Equity and Fixed Income Strategy

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Stock Markets Can Continue to Climb the Wall of Worry

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For the better part of the last 12 months, numerous pundits have assured us that a recession was at hand or had already begun. Well, here we are, a third of the way through 2023, and still no recession in U.S. or in Canada. Could we see one occur before the end of the year or in early 2024? It is certainly possible, but it is still not a foregone conclusion in our view. As a reminder, we always caution against using "official" Gross Domestic Product (GDP) figures to inform us on the direction of securities markets since they are ancient history by the time they are published, and the stock and bond markets are forward looking (i.e. the stock market tells us what is going to happen in 3-6 months). Still, this data has its uses. In this case, to debunk the notion that we were already in a recession at the start of the year. Case in point, the recently released Real U.S. Q1 GDP showed a slowdown (fully expected) but still grew 1.1% annualized (down from 2.6% in Q4) as inventories shrank meaningfully, offset by continued strong consumer spending. Clearly, companies are being cautious as shown by their focus on cash conservation and cost cutting through multiple layoff announcements. The upside of this corporate behavior is that profit margins should remain robust and that the unavoidable economic reacceleration will be further helped by inventory restocking.

The political rhetoric is intensifying regarding the U.S. debt ceiling standoff and it does present a risk to markets and may lead to increased volatility in the next months. Still, the political expert of our research partners at Piper Sandler notes that "Our base case is Democrats and Republicans will reach a deal at the eleventh hour, avoiding an outcome where the Treasury won't have sufficient funds to pay all the federal government's bills. To get the votes to raise the debt ceiling in both the House and Senate, Democrats are probably going to have to offer a modest policy concession to Republicans, which may or may not have anything to do with the budget. We put about 10-15% odds there is no deal by June. The political pressure to reach a deal will be immense, so even if Congress goes past the deadline a deal is likely to be reached within hours or days of checks not going out. To be clear, this may put rating agencies on alert but bondholders get paid in any scenario".

Figure 1: BMO Nesbitt Burns Investment Strategy Committee's Recommended Asset Allocation (%)

	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	0	5	0	5	0	5	0	5
Fixed Income	70	70	40	45	20	25	0	0
Equity	30	25	60	50	80	70	100	95
Canadian Equity	25	15	35	25	45	35	50	40
U.S. Equity	5	5	20	15	20	20	30	30
EAFE Equity	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

Source: BMO Nesbitt Burns Private Client Strategy Committee

The silver lining from the recent banking scare is that 10-year interest rates – the cornerstone of financial markets – actually fell by about 50 basis points. The combination of slower growth, slower inflation, uncertainty surrounding U.S. regional banks, and the U.S. Federal Reserve (Fed) likely pausing its tightening after hiking in early May contributes to lower long-term yields. Given our long-held view that inflation has peaked, we believe rates will stay range-bound which has a positive impact on the fair value of stock markets. The fundamental question for stock investors – and unfortunately, there is no definitive answer on this – is how much economic slowdown is currently priced in? Our view is that a mild recession is priced in at this point but a severe one is not. This is also reflected in short-term markets pricing in easier Bank of Canada and Fed monetary policies by Q1 next year (rate cuts of between 0.25% to 0.50%). Thankfully our base case falls in the former category which leads us to the view that investors should make moderately positive returns from both stocks and bonds this year. It will continue to be a bumpy ride though.

The tables below show our "fair value" estimates for the Canadian and U.S. markets based on 3.5% long-term interest rates in Canada and the U.S. In summary, this move increases the value of North American stock markets by approximately 5%. Specifically, we believe the TSX and S&P could rise to 24,000 and 4,300 respectively in the next year or so. Clearly, this provides far more upside for the Canadian market which had underperformed the S&P 500 in the last decade (until last year). Market composition has a lot do with it. Our market has a far greater proportion of cyclical and value stocks (think Energy, Mining, and Financial stocks which trade at low multiples of earnings) than the U.S. which is strong in Technology, Healthcare, and Consumer stocks. We happen to believe that prospects and risk/reward is very attractive for several Canadian Financial, Energy, Mining and Industrial heavyweights (e.g. CP Rail, Canadian National Railway, Finning, Toromont, Royal Bank of Canada, Canadian Natural Resources, and more).

Figure 2: S&P 500 Fair Value Estimate

	Present value	% of value	Earnings per share growth	Discount rate
Period 1 (2023-2026)	988.52	22.9%	7%	9.0%
Period 2 (2027-2030)	696.63	16.1%	6%	9.0%
Period 3 (2031 -)	2,638.34	61.0%	3%	9.0%
Rounded Fair Value	**4,300**	100.0%	Next 12 month consensus	214
			Implied terminal mult.	15.3 X
Current Price (March 17, 2023)	**3,970**		Long Bond	3.5%
			Historical Equity Risk Premium	4.5%
Upside Potential	**8%**		Additional Risk Premium	1.0%
			Total discount rate	9.0%

Figure 3: TSX Fair Value Estimate

	Present value	% of value	Earnings per share growth	Discount rate
Period 1 (2023-2026)	6,481.78	26.7%	6%	9.0%
Period 2 (2027-2030)	4,226.81	17.4%	4%	9.0%
Period 3 (2031 -)	13,607.22	56.0%	2%	9.0%
Rounded Fair Value	**24,000**	100.0%	Next 12 month consensus	1,500
			Implied terminal mult.	13.1 X
Current Price	**19,700**		Long Bond	3.5%
			Historical Equity Risk Premium	4.5%
Upside Potential	**22%**		Additional Risk Premium	1.0%
			Total discount rate	9.0%

