GLOBAL MARKETS
Commentary

BMO Private Wealth

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New and Renewed Feuds

Jawboning (noun): the use of spoken persuasion

– Merriam-Webster Dictionary

July saw capital markets react to conflict, discord and feuds: all the way from war in the Middle East to the return of U.S. tariff threats and a family feud at the U.S. Federal Reserve.

Each situation elicited a generally negative response from the markets. However, in the grand scheme, the setbacks for stocks and bonds are modest and understandable.

Price action across global equity markets was mixed. Some markets that posted the strongest earlier-year returns (Japan, Nasdaq and emerging markets) briefly entered correction territory (down more than 10% from recent peak to trough). Nevertheless, they still top the charts for the year. In many markets, including the S&P 500 and S&P/TSX indices, declines from their peaks are merely mild, low-single-digit percentages, which is consistent with a healthy test rather than a breakdown.

In some areas, the pullbacks represent constructive rotations between sectors; in others, they are important tests and displays of discipline. Elsewhere, they reflect a cleansing of over-exuberance. We don't view July's red ink as a harbinger of doom or the makings of a peak for this bull market. Rather, we see it as a pause that can refresh.

Despite the list of concerns, the structural trends supporting the economy and asset prices remain intact. The resilience of global growth and financial markets has been tested repeatedly. Our view that the backdrop remains sound is reinforced by how the markets navigated July's hurdles.

Tariff troubles return

July brought the U.S. administration's trade agenda back into focus. Canada and the U.S. did not reach a CUSMA deal. The White House launched new threats of 50% tariffs on certain Canadian goods, including some that are currently under the free-trade umbrella. While no deal was reached, the treaty remains in force and is now subject to annual review.

Markets largely shrugged off the announcement. Context matters: the new tariffs would apply to roughly 5% of Canadian exports to the U.S. – not insignificant, yet not enough to shock the whole economy. The breach of CUSMA exemptions is unwelcome; then again, the evidence indicates that this could be a negotiating tactic designed to pressure Canada to bring more to the table. Since the tariffs are not scheduled to take effect for several weeks, there is time for de-escalation.

Even though trade remains an overhang for the Canadian economy, Canadian financial markets continue to power on. The Canadian economy is not the Canadian stock market: the S&P/TSX Composite is up 11% year to date, helped by large weights in energy and financials. Resource companies face a lighter tariff impact; financial services face none.

The industrial sector, representing 10% of the S&P/TSX Composite and home to railroads, airlines, and heavy industries, is also helping drive performance as build-Canada projects emerge and the economy holds up better than feared. Many tariff-exposed firms also operate plants inside the U.S., where output is not subject to tariffs.

Dire straits

Renewed conflict in the Middle East saw spot oil prices push back toward US$100 per barrel before falling slightly. The consequences of higher oil prices and limited egress from the region are inflation fears and higher bond yields. For the U.S., elevated borrowing costs complicate the government's ability to finance an already bloated debt and deficit. Ahead of November midterm elections, voters are frustrated by inflation; the result could be a backlash against the ruling Republican Party.

For Iran, the economic pain inflicted by a full U.S. naval blockade will only increase. Stubborn though the regime may be, it cannot hold out indefinitely without risking total economic collapse.

While the failure of the Middle East ceasefire is a step in the wrong direction, pressure on both sides should encourage a return to negotiations. Oil futures support this view: prices for delivery 12, 24, and 36 months ahead remain in the US$70 range, suggesting markets are not pricing a lasting supply shock.

Discipline meted out

Artificial Intelligence remains a central equity-market theme. Second-quarter earnings show the buildout of compute capability continues, but investor scrutiny has intensified. Hyperscalers have underperformed year to date as concerns grow around the scale, sustainability and the future return on their spending.

In contrast, semiconductor, memory and data-centre infrastructure companies have strongly outperformed, albeit experiencing sharp pullbacks along the way. Many key players continue to beat earnings expectations. Nevertheless, some of the companies that saw their share prices triple in a matter of months have seen those share prices cut back by half.

Bond investors are also weighing in, demanding more discipline. Recent hyperscaler debt issuance is receiving less enthusiastic support and commanding higher yields.

All of this is healthy. Stock and bond investors are asking the right questions and voting with their capital – exactly the type of discipline we want to see accompanying this fast-growing investment theme.

Equity market support isn't just AI capex

Equities are not being supported by AI capital spending alone. With 62% of companies reporting, the S&P 500 earnings growth rate for Q2 stands at 47%, blowing away pre-reporting expectations for 23%. Moreover, every single sector is beating expectations.

Earnings growth is outpacing price appreciation, leaving the S&P 500 cheaper on a forward price-to-earnings basis than it was through much of the last two years. The S&P 500 currently trades at 21.2 times next 12-month forward earnings, well below the near-term peak of 26.9 and the two-year average of 23.6, and just above the post-Liberation Day level of 18.6.

Results from Canadian companies are also robust. With 40% of S&P/TSX Composite companies reporting, aggregate earnings growth stands at 37%; eight of 11 sectors are beating expectations.

