Putting the Pieces Together

Shades of 08 all over again

Bank panics are nothing new. 2008 is fresh in our mind and what happened with SVB Bank brought back memories of the Financial Crisis. That said, the current episode qualifies at this point and in our view; more of a “scare” since only four banks have gone under so far. Two of them being crypto related and the other two being SVB and Credit Suisse, both victims of very poor risk management practices. As it stands it doesn’t seem to have the same contagion effect as the Financial Crisis had in 2008. Currently, credit spreads which measure the amount of risk in corporate debt, have remained in normal levels which is a positive sign. However, the current bank failures did demonstrate that there might be other liquidity issues within the financial system and even though it might not have the same impact as 2008, it certainly has tightened credit conditions considerably. As a result, this will have an impact on lending and that translates to lower earnings in general. And thus, leads us to ask ourselves are equity markets overvalued or undervalued?

That is not a simple question. We will examine that question in this quarter’s newsletter. In short, value stocks have been out of favor for most of this year as investors navigated back to growth-focused areas of the market, a notable shift from 2022. From our perspective, value's underperformance versus growth has been overdone, and we expect the longer-term relative price uptrend for value, which started in November 2021, to resume in the coming months, particularly given underlying P/E and growth trends at the style level and the higher for-longer interest rate backdrop that remains in place. In fact, we have already started to see early signs of a price reversal on the style front toward the end of March with the Russell 1000 Value eclipsing its growth counterpart by more than 3% since March 23. Therefore, as we look ahead to the rest of 2023, we continue to advise investors to maintain a value tilt in their portfolios and use periods of weakness as opportunities to add to positions in this area.

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Currently, we are experiencing conflicting narratives between the impacts of higher stock valuation multiples when inflation comes down and declining earnings trends when economic momentum slows. Both are happening right now. In fact, the Institute for Supply Management's gauge of manufacturing activity decreased to 46.3 in March, missing consensus expectations from economists. Still, we believe the tailwind from lower inflation will trump the headwind from lower EPS trends resulting in a positive year for equities.

First and foremost, financial sector stress should never be taken lightly. However, before running off in a panic, it is important to look at fixed income indicators that have proven their worth in the past. At this point, there does not seem to be significant fear in the fixed income market. FRA-OIS spreads (which basically shows the difference between a rate that builds in the credit risk of major banks vs. the risk-free rate) along with credit default swap spreads (think of those as an insurance contract that pays off if the issuer defaults) and bond spreads have come down significantly. In every case, a move lower shows that the perception of risk has come down. Also encouraging is that the Federal Reserve's (Fed's) data showed a marginal decline in demand for the liquidity facilities available to banks. As noted by U.S. Financials analyst James Fotheringham, this implies that deposit outflows may have slowed enough to dampen bank funding needs relative to prior weeks.

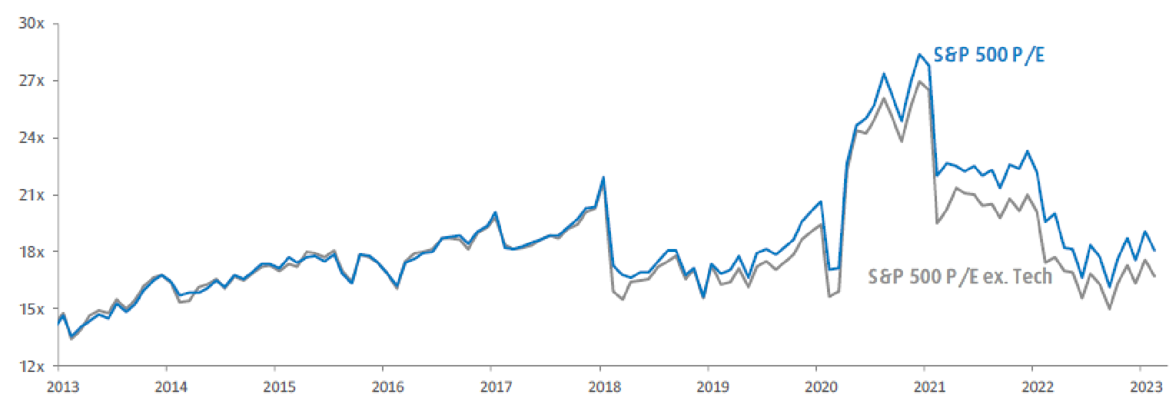
This can certainly change quickly depending on any future bank problems, but it helps explain the relative resilience of equities, along with the fact that the 10-year yield has moved down substantially, which boosts the fair value for stocks, especially high duration ones (e.g. tech). It is also worth noting that real estate markets – despite some price weakness – are proving resilient, bank capital ratios are generally very strong, and regulators are far more proactive than they were in the past (i.e. Swiss authorities adding $24 billion of additional capital and up to +$100 billion of additional liquidity for UBS, the FDIC guaranteeing uninsured deposits at SVB and SBNY).

