Portfolio Management

January 2019

Equity Strategy

January 2019: A New Hope

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Slower U.S. Interest Rate Increases and China Economic Stabilization Are Good Omens

After a 2018 where not much went right for Canadian investors (with the S&P/TSX Composite down ~12% and even the mighty S&P 500 down ~6% in U.S. Dollars), they can easily be excused for taking a "glass half empty" outlook. The list of negatives is long. U.S. President Donald Trump is becoming more isolated and unpredictable, trade wars are weighing on corporate sentiment, the Brexit process continues to fumble along, economic momentum has slowed and more.

Our message to investors since early 2018 has been to get more defensive in their equity exposure and we continue to advocate caution in the short term. Still, with so much value having been created so quickly in the stock market (with several high quality stocks now yielding over 3%), we strongly feel that now is not the time to sell core holdings. Quite the opposite in fact; we believe now would be a good time to sharpen pencils and build a shopping list of companies with strong competitive advantages (our readers know that we love investing in oligopolies such as railroads and pipelines), excellent balance sheets and superior dividend growth potential. Please contact your BMO Nesbitt Burns Investment Advisor for suitable recommendations.

Let us state from the outset that we are well aware of the old Wall Street adage that hope is not an investment strategy. Still, looking back at several economic and market cycles, we can't help but take a contrarian stance and look for potential positives when panic sets in. First and foremost, our models still show a low probability of recession in the next year. Central banks seem unlikely to push up interest rates aggressively from here (more on this below). The credit market, while shaky of late, is in a different (more positive) universe than during the financial crisis. Sharply lower oil prices, while negative for Canada as a whole, do act as a material tax cut for consumers (just look at gas prices as of late). Perhaps more importantly, looking at our proprietary BMO Risk Appetite Index, we are now firmly in the panic zone, judging by the relative performance of risky assets (stocks, High Yield Corporate bonds) to safe assets (U.S. and Canadian Government and Municipal bonds). In fact, looking at Figure 2, the level of loathing for stocks has not been this high since the European debt crisis of 2011. Given the market is inherently "mean reverting", being able to know where we are on the risk appetite continuum can help investors optimize portfolios and boost long term returns in our view.

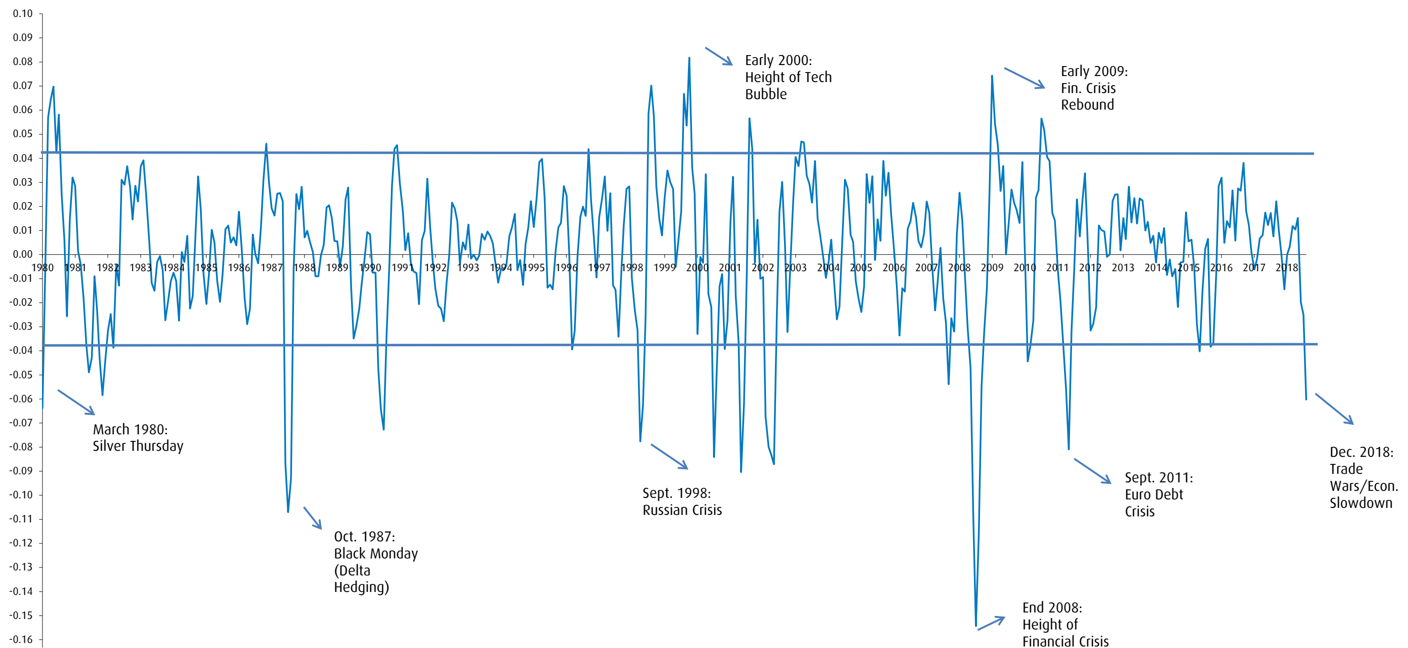
Figure 1: BMO Nesbitt Burns Investment Strategy Committee's Recommended Asset Allocation (%)

