Putting the Pieces Together

New Year, New Variant, Same Old Virus

Last month felt like we were all playing Russian roulette every time we stepped out of the house. Consequently, volatility seeped into global markets. The Omicron variant is now a household name all over the world only a few short months after having been discovered in South Africa. We do believe there is a silver lining, as Omicron is fast crowding out all other forms of the variant and appears to have milder health implications. The symptoms are very much like the flu, fever and headache as opposed to much more serious respiratory issues as it has been widely reported in initial scientific studies. The other good news is once we are past the initial surge in Omicron infections, we could see a very sharp reduction in cases. In fact, reports indicate that infections have peaked in South Africa and may have plateaued in London. Therefore, global markets are looking ahead and have discounted the worries of the shutdowns due to the variant.

As this is the first newsletter of the new year, we usually look back of what was of the previous year. We are not sure how useful this exercise would be because since the pandemic the market is driven by momentum. Hence, and as we've discussed all along in our previous newsletters, the rotation between cyclicals and defensives sectors and/or growth and values investment styles has been occurring every six months. That is why looking ahead into 2022, we will focus and screen for companies that have consistently demonstrated their capabilities in growing their earnings. In this momentum driven market, we have put a lesser emphasis on valuation ratios and momentum ratios and more so on growth at a reasonable price. In doing so, we avoided the peaks and valleys of share prices.

As stated above, the market is looking passed the Omicron variant. The re-opening trade is at the forefront. Hence the market is driven by momentum and thus cyclicals are trending higher. In other words, the 10-year US rate is rising and as we write it is currently at 1.90%. Consequently, cyclical sectors are doing well like the financials, resources, and industrials. In this newsletter, we will get straight to the point and touch on the main areas of concerns for investors. We will take a closer look on monetary stimulus followed by rates and bond yields and finally inflation and supply chains. These latter issues are front and center in the headlines and we will see how they impact the markets.

Let's connect

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BMO Private Wealth

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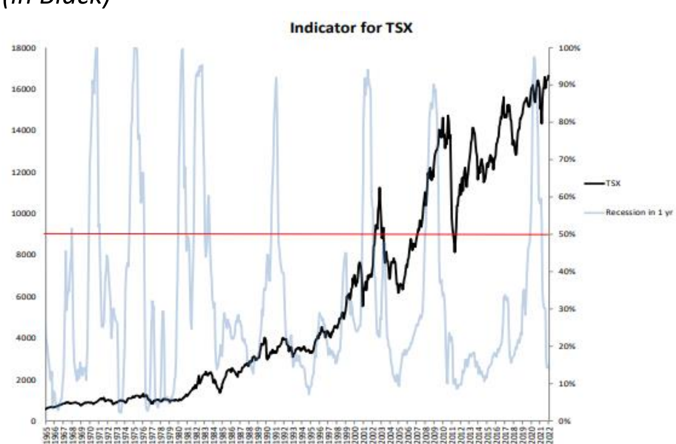
At the outset, we believe the investment implications of a rising 10-year rate coupled with the number of positive Omicron variant cases subsiding are likely quite positive, especially for so called recovery stocks which have been under pressure for months. By this we mean travel and hospitality related companies (i.e. Air Canada, McDonalds). More generally, we remain bullish on stocks, particularly in Canada which has a strong valuation advantage over the U.S. and a market composition that benefits from inflation. BMOCM (BMO Capital Markets) expects consumers to remain strong and businesses to continue investing in technology, automation and to generally bolster their supply chains, which will help give more momentum to the rising capital expenditure cycle. For example, one topic which we touched on in our previous newsletter is onshoring which basically is the opposite of outsourcing. Onshoring is changing global supply chains; a trend whereby companies are investing in North America. As we write, the senate is looking at different proposals to subsidize companies that want to bring back their operations from offshore.

Taking a step back, our bullish call on equities is anchored by our still positive view of the economy. While it would be far too optimistic to expect a repeat of 2021's stock returns, we believe we are transitioning into a continued – albeit slightly slower economic recovery in 2022. Most importantly, BMO's Portfolio Advisory Team models show a very low probability of recession in North America.

