War and Higher Rates: A Volatile Mix

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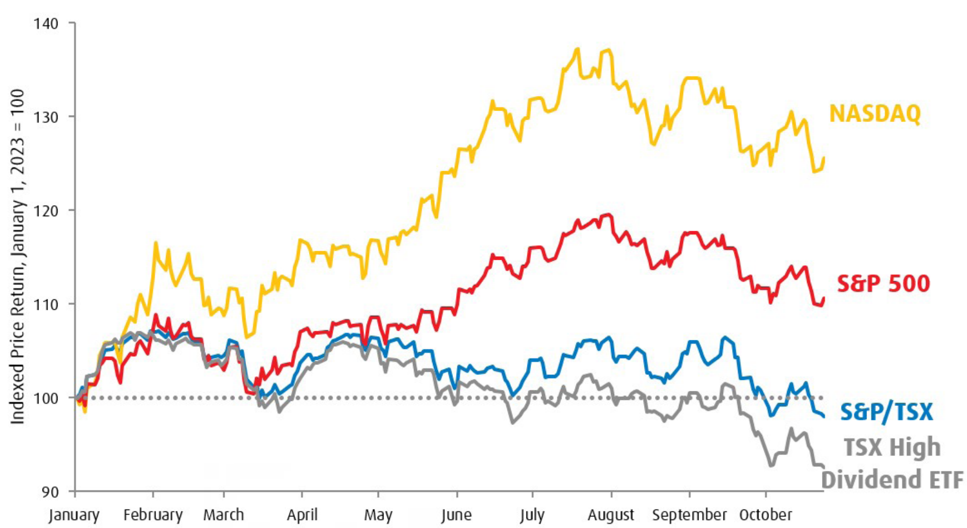
The human toll in both the Middle East and Ukraine is heartbreaking, with no end to these conflicts in sight. Where the markets are concerned, these events have contributed to short-term bond and stock volatility but, in our opinion, a far bigger driver for the markets has been inflation and the relentless rise in interest rates during 2023. But not all is lost. Recent weakness has created value in a number of sectors and stocks, although our modus operandi is still very much to be selective. In other words, the focus should continue to be on companies with strong competitive positions, rock solid balance sheets and reasonably valued stocks. Importantly, the odds of a North American recession in the next year have steadily decreased on our models (now below 45%, but still far from negligible of course). This considerably lowers the odds of a painful bear market, at least in the next few quarters.

Figure 1: There has been a wide discrepancy in market performance this year with mega-cap Tech stocks leading the way



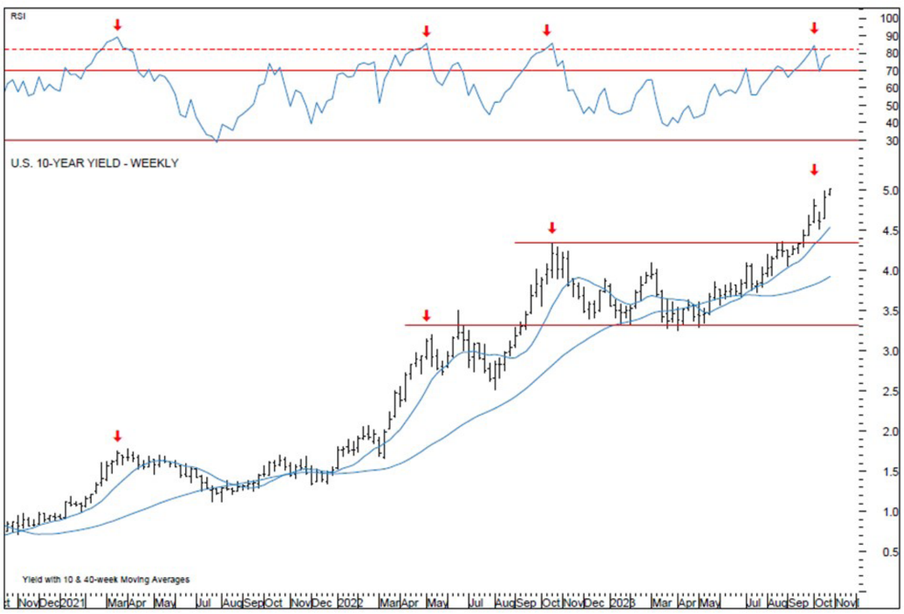
Source: FactSet

We also believe that we are about to enter an era with more interest rate stability. The Bank of Canada and the U.S. Federal Reserve appear to now be on pause, with the caveat that there may be one final increase in 2023. Our work has shown that the market tends to act well when interest rates are stable, which makes intuitive sense since traders and investors at large have historically rewarded visibility and stability with higher valuations. Another key conclusion is that so-called “value” stocks (think Banks, Utilities and Energy Producers) tend to outperform expensive growth equities (i.e., Technology and some Consumer and Commmunication stocks) 12 months after interest rate stability is achieved.

However, the factor to rule them all is longer-term interest rates. In fact, investors have become fixated with 10-year U.S. Treasury rates – the cornerstone of all financial markets – which went above the psychologically important 5% level very recently (from 3.5% as early as May of this year). We are now at the highest level in over 15 years. This matters because bond prices move inversely with interest rates, and long-term bonds are the most vulnerable of all. Stocks are also vulnerable to higher rates, but in a less direct way. The key reason for this is that higher rates make the present value of years out cash flows less valuable. Also, stock dividend yields become less attractive relative to lower risk government bonds. The silver lining is that this math also works in reverse (in a positive way), and we believe we may be close to reaching a near-term peak in yields.