	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	5	5	5	5	5	5	0	5
Fixed Income	70	70	40	45	20	25	5	0
Equity	25	25	55	50	75	70	95	95
Canadian Equity	15	15	25	25	35	35	40	40
U.S. Equity	10	5	25	15	25	20	35	30
EAFE Equity*	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

** Within EAFE, we specifically recommend Continental European equity. Canadian Equity = S&P TSX; U.S. Equity = S&P 500; Cash = Cdn T Bills; Fixed Income = Cdn Bond Universe; EAFE = MSCI EAFE Index; Emerging Equity = MSCI Emerging Markets; Source: BMO Nesbitt Burns Private Client Strategy Committee*

Risk Appetite Index

Figure 2: Risk Appetite Index is firmly in the "Panic Zone" – This Has Historically Been a Good Contrarian Indicator



Source: Bloomberg, BMO Nesbitt Burns

As a reminder, in the summer of 2017 we created the proprietary BMO Private Client North American Risk Appetite Index (RAI) which attempts to minimize the emotion and bias which are prevalent in a number of market indicators. In order to do this, we use exclusively market price data and compare the relative performance of risky assets (a composite of the S&P 500, TSX, Philly Semiconductor Index, Nasdaq Biotech Index and several other indices) versus safe assets (several Canadian and U.S. Government, provincial and municipal bond indices). Simply put, when stocks are outperforming bonds, the RAI goes up and when bonds do better than stocks (which is typical when investors fear an economic slowdown, as is currently the case), the RAI goes down.

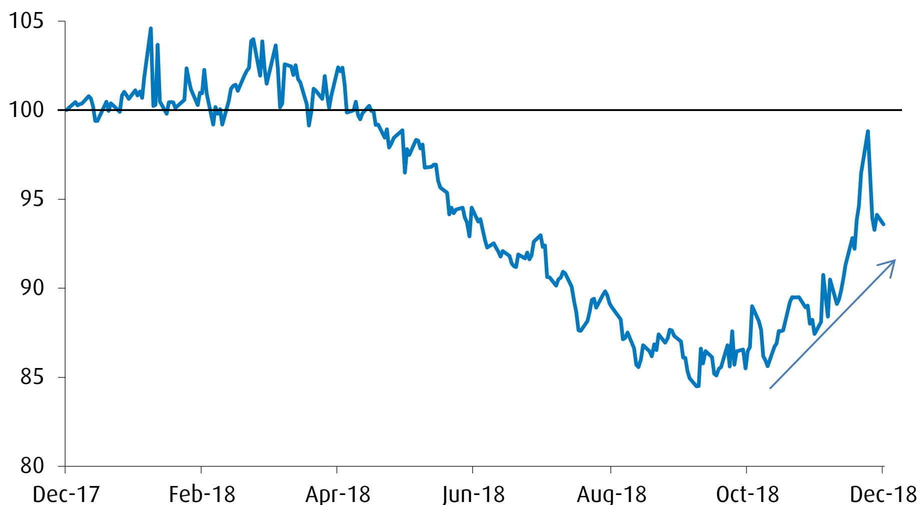
Once we have the monthly relative returns going back to 1980, the Index is normalized around a 0 central value. Looking at past episodes of over optimism and over pessimism is instructive to gauge the effectiveness of our new model in our view. As can be seen on the chart, the RAI clearly shows periods of extreme optimism or pessimism of the last four decades (i.e. the tech bubble which peaked in early 2000, the October 19 crash of 1987, the financial crisis of 2008/09 etc). Interestingly, after risk appetite peaks or troughs, the market tends to move in the opposite direction within a month or two. Of course, we only know the exact peak or trough level after the fact. But, as a rule of thumb, we have found that +0.04 and -0.04 values on our Index are historically important levels to monitor for a possible near-term reversal in trend. The number indicates the amount of monthly outperformance for stocks over bonds in percentage terms; so 0.04 on the vertical axis = 4% monthly outperformance. Since this is a 3 month moving average, attaining that level means that stocks have outperformed bonds by approximately 12% over the last 3 months, which does not happen often. Conversely, we have seen more extreme moves to the downside since 1980. For example, stocks underperformed bonds by almost 50% at the height of the financial crisis liquidation phase). This is good illustration of the old market adage that stocks "grind up" but gap down".

