# Putting the Pieces Together

## High Rates vs Equity Markets

Between another averted U.S. Government shutdown and war breaking out in Israel, stubborn inflation, investors have had plenty of risks to consider. However, the risk to rule them all has to do with interest rates. In fact, investors have become fixated with the U.S. long-term interest rates which went above the psychologically important 4.50% level (we were at 3.50% as early as May of this year), now close to 5.0%. We are now at the highest level in over 15 years. This move has many investors contemplating how much longer the 2023 YTD market rally can last should interest rates continue to rise or stay elevated. However, work done by BMOCM (BMO Capital Markets) shows that investors should not fear higher rates, despite conventional thinking. In fact, they found that some of the strongest periods of S&P500 performance have coincided with rising or higher levels of rates over the past few decades. Thus, we believe it is important for us to stay the course and maintain our investment discipline that sets an emphasis on predictable and growing profit margins.

Adding fear to the narrative, the Federal Reserve has done a fantastic job. However, according to the Minutes from the September 20th FOMC Meeting showed a growing sensitivity from the Committee to the two-sided risks to their currently restrictive monetary policy stance. The tone of the Minutes suggest that the Fed now has the luxury of proceeding cautiously and patiently. "***Participants generally judged that, with the stance of monetary policy in restrictive territory, risks to achievement of the Committee's goals had become more two sided.***" On the policy outlook, "***All participants agreed that the Committee was in a position to proceed carefully…***" though "***all participants agreed that policy should remain restrictive for some time until the Committee is confident that inflation is moving down sustainably toward its objective*".** This is a nod to the higher-for-longer crowd. Several participants commented that, with **the policy rate likely at or near its peak**, the focus of monetary policy decisions and communications should shift from how high to raise the policy rate to how long to keep it restrictive. Still, three weeks ago, at the September meeting, most participants judged that one more increase in the target fed funds rate at a future meeting would likely be appropriate, while some judged it likely that no further increases would be warranted. Since then, the 10-year Treasury yield has moved up by around 30 basis points, helping the Fed to slow somewhat economic activity.


Let's connect

**Roux & Associates**
**Wealth Management Group**
BMO Nesbitt Burns

1501 McGill College Ave.
Suite 3200
Montréal, QC
H3A 3M8

**www.christian-roux.com**

**Christian Roux**
514-871-7026
christian.roux@nbpcd.com

**Nektarios Pouliezos**
514-282-5929
nektarios.pouliezos@nbpcd.com

**Nancy Bélanger**
514-871-7076
nancy.belanger@nbpcd.com

**Elizabeth Le Comte**
514-282-5808
elizabeth.lecomte@nbpcd.com

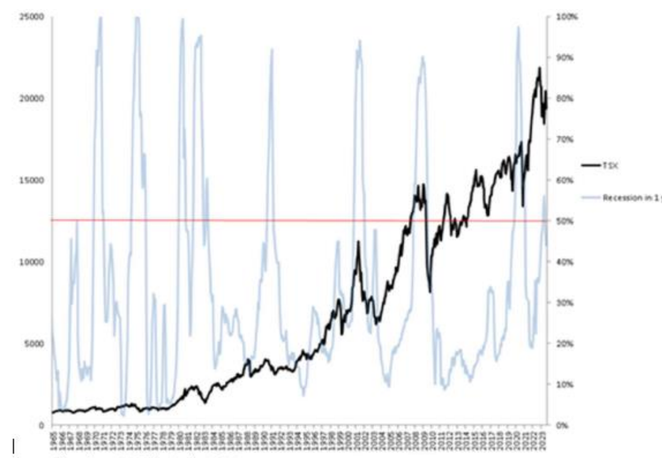
**Bottom Line:** The Fed Minutes' tone was a bit more dovish than expected, despite the threat of one more rate hike from the Fed still on the table. Notably, the probability of another Fed rate hike at the November FOMC meeting plunged to just 9.8% in the Fed funds futures market, following the release of the Minutes, with the probability of a December hike at around 29.0%. This is in-line with BMO Economics' forecast for no more rate hikes from the Fed, but a higher-for-longer hold in 2024.

Conventional thinking seems to suggest that any form of higher yields is automatically bad for stocks. However, from 1990 through 2007 (pre–Financial Crisis) the average 10-year Treasury yield was 5.8% while the S&P 500 delivered a 9.6% CAGR (Compound Annual Growth Rate) and had an average NTM (Next Twelve Months) P/E of 19.9x. By contrast, since 2008, the average 10-year Treasury yield has been 2.5% with the S&P 500 delivering a 6.6% CAGR and an average NTM P/E of 17.2x. In other words, the S&P 500 performed better and had a higher valuation during a period of significantly higher average interest rates.