More specifically, our Technical Analyst, Russ Visch, notes that the recent sharp run-up in long-term interest rates has been the main driver for equity market weakness. Relief may be in sight though, as he believes the U.S. 10-year yield has likely peaked for the time being. In particular, rates have risen so fast on both a short- and medium-term basis, and to a degree which rarely occurs and typically results in significant declines. In fact, the last time medium-term momentum gauges were at these levels, it resulted in a material move down in rates. A similar move this time would be a significant tailwind for equity markets into the new year.

Figure 2: U.S. 10 Year Treasury Yield (Weekly)



Source: Russ Visch, CMT, Technical Analyst, BMO Nesbitt Burns Portfolio Advisory Team

Returning to the conflicts in the Middle East and Ukraine, we have long maintained that exogenous shocks tend not to have a long-lasting impact on the markets and that the economic cycle and interest rates are by far the most important drivers of financial asset returns. We stand by that view. **Figure 3** shows the market impact of different military conflicts, and the results are clear: a negative initial reaction with a subsequent recovery in the vast majority of cases. Going back to 1940, the median downdraft was 2% in the month leading up to the event, followed by a gain of 10% in the subsequent year.

Figure 3: Market Impact of Major Military Conflicts

	Event Reaction Dates		S&P 500 Index % Gain Around the START of Crisis Events							
Event	Start Date	End Date	-12 MONTHS	-6 MONTHS	-3 MONTHS	-1 MONTHS	+1 MONTHS	+3 MONTHS	+6 MONTHS	+12 MONTHS
Germany invades France	1940-05-09	1940-06-22	6.0	-3.7	-2.0	-2.7	-23.0	-15.3	-5.9	-22.0
Pearl Harbor	1941-12-06	1941-12-10	-10.9	-1.2	-8.2	-2.1	-3.5	-13.0	-10.5	-0.3
Korean War	1950-06-23	1950-07-13	35.7	15.0	9.0	2.3	-8.1	1.6	4.9	12.6
Cuban Missile Crisis	1962-10-19	1962-10-27	-18.8	-19.0	-1.5	-5.7	7.6	17.3	24.5	31.9
U.S. Bombs Cambodia	1970-04-29	1970-05-14	-20.4	-15.5	-4.5	-9.0	-6.4	-4.6	1.9	27.9
U.S.S.R. Invades Afghanistan	1979-12-24	1980-01-03	11.8	4.9	-1.8	2.9	5.6	-7.8	7.0	26.2
Falkland Islands War	1982-04-01	1982-05-07	-16.7	-2.8	-7.2	0.4	2.3	-4.5	7.2	34.4
Beirut Bombing	1983-10-21	1983-10-23	19.3	3.7	-1.8	-1.5	0.1	0.2	-4.8	1.2
U.S. Invades Grenada	1983-10-24	1983-11-07	19.6	3.5	-1.7	-2.1	0.6	0.0	-4.8	0.7
U.S. Bombs Libya	1986-04-14	1986-04-21	31.4	27.3	14.8	0.3	0.1	0.4	-0.8	17.7
Invasion of Panama	1989-12-15	1989-12-20	27.6	9.4	1.5	2.8	-3.7	-3.4	3.7	-6.6
Iraq Invades Kuwait	1990-08-02	1990-08-23	2.1	6.2	5.1	-2.2	-8.2	-11.3	-2.4	10.2
Gulf War	1991-01-16	1991-01-17	-7.2	-14.3	5.8	-3.3	16.7	22.6	20.7	32.3
World Trade Center Bombing	1993-02-25	1993-02-27	7.8	7.5	3.1	0.5	1.9	1.5	4.0	5.4
U.S. Embassy Bombings Africa	1998-08-06	1998-08-14	13.5	7.6	-1.4	-5.9	-10.6	4.7	13.8	19.3
U.S.S. Cole Yemen Bombing	2000-10-11	2000-10-18	2.2	-9.1	-7.9	-8.4	0.1	-2.8	-14.6	-19.6
WTC and Pentagon terrorist Attacks	2001-09-10	2001-09-21	-26.9	-11.4	-13.6	-8.2	-1.1	4.3	6.6	-16.8
War in Afghanistan	2001-10-05	2001-10-09	-25.4	-7.0	-12.1	-5.3	2.9	9.4	4.8	-25.3
Iraq War	2003-03-19	2003-05-01	-25.3	3.6	-1.2	3.4	2.2	13.8	18.6	27.0
Madrid Terrorist Attacks	2004-03-10	2004-03-24	39.2	11.2	6.1	-1.9	1.4	1.1	0.0	7.6
India Israel and Lebanon Bombings	2006-07-11	2006-07-18	4.4	-1.7	-1.1	1.6	-0.5	6.1	11.9	19.4
Russia Invades Georgia	2008-08-08	2008-08-16	-13.4	-2.6	-7.3	1.8	-2.2	-28.2	-33.0	-22.1
Israel Invades Gaza	2008-12-27	2009-01-21	-40.9	-31.7	-28.1	-1.7	-3.1	-6.5	5.3	29.1
Russia Invades Crimea	2014-03-07	2014-03-14	21.6	13.5	4.0	4.5	-1.8	3.8	6.9	10.3
Russia Invades Ukraine	2022-02-24	2022-03-14	9.3	-4.4	-8.8	-2.8	5.4	-8.1	-3.5	-7.4
Hamas/Israel War	2023-10-07	2023-10-23	18.4	5.0	-2.3	-3.5				
		Events Median:	5.2	1.2	-1.8	-2.0	0.1	0.2	4.0	10.2

Source: BMO Nesbitt Burns Porfolio Advisory Team, NDR, S&P Dow Jones Indices

As always, we strongly recommend against overreacting to the current bout of volatility. The key is to maintain a well diversified portfolio including bonds, cash and high-quality stocks.

Please contact your BMO Nesbitt Burns Investment Advisor if you would like to discuss your invesment portfolio.

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