Putting the Pieces Together

How much longer?

This title summarizes the foremost question on investors' mind lately. How much longer does the bear market last. And the answer to that is followed up by another question; how much of the inflation threat and growth slowdown is embedded in stock prices? Quite a bit of it after a very difficult stretch for the market. That is our short answer to what has become the most important question for investors.

Just to put things into perspective, the S&P 500 plunged 9.3% in September, marking the biggest monthly loss for the index since March 2020 and worst September since 2002, and fell to a new bear market low in the process, finishing the month more than 25% off its January high. The catalyst for this downside is the stubbornly high inflation data. Coupled with the rhetoric coming from the Federal Reserve which plans to be focused on rising rates as long as inflation remains elevated. The FED has signaled to the market what it wants to see before they reduce the magnitude of the rate hikes. In our previous newsletter, we outlined the PCE index which is the index that measures what American households spend monthly. They want to narrow the gap between the PCE index and the Fed fund rate. Currently the PCE index stands at 4.7% and the Fed fund rate is at 3.00%-3.25%. Hence, consensus has the Fed fund rate at 4.50%-4.75% by year end. Thus, the gap should narrow substantially by the end of the year. Further the FED has outlined that they wish to see wage growth reverse. In the October's jobs report we saw a slowdown in wage increases and in job growth. It also wants to see unemployment rise. That will be more challenging and will take more time (we will cover that subject in the following section). Further real estate inventory must increase which has already happened. Lastly, it wants to contain speculation in very risky assets and that has certainly happened months ago, just look at what happened in the crypto currency markets. In short, besides unemployment rising, all other factors which the FED has earmarked as important variables to reduce the magnitude of the rate hike are pivoting or at the very least slowing down form their peaks.

We are in the third quarter earnings season as we write this newsletter. Throughout the year, earning expectations have been reduced substantially. That said, as we stated in the opening, we believe those negative revisions have been reflected in equity markets. This quarter's earnings release will give us a better idea if those valuations are indeed properly reflected in the markets.

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

Catherine Lach
(514)282-5832
catherine.lach@nbpcd.com

Nancy Belanger
(514)871-7076
Nancy.belanger@nbpcd.com

Elizabeth Le Comte
(514)282-5808
Elizabeth.lecomte@nbpcd.com

However, that does not negate the potential of another selloff stemming from geopolitical risk or credit conditions. If the latter were to happen and valuations are properly reflected, then the potential selloff should have a quicker recovery from the bottom.

In this month's newsletter, we will dive into further detail on inflation. A hotter-than-expected September CPI report initially sparked the selloff with further price weakness driven by rising global interest rates, increased hard landing fears, tightening financial conditions, and geopolitical risk. Secondly, we will look at the credit markets. What happened in England served as a warning sign that liquidity can dry up if companies and countries are not fiscally responsible.

The ongoing U.K. political and economic drama continued to make ripples across financial markets three weeks after the epically ill-advised budget. A further U-turn on the proposed measures, and the replacement of the Chancellor helped temporarily calm the waters. In fact, the pound is now back above levels prevailing prior to the budget bungle, while Gilt yields took only a small step back from their second abyss. Furthermore, we want to take the time to highlight the agricultural sector because in times like these it is hard to see where growth lies. Lastly, we will revisit certain technical indicators.

Inflation

We will start our newsletter like we have in our previous three newsletters by looking at inflation. September's CPI number just came out and it continues to be higher than expected. The issue with the higher inflation remains in the servicing sector, mainly wages remain elevated and rents. The question we find ourselves asking is will higher rates really solve that problem. Wages remain elevated because we have structural issues with supply chains and the labor force. We don't believe higher rates really addresses those issues. This is more a secular trend whereby monetary policy is more of a cyclical trend. We assume that a fiscal response is more appropriate. The Fed's determination to fight high inflation, solely focused on getting the core level (i.e. excluding food and energy) back to 2% without recognizing the risk for economic pain helps explain increasing recession forecast calls. This is being felt across risk asset markets including corporate bond yield spreads and causing liquidity issues in the credit markets.

