Portfolio Management

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A New Hope

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Potentially Slower U.S. Interest Rate Increases and Emerging Market Outperformance Are Good Omens

After a year where not much went right for Canadian investors (with the S&P/TSX Composite down ~12%, and even the mighty S&P 500 down ~6% in U.S. dollars), they can easily be excused for taking a "glass half empty" outlook. The list of negatives is long. U.S. President Donald Trump is becoming more isolated and unpredictable, trade wars are weighing on corporate sentiment, the Brexit process continues to fumble along, and economic momentum has slowed, to name just a few of the issues that have alarmed investors. But those negatives are well understood and priced into the market, in our view.

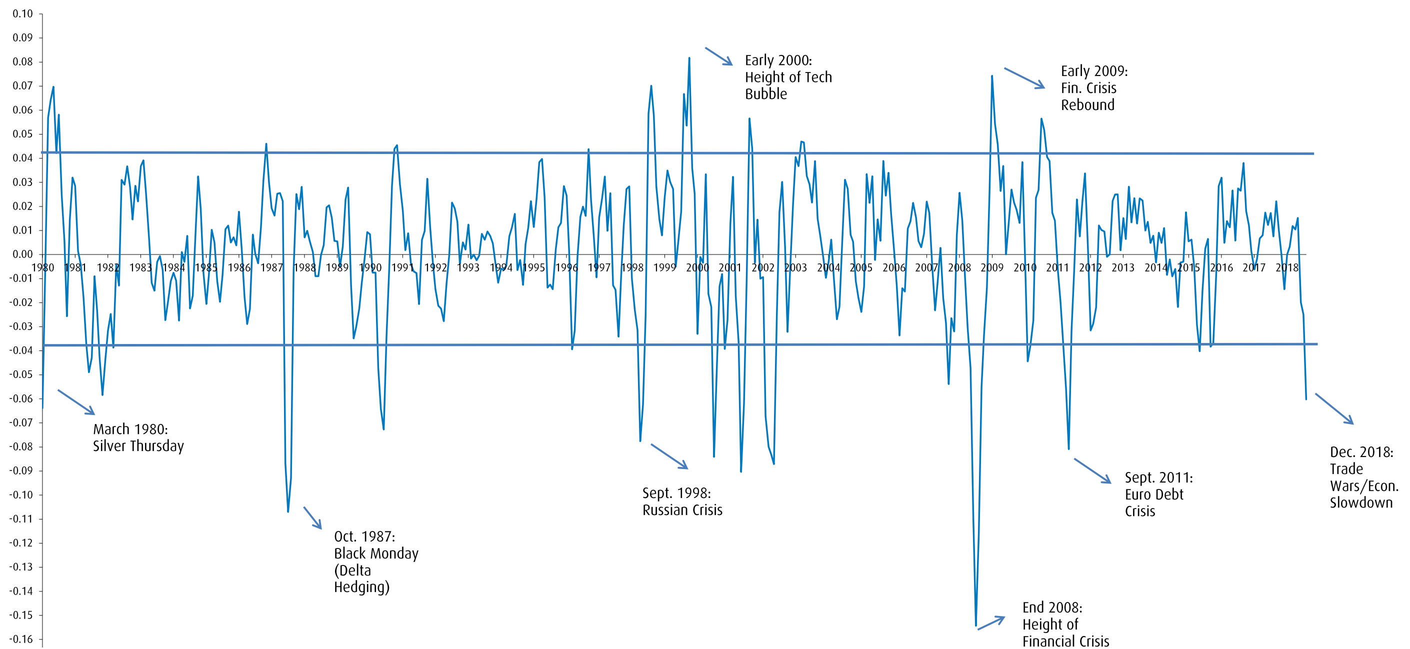
So what could go right? First and foremost, and at the risk of sounding like a broken record, our models still show a low probability of recession in the next year. This is a critical point, as the vast majority of market pullbacks of more than 20% in the last forty years have been associated with recessions. Also encouraging is that we are seeing Emerging Markets stocks starting to outperform. This is a good omen given they tend to be leading indicators of global growth, and since they are highly correlated to the TSX (i.e., they tend to move in the same direction). BMO Chief Economist Doug Porter notes a number of other recent positives which have served to calm the market somewhat. "First, it was announced that China/U.S. trade talks would resume in earnest this week, and China cut its reserve requirements for banks. As well, oil prices continued to forcefully recover on supply restraint from OPEC, rebounding 15% from last week's depths. Next, the always important U.S. jobs report calmed growth concerns with an emphatic show of strength in December, replete with a 312,000 payroll gain and a cycle-high 3.2% year/year wage gain. Finally, Fed Chair Powell suggested on Friday that the Fed is indeed sensitive to the market's message, that rate hikes are not pre-set, and that they could adjust the balance sheet unwind if it truly is causing the market stress."