Clearly, as always happens in situations like these, the strong will get stronger and gain market share in deposits, wealth management and banking business. Clear medium-term winners include J.P. Morgan, Bank of America, UBS, and some Canadian Banks. On the negative side, bank lending will get tighter as risk management departments will be more empowered to turn down marginal business which means that the odds of a mild recession have increased.

North American Stocks Already Discounting Some EPS Erosion - Especially When Tech Sector is Excluded

The S&P 500 price-to-earnings ratio has come down significantly and is 1.5x multiple points cheaper when excluding the tech sector. This further strengthens our argument that investors must be selective and price sensitive when building out their portfolios.

S&P 500 P/E Ratio vs. P/E Ratio Ex-Tech



Source: BMO Private Client Strategy, Bloomberg

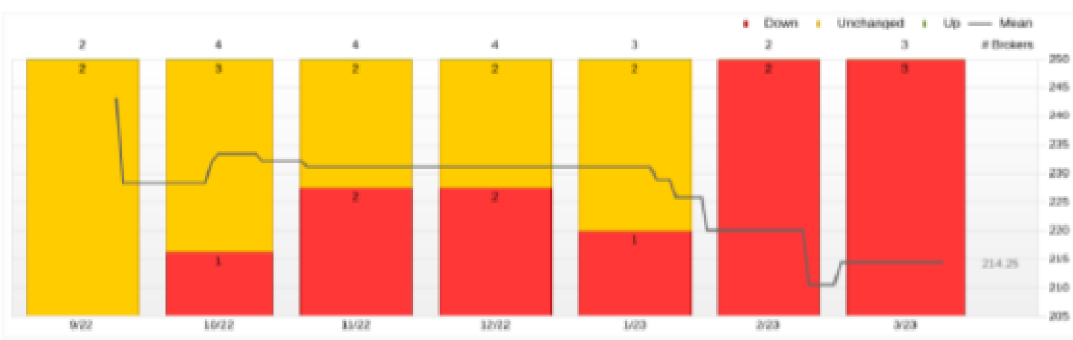
Canadian stocks continue to present better value than their U.S. counterparts and are also cheaper when excluding tech and communications.

TSX P/E Ratio and P/E Ratio Ex-Tech

Source: BMO Private Client Strategy, Bloomberg

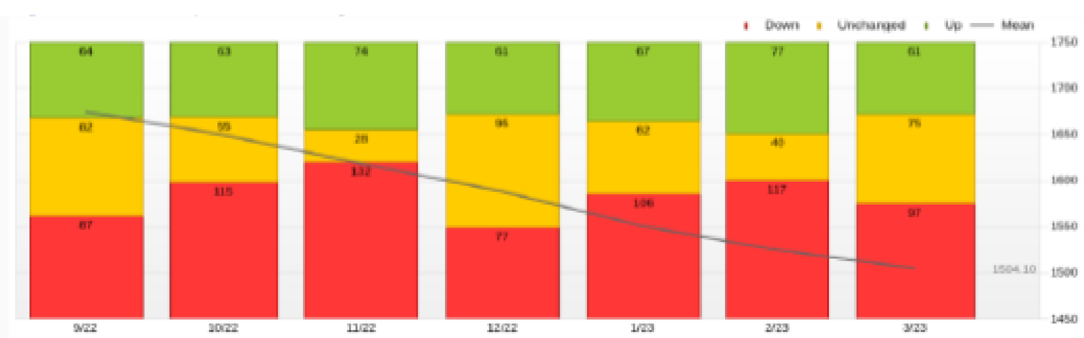
The Decline in Economic Momentum is Well Under Way. Earnings Estimates Have Come Down by 10-15%