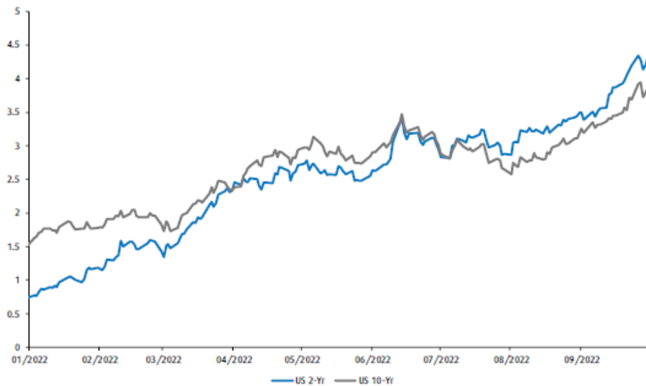
Demand for labor still far exceeds the supply of available labor and the unemployment rate is still far below the level considered to be "full employment". In a separate report, the Labor Department said the number of job openings eased to 10.1 million in August from 11.2 million the month before. This shows a slight slowing in labor demand. However, there are still around two job openings for every unemployed worker. Another disappointing indicator from the monthly jobs report was a decrease in the labor force participation rate, which fell to 62.3% in September compared to 62.4% the previous month. While labor participation of prime-age workers (25-54 years old) has nearly returned to pre-pandemic levels, the participation of workers 55 and older remains far below levels in 2019.

Henceforth, it remains a key concern, however we stand by our call that inflation has likely peaked in North America. Backing this view, the latest Canadian CPI figure came in below expectations at 7% vs. 7.3%. Still too high, but at least moving in the right direction. However, it will not be a straight line down from here. BMO Economics outlook on the BoC overnight rate is that it will end the year at 4.00% and it will maintain that level for all of 2023. Hence, they do not expect the Bank of Canada to start lowering rates any time soon. As for the Fed Fund rate, they expect it to peak in the first quarter of 2023 at around 4.25% and maintain that level for all of 2023. That said, with this week's CPI data some have the FED fund rate closer to 4.75%.

BMO Chief Economist Doug Porter states that "prospects are now higher for longer interest rates" which will exacerbate fears of a prolonged growth slowdown. Recall that the impact of interest rate tightening on the "real economy" typically takes 12 months or more, with the exception of housing which feels it much more rapidly (negatively) through the mechanism of higher mortgage rates. Since the August Jackson Hole conference, the U.S. Federal Reserve (Fed) has clearly signaled the policy

narrative of higher for longer interest rates having ripple effects in the U.S. bond market. Consequently, all U.S. interest rates were dragged higher. The impact weighing more in shorter securities and leading the yield curve to resume its inversion (2-year yield rising faster than 10-year yield).

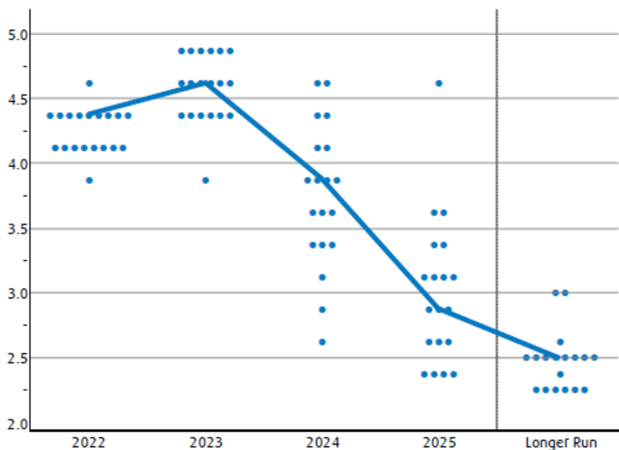
U.S. Treasury 2-Yr & 10-Yr Yields (YTD)



Source: BMO Nesbitt Burns Private Client Strategy, Bloomberg

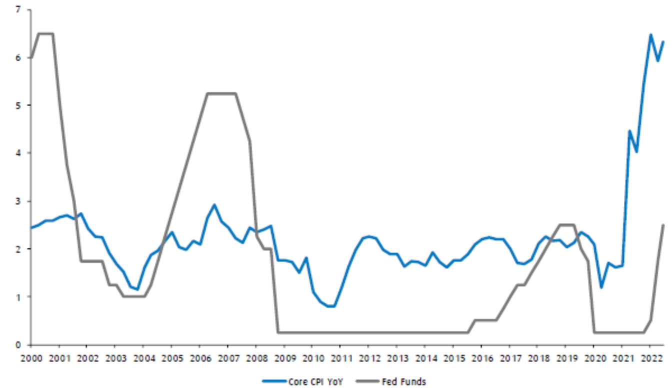
The high inflation and stubbornly strong labor market support the Fed's hawkish narrative, and even after lifting rates another 0.75% to 3.25% last month, it signaled more tightening would be required in the near term. The September Fed's dot plot, which summarize the committee members' latest outlook for the terminal policy rate showed a significant jump in the average expectations prompting the market to quickly adjust.