Source: BMO Private Client Strategy

Figure 4: TSX Sector Weights

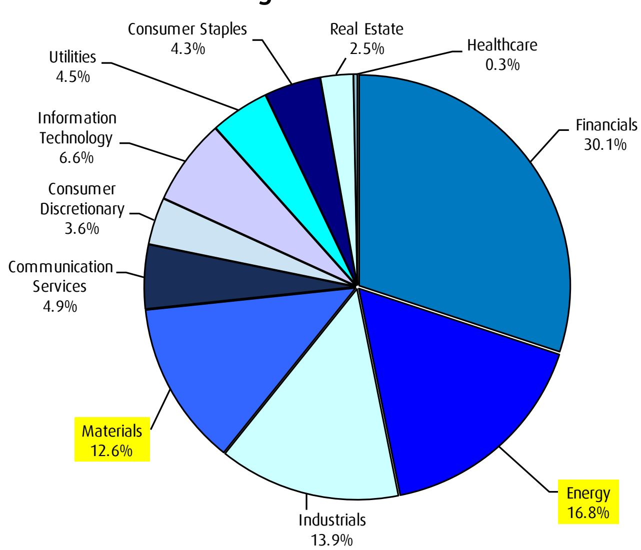
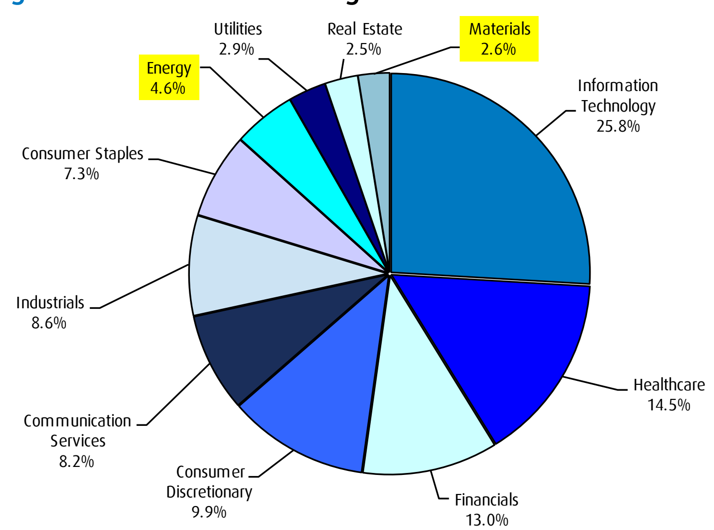


Figure 5: S&P 500 Sector Weights



Source: BMO Private Client Strategy, FactSet

We believe that history is on our side with respect to our relatively bullish call on stocks. The table below shows that the market very rarely has two negative years in a row, and when it does, it tends to be because of major disruptions such as the Depression of the 1920s/1930s, the tech crash of the early 2000s, or the 2007/2008 financial crisis.

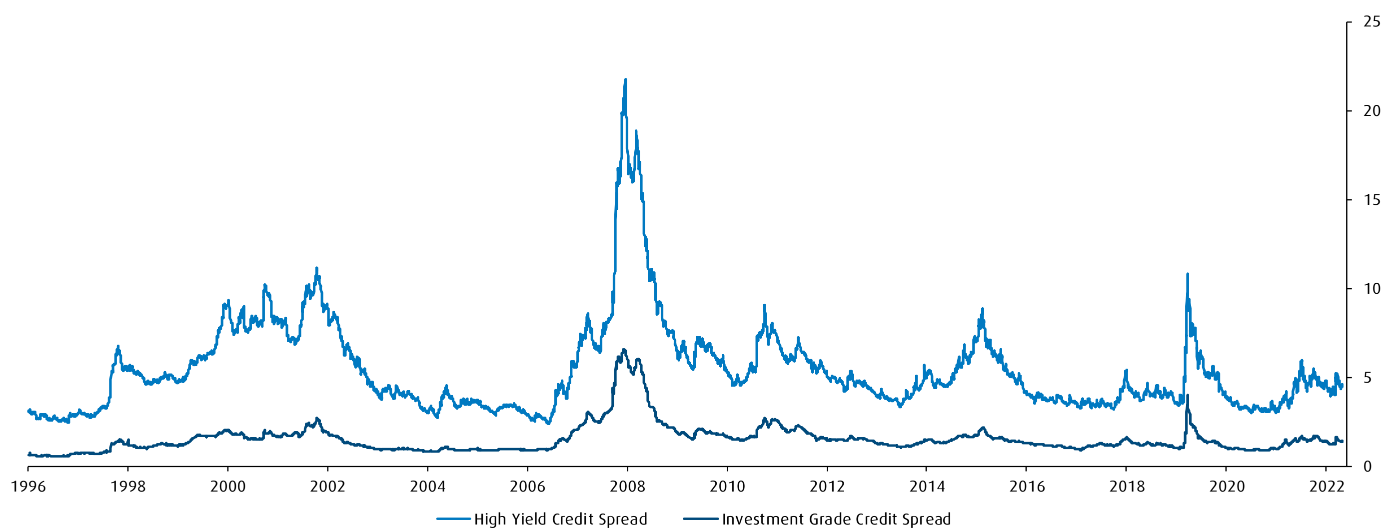
Figure 6: TSX and S&P 500 Episodes with Two or More Consecutive Negative Years

	TSX	S&P 500
2 Negative Yrs.	**1**	**2**
3 Negative Yrs.	**0**	**2**
4 Negative Yrs.	**0**	**1**
	2001	1929
	2002	1930
		1931
		1932
		1939
		1940
		1941
		1969
		1970
		1973
		1974
		2000
		2001
		2002

Source: BMO Private Client Strategy

Also, as we have noted before, key fixed income indicators (Credit Default Swaps[1] and credit spreads) currently point to a relatively benign environment. Despite signs of tightening bank credit conditions, credit spreads continue to behave relatively well, having tightened not widened in the last month. While counterintuitive to the current market environment, it shows that corporations came into 2023 with strong cash/balance sheet positions, well-funded from years of low interest rates.

