Putting the Pieces Together

Second Wave

As always, we would like to begin by wishing all of our clients and friends good health and by thanking all of whom that are on the front lines on a daily basis battling this virus. As we write, our province and others, states and countries are imposing or restating some restrictions in order to limit the spread of this virus during this second wave. Naturally, because of this reality and the political uncertainty south of our border, these two elements have festered continued market volatility.

As a reminder, we will be hosting our second real estate outlook seminar on October the 20th. However, due of our new reality, it will be on a virtual platform. The idea for hosting a second seminar is really from the positive feedback we received from the first one held earlier this year, in February. We thought it was important to revisit the sector especially during Covid-19 and the fact that real estate for many represents an investment either it being your home or as a revenue asset. We encourage you all to register via our e-vite, which we sent out at the beginning of the week. In addition, we will also be sending out a reminder.

Before we begin, let's take a look at our new Governor at the Bank of Canada, Mr. Richard Tiffany (Tiff) Macklem. After all, his committee's decisions will impact us because the Bank is the stewards of monetary policy and interest rate policy. Mr. Mecklam is a homegrown talent, raised in Montreal and you'll find his signature on our twenty dollar bill. He did earn a lot of recognition during the financial crisis as being a vital aid to then Prime Minister Harper, where he served as an associate deputy minister and as a conduit to the international community in order to steer the Canadian economy from potential disaster. To understand his mindset we'll just highlight a recent quote of his; "When you're faced with a real crisis, you have to step beyond the normal responses. You have to have the mentality that you need to overwhelm this crisis… you have to do probably more than you think you're going to need to do, and certainly more than many people will tell you, you need to do."

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

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

Basically, he thinks big. Under his leadership, the Bank of Canada does have ambitious goals and are pushing ahead on a major item on their agenda that would be ambitious even without the COVID crisis. The bank is in the midst of a major review of its mandate that will culminate, sometime in the fall of 2021, in a new five-year agreement with the federal government on the bank's policy framework. The results may well be significant changes to the inflation-targeting regime that has rooted Canadian monetary policy for a quarter-century.

The bank is seriously considering several alternatives to its long-standing 2% inflation target, including targeting price levels rather than inflation rates; seeking a 2% average over time rather than a firm target; and adding a full-employment objective in addition to an inflation target, similar to the "dual mandate" of the U.S. Federal Reserve.

In this quarter's newsletter, we will review the differences between the two presidential candidate's platforms, followed by how lower rates are supportive for equity markets and we will take a deeper dive into the technology sector where concerns have been raised in terms of their valuations.

Investors have many concerns these days including rising COVID-19 cases which are leading to fears that a dreaded "second wave" is upon us. There is also the upcoming U.S. Presidential Election. The train wreck that was the first Trump/Biden debate certainly did not help ease concerns from that perspective. And yet, we believe the market will remain well-supported through year-end. This may seem like rose colored optimism to some but we believe that the most important variable for the market is the level and trajectory of interest rates, and the outlook remains very positive on that front. History solidly supports our view and we have the data to prove it.

We begin with politics which has dominated the narrative lately with the erratic first presidential debate, secondly with the ongoing negotiations of the second round of a stimulus package and lastly with the cession of powers after the election. We are not political commentators but all the latter issues have definitely had an impact on investor sentiment. Hence, we will highlight some key differences between the two platforms. We would like to preface by stating even though there are some differences, the market in general sees either or candidate as supportive for equities. Reason being, as we write, Senator Biden is leading in the polls and the market hasn't corrected. Even earlier this year when he won his party's nomination the market didn't correct.

Key elements of a Trump Second Term

Corporate and Personal Taxes:

- "Made in America" tax credit for manufacturing
- Allow 100% first-year expensing for certain manufacturing-related industries, such as pharmaceuticals and robotics
- Tax credit for companies that repatriate employees or operations from China to the U.S.
- Permanent payroll tax cuts
- Extend the current lower income tax rates
- Unspecified middle class tax cut
- Reduce the maximum rate for the net long term capital gains to 15%

Trade:

- Will likely double down on his America First policies, including aggressive approach to the U.S. economic relationship with China through additional tariffs and sanctions
- The potential withdrawal from the WTO

Infrastructure:

- It's probably the only area where he could work with a Democratic controlled congress. This is the reason we believe that a stimulus bill for Covid will ultimately pass either before the elections or after. Fiscal stimulus is still needed in terms of a relief package as outlined by Chairman Powell. If we go back in time at the beginning of his presidency whereby Republicans controlled both Houses of representatives, they never passed any infrastructure bill as promised in his campaign. Typically "traditional" Republicans don't like spending.