Probability of Recession for the Next Year (in Blue) vs. TSX (in Black)

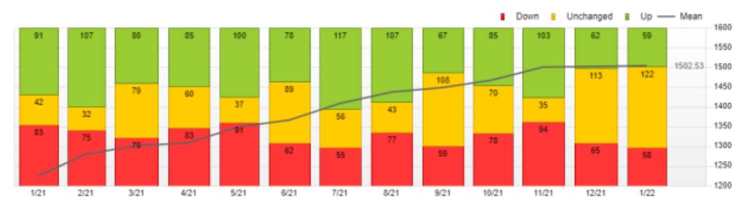


Source: BMO Nesbitt Burns Private Wealth, FactSet, FRED, Bloomberg

Specifically, they get odds of 12% but adjusting for the most recent data and the bullish yield curve move they have seen so far this year, they believe the true probability is even lower and certainly below 10%.

On a related note, corporate earnings estimates have increased relentlessly over the last year and recent public company quarterly reports support a continued upward trajectory, especially for energy, financial, consumer and industrial companies which happen to carry the biggest weight in the TSX Index.

S&P/TSX Composite Earnings Estimates



Source: FactSet

The latest and the all-important U.S. ISM report (which is a real-world gauge of economic activity) was released and it was unequivocally bullish. Most importantly, New Orders (the most forward looking of the sub-components and the one most positively correlated to stock performance) stayed above 60 and Supplier Deliveries and Prices Paid continued to decline. **As noted by BMO Economics: Against a backdrop of sturdy demand, both supplier delivery delays and prices paid for materials took a big step down, suggesting capacity constraints started to ease at the end of 2021**. And while Omicron will likely add to supply pressures over the next few months, factories are still expected to stay in expansionary mode, even as overall momentum slows. Some corporate anecdotes include: "Price increases appear to be slowing. Lead times are shrinking slowly, and inventories are growing." (Fabricated metals); "Overall performance by suppliers has improved. On-time deliveries have improved." (Machinery); and "Chemical supply chains are filling very slowly. Still not full, but (my) gut feeling says it's getting easier to source chemical raw materials." (Chemicals).

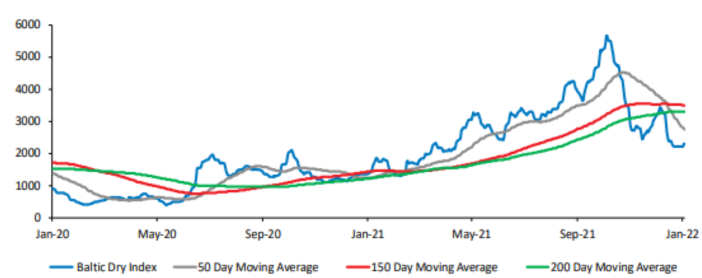
ISM Mfg: Supplier Deliveries Index

Source: ISM/Haver, Bloomberg

There was also relief on the labor front. What the ISM describes as an "overwhelming majority of panelists" who are hiring (or trying to), 37% say that workers are harder to come by, which is fewer than November. So, people are coming back.... because they want to, or because they have to. Regardless, they're coming back. The private sector increased hiring (in all major industries except manufacturing, oddly), as did the government. The quits rate in the private sector jumped 0.3 ppts to 3.4%, suggesting more confidence to leave one's job for another. This data is highly supportive for consumer spending and the housing market at least for the next few quarters.

Backing up the supply chain improvement narrative is the sharp decline we have seen since last October in the Baltic Dry Index which provides a benchmark for the price of moving major raw materials by sea. The index has come down more than 60% and now sits close to its historical average.

