The **Neil Beube** Brief

Are We There Yet [1]

November 2022

You can keep asking but that won't get us there any quicker…

Global equity performance was mixed this week with stocks whipsawed by a slew of central bank announcements, economic data and other market developments. The central bank calendar certainly had a busy start to November, with the Fed taking top billing on Wednesday, raising rates by 75 bps for a fourth straight meeting. While Chair Powell suggested the pace of hikes could slow, he importantly noted at the press conference that the Fed may have to lift rates higher than previously expected, taking some wind out the equity market's sails. Friday's jobs report also provided a bit of a head fake following mixed results from the establishment and household surveys. Payrolls were up, but household employment was lower, pushing the unemployment rate higher (first, the good news was bad news, then the bad news was good news). In any event, we now expect an additional 25 bps worth of rate hikes out of the Fed compared to our previous call (so 100 bps more to go, instead of 75 bps).

When all was said and done, the S&P 500 finished the week 3.3% lower compared to last Friday, snapping a strong run in the back half of October. Sector-wise, energy led the few areas that managed to remain in positive territory, though they were handily offset by big declines in telecom, tech and consumer discretionary.

North of the border, the TSX also declined, but to a lesser extent, dipping 0.1% from last Friday's close, supported in part by renewed strength in oil prices (WTI surged above $92 for the first time in about a month) and the government's moderately positive fall fiscal update. Here, energy also stood out to the upside, balanced out by a large decline in tech and moderate declines in consumer sectors, utilities and materials.

Some other developments moving markets this week included Russia's sudden return to the Ukraine grain deal, which eased some worst-case scenarios for food inflation, and rising optimism over China's potential reopening strategy. The latter lit a fire under Chinese stocks, helping the CSI 300 and Hang Seng notch their best weekly gains since July 2020 and October 2011, respectively. That said, the two indices are still well below recent peak levels and are coming off multi-year lows (multi-decade for the Hang Seng!).

In any event, the enthusiasm didn't last in Japan, with the Nikkei erasing most of its gains for the week by Friday, finishing up just 0.3% as the finance minister warned on the potential fallout from U.S. inflation and changes in monetary policy. While the BoJ-Fed policy gap has been one factor affecting the ailing yen, which flirted with ¥150 in recent days, the currency did manage to find some traction by the end of the week.

Over in Europe, UK stocks rallied on Friday, with the FTSE 100 closing 4.1% higher for the week—its third straight weekly uptick—as domestic equities took the Bank of England's 75 bp rate hike in stride. Despite the upsized policy move, positive investor sentiment was prodded by the Bank's dovish tilt, with further extreme rate increases less likely given the precarious economic backdrop. Still, with headline inflation running at over 10% y/y and core crackling at a multi-decade high, the simple answer to 'are we there yet?' for the conclusion of rate hikes is likely… No.

Market	Returns YTD*	Oct*	YR/YR*	2021*	2020*	2019*	2018*
S&P/TSX	-8.47%	5.32%	-7.66%	21.74%	2.17%	19.13%	-11.64
Dow	-9.92%	13.95%	-8.62%	18.73%	7.25%	22.34%	-5.63
S&P 500	-18.76%	7.99%	-15.92%	26.89%	16.26%	28.88%	-6.24
NASDAQ	-29.77%	3.90%	-29.10%	21.39%	43.64%	35.23%	-3.88
FTSE 100	-3.93%	2.91%	-1.98%	14.30%	-14.34%	12.10%	-12.48
DAX	-16.56%	9.41%	-15.52%	15.79%	3.55%	25.48%	-18.26
DJ Euro Stoxx	-7.20%	6.35%	-3.93%	22.85%	-8.66%	23.30%	-13.15
Nikkei 225	-4.18%	6.36%	-4.52%	4.91%	16.01%	18.20%	-12.08
Hang Seng	-37.23%	-14.72%	-42.13%	-14.08%	-3.40%	9.07%	-13.61
MSCI World US$	-21.17%	7.07%	-11.69%	20.14%	14.14%	25.19%	-10.44

