Investment Strategy

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Still overweight equities, Emerging Markets increasingly attractive

With investors still focused on inflation trends—which have admittedly been running a little hotter than expected in the U.S.—some may have missed the global uptrend occurring in stocks. Artificial Intelligence plays continue to move higher—which primarily benefits the U.S. market—and are gathering a disproportionate amount of airtime. And yet, the rally is truly a global phenomenon with major markets such as Germany, France, the U.K, Switzerland, Japan, and South Korea all making 52-week new highs (or all-time highs as well), despite sluggish economic growth. The net result is a fresh 52-week high in the MSCI World Ex-U.S. Index. Emerging Markets are no slouch either. The MSCI Emerging Markets Index just broke out of a massive multi-year base pattern (thanks in large part to the recent bullish turnaround in Chinese stocks). As noted in previous missives, the rally is also broadening out on a sectoral level. Along with Energy and Mining, even traditionally very defensive Utilities are getting in on the action, partially because of the increasing power demand from data centers and electric vehicles, along with manufacturers moving their production back to North America. For example, clean power generation names such as Northland Power or Boralex seem quite attractive to us right now.

These trends support the large overweight position in equities we have recommended since the end of 2022. From a regional perspective, we continue to favour Canadian and U.S. equities and are warming up to Emerging Markets. While Canada is slightly lagging the U.S. year to date, we believe the S&P/TSX could catch up through year end based on: 1) monetary policy (i.e., the Bank of Canada ("BoC") began cutting interest rates on June 5, while the Federal Reserve ("Fed") remains on pause); 2) sector weights could be helpful, especially with the commodity upswing that we're seeing that clearly favors Canada (Energy and Materials are a third of our market vs. 6% in the U.S.); and 3) there is a strong valuation argument for Canada with the U.S. now trading at 22x forward earnings while Canada is at 15x and the S&P/TSX dividend yield is roughly double that of the S&P 500.

We also find Emerging Markets attractive given prospects for easing global monetary policy which should help reignite global growth momentum. Country weights for the MSCI Emerging Markets Index are quite concentrated with about 30% for China, another 30% for Korea and Taiwan—which are benefitting from very high global technology/semiconductor demand—while India is at about 20% and Brazil rounds out the top 5 at a 5% weight (Brazil, like Canada, is positively impacted by stronger commodity and energy prices). These stock markets are generally inexpensive with the exception of India and Taiwan where outsized growth prospects warrant a higher valuation multiple. China is particularly cheap and political authorities have eased their crackdown on China's internet giants and now seem more supportive as they try to reignite economic growth. This is very positive for investors as it will reduce political uncertainty and should eventually lead to multiple expansion. Longer term, Chinese economic growth will increasingly depend on consumer spending (vs. construction and manufacturing), for which mega-cap Tech companies (i.e., Alibaba, Tencent, and Pinduoduo) are very well positioned.

S&P/TSX and S&P 500 fair value estimates

We raised our fair value estimates for the benchmark S&P/TSX and S&P 500 indices to 27,000 and 5,500 from 25,000 and 5,000, respectively. Earnings estimates in Canada and the U.S. have been moving higher and we are now using calendar 2025 consensus estimates to derive an approximation of where the market could be 12 months from now. Given the much more constructive inflation and monetary policy picture (i.e., no more rate hikes), we shaved our equity risk premium by 0.5% in both markets and are now at a reasonable 9%.

Recession Probability Index

Gauging where we are in the economic cycle is critical to portfolio risk management since virtually all 25%+ stock corrections (i.e., bear markets) have been associated with North American recessions in the last 50 years. It is therefore encouraging that our proprietary recession model now shows the probability of such an event ticking down (from 60% last year to under 40% currently). As our readers know, for financial markets the trend always matters far more than absolute numbers, so lower recession odds have clearly been a tailwind to equities, which is consistent with history.

Risk Appetite has clearly risen but not in "euphoria zone" (yet)

Our Risk Appetite Index has been rising strongly from near-panic levels at the end of last year. Recall that this is a relative index comparing the performance of risky assets (equities and high yield) vs. safe assets (Government bonds). Interestingly, both bonds and stocks have rallied (but stocks have rallied more in this risk-on phase), so this is clearly good news for investors with a balanced asset mix. Also, corporate earnings have generally been strong in North America. The fact that we are not yet in the "euphoria zone," where stocks are vulnerable to sharper pullbacks, supports this view from a trading perspective.

