Maintaining a Long-Term Perspective

Client Conference Call Transcript – Tuesday, March 3, 2020

The following is a transcript of the March 3, 2020 BMO Wealth Management conference call featuring BMO-resident experts who provided their insights on recent events, their impact on markets, and their longer-term perspectives.

Stéphane Rochon

Managing Director and Equity Strategist, Portfolio Advisory Team
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Welcome everybody.

Now, clearly, it has been a very volatile two weeks in the markets, to put it mildly. We had a big rebound yesterday. The Federal Reserve cut interest rates by 50 basis points in a very rare inter-meeting move; you'll hear from Doug Porter about that in just a moment.

Things are turbulent out there, and all eyes are on the so-called coronavirus, or COVID-19, which has spooked investors. Well it spooked a lot of people for good reason. Now we want to kick off the call by confirming that we are not health experts, we're not scientists, we're not doctors.

The purpose of this call is really not to try to predict the ultimate containment of this coronavirus, but rather to give you some perspectives and historical context, and also some portfolio and risk management advice in terms of navigating these turbulent times.

Generally speaking – and I'm starting with the punch line here – we never advise to sell in a panic, and history backs us up on this. I'll give you more details in just a moment. But holding a well-diversified portfolio with quality stocks, bonds and a cash position is always your best defense against bouts of volatility like this, and we have seen a number of them in the past.

The most important thing we can tell you is to contact your BMO financial professional. They are well-equipped to provide advice tailored to your needs; address liquidity needs and manage risk, which is obviously very relevant in times like these.

Without further ado, I'm very pleased to introduce our speakers for the call. First up is Doug Porter, Chief Economist at BMO. He'll give you some much needed macro perspective. Following Doug will be Lesley Marks. She's the Chief Investment Strategist at BMO Private Wealth. And, I'm an Equity Strategist with BMO Nesbitt Burns' Portfolio Advisory Team. I will close the remarks after Doug and Lesley.

Doug Porter

Chief Economist and Managing Director
BMO Financial Group

Thank you and good afternoon everyone.

It's already been an interesting and eventful day in financial markets, after an eventful couple of weeks. Today the Federal reserve cut its key lending rate 50 basis points…unleashing its first intermeeting rate move since the fall of 2008.

The fact they cut rates – and cut aggressively – was not a complete shock, especially not after they signalled some sort of action late last Friday. But the timing was a mild surprise … it's not obvious that the surprise worked in their favour. We will hear as well from the Bank of Canada tomorrow, at their regularly scheduled meeting --- most are now expecting a similar 50 bp cut by the Bank at 10 am, and we lean to that view as well.

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Of course, as recently as 10 days ago, financial markets had expected perhaps one 25 bp cut by both central banks at some stage much later this year... and certainly not a half point cut immediately. What changed are signs that COVID is clearly spreading beyond China in a meaningful way, especially in Italy, Iran and Korea. Previously, most analysts had seen this as a growth dampener on China mostly, and on commodity prices, but not on the global economy more broadly. But the wider spread of the virus, and the response to that spread has prompted a change to the outlook for other economies, markets, and the policy outlook.

For instance, we have revised our forecasts in the past week, assuming that we will get a limited outbreak in North America and the rest of Europe... and we will continue to re-assess as conditions change. For now, we have trimmed our estimate of global growth this year by a further ¼ ppt to 2.4%... that's down from 2.8% last year, which was already a below-average performance (due to the trade war). We judge a "normal" year for the global economy to be growth of about 1 ppt higher than this year's estimate.

The U.S. economic growth outlook was cut by 3/10ths to 1.5%. That's about half of the pace that the President has been aiming for, and compares with 2.3% growth last year. For Canada, we think the impact will be a bit more negative, mostly because of the related weakness in commodity prices, and the added small negative of the recent rail blockades. As a result, we have cut our call on Canadian growth this year by half a point to 1.2% --- that's a bit below population growth, and is expected to be weak enough to push up the unemployment rate somewhat (albeit from 45-year lows).

Such growth downgrades are a reason why the interest rate outlook has changed so abruptly. But clearly, interest rates were not the impediment, or hurdle, to growth. Even before this week, we were looking at the lowest long-term government bond yields on record in the U.S., and their 10-year yield dropped below 1% this afternoon for the first time ever ... at least temporarily.