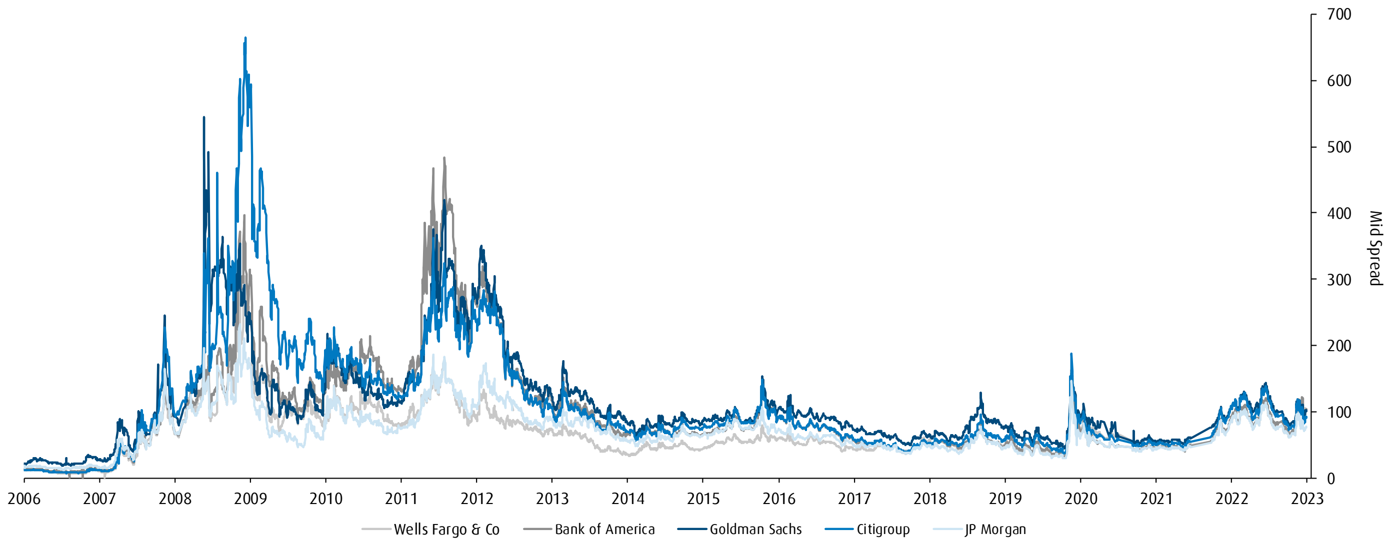
Figure 7: U.S. Corporate Credit Spreads Back Below Long-Term Averages



Source: BMO Private Client Strategy, FRED

[1] Credit Default Swaps (CDS) are the cost in basis points (0.0001%) to insure against an issuer bond default.

Figure 8: U.S. Major Financial Institutions Credit Default Swaps Stabilize



Source: BMO Private Client Strategy, Bloomberg

History is also on our side relative to inflation coming down. The tables below show the stark difference in performance over the last 50 years when inflation was up or down at least 2.5%. Clearly, when inflation declined materially – irrespective of the starting point – the S&P was up double digits on average with notable outperformance from sectors we recommend such as Consumer Discretionary and Financials. Technology has bounced back impressively year to date, but very expensive valuations and declining growth prospects keep us cautious for the time being. As will all sectors though, we can still find attractive opportunities such as CGI, Broadcom, and Alphabet (Google) for instance.

Figure 9: Performance When Inflation "Reversed" (Down or Up 2.5%) Since 1972

Rising CPI	
Sector	**% Annualized Gain**
Energy	11.2
Healthcare	3.4
Consumer Staples	3.0
Materials	2.9
S&P 500	**1.7**
Industrials	1.6
Comm. Services	1.0
Utilities	0.9
Real Estate	0.3
Info. Technology	0.0
Consumer Disc.	-2.3
Financials	-6.1