Fed Expects Higher Rates in 2023



Source: BMO Nesbitt Burns Private Client Strategy, U.S. Federal Reserve

Core Consumer Price Inflation and Federal Fund Rate

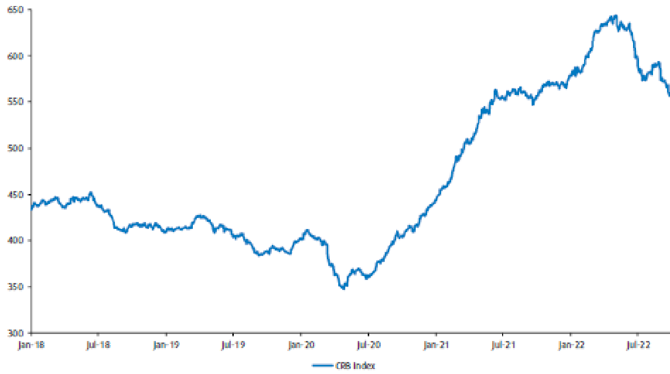


Source: BMO Nesbitt Burns Private Client Strategy, Bloomberg

An inverted yield curve, tighter financial conditions, worsening credit conditions, and monetary base contraction (quantitative tightening) should not go unnoticed. The problem is that the Fed and other central banks may not have a choice, at least not yet. The negative impact of inflation on households' daily lives is significant and the Fed needs to maintain a tough stance, at least until inflation trends are clearly on the downside. For homeowners, or aspiring ones, the quickly rising mortgage rates means monthly payments have almost doubled this year for the average mortgage size! Consequently, you could have scenarios whereby the interest payment on the monthly mortgage payment could be higher than rental cost.

At a time when the focus is on rate trajectory, there are clear indications that inflation may have peaked with long-term expectations already back to or near the 2% target. However, we don't believe the 2% target is realistic and thus the FED should target closer to 3%. This includes lower energy/commodity prices, median rents, shipping (and more specifically trucking freight rates), manufacturing and services PMI prices, and core import prices. All signaling pressures are abating. Even the average hourly earnings and used car price increases are slowing and home prices have started falling, a sign the effects of monetary policy decisions that normally come with a 6-to-12-month lag are starting to have an impact.

Commodities are Moving Lower to Long Term Trend

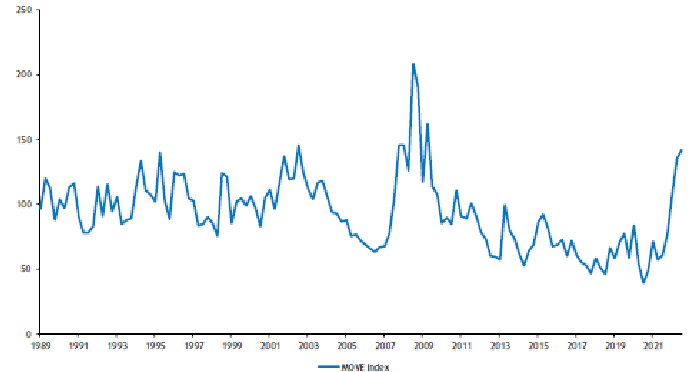


Source: Bloomberg

Credit Market Woes

It may still be early to change the narrative on inflation, but some Fed members have recently offered some caution to the risk of moving too fast, providing a slight variation to what was perceived as a unanimous committee. Inflation may be the focus, but for central banks the financial stability is equally if not more important. Deteriorating financial conditions, weakening market liquidity conditions, and rising credit risk can have a lasting impact. The Bank of England's (BoE) response to an ill-advised U.K. government fiscal policy is a recent example on how rapidly rising interest rates can de-stabilize financial markets. The combination of energy subsidies and major tax cuts while the country is battling double digit inflation pushed rates significantly higher and weakened the currency, threatening the stability of the financial system. While inflation risk led tightening expectations higher, the significant upward pressure on long term rates forced the BoE not only to delay quantitative tightening but to start buying 20+ year government bonds to avoid forced liquidation by pension funds. The Fed does not face similar fiscal policy issues, but financial stability could still be compromised by an aggressive tightening cycle. The worsening liquidity conditions marked by high volatility in the treasury markets since March/April 2020 is a warning call. The Fed may not want to bulge on its inflation fight yet but the combination of reduced-price pressure and rising financial stability risk may alter the rate trajectory and force the Fed to slow down.

