BMO Nesbitt Burns

Putting the Pieces Together

2020 Market Outlook

Facts are what the facts are: the S&P 500 Index has posted positive returns 8 out of the past 11 years since this bull market began. While this period includes our assumption that stocks will hold onto their gains as 2019 concludes it sure does not feel like US equities have been averaging roughly 15% annual returns since 2009. In addition, the months of May and August in 2019 clearly crippled investors into being controlled once again by rhetoric, fear, innuendo and momentum versus process, discipline, patience and common sense, in our view. Yet, the S&P 500 still managed to post several new record highs following those hiccups, while also helping to pace global equities more recently. To be sure, all-time highs have been wrestling with investor neurosis for the past 10 years – with no end in sight for either, in our view.

So as we have liked to say lately, welcome to the second half of the bull market.

BMO Capital Markets states; “We made a prediction in 2010, that US stocks were likely entering a 20-year secular bull market. We are sticking with that call. To be clear, we are not maintaining our longer-term bullish position to be stubborn. Rather, many of the same core principles remain in place – namely, US corporate superiority in terms of earnings stability, cash flow, innovation, product and services, and company management. Granted, a 15% annual return akin to the first 10 years of the bull will undoubtedly be more difficult to match considering that emerging markets, Europe and commodities will likely come into favor again at some point. However, we believe that a leadership shift that many investors have been hoping and praying for is at least a few years away. There just is not enough believability in the US yet – even after the performance of the past 10 years. Furthermore, as the market heads toward 2020, we believe there are at least three points that will only make the neurosis louder:”

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1. Analysis paralysis – We believe there remains too much focus on macro and quant investing.

    - Inverted yield curve mania defined pre-conceived negativity in 2019 – will the opposite (inflation concerns and/or higher rates) take over in 2020?

    - False signals in the ISM and PMI are more about crippled corporate psychology than a looming recession – especially since manufacturing is only 20% of the US economy and a presumed trade truce (or mini-deal) will significantly improve corporate and investor psyche, in our view. Furthermore, we believe the deep desire to define the investment cycle as early, mid, or late, is laced with academia practices that have largely not worked for the majority of the current bull market.

    - Overreliance on quant models have become a "defense mechanism" by many investors that would rather "blame the model" for being wrong relative to doing the work themselves, let alone default to good old-fashioned bottom up stock picking, in our view.

2. Lack of Perspective – We believe momentum and "short-termism" has taken over for longer-term patience and process as many investors guard against being wrong or "missing it."

    - Reacting to tweets and bullet point headlines instead of just staying invested has hurt returns.

    - Historically low earnings estimate dispersions is an issue and is hurting the efficacy of analysis (no differentiation).

    - Limited "market veteran" analyst and portfolio manager tenures (i.e., those in the role for more than 10 years) means that many investment professionals began their careers during a once in every other generation event (2008 crisis) and are "programmed" to be negative, cynical, too macro and non-reliant on fundamentals, in our view.

3. Election Focus – Too much credit or negativity is being placed on politics.

    - There is no doubt that politics can either detract or enhance the underlying trend of the stock market and economy. However, fundamentals drive absolute performance. Granted, US Presidential election cycles are important and topical.

    - Prognostications of corrections exceeding 20% (which constitute a bear market) are more about creating headlines than reality, in our view.

    - The last time a US President was partially impeached was 1998 – when the S&P 500 Index was up 27%.

To mute this noise, here are three guideposts for 2020 that investors should consider:

1. DDA = Dollar Denominated Assets

    - Zero and negative rates around the world will continue to drive inflows in US bonds.

    - The US dollar remains the world's reserve currency, which has only been exasperated by Brexit (↓sterling) and negative rates (↓euro, ↓yen).

- High single-digit, stable earnings growth during a period of continued low interest rates and 17-19x multiples relative to ever increasing volatile global equities make US stocks an admittedly reluctant destination for most global investors to be, in our view.

2. Resilience of the 1995-1997 stock market

- We believe a similar environment is currently under way.

    ✓ The Federal Reserve's pivot in November 1994 (e.g., cut interest rates in 1995);

    ✓ Ushered in a goldilocks period defined by low rates, steady growth and US large cap quality stock outperformance;

    ✓ The Federal Reserve's pivot in January 2019 ushered in three 25 bps cuts;

    ✓ US large cap, high quality, brand name companies are setting the pace for global stock market performance once again;

- 2020 Base Case – The Notorious Bull Market Continues:

    ✓ With the Fed likely on hold through the election;

    ✓ Phase one tariff deal eases investor strife;

    ✓ Investors seek stable earnings – therefore favoring the US;

3. The Stock Market Is a Market of Stocks

- There remains too much focus on defining leadership – especially in terms of FANG, growth, value, early or late cycle; let alone having outsized sector bets.