S&P 500 2023 EPS Estimates



Source: Factset

S&P/TSX Composite 2023 EPS Estimates



Source: Factset

Inflation Still the Key Variable for Financial Markets

Maybe more important in this episode is the inflation dynamic. Equities have historically performed very well in periods where inflation is high but falling back toward 2%, and that is the case today with clear evidence that price pressure is cooling. Going back to 1960, the S&P 500 averaged annualized total returns of 14% in that environment (versus 7.5% for all years), while the TSX averaged total returns of just over 9% (versus 6.5% for all years). Both markets also outperformed 10-year Treasuries and cash. This makes intuitive sense since the value of future corporate cash flows is worth more in today's dollars when inflation and interest rates are low. Again, the timing with respect to a possible recession matters in this context too, but from a big picture perspective, the inflation backdrop now looks bullish if trends hold.

The U.S. Market Has Benefitted From a 30% Multiple Expansion When Inflation Was in a Long-Term Downtrend

Period	Dates	CPI Starting Level	CPI Ending Level	Starting P/E	Ending P/E	P/E Expansion (Contr.)	P/E Expansion (Contr.) %	No. of Months
2	Dec 66 - Oct 67	3.5	2.4	14.84	17.94	3.1	21%	11
4	June 70 - July 72	6	2.9	14.18	18.45	4.3	30%	26
6	Jan 75 - Dec. 76	11.8	4.9	7.99	11.02	3.0	38%	24
8	Apr 80 - Jun 83	14.7	2.6	6.96	13.25	6.3	90%	39
10	Apr 84 - Dec 86	4.6	1.1	11.18	16.33	5.1	46%	33
12	Dec. 90 - May 94	6.1	2.3	15.28	20.89	5.6	37%	42
14	Jan 97 - Apr. 98	3	1.4	20.32	25.32	5.0	25%	16
16	Jun 01 - Jun 02	3.2	1.1	24.26	22.93	-1.3	-5%	13
19	Aug 08 - Jul 09	5.4	-2.1	19.24	19.46	0.2	1%	12
21	Oct 11 - Apr. 15	3.5	-0.2	13.97	18.54	4.6	33%	43
23	Aug 18- May 20	2.7	0.1	20.84	20.95	0.1	1%	22
								281
Average						3.27	28.7%	
Median						4.27	30.1%	

Source: BMO Private Client Strategy, Bloomberg

Also, BMOCM's work on interest rate cycles going back over 40 years has shown that the best market returns are achieved when policy rates stay unchanged for long periods, something the Bank of Canada (BoC) and the Fed are signaling, "higher for longer". This is no doubt explained by markets' preference for stability and visibility. The table below speaks for itself.

Fed Funds Flat

Period	Dates	Fed Funds Starting Level	Fed Funds Ending Level	No. of Months	S&P Annualized Price Return	TSX Annualized Price Return
6	Jun 81 - Mar 82	15.5	15	10	-17.3%	-37.9%
12	Oct 92 - Jan 94	3	3	16	11.1%	26.3%
15	Feb 96 - Jul 98	5.25	5.5	30	25.1%	14.6%
19	Jul 03 - Apr 04	1	1	10	14.3%	16.5%
21	Jul 06 - Jul 07	5.25	5.25	12	14.0%	17.2%
23	Jun 09 - Oct 16	0.25	0.5	94	12.8%	7.0%
26	May 20 - Jan 22	0.25	0.25	21	25.3%	20.6%
				193		
Average					12.2%	9.2%
Median					14.0%	16.5%

Source: BMO Private Client Strategy, Bloomberg

An important consideration when encountering a Fed pause is sector allocation. The below figure highlights historical performance sector and market performance 6 and 12 months after the Fed stopped raising rates. The key takeaway is that the market does reasonably well a year later with an almost 10% return on average with standout performance from healthcare, staples, financials, and utilities. This makes intuitive sense given the interest rate sensitivity of many of the stocks included in those sectors.

