# Monthly Market Commentary

## Equity Strategy

**Recession probabilities have increased but 1990s parallels keep us positive**

There seems to be a disconnect between the stock market and the never-ending refrain of bad news: global economic slowdown, trade uncertainty, tension in the Middle East, and increasingly more pundits trying to convince investors that a recession is on the way. And yet, major North American stock indices are at, or close to, record highs. In order to provide some perspective and separate fact from emotion, the BMO Nesbitt Burns Portfolio Advisory Team created a proprietary recession probability model. The model shows that the odds of a North American recession occurring in the next year have increased to over 40% from 35% six months ago. This is mainly due to two factors: 1) lackluster manufacturing employment; and, 2) increased Economic policy uncertainty. However, we are still below the dangerous 50% threshold.

The recession probability model also went above 40% on a few occasions in the 1990s and the odds of a recession subsequently receded. We could be looking at a similar scenario in 2019. There are many similarities between the current expansion and the one in the '90s. The recession of 1990 has been largely attributed to restrictive monetary policy (i.e., higher interest rates) enacted by the U.S. Federal Reserve (the "Fed"), along with the 1990 oil price shock, caused by the first Gulf War. The following decade, however, became associated with one of the strongest periods of sustained economic growth and prosperity on record. The 1990s bull market eventually culminated in the tech bubble, but reassuringly, we are still far from that type of market "euphoria," based on the Portfolio Advisory Team's models.

The key silver linings are that some manufacturing indicators are starting to improve globally (particularly in China, Europe and the U.S.), trade policy uncertainty is slightly receding with talk of a "Phase 1" trade deal with China, and the U.S. and Canadian yield curves are starting to steepen again, indicating that the bond market is expecting stronger growth in the future.

**Housing continues to be a major source of strength, and household net worth keeps hitting new highs**

The biggest purchase a consumer can make is a house, and with the 30-year mortgage rates in the U.S. falling to 3.80% from 4.90% a year ago (and mortgage rates close to all-time lows), that is going to be supportive for the consumer and the stock market longer-term, given housing's economic importance. Put another way, the reduction in mortgage rates has improved housing affordability by over 10% in the U.S. and Canada since the start of the year. Sure enough, homebuilders and even lumber stocks are acting very well which is inconsistent with an economy on the edge of the proverbial cliff.

Russ Visch, BMO Technical Analyst, notes that: "A number of significant improvements have recently occurred in equity markets, all of which suggest the next major multi-month move for equities will be to the upside. This includes the NYSE Advance-Decline lines making new all-time highs, the sell-off in the bond market that now appears to be picking up steam, and the major technical breakouts in bellwether markets such as Germany and Japan. More recently, the S&P 500 Equal Weight Industrials Index has also broken out of a two year trading range. The performance of the traditional capitalization- weighted index is being dragged down by Boeing's recent woes, so the Equal Weight Index is a truer measure of how the average industrial stock is performing. This sector is just about as economically sensitive as you're going to get, which bodes well for the markets overall."

## Fixed Income Strategy

A couple of months ago, what seemed to be the sum of all fears was leading global yields to multi-year lows — and some deeper into record negative territory — with U.S.



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and Canadian yield curves flirting with inversion as geo-political risks raised the probability of a domestic and global recession. For many, the next logical step was for much lower yields, but it failed to materialize, despite further stimulus from some of the largest central banks. However, since early September interest rates have, in fact, trended higher in major markets — Canada included.

In a fairly volatile environment, especially for bonds this year, this is not surprising; however, what has changed? For one, North American economies appear to be more resilient than initially expected. The de-escalation of the China/U.S. trade war and confirmation that Brexit is again delayed further by three months also helped. It's still early, but some credit should also be given to central banks' policies, including the Fed's pre-emptive rate cuts, which were made to further support the current economic expansion. The North American economic backdrop may be more positive, but not all is well.

The strong performance of multiple asset classes sends conflicting messages about the economic outlook and is somewhat puzzling to investors. So far this year, U.S. equities and oil, and U.S. 10-year Treasuries and gold, have all returned more than 10% — a rare occurrence that seems a little counterintuitive. While bond and gold investors seem to be bracing for darker times and safer grounds, equity investors continue to sail under a relatively blue sky. Before concluding that a correction is imminent in any one, or all, of these markets, it's better to understand the underlying support for the performance and whether it can be maintained, in particular from a fixed income perspective.

Monetary stimulus has been supportive of financial markets, and it appears that many central banks will remain on the easing path for a prolonged period. The Fed cut rates in late October by 25 basis points for the third time this year, and the European Central Bank launched a new open-ended euro 20 billion monthly bond purchase program that is expected to start in December. In the absence of any negative impact from this stimulus (i.e., inflation), this monetary stimulus will remain supportive in general for all asset classes. With the U.S. and Canada boasting the best rates in the developed world, both will continue to attract foreign demand especially from countries where interest rates are negative. Low and stable inflation has also been proven to be supportive. The absence of inflationary pressure despite the extraordinary monetary stimulus has led to lower yields globally and flatter yield curves.

The recent messages from both the Bank of Canada ("BoC") and the Fed should also continue to be supportive of Canadian and U.S. bond markets in the near future. Bank of Canada Governor Poloz sounded more dovish, noting that the "resilience of the Canadian economy will be tested" in coming periods, highlighting the BoC's apprehension about ongoing global trade uncertainty and global growth outlook deterioration. As a result of the bank's dovishness, odds of a rate cut in Canada over the next two quarters are rising.

Most interestingly, Fed Chair Powell discussed what could lead the Fed to reverse this year's three rate cuts. He linked future policy rate increases to not only an increase in inflation, but also market-based inflation expectations for these levels to be well anchored around the Fed's 2% target. Since inflation has been mainly running below target over the last 25 years, this sounded like the Fed Funds rate would be capped at the mid-range of 1.625%. This would mean that, assuming growth remains in an acceptable range, the Fed could be on hold for longer, leading investors to further reduce the inflation expectation premium in longer-term interest rates. This would also mean that the bar may be set lower than expected for the Fed to cut rates should growth and/or inflation deteriorate significantly from current level.

In the short-term, monetary stimulus and low inflation will continue to support low yields. For that reason, and considering that the long list of geo-political uncertainties will continue to affect markets, the recent trading range in Canada and the U.S. should be maintained through the fourth quarter. In the absence of a significant trade deal, we would not even be surprised to see yields retest the lower bound of that range. This would be most welcome for fixed income investors after years of low total returns. The Portfolio Advisory Team offers a word of caution; if recent activity is any indication, this will come with market volatility, justifying a neutral approach.

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

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