Monthly Market Commentary

Equity Strategy

Value stocks catch a bid—a good omen for Canada

In September, the BMO Nesbitt Burns Portfolio Advisory Team made its first strategic asset allocation change since June 2017, decreasing the weighting in bonds by 5% and increasing Canadian equities by this same amount. So far, the timing of this call has been apropos, with 10-year Canadian interest rates rising about 0.38% from deeply oversold levels — meaning, 10-year bond prices fell by over 2.5% MTD, which is considerable in the fixed income market — and the S&P/TSX Composite Index hitting all-time highs (up ~2% MTD). Going forward, the team continues to believe that the reduction in rates makes high quality, dividend growth equities that much more attractive. In particular, the Canadian market offers better upside potential.

A rebound in global economic momentum will be key for continued S&P/TSX Composite outperformance (particularly compared to the U.S. market), as this should act as a tailwind for the very important and beleaguered Energy and Mining sectors, which together represent almost 30% of the S&P/TSX Composite's market capitalization. While Purchasing Manager Indices ("PMI") have been weakening for over a year, the Portfolio Advisory Team believes that we may be close to a bottom in economic momentum, which should manifest itself soon. This view is based on: 1) Easing of trade war tensions; 2) The massive Chinese stimulus program (China is still the biggest driver of global economic growth; 3) Massive monetary/interest rate stimulus (Europe just restarted quantitative easing, and the U.S. Federal Reserve (the "Fed") plans to cut rates again); and, 4) China PMI data and the fact that composite Global PMI just rose for the first time since 2018.

Moreover, the recent outperformance of small-cap versus large-cap stocks, along with the recovery in base metal prices and Materials sector equities all indicate that growth should reaccelerate soon (this has been the historical pattern). However, should there be near-term improvement in global economic growth, the trend will change in favour of value stocks and, by extension, the attractively valued Canadian market. Such a sustained trend reversion in favour of value stocks could be meaningful given the extent of their underperformance since 2007. BMO Global Asset Management notes that, "Since the mid-1970s, value stocks have generally outperformed growth stocks in developed markets around the globe. The current cycle of growth's outperformance, starting in 2007, has had both the longest duration and highest magnitude in history." From the Portfolio Advisory Team's perspective, this means that value stocks have a long way to go (upwards) to revert back to the mean. As a reminder, the team is a firm believer that markets always revert back to the mean; the only uncertain (and critical) variable is the timing for such a move.

Is the oil market complacent about geopolitical risk? We think so.

BMO Capital Markets believes that the market underestimates the disruption risk following the recent attack on Saudi Arabia. While Canadian Energy stocks are starting to catch a bid, the Portfolio Advisory Team believes that safe Canadian-based oil supply is wildly underappreciated by the market. If the production disruption lasts longer than expected or if there are further attacks, prices could move materially higher. Moreover, U.S. crude oil inventories have been declining and are now slightly below five-year average levels. Taken together, these factors do not suggest a material slowing in global oil demand.

Precious metal stocks could also provide a tailwind to the Canadian market

BMO Capital Markets also updated its precious metal outlook, raising gold and silver prices by an average of 14% and 22%, respectively, over the next 12 months, and by an average of 11% and 12% through 2022. In BMO Capital Markets' view, low- to negative-yielding bond rates, prospects of renewed easing, and escalating trade tensions provide support for gold and silver to trade for a sustained period above their long-run equilibrium estimate.

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Fixed Income Strategy

Add impeachment proceedings to the growing list of risks to the global economy

An impeachment inquiry into U.S. President Trump joined an already long list of risks to monitor in the fourth quarter. It is too early to assess the success or failure of this process, but if history is any indication, it will be long and arduous for Trump, and he could still be in office come the 2020 election. In the short-term; however, this is one more factor that could negatively impact consumer sentiment and lead to greater uncertainty and volatility — an environment normally supportive of fixed income investments. Yet, this was not the case in the first half of September. After months of trending lower, we saw the first significant pullback in global interest rates that resulted in Canadian bond indices posting the worst monthly performance for 2019. Indications that trade talks would resume in October, and slightly better than expected data in Canada and the U.S., helped temporarily push rates upwards as expectations for further central bank easing were lowered.

