GLOBAL MARKETS
Commentary

BMO Private Wealth

BMO Nesbitt Burns NOVEMBER 2026

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Seas of Blue, Green and Red

"We have met the enemy and he is us," cultural idiom coined for a 1970 Earth Day poster

– Walter Kelly Jr. (1913-1973), American cartoonist best known for his whimsical and satirical children's cartoon strip *Pogo*

We intentionally delayed our November commentary to incorporate the U.S. midterm election results. Based on that decision, the surprising breadth of the outcome, and massive global media coverage, it would be easy to conclude that we consider the midterms the defining market event of the past six weeks, or even the year. We do not. In the coming weeks, we expect their perceived impact to cool from its current fever pitch.

Debate over whether the outcome is good or bad for the economy, capital markets and U.S. fiscal, domestic or foreign policy will subside. We anticipate that some things will change, but the impacts will be incremental – not monumental.

The blue wave brought a sea of green to capital markets on the first day of post-election trading, followed by a sea of red the next day. Although this may seem manic, it supports our view that change will be incremental and therefore manageable.

Day one's gains partly reflected relief that the uncertainty had passed. The most important thing about the midterms was that they simply needed to be over.

U.S. midterms – Maybe the end, not the beginning, of market choppiness

With headlines screaming "market turmoil," this year's turbulence requires some context. Given the many surprising political and geopolitical events, it is understandable that things feel chaotic – or volatile, in market parlance. However, what's happening in the main indices doesn't support this view. Year to date (November 6), major equity indices outside China show decent gains, some up to 15%. The S&P 500 is up 8%; its equal-weight version and the S&P/TSX are each up 13% – evidence that the year's gains aren't all driven by a runaway AI trade. The largest drawdown in the S&P 500 and S&P/TSX is 9% on the outbreak of the Iran war; this is well within historical norms. We simply have not seen excessive equity market volatility at the index level. Under the surface it's a different story and the reason why the media can stoke fears of wild market swings on any given day.

The AI trade is where the large swings have been. Japan's Nikkei, accompanied by indices in Taiwan and South Korea, recently entered bear market territory (a 20% decline from a peak). The NASDAQ registered a correction (a 10% decline) – all from peaks set just weeks ago. Despite the drop, Japan, Korea and Taiwan – home to giant global semiconductor companies – remain top performers year to date. The tech-heavy NASDAQ, among the weakest, is still up around 6%.

Volatility has been concentrated in select areas; when one sector or high-profile company stumbles, investors have found others to reward. This rotation, or broadening, is healthy. For globally diversified investors it extends across asset classes and geographies. On November 6, the S&P 500 was only 5.7% below its October 6 peak. Canadian and European equities were within a few percent of all-time highs.

Even if the global economy is less robust than the U.S. economy, it is performing better than feared, supporting a broadening equity opportunity. Small and mid-cap shares are also faring well, unlike earlier in the four-year bull market when mega-caps were the only story.

Volatility has been present beneath the surface all year – arguably throughout the bull market – and ticked up around the election (although not in a disorderly way). The midterm outcome is recalibrating existing trends at the margin, not reversing them. We are likely closer to the end of the choppiness than the beginning after three months of fluctuating but sideways equity markets and bond yields moving sharply higher, only to then retreat.

Bonds return to diversifier role

So far this year, bonds haven't provided much return since yields have generally risen. Bonds have provided ballast for balanced investors amid recent fears over slowing growth – especially in Canada. Canadian bonds have outperformed global peers: yields rose less than in many other markets and have since followed global yields down from their peak, turning a 0.8% year-to-date loss on September 30 into a 1.7% gain by November 6.

The Bank of Canada had been cautious in the face of expected economic weakness and trade frictions yet hiked rates on elevated oil prices and better-than-feared growth (and hey, everybody else is doing it).

It's dangerous to read too much into short-term data. However, after the hike the outlook for oil and the Canadian economy softened thanks to weak signals from employment, trade volumes and wages. While WTI oil has retreated to the US$90 per barrel range, Western Canadian Select has fallen into the US$60 per barrel range, weighed down by freight costs, U.S. Gulf Coast congestion, weaker diesel demand due to higher end-user prices and competition from Venezuelan heavy crude. Nation-building projects can't come soon enough. In the meantime, the BoC can tread lightly.

Equity and bond market recalibrations set up a brighter future

Economic and earnings fundamentals continue to look good. Inflation and bond yields might have peaked, and the "higher for longer" fever has broken. The current recalibration in equity and bond markets has a good chance of setting up brighter medium- to longer-term prospects.

Markets have spent the last three months balancing two powerful forces: the global growth outlook and broadening inflation pressures (largely a product of that growth) that pushed government bond yields higher and raised fears of central bank tightening. The last holdouts – the Bank of Canada and the Bank of England – recently joined the global hiking parade. Markets are on watch because disorderly rising bond yields can be kryptonite for an equity bull market.