- Instead, we encourage investors to not try and time the market, but rather stick with their convictions and process.

- In addition, we believe investors should focus on high quality dividends and stable growth opportunities given what we believe could be another year of unpredictability for investment decision making.

Old habits are hard to break. As such, the stock market's neurotic nature and dependence on negativity is not going away anytime soon. Therefore, what we like to call the most hated and mistrusted bull market in history rolls on to our campaign chant of "10 MORE YEARS!"

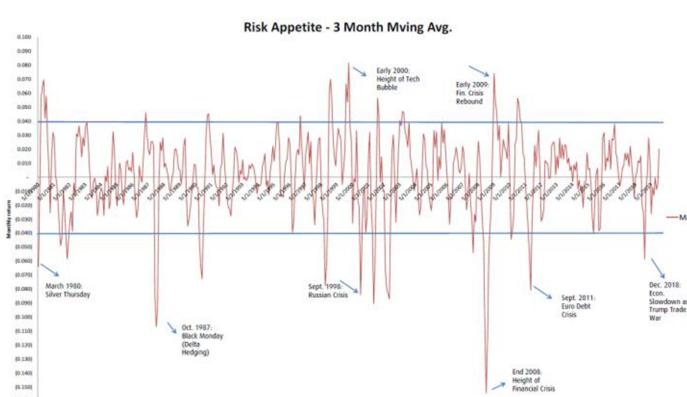
We continue to have a high degree of conviction in the view that, among asset classes, equities hold far better value than cash or bonds at this juncture - something we have been reiterating since the sharp market pullback of last year. We believed at the time that this was a massive overreaction to fears of an upcoming recession. While a recession will eventually come, we still think this is more of a mid to late-2021 event (odds of a recession in the next year still sit at a manageable 45% on our models), which means that markets still have room to run before we get a more meaningful pullback. Recall that the stock market "discounts" the real-world economy 6 to 9 months ahead of time.

BMO Risk Appetite Index Update: Still in Neutral Range despite Markets at Records

Our Risk Appetite Index ticked up in November, but still sits comfortably below "euphoric" levels which have historically preceded a sharp pullback. This, despite North American stock indices hitting a series of new record highs which we view as a positive contrarian indicator. In other words, many investors - and especially retail investors based on the numerous client events we have had - do not believe in this rally and are still sitting with a lot of cash. Further upside could also force institutional PMs to "throw in the towel" and buy into this rally for fear of further underperformance into year-end. Case in point, according to Morningstar Direct, for Canadian domiciled funds, only 16% of Canadian Equity Mutual Funds have outperformed the TSX Composite year-to-date (YTD) after fees, and only about 28% of US Equity Mutual Funds have outperformed the S&P500 YTD after fees.

Recall that this is a relative index comparing the performance of risky assets (equities and high yield) vs. safe assets (Government bonds). In numerical terms, stocks would have to outperform bonds by over 6% to get us to the more dangerous euphoric area (above the top blue line).

BMO Nesbitt Burns Risk Appetite Index



Source: BMO Private Client Strategy, Bloomberg

The Technical View

Away from the above purely quantitative construct, other widely followed sentiment indicators are giving similar signals. As our technical analyst Russ Visch notes, "Sentiment surveys in the last few weeks have been universally higher, resulting in a persistent uptick in our Composite Sentiment Indicator. The aggregate level of bullishness, as measured by this gauge (slightly above 50%), is surprisingly tame considering the S&P 500 is at an all-time high. Frankly, we are amazed that the major averages can be at all-time highs and essentially half of market participants are still neutral or bearish. i.e. - we've got a long way to go before sentiment will be a concern for equity markets".

Composite Bullish Advisory Sentiment

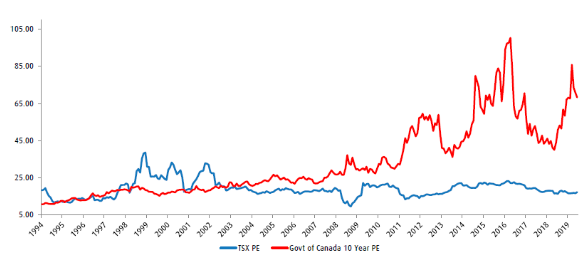
He also makes the following observations which are undeniably supportive of our positive stance on equities: "Breakouts in North American equity markets has garnered the lion's share of media attention recently. However, it's not just local markets breaking out – it's actually a global phenomenon. In recent weeks we've seen new 52-week (or all-time) highs in major economies such as Japan, France, and Germany just to name a few (the Eurozone, in general, has been mired in economic stagnation for a long time).