So What Could Go Right?

The two most important economies from Canada's perspective happen to be the two largest ones in the world: the U.S.A (our largest trading partner) and China (the largest driver of commodity prices). Trade tensions between the two have exacerbated concerns about slowing economic growth and it is clear that additional détente would be well received. Unfortunately, given the current rhetoric, it is hard to handicap when and if progress will be made, although both sides have agreed to face-to-face talks in early January. However, away from trade issues, there are potential positives we can point to in the form of stimulus measures in the Middle Kingdom and a slower rate hike path south of the Border.

Clearly, the leadership in China is trying to stimulate the economy with roughly 50 easing moves in 2018 (lower reserve requirements for banks, lower interest rates, infrastructure spending etc). At some point this should lead to an inflection where growth accelerates slightly from current moribund levels. As our readers know, we firmly believe that the trajectory is what matters for markets rather than absolute levels. So, even a slight uptick combined with very low current expectations could help commodity prices stabilize and boost investor risk appetite generally. Notably, we are seeing emerging market stocks starting to outperform which is a good omen given they tend to be leading indicators. It is also typically a good sign for the Canadian market since the TSX and Emerging Markets are highly correlated (given our market's sensitivity to commodities).

Figure 3: Emerging Markets (EM) Have Started to Outperform the S&P 500 since October



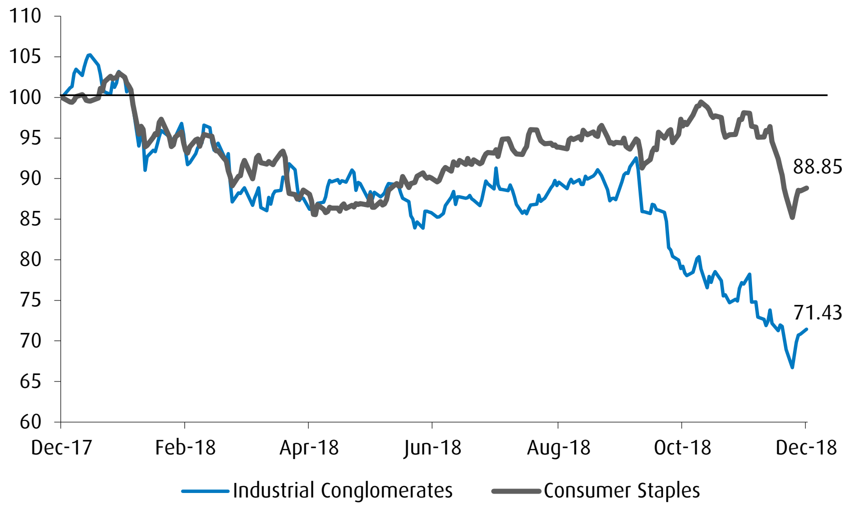
Source: FactSet

Economic Momentum Has Slowed But NOT Collapsed (unlike in 2008):

At this point, it is well understood that global economic momentum has slowed down considerably as proxied by International PMI[1] data. Investors only need to look at the terrible performance of cyclical stocks (i.e. Technology, Industrials, Financials, Consumer Discretionary, Basic Materials and Energy which are more exposed to economic trends) relative to defensive sectors where investors have been hiding for the last few months (Utilities, Consumer Staples, Healthcare).

