

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

Interest Rates are Rising, Making Bonds More Attractive and Equities (Slightly) Less So

It appears “Bond Vigilantes”¹ have woken up. As the deficits and debt loads of major economies continue to increase and inflation pressures persist, bond investors are asking for better compensation in the form of higher interest rates. The lack of fiscal discipline in developed countries is becoming a bigger concern for investors as this means more debt issuance in the face of a finite pool of capital to absorb this growing supply. Case in point is the U.S., which is already running a 7% annual deficit, even before the passage of Trump’s “One Big Beautiful Bill,” which will further increase borrowing. For high-quality sovereign bonds like U.S. Treasuries, getting one’s capital back is not the issue, as we assume they will be money good for the foreseeable future. The real problem is that the coupon payments are fixed, leaving investors vulnerable to inflation which erodes the real value of the bond. This problem is compounded for international investors when the currency of the issuing country finds itself under pressure, as we have begun to see in 2025, with the U.S. dollar. To illustrate, Bloomberg noted that Taiwan insurers lost over US\$600 million in April alone due to U.S. dollar weakness in the wake of Trump’s tariff threats. Given countries in Asia own over US\$7 trillion in American assets, continued U.S. policy uncertainty and volatility could cause diversification away from these assets for years to come.

While the recent U.S. Trade Court decision to strike down the Administration’s reciprocal and 10% baseline duties and the fentanyl-related levies on Canada, Mexico, and China is positive on its face, we believe it actually increases uncertainty since Trump has many other legal levers to maintain or even increase tariffs. Net-net, this lowers the incentive for trade partners to negotiate in the short term.

As *The Economist* recently noted: “A structural source of demand for long-dated government debt is drying up. Asset-liability managers, meaning institutions such as defined-benefit pension funds that use the fixed income streams from bonds to guarantee their future liabilities, have long been big buyers. But yields have now been high enough for them to lock in these cash flows at attractive prices for years, meaning many can afford to withdraw from the market. As the supply of bonds remains high, fueled by fiscal deficits and central banks shrinking their balance sheets, this sets the stage for long-term borrowing costs to rise even more.”

It is important to keep things in perspective, however. While rates are increasing, they still remain relatively low by historical standards. Still, rising Government yields also means higher mortgage rates. Specifically, 30-year mortgage rates in the U.S. recently pushed above 7%, not exactly supportive for the housing market (which in total accounts for 15%+ of GDP). The impact is being felt by large homebuilders whose confidence is at multi-year lows and whose stocks have been battered. While housing is even more important to Canada’s economy, we are currently enjoying much lower interest and mortgage rates which is a clear advantage for our market.

The just-released Fed minutes do not show a high likelihood of rate cuts in the next few months. They state: “In discussing risk-management considerations that could bear on the outlook for monetary policy, participants agreed that the risks of higher inflation and higher unemployment had risen. Almost all participants commented on the risk that inflation could prove to be more persistent than expected.” BMO Economics concluded three weeks ago that the Fed was ringing the stagflation alarm, and it appears that the inflation side is still more worrisome.

Stock valuations will matter again sooner than later

Rising 10-year interest rates directly impact the price of bonds as higher rates mathematically lead to lower bond prices. The longer the maturity² of the bond, the more pronounced the impact. They also have a significant impact on equity sector valuations and performance. It is well understood that rising interest rates have a nefarious impact on the performance of capital-intensive sectors such as Industrials, Utilities, Telecoms, REITs and even Technology (think of recent huge investments in data centers, AI chips, etc.) since: 1) their costs of funds go up when interest rates rise; and 2) it makes the typical dividend yield advantage of these sectors less attractive relative to bond alternatives. The other more important impact concerns the higher discount rate applied to future cash flows. This lowers the present value of future profits, impacting valuations.

As we have written many times, looking at valuations for stocks – or other asset classes for that matter – is a terrible timing tool. However, financial history has shown time and time again that being disciplined about the price paid for assets (having a “margin of safety” as Warren Buffet famously put it) is the best way to ensure an appropriate return for long-term investors. This principle applies as much to real estate as it does for financial assets such as bonds and stocks. The principal reason for this is that the stock market is inherently mean reverting, meaning that excesses to the upside or downside tend to be corrected with opposite reactions (think of an elastic band which is pulled too far and then snaps in the opposite direction).

However, the changing inflation and interest rate landscape provides some interesting geographic allocation opportunities. In Canada specifically, the market has reacted quite differently, posting far better median gains when interest rates were rising, likely because these periods coincided with inflationary pressure and associated strong commodity price cycles. We remind our readers that approximately a third of the S&P/TSX market capitalization is in the Energy and Materials sectors versus less than 10% in the U.S.

Canada: Still trading at an unusually steep discount to the U.S. based on price-to-earnings (lower) and dividend yield (higher)

We again turn to the relative value advantage of Canadian stocks vs. U.S. stocks. Yes, Canada has already outperformed the U.S. by 8% in the last year, but we still consider the current discount to be excessive not only relative to

history but also to the profit growth potential for a number of financial, industrial and natural resource industries. Compared to the S&P 500, the S&P/TSX Composite Index has both a lower price-to-earnings ratio (21.3x vs 15.8x) and a higher dividend yield (1.64% vs. 3.09%).