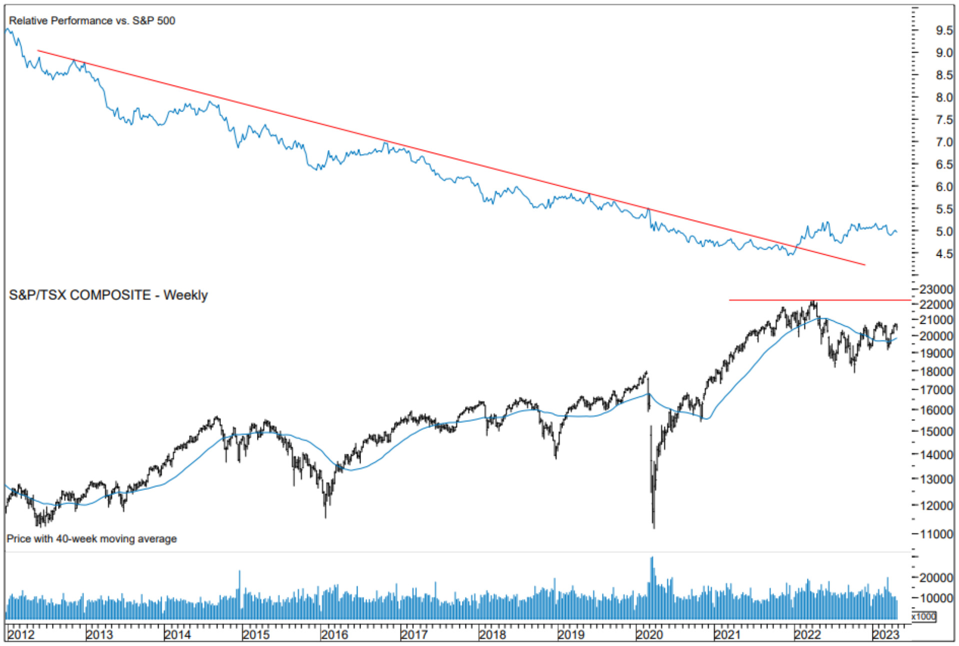
Falling CPI	
Sector	**% Annualized Gain**
Consumer Disc.	15.5
Info. Technology	15.3
Financials	15.3
Healthcare	14.2
Consumer Staples	13.5
S&P 500	**12.1**
Industrials	11.5
Comm. Services	11.3
Materials	9.1
Real Estate	7.5
Utilities	5.7
Energy	4.3

Source: BMO Private Client Strategy, NDR

Technical Analysis – Russ Visch

In early 2023, the S&P/TSX Composite reversed a ten-year trend of underperformance versus the S&P 500 and hasn't looked back. Yes, there have been minor pauses along the way but the TSX has been outperforming consistently since then, and there is no sign of that trend changing either. The expectation is that this should remain the case throughout 2023 at least.

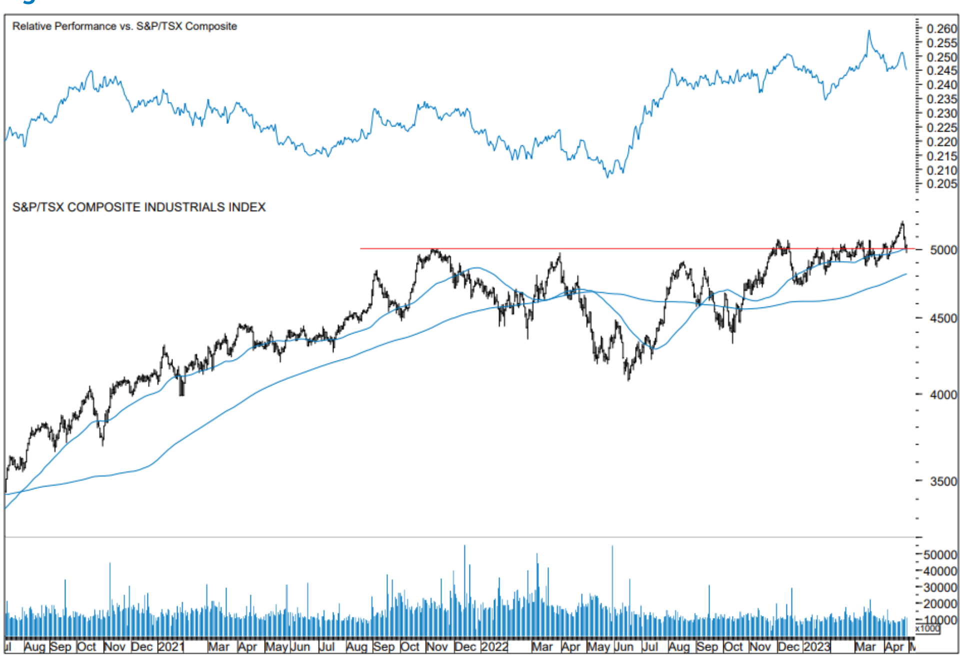
Figure 10: TSX vs. S&P 500



Source: BMO Nesbitt Burns Technical Analysis

The TSX Industrials Index broke out from a massive 18-month trading range. The recent close above the resistance at 5,010 signaled a resumption of the long-term uptrend and opened a new upside target of 5,940. The index has also been consistently outperforming the S&P/TSX Composite since the low of last October. This is consistent with how pro-cyclical economically sensitive sectors tend to perform as markets shift from bear markets to bull markets.

