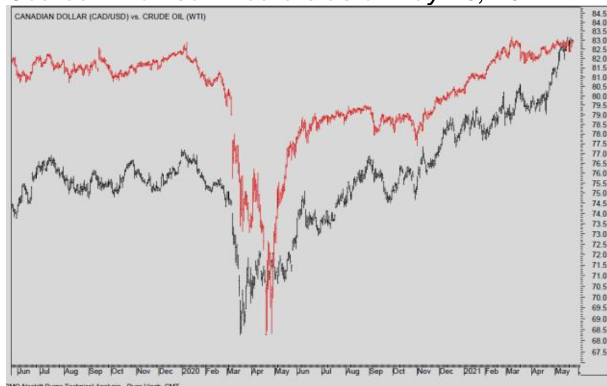
Portfolio Management
Monthly update

May 2021

Booming Earnings for Reopening Companies

Weekly Chart CDN$ vs. Oil
Loonie: black, crude oil: red
Source: Thomson Reuters as of May 26, 2021



Highlights

- **Inflation the biggest worry-hitting growth stocks**
- **Huge earnings growth especially in reopening companies**
- **Volatility enabling great buys on pullbacks**
- **Big drop in Chinese credit stimulus- lag effect**
- **CDN$ rising with energy & other commodity currencies**

Massive Sector Rotation, High Valuations, Jumping Inflation & Heading into the Seasonally Weaker Time of Year - Certainly, lots to worry about these days. We need to address each of these issues and put it all together to navigate the second ½ of the year.

Earnings versus Inflation - US April CPI rose 4.2% over April last year, the biggest increase since September 2008, causing the S&P 500 to drop 2.1% the day of the release. (BMO Economics May 14). Escalating Post Covid demand pressure hit supply chains causing disruption. This huge increase was coming off the big drop from the shutdown last April, so it won't likely be repeated, but easy money and stimulus spending are likely going to last longer than necessary while unemployment remains high. BMONB Economics raised their US inflation estimates to 2.8% from 2% for 2021 and to 2.9% from 2.6% for 2022. We are also seeing inflation in the service-sector as pricing rebounds off the floor. Core CPI was up 3.0% in April year over year, the fastest clip since December 1995. BMONB raised their U.S. core CPI forecast to 2.8% for 2021 (previously 2.0%) and 2.9% for 2022 (from 2.6%).

Brian Belski, our chief strategist, noted that rising inflation & interest rates aren't so bad for stocks if earnings are strong. He is revising up his 2021 & 2022 earnings estimates and targets in his recent US Strategy Snapshot: **"***As the economic recovery gains steam, **earnings have far exceeded expectations** this year with S&P 500 companies posting record levels of EPS growth, surprises, beats & raises. It has become clear that our original 2021 EPS is too low despite being on the higher end of forecasts when we initiated it back in November. **We are raising 2021 S&P 500 EPS target to $190 from $175, up 8.6%.** We are also increasing our 2021 year-end S&P 500 price target to 4,500 from 4,200, 7.1% increase & assuming price multiples will remain above-average amid still historically low interest rates. The P/E on our new targets is marginally lower 23.7x vs. 24x- given inflation concerns & the time it typically takes for PEs to compress following prolonged peaks.***"**

Since Earnings are so important comments from Robert Kavcic, a Senior Economist at BMO are also useful. **May 7, 2021 Quiet Earnings Boom: Is It Enough?** *"Questions about excessive froth are mounting. But, there's a quiet boom in corporate earnings which is helping to at least partly justify the market's recent moves. Of the S&P 500 firms reporting their Q1 results, an impressive 87% have topped analyst expectations according to Refinitiv's tally—that's more than 10% above typical norms. And, the surprises have been relatively widespread across sectors, with technology, financials & consumer discretionary all witnessing more than 90% of companies top the mark. Further, the average surprise factor across all industries is running at a hefty 22%.* ***S&P 500 profits have now jumped 46% y/y****. 2 reasons why market may go sideways instead of down.*

1.Expectations for Q1 at the start of the year were only for 16% growth y/y, vs 46% results. *So, where does that leave equities? For one, it helps justify the run we've seen over the past 6 months, keeping in mind that the market is always moving ahead of the news. The forward PE on the S&P 500 is elevated, now sitting at about 22x forward consensus. That is up from about 18x pre-COVID, but it's little changed over the past 8 months. There was a sharp re-pricing through the early stages of the pandemic, but now it looks like underlying earnings are carrying a lot of the load again.*

2.Does that repricing just reflect the drop in long-term interest rates and easy money? *The spread between the S&P 500 forward earnings yield & 10-yr Treasury yields has tightened considerably but is not pushing beyond past-decade readings yet. That said, at just over 3%, it is at risk of falling through the lows set in early-2018. That was the richest level of equity valuations vs Treasuries of the post-financial crisis cycle, and the S&P 500 subsequently went sideways for 2 years. Perhaps that's one reason why stocks initially reacted positively to a much weaker-than-expected payrolls report (and drop in Treasury yields) recently."*

RBC's Macro "The Big Picture" May 21 noted that **Chinese credit has fallen 60% since the January 2020** pandemic peak. Chinese spending has a big effect on inflation; they consume about 60% of global base metals for example. The Chinese see little reason for massive stimulus now as their economy has rebounded as consumers are confident enough to attend movie theaters in greater numbers than before the pandemic. The U.S. may be the biggest inflation driver with massive stimulus spending continuing. Many countries are talking about paring back stimulus and with massive amount of debt everywhere, even small rate increases will slow inflation.

