

Investment Strategy

BMO Nesbitt Burns | April 2024

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Let the Rate Cuts Begin & Commodities Showing Signs of Life

Lest you think you missed some major local news, the rate cuts to which we refer are not from the Bank of Canada (“BoC”) or U.S. Federal Reserve (“Fed”). At least not quite yet. Rather, it was the Swiss National Bank (“SNB”; which punches above the country’s demographic weight in financial circles) and the Bank of Mexico which eased very recently. Why does this matter for investors? Simply put, rate cuts boost future economic growth (primarily through better consumption and housing strength), and equity markets anticipate this well in advance of official economic data. It is therefore no surprise that stocks have performed admirably during “easing cycles”. While we have been consistently bullish on stocks since the end of 2022, we do concede that markets feel a little stretched at this point, especially among high flying AI-related stocks. In our view, a minor 4-5% pullback would present an attractive opportunity in lagging sectors. We hasten to add that the numerous models and indicators we track show a very low likelihood of a more painful 10-15%+ correction at this point. Our technical analyst believes one area that looks very promising for new money are commodity stocks (Energy, Base and Precious Metals) where we’ve seen several breakouts in underlying commodities. More on this below.

Rate Cuts Starting

As noted by BMO Chief Economist Doug Porter, the Swiss National Bank (“SNB”) became the first central bank in the developed world to trim, slicing its policy rate 25 bps to 1.5%, as the combination of slow growth and 1% inflation has chopped Switzerland’s nominal GDP growth to just 1.3% y/y. Soon after, the Bank of Mexico also delivered its first cut of 25 bps to 11.0%. Mexico was a leader on the way up – first lifting rates in June 2021 – and the full cycle saw 725 bps of hikes, outdoing the Fed by 200 bps in total. But Brazil has truly been in the vanguard, first tightening in March 2021 – a full year before the Fed – and hiking rates by a staggering 1175 bps (from 2.0% to 13.75%). Brazil began cutting last August, and chopped another 50 bps this week to 10.75%. The point of this brief trip abroad is that the emerging markets that sniffed out the inflation trouble early on, and responded accordingly, are now beginning to send out the almost-all-clear signal.

Investors expect other central banks, including North America, to follow this fruitful lead (more details in the fixed income section of this report).

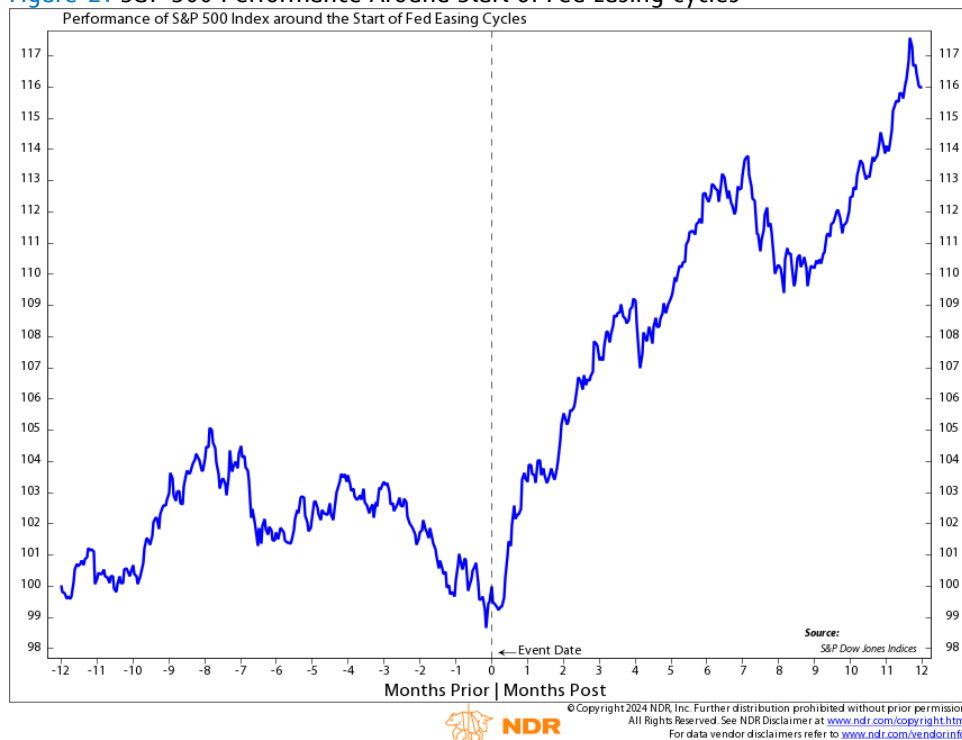
Figure 1: BMO Nesbitt Burns Investment Strategy Committee’s Recommended Asset Allocation (%)

	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	0	5	0	5	0	5	0	5
Fixed Income	70	70	40	45	20	25	0	0
Equity	30	25	60	50	80	70	100	95
Canadian Equity	25	15	35	25	45	35	50	40
U.S. Equity	5	5	20	15	20	20	30	30
EAFE Equity	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

Source: BMO Nesbitt Burns Private Client Strategy Committee

As we have noted before, stocks typically post very strong gains during easing cycles. Based on data collected by our research partners at NDR, going back to 1933 (post-depression), mean returns turned positive almost immediately following the first Fed rate cut, with 20% average annualized returns 12 months after the first rate cut. This represents more than 10% better performance vs. the market's historical return (i.e., including non-easing cycles).