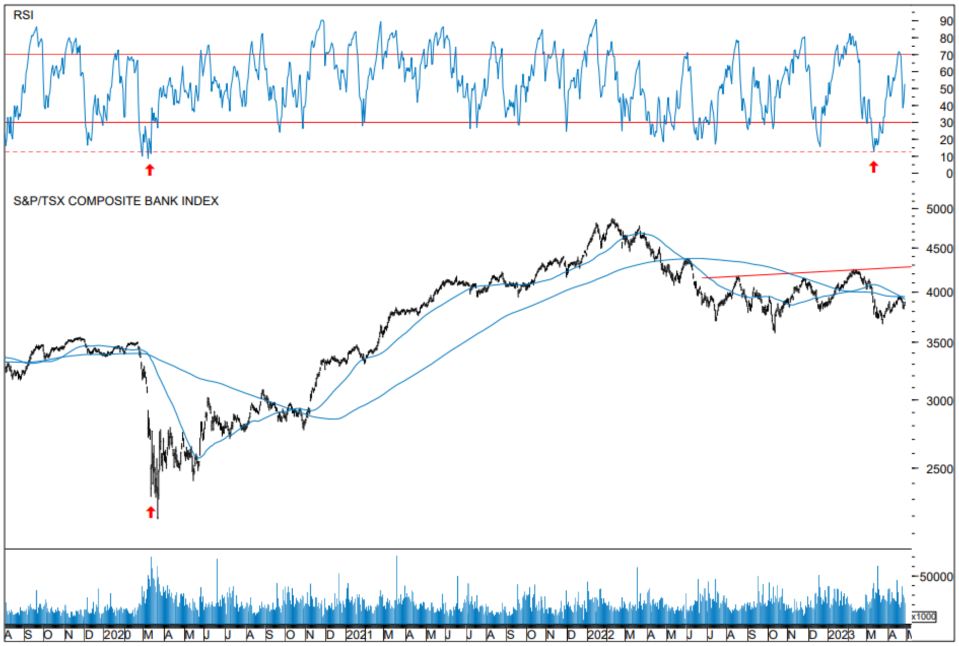
Figure 11: TSX Industrials Index



Source: BMO Nesbitt Burns Technical Analysis

The TSX Bank Index is reversing back to the upside from a successful test of the mid-2022 low accompanied by new buy signals in short-term momentum gauges (from the steepest oversold reading since the pandemic low, no less). There is at least a trade back to the upper end of the base at 4,280. A breakout there would shift the long-term trend to bullish and open a new upside target of 4,975, essentially in line with the late 2021 all-time high.

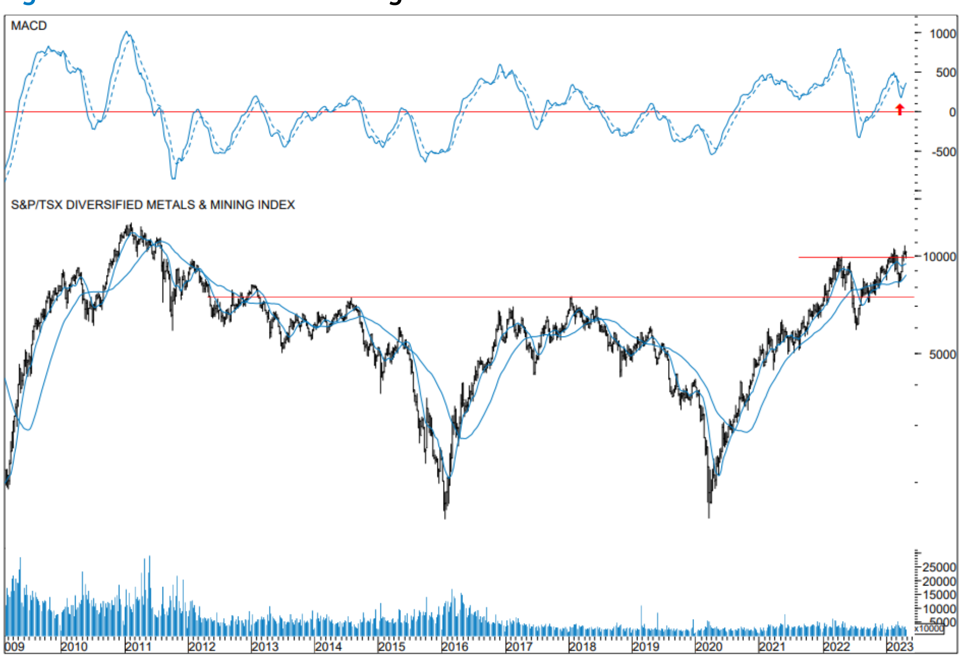
Figure 12: TSX Bank Index



Source: BMO Nesbitt Burns Technical Analysis

The TSX Diversified Mining & Metals Index broke out from a massive ten-year base pattern. The close above resistance near 7,500 shifted the secular (multi-year/multi-decade) trend to bullish and opened a new upside target that measures to 13,300. Currently reversing back to the upside from a successful test of the breakout, a close above the early 2022 peak at 9,990 would open an additional target of 14,000.

