Putting the Pieces Together

Summer 2023

Hello to all friends, clients and colleagues

The first half of this year had witnessed a period of global market volatility as several factors influenced the world economy. Uncertainties surrounding global trade tensions, geopolitical developments, and fluctuations in commodity prices created a challenging environment for investors. Additionally, central banks' monetary policy decisions and concerns over inflation further contributed to market fluctuations. Nevertheless, sectors such as technology, renewable energy, and healthcare demonstrated resilience and attracted significant investor interest.

Thus far performance has been impressive, albeit that a minority of large cap companies have driven this performance. However, we would expect the momentum to persist during the second half, but at a slower pace judging by BMOCM's (BMO Capital Market) 4,550 year-end S&P 500 price target. From our perspective, all the worries that damaged 2022 market performance are slowly beginning to subside (inflation/Fed). Yes, earnings growth is likely to remain a sticking point, but we believe investors fully understand this and are looking past 2023 results and expecting growth to reaccelerate in 2024 and beyond. Moreover, narrow market breadth has started to broaden out and is a trend we expect will continue. Selectivity will be key, but we are still tilted toward value style investing over growth.

From our perspective, the sharp underperformance of the TSX over the last few months (especially relative to the S&P500) has been largely driven by declining confidence in the earnings outlook for the big three sectors in Canada (Energy, Financials and Materials). As such, restoring assurance in the earnings outlook for these sectors will likely be key to a second half recovery. We believe the second half will be defined by a combination of stabilizing revision trends and longer-term earnings outlooks, thereby ultimately generating newfound investor confidence. Therefore, a return in equity flows and a rebound in valuations should follow suit. Overall, we remain steadfast in our view that Canadian equities offer strong relative value, cash generation and stability as global markets travel towards historical normalization.

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

Equity markets paused momentarily with the Fed's decision to hold rates steady for the first time in 11 meetings. While the FED did their best to warn that the rate hike campaign was not finished, the markets proved to be resilient. Part of the reason for the quiet confidence among investors is that the long-awaited, much-anticipated recession is still missing in action. Furthermore, part of the reason for the simmering market optimism is that inflation continues to climb down. Along with the FED meeting, the May CPI was the other big event, and the headline did not disappoint. Rising just 0.1% m/m, the annual inflation rate tumbled almost a point to 4.0% and it's poised to take another big step down in June to the low-3s on very friendly base effects. True, core inflation remains sticky and stubborn at 5.3% y/y. However, the weighty shelter components are expected to cool notably in coming months (especially owners' equivalent rent), while a recent flare-up in used car prices should reverse. And even an unreformed inflation hawk would concede that Powell's measure is fading to more manageable levels, 3% on a three-month annualized basis.

The global inflation fight is getting a big helping hand from calmer commodity prices; one index is down 30% from year-ago levels, with even ex-energy prices down 10% y/y. Oil seems stuck around $70, despite Saudi Arabia's series of production cuts and the upside surprise on global growth this year. Calmer energy has helped carve Euro Area inflation from last year's 10.6% peak to 6.1%, and it, too, looks ready to fall fast in coming months. Still, core is right in line with the U.S. at 5.3%, keeping the pressure on the ECB to keep raising. Meantime, China weighed in with a 10-bp interest rate trim on June 20th, amid a sluggish recovery and meagre 0.2% CPI inflation—a true outlier (besides the BoJ).

The over-riding message is that the economy has managed the heavy-duty tightening remarkably well**, at least so far**, and investors are gradually regaining confidence that a soft landing can indeed be achieved. That view is gaining support with headline inflation falling, mostly on plan, with lower oil prices adding an assist. However, the **key question looking ahead is whether core inflation can be cracked without some real economic pain**. If anything, the equity market's comeback may make it even tougher to quell underlying inflation; consumers are highly unlikely to pull back when stocks are on a tear. We expect the Fed to be back at the tightening well next month, and the risk is that there could be yet more to come.

After an extended period of outperformance relative to its neighbor to the South, the TSX has significantly underperformed the S&P 500 so far in 2023. While on the surface it may appear as if the TSX does not have the same resilience as the S&P 500, BMOCM's work disagrees with this notion when they more deeply examine the data. In fact, they uncovered that the TSX is showing much broader equity performance than many investors realize. Indeed, despite the sharp underperformance of the index, the S&P/TSX **equally weighted index** is outperforming the S&P 500 equally weighted index, highlighting the concentration of performance of the US mega-caps in the S&P 500. Excluding these mega-cap names, Canada is showing similar and often stronger returns than the US. While the broader performance discrepancy between the TSX and the US may persist in the short term as investors continue to chase the US mega-caps, we continue to believe Canada offers investors strong relative value, cash generation and stability. From our perspective we believe the focus on US mega-caps has left many areas with strong underlying fundamentals (like Canada) largely ignored, thereby creating many opportunities for more patient investors.

