Monthly Market Commentary

Equity Strategy

The virtue of oligopolies

Despite the recent volatility, the BMO Nesbitt Burns Portfolio Adviosry Team continues to believe equities offer reasonable relative value in this market. However, for longer-term investors, given we are late in the economic cycle, the objective is to invest in the right type of stocks. And, as the title suggests, the Portfolio Advisory Team are big fans of oligopolies, or companies with very high "barriers to entry." This means it is difficult to compete against these companies; thereby reducing the risk that they will be disrupted by emerging technologies, or destructive price wars, among other nasty outcomes for shareholders. History has shown that such companies tend to generate outsized profits over the long term, and they also act more defensively in tough environments such as the one we are currently experiencing. On the contrary, cyclical companies with high debt leverage tend to do well when the economy is expanding but will underperform in slowdowns (and sometimes die in recessions).

The bottom line is that the Portfolio Advisory Team continues to recommend a more selective approach to sectors and stocks going forward, given we are later in the cycle and inflationary pressures are building. Another reason for this approach is the massive disparity in performance and valuations experienced over the last few years.

A slowdown in economic momentum

Since the start of 2018, we have seen a broad slowdown in economic momentum. This has spooked investors who have reacted by aggressively selling more cyclical sector stocks (i.e., Technology, Industrials, Financials, Consumer Discretionary, Basic Materials and Energy), as has been the historical script.

While any negative trajectory in the economy hits risky assets such as stocks, the Portfolio Advisory Team stresses that we are still well above recession territory. The BMO Economics team continues to forecast 3.5% global Gross Domestic Product ("GDP") growth next year, down only slightly from 3.6% in 2018. Corporate earnings have likely peaked in the U.S. at 20%+, but profit growth is expected to remain robust, at approximately +10% in 2019, which should support the market.

Fixed Income Strategy

Sentiment shift: Closer to neutral changes 2019 monetary policy expectations

The recent underperformance, and particularly the volatility, of equity markets have shadowed what is unfolding in the fixed income markets. In the third quarter of 2018, at a time when bonds should have provided better portfolio protection by mitigating the impact from low to negative equity returns, both the equity and fixed income markets seemed to be more correlated than one would have wished. Not only were corporate yield spreads widening as investors demanded greater risk compensation, but government yields were also rising as the U.S. Federal Reserve (the "Fed") and the Bank of Canada ("BoC") continued to signal tighter monetary policy ahead, providing limited shelter for investors and significantly impacting fixed income performances.

This relationship somewhat changed in November as market sentiment towards monetary policy shifted, leading bond yields lower. First, the Fed adopted a less hawkish tone signaling its policy rate was likely getting closer to the neutral rate and, despite gradual policy adjustments, a hike every quarter is not necessarily implied. Next year's expectations have melted away quickly; from three to four rate hikes to barely one policy adjustment over the next 12 months. It is a similar story in Canada, where the BoC

adopted a more precautionary tone in signaling the need for further policy rates, and sounding less upbeat on the economy than at its last meeting in October.

When combining the reduced tightening and inflation expectations with the increased equity volatility, we had the perfect storm that finally pressured Canada and U.S. yields lower, with the larger drop in the 5- to 10-year sector. This also led the Canada and U.S. yield curves to flatten further. On average, the U.S. economy has traditionally fallen into a recession 311 days following a curve inversion. If history is any guide, and assuming the flattening trend continues, the odds are that a recession in Canada, the U.S., or both, could potentially be a late 2019 or 2020 event. This would potentially leave a bit more room for the Fed and the BoC to further tighten. If that is the case, this also indicates that we may be closer to the end of this tightening cycle, and government yields may have limited upside from here.

Not all fixed income securities are created equal

After a number of difficult months, 2018 bond performance improved in November, as investors sought refuge in safer fixed income securities, driving yields lower. However, this was mainly felt in the government sector as limited shelter was found in corporate bonds, including the non-investment grade sector. And, for many investors, the conservative portfolio allocation did not perform as expected from conservative investments in volatile and risk-off environments. One of the reasons is the general tendency over the recent years for investors to increase their fixed income risk allocation to compensate for historically low government yields.

The year-to-date return of the U.S. High Yield Senior Loan sector remains slightly positive thanks to the earlier strong performance of the lower-rated securities, but the Portfolio Advisory Team believes that performance is becoming more at risk as concerns for the corporate credit market are rising. In particular, the significant growth in corporate indebtedness since the financial crisis, combined with the rise in interest rates, is starting to put pressure on spreads as interest costs are rising and could soon have a greater impact on margins.

Without being alarmist, the Portfolio Advisory Team continues to recommend that investors focus on improving the average credit quality of their fixed income portfolio as the Canadian and U.S. economies continue to face many risks. With the understanding that not all fixed income securities are considered conservative investments, it is prudent to review your overall fixed income portfolio risk exposure to confirm if it continues to reflect your investment objectives and risk profile. If we are late in the business cycle, an economy that is slowing down as debt re-financing and servicing costs rise would intensify financial stresses, particularly in the higher risk sector of the fixed income market. This would result in further pressure on corporate credit spreads and increase demand for safer government bonds. In this environment, not only is a quality investment bias important, but a focus on shorter-term corporate bonds, while adding longer-term government bond exposure, should be beneficial to portfolio performance.

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

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ID2545 (12/18)