This past October 12, 2023, marked the one-year anniversary of the S&P 500 price low stemming from the Fed's most aggressive rate hiking campaign since the early 1980s. As a reminder, the S&P hit an all-time high of 4,796 on January 3, 2022, then proceeded to plunge 25.4% through October 12 alongside the 300-bps increase in the Fed Funds rate that occurred during the period. That said, it has become increasingly clear over the past year that the economy has held up much better than expected while inflation has cooled closer to normal levels and consequently the S&P 500 increased some 20.0% from last year's low. While this one-year gain is certainly not impressive by bull market standards, BMOCM believes it is notable since many entered the year prognosticating a doom-and-gloom for US stocks. In addition, they believe it is important to point out how orderly the rally has been judging by the standard deviation of daily returns, which aside from the beginning of the early 1990s bull market, was at its lowest level since the 1960s. BMOCM has stated on numerous occasions that they believe the bull market has started and it's alive and well.

Our equity and Fixed Income Strategists team echoes BMOCM's thoughts on this recovery. Recent weakness has created some value in stocks, however we still must remain selective and focus on growth at a reasonable price. According to their proprietary recession probability model the odds of a North American recession on the next year has decreased to 45%. Backing up this view, important industrial indicators have started to stabilize and even turn up in some cases. More specifically, BMO's Commodity Strategist Colin Hamilton notes that while still weak in absolute terms, there has been improvement. Corporate earnings estimates have followed suit, rising for the first time in over a year.

*Recession Probability Model – S&P/TSX Composite*




*Source: Bloomberg, BMO Private Client Strategy*

Our strategy team looked at the impact of higher rates on historical sector performance. The most important conclusion is that 2 years after a 3% increase in long rates (this has only happened on 5 occasions since the 1970s), the market typically shows healthy returns, albeit with a wide variation of returns among sectors. The top performers have been defensive sectors such as Consumer Staples and Healthcare along with more cyclical areas like Financials, Consumer Discretionary and Energy. The one sector that has systematically underperformed is Technology. We do not recommend avoiding the entire Tech sector because the world has drastically changed since the 70s, but rather to be particularly sensitive to barriers to entry and valuations.

*Historical Performance Post 3% Increase in Long Rates*

| Sector | Average Return (%) 1 Year | 2 Years | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|
| Consumer Staples | 6.39 | **46.46** | 67.57 | 138.57 | 444.88 |
| Healthcare | 7.90 | **44.80** | 66.08 | 92.10 | 301.79 |
| Financials | 10.02 | **36.80** | 26.84 | 58.19 | 152.74 |
| Communication Services | 8.42 | **34.21** | 40.47 | 78.26 | 208.35 |
| Consumer Discretionary | -0.79 | **28.36** | 43.78 | 77.18 | 192.47 |
| Energy | 4.46 | **27.28** | 30.90 | 36.23 | 134.28 |
| Industrials | -1.38 | **26.25** | 26.81 | 52.20 | 152.30 |
| Materials | 0.41 | **20.56** | 32.44 | 49.63 | 133.98 |
| Utilities | 5.20 | **19.98** | 26.54 | 40.90 | 84.32 |
| Real Estate | -6.41 | **14.38** | 17.92 | 18.53 | 59.12 |
| Information Technology | -11.43 | **7.46** | 18.54 | 26.19 | 86.00 |

*Source: NDR, BMO Private Client Strategy*

## Growth/value vs Fed Funds cycle

As BMO Economics and BMOCM state, a pause in the rate hikes is upon us. There remains a possibility of one more hike, but nonetheless we are at a peak. That said, our Strategy's Team and BMOCM work shows that the market tends to act well with interest rate stability. The other conclusion is that value stocks tend to outperform growth equities 12 months after interest rate stability is achieved.

*S&P 500 Sector Performance after Fed Pause since 1973*

| Sector | 6 Months After Fed Cycle: % Succeeded by Positive Returns | 6 Months After Fed Cycle: Average Return (%) | 12 Months After Fed Cycle: % Succeeded by Positive Returns | 12 Months After Fed Cycle: Average Return (%) |
|---|---|---|---|---|
| Healthcare | 75% | 9.2 | 88% | 17.9 |
| Consumer Staples | 88% | 10.7 | 88% | 15.9 |
| Financials | 88% | 10.4 | 88% | 14.0 |
| Utilities | 88% | 8.4 | 88% | 13.7 |
| Comm. Services | 75% | 7.4 | 63% | 11.1 |
| Energy | 75% | 4.7 | 88% | 10.5 |
| Industrials | 75% | 4.4 | 75% | 10.1 |
| **S&P 500** | **63%** | **5.6** | **63%** | **9.9** |
| Consumer Disc. | 63% | 4.2 | 63% | 8.5 |
| Materials | 63% | 1.9 | 88% | 8.1 |
| Info. Technology | 63% | 4.2 | 38% | 5.7 |
| Real Estate | 63% | 1.9 | 63% | 2.3 |