Monetary policy and interest rates cannot fix the underlying economic problems caused by the virus. As many have noted, the initial effects of the virus are on the supply side...factories and workplaces are closed, supply chains get disrupted, and some workers simply can't go into work. There's nothing that interest rates can do to fix this. But, there are then second round effects, where people may be reluctant to spend, especially if financial markets are volatile, and there is uncertainty over the outlook... and this is where policy can help soften the damage, whether through lower interest rates or stimulative fiscal policy.

Having said that, today's sour market reaction to the Fed's aggressive rate cut is interesting, and reinforces the point that this is not really a job for central banks. The reaction may also have reflected a bit of concern that the "Fed knows something we don't" ... I don't believe that is really the case. It's probably more the recognition that lower interest rates can only accomplish so much in this very unusual situation. Still, interest rates may yet go lower still in the months ahead, as policymakers will do what they can to support the economy and financial markets.

This whole issue arises at a very delicate time for Ottawa too – the Federal Budget was expected later this month, and Finance Minister Morneau will be speaking at the Canadian Club on Friday morning in Toronto. He has already warned that COVID presents a downside risk to the domestic growth outlook. We had been expecting a generous budget in any event – with an increase in spending and higher deficit – and this downside risk to growth reinforces that view.

It's not clear what form any new fiscal measures may take, but it would seem that a direct tax cut/rebate would be the most effective step to support spending at this point. Probably more likely will be a ramping up of some temporary spending measures by Ottawa. While the budget deficit was already poised to hit $28 billion in the coming fiscal year, Canada arguably is still in better position than most to provide some stimulus, as our combined deficits are less than half of those in the US at the moment.

The main takeaway is that, clearly, the near-term downside risks for the economy have risen, and the outlook is less certain than unusual given the unpredictable nature of the COVID threat. But we do believe that the downdraft will be relatively short-lived, and that the economy will be on the mend in the second half of the year, supported as well by lower interest rates and fiscal stimulus.

With that backdrop, I'll now pass the call over to my colleague, Lesley Marks.

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Lesley Marks
Chief Investment Strategist
BMO Private Wealth Canada

Thank you, Doug, and good afternoon.

What I'm going to talk about today is just a little bit more on the asset class impact and what we've seen, particularly in the context of equity markets versus bond markets.

Our equity markets are broadly responding to the expected slowdown in global growth and a decline in sentiment. And, of course, reading about the Coronavirus in the media and every move, in every virus case that we're seeing beyond the borders of China is not helping from a sentiment perspective.

I would classify the fears that are infiltrating the markets into four categories. The first one is probably the most obvious and one that was really driving the Chinese markets, which was the disruption of global supply chains. The second being speculation around consumer activity, which Doug mentioned; this idea of consumer confidence and people not feeling confident to spend or to travel or to do things like eat in restaurants. And then, in turn, economic growth will decline, and then this will cause corporate profits to evaporate.

We are starting to see these four fears being discounted into markets quite heavily. When you look at the speed and the magnitude of the recent selloff in—particularly North American markets, but U.S. equities in particular – we have not seen a selloff like this at this speed and size other than in other major events in history, such as 9/11, or the crash in 1987, and the long-term capital demise in 1998. These are examples where we saw a major event occurring which filtered through into our equity markets.

In this case we would describe coronavirus as more of an exogenous shock, not necessarily financial related, although the Fed is probably recognizing that this could become a financial mishap if growth declined substantially from the expectations, which were already quite modest as Doug noted.

It's also interesting to think about the context of U.S. equities in comparison to Canadian equities. Canadian stocks have not corrected to the same extent as U.S. stocks, and as the virus continues to make its way through the developed world, we would expect that to continue to be the case, largely because of the construct of the Canadian stock market. Our stock market does not have the heavy exposure to high growth technology shares that you see in the S&P 500, and some of those high growth stocks have been the hardest hit due to their high valuations.

The Canadian stock market is also more exposed to the gold sector. Gold has been the one standout commodity, rallying almost 10 percent since the start of this year as demand for safe haven assets has increased, similar to what we've seen with bonds, where yields have hit record lows and they continue to benefit from the flight to safety trade.