S&P 500 and Super Sector Performance After Fed "Pause" Since 1973 (8 Cycles)

	6 Months After Fed Cycle		12 Months After Fed Cycle	
Sector	% Succeeded by Positive Returns	Average Return (%)	% Succeeded by Positive Returns	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: BMO Private Client Strategy, NDR

The current inverted yield curve (when short-term interest rates are higher than longer-term rates) has caused investors anxiety since it has been a fairly reliable indicator of upcoming recessions in the last number of decades. This being said, the yield curve has been steepening of late – especially in the U.S. – as investors expect an imminent pause in Fed interest rate increases. This is good news since the market historically tends to perform well in a relatively flat yield curve environment.

Market and Sector Performance Since 1976 in a Flat (<0.5%), Normal (0.5-1.5%) and Steep (>1.5%) Yield Curve Environment

	Flat
Sector	% Annualized Gain
Healthcare	15.3
Consumer Staples	10.7
Info. Technology	10.5
S&P 500	**9.6**
Financials	9.3
Industrials	9.2
Comm. Services	8.8
Utilities	8.5
Energy	8.0
Consumer Disc.	4.9
Materials	4.8
Real Estate	4.4

	Normal
Sector	% Annualized Gain
Healthcare	12.1
Consumer Staples	11.9
Energy	9.1
Consumer Disc.	8.8
S&P 500	**8.2**
Info. Technology	7.6
Financials	7.5
Industrials	7.5
Materials	7.0
Comm. Services	5.8
Utilities	1.4
Real Estate	-1.4

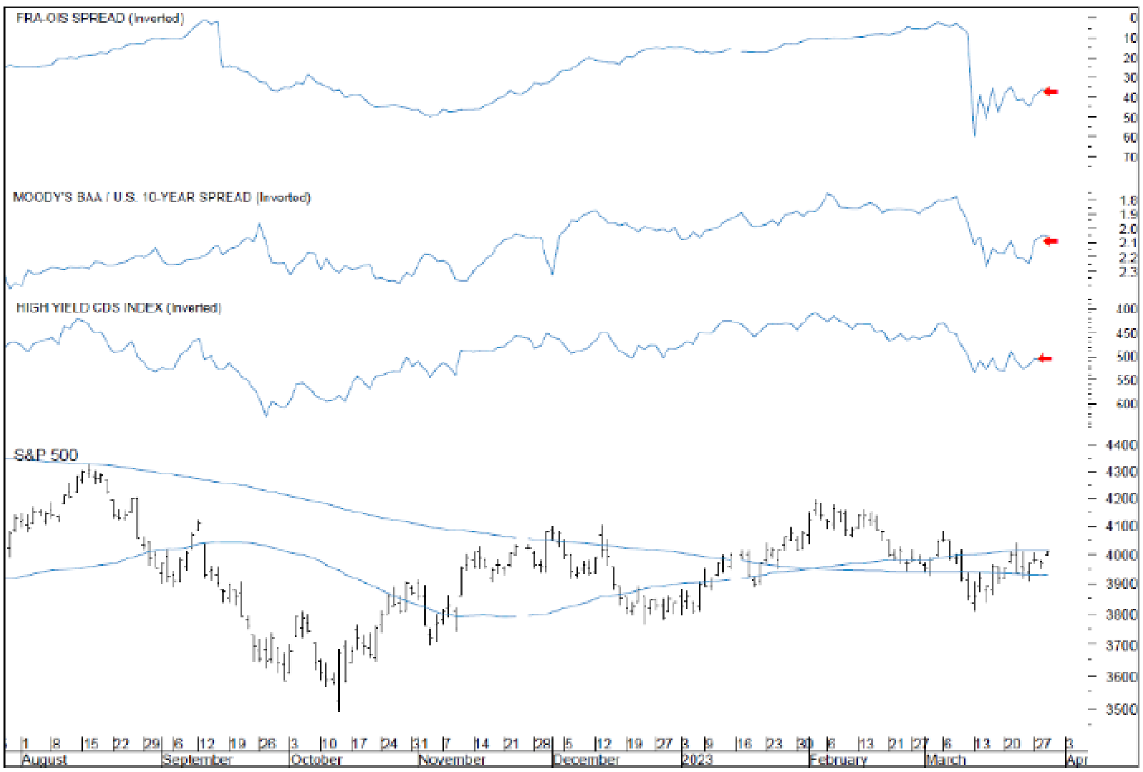
	Steep
Sector	% Annualized Gain
Consumer Disc.	13.9
Info. Technology	10.5
Real Estate	8.3
Industrials	7.3
Comm. Services	6.9
Materials	6.8
S&P 500	**5.9**
Consumer Staples	5.4
Utilities	3.6
Energy	3.2
Financials	2.9
Healthcare	1.0