Despite of the narrow market breadth of the S&P 500, the latter is still proving resilient. Some investors are still calling for a sharp price drawdown in the second half of the year that would bring the market back down near its October low. However, BMOCM's work suggests that strong starts to calendar years of this magnitude rarely lead to declines in the final seven months with above-average returns the much more likely scenario.

When US stocks ascend 20% from recent lows, those lows are typically not violated

S&P 500 Price Performance Following 20% Gains Off Bear Market Lows (bear mkts since 1950)

Start of Bear Mkt	Bear Mkt Low	Actual Bear Mkt Low?	Price % Decline	Date of 20% Gain From Bear Mkt Low	+3-Mos	+6-Mos	+12-Mos
8/2/56	10/22/57	Yes	-21.6%	7/25/58	8.2%	19.2%	27.0%
12/12/61	6/26/62	Yes	-28.0%	12/5/62	2.9%	12.1%	18.1%
2/9/66	10/7/66	Yes	-22.2%	2/14/67	6.0%	7.3%	2.2%
11/29/68	5/26/70	Yes	-36.1%	9/24/70	7.9%	18.7%	17.2%
1/11/73	10/3/74	Yes	-48.2%	11/5/74	5.1%	19.9%	18.7%
11/28/80	8/12/82	Yes	-27.1%	9/14/82	11.6%	22.5%	34.3%
8/25/87	12/4/87	Yes	-33.5%	3/8/88	0.8%	-1.3%	9.1%
7/16/90	10/11/90	Yes	-19.9%	2/6/91	6.1%	9.1%	15.6%
3/24/00	9/21/01	No	-36.8%	12/5/01	-2.1%	-10.3%	-22.5%
3/24/00	7/23/02	No	-47.8%	8/22/02	-3.3%	-11.9%	3.2%
3/24/00	10/9/02	Yes	-49.1%	11/21/02	-9.2%	-1.1%	10.9%
10/9/07	11/20/08	No	-51.9%	12/8/08	-24.9%	3.2%	20.0%
10/9/07	3/9/09	Yes	-56.8%	3/23/09	8.8%	28.9%	42.7%
2/19/20	3/23/20	Yes	-33.9%	4/8/20	15.3%	25.3%	49.0%
1/3/2022	10/12/22	???	-25.4%	6/8/23	???	???	???
				Average	2.4%	10.1%	17.5%
				Prob of Gain	71.4%	71.4%	92.9%

Source: BMO Investment Strategy Group, FactSet.

Canadian Banks Starting to Look Very Good

Sometimes in the world of investments the best longer-term risk reward vehicles are found on the road less travelled. Case in point, since the start of 2022, Canadian banks have been very much out of favour with investors (despite their stellar long-term track record of dividend increases and shareholder value creation). While timing is always tricky, we see this as an opportunity for long-term investors. Furthermore, our technical analyst notes, participation among smaller stocks and across sectors is really starting to broaden out which is an encouraging sign for some sectors that have been left behind like financials.

Canadian and U.S. Sector Performance

Canada		
Sector	**YTD**	**2022-Today**
Information Technology	41.70	-32.20
Real Estate	-3.27	-26.75
Multi-Family REITs	**13.63**	**-19.11**
Banks	**-3.98**	**-16.06**
Financials	-1.52	-14.00
Utilities	1.20	-13.01
Communication Services	-3.05	-9.87
S&P/TSX Composite	1.04	-7.71
Consumer Discretionary	5.04	-3.45
Materials	-2.30	-2.49
Industrials	4.76	4.97
Consumer Staples	1.17	9.79
Energy	-6.88	15.86

As of June 26, 2023

USA		
Sector	**YTD**	**2022-Today**
Banks	**-12.16**	**-31.10**
Real Estate	-0.85	-29.05
Communication Services	32.54	-21.03
Consumer Discretionary	27.52	-20.40
Financials	-4.50	-16.30
Materials	3.58	-10.98
S&P 500	12.74	-9.18
Utilities	-6.90	-8.24
Health Care	-3.46	-6.89
Consumer Staples	-0.56	-3.71
Information Technology	36.60	-2.89
Industrials	5.99	-1.54
Energy	-9.96	43.20

As of June 26, 2023

Source: BMO Nesbitt Burns Portfolio Advisory Team, FactSet

Last month BMO Economics, stated that they believe the housing market in North America has bottomed. There are several investment possibilities related to this view, but we believe large cap banks should be prime beneficiaries given their high economic and housing exposure.