On growth, the evidence leans toward strength. In the U.S., it is supported by capital investment (a big chunk of it AI), solid employment, consumer spending and strong corporate earnings. Sustainability is the issue. The new political landscape adds to mounting social pressure on AI, the data centres required by AI, and the unknown consequences of the technology.

AI blues

Political rhetoric amplifies the question of just how much growth could cool under a Democratic-controlled Congress that campaigned on AI regulation. Loud voices range from "kill AI before it kills us all" to "if we pause, the competition will eat our lunch." Investors should avoid both extremes.

Campaign promises often bear little resemblance to what eventually comes to pass. A brief pause for lawmakers to debate may prove valuable since a pipeline of projects and spending will carry the economy for some time.

The notion that AI needs to cool isn't a Democrat invention. Investors have already been debating whether the AI investment cycle has moved too far too fast. Spending by hyperscalers such as Alphabet (Google), Amazon, Meta and Oracle has moved from spending money out of cash generated by their operations to spending borrowed money (negative free cash flow). These former software and advertising businesses that were high margin, asset light, high cash flow and low debt have become something very different: capital-intensive, utility-style builders that are strapping on debt and issuing shares rather than buying them back.

Not every company has done this: Microsoft is spending big even though it remains free cash-flow positive. Apple has significantly reined in spending. This move once risked being labelled as falling behind. Now it's being rewarded for demonstrating disciplined capital allocation. (Apple is openly discussing the tradeoff here and trying to strike the right balance.)

Investors have been meting out discipline in the AI arena for months. Year to date (to November 6), Apple is up 36%, Nvidia is down 2.5%, Meta is down 8% and Alphabet is down 11%. These aren't endorsements or repudiations of any company; rather this is evidence that investors are reacting vigorously to new information in a rapidly evolving space.

Many, many bubbles

While some of the above moves reflect share prices that had gotten ahead of themselves (hence the persistent bubble talk), most AI-related companies can boast about exceptional returns over two or three years. The cycle has lifted many, but not all, boats. Semiconductor shares – the bleeding edge of bubble worries – have both doubled and been cut in half. Many bubbles have already inflated and burst in this cycle, so the answer to the question of whether we're in a bubble is yes – many, many bubbles. Thankfully, myriad bubbles inflating and popping is a glass of bubbly investors can drink; it's not the Hindenburg.

Be cool

Global bond yields have risen yet are well off their highs. A disorderly rise in bond yields, which risks upending the equity advance, stems from inflation fears and supply-demand dynamics: more borrowers require higher yields to attract lenders. Some moderation in hyperscaler borrowing and capital spending could ultimately help, reducing financing needs and easing pressure on yields and prices, especially in electricity and equipment supply chains.

We consider these potentially very healthy adjustments to the AI buildout. Significantly, AI remains economically and strategically important to all advanced economies, and the longer-term theme is intact.

Asset allocation considerations

Our outlook remains constructive on risk assets, and we continue to favour equities. Global economic growth and an innovation cycle underpin solid corporate earnings growth.

Bond yields are off their highs; bond yields at the upper end of their recent range were attractive to us. The recent decline for bond yields came as questions arose over the magnitude of global growth going forward, given the prospect for some slowdown in AI buildout, the weight of higher bond yields and tighter central bank policy.

Falling bond yields (higher bond prices) provided the kind of downside protection we want when the narrative turned toward slowing growth, affirming our view that fixed income is an important diversifier for balanced investors.

We continue to maintain a preference for Canadian and U.S. equities because earnings fundamentals remain strong and sector exposures are complementary. Canadian equities provide exposure to financials, energy and commodities, while U.S. markets remain home to many of the world's leading technology, healthcare, industrial and consumer products companies. We remain neutral on EAFE and emerging market equities.

The last word: Discipline reins in excess

Like every innovation cycle in history, AI is a race – a feature of capitalism, not a bug. Still, unbridled capitalism breeds excess: an arms race in which no company can stop spending for fear of falling behind. Herein lies the enemy.

While AI companies themselves have discussed regulation, slowing development for safety's sake and the risks of their discoveries, this is hard to coordinate. Note that Public First, a super PAC funded by Anthropic co-founder Dario Amodei plus other AI safety advocates, poured millions into the midterms to back candidates favouring stricter AI regulation.

Today's investors carry scars from the dotcom and housing bubbles; the memory of those hangovers manifests as discipline. Higher bond yields and credit spreads, plus sharp declines in selected shares, are curbing excess in spending and investment and bringing scrutiny to raising capital through debt, equity and IPOs.

Combine these aligned yet sometimes conflicting interests with a government that now has opposing voices and we see a chance for a healthy pause that extends the cycle.

Equity markets have moved sideways to lower for several months. Bond yields have stretched and retreated. We have met the enemy, and it is us – in all our excess. Discipline is the path to defeating this adversary.

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PW6634 (11/26)