[1] As our readers know, we very much like ISM (or PMI data internationally) since it correlates very well with market returns as shown by the chart below. Recall that ISM data is a real world survey of hundreds of companies in multiple industries. A lower reading indicates conditions are slowing which is a good leading indicator for a slowdown in sales and profitability.

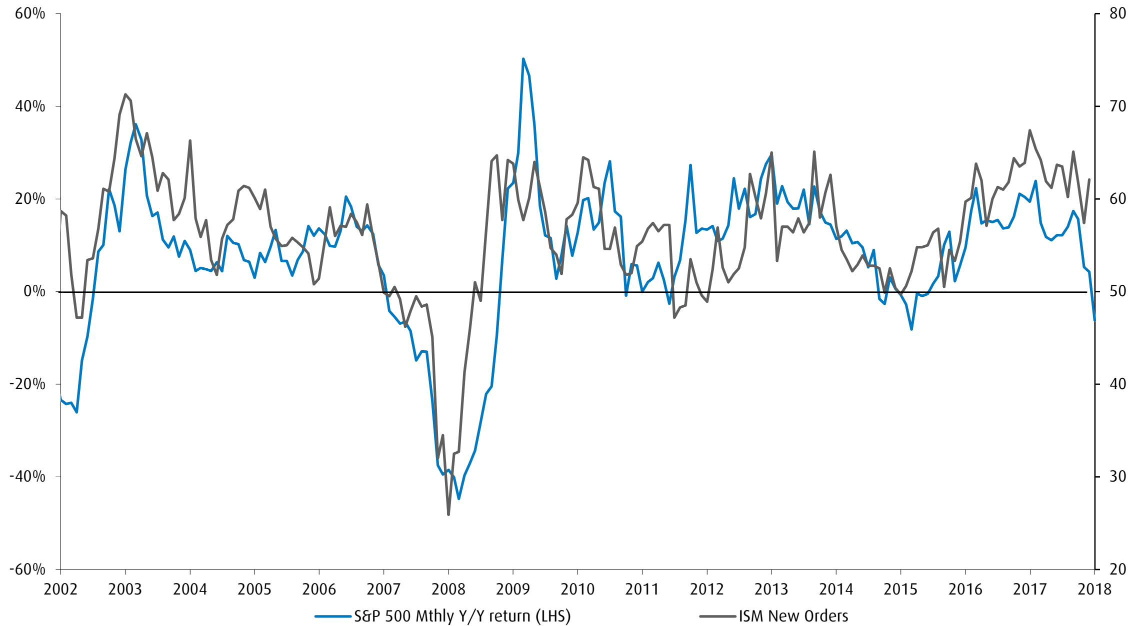
Figure 4: S&P 500 Industrials have underperformed Consumer Staples by Almost 20% Year to Date!



Source: FactSet

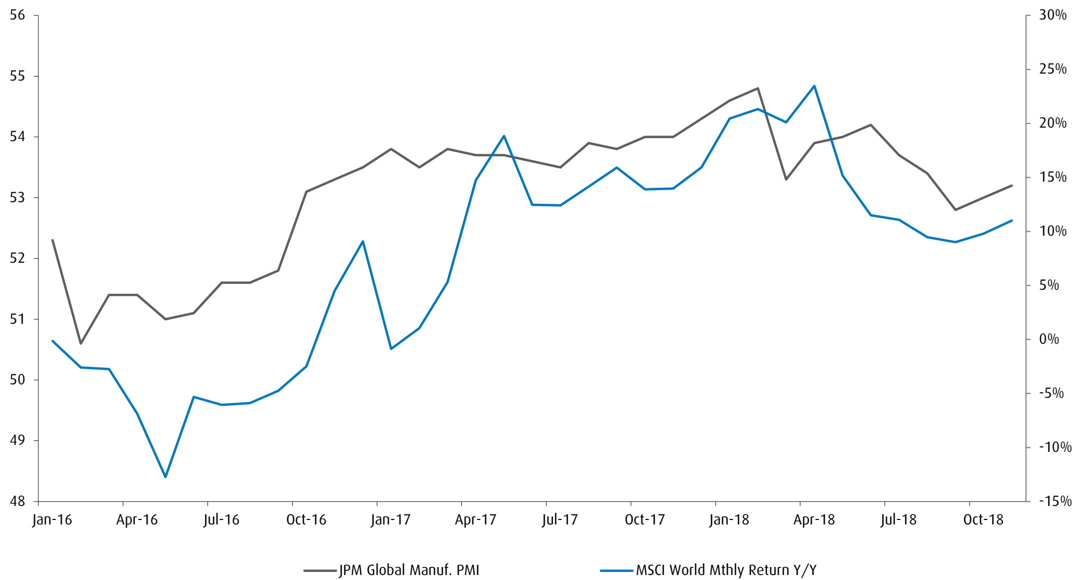
As we noted several times, since the start of the year, we have seen a broad slowdown in economic momentum This has spooked investors and the reaction of selling more cyclical stocks aggressively has followed the historical script. Still, in our opinion things are not quite as bleak as the stock market would have us believe. Equities appear to have "overshot" to the downside based on a simple historical relationship with ISM/PMI data.