Sector Rotation Continues

When the S&P fell 2.1% on the inflation news release there didn't seem to be any inflation-hedge asset classes working, with almost all pockets of the equity market down, even precious metals. Zooming out and looking at this week's action overall might give us some clues about what won't work in an environment of ramping inflation concerns, and what might hold up better. On the downside, U.S. technology lost 2.2% on the week, and might be most exposed given richer valuations, and the need for low interest rates to discount earnings that are more highly tied to future growth. Consumer discretionary also struggled on the week, down 3.7%, likely since it just had a big run up. Safe heaven consumer staples held up.

The dramatic sector rotation out of the "stay at home" theme to the back to work & play them has continued. The TSX and Dow Jones indices representing more traditional value, cyclical and back to work companies are both up over 9% this year, while the Nasdaq is down over 3%. This understates the difference however because the Nasdaq is dominated by Amazon, Microsoft, Apple & Google which have held up quite well. The big drop has been in high growth very expensive tech and online stocks such as Draft Kings, Pinterest, Teledoc, Square, Fastly, etc down 30-50% (and these are the good companies!)- they still look interesting once prices stabilize. Alternative energy companies such as Ballard Power and the solar ETF TAN are down even more in the 40-60% range. Although they were expensive, the severe drop is somewhat surprising given the number of new funds & ETFs in the sector which increase demand. It seems the growth at any price as a trade is done.

We will revisit the high growth space when earnings catch up to the reduced valuations and volatility subsides.

Value stocks such as financials, materials & consumer discretionary companies are still creeping higher since reopening is a huge boost to their earnings. Many of these have had a big run but still look interesting on pullbacks. The energy stock rally although very strong has lagged energy prices dramatically. Although not the sector it was, we still see big gains ahead as the world needs oil & gas for several more decades at least.

We like consumer discretionary stocks as the economy recovers and house bound consumers release pent up demand. Home prices saw the highest growth in 15 years in the US. This really supports home furnishings & car sales due to the wealth effect- helping stocks like BorgWarner & Linamar. We bought Disney on a pullback since a huge % of their earnings is theme parks which are reopening. We have also been buying CNR after the big drop on the KSU bid, since transports will be strong and CNR is the most efficient railway in North America. We like to buy high quality stocks on pullbacks as we did with Costco, Nvidia and Visa in the last few months. Canada is lagging the US on reopening giving US a chance to continue to buy Air Canada below the valuation of US airlines.

Health care stocks have generally lagged, falling between growth and the strongest reopening plays, but medical devices companies such as Medtronic should have great earnings growth off a low base in the next year.

AT&T looks very interesting as a turnaround; the dividend will be dropping to about 4.5%, still great for registered accounts with no withholding tax. The Discovery entertainment spin off is already generating more shareholder value.

The Canadian Dollar has had a big run, where to from here (BMO Economics May 20). The loonie is the best-performing major currency so far this year, despite the U.S. dollar's firming trend in Q1. This reflects rising commodity prices, an improving balance of payments situation (best since 2008), along with the Bank of Canada's less dovish shift in forward guidance and QE.

BMO Economics looks for the Canadian dollar's rise to continue, particularly with the U.S. greenback likely back on a weakening trend, **averaging above US$0.83 by the end of this year and $0.851** by the end of 2022. Greg Anderson of BMO Economics commented on the outlook on a podcast titled "**Muddied Waters Run Deep"** : *"The Canadian $ reached a new cycle high against the US breaking resistance at $.833 May 7th I don't think this is about the outlook for the Canadian economy. Rather, this is a delayed FX market reaction to this year's commodity price rally. That rally benefited commodity currencies in particular. The Canadian $ leads the G10 with a 5% rise on the year, the Norwegian Krone + 4%, then Aussie & Kiwi up 2% & 1% respectively. The main reason for the strength is* ***the remarkable turnaround in Alberta,*** *with WCS crude averaging over $50 a barrel lately. If that is the new equilibrium for WCS, then it should move the dollar Canada above $.84 US. We should see a catch-up rally in the lagging commodity currencies like Aussie & Kiwi, as well as the Mex peso."*

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We have increased Canadian investments in the last 4-6 months as the TSX finally outperforms the US indices. We will still keep large US exposure since that is the home on many of the world's best companies and many have global currency exposure.

Barron's 100-year Anniversary. Our Favourite research periodical deserves highlighting a few standout reports.

1920- Charles Ponzi's schemes crumbled under the scrutiny of Clarence Barron, who went on to found Barron's a year later.

2001- Barron's questioned the lack of transparency from hedge fund manager Bernie Madoff.

2008- Baron's warned readers about a possible financial crisis, specifically highlighting Fannie Mae & Freddie Mac.

2019- Baron's called attention to the transformative power of Moderna & its mRNA technology.

Regards,

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Monthly updates also available on our website at https://nesbittburns.bmo.com/don.behan/page_80889

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