Interestingly, what caught the Portfolio Advisory Team's attention as yields increased was that despite easing from the Fed and the European Central Bank ("ECB"), there were an increasing number of voices raising concerns over the efficacy of negative rates, increased monetary stimulus and the need for even lower interest rates. In particular, the Fed's decision in September to cut rates was not unanimous as three voters dissented; one hoped for a more aggressive cut, but two members were in favor of leaving the policy rate unchanged. This was not only the largest dissention under Fed Chairman Powell, but also the largest for the committee since 2016. Additionally, the Fed's interest rate forecast interestingly indicated no more rate cuts for 2019, and a relatively divided view on the next action. The Bank of Japan, one of the more aggressively dovish central banks of the last 20 years, finally decided to relax its targeting of longer-term rates and focus primarily on anchoring short-term rates. The Bank of Canada ("BoC") left rates unchanged, reluctant to follow the global central bank movement or to bend to market pressure despite an inverted yield curve, with the 2-year Government of Canada yield above the 10-year yield. While limited guidance for further stimulus was provided, the BoC acknowledged that negative real rates already indicate considerable stimulus, especially considering the decent economic data, on-target inflation, and stable currency.

More importantly, there is growing concern that central banks may soon run out of tools to fight the next recession. This is not yet the case in Canada, and the U.S. is definitively a concern for the ECB and the Bank of Japan. However, in a relatively low inflation environment, the focus is shifting to real yields as an indication of how stimulative monetary policies are. Even Canadian real government yields are negative, supporting the BoC's statement that the current level of stimulus is adequate. Considering some of these very stimulative yield levels (e.g., Switzerland, Germany and Netherlands), we can question whether an additional 25 basis point cut, or further asset purchases in these economies would have any significant impact, especially given the risks of unintended (and unforeseen) consequences. For some, this could be a sign that we are effectively approaching the limits of conventional monetary policy and yields may be closer to bottoming, helping explain the recent pause in the global bond rally.

Having said that, the Portfolio Advisory Team believes that it would be too early to think that interest rate lows for this cycle are behind us and further risk is to the downside. There may be signs that central banks' appetite for further stimulus is waning, but they are not yet ready to significantly reduce it. Also, the list of risks to the domestic and global economies continues to grow and, after seeing slower growth abroad, we are starting to see weakening North American fundamentals. In particular, disappointing manufacturing and non-manufacturing activities indicate the trade war is having a negative impact on the U.S. economy, leading the interest rate downtrend to resume in the fourth quarter.

Notably, the ISM Manufacturing Export Orders, which tend to lead the ISM Manufacturing PMI, forecasts further weakness ahead. Considering the positive correlation between the ISM and U.S. 10-year yields, the lower exports would suggest a re-test of not only this year's low of 1.42%, but the record low of 1.36 % for 10-year U.S. Treasuries in 2016. Add to this the potential negative impact of the GM strike, U.S.-China October trade talks, the Brexit deadline (October 31), newly announced European tariffs, to only name a few, and there is further support for lower rates. It helps explain why interest rates resumed this year's downtrend and why we are starting to see a back-up in corporate credit spreads as investors start requiring a higher

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yield compensation for credit risk. It also helps explain why markets are pricing a Fed rate cut for the October 30 meeting. In comparison, the outlook for Canada remains more constructive and the BoC is still expected to remain on the sidelines for the remainder of 2019. Despite this, we should not think that the domestic economy will be shielded from the global economic slowdown. The growing list of risks can also have a significant impact on Canada's economy, given our country's status as a trading nation.

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

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