Bond Volatility Index



Source: Bloomberg

Agriculture – A Very Promising Area for Long Term Investors

We believe that we are only two years into what could be a multi-year uptrend for grain prices, and, by extension for agricultural-related investments. Some bullish factors that support our view are: 1) relentless population growth and the increasing wealth in emerging markets which supports higher protein consumption (very land intensive); 2) the increasing difficulty in finding additional land for planting; 3) global warming which greatly increases extreme weather events and threatens the quality and yield of crops; and 4) the invasion of Ukraine which has created massive disruptions as the country produces a fifth of the world's high-grade wheat and 7 percent of all wheat.

BMO Capital Markets' Food analyst Ken Zaslow continues to predict a tight market for corn globally given the war in Ukraine, though demand for U.S. corn, even with harvest, could be impacted by waning competitiveness to South America (SA). We continue to believe that at least two to three above-average crop cycles are needed to temper grain inflation given the war in the Ukraine, the smaller than initially expected SA crop, the structural shift in demand from renewable diesel, and the multi-year demand shift to grains from protein in China. First, we expect the likely severe reduction in Ukrainian and

Russian corn and wheat output to support corn and the entire commodity complex. Second, we expect ethanol production to remain strong given high energy prices and ethanol still trading at a discount to gasoline (i.e. making it more attractive to blend into the fuel supply). Ethanol production has recently settled at a run-rate of just over 15 billion gallons (down from 16 billion gallons last month), as the margin outlook remains mostly favorable.

Our Fertilizers analyst Joel Jackson concurs and recently wrote that he sees a clear commodity "risk-on" environment for the stocks he covers. This as nitrogen starts to rally sizably with dry weather in many jurisdictions, European gas surging somehow even more, and European nitrogen plant closures. Seasonally, fertilizer names tend to be relatively strong in Q4 and through March… Fall demand is only beginning and even with some demand destruction or high inventories in some places, we must believe potash/phosphate will stabilize. We still think the equities are not pricing in windfall free cash flow considerations and the scenario where ultimate mid-term earnings levels end up being higher than expected. Of course, any turn in ongoing geopolitics/macro would be material.

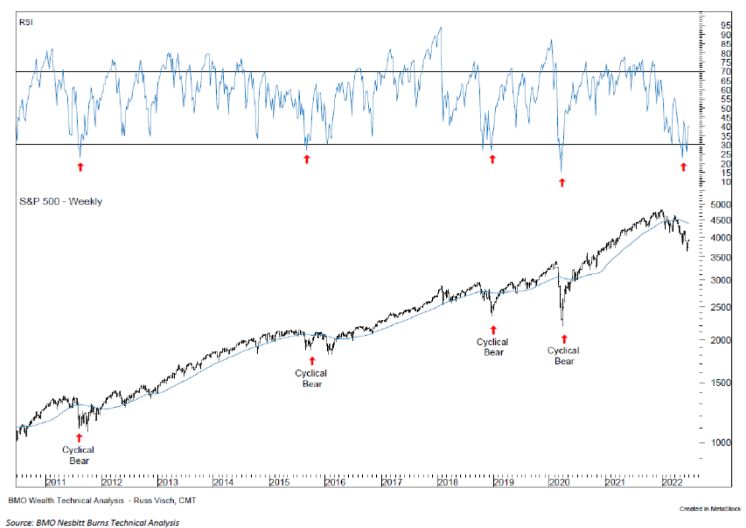
BMO Capital Markets Industrials analyst, John Joyner, who covers agricultural equipment powerhouse AGCO adds that "the upcycle for agricultural equipment arguably has many years to run. Sales of high-horsepower (>100 HP) tractors in North America last topped out in 2013. After reaching nearly 43K units at the time, demand tumbled and appeared to find a bottom in 2017 at almost 21K tractors and stayed at this level for the next three years. After growers had delayed replacing aging farm machinery over the past several years, there is considerable pent-up replacement need that is now starting to get unleashed. And even though we have witnessed a significant improvement beginning in late 2020, unit volume is still hovering at 67% or so of the prior peak. Because of today's budding equipment need, inventory-to-sales ratios for agricultural machinery are at levels never before seen and are not anticipated to improve meaningfully until sometime in 2023."