Key elements of a Biden Presidency

Corporate and Personal Taxes:

- Raise the corporate rate 28%
- Impose a 15% minimum tax on book income for companies that report a net income of >$100M, but owe no U.S. income tax
- Disallow accelerated depreciation deductions
- Raise personal top rate to 39.6%
- Expand payroll taxes to apply to wages >$400k
- Tax capital gain/dividends as ordinary income for those with income >$1M
- Apply $3.5M estate tax threshold, repeal stepped-up basis

Financial Services:

- In general, expand regulatory requirement in banking services and promote regulations protecting the consumer. No specific policy goals yet, but with progressive representation in the Congress there will be a push for more regulations.

Infrastructure:

- Biden plans to invest $2T of federal dollars into infrastructure development, with a focus on sustainable projects and clean energy, enhanced by innovative financing mechanisms that leverage private sector dollars.

Macro Impact

Clearly the biggest risk is related to an increase in corporate and personal taxes (which Biden has discussed) which would hurt company profitability while somewhat reducing the available equity buying power from rich households (although that part is very hard to quantify).

According to FactSet, the effective tax rate (the nominal tax rate does not fairly represent the actual corporate tax burden because of deductions, loopholes, .etc.) for S&P 500 companies has come down to approximately 19% from 26% following the landmark 2017 tax cut. Assuming Biden reverses only half of this decrease (since the U.S. will want to maintain a somewhat competitive rate with other developed countries), this would cost the S&P 500 approximately US$10 on a consensus figure of US$160 next year.

Some major offsets however would be a softening of trade rhetoric and tariffs which should help boost global economic growth, consumer demand and profitability for multinational companies (about one third of S&P 500 sales come from abroad). This would be an unequivocal positive for Canada which has been on the receiving end of tariffs (i.e. the recently re-imposed 10% tariffs on aluminum) from the Trump administration. Aside from the direct costs, a relief from the threat of further negative actions would be helpful to a host of Canadian sectors. BMO Economics estimated that the combined impact of the imposed and potential tariffs could reduce U.S. GDP by about 1¼%.

The Bank of Canada, for its part, estimated that the tariffs on metals, as well as duties on newsprint and softwood lumber, could reduce Canadian GDP by almost 1%. Given the historical relationship between economic growth and corporate profit growth, the boost in economic growth from “freer trade” could almost fully offset the headwind from higher taxes noted above.

Also, an increase in the minimum wage could boost aggregate demand but could hurt service companies with limited pricing power, particularly as restaurants and bars for example are already struggling to recover from the Coronavirus.

Higher Infrastructure spending could boost sales for a number of sectors, particularly in alternative energy and green technologies, public transportation, power and communication systems.

Biden and a Democratic Congress could in fact provide more fiscal discipline (counter-intuitively Democrats have been far more disciplined on deficits in the last few decades) which is sorely needed to reduce the risk of the debt time-bomb. As a reminder, we consider the vast expansion of debt and deficits –which has only accelerated in the face of the Coronavirus- to be the biggest long term threat to the economy and equity markets.

Sector Impact

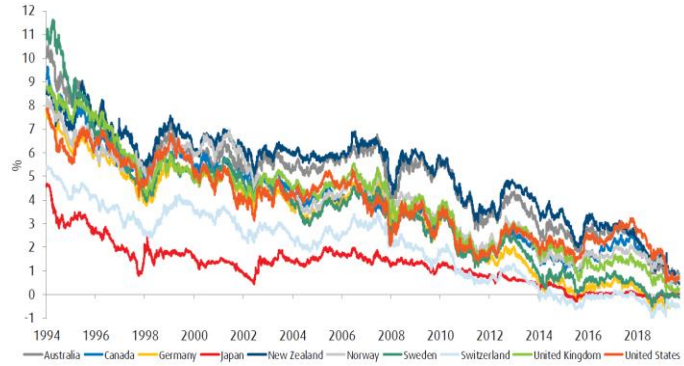
From a sector perspective, our research partners at JP Morgan noted that Democratic Sweep winners include (1) Minimum Wage Hike Beneficiaries should benefit from higher demand while margin pressure should be more limited given pricing power; (2) Alternative Energy / Green Tech; (3) Infrastructure Plays; (4) High China Revenue Exposures and Importers should benefit from tariff de-escalation; and (5) Healthcare.