Our message to investors since early 2018 has been to get more defensive in their equity exposure and we continue to advocate conservatism in the short term. Still, with so much value having been created so quickly in the stock market (with several high quality stocks now yielding over 3%), we strongly feel that now is not the time to sell core holdings. Quite the opposite in fact. We believe now would be a good time to sharpen pencils and build a shopping list of companies with strong competitive advantages (our readers know that we love investing in oligopolies such as railroads and pipelines), excellent balance sheets and superior dividend growth potential.

We fully agree with the old Wall Street adage that hope is not an investment strategy. Still, looking back at several economic and market cycles, we can't help but take a contrarian stance and look for potential positives when panic sets in. And make no mistake, our proprietary BMO Risk Appetite Index – which measures the relative performance of risky assets (stocks, High Yield Corporate bonds) to safe assets (U.S. and Canadian

Government and Municipal bonds – shows that the level of loathing for stocks has not been this high since the European debt crisis of 2011. Given the market is inherently "mean reverting" (meaning it moves sharply in the other direction when we reach oversold or overbought extremes), we think this is a good contrarian indicator and that stocks are setting up for a powerful rally in the not too distant future.

Risk Appetite Index is firmly in the "Panic Zone" – This Has Historically Been a Good Contrarian Indicator



Source: Bloomberg, BMO Nesbitt Burns

Our technical analyst, Russ Visch, states unequivocally that, "It was no doubt an ugly end to the year but there are some constructive takeaways from the action in December. For example, in terms of the price damage from the decline in the S&P 500 into the lows on the 24th, it is basically exactly in line with prior cyclical bear markets. Historically, cyclical bear markets in the S&P 500 within bigger secular bulls tend to last about six months on average with losses averaging 21%. As of today, the S&P 500 is down 20.2% peak-to-trough over the past three months. Using that as our guide most, if not all, of the price damage is baked into the market. Note that in cyclical bears, the price damage occurs early. The remainder of the time is the repair process – i.e., the "low, rally, re-test" bottoming sequence.

More importantly, though all of our medium-term indicators, which measure 3 to 6 month trends, are now as bad (or worse) than they were at the lows during the 2011 and 2015 cyclical bears. In fact, some of them have actually begun to turn positive again, further evidence that the worst is now behind us. If history is any guide then most, if not all, of the price damage is done. We still expect another test and perhaps a slight undercut of the late December lows, but at this point investors should begin to shift their focus away from selling strength towards buying weakness.

Going forward, investors should be preparing to accumulate stocks aggressively into a cyclical low in the weeks ahead because during the last two cyclical downturns (2011 and 2015) the S&P 500 broke into new all-time highs above those bear market peaks less than 12 months later. Additionally, the average gain for the S&P/TSX Composite in the 12 months following the bear market lows in 2011 and 2016 was 25%. The average gain for the S&P 500 in the 12 months following those bear market lows was an astounding 32.5%!"

Please contact your BMO financial professional if you would like to discuss your invesment portfolio.

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