Technical Views

Admittedly, there's not a lot of positive economic data. If anything, the positive stems more from contrarian signals. For example, sentiment and confidence indicators are so low that historically this represented entry points in risky assets. This behavior proves to be constant in every recession because equity markets are based on valuations and expectations. We had a look at technical indicators in our previous newsletter, but we think it is worth repeating because it puts things into perspective.

Recall that the sell-off in the S&P 500 during the pandemic was the worst since the early 1940's and we are now more oversold than that. The same is true for breadth oscillators such as the percentage of stocks in the S&P 500 trading above their 50 and 200-day moving averages.

Percentage of S&P 500 Stocks Above Moving Averages

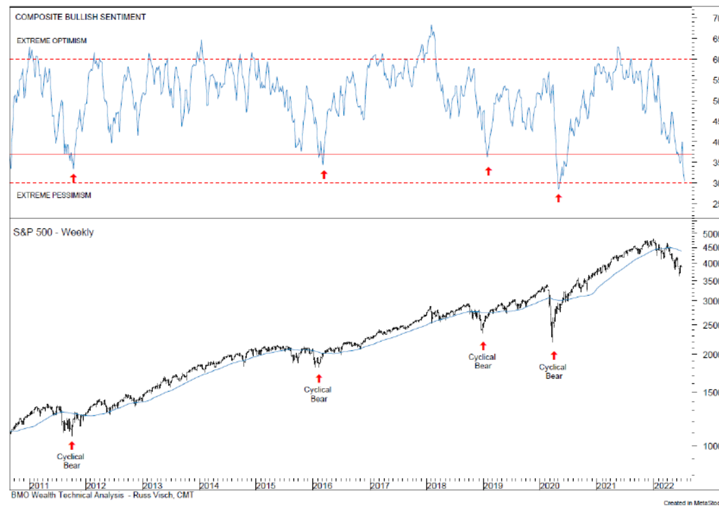


Source: BMO Nesbitt Burns Technical Analysis

Secondly, sentiment is also rampantly pessimistic. BMO's Composite Sentiment Indicator is an aggregation of several different sentiment surveys which poll different segments of the market asking them if they are bullish or bearish. It is now just 2 points away from the bearish extremes that developed at the pandemic low.

In fact, it has only been this negative three times in the past 15 years (including the present time); at the end of the early 2020 pandemic sell-off, and at the March 2009 low following the 18-month, 58% decline in the S&P 500. This just begs the question – who has not sold everything they have wanted to sell yet? Given the state of these indicators our expectation is that this bear market ends sooner rather than later. As such, investors should soon be shifting their focus from being defensive to taking on more risk.

Composite Sentiment



Source: BMO Nesbitt Burns Technical Analysis

The effects of the pandemic are still being felt in our daily lives and in the stock markets. However, 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 Nesbitt Burns

BMO Private Wealth is a brand name for a business group consisting of Bank of Montreal and certain of its affiliates in providing private wealth management products and services. Not all products and services are offered by all legal entities within BMO Private Wealth. Banking services are offered through Bank of Montreal. Investment management, wealth planning, tax planning, philanthropy planning services are offered through BMO Nesbitt Burns Inc. BMO Bank of Montreal are Members of CDIC. ® Registered trademark of Bank of Montreal, used under license. BMO Private Wealth provides this publication for informational purposes only and it is not and should not be construed as professional advice to any individual. The author makes every effort to ensure that the contents have been compiled or derived from sources believed to be reliable and contain information and opinions, which are accurate and complete. The information contained in this publication is based on material believed to be reliable at the time of publication, but BMO Private Wealth cannot guarantee the information is accurate or complete. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. Individual results of clients' portfolios may differ from that of the model portfolio as fees may differ, and performance of specific accounts is based on specific account investiture. All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of BMO Private Wealth. BMO Nesbitt Burns Inc. is a wholly owned subsidiary of Bank of Montreal. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information.