Figure 2: S&P 500 Performance Around Start of Fed Easing Cycles



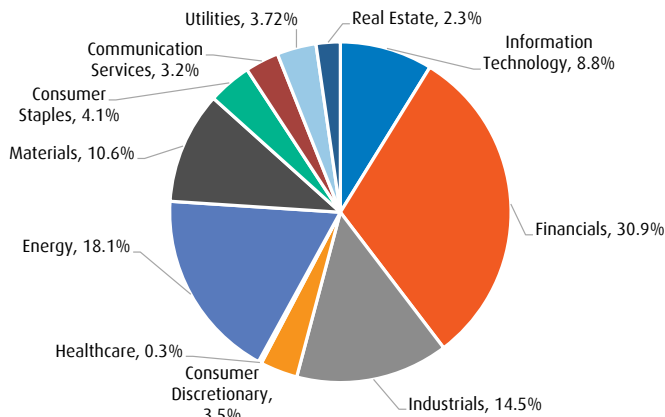
Source: NDR

Commodities Perking Up – Great News for Canada

After a difficult 2023, commodities have been acting much better of late. In fact, we see positive signs from a number of different perspectives. Should this trend continue, which we expect, it would be a great omen for Canadian stocks and potentially even the Loonie (should the historically very strong correlation between the Canadian dollar and oil/copper reassert itself).

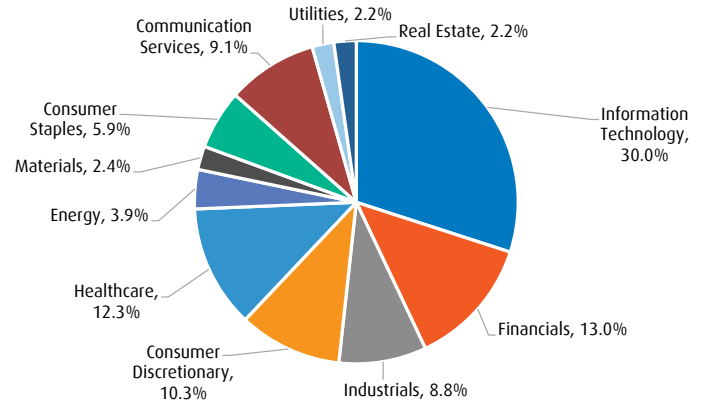
Investors need look no further than sector weights to see why the TSX would benefit. As shown in the charts below, Canada has by far the highest exposure to oil and Basic Materials at approx. 30% of the market vs. 6-7% for the S&P 500 and MSCI World Index. Even Emerging Markets only have about 13% exposure to those sectors, a massive change from a few decades back (given the importance of Tech, Financial and Consumer stocks in contemporary China and India in particular). A very simplistic numerical example will help illustrate. If Energy and Material stocks rally 30% across the board from here (a conservative number looking at past commodity upcycles) and every other sector remains approximately flat, Canada would outperform the U.S. and world indices by a full 7%. Given our much lower exposure to the extremely expensive Tech sector, a pullback there (which we think is plausible if not likely) would further amplify the “Canadian advantage”.

Figure 3: S&P/TSX Composite Weights



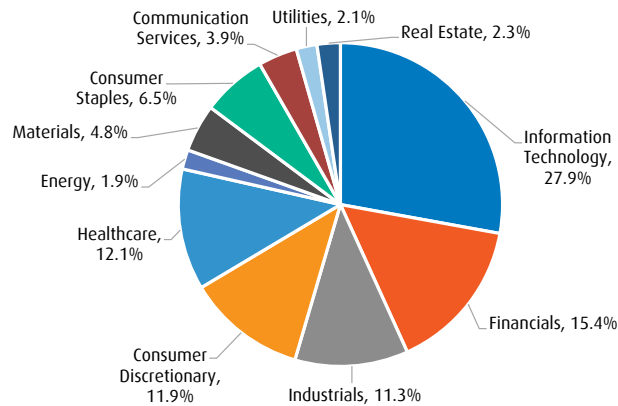
Source: BMO Private Wealth Portfolio Advisory Team, Factset

Figure 4: S&P 500 Weights



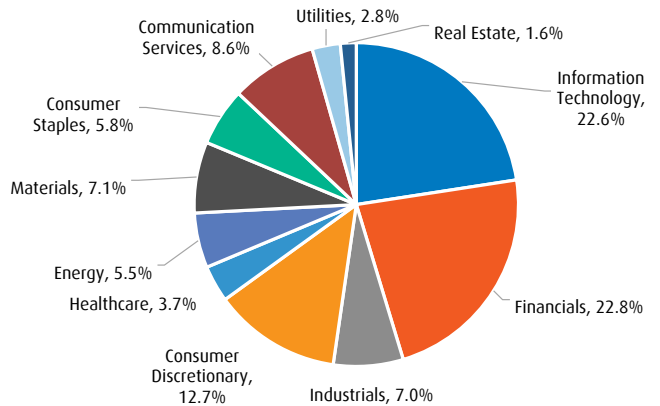
Source: BMO Private Wealth Portfolio Advisory Team, Factset