Technical analysis

The primary trend for equity markets remains bullish, accompanied by continued improvement in all of the indicators in our medium-term timing model. For example, weekly momentum gauges are now “4 for 4” bullish for both the S&P/TSX Composite and the S&P 500 after giving new buy signals in recent weeks – the first such combined buy signal since the 2022 bear market low.

Some of these indicators turned positive from the steepest oversold readings since the 2022 bear market low, so there’s plenty of room for them to move on the upside before they become any sort of headwind for equities.

Breadth indicators measure the quality of a market rally in terms of the number of stocks participating and we’ve seen some real improvement here as of late. Most advance-decline lines including the traditional NYSE A-D line as well as the S&P 500 A-D line have made all-time highs.

Historically, breakouts in these indicators typically precede breakouts in the S&P 500, so that sort of improvement bodes well for the index. That follows on the heels of the “breadth thrust” buy signal that occurred in late April. Recall that the seven breadth thrust signals since the credit crisis have resulted in an average 12-month gain of 35% for the S&P 500.

Last, but not least is sentiment. Surveys out recently were uniformly higher yet again, resulting in another solid uptick in our Composite Sentiment indicator.

This was the biggest four week change in this indicator since the markets lifted off from a medium-term correction in the fall of 2023 (i.e., risk appetite continues to build, which is bullish for equities).

In terms of upside potential, there are minor resistance levels along the way for the S&P 500, but the main level to pay attention to is its early 2025 peak at 6,147. A breakout there would shift the long-term trend back to bullish and open a new upside target that measures to 7,460. Here in Canada, the S&P/TSX Composite has already broken to a new all-time high when it closed above resistance at 25,875 in the last week of May. That breakout signaled a resumption of the long-term uptrend and opened a new upside target that measures to 29,523.

The one “bogy” that could throw our market call into question is the direction of long-term interest rates. The U.S. 10-year yield recently reversed a declining trendline drawn from the early 2025 peak. That reversal cleared the way for a challenge of the April peak at 4.59% (already done) and possibly even the early 2025 peak at 4.81%. The big problem is the impact that the recent surge in rates has had on our medium-term timing model. Weekly momentum gauges are giving new buy signals for the first time since last fall.

Since late 2021, these buy signals have resulted in an average move of 108 basis points over 14.5 weeks. Using the average, the measure from where the medium-term momentum buy signal occurred would give an upside target of 5.59% and that would be a massive headwind for equities into the end of the third quarter.

Central banks likely on hold a bit longer

For bond investors, all the noise around the trade and policy uncertainty has led to short-term volatility, but at the end of the day, it all comes back to two things: deficits and inflation. Large deficits fueled in part by an ever-growing debt service obligation, especially in the U.S. where interest costs now exceed defence spending, are getting a lot more attention. On top of this, domestic and globally high inflation currently fueled by the renewed U.S. protectionism keeps the prospect of stagflation³ alive, further adding to investors’ concerns.

As stated above, the U.S. Trade Court ruling on tariffs – while encouraging – only adds further to the uncertainty. It may alter the journey, but it does not necessarily change the expected destination. While lower tariffs could be positive for the economy in the short term, it would not necessarily lead to lower inflation and interest rates. Additionally, lower tariff revenues could limit progress on reducing the deficit, which would likely grow due to the impact of the One Big Beautiful Bill Act (the “Act”). The Act will likely be sealing a good part of the fiscal policy over the next decade, risking an additional US\$3 trillion in deficits and adds to the rapidly growing U.S. debt pile.

The Act still needs to be approved by the Senate by early July, a process that could be slowed down by the intervention of the more debt hawkish senators. The Act includes an increase in the debt ceiling and considering the U.S. Treasury is expected to have exhausted all its emergency funding measures sometime in August – reaching the US\$36.1 trillion limit – it will only add to the uncertainty over the summer.

This helps explain the recent move to higher rates in the fixed income market. First, stickier inflation is leading investors to re-assess long-term expectations embedded in the yield curve. Second, despite slower economic growth, the risk of large deficits is leading real yields and term premiums to rise. Finally, the inflation background and the trade uncertainty leave little room in the near term for the U.S. Federal Reserve (and many other major central banks) to ease policy, pushing market expectations for rate cuts in the U.S. to later in 2025.

The same could be said for the Bank of Canada. A recent uptick on core inflation measures is likely going to delay the next rate cut a little longer. More aggressive fiscal policies from the new Liberal government could mitigate some of the trade war impact on growth and add to the current inflationary pressures. When combined with the absence of clarity on Canada’s fiscal health (the next budget and fiscal update is expected in the fall), mid-to-long-term rates could continue to be under pressure, which supports a more defensive portfolio duration.

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



¹ A bond market investor who protests against monetary or fiscal policies considered inflationary by selling bonds, thus increasing yields.

² Effective duration is an approximate measure of a bond's price sensitivity to changes in interest rates. If a bond has an effective duration of 10 years, for example, its price will rise about 10% if its yield drops by one percentage point (100 basis points), and its price will fall by about 10% if its yield rises by that same amount.

³ Stagflation is a period in which a country's economy exhibits persistent high inflation along with high unemployment rates and stagnant economic growth. Tariffs are economically inefficient, theoretically increasing the probability of stagflation: costs generally rise which, in turn, move prices higher (inflation), applying downward pressure to economic growth. The most notable period of stagflation was in the 1970s, when oil prices skyrocketed and caused significant supply shocks (therefore increasing inflation), contributing to multiple recessions and high unemployment.

General Disclosure

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 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.