Recent data continues to strengthen their conviction on this view. First and foremost, inflation continues to slow. The implications for this trend are profound. Not only will this reduce the odds of seeing too many more rate increases, but it will boost both the fixed income and equity markets (historically, stocks have benefitted from 30% multiple expansions on average when CPI slows). In Canada, the latest data was quite encouraging. Specifically, consumer prices (CPI) rose 0.4% and 3.4% year-over-year (YoY) in May, with headline inflation slowing a full percentage point from the prior month. On a seasonally adjusted basis, CPI rose a mere 0.1%, the smallest increase of the year. South of the border, inflation expectations for a year out slipped for the third consecutive month.

One of our BMO Capital Markets' analysts recently conducted a detailed analysis of credit trends and loan reserves for Canadian banks. He concluded that *"allowances for credit loss levels are generally higher than pre-pandemic levels. Our review of credit risk and reserve levels at Q2/23 end leads to no changes to our provision for credit loss forecasts… If our credit quality, reserve adequacy, and provision cost conclusions hold, one important risk to our earnings forecasts is eliminated, suggesting to us there is limited downside risk to lower forward P/E valuation multiples; the path to re-rating higher would need to include a more favorable revenue environment. Once sentiment toward the banks improves (tied to the macro-outlook), we expect the "cheaper" valuation names to be relative outperformers…"*

Canadian Bank Forward Price-to-Earnings Ratio

Source: BMO Nesbitt Burns Portfolio Advisory Team, FactSet

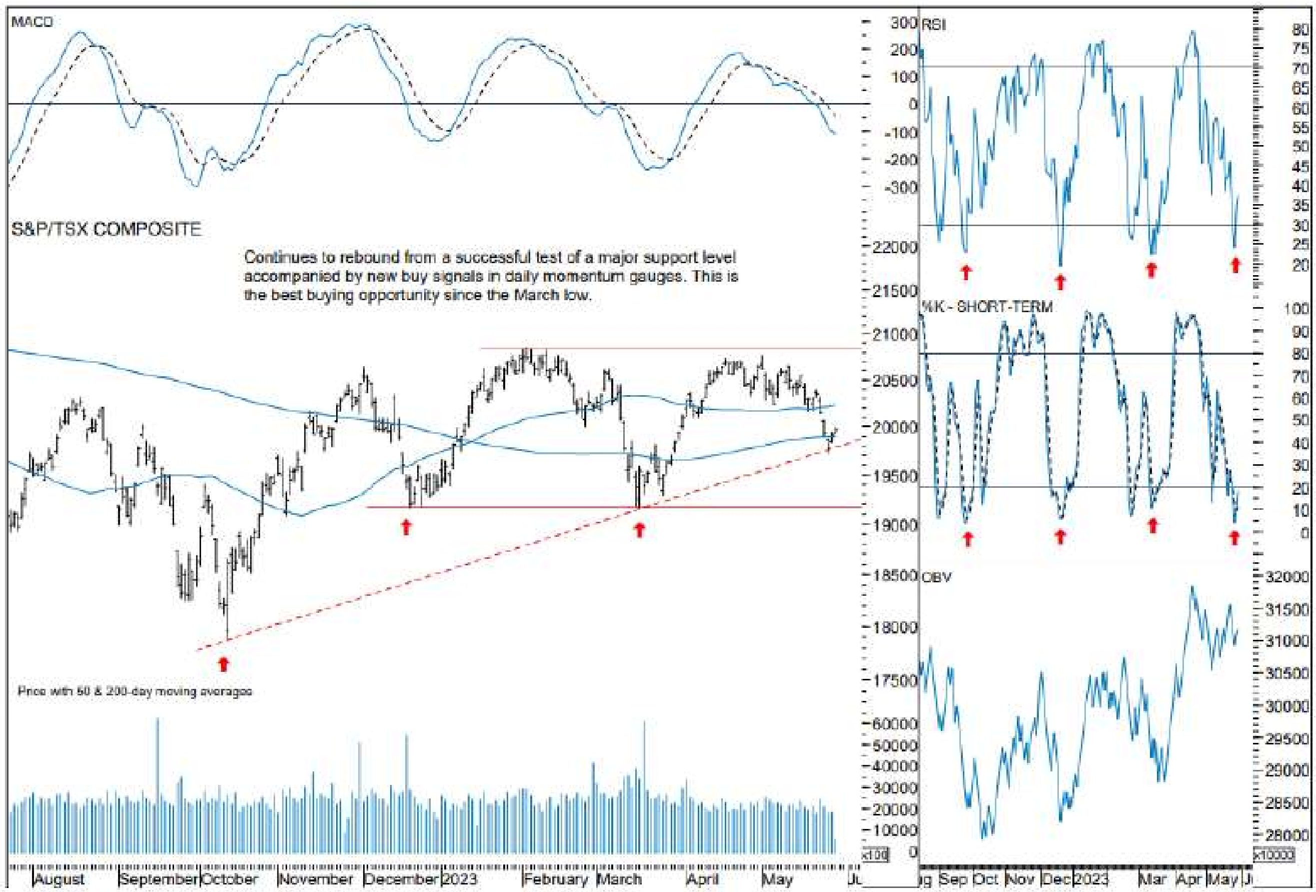
Canadian Bank Forward Price-to-Book Ratio