Baltic Dry Index

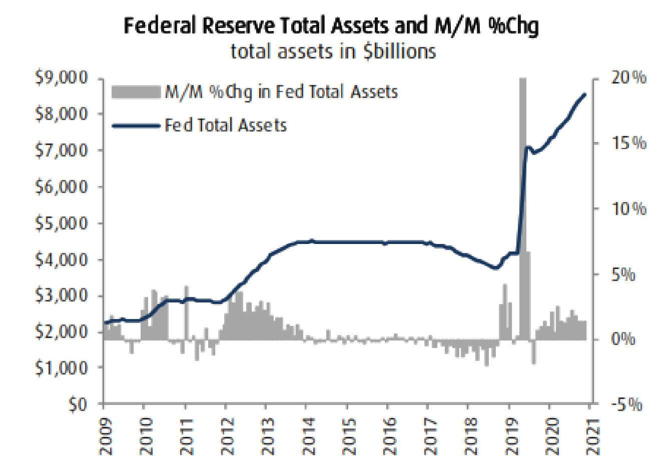


Source: FactSet

Monetary Stimulus

We addressed this topic in our last newsletter. That said, it is worth revisiting because money supply impacts directly the credit markets. In the risk of sounding repetitive, when the pandemic started, the Federal reserve and other global central banks started printing money to offer liquidity and credit to companies. At this point, Fed tapering has already been announced and no, we do not think the reduction of the asset purchase program will cause any sort of prolonged havoc as it relates to US stock market performance. That said, it will cause some volatility and re-pricing of assets. They started reducing last month and we've seen the market pullback. However, if we look back in history and revisit the last time the FED started reducing its asset purchase program, their balance sheet remained very large for quite some time thereafter, which should continue to be supportive of stocks.

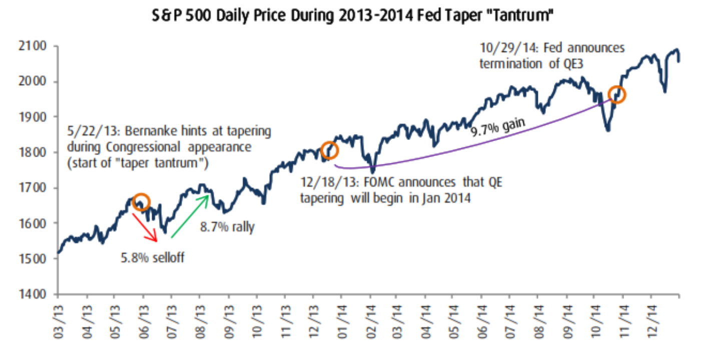
FED's Balance Sheet



Source: BMO Capital Markets Investment Strategy Group, FactSet, Haver, FRB.

There is no denying that quantitative easing periods have coincided with strong gains for US stocks with the S&P 500 averaging a 19.6% annualized price return during all four of the Fed's QE programs. However, even when the Fed was not purchasing bonds, the S&P 500 still managed to log a decent 7.8% annualized price return.

2013 Taper Tantrum returns

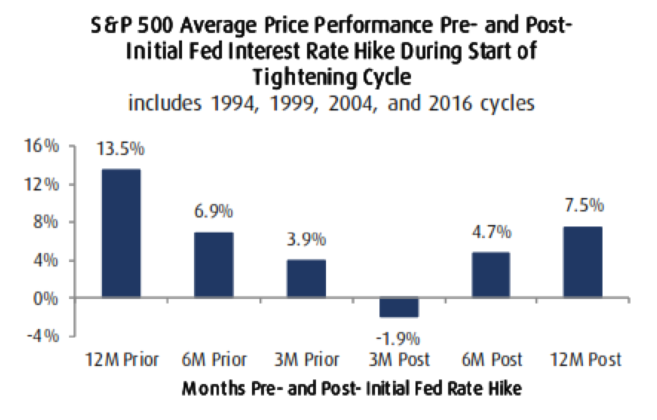


Source: BMO Capital Markets Investment Strategy Group, FactSet, Haver, FRB.

Interest Rates and Bond Yields

The market is pricing in a rate hike by mid-2022, which would kick off the first tightening cycle in five years. US stocks have struggled in the initial three months after the Fed's first interest rate hike of the cycle with the S&P 500 logging a 1.9% average loss. However, the index has done well thereafter, gaining 7.5%, on average, in the subsequent 12 months.

US Stocks performance following the start of the Fed tightening cycle after 3-month consolidation period

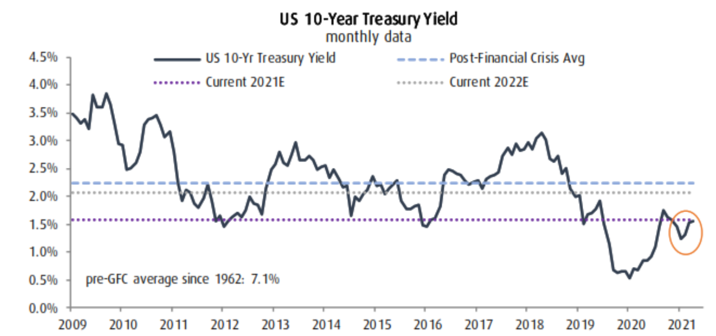


Source: BMO Capital Markets Investment Strategy Group, FactSet, Haver, FRB.