Figure 5: MSCI World Weights



Source: BMO Private Wealth Portfolio Advisory Team, Factset

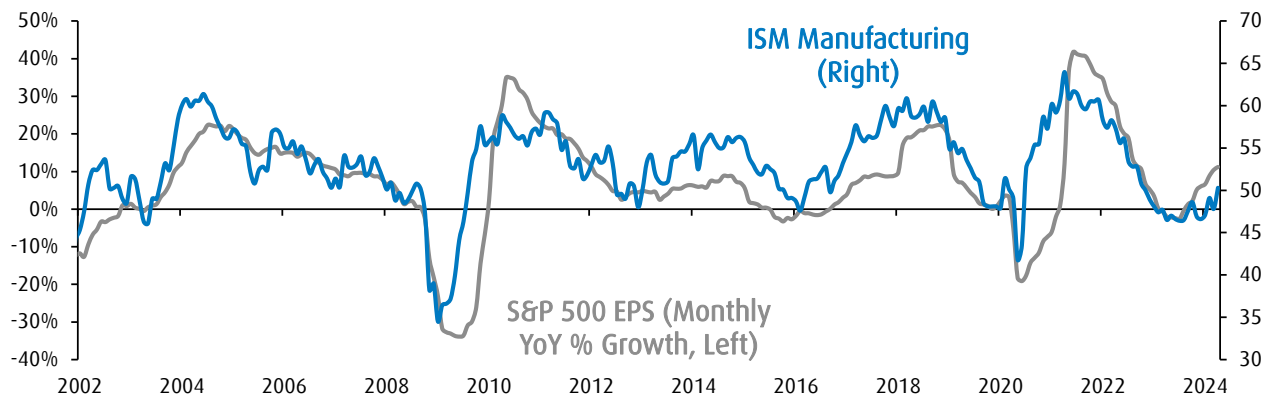
Figure 6: MSCI Emerging Market Weights



Source: BMO Private Wealth Portfolio Advisory Team, Factset

Newly-released manufacturing data from the world’s largest purchaser of commodities, China, shows a large uptick in manufacturing, signalling increased macroeconomic stabilization and overseas demand. The Caixin/S&P Global China Purchasing Manager’s Index (“PMI”) came in above expectations at 51.1 in March, its strongest reading since February 2023. This bodes well for commodities; an index value of above 50 puts China in expansion territory which means demand for commodities are high, underpinning Canadian stocks which, as we noted, are exposed to commodity prices. The U.S. is seeing similar progress, with March ISM PMI at a hotter-than-expected 50.3. PMI is generally correlated to EPS growth which provides us comfort in our bullish call for equities.

Figure 7: S&P 500 Monthly EPS Growth vs. ISM Manufacturing – A Bullish Signal



Source: BMO Private Wealth Portfolio Advisory Team, Factset

View From BMO’s Commodity Strategy Team

With the industrial destocking cycle looking to be in its final throes as manufacturing indicators and global trade improve, we are incrementally more confident on improvements in underlying **metal and bulk** commodity demand for 2024 versus our previous forecasts. We see fundamentals stronger than current sentiment would imply, particularly in key areas such as investment into the global fuel to materials transition and China economic growth, where we see the expected 2024 fiscal impulse merely delayed rather than cancelled. Moreover, the moves towards a global capex cycle and wider rate cuts should also bolster medium-term confidence. We are also more positive on the **gold and silver** markets, with concerns about global fiat currencies increasing as the political trend towards aggressive fiscal spending remains strong in a year with a plethora of elections covering much of the world’s commodity consumers.

Base and Bulk Equity Changes: Along with our more bullish view on industrial metals, we are starting to see “risk on” movement in equity exposure, particularly at the beginning of the year. In the longer term, we remain positive on producers of energy transition commodities. In terms of preference, we continue to favor copper-exposed producers, more defensive global diversified miners, and selective companies which continue to generate healthy free cash flow.

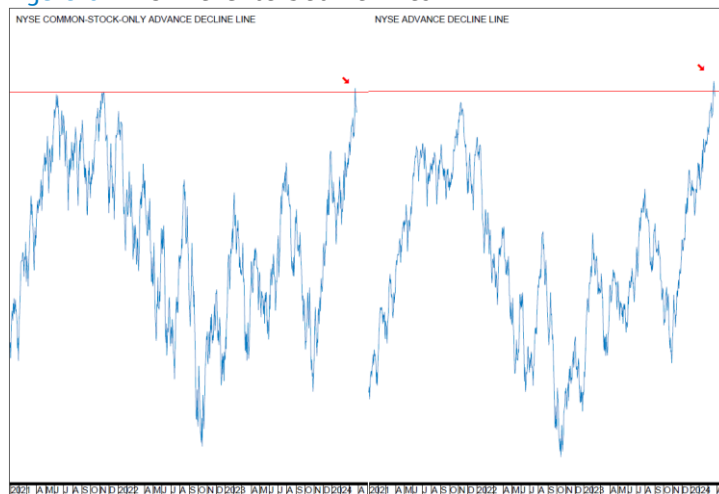
Precious Metals Equity Changes: Despite the elevated gold price around the \$2,200/oz level, precious metals equities seem to be languishing to start the year. We expect investors to remain in favour of capital returns and balance sheet management over growth projects, as the ability to successfully deliver on large capital projects remains a concern. We favour stable, low-cost producers in favorable jurisdictions, discounted companies with strong catalysts, companies looking to streamline operations, and developers with significant resource sizes.

Please contact your BMO Nesbitt Burns Investment Advisor for specific stock ideas.

