Equity and Fixed Income Strategy

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Increasing Fixed Income Allocation by 5% – Best Bond Values in Years

We are increasing our Bond allocation by 5% across the board (taking the money from our overweight cash position) for the first time in over a decade. With the historically poor performance witnessed from bonds at the start of the year, value has been created for this asset class. With a pause in central bank rate increases in sight, we want to take advantage of this opportunity. More importantly, following years of low interest rates, investors are now being compensated for adopting a more conservative, tactical bond allocation in these times of higher risk and lower return potential from risk assets. This still leaves us slightly underweight bonds and overweight equities.

After a recent powerful rally, we think the equity market is vulnerable to some weakness in the short term, but this should set up a nice buying opportunity in the months to come. As we have stated since the end of last year, investors need to be selective in their choices. In an inflationary environment, and especially when growth momentum is slowing, strong companies with entrenched competitive advantages and pricing power (i.e., the ability to pass on price increases to their customers) will be better able to protect their profit margins, thereby offering a measure of protection to their share price. More specifically, we continue to advocate a defensive "blue chip" stance (i.e., CVS, Walmart, Coca-Cola, Enbridge, CN Rail) supplemented by companies that will benefit from the unavoidable recovery which we expect in the first half of 2023 (i.e., BRP Inc., Honeywell, Mattel, Qualcomm, Cisco). Again, it is crucial not to overpay for stocks (buying below fair value to maintain a margin of safety), and to remember that the market will begin to discount better economic momentum (and profit growth by extension) well ahead of official economic data releases.

U.S. Economic Momentum Continues to Decline – Potentially Bottoming in Early 2023

Looking at the recent data points from the all-important U.S. ISM (i.e., Institute for Supply Management which is the Purchasing Managers' Index in the U.S.), along with comparable international indices, it is very clear that economic momentum continues to decline. A recession is not yet a foregone conclusion but the best days of the post-COVID rebound are well behind us. This is the main reason why we are not yet inclined to boost our equity recommendation. Recently-released U.S. ISM data, while slightly better than expected (52.8 vs. consensus estimates of 52), is still consistent with a downtrend in economic momentum which started at the end of last year.

Canadian manufacturing activity contracted in August for the first time since the early stages of the COVID-19 pandemic, amid stronger declines in output and new orders and the first drop in employment in two years.

The S&P Global Canada Manufacturing Purchasing Managers' Index ("PMI") fell to a seasonally adjusted 48.7 in August from 52.5 in July, its lowest level since June 2020. A reading below 50 shows contraction in the sector.

Central Banks Continue to Tighten the Screws

The U.S. Federal Reserve (the "Fed") started raising rates in March of this year and the market expects at least one more increase on September 21 (between 0.50 and 0.75). We are now almost 6 months into the rate increase cycle.

While conventional wisdom is that the stock market always struggles when rates are rising, our work has shown that history is far more nuanced and depends on a host of other factors. In order to better address this issue, we conducted a detailed analysis of the impact of the Federal Funds rate cycles on stock returns going back to 1971. We've concluded

that the S&P 500 Index had actually performed better when the Fed Funds rate is flat or rising relative to when interest rates are declining. For Canadian stocks, the performance discrepancy is even wider with the S&P/TSX Composite Index rising far more in flat/rising environments than in declining rate periods.

This result makes intuitive sense as the Fed typically raises rates to prevent an acceleration of inflation when the economy is strong and lowers the Fed funds rate to stimulate the economy when times are hard. Clearly, company profits are stronger in an improving economic scenario which drives market valuations higher.

Our research partners at Ned Davis Research analyzed nearly 100 years of data and on average, while the market typically struggles for the first few months, it stabilizes and tends to be higher a year later.

Attractive Bond Valuation Triggers Tactical Allocation Shift

Concerns for higher long-term rates supported our decision last spring to allocate an additional 5% to cash instead of fixed income, but we believe the worst of the storm for bond investors is now behind us. The combination of significant policy tightening and an upward shift in rates have resulted in fixed income markets offering some of the best total return potential not seen in more than 10 years. It's difficult to believe that the last time a government of Canada 2-year yielded above 3.50% was in 2008! Even more difficult to believe is the current level of interest rates compared to decades high inflation! So why now?

Intuitively, this fundamental background would mean more work from central bankers and yes, higher interest rates. It explains why the markets continue to price more rate tightening for 2022, as reflected in short-term yields. At the same time though, recent signs of slower economic momentum and the Consumer Price Index nearing peaks suggests early policy decisions may start to impact some parts of the economy, the Real Estate sector, and reduce upside risk to long term yields. Objectively, the combination of total rate hikes of 2.25%, expected additional hikes of 1.00% to 1.25% before year-end and the balance sheet reduction should help the Bank of Canada ("BoC") and the Fed manage the strong aggregate demand and reduce price pressure overtime.

Also, considering that central bank tightening can take between 6 to 18 months to have an impact, a pause could be warranted soon to give time for significant tightening to take effect. More importantly, since higher interest rates may have limited success solving some temporary supply shocks (Ukrainian conflict, drought), the BoC and the Fed cannot continue raising rates aggressively until inflation trends back toward target as it could take longer. Both will likely need to move more carefully in the next couple of meetings to avoid over-tightening. Further deterioration of economic fundamentals, in particular the labour market, could also support a pause before year-end. Even a recession, which the odds of an early 2023 occurrence have increased, has historically helped quell domestic price pressure and could diminish the need for further policy actions.

The Technical Picture – Russ Visch CMT, Technical Analyst

Our medium-term timing model continues to improve, increasing our confidence that the cyclical bear market underway since the beginning of the year is very near to being complete. Certainly most, if not all the price damage anyway. For example, weekly momentum gauges for all the major averages have given their first "4 for 4" buy signals since April of 2020. Breadth oscillators, such as the percentage of S&P 500 stocks trading above 50- and 200-day moving averages, also continue to improve after matching the deep oversold reading that occurred in early 2020, and bullish sentiment has climbed steadily for five weeks in a row after achieving one of the most overly pessimistic extremes in the past 15 years.

Granted, the recent rally has many shortcomings (most notably the lack of volume), which suggests there is still risk of a pullback through these traditionally weak Q3 months. We think the high probability trade is that we see a 50% retracement of the rally since mid-June. That would bring the S&P 500 back to 3,980 and the S&P/TSX back to 19,250. But, considering all the indicators in our medium-term timing model have just given new buy signals similar to the ones that occurred in April of 2020 (and all of the other cyclical bear market lows since the credit crisis, in fact), we view any weakness going forward as a buying opportunity since what we are talking about here is the end of a cyclical bear and the emergence of a new cyclical bull market. What does that mean? Well, here are some statistics for you: The average 12-month return for the S&P 500 coming out of the past four cyclical bears since the credit crisis is just under 45%. The average 18-month return is just under 60%.

And, if you look back over the past 80+ years of history an average cyclical bull in the S&P 500 when it's in a bigger secular bull, such as we are now, has carried it 86% higher over 30 to 31 months.

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

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