Our valuations and asset allocation recommendations are based on expectations for gradually easier monetary policies, lower interest rates, and a soft landing for the economy. We recognize that some factors could keep rates higher in the near term, including stickier inflation which has already pushed the first U.S. Federal Reserve ("Fed") rate cut expectation to the second half of 2024. There is also the potential for slower economic growth and the constant reminder of the risk of a recession indicated by the inverted yield curve (short-term rates higher than long-term rates) in Canada and the U.S. that could drive both inflation and interest rates lower. While the results would be welcome by central banks and positive for bonds, we admit this would not be an ideal scenario from a risk asset valuation perspective. However, our recession model trending lower continues to support our view that equities should perform well. Additionally, our expectation for the BoC to lower rates by at least 50 basis points ("bps") this year supports our Canadian equity preference. Finally, unlike previous cycles when interest rates were much lower, we believe our current fixed income allocation will help alleviate some of the asset risk volatility, but we prefer to remain slightly underweight our benchmark and keep a defensive tilt on our recommended duration as markets continue to absorb significant supply and the potential for the gradual re-steepening of the yield curve as major central banks slowly shift to easier policies.

Macro update on largest Emerging Markets

China

As noted by BMO Economics, there are some encouraging signs that the Middle Kingdom's economy may finally be bottoming out after a couple of tough years. Much to the relief of the Chinese authorities and beleaguered stock market participants, most of the economic data released this year have exceeded market expectations. Thus, BMO Economics has nudged their 2024 real GDP forecast to 4.6% from 4.4% (the IMF increased their own forecast to 5% on May 29, 2024). However, it is not all blue skies ahead as the economy is facing some major domestic and external headwinds (e.g., excessive debt, extended housing downturn, rising global protectionism). The housing market, estimated to account for between 20% to 30% of economic activity, is likely to remain a heavy drag even though it has already been over two and a half years since the Evergrande debt crisis erupted. The good news is that the event did not morph into a full-blown financial crisis as banks avoided becoming saddled with large amounts of non-performing mortgage and corporate loans. The IMF recently estimated that the housing market may not bottom out until 2026, only gradually recovering thereafter.

Still, the authorities appear likely to tolerate a bumpy road as they remain intent on bolstering the country's technological prowess. Beijing's number one objective this year is to focus on innovation, namely "developing new quality productive forces at a faster pace". The emphasis on new productive forces (e.g., artificial intelligence, biomanufacturing, low-altitude transportation, etc.) highlights that the Middle Kingdom is looking to expand its technological frontier beyond the recent successes in electric vehicles, lithium-ion batteries, and solar products. All this explains why investments are booming in many high-tech-related sectors.

India

India's economy has exited the pandemic with very strong momentum, backed by rising capital expenditures and lower inflation. The external position has firmed and, while public finances remain a relative weak spot, the debt-to-GDP ratio is nevertheless expected to stabilize amid a gradual reduction in the deficit. The positive economic cycle is interconnected with improvements in bank and corporate

balance sheets, underpinning a strong pickup in credit growth. Crucially, the stock of legacy problem loans continues to unwind—albeit at a gradual pace—with resolution facilitated by the 2016 Insolvency and Bankruptcy Code, and capital buffers have been augmented (though there remains a divergence between the private sector and public banks). It was telling that the Indian banking sector largely brushed off the financial stress emanating from the U.S. and Europe in early 2023.

The economy has consistently outperformed expectations over the past year, with real GDP growth topping 8% year-over-year in each of the last three quarters. As a result, the labour market has seen a big improvement, reflected in strong employment growth (averaging 4.3% year-over-year in the last 12 months), real wage recovery, and an increase in the participation rate (though it remains below pre-pandemic levels). IMF staff raised their estimate of potential growth from 6% to 6.3% in the December 2023 Article IV review, amid stronger investment dynamics and higher employment, and we suspect this assessment will face further upside. While the trend growth estimates of Fitch and Moody's are close to the IMF's (up from the pandemic era but still lower than during the 2010s), other studies place the figure in the 7% range.

Taiwan

Taiwan is experiencing a sharper-than-expected rebound compared to expectations last year, due a big rebound in Tech exports, pushing its expected real GDP growth rate to 3.4% in 2024, up from an anemic 1% in 2023.

The escalation in cross-Strait tensions along with increasing strains in the U.S./China relationship remain a big source of concern. Although the situation remains fluid and unpredictable, we still view the risk of an imminent large-scale military conflict as a remote but high-impact event. Otherwise, it does not appear that the escalation in cross-Strait tensions has had a significant impact on the economy in terms of prior large-scale investment plans being shelved or a reduction in the island's longer-term potential growth rate.

For now, it appears that the economy should continue to benefit from the reshoring of manufacturing activity from mainland China in response to persistent U.S./China frictions. Note that the authorities continue to actively promote the "Three Major Programs for Investing in Taiwan", which include: 1) the Action Plan for Welcoming Overseas Taiwanese Businesses to Return to Invest in Taiwan; 2) the Action Plan for Accelerated Investment by Domestic Corporations; and 3) the Action Plan for Accelerated Investment by Small and Medium-Sized Enterprises.

South Korea

The South Korean economy appears to have turned the corner after slowing last year in response to higher interest rates and the downturn in global Tech. However, one needs to keep an eye on the geopolitical situation this year as there will likely be an uptick in North Korean belligerence. Pyongyang has typically ramped up provocations during U.S. presidential election years. It bears mentioning that Pyongyang has not been receptive to engaging in any dialogue with the U.S. despite numerous attempts by the Biden Administration to make contact. Nonetheless, we still view the risk of a large-scale direct military conflict as a very low-probability/high-impact event.