It's important to recognize that when investors have let their fears dictate their strategy (i.e., their trading strategy), to Stéphane's earlier point in his introduction, and are guided by their emotions – thus exiting the market – market timing strategies such as these tend to have a devastating impact on their long-term return profile.

If you missed the 10 biggest return days for the TSX, your long-term compound returns would be cut in half. Obviously, it's very difficult to time markets, on the exit and reentry points, particularly when the biggest up days tend to be during the most volatile periods. And, I think Monday was a case in point on that front, with the biggest point move ever for the Dow, which moved more than a thousand points.

It's very important that you revisit your long-term wealth plan to ensure that how you are aligned with your investments today is in line with that plan and stick to that plan in times where emotions are running high. And, as I said, the media is certainly our own worst enemy given the focus on all of the events and machinations to do with the movement of the virus through countries and through individuals.

I think the important catalysts to watch for to indicate a bottom are, first, the perception forming that the spread of the virus has peaked or has been curtailed. I would direct you to look at what's been happening with Chinese equities in the face of the

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large drawdowns that we've seen in the developed world. In fact, the media has not focused on the statistics coming out of China where the number of cases being reported, new cases, is actually less than those that are cured. The Chinese stock market was actually up quite strong in February, certainly before the last few days when all equities around the world were selling off.

We believe that this will be an important catalyst to bring stability back into the market.

The second important catalyst, and I think we've already seen some evidence of it, is related to the policy decisions that will be and have been put in place to cushion the blow to global economies. So, not just lowering of interest rates – as we've already started to see and will continue to see in the U.S., Canada, Australia, and China – but also spending on the fiscal front in other economies where lowering rates may not be an obvious tool because rates are already on the negative side. But also things such as quarantine decisions and travel restrictions will impact the path for the virus and in turn riskier asset classes such as equities. We will continue to watch policy decisions not just on the monetary front, but also on the fiscal side and containment efforts.

The bottom line I would leave with you today before I turn it back to Stéphane, is related to our view on adjusting portfolios. To date, we have not made any adjustments to portfolios. We believe that this continues to be a transient issue in the market and may last one to two quarters without significant long-term impact. Of course, that is subject to change, especially if things play out differently with respect to the speed and the magnitude of cases in the developed world.

We believe that it's too early to fully understand the full economic impact of the virus, but at this point we continue to focus on this being more transient in nature.

At this point, I will turn things back over to Stéphane.

Stéphane Rochon

Managing Director and Equity Strategist, Portfolio Advisory Team
BMO Nesbitt Burns

I really want to touch on three points. I want to talk a little bit about history for context. I want to talk about very low interest rates, because that is critical at this juncture. It is, in my opinion, probably the most important macroeconomic variable right now to explain the future performance of securities markets, bonds, obviously, but also the equity markets. And then just talk about certain areas that are becoming interesting, because obviously value is being created in the markets. We're not here to say you must run out and buy, put all your money in stocks tomorrow, that's not the way bottoms are made in the markets. However, certain opportunities are definitely starting to show up.

Let me start with history. If we look at some of the more recent pandemics, Avian flu, SARS, H1N1, Ebola, all pretty sinister stuff; but if you look at the market performance after the initial shock was digested by equity markets, invariably, six months later the market was actually higher. In the case of H1N1, up by 25 percent, because this was after the financial crisis, so the markets were rebounding anyway. You can take an even longer term view and go back to the panic of 1907, and here we're not talking about epidemics, we're talking about armed conflict, we're talking about political events. And all those fall in the grand category of exogenous shocks. What's kind of interesting, if you look at this list and if you look at the performance of the market after the initial shock, or if you will, the initial drawdown in the market, a year later, in almost every case, the market was higher and in many cases substantially higher.

The few exceptions to this rule were when the economy was going through a recession. And that's why it is so important to keep our eye on the probabilities of recession. We just heard from Doug, who said that growth will take a hit, undeniably. Globally, growth will take a hit, but we're not talking about a recession right now. In our own models, where we use variables that have proved themselves to be very predictive of a recession in the next six to 12 months, they indicate a lower than 40 percent probability of recession in the next year. That gives us a little bit of comfort because, again, what we're really worried about are not 5 percent or 10 percent corrections, even though they're painful, what we're trying to avoid and to help our clients with is avoiding those 20 percent, 25 percent drawdowns in the markets, which tend to happen around recessions, almost exclusively.