Technical Analysis

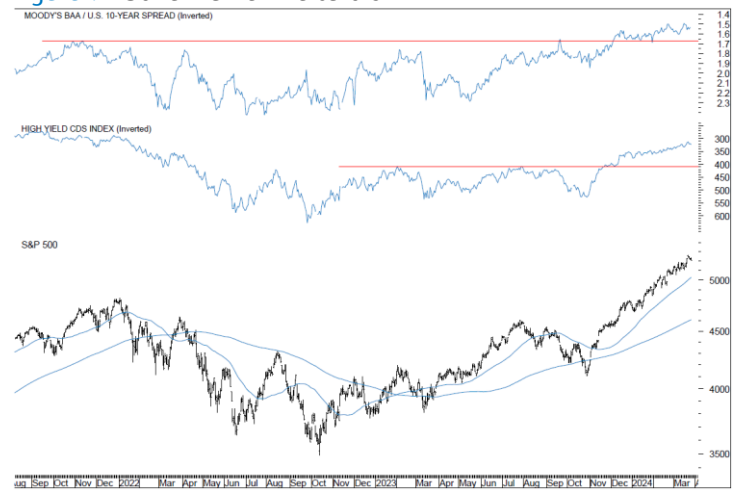
In technical analysis there are basically two types of indicators, 1) general barometers of market health, and 2) timing. The former give you a sense of what the risks are for a real bear market (15-20%+) occurring. As we wrap up the first quarter these structural “canaries in the coal mine” are about as healthy as they ever get. NYSE advance-decline lines recently made new all-time highs and bond market indicators (credit spreads, credit default swap indexes) are either at 52-week or multi-year lows.

Figure 8: NYSE Advance-Decline Lines



Source: BMO Private Wealth Technical Analysis

Figure 9: Bond Market Indicators

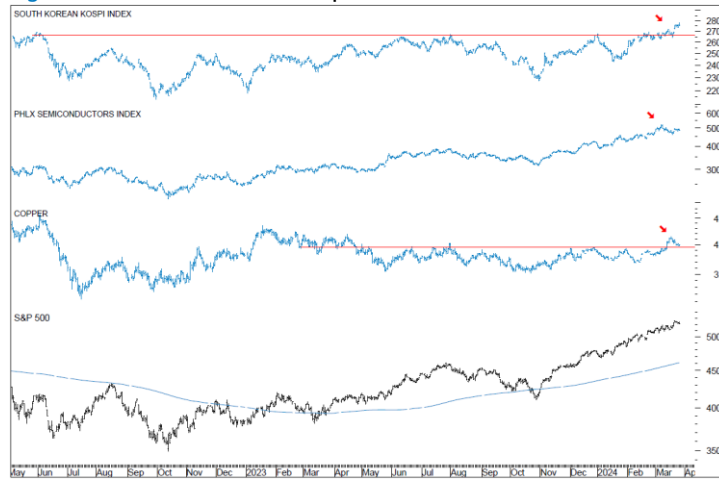


Source: BMO Private Wealth Technical Analysis

When the going gets tough in global financial markets, bond market participants sell their “riskier” corporate bonds in favour of the “safer” government bonds, which sends credit spreads soaring. They also pile into credit default swaps, which are essentially an insurance policy against corporate bankruptcies. The fact that these gauges are at multi-year lows shows that bond market participants are not worried about the global economy right now and as we always like to say: if the bond guys aren’t worried, then we’re not worried. At the same time, market-based measures of the economy (semiconductors, South

Korean Kospi index, industrial/commercial commodities) continue to improve as well. Most of these gauges begin to deteriorate 6-12+ months ahead of major declines so the fact they're all still improving suggests the threat of a real bear in 2024 is virtually nil.

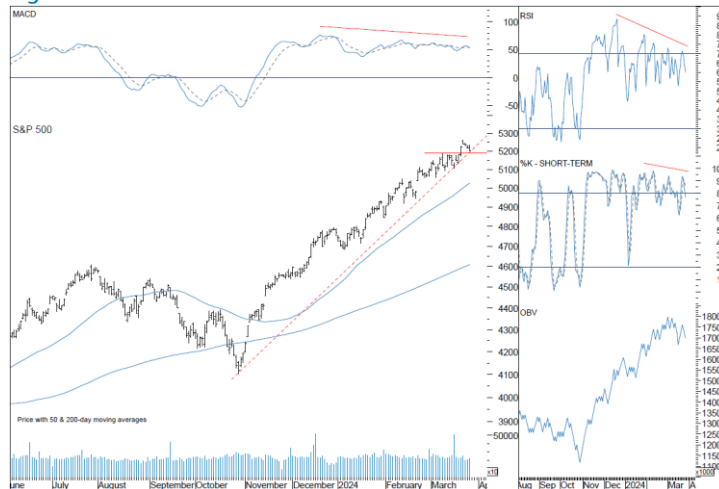
Figure 10: South Korean Kospi Index, PHLX Semiconductors Index, Copper, and S&P 500



Source: BMO Private Wealth Technical Analysis

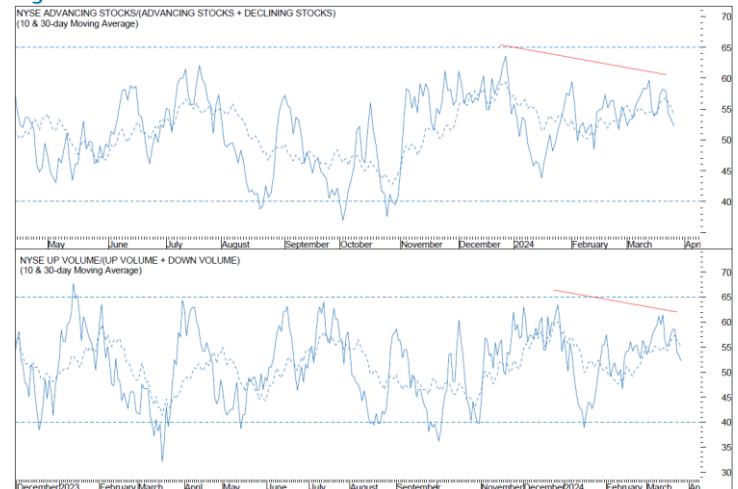
Timing indicators, on the other hand, give you an idea of what the probabilities of a pullback occurring and that's where there is a problem. For example, negative divergences have been building in short-term breadth and momentum gauges for all of the major averages for the better part of two months now.