Investors should celebrate – not lament – price gains backed by earnings growth and the many examples of market discipline we've seen.

Rising real yields a feature (and a bug)

Now that oil prices are up, investors might instinctively conclude that inflation concerns are driving yields higher. While inflation expectations are a part of the story, core inflation appears to be on a structurally driven downward trajectory, and recent headline inflation prints surprised lower in many countries. The more durable force behind higher bond yields has been rising real yields.

Rising real yields are often a sign of robust economic growth, which is why we see them as a feature more than a bug. Stocks cheer validation that the economic backdrop is healthy, but higher bond yields always bring some bite. Historically, when real yields reach the levels we see today, equity markets stumble. The fact that July's stumbles were modest is another positive sign.

Fed family feud

Bond yields rose in part because of turmoil around the U.S. Federal Reserve. Incoming Fed Chair Kevin Warsh wants to abandon the practice of issuing forward guidance and openly mused that the July FOMC meeting would be a family feud. On forward guidance, his preference is to return to a world where markets must come to their own conclusions on the future of Fed policy without explicit Fed guidance; the theory is that capital markets are important mechanisms of price discovery. Unencumbered by the weight of the central bank's guidance, capital markets become better at providing important signals to policymakers rather than the other way around. The markets themselves are considered good economic forecasters. As for the feud, Mr. Warsh believes the Fed should be an institution that encourages vigorous debate. Both ideals have merit.

However, the result of these changes and uncertainty left market participants worried the central bank might not do enough to keep inflation in check. We would not call this panic, but it does recall an old adage: the bond market stops panicking when the Fed starts panicking. Mr. Warsh appeared far from panicked in his press conference, although bond markets were certainly roiled.

Absent guidance from central banks, market participants can overreact to information. Bond volatility is part of the growing pains of a new central bank regime.

Asset allocation views – overweight equities but cautious on risk

We continue to favour equities relative to fixed income. Earnings growth is robust and nearly everywhere – always to varying degrees, but good to great across many geographies and sectors. In some markets, valuations remain elevated, yet are decently improved in the U.S, Japan and emerging markets on a combination of lower prices and stronger earnings. We continue to monitor developments and reassess positioning to ensure portfolios are taking an appropriate level of risk.

Within equities, we believe it is prudent to maintain an overweight to Canadian and U.S. equities. Canadian equities have performed strongly this year, helped by the market's cyclical tilt and significant energy exposure rallying on higher oil and gas prices. In our view, Canada is an attractive complement to the tech- and growth-heavy U.S. allocations that dominate global portfolios.

The U.S. remains home to many dynamic businesses. We are encouraged that solid earnings growth and price gains are broadening out across a wider array and size of companies. Valuations were somewhat tempered by the recent pullback.

We have a neutral view on international developed market equities. Expectations for European earnings growth remain below those of other market choices we have.

We are more positive on Japan, where normalizing financial conditions and structural reforms have driven a stock-market renaissance. The recent pullback improves valuations.

Investors may wish to consider a modest overweight to emerging market equities where appropriate, given risk tolerance. Earnings growth expectations are strong and valuations have improved on the recent pullback.

The last word: Talk is cheap

Among all the month's developments, the Middle East and trade fronts were largely more of the same. The change in tone and procedure at the Fed was new information to digest.

In addition to the overnight rate and use of their balance sheet to intervene in bond markets, another tool central bankers can use is talk, or jawboning in the economic and political lexicon. However, talk is cheap. Chair Warsh is running through his allowance quickly although he's getting results.

It is believed – and borne out by his vote – that Mr. Warsh does not want to raise the fed funds rate. He is a consummate academic and understands that the bond market can tighten financial conditions on his behalf; even better, the bond market has greater flexibility and no reputation to protect. For now, that is exactly what the Fed has been able to achieve: lower bond yields at the short end of the spectrum (the front of the yield curve) and higher yields at longer-dated maturities. These moves impacted stocks and bonds negatively, but Mr. Warsh may think because markets are on a good run it's a small price to pay in order to advance his goals.

For now, Mr. Warsh is content with this outcome. If his approach goes too far, it may not be wise for the medium-term health of the U.S. economy or stock market. In fact, the opposite might be needed – higher short rates and lower long bond yields. To achieve that, the Fed will need to see very good outcomes (and soon) on productivity or inflation. Both could happen, but if not then jawboning will need to be backed up by action. Otherwise, Mr. Warsh risks overplaying his hand.

We think a less transparent Fed is a good thing; reserving forward guidance for emergencies makes it more powerful. Allowing capital markets to digest information and provide price discovery without central bank guidance is a return to normal. The capital market reactions showed us that old habits die hard. We lean toward the view that the men and women in charge at the Fed (all of them, it isn't a one-person show) won't push these issues so far that they upset the economy or markets too much, which would be at odds with their goals.

Although the last few months have been choppy, fundamentals have improved: inflation cooled more than expected in many countries while employment and growth held up (especially in Canada). Corporate earnings continue to deliver. Shocks can come and go – July saw them come, but they can also fade quickly. Meanwhile, resilient capital markets and economies soldier on.

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

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