On the other hand, key underperformers could include: (1) Higher Corporate Tax Rate should impact companies with very low effective tax rates; (2) Minimum Higher Wage Underperformers should be negatively impacted companies with high labor intensity and low pricing power / margins; (3) Low ESG / Fossil Fuels; (4) Defense; and (5) Anti-Guns / Private Prisons losers. We note that large healthcare/pharmaceutical companies could also suffer from headline risk as Democrats try to curb medical care and drug price inflation (although an expansion of “Obamacare” would increase accessibility for currently uninsured people, thus boosting demand for drugs etc.).

Lower for much Longer

As every seasoned investor intuitively knows, lower rates are generally a good thing for stocks. A notable exception to this rule is when they signal a deflationary spiral -a la Japan- but this has been exceedingly rare in the last two centuries of economic history. Just how good they are for equity performance may, however, come as a surprise to many and that is what we address below. Given long term interest rates are converging toward zero in North America and across developed countries, this has very positive implications for the huge real estate market (approximately 20% of the Canadian and U.S. economies), for the cost of financing for companies and governments, and for the relative value of stocks (e.g. a growing 2%+ stock dividend yield compares very favorably to a fixed 0.55% 10 year Government of Canada yield).

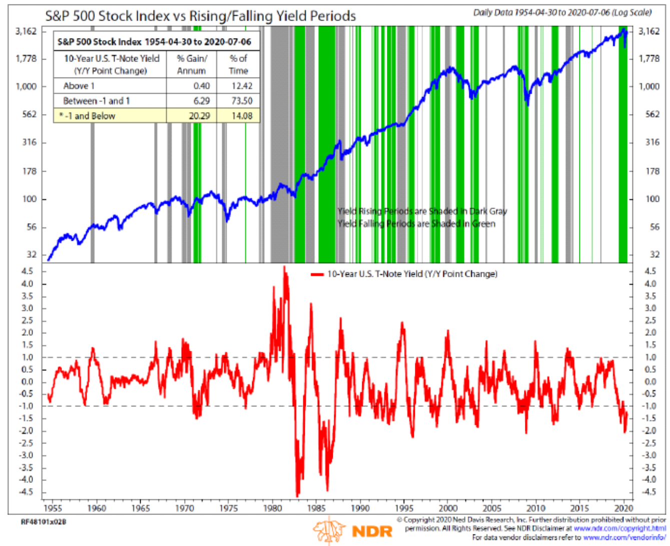
10-Year Yields in Developed Countries



Source: FactSet, BMO Nesbitt Burns; as of October 01, 2020

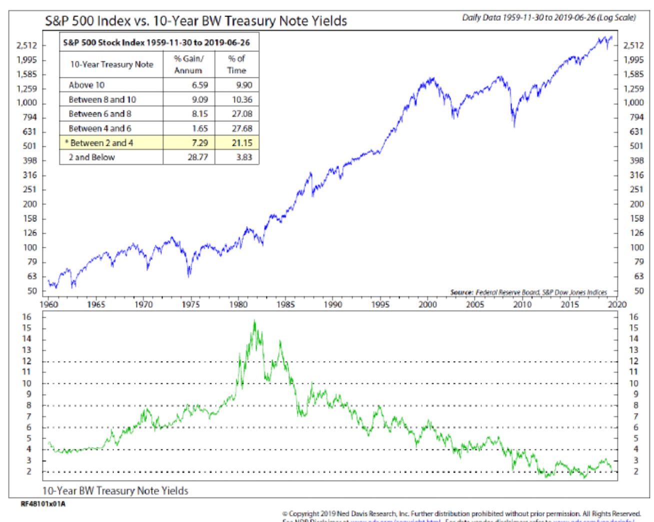
BMO's research partners at Ned Davis Research conducted an analysis of market performance going back to 1959. The results are summarized in the tables below. What we notice immediately is that the current <1% interest rate environment, while quite rare, has historically been associated with excellent stock returns (almost 23% annually for the S&P 500) and that substantial year over year declines in rates (i.e. a downward trend in rates) tend to turbocharge equity returns. This also happens to be the prevailing environment. The best performing U.S. sectors when rates decline by 1% or more, going back to 1959, have been Consumer Discretionary (+32%), Technology (+27%), Health Care (+24%), and Industrials (+23%). The market appears to be largely following this playbook but we note that we have not seen such massive Tech outperformance since the tech bubble.