Figure 11: S&P 500 Momentum



Source: BMO Private Wealth Technical Analysis

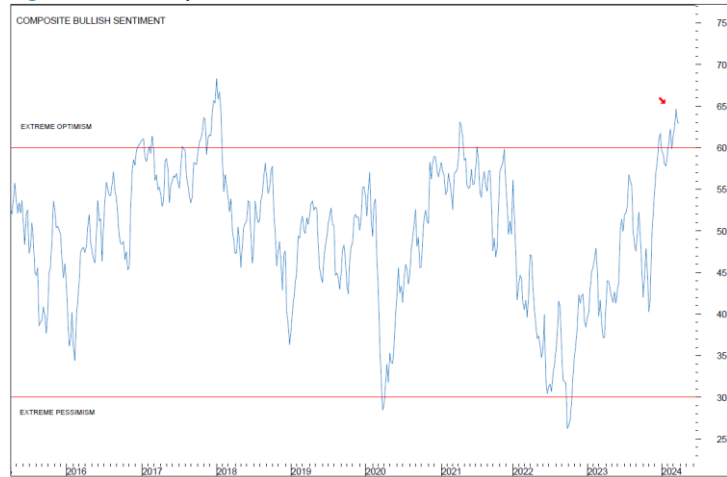
Figure 12: NYSE Breadth Oscillators



Source: BMO Private Wealth Technical Analysis

At the same time, sentiment (as measured by our Composite Sentiment indicator) is now stretched into multi-year highs. A bit of a "breather" to calm this overly bullish sentiment would be a healthy development. In terms of downside risk, there are multiple support levels in the 21,200 zone for the S&P/TSX Composite which should contain any weakness, while the 50-day moving averages for the S&P 500 and the Nasdaq Composite (SPX: 5,026 Nasdaq: 15,828) will likely be as bad as it gets for those indexes. That would represent a fairly benign 4-4.5% pullback from recent intraday highs. Viewed through the lens of how constructive our general barometers of market health look, we view any weakness that develops in the second quarter as nothing more than a healthy pause following the huge run-up that's occurred since last October and should be used as a buying opportunity.

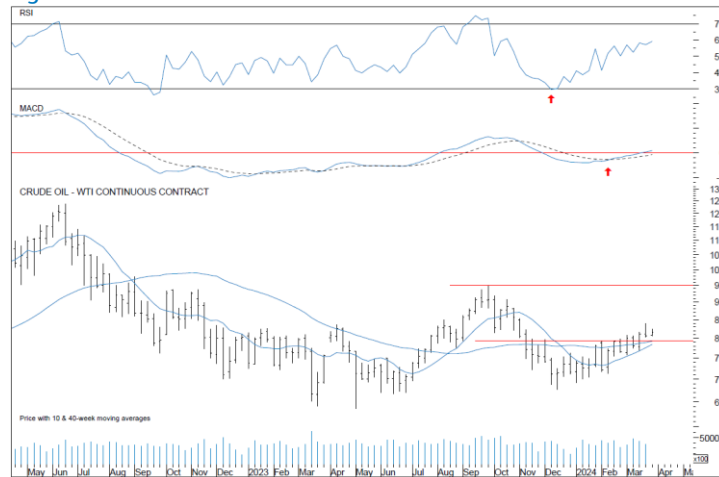
Figure 13: Composite Sentiment Indicator



Source: BMO Private Wealth Technical Analysis

One area that looks great for new money right now are commodity stocks where we've seen a number of breakouts in underlying commodities. Medium-term momentum gauges for crude oil (WTI contract) continue to improve and the recent close above interim resistance at \$79.50 cleared the way for the rally to extend back to \$95. (CHART 07) Gold also broke out of a massive multi-year trading range as well. The recent close above resistance at \$2072 shifted the long-term trend for gold back to bullish and opened a new upside target of \$2475. (CHART 08) Given the size of the pattern it broke out of though, higher targets are likely. Copper cleared an important hurdle at \$4.02 recently. (CHART 09) That breakout clears the way for the rally to extend to the upper end of the base pattern at \$4.30. A close above \$4.30 would shift the long-term trend back to bullish and open new upside targets of \$5.05 then \$5.46.

Figure 14: Crude Oil



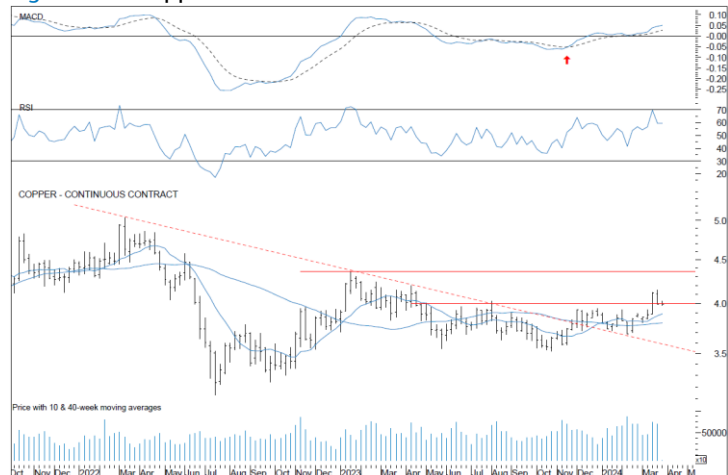
Source: BMO Private Wealth Technical Analysis