South Korea's export-led economy is expected to rebound in 2024, following last year's Tech-driven downturn. In line with consensus, BMO is forecasting real GDP to grow 2.0% in 2024, and 2.3% in 2025 (vs. 1.4% in 2023) mainly due to the recovery in semiconductors demand and global trade. Note that the IMF is projecting world trade of goods and services in volume terms to increase 3.3% and 3.6% in 2024 and 2025, respectively. On the flip side, consumer spending is expected to remain subdued on account of the lingering impact of relatively high inflation, elevated interest rates and the drag from a weak housing market. The job market remains fairly healthy though the seasonally adjusted unemployment rate ticked up to 3.3% in December. It bears mentioning that the IMF still believes the country's potential growth sits at 2.0 to 2.5% despite a shrinking population (-0.2% in 2022). Meanwhile, consumer price inflation, at 2.8% year-over-year in January, continues to ease, though at a moderate pace. This explains why consensus estimates project that the Bank of Korea will only be able to lower its benchmark policy rate (currently 3.50%) by 50 bps this year and a further 50 bps in 2025.

Brazil

Brazil's economy has proven to be surprisingly resilient of late thanks to a combination of fiscal stimulus (e.g., increased social welfare spending and higher minimum wages) and an unexpected bump in agricultural output (e.g., soybeans and corn). As a result, real GDP grew 2.9% for 2023, following a 3.0% increase in 2022. The job market has also improved with the (3-month moving average) unemployment rate falling to 7.5% in April, which is approaching levels not seen since early 2015 (in the wake of the Operation Car Wash scandal), thanks in part to jobs created in the gig/new economy. Looking forward, real GDP growth is expected to slow to 2.2% in 2024, and 2.1% in 2025, as agricultural output normalizes and fiscal policy is tightened. However, the economy should receive offsetting support from monetary policy easing as the Central Bank of Brazil ("BCB") has already cut its key policy rate by 325 bps since August 2023, to 10.50%. The BCB is expected to continue cutting, with a Bloomberg poll projecting the policy

rate to decline slightly to 10.0% by 2024 year end, and 9.0% by 2025 year end alongside softer inflation. Headline CPI inflation, at 3.7% year-over-year in April, is now below the BCB's 2024 year-end target of 1.50% to 4.50%. Meanwhile, the BCB's official inflation projection stands at 3.8% for 2024.

Technical Analysis

As we start the summer, it is still "all systems go" for equity markets as all the major averages freshly made new all-time highs. The main thing that stands out to us though is that there is no deterioration in the indicators we refer to as our "canaries in the coal mine" that typically pre-warn of impending bear markets six to 12 months ahead of time. This includes:

- **Bond market sentiment gauges** such as credit spreads and CDS indexes, which remain at/near multi-month or all-time lows. Yes, there is a case to be made that these indicators are about as good as they ever get, but until we see the bond guys get worried it's still "game on", and the bond guys aren't worried yet.
- **Breadth indicators** such as the various advance-decline lines we follow recently made all-time highs, and the percentage of stocks trading above short- and long-term moving averages continue to hold up well (i.e., the mega-cap Tech names are what's driving the performance in cap-weighted indexes, but the average stock is still doing extremely well).
- **The performance of "risk on vs. risk off" sectors.** Utility stocks roared as of the end of May but, overall, it's the pro-cyclical, economically sensitive areas of the market such as Technology and Industrials which continue to outperform the broad markets.
- **NIVIDIA and the mega-cap Tech stocks have been getting all the press** as of late, but the rally is truly a global phenomenon too, with major economies such as Germany, France, the U.K, Switzerland, Japan, and South Korea all making 52-week new highs or all-time highs as well. The net result is a fresh 52-week high in the MSCI World Ex-U.S. Index. Emerging markets are no slouch either.
- **The MSCI Emerging Markets Index** just broke out of a massive multi-year base pattern (thanks in large part to the recent bullish turnaround in Chinese stocks) which opened an initial upside target that measures 15% higher from the recent closing price.
- **In terms of upside potential,** the recent breakouts to new all-time highs have opened upside targets of 23,224 for the S&P/TSX Composite and 5,575 for the S&P 500.

Our expectation is that the general bias for equities should remain to the upside out until July or so, when seasonality—both traditional and U.S. presidential election year seasonality—start to become a headwind for stocks (i.e., we are still expecting a more pronounced pullback at some point in the third quarter, in line with what we normally see during U.S. presidential election years). Historically, they tend to get underway in August, last about 5-6 weeks with a decline of around 8%, and usually bottom before the election.

So don't be surprised if the markets get a bit squishy in late summer as investors sit on their hands during that period of uncertainty. It's likely that the pullback gets underway from much higher levels than where we are at today, and since there's no deterioration in our "canaries in the coal mine", then the expectation should be for further new highs following any summer pullback

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

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