Source: BMO Private Client Strategy, NDR

Technical Analysis

There is lots of uncertainty in the markets right now regarding the state of the U.S. banking system, but chart-wise, there are three important things for investors to focus on. First, the main thing to pay attention to right now are the gauges in our bond sentiment model which remain very far away from the extreme readings that developed during the credit crisis and early on in the pandemic, i.e. despite all the hand-wringing in the media about “contagion”, we are nowhere near the levels that defined the actual systemic risk of those events.

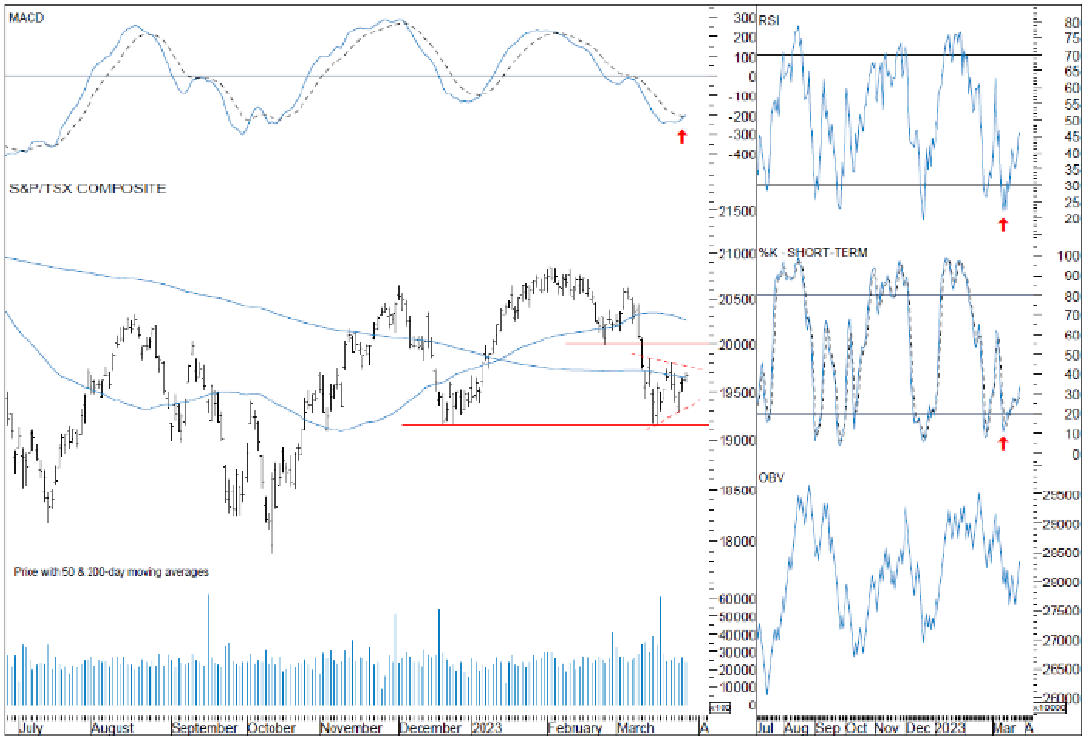
FRA-OIS Spread, Moody’s BAA/U.S. 10-Yr Spread, High-Yield CDS Index, and S&P 500



Source: BMO Nesbitt Burns Technical Analysis

More importantly, they have generally been improving for 2-3 weeks now so things are getting better underneath the surface, not worse. Second, despite the recent volatility and lack of upside progress, our short-term timing model remains fully bullish after giving new buy signals in late March.