Figure 15: Gold



Source: BMO Private Wealth Technical Analysis

Figure 16: Copper

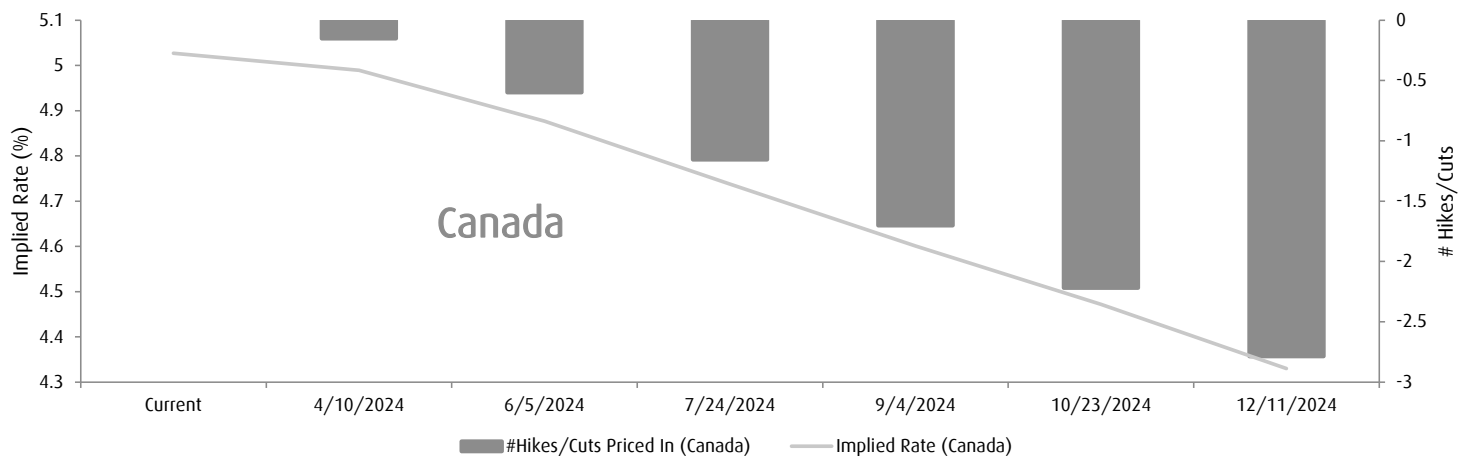


Source: BMO Private Wealth Technical Analysis

Fixed Income – ‘Tis The Rate Cut Season!

The surprise cut by the SNB, the first of the major central banks, is leading a global shift from pause to easing that is starting to be felt in North America with expectations for rate cuts to start this summer.

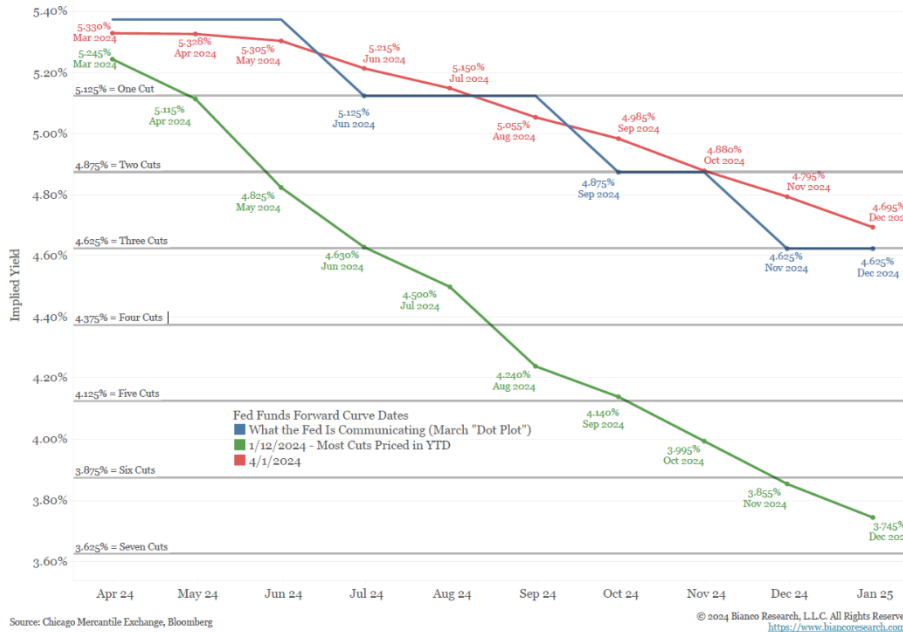
Figure 17: Rate Cuts Expectations for the Bank of Canada



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

For the BoC, with two consecutive benign inflation reports that brought down CPI back within the bank’s acceptable range of 1-to-3%, the door for less restrictive policy is opening. Our BMO Economists expect the BoC to likely start cutting rates as early as June with the potential for up to four cuts of 25 bps in 2024 that would bring the policy rate down to 4%. This is slightly more aggressive than the 75 bps cuts expected by the market. The stronger-than-expected January GDP report likely played a role in casting doubt upon the need for lower rates (for now), but it may not be enough to delay further policy re-normalization as growth is expected to continue trending below potential.