The MSCI World ex.-U.S. index provides what is perhaps the most balanced view of how global financial markets are performing, and that index just broke out of a year-long base pattern, opening a new upside target that measures 15% higher from current levels. So despite the recent spate of weak economic data (all of which is based on backwards-looking data, of course) it's clear that equity markets are beginning to discount something much more bullish".

Lower Rates a Major Tailwind for Stocks Historically

As we have noted before, 10-year interest rates are the foundation of all finance. They have a significant impact on equity sector valuations and performance. On that point, we reiterate our long standing view that high quality dividend growth equities continue to look very appealing versus bonds. In the chart below, we inverted the Government of Canada 10-Year yield to get the bonds' "Price/Earnings (P/E) ratio" (In this case the E would be the annual interest payment). If we plot the P/E of the TSX against the 10-Year Government of Canada Bond's P/E, we can effectively see how "expensive" the bond market is relative to stocks. The value argument for stocks is even more compelling when one considers that bond coupon payments do not grow, unlike dividend payments for high quality stocks.

S&P/TSX Composite P/E ratio versus Government of Canada 10-Year 'P/E ratio'



Source: BMO Private Client Strategy, Bloomberg

While our dataset for Canada is limited, we looked at subsequent returns for the S&P 500 for different 10- Year "P/E" valuation bands going back to 1980. Specifically, the average annualized S&P return has been a whopping 16% when the bond's "P/E" is between 50-60x (i.e. U.S. 10-Year interest rates are between 1.67% and 2%), which is where we find ourselves currently.

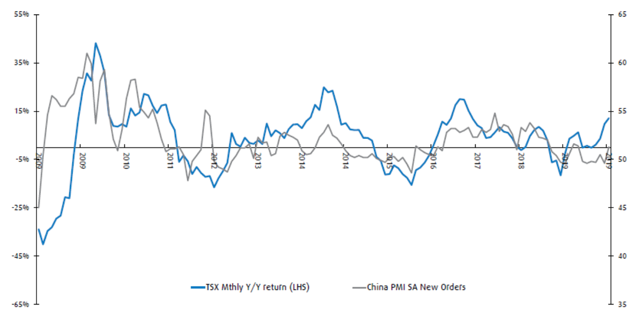
As a reminder, we also asked our research partners at Ned Davis Research to conduct an analysis of market performance going back to 1972. The key conclusion is that the current interest rate environment - characterized by 10-Year rates below the 2% level in the U.S. and Canada - has historically been associated with excellent stock returns. The market has also been quite strong when rates have declined substantially in the previous year. Specifically, the market has increased by 15% annualized when rates decline by over 0.5% year over year.

Canada: Still Trading at an Unusually Steep Discount to the U.S. based on Price to Earnings (lower) and Dividend Yield (higher)

We now turn to the relative value advantage of Canadian stocks vs. U.S. stocks. We do think Canada should trade at some discount given our inherently more cyclical sector composition and relative lack of dominant Tech, Consumer and Healthcare companies (which tend to command higher multiples). Still, we consider the current discount excessive since global economic momentum - and China's growth most importantly - appear to have bottomed, and are starting to move back up. This is particularly important for Canada since China's growth has an outsized influence on commodity prices.
Looking at the just released data, BMO Economics notes that "After months in contraction terrain, China's official PMI unexpectedly jumped in November, up 0.9 pts to 50.2.

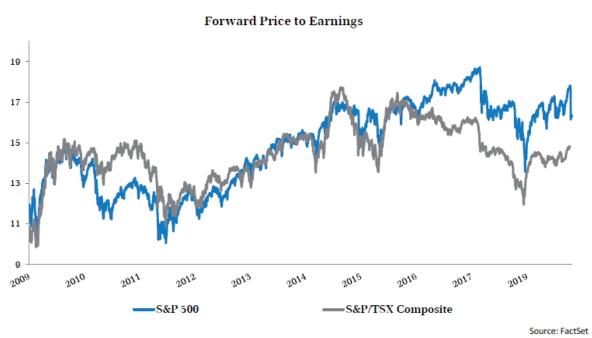
That marks the first time in expansion mode since April, amid government stimulus measures to shore up the economy. Meantime, the private Caixin manufacturing PMI climbed to 51.8 in the month from 51.7 in October. And, the better figures weren't limited to just China, with factory PMIs edging up in many other Asian economies including Japan, South Korea, and Malaysia. Adding to the risk-on tone, China's non-manufacturing PMI climbed 1.6 to 54.4, the highest level since March".

S&P/TSX Composite Returns versus China PMI New Orders



Source: BMO Private Client Strategy, Bloomberg

S&P/TSX Composite and S&P 500 Forward Price to Earnings Ratio



Source: BMO Private Client Strategy, FactSet

Wishing all our clients and friends a healthy and prosperous New Year!

Cheers to all,

Team Roux