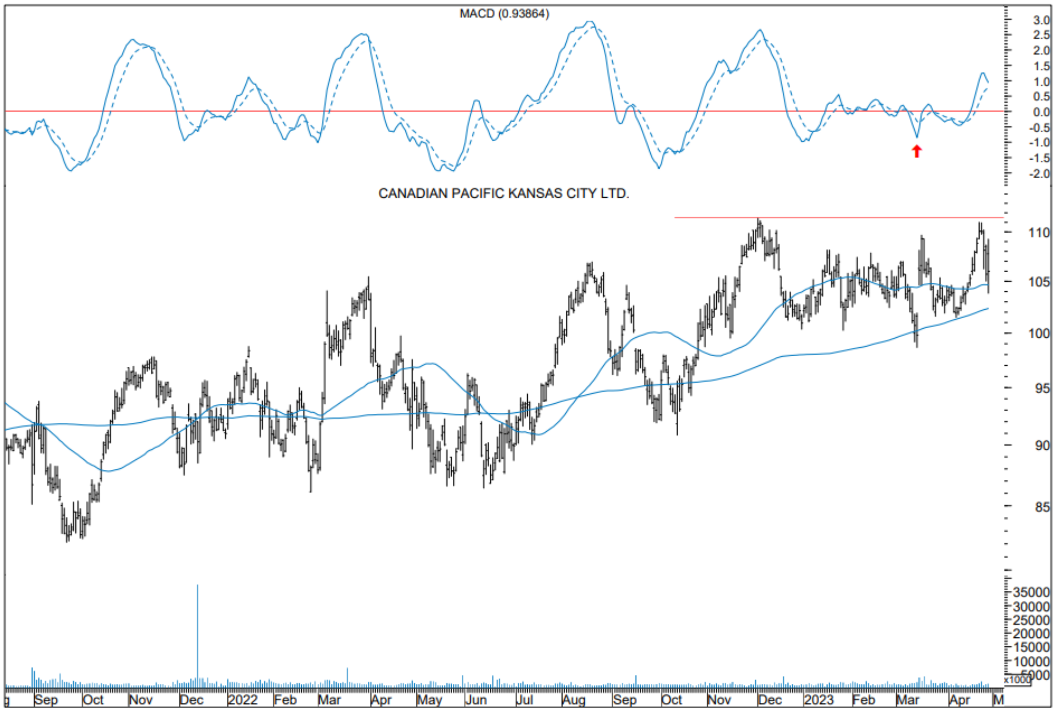
Figure 13: TSX Diversified Mining & Metals Index



Source: BMO Nesbitt Burns Technical Analysis

CP is reversing back to the upside from a successful test of its rising 200-day moving average accompanied by new buy signals in daily momentum gauges. Tradable back to the recent peak at $111.50. A breakout above that level would open a new upside target of $124.

Figure 14: Canadian Pacific Kansas City (CP-T)



Source: BMO Nesbitt Burns Technical Analysis

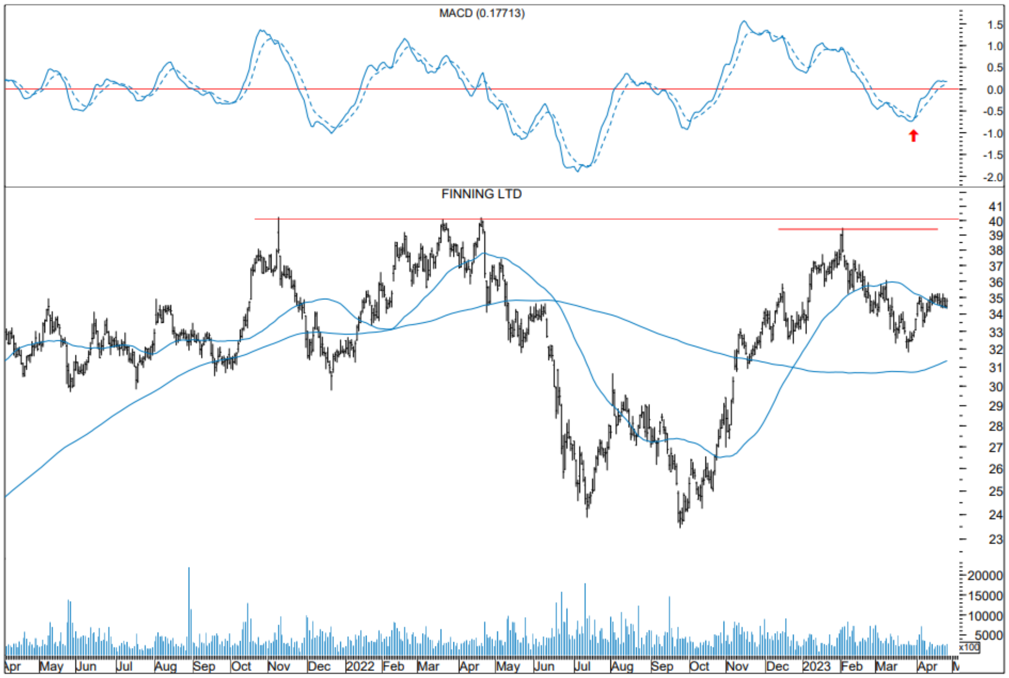
RY is in a short-term pullback within a bigger medium-term uptrend. Recent sell signals in daily momentum gauges suggest risk exists for a test of the 200-day moving average at $129.50. Use that as an opportunity to buy the stock. Medium-term timing indicators (not pictured) remain bullish and supportive of more upside. For example, expect a challenge of the upper end of the rising channel near $146, more or less in line with the 2022 peak, at some point in 2023.

Figure 15: Royal Bank (RY-T)

Source: BMO Nesbitt Burns Technical Analysis

FTT is reversing back to the upside from a successful test of its rising 200-day moving average accompanied by new buy signals in daily momentum gauges. Tradable back to resistance in the $39.50-40 zone. A breakout above $40.50 would open a new upside target of $55-56.