Figure 5: S&P 500 Monthly Returns (year over year) versus ISM New Orders Index



Source: Bloomberg

Figure 6: MSCI Monthly Returns (year over year) versus JP Morgan Global Manufacturing ISM



Source: Bloomberg

Interest Rates

Clearly, for equity investors, lower interest rates are preferable since this keeps the cost of financing down for companies (boosting profits) and for consumers (boosting disposable income). Also significant is that the majority of recessions in the last century have been caused by excessively tight monetary conditions. In other words, in an effort to combat inflation, Central Banks raise short term rates and eventually choke off economic growth. Good recent examples of this are the recessions of 1973, the early 1980s, 1990 and 2001. Looking at it from that lens, current benign inflation provides the Federal Reserve and the Bank of Canada "air cover" to take a slower, more methodical approach.

Case in point, while Federal Reserve Chairman Powell's interest rate increase and commentary on December 19th was poorly received by investors, we believe the longer term message was actually positive since the Fed signaled a slower, more occasional rate hike cadence in 2019. Our research partners at Cornerstone Macro make a convincing case that the Federal Reserve is now on a more dovish path, meaning that the risk of an overshoot on interest rates has been lowered. This is quite positive for equity investors since most recessions in the last century occurred because of overly tight monetary conditions. It also matters greatly for Canada since the Bank of Canada typically takes its cue from the U.S. Federal Reserve.

Cornerstone Macro states: *"In other words, it was unrealistic to expect that the Fed would signal the end of the tightening cycle – the evidence in support of that outcome is just not conclusive enough. Instead, the Fed did the second-best thing it could have done from the point of view of equity investors: It signaled that it would stop tightening if global or financial conditions deteriorate further. That statement does not commit the Fed to anything but leaves the door wide open to it stopping the hiking cycle should conditions warrant it.*

This is why the FOMC was very dovish (on December 19th): It said clearly that the Fed is not blind to what's going on, it's not on autopilot, and will pay close attention to adverse developments. Having contributed to drafting many FOMC statements in the past, we can tell you without uncertainty that the "monitoring" language was put there for a specific reason, and that reason was to communicate to investors an openness to slowing it down further or even calling it a day should the outlook continue to deteriorate. We would think this is good news for equity investors: It means that the Fed is on their side."

Stock Fair Value Update

Given we believe interest rates will continue to rise (albeit slowly) over the next several years, we have updated our fair value estimates for the TSX and S&P to incorporate a higher 10 year bond risk free rate (we now use 4% to be conservative). We have also updated the models with 2019 consensus EPS estimates but used lower growth estimates for the next few years to incorporate the risk of an economic slowdown. Our fair value estimates stay roughly the same given higher corporate profitability largely offsets the rise in interest rates.

Figure 7: S&P 500 Fair Value (still approximately 2,900)

	Present value	% of value	Earnings per share growth	Discount rate	
Period 1 (2019-2022)	616.26	21.3%	6%	10.0%	
Period 2 (2023-2027)	634.60	22.0%	5%	10.0%	
Period 3 (2028 -)	1,638.57	56.7%	3%	10.0%	
Rounded Fair Value	**2,890**	100.0%	Next 12 month consensus		179
			Implied terminal mult.		14,2 X
Current Price (December 31, 2018)	**2,507**		Long Bond		4.0%
			Historical Equity Risk Premium		4.5%
Upside Potential	**15%**		Additional Risk Premium		1.5%
			Total discount rate		10.0%