Short-Term Timing Model Shows Bullish Signals

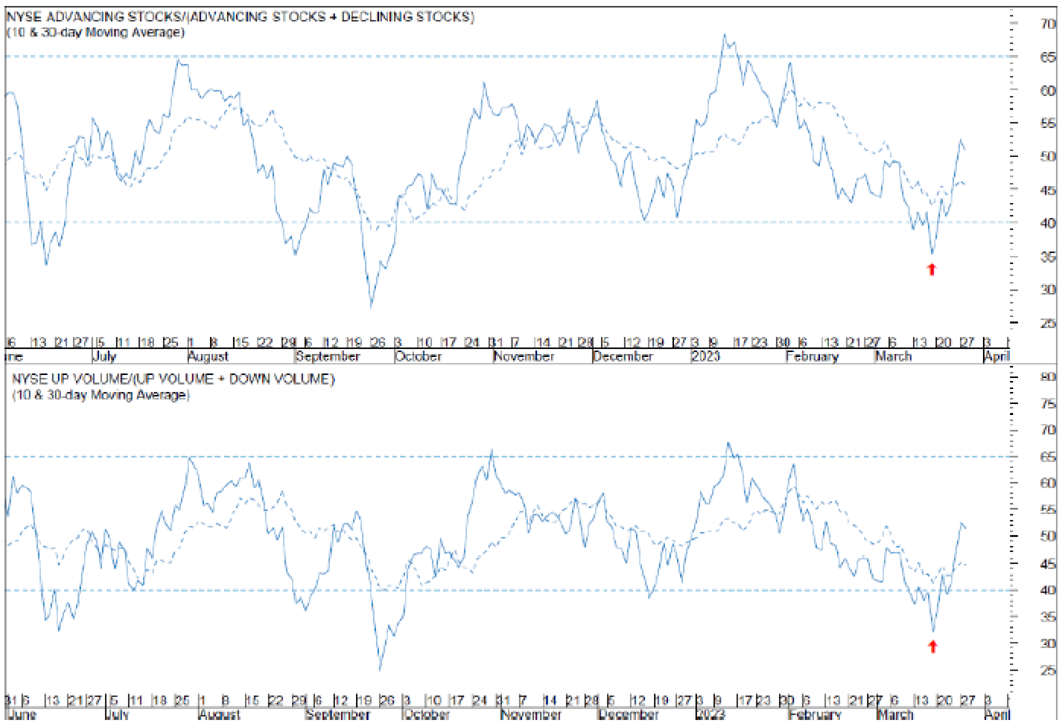


Source: BMO Nesbitt Burns Technical Analysis

It's also the first time we have seen simultaneous buy signals in all of the breadth and momentum gauges in that model since last October. In fact, the last two times we saw them all turn bullish at the same time were at the major trading lows in June and October of last year. So, despite the lack of upside progress in recent trading, the recent low likely represented a significant turning point in equity markets.

Last but not least, despite all the talk of a recession in 2023, most market-based measures of economic activity continue to improve. Some examples include the S&P 500 Steel Sub-Industry which recently made a new all-time high, the PHLX Semiconductor Index recently making a 52-week high, homebuilding stocks recently making 52-week new highs, and copper remains in a long-term uptrend after breaking out of a base pattern late last year.

NYSE Breadth



Source: BMO Nesbitt Burns Technical Analysis

The bottom line is that for all the uncertainty and doubt in the markets right now, the improvement in our short-term timing model suggests equity markets made a significant trading low in late March. In terms of upside potential, the minimum expectation is for a challenge of the February price peaks. That's 20,843 for the TSX and 4,195 for the S&P 500. Breakouts there would clear the way for the TSX to rally back to its all-time high at 22,213, and for the S&P 500 to challenge its August 2022 peak at 4,325.

Your team will remain alert to 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

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