The conclusion here is that yes, COVID-19 is getting a lot of headlines right now. But the most important driver for stocks – and for stock returns - is the economy, and where we are in the business cycle. And, this brings me to my second point on interest rates, and the fact that interest rates are extremely low. As Doug said, we just went below one percent in the U.S. for the first time ever. I think the irony here, even though by historical standards those are very, very low interest rates; but by global standards North American interest rates are actually pretty high. So when you hear Donald Trump criticizing the Fed and saying cut rates, cut rates, he may or may not be right about that, but he does have a point in the sense that interest rates are lower elsewhere. When I look at developed countries like Japan, or Switzerland or, virtually all of Continental Europe, their interest rates are actually negative and real interest rates, if you subtract inflation, are negative pretty much across the board.

Now what does that mean? Why am I delving so much on interest rates? It is critical to the relative value of stocks because you have a choice. We all have choices as investors. You can put your money in a one percent coupon 10-year bond, or you can turn around and buy a high quality company that has, let's say, a 3 percent dividend yield, and that dividend is actually growing by 8 percent to 10 percent a year. Not every company is like that obviously, but our job is to try to identify companies like that. Pipeline companies in Canada are a good example. You also have some healthcare stocks. In the U.S, I'm thinking of Medtronic and others like Bristol-Myers. These are just examples, Blue chip examples of stocks that appear attractive to us. Clearly, you'll need to consult your financial professional based on your investor profile. But, in my opinion, if I look at the relative value of equities, it is very, very good, even though we're not that far from record highs, and that has everything to do with low interest rates.

The other advantage of low interest rates, obviously, is that it is very supportive for housing, and housing was already recovering very strongly in most parts of Canada and in the U.S. So, this rate cut and the associated decline in long-term interest rates has to be supportive for housing as well. And housing is not trivial. It represents 25 percent to 30 percent of GDP in North America, if you include the ancillary services. And, it is a big source of wealth. So, clearly, housing matters and it's going to be supported by these lower interest rates.

One quick point as well. I wasn't particularly shocked that the market went down despite the interest rate cuts. The thing we need to remember is that after a cut in interest rates, there is a lag effect between the actual cuts and when it has an impact on the real economy, and that lag can be between 12 and 18 months. It's not something that's going to show up right away. It will show up in lower prime lending rates and it also increases the fair value for equities. Our historical work has shown pretty clearly that when we're in this range of interest rates, the S&P 500 has had an average annual performance of over 16 percent.

History is on your side from that perspective, if you can just look through these very negative headlines on the coronavirus. But the bottom line, based on our perspective, is that it's the business cycle that matters. The low interest rates make equities more attractive, they encourage consumption, and they also increase the net worth for households. So, if you look at the net worth in the U.S. and in Canada, despite certain negative headlines, they are at record highs currently, and that is encouraging from our perspective.

That's why it's important to maintain a diversified portfolio and be able to ride out these bouts of volatility without selling in a panic. As Lesley put it very well, that can have disastrous consequences when you sell at exactly the wrong time and don't benefit from the rebound that's coming. We're not trying to be rose coloured optimists here. There will be a recession at some point. We just don't think it's in the near future. These interest rate cuts that just happened today, for example, while they don't have a significant direct impact on the market right away, what I think it does is increase the stimulus and could in fact prolong the recovery. So, it delays a recession, if you will.

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From that perspective, and as I look at our models and the broader market, including the bond market and the equity markets, we see a big valuation advantage for high quality stocks at this point.

In summary, the coronavirus is worrisome. It is contagious and it will have an impact on growth, but not enough at this point to throw the North American economy into a recession. However, the cornerstone of our call is to tell you to stay invested in high quality equities, within a diversified portfolio. At times like these, it's actually extremely important to contact your BMO financial professional and to review your financial plans, especially in periods of volatility.

We thank you all very much for joining us.

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