*Source: NDR, BMO Private Client Strategy*

*Value Tends to Underperform During Tightening but Outperforms growth Following a Fed Pause*

| Russell 1000 Growth vs. Value: Date | -12 MONTHS | -9 MONTHS | -6 MONTHS | -3 MONTHS | +3 MONTHS | +6 MONTHS | +9 MONTHS | +12 MONTHS |
|---|---|---|---|---|---|---|---|---|
| 1995 | 6.7 | 7.69 | 7.78 | 0.17 | 0.01 | 3.4 | 4.46 | 2.54 |
| 2000 | 32.16 | 26.55 | 12.95 | -6.72 | 2.73 | -13.71 | -28.49 | -33.65 |
| 2006 | -3.88 | -3.77 | -6.5 | -3.68 | -2.01 | -3.55 | -3.53 | -1.23 |
| 2018 | 7.16 | 1.97 | -2.52 | -2.96 | 3.49 | 6.86 | 7.27 | 9.68 |
| 2023 | 12.15 | 14.7 | 18.76 | 7.86 | | | | |
| Average | 10.86 | 9.43 | 6.1 | -1.07 | 1.06 | -1.75 | -5.07 | -5.67 |

| S&P 500 Growth vs. Value: Date | -12 MONTHS | -9 MONTHS | -6 MONTHS | -3 MONTHS | +3 MONTHS | +6 MONTHS | +9 MONTHS | +12 MONTHS |
|---|---|---|---|---|---|---|---|---|
| 1995 | 7.26 | 7.47 | 7.17 | 0.35 | -0.25 | 2.75 | 5.21 | 3.79 |
| 2000 | 17.53 | 13.1 | 4.79 | -5.22 | 1.65 | -12.92 | -26.41 | -29.63 |
| 2006 | -6.11 | -6.24 | -6.49 | -3.58 | 0.73 | -0.97 | -2.07 | -1.26 |
| 2018 | 10.14 | 3.36 | -0.43 | -0.39 | 1.07 | 4.4 | 2.27 | -0.19 |
| 2023 | -3.28 | 0.87 | 8.62 | 2.88 | | | | |
| Average | 5.11 | 3.71 | 2.73 | -1.19 | 0.8 | -1.68 | -5.25 | -6.82 |

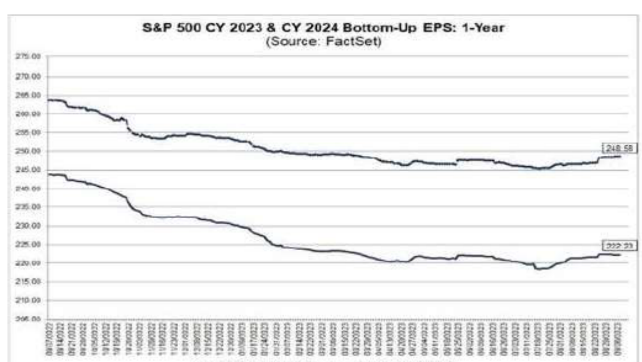
*Source: FTSE Russell, NDR, BMO Private Client Strategy*

## Earnings Themes

Most importantly, analyst earnings estimates have started moving back up for 2023 and 2024 after consistently coming down since 2022. Thematically, more companies than ever are citing AI in their conference calls and less companies are citing inflation as CPI and producer prices have come down. These trends are encouraging as a whole because of lower inflation and as we write this earning season equities are beating their estimates.

In terms of estimate revisions, analysts have increased earnings estimates for Q3 2023 for the first time since Q4 2021. On a per-share basis, estimated earnings for the third quarter have increased by 0.4% since June 30. In terms of revenues, analysts have also increased their estimates during the quarter.

*Bottom-Up EPS Estimates*




*Source: Factset*

## Technical Views

It’s not all bad news for equity markets though, in fact, there’s plenty of evidence to suggest that at a very top level, equity markets have for the most part discounted the shift in the interest rate regime and are set to rally through the remainder of the year. For example, while equity markets have come under a considerable amount of pressure through the month of September, the conditional elements are mostly all in place for a trading low to develop any time now. For example, the last time the S&P 500 and Nasdaq Composite were this oversold on a short-term basis was shortly before the major bear market low in October of 2022.

*S&P 500*


*Source: BMO Nesbitt Burns Technical Analysis*

*Nasdaq*


*Source: BMO Nesbitt Burns Technical Analysis*

Many other breadth oscillators are also now stretched into oversold extremes that typically only occur at major turning points and put-call ratios are beginning to skew heavily bearish as well. Usually, major lows in the market are accompanied by aggressive put buying as investors make heavily negative bets on the market. At the same time, we’re not seeing any real deterioration in bond market sentiment gauges. In fact, the Moody’s BAA/US 10-Year yield spread just registered a six-year record narrowness in late September, thus the bond market isn’t worried about what’s going on in equity markets.

Your team will remain alert to the developing trends and remain active to keep your short and long-term plans on track.

Hope to talk to you soon,

**Team Roux & Associates**

BMO Private Wealth

Roux & Associates Wealth Management Group

BMO Nesbitt Burns