffs are in place, the more damaging it can be to our economy and the door is wide open for the BoC to provide more stimulus. If not for the tariffs, the economy was already showing encouraging signs that previous cuts were helping, but more will likely be needed if the trade war persists. As such, markets have now priced in a 25-basis-point rate cut for its March 12 meeting and see at least a minimum of two other rate cuts. BMO Economics also updated their forecast, more aggressively with a cut at each of the next four meetings, taking the BoC policy rate to 2% in July. As the situation remains fluid, and more tariffs could be imposed by April 2, the BoC could need to act more swiftly.

As we mentioned last month, in times of uncertainty there is an incentive to add duration, focusing on longer-term Government of Canada bonds. But with most Canada yields already trading below 3%, and the mid-part of the curve (5-year sector) below 2.50%, the market is already pricing in some significant hit to our economy. While the odds of interest rates declining further remains elevated, caution is warranted as uncertainty may drive yields further away from fundamentals. Also, as we saw only 30 days ago, President Trump can change his mind again.

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

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