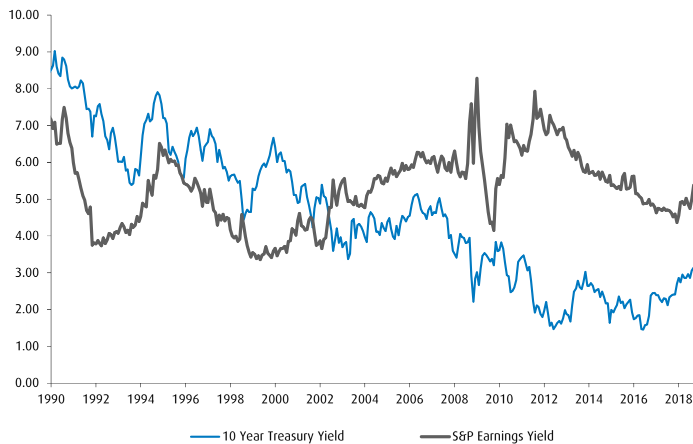
Source: Bloomberg, BMO Nesbitt Burns

Figure 8: S&P/TSX Fair Value (was 18,000; now 17,600)

	Present value	% of value	Earnings per share growth	Discount rate	
Period 1 (2018-2022)	4,333.11	24.7%	5%	10.0%	
Period 2 (2023-2027)	4,159.37	23.7%	3%	10.0%	
Period 3 (2028 -)	9,062.49	51.6%	2%	10.0%	
Rounded Fair Value	**17,600**	100.0%	Next 12 month consensus		1,16
			Implied terminal mult.		12.5
Current Price (December 31, 2018)	**14,323**		Long Bond		4.0
			Historical Equity Risk Premium		4.5
Upside Potential	**23%**		Additional Risk Premium		1.5
			Total discount rate		10.0

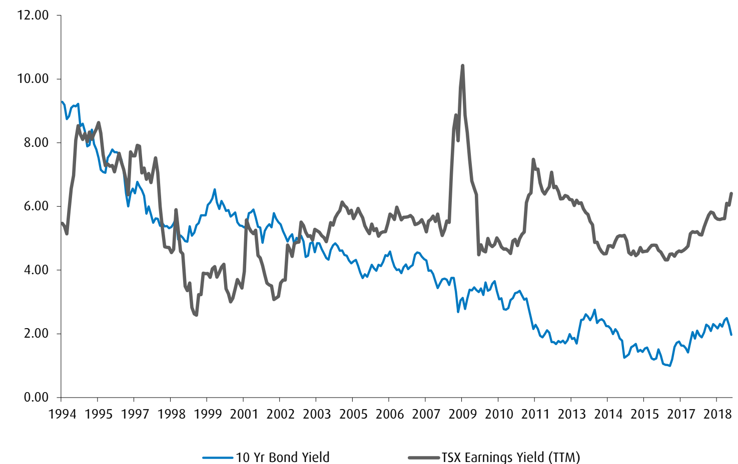
Source: Bloomberg, BMO Nesbitt Burns

Figure 9: S&P 500 Earnings Yield vs 10-Year Treasury Yield



Source: Bloomberg, BMO Nesbitt Burns

Figure 10: S&P/TSX Earnings Yield vs 10 Year Bond Yield



Source: Bloomberg, BMO Nesbitt Burns

Figure 11: S&P 500 Index Sector Total Returns to December 2018

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Health Care	-8.61	6.47
Utilities	-4.02	4.11
Cons. Discretionary	-8.37	0.83
Info. Technology	-8.46	-0.29
S&P 500 Index	**-9.03**	**-4.38**
Real Estate	-7.91	-5.64
Consumer Staples	-9.11	-8.38
Telecom. Services	-7.29	-12.53
Financials	-11.28	-13.03
Industrials	-10.70	-13.29
Materials	-6.90	-14.70
Energy	-12.67	-18.10

As of December 31, 2018

Source: Bloomberg

Figure 12: S&P/TSX Sector Total Returns to December 2018

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Info. Technology	-5.16	12.96
Consumer Staples	-1.02	2.01
Telecom. Services	-2.75	-0.81
Industrials	-9.26	-2.44
Real Estate	-4.79	-2.76
S&P/TSX Composite Index	**-5.40**	**-8.89**
Utilities	-3.14	-8.94
Materials	5.73	-9.29
Financials	-7.13	-9.32
Health Care	-16.61	-15.94
Cons. Discretionary	-8.53	-16.01
Energy	-6.82	-18.28

As of December 31, 2018

Source: Bloomberg

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