Monthly Market Commentary

Equity Strategy

Productivity growth could lengthen this cycle

The BMO Nesbitt Burns Portfolio Advisory Team's asset allocation strategy is to continue to overweight equities and to underweight fixed income. The severity of the financial crisis of 2008/09, and the relatively slow recovery, argue for a prolonged global recovery and an associated longer bull market than with typical cycles. This view fits the narrative from Russ Visch, Vice President, and the Portfolio Advisory Team's Technical Analyst. Taking a very long-term view, he argues that the U.S. stock market has exhibited fairly consistent 16-year cycles. Of course, markets never rise in a straight line and there will be cyclical (i.e., medium-term) bears along the way. For example, during the 1950-1966 cyclical bull market, there were four significant pullbacks with an average 20% decline, lasting an average of seven months. The conclusion for long-term investors, based on the team's fundamental and technical models, is that pullbacks continue to present buying opportunities.

While the U.S. Federal Reserve ("the Fed") is leading the charge in raising interest rates, they are doing so in a slow, deliberate fashion, while monetary conditions remain very accommodative in Canada, Europe and Japan. Inflationary pressures are building in North America (for example, wages, commodities and producer prices paid), but have not yet translated into an ominous rise in the consumer price index ("CPI"). Aside from potential trade wars, and the latest European existential crisis (courtesy of Italy), inflation presents the greatest risk to financial markets over the next few years. As the team's historical work has shown, the market can withstand some inflation and associated higher rates, but not too much. Specifically, there is a concern about equity valuation compression if the CPI rose to the 3% range.

Everyone is talking about inflation, but what about productivity?

Productivity growth could come to the rescue and lengthen the economic cycle by offsetting some price pressure. This concept is hugely important because higher productivity reduces unit labor costs (the cost of producing a given quantity of goods and services). Simply put, even if salaries are rising by 3% annually, if the economy can produce 3% more with the same equipment and workers, then companies in aggregate won't have to increase prices to protect their profit margins (all things being equal).

Nancy Lazar, a Partner at research firm Cornerstone Macro notes, "Although (U.S.) productivity gains are still historically low, they have moved up from averaging 0.7% year-over-year over the past five years, to averaging 1.3% year-over-year over the past four quarters. And, our model forecasts productivity will accelerate on a sustained basis to 1.5% year-over-year by 2020, which is very impressive given that this expansion is in late cycle."

One of the drivers for this acceleration will be the lower U.S. corporate tax rate, which is finally competitive with other developed countries. This makes the U.S. all the more attractive as an investment destination for companies (especially with full capital expenditure expensing providing a significant tax break).

Fixed Income Strategy

And then there was Italy

In May, fixed income market activity was yet another example that it may be a bit premature to call the death of the bond bull market. Despite the North Korean nuclear threat abating, and a bleak outlook for bond investments, another geo-political event led to a global flight-to-quality into U.S. and German bonds, dragging Canada along for the ride.

While the trend continues to point to higher rates, this will not be done in a straight line, and likely not over a short period of time. In fact, despite the gloom and doom on interest rate markets, they have been trading in a range, more or less, since January.

Concerns over Italy have definitely increased the level of global uncertainty. However, these concerns are not expected to have any lasting impact on the economy nor on tightening expectations, at least not to the extent that a trade war could. In fact, since 10-year Treasury yields crossed the 3% mark, nothing has really changed from a domestic perspective that would justify a major shift on trend.

As for the Bank of Canada ("BoC"), it should follow the Fed with a 0.25% lift of its policy rate to 1.50% in July, but in the absence of any forward guidance and with less transparency than the Fed, the level of conviction in the tightening path is weaker. Any negative surprise on data or trade negotiation (i.e., NAFTA) could lead the BoC to surprise the market with delayed action on rates.

Italian markets have partly recovered, but North American yields have not yet resumed their uptrend, highlighting the continued global uncertainty, in particular, with commercial trades. The expected windfalls from U.S. tax cuts may actually be already factored in, and the growth outlook may not be as positive moving into the second half of 2018.

In the short-term, the market's focus has slightly shifted toward political woes, but North Korea/U.S. relations and, most importantly, a trade war and its potential economic implications should continue to lead headlines and drive interest rate markets. Furthermore, concerns over rising U.S. deficits and the expected increased supply from government and corporate issuers could force interest rates higher. So far, however, the message conveyed by the yield curve seems to differ. The short-term yields are definitively attuned to central banks, but the long-end is not yet convinced, or too positive, on growth, and the inflation trajectory.

From a fixed income perspective, this tells us that despite the concern for rising interest rates, it is does not yet warrant an increase in cash, nor a further reduction of a portfolio's interest rate sensitivity. So far, 2018 has not been a great year for fixed income investments. As investors take advantage of the higher interest rates, it should help portfolio returns improve in the second half of the year.

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

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