Monthly Market Commentary

Equity Strategy

Lower for longer interest rates increase stocks' appeal

Low and declining interest rates continue to be one of the most important drivers for markets. In June, European Central Bank ("ECB") President, Mario Draghi, made dovish comments on the potential need for further stimulus which would provide an additional boost to an already strong global fixed income market. These comments followed rate cuts in Australia and India; coupled with dovish messages from the U.S. Federal Reserve ("the Fed") and Bank of England, this is a clear sign of a shift to add stimulus to global markets. The positive impact of lower interest rates on the bond market is clear, but the BMO Nesbitt Burns Portfolio Advisory Team believes that lower interest rates should also support valuations for stocks in the long run.

The Team's historical analysis shows the markets have had excellent performance when rates are both low and declining, which happens to be the current environment. Specifically, going back to 1972, the S&P 500 Index has had annualized gains of almost 15% (led by cyclical sectors) when long rates declined by more than 0.5% year-over-year (in fact, rates are currently down 0.85% year-over-year). The pushback from "bears" will be that further monetary easing at this point comes in reaction to a global growth slowdown. While the odds of a North American recession in the next year have slightly increased, the odds are still relatively low, at 30%. From this perspective, recent improvement on the U.S./China trade war front and narrower credit spreads can only help.

Typically, lower interest rates have a positive impact on the performance of defensive sectors such as Utilities, Telecommunications and REITs, and this still holds true for two key reasons: 1) these sectors are typically very capital intensive and carry high debt loads, so as interest rates go down, their costs of funds are lower; and 2) it makes the typical dividend yield advantage of these sectors more attractive, relative to bond alternatives.

Increasing fair value estimates for the S&P 500 and TSX

To quantify the impact of lower interest rates, holding corporate earnings estimates constant, a permanent one per cent reduction in the "risk-free rate," from 4% to 3%, would theoretically increase the fair value of the S&P 500 by about 15%, and the TSX by 13%. Clearly, stocks can deviate from fair value for a very long time and for a host of reasons (i.e., recession fears, trade wars etc.), but it's undeniable that the present value of future corporate cash flows goes up with rates at a lower-than-previously-expected level for a multi-year period. The Portfolio Advisory Team updated their market fair value models with 2020 consensus estimates by reducing the long-term discount rate to 3% for the S&P 500, while maintaining the 3% level they were using for the TSX. The resulting fair value estimates (for the end of 2019) are reasonable, at 3,300 for the S&P 500, and 18,500 for the TSX, which corresponds to 11% and 13% upside potential, respectively. These results fit with their view that the near-term upside potential is greater for the Canadian market, given years of chronic underperformance, and the potential for a recovery in beaten up Energy and Basic Material shares (those sectors' weights are far greater in Canada than in the U.S.).

Key risk: Tariffs and their impact on consumers

The link between consumer confidence data and the recent G20 meeting in Osaka, Japan, may not seem obvious at first glance, but the former may have had some impact on the latter. Specifically, the most recent Conference Board's Consumer Confidence Index was notably weak as trade and tariffs began to increase the cost of living. For example, Lennar Corporation, a home construction and real estate company, recently said tariffs on China are increasing the cost of new houses by $500, on top of the thousands of extra dollars consumers are paying due to lumber tariffs. Sure enough, at the G20 meeting, Presidents Trump and Xi agreed to restart talks.

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Uncommon value opportunity: Canadian Oil & Gas stocks

With OPEC+ (led by Saudi Arabia and Russia) agreeing to continue production cuts of 1.2 million barrels per day until March 2020, and signs that demand growth is bottoming, the Portfolio Advisory Team believes that downside risk for oil prices is limited. As BMO Capital Markets notes, "We believe that crude oil prices are well supported by fundamentals in a range of $50-$60 per barrel for West Texas Intermediate ("WTI") over the next two years."

Fixed Income Strategy

Summer easing, anyone?

ECB President Draghi's comments quickly drove major European yield curves lower—and in many cases, further into negative territory. German government bond 10-year yields hit a new record low, falling below -0.30%; Finland, Denmark and Sweden 10-year yields turned negative; and Switzerland's one to 30-year yield curve dropped entirely below 0%. The wave also hit the European Corporate bond markets, where yields of short-term, higher-quality issuers have also turned negative. An investor in Nestle Holdings' euro bonds will now need to extend term to a minimum of at least five years, to expect earning a positive yield. While detrimental to savers, these low yields have been welcome by Corporate issuers and continue to attract capital, including from our own Canadian banks that have increased issuance overseas.