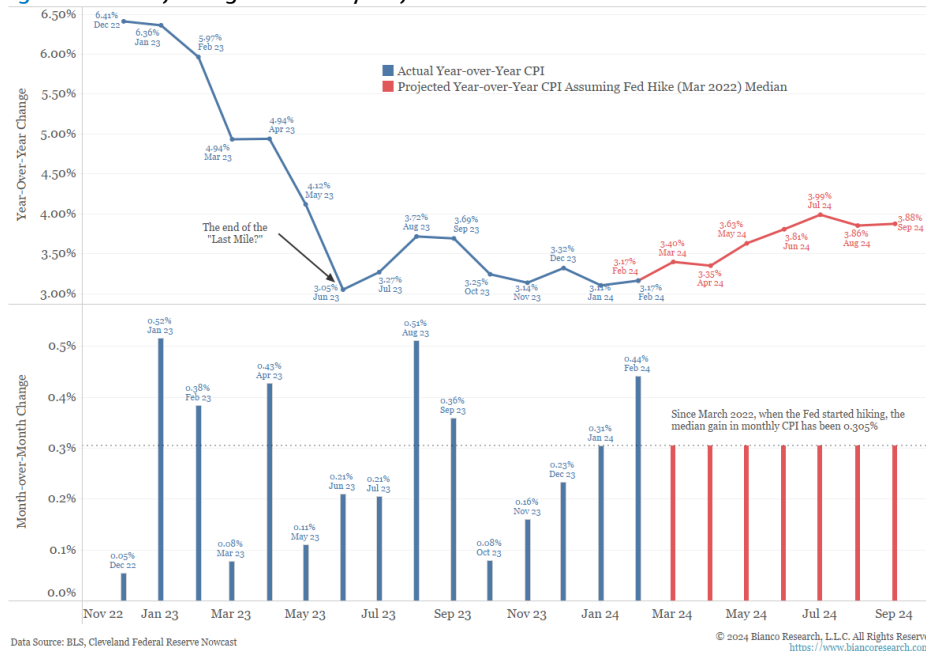
Figure 18: U.S. Federal Reserve Rate Cut Expectations



Source: Chicago Mercantile Exchange, Bloomberg, Bianco Research

For the Fed, after pricing almost seven rate cuts (25 bps each) at the start of the year, the market expectations have come down, closer to 3 cuts in 2024, better aligning with the Fed’s/economists’ average forecast. While this better reflects the current strong U.S. macroenvironment, it remains questionable as to why the Fed would not wait further. Admittedly, the last year’s progress on lowering inflation, the slowing economy, and a better-balanced labour market likely no longer need the policy to be as restrictive. However, despite the progress, wages and inflation remain elevated and may not be low enough by June or July to justify a cut. And what if inflation re-accelerates? In the chart below, Bianco Research shows a potential path for the CPI using the median monthly gain since March 2022, and CPI could still be above 3.5% instead of closer to 2.5% by the time the rate decision comes. Even using the last 6- and 12-month averages of 0.26% would yield fairly similar results.

Figure 19: Projecting Seasonally Adjusted U.S. CPI



Source: BLS, Cleveland Federal Reserve Nowcast, Bianco Research

Instead of inflation, could the Fed be worried about negative surprises in the labor market? Or could it be a potential credit event brought on by the lagged effect of tightening? Could the growing concerns over commercial real estate loans and the delinquency rate in the leverage loan markets rising to 6%, double the average of the last 25 years, be on the Fed's radar when they continue to forecast three cuts this year despite sticky inflation?

One thing for sure, the inflation story has helped remove the exuberance in the U.S. Federal Funds (policy rate) pricing and explains the back-up in yields in the quarter, a trend that could persist a bit longer until we see further confirmation that conditions are better aligned for less restrictive policy. Until then, the risk is that a continued Fed dovish bias may add pressure – especially at the longer end of the yield curve – if the market believes the Fed may be willing to accept above-target CPI. Barring any credit events, the risk to the easing call, especially in the U.S., is for less cuts, not more. Considering 2024 is an election year in the U.S. and it may interfere with the willingness of the Fed to be seen as political in its decisions, the policy rate re-normalization story may be more for late 2024, if not a 2025 story. This may be a bit early to call with a lot more data to flow before decision day, but it supports our slightly defensive recommended duration while we continue to gradually earn our coupons.

Figure 20: S&P/TSX Composite Total Returns

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Health Care	13.47	18.37
Energy	7.30	13.08
Industrials	2.94	11.09
Materials	15.38	5.85
S&P/TSX Composite Index	3.76	5.77
Financials	3.44	5.55
Info. Technology	-0.27	4.83
Cons. Discretionary	0.97	4.53
Consumer Staples	-3.05	3.96
Real Estate	2.29	1.69
Utilities	2.55	-1.10
Telecom. Services	-6.64	-8.48

29-Mar-24
Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 21: S&P 500 Sector Total Returns

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Telecom. Services	4.34	15.82
Energy	10.60	13.69
Info. Technology	1.97	12.69
Financials	4.78	12.46
Industrials	4.41	10.97
S&P 500 Index	3.22	10.56
Materials	6.50	8.95
Health Care	2.38	8.85
Consumer Staples	3.49	7.52
Cons. Discretionary	0.10	4.98
Utilities	6.62	4.57
Real Estate	1.77	-0.55

29-Mar-24
Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 22: S&P/TSX Composite Earnings Yield vs 10-Yr GoC Yield



