

Carol Schleif, CFA, SASB-FSA, Chief Market Strategist

## Resounding Resilience

*“When everything seems to be going against you, remember the airplane takes off against the wind, not with it.”*

– Henry Ford

Most global equity indices turned in a surprisingly robust performance in April despite the unresolved Middle East conflict. Transit of everything (including dry goods) remained at a virtual standstill in the Strait of Hormuz. Gasoline prices soared more than 20% – the biggest monthly spike in over 50 years – thanks to the closure of this mission-critical pathway that normally sees daily traffic of roughly 20 million barrels of crude oil and related products. Prices for key derivative products like liquefied natural gas (LNG) surged even more.

These sharp spikes quickly translated into higher headline inflation numbers and nearly universal handwringing among energy strategists. They have been predicting dire consequences because the knock-on impacts can potentially burrow their way deeper into core inflation readings. Decision makers at central banks heard the message loud and clear. They postponed talk of continued rate cuts until far into the future and formally debated the possibility of rate hikes if the Strait fails to open soon. Equity investors, on the other hand, missed the memo.

Instead of taking cover from the stormy fundamentals, stock indices of almost all flavours advanced during the month. The blue-chip-dominated S&P 500 rallied 10%; the Russell 2000, a yardstick for smaller companies, gained 12%. Although stock investors are wary of sustained high inflation, they are typically more mindful of factors that impact growth. Thus, they spent the month leaning into the continued potential that spending on AI and other technologies (e.g., robotics, cloud, cyber security and advanced manufacturing) might provide. It’s worth noting too that stocks can play a key inflation-hedge role relative to fixed income instruments (given the potential for growth in earnings and dividends).

The optimism re growth was evidenced by an uptick of nearly 15% in the NASDAQ (which has a disproportionately greater percentage of technology names versus other indexes). Semiconductor stocks (proxied via the PHYX Sox Index) advanced over 30%, including a record consecutive run of increases that

lasted more three trading weeks. Even an index of software stocks was up 5% (a nice rebound after the drubbing it took earlier in the year thanks to the release of new AI models). Despite the disproportionate impact of the Strait’s closure on the fortunes of Asia (the destination for most Mideast oil), South Korea’s tech-dominated KOSPI Index was 23% higher on the month; it’s now up 57% year to date and more than 150% over the last 12 months. The S&P/TSX, which has a notably lower technology weighting, advanced only 3.7% but is up more than 35% over the past 12 months. Bonds sat out April relatively quietly; yields ended within an eyelash of where they began the month, playing their role as ballast with reasonable alacrity.

## April showers bring early flowers

Solid earnings results at the start of the Q1 reporting season buttressed the more optimistic bias of stock investors. In the U.S., 63% of companies – including six of the Mag 7 names (Tesla, Apple, Amazon, Meta, Google and Microsoft) – have released their numbers. Aggregate sales growth is 11% while earnings advanced over 28%. The participation is spread broadly: eight of 11 sectors reported bottom-line growth of 10% or more. The better news is coming not only from tech but also from materials, industrials, and financials. Key themes there include resilient consumer spending; hearty capital markets activity (mergers and acquisitions, trading and debt issuance); growing backlogs and deliveries for key industrial and transportation companies; and better volumes for purveyors of consumer goods.

## Bottom line

Companies in aggregate are executing well despite (or perhaps because of) the repeated challenges thrown at them over the last few years. Just like sports teams tend to play better against a worthy opponent, the muscle memory honed from repeated

supply chain disruptions, policy changes and shifting trade and alliance relationships shows up in the data. Many policy changes (U.S.) and proposals (Canada) are also supportive. Case in point: in the U.S., immediate deduction of R&D expenses, reduced regulation in key industries, and broader tolerance for large M&A are goosing activity and facilitating growing backlogs, new orders and ever larger acquisition activities in a broad swath of industries.

## Industrial Revolution 4.0 – Transformational change is here

The launch of ChatGPT in November 2022 propelled a long-standing technology (machine learning) into hyper drive, similar to how the launch of the iPhone in 2007 made a largely stationary activity mobile. It's hard to remember the old days, before we had all that utility in the palms of our hands – even for those of us who spent a good chunk of our lives defining phone mobility by the length of the cord attaching it to the wall.

Despite the fact that AI gets top billing, it is just one of many rapidly advancing technologies (e.g., robotics, cloud computing, autonomous vehicles, enhanced automation) thrusting us into a new age. Employees, employers, managers, regulators and citizens have a great deal of work ahead to figure out how to engage with the tools. While hundreds of millions of individuals use AI agents on a personal level, corporate deployment is still in the very early innings. Process reengineering, compliance, record-keeping and legal requirements must all be factored into a technology that is evolving at an unprecedented rate – leaving regulators/laws scrambling to catch up.

Transformational change will undoubtedly transition major swaths of information jobs to machines as mechanized, routine tasks are offloaded. Housework was forever changed by the advent of washing machines, dishwashers and gas ovens. Now sophisticated, satellite-guided tractors can do the back-breaking farm labour that was once largely manual.