The US 10Y Treasury yield has ticked higher in the last couple of months, and has unsurprisingly caused worries among investor, as it relates to future US equity performance.

This is a normal concern, but we must put things into perspective. Interest rates have largely been stuck in a low range since the Great Financial Crisis (GFC), and any further increase would likely still leave rates at historically low levels, especially relative to the pre-GFC average. In addition, the current 2022 US 10Y Treasury yield forecast of 2.1% remains below the post-GFC average of 2.2%.

US 10Y Treasury Yield



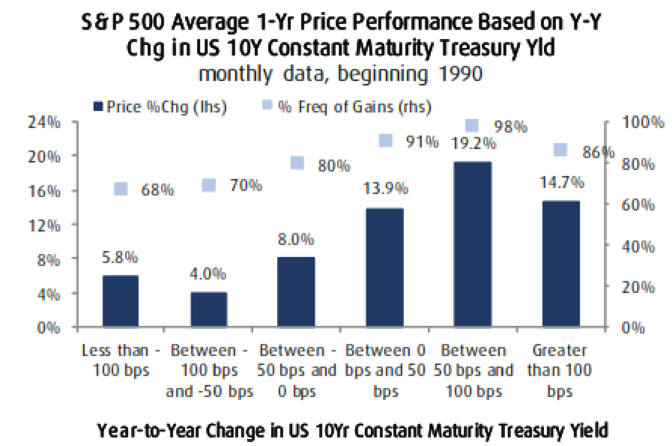
Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Rising rates have coincided with stronger market price returns, particularly when rates increase from low levels. Going back to 1990, the S&P 500 has posted a 16.1% average price return during periods of rising y/y rates compared to a 6.1% gain during periods of falling y/y rates. When the US 10Y Constant Maturity Treasury yield increased from a below-average level, price returns were even stronger with the S&P 500 registering a 23% gain, on average.

Further, the S&P 500 has averaged a one-year gain of 19.2% when the US 10Y Treasury yield jumped by 50-100 bps y/y, which is the range that the 2022 yield forecast currently implies.

Finally, the work done by BMOCM shows that the broader market and the Technology sector can register solid gains during rising interest rate cycles. In fact, annualized returns for Tech have eclipsed those of the market during five of the prior seven periods of increasing rates and is currently outpacing the S&P 500 in the present cycle, which started at the end of July 20.

S&P 500 Average 1-YR Price Performance based on Year over Year Change in 10Y

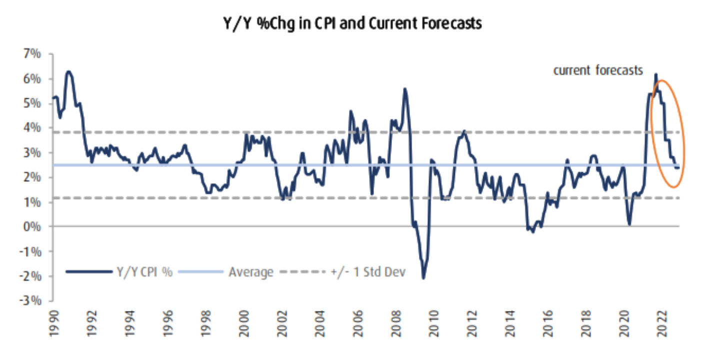


Source: BMO Capital Markets Investment Strategy Group, FactSet, Haver, FRB.

Inflation

The latest CPI number came in hotter than expected, pushing the yearly rate up over 7.0%, the highest in nearly 31 years. That being said, inflation forecasts are implying that CPI has likely peaked, as estimates indicate a sharp drop in the coming quarters with the yearly rate forecasted to end 2022 at 2.4%

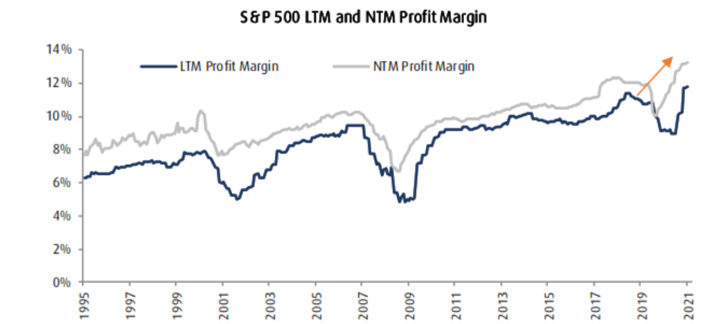
Y/Y % Change in CPI and Current Forecasts



Source: BMO Capital Markets Investment Strategy Group, FactSet, Haver, BLS.