Price returns in each local country currency Source: Bloomberg, October 31 , 2022

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Investment Strategy

Asset Mix Recommendations (November 2022)[2]

	Income		Balanced		Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	5	5	5	5	5	5
Fixed Income	70	70	40	45	20	25
Equity	25	25	55	50	75	70
Canadian Equity	20	15	30	25	40	35
U.S. Equity	5	5	20	15	20	20
EAFE Equity	0	5	0	5	5	10
Emerging Equity	0	0	5	5	10	5

Hawkish Fed a Looming Issue for the BoC [3]

This week's hawkish tone from the **Fed** came in **stark contrast** to what we heard from Governor Macklem and the **Bank of Canada** last week. Growth worries loom large for Canada; while Chair Powell made it clear that though the economy and lagged policy impact are on the radar, inflation remains the #1 priority. The Bank of Canada surprised markets with a 50 bp hike when it was 70% priced for 75 bps, while the Fed disappointed those looking for a clear signal that a downshift in tightening was coming after the fourth straight 75 bp hike. **October's strong employment report and an anticipated big CPI print later this month have prompted us to look for 50 bps from the BoC at the December meeting and a final 25 bps in January.** Meantime, we've added 25 bps to our Fed rate hike forecast, with a total 100 bps still to come.

The **biggest divergence** was in the **tone of where policy rates are headed**. Governor Macklem said that they're nearing the end of rate hikes, though not quite yet. His language suggested that the Bank could opt for another 50 bps in December, or move in two 25 bp increments; either way, taking it meeting by meeting thereafter. Chair Powell made it clear that a pause isn't even a thought at the moment and that a 5-handle for policy rates could be in the cards. That divergence has the potential to create a difficult dilemma for the BoC.

Following the IMF meetings, Governor Macklem held a media roundtable (now semi- infamous) in which he noted that **a weaker Canadian dollar** is something that policymakers need to watch. There was no mention of the loonie's weakness and potential inflationary impact in October's policy statement and MPR, but that doesn't mean his words weren't true. Rather, the loonie has been firmer of late amid a friendlier environment for risk. That may explain the lack of mention last week, as they don't want to waste bullets and would have sent a bit more hawkish message.

Post-Fed, the C$ was on the defensive as interest rate spreads moved further in the US$'s favour (until the blowout Canadian employment report). Terminal rates in the U.S. are now about 70 bps above Canada's. The widest spread in the U.S.'s favour since 2000 was 100 bps in the mid-2000s. At the time the C$ was consistently appreciating as commodity prices were ramping up. Before that, the mid-1990s saw a monster 250 bp spread as the U.S. economy was on fire, and Canada was in the midst of a fiscal consolidation and still recovering from early 1990s weakness. The loonie came under severe pressure in the late 1990s even as that rate spread narrowed, prompting the BoC to hike 100 bps in August 1998 to defend the currency.

Given the higher sensitivity to interest rates in Canada versus the U.S., it's possible interest rate spreads could revisit the mid-2000s level, and even move beyond it. That's where the BoC's dilemma arises. **If interest rate spreads continue to run, the Canadian dollar will likely weaken further, adding to already heated inflation.** At that point, we'll probably have policy rates north of 4%, and further hikes have the potential to turn housing-driven weakness into something much nastier.

Key Takeaway: The divergence in Fed and BoC policy has the potential to create a dilemma for the Bank: allow the C$ to weaken and add to inflation, or continue to hike rates to shore up the loonie and risk an even deeper economic downturn. While the huge job gain puts this issue aside for now, it's looming on the horizon.

(1) BMO Global Equity Weekly, November 4 2022
(2) BMO Nesbitt Burns, Equity Strategy November 2022
(3) BMO Nesbitt Burns, Focus November 4, 2022
To obtain a full report or the research mentioned in this newsletter, please contact me.
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