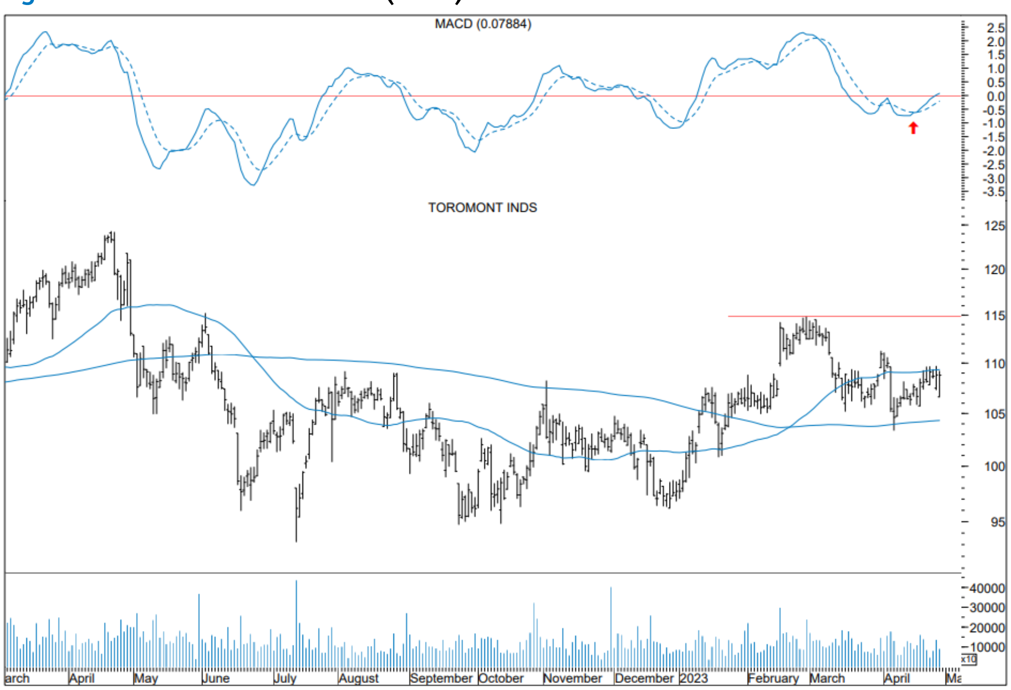
Figure 16: Finning (FTT-T)



Source: BMO Nesbitt Burns Technical Analysis

TIH is reversing back to the upside from a successful test of its rising 200-day moving average accompanied by new buy signals in daily momentum gauges. Tradable back to the recent peak at $114.75. A breakout above that level would open a new upside target of $124.25.

Figure 17: Toromont Industries (TIH-T)



Source: BMO Nesbitt Burns Technical Analysis

Figure 18: S&P/TSX Composite Total Returns

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Info. Technology	1.49	28.41
Materials	3.22	11.56
Telecom. Services	6.56	9.98
Utilities	2.41	9.32
Consumer Staples	1.26	9.24
S&P/TSX Composite Index	**2.90**	**7.59**
Industrials	0.59	7.14
Health Care	5.68	6.60
Cons. Discretionary	1.39	6.09
Real Estate	0.83	5.76
Financials	3.23	4.96
Energy	4.62	2.18

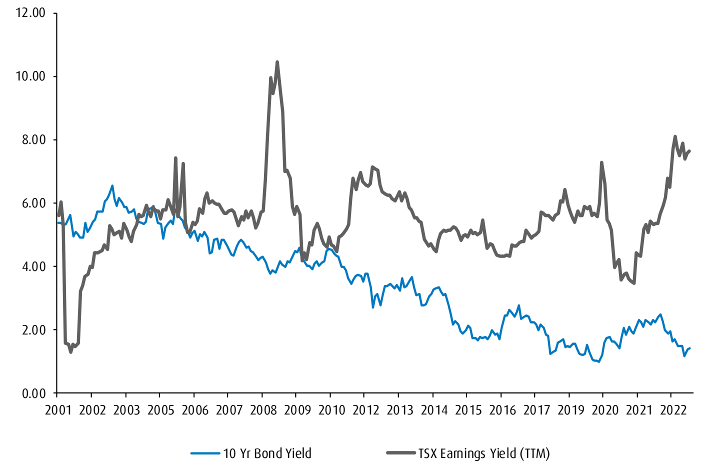
30-Apr-23
Source: Bloomberg

Figure 19: S&P 500 Sector Total Returns

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Telecom. Services	3.77	25.05
Info. Technology	0.45	22.37
Cons. Discretionary	-0.95	15.03
S&P 500 Index	**1.56**	**9.17**
Consumer Staples	3.59	4.45
Materials	-0.14	4.14
Industrials	-1.18	2.24
Real Estate	0.83	1.88
Health Care	3.07	-1.37
Utilities	1.87	-1.44
Energy	3.30	-1.52
Financials	3.18	-2.56

