Monthly Market Commentary

Equity Strategy

Despite stock markets at record levels, risk appetite remains muted and equities still hold far more relative value than bonds

The BMO Nesbitt Burns Portfolio Advisory Team continues 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 point in time. The sharp market pullback of last year was a massive overreaction to fears of an upcoming recession. While a recession will eventually come, the team predicts it will not be until mid- to late-2021, as the odds of a recession in the next year still sit at a manageable 45%, based on the team's models. This means that markets still have room to run before there is a more meaningful pullback. As a reminder, the stock market "discounts" the real-world economy six-to-nine months ahead of time.

Back in July, the Portfolio Advisory Team raised their fair value estimates for the S&P 500 and S&P/TSX to 3,300 and 19,000, respectively. These numbers seemed optimistic at the time, but are starting to look quite conservative, given persistently low interest rates and signs of a global economic growth rebound coming in the next few quarters, after a year-and-a-half of deceleration. This should translate into better corporate earnings growth in 2020.

BMO Private Client North American Risk Appetite Index update: Still in neutral range despite markets hitting record levels

The Portfolio Advisory Team's Risk Appetite Index increased in November, but still sits comfortably below "euphoric" levels, which have historically preceded a sharp pullback. This is despite North American stock indices hitting a series of new record highs, which the team views as a positive contrarian indicator. In other words, many investors do not believe in this rally and are still holding a lot of cash.

BMO Nesbitt Burns 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."

Lower rates a major tailwind for stocks historically

10-year interest rates are the foundation of all finance and have a significant impact on equity sector valuations and performance. On that point, the Portfolio Advisory Team stands by their long-standing view that high quality dividend growth equities continue to look very appealing versus bonds. 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.

Canada: Still trading at an unusually steep discount to the U.S.

Looking at the relative value advantage of Canadian stocks vs. U.S. stocks, the Portfolio Advisory Team thinks Canada should trade at some discount given our inherently more cyclical sector composition and relative lack of dominant Technology, Consumer and Healthcare companies (which tend to command higher multiples). Still, the team considers 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. 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 it's been 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,

up 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."

Fixed Income Strategy

As fears of a recession have eased, and daily talks of trade negotiations replace concerns over yield curve inversion, global interest rates have continued to trend higher from the summer lows. The perception that global growth is stabilizing, in addition to further stimulus from the U.S. Federal Reserve ("the Fed") and the European Central Bank ("ECB"), is reducing the downside risks and helping improve the economic outlook prospects. However, the Portfolio Advisory Team does not believe that even if the U.S. and China reach a partial trade deal, that it will be enough to lead interest rates significantly higher.

The team continues to be constructive on the fixed income market and would take advantage of the recent back-up in yields and the re-steepening of the yield curve to adjust portfolio sensitivity, if necessary. The team recommends targeting a neutral portfolio interest rate duration (sensitivity) around 4.65 years.[1] This target would be representative of the sensitivity of a 5-year Government of Canada bond. The team also advocates for a better quality bias, as there are signs of potential deterioration in the quality of corporate issues, which are worth monitoring as they could risk negatively impacting the sector's performance.

Since August, the economic outlook has brightened slightly. Continued strong labour markets, rising wages, and the perceived appearance of a U.S./China trade war truce have continued to support the current economic expansion, albeit at a slower pace, leading risk asset valuations and interest rates higher. Monetary stimulus from three Fed rate cuts and balance sheet expansion from both the Fed and the ECB were also supportive in helping to mitigate risk of further deterioration. Indications that major central banks stand prepared to let inflation run a little hotter also contributed to the re-steepening of major yield curves, as concerns of inflationary pressures normally lead to higher inflation expectations which are embedded in nominal yields.

Overall, this has been good news for yield-starved investors as it resulted in the reduction of total outstanding negatively yielding securities from a record of over USD$17 trillion to USD$12.3 trillion. Before starting to cheer at the potential for re-normalization of interest rates, we may still have to lower our expectations again, as the Portfolio Advisory Team does not see the underlying market and economic forces that would lead interest rates to re-test 2018 peaks, yet. As a reminder, Canada and U.S. 10-year yields ended the month of November at 1.46% and 1.78%, respectively, a long way from 2018 highs of 2.61% and 3.25%. While nominal yields have been rising, real rates have not followed and most real interest rate curves of advanced economies remain in negative territory, including Canada.[2]

For the uptrend in yields to continue, a significant change in domestic and global economic sentiment and/or further improvement in current and longer-term inflation expectations would be necessary. More importantly, de-escalation in the current trade wars would also go a long way in reducing uncertainties and providing support to the current expansion.

The combination of the decline in interest rates over the last 12 months and the tightening of credit spreads have provided corporate bond investors with above-average capital gains. Year-to-date, the Canadian short- and mid-term corporate bond indices have returned 4.53% and 9.02%, respectively. In a low yield environment these returns are attractive, but the Portfolio Advisory Team recommends using caution in adding new securities, and prudence in managing your portfolio's corporate bond exposure. First, it will be difficult to repeat these performances as low rates and tight corporate spreads risk limiting further capital gains. Second, while the economic conditions may not have been as weak as reflected by the strong rally in yields this past summer, they may not be as positive today as currently portrayed by corporate credit spreads. Considering the excess leverage and elevated debt level of corporations, slower economic growth could have a greater negative impact on earnings and interest coverage which may lead to wider credit spreads.

Please contact your BMO Nesbitt Burns Investment Advisor if you have any questions or would like to discuss your investments.

[1] The main benchmark used for this recommendation is a 50%/50% blend of the FTSE short-term and mid-term bond indices.

[2] A real interest rate is an interest rate that has been adjusted to remove the effects of inflation to reflect the real cost of funds to the borrower and the real yield to the lender or to an investor.

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