Despite the uptick in inflation this year and corresponding fears among investors that these higher prices could have a detrimental impact on companies' margins, S&P 500 LTM (Last Twelve Months) profit margins, in aggregate, have held steady with forecasts implying that margins could expand, not compress, over the next 12 months.

S&P LTM and NTM (Next Twelve Months) Profit Margin



Source: BMO Capital Markets Investment Strategy Group, FactSet, Haver.

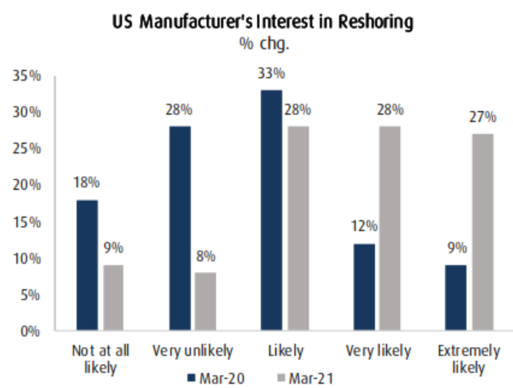
Onshoring

COVID-19 has brought the inherent issues of the global supply chain to the forefront. 18 months into the pandemic, consumers are still facing shipping delays and inflated prices. Labor shortages, lack of raw materials, and port congestions are only some of the factors contributing to an unprecedented supply chain fallout, which is not expected to recover until sometime in 2022. However, global supply chain disruptions have occurred in the past, but not to this extent nor length. In fact, this time around, supply chain disruptions are prompting a fundamental shift in manufacturing processes. While the pandemic certainly exposed the frailty of the global supply chain, a closer examination suggests that an overreliance on China with respect to manufacturing, labor and raw materials is how the current situation differs from the past. US companies began manufacturing in China 40 years ago as a source of cheap labor, and in the last couple of decades, US manufacturing employment has continued to fall.

During the same period, China has become a global industrial powerhouse with its highly efficient manufacturing facilities, myriad of raw materials, robust labor force and strong port infrastructure, accounting for almost 15% of global exports in 2020. In addition, its huge population and growing middle class has made it an attractive place for companies to do business. In 2020, China's e-commerce sales totaled $2.4 trillion, dwarfing US $792 billion.

Frankly, the pendulum has swung too far. As such, moderation, normalization, and common sense all point toward a structural, if not secular change in supply chain management. We believe at least part of the answer is already under way. Which is what we previously referenced too, onshoring. In the US, the effects of COVID-19 combined with a rise in nationalism have led to onshoring emerging as one of the solutions to address the supply chain issues. According to Thomas' 2021 State of North American Manufacturing Report, US manufacturer's interest in reshoring significantly increased as of March 2021 with 83% of the polled manufacturers indicating they are extremely likely to reshore, compared to 54% a year prior.

US Manufacturer's Interest in Reshoring



Source: BMO Capital Markets Investment Strategy Group, Thomas State of North American Manufacturing 2021 Annual Report.

The arguments for reshoring are clear: proximity to customers, supply chain optimization, less lead times, increase in domestic jobs and technological advances, but the complexity of the global supply chain needs to be factored in when considering this move. Incentives provided by the government in the form of direct funding, tax breaks, and legislation could determine which industries are more susceptible to moving back home. For example, certain manufacturing processes that produce components critical to national security, such as aerospace and defense, personal protective equipment, medical devices, and pharmaceuticals will likely receive stronger and near-term support. Also, high tech manufacturing including computers, electronics, electrical equipment, and components which have high R&D budgets and potential security breach concerns will be beneficiaries as the government looks to strengthen areas that were previously outsourced abroad.

The fight against Covid-19 and the return to normalcy is not over, and so your team will remain alert to emerging trends. Hope to talk to you soon.

Team Roux & Associates