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

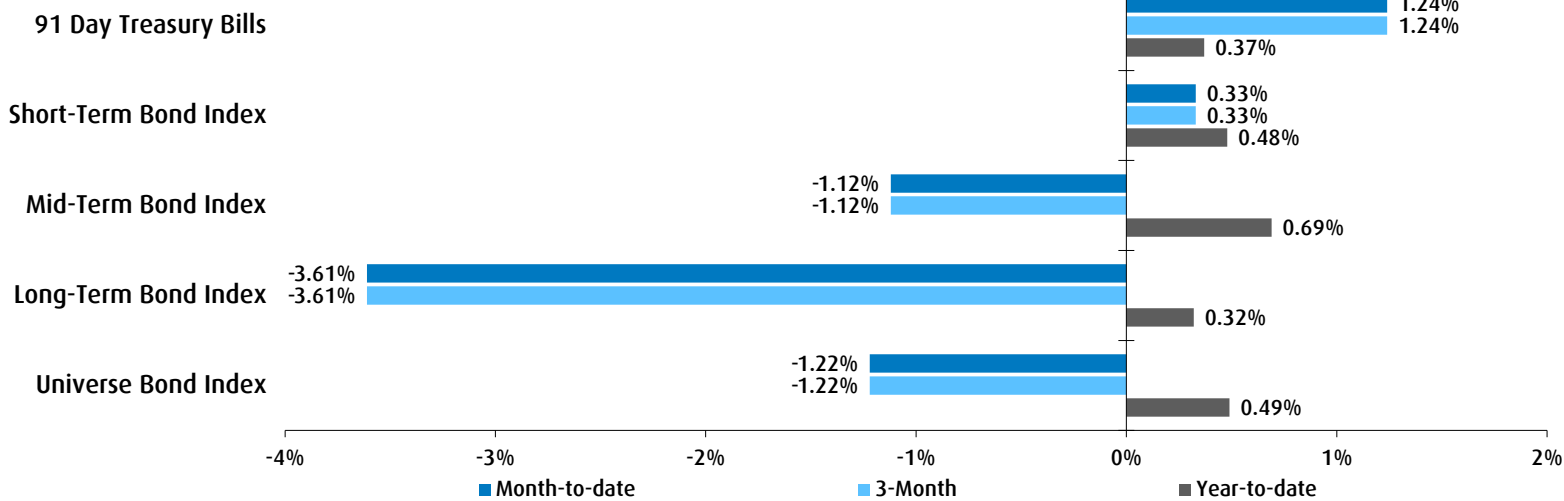
Figure 23: S&P 500 Earnings Yield vs 10-Year Treasury Yield



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

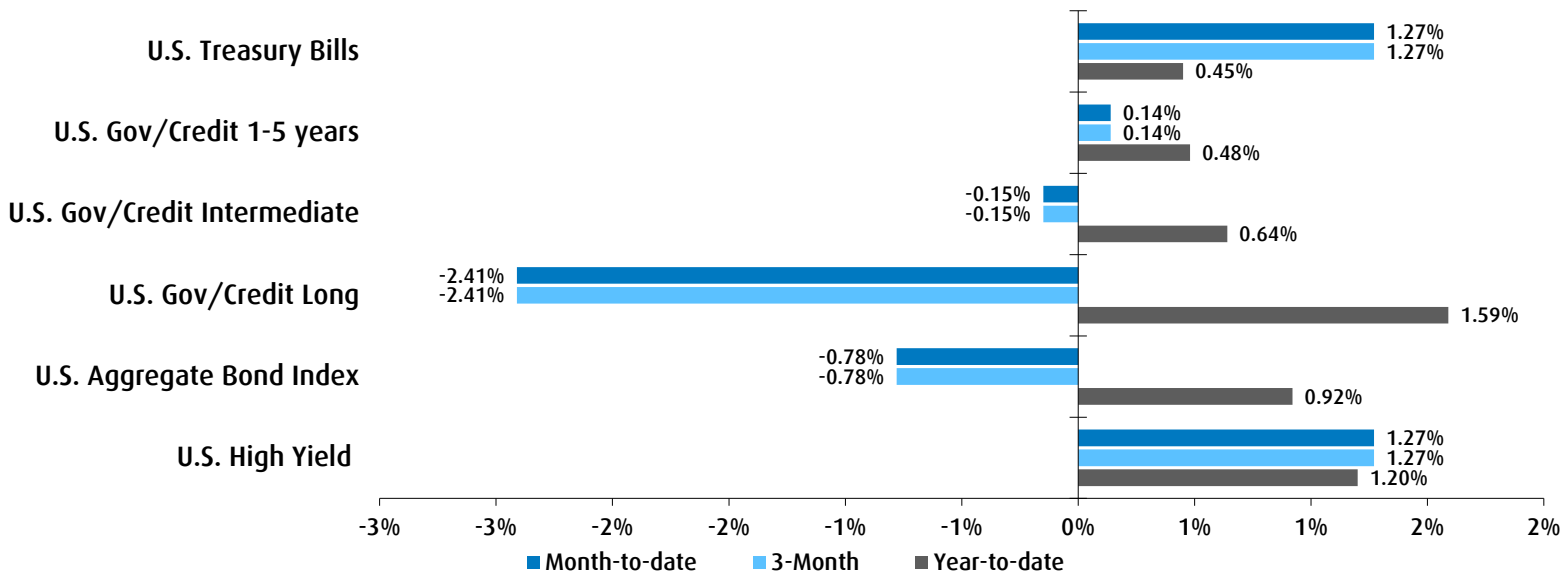
Figure 24: Canada/U.S. Bond Index Total Returns Through March 2024

Canada



Source: BMO Private Wealth Portfolio Advisory Team, FTSE

U.S.



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg Barclays

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