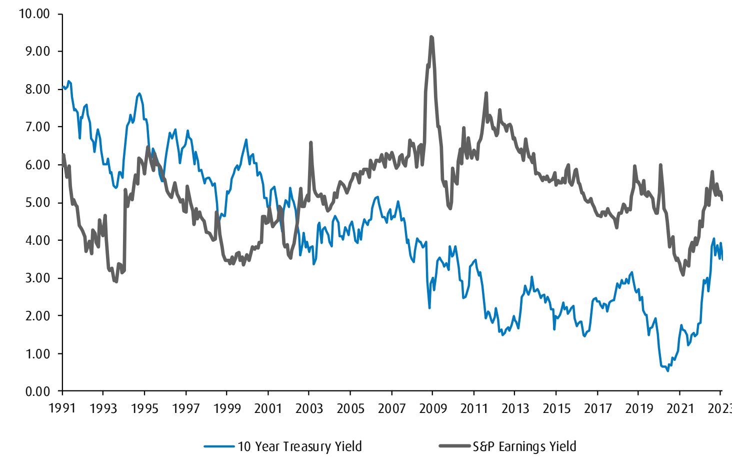
30-Apr-23
Source: Bloomberg

Figure 20: S&P/TSX Composite Earnings Yield vs 10-Year GoC Yield



Source: BMO Private Client Strategy, Bloomberg

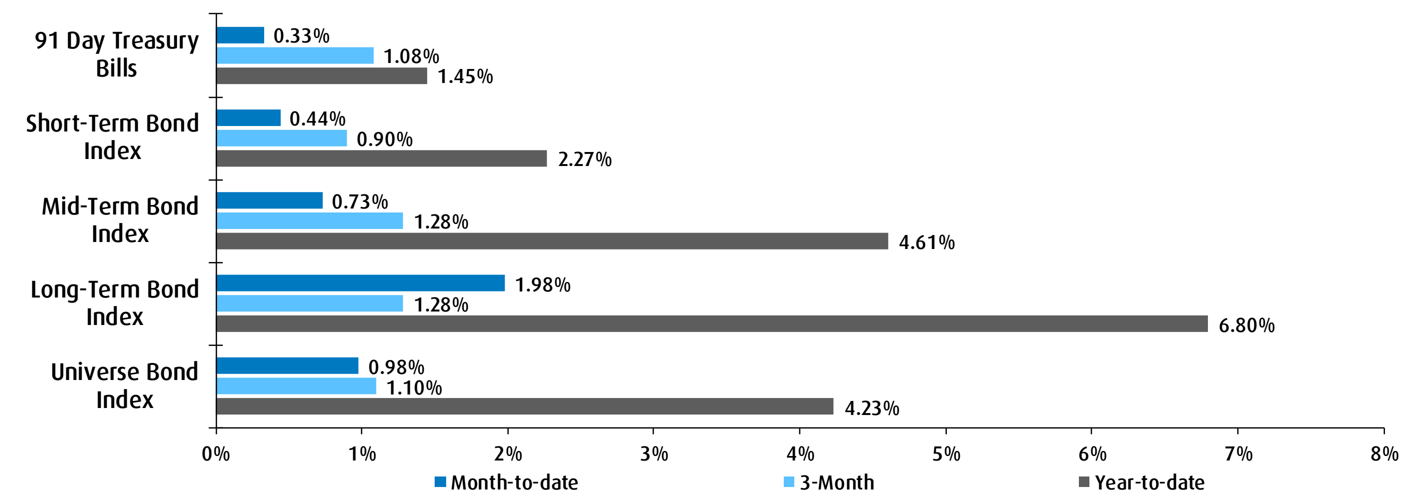
Figure 21: S&P 500 Earnings Yield vs 10-Year Treasury Yield



Source: BMO Private Client Strategy, Bloomberg

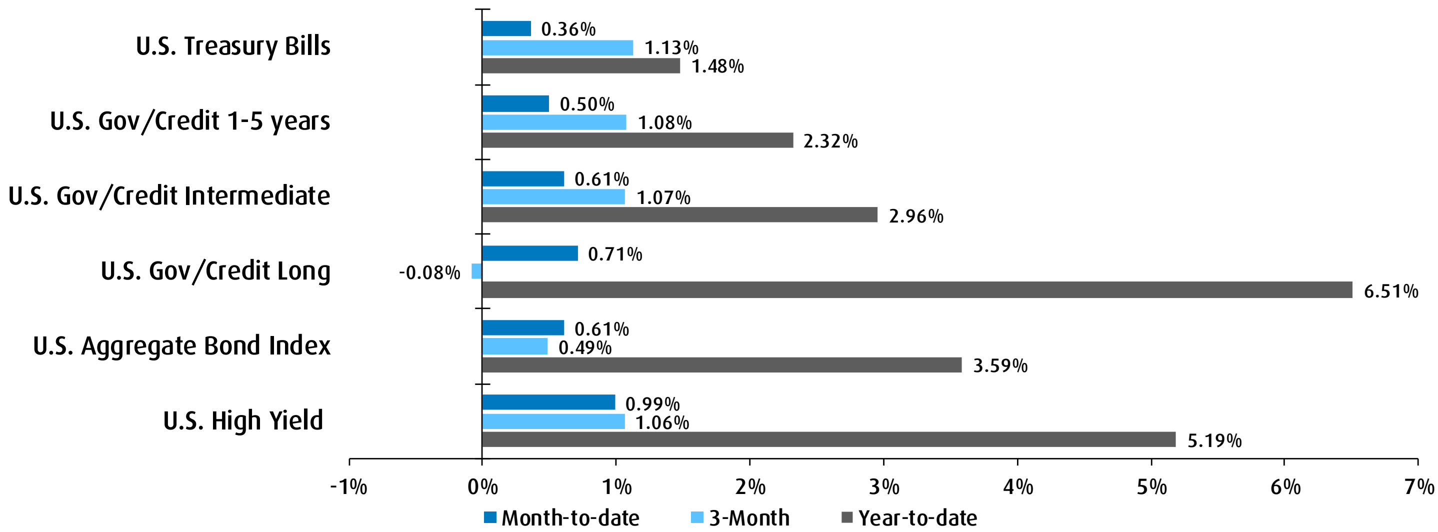
Figure 22: Canada/U.S. Bond Index Total Returns Through April 2023

Canada



Source: FTSE

U.S.



Source: Bloomberg Barclays

General Disclosure