Source: BMO Nesbitt Burns Portfolio Advisory Team, FactSet

Technical Analysis

According to BMO's Technical Analysis Team, the TSX is currently reversing back to the upside from a successful test of a major support level (this time it is a rising long-term trendline) accompanied by new buy signals in daily momentum gauges. The set-up in short-term momentum gauges is similar to the October, December and March lows which resulted in 15.47%, 8.8%, and 8.4% rallies respectively, and there is no reason to think this time will be any different. In terms of upside potential, there really is not any significant price resistance until the February peak at 20,843. A breakout there would open an upside swing target that measures to 22,531 which is only slightly above the all-time high at 22,213.

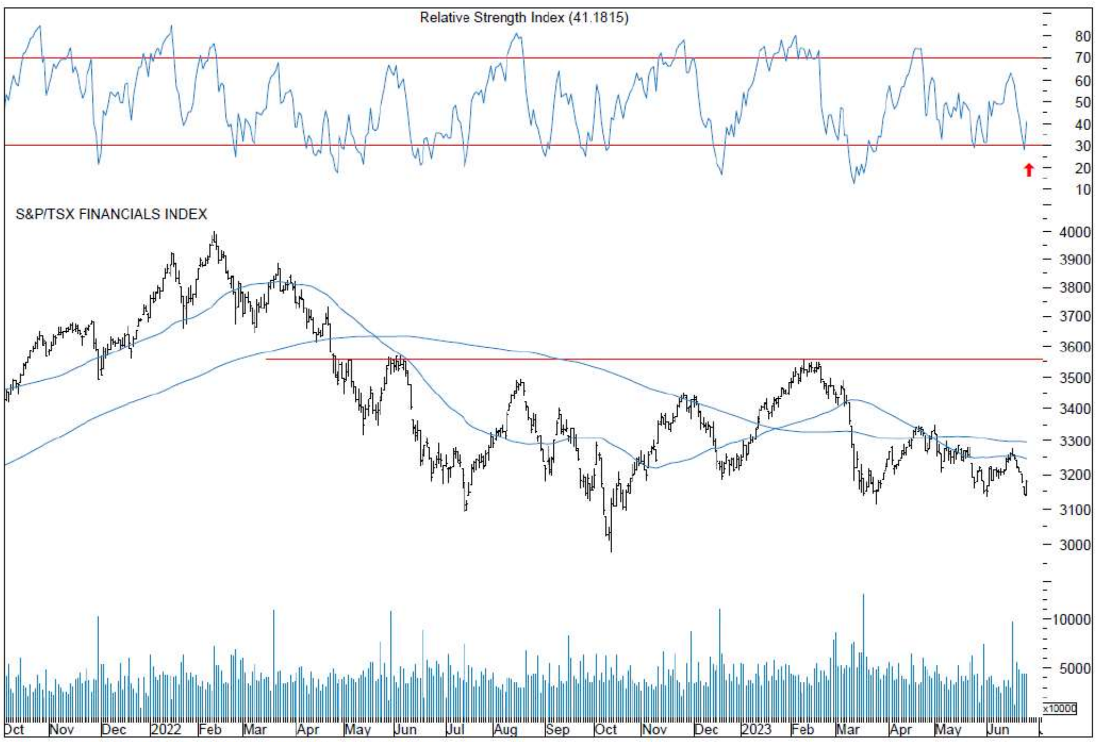
S&P/TSX Composite



Source: BMO Nesbitt Burns Technical Analysis

TSX Financials Index – Base pattern: the transition phase between a bear market downtrend and a bull market uptrend. A close above resistance at 3,560 would signal the beginning of a new long-term uptrend with an initial upside target that is measurable to 3,965. New buy signals in short-term momentum gauges suggest the next major move here will be to the upper end of the base. By itself a trade to the upper end of the base would represent a 25% gain from the late June level, but given the bullish macro call a breakout of the base is the expected outcome. Bank stocks are all testing the lower end of their own year-long base patterns and are all buys right now.

TSX Financials Index



Source: BMO Nesbitt Burns Portfolio Advisory Team

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

Roux & Associates Wealth Management Group BMO Nesbitt Burns