Only six to eight months ago, the question was not whether central banks should be raising interest rates, but by how much and how fast. Fast forward to today, and the global central banks have shifted their position. In fact, the Fed has done not one, but two, major policy shifts so far this year; after pausing in January in the midst of its tightening cycle, it has now officially gone into an easing mode. As indicated by the most recent projections — the Fed dot plot[1] median rates — Fed officials expect a 25 basis point (0.25%) rate cut in 2019 and 2020, compared to previously forecasted rate hikes.

With Q1 U.S. GDP growth of 3.2% and a tight labour market boasting a cycle low 3.6% unemployment rate, some may argue the U.S. economy has enough stimulus. However, given the Fed is determined to act appropriately to sustain the economic expansion, the weaker business investments, trade jitters, and benign inflation justify a more dovish approach.

The weaker economic data, which has prompted downward revisions to Q2 GDP, and the Fed's call for below target inflation for both 2019 and 2020, suggests that rates may actually already be too restrictive.

The Fed is yet to explicitly confirm a cut is imminent, and there is still time for a data-dependent Fed to decide on the proper policy course before they meet at the end of July. The market; however, seems to have a different opinion. While the Fed seems to signal an ''insurance cut'' of 0.25% this year and for 2020, the market is more aggressively pricing between three to four throughout 2019. Some economists would go as far as forecasting a 0.50% cut in July.

It's still too early to tell whether the Fed will succeed, but inflation measures are generally declining, moving below the Fed's target, a target that has been missed over 75% of the time since the financial crisis. The market's long-term inflation expectations have also been trending below the target. Assuming a more pronounced economic slowdown and persistent low inflation, the risk is for the rest of the yield curve to continue moving lower in anticipation of further stimulus from the Fed, and from major central banks globally. If that is the case, we should expect short-term yields to continue to be pressured lower and the yield curve to gradually re-steepen, which has not happened yet. In this environment, U.S. Treasuries, which have performed very well this year, should continue to perform well if, and when, the Fed starts easing. Considering how far yields have travelled, and the easing currently priced in, returns should be more moderate going forward compared to the first six months of 2019. Inherently, risk of late cycle inflationary pressures and/or progress, or even a surprising U.S.-China trade deal, would likely alter the Fed's view and force a re-pricing of interest rate markets higher. This would be a clear negative for fixed income investments, and for that reason the Portfolio Advisory Team favours concentrating on U.S. Treasury exposure in terms to maturity of between two and 10 years.

Bank of Canada not yet on the easing path

While Canadian yields trended lower alongside the U.S., the decline was not as significant and the Canadian bond market underperformed. While the market has factored in a 0.25% cut in rates over the next 12 months, the BoC has not confirmed its willingness to lower rates and would likely not follow the Fed on the path of easing in the early days.

[1]Dot plots are well known as the method that the U.S. Federal Reserve uses to convey its benchmark Federal Funds interest rate outlook at certain Federal Open Market Committee meetings [...] The dots represent each member's view of where interest rates should be at the end of each year. Source: Investopedia

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BMO Economics believes the bar is still set relatively high for the BoC to cut rates for at least three reasons:

1. The starting point for short-term rates — that is the BoC overnight rate (1.75%) — is lower than the U.S. Federal Funds rate (2.25%), and remains well below the lower band of what the BoC considers to be an appropriate neutral rate range;
2. After some notable excessiveness, the last thing the BoC wants is to light another fire under the housing market, especially after signs that some markets are stabilizing or even regaining strength; and,
3. Core inflation, unlike the U.S., is not below the BoC's target, arguing against adding further stimulus.

Additionally, the Canadian yield curve is below the U.S. and, more importantly, real yields are negative, which in itself is already very stimulative. However, we cannot assume that the BoC will not at some point be forced into providing further stimulus if domestic and global growth prospects deteriorate.

For that reason, interest rates are in risk of remaining low for longer than initially expected, and we may not yet have seen the cycle lows in Canada.

This has investment implications. The strong possibility that rates could be lower in six to 12 months is increasing re-investment risk and supporting the Portfolio Advisory Team's recommendation to remain invested and avoid concentration in better-yielding, short-term investments (one year or less) or cash. Similar to their U.S. bond recommendation, they recommend focusing on better quality investments, with a bias to increasing government bond exposure.

The other implication is that lower policy rates will not be optimal for floating rate bond structures like the ones in the Portfolio Advisory Team's recommended Canadian and U.S. portfolios. While floating rate bonds continue to perform well and earn a high coupon due to their Corporate exposure, they will become more at risk the closer we get to rate cuts.

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

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