New jobs, careers and industries will be created. Yet, our linearly processing brains struggle to grasp what they might look like. Employment in select fields will be impacted (potentially threatening employment statistics, investor psyches and/or central bank plans) if job reductions are too aggressive. Canada's spring economic update (*Canada Strong for All*) calls for funding apprenticeships and retraining programs to help swell the numbers of increasingly critical workers and support transitioning of those displaced by technology's march. It references/plans for the need to invest in critical infrastructure to support intensified demand for computing power. In addition, policy makers must address the implications for the advancement of emerging economies: if we don't need access to cheap labor because we have humanoids, agentic AI, and automated factories, it may well change the location argument (and mitigate tariff, import/export duties, etc). All scary in scope, speed and scale – but likewise ripe with opportunities for those who lean in.

## Are we in a bubble yet?

Investors, too, are struggling to map out what the future holds – prompting considerable volatility in subsectors that may or may not ultimately be impacted (e.g., the aforementioned software index that did so well in the current month is down 18% year to date). Now that several of the biggest AI model creators are readying to launch initial public offerings (IPOs) later this year, the “all things AI” narrative is likely to continue – at least in the short term.

Recall that the dotcom bubble brought thousands of companies public, only to see thousands disappear when it burst. Though investor optimism and exuberant stock-price performance of many companies related to new technologies seems similar to that prior period, there are many differences too. From 1995 to 2000, untested companies spent profligately, hired extravagantly and crafted utterly untested business models. IPOs were coming by the dozens if not hundreds. Many had no earnings – some had no revenue – yet investors eagerly lined up to buy, hoping to get in early on the next 10-bagger (a stock that grows to be worth at least 10 times its initial purchase price). Traditional valuation metrics morphed into “per eyeball” or “per click” valuations to support the narrative.

While many high-profile companies from that day are gone, a handful remain, including several of the Mag 7 names that have been so influential on market performance in the past few years. It's actually quite amazing that a quarter century later several of those businesses have endured. Still more impressive: they are generating double-digit earnings and revenue growth with margins roughly between 30% and 40%. To date, the companies themselves are underwriting much of the amplified spending required to support data centre buildout – not stock investors via IPOs. Although some are starting to issue debt selectively, most have “fortress” balance sheets; some actually borrow at rates equivalent to or below those paid by the U.S. government.<sup>1</sup>

It's been more than 15 years in the U.S. and technically even longer in Canada since a lasting economic downturn occurred. Economic slowdowns historically followed the cyclical nature endemic in the more manufacturing-dominant system of the WWII era and provided an important opportunity to cleanse the system of excess, resetting it for continued growth. As economies shifted toward more information and services-based activities, however, the time between normal growth/pullback periods extended. This has tended to smooth the peaks and troughs but also allows potential excesses to accumulate. The time since the last sustained economic downturn juxtaposed against a burgeoning secular growth theme is taxing to investors wondering which side of the split-screen narrative will dominate. In April, the performance of capital markets encapsulated much of that struggle when investors' attempts to lean into the secular growth potential of advancing technology ran headlong into an unexpected social media post or evolving near-term headline.

From a macro perspective, the secular growth potential – and rewiring of virtually all areas of human/economic activity – is unlike anything we have ever witnessed both in scope and speed at which the technologies are being adopted. This presents compelling opportunity for growth-seeking stock investors. But it also brings risks since the speed and trajectory will prove disruptive for established companies/industries that don't keep pace. Eye-watering levels of investment are required to create/train AI models, buy the chips and establish the data centre infrastructure to house and support the whole system. Announced spend to date totals approximately three-quarters of a trillion dollars via just a handful of hyperscalers, and dwarfs what was spent to wire the internet, construct railways, or send humans into space. Those companies are spending like their very lives depend upon it – treating the whole situation like an existential exercise. Demand for construction materials, land, infrastructure and a host of other second- and third-tier (and beyond) knock-on effects adds to the potential – and investor complexity as the ultimate winners and losers are parsed.

At some point, arguably, spending must slow and/or there will be inevitable hiccups in actually bringing the intended capacity online. Investors may not have worked out how to handle that eventuality when it comes. They will need to realize a slowing in data centre spending will not equal a turnback in the technological momentum. The internet did not stop evolving when the dotcom bubble burst.

## The last word – Bringing it home

April's performance left global market averages once again in all-time high territory. Bonds remained relatively calm throughout, despite the fact that triple-digit energy prices drove headline inflation higher and central bankers to the sidelines, shelving any hope of near-term rate relief. The relatively unusual combination of factors has made investors skittish and anxious, forgetting that the typical trajectory of markets is up and to the right. New highs tend to beget new highs – provided fundamentals and valuations remain directionally appropriate. While valuations are full, market choppiness (especially through the first three months, including a near 10% pullback and significant corrections in individual stocks and sectors) and double-digit earnings increases are helping share prices grow into valuations. Plus, markets will begin to look toward 2027 earnings potential in the next couple of months – psychologically easing the earnings comparisons that much further. As Henry Ford noted, airplanes take off against the wind. That creates lift, which allows them to simultaneously move forward and skyward.

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



<sup>1</sup> *Why Microsoft Has Lower Borrowing Costs Than the U.S.*, The Wall Street Journal

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