S&P 500 Stock Index vs Rising/Falling Yields Periods



Source: Ned Davis Research

S&P 500 Index vs 10-Year BW Treasury Note Yields



Source: Ned Davis Research

Tech Valuations

As of late, there's been a lot of business news coverage in regards to the valuations of the technology sector. BMO Capital states, that they find these constant comparisons to the early 2000s pretty absurd given the significant differences that exist in the underlying fundamentals for Tech stocks between the two periods. In fact, when it comes to earnings, dividends, balance sheet strength, valuation, and quality attributes, the stocks comprising the current Technology sector are substantially better positioned than the Tech names from 20 years ago, which should provide support for prices in the coming months. Indeed, we view any selloff in the group not as a harbinger of things to come, but instead as a healthy period of consolidation after a dramatic price rebound over the past six months and, as such, we remain Overweight the S&P 500 Information Technology sector.

Aside from the underlying fundamentals, the present interest rate environment is vastly different than the one seen in 2000 when the tech bubble popped. At the moment, the Fed funds target rate stands at 0.25% and is likely to stay there for the foreseeable future given the recently modified inflation targeting policy. Contrastingly, by the end of March 2000, the Fed funds rate was at 6% with the Fed having already raised rates 125 bps since June 1999.

Furthermore, valuation is another significant difference as it relates to comparisons to 20 years ago. Yes, current aggregate P/E levels for the S&P 1500 Technology sector are above historical averages, but they are well-below the excesses exhibited in the early 2000s on both a trailing 12-month and forward 12-month basis.

Earnings, dividends, and balance sheet strength are also characteristics that suggest Technology is in a much stronger position to support current prices.

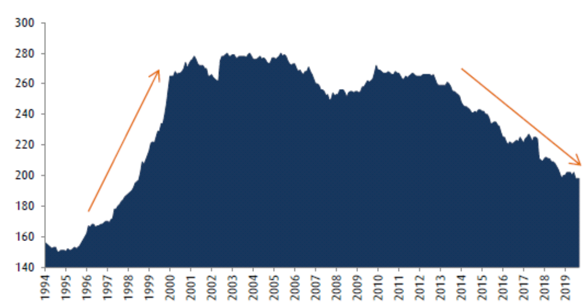
- For instance, nearly 87% of Tech stocks in the S&P 1500 have not exhibited EPS losses in the any of the prior five years, compared to just ~64% in early 2000.

- Additionally, many more stocks are paying dividends now vs. 20 years ago (47.2% vs. 19.5%), and cash positions as a percentage of total assets are notably higher (22.3% vs. 18.7%), suggesting a meaningful improvement in balance sheet strength.

In addition, data demonstrates that almost all financial bubbles share one common characteristic: **excess capacity.**

Indeed, looking back at the dotcom bubble, the number of Technology stocks within the S&P Composite 1500 index grew exponentially in the years leading up to the eventual market top with the count hitting more than 260 by the end of 2000 (the S&P 1500 is a better gauge for analyzing "new" stocks since its inclusion constraints are less severe relative to the S&P 500). By contrast, the sector has actually shrunk over the past several years with the number of Tech constituents falling below 200 in recent years.

Count of S&P 1500 Technology Stocks



Source: BMO Investment Strategy Group, FactSet, IBES

The fight against Covid-19 is not over and so your team will stay alert to the trends developing and will be active so that your short and long term plans remain on track.

Safe regards

Team Roux

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