Monthly Market Commentary

Equity Strategy

Still loving Financials: the bullish case for the Financials sector

On February 21, 2012, the BMO Nesbitt Burns Portfolio Advisory Team made a very bullish call on U.S. mega banks – an unfavourable sector at the time. Since then, they have reiterated their stance several times and continue to recommend many of the same stocks, such as Bank of America, Morgan Stanley, Citigroup and JPMorgan, despite the very strong performance of these stocks over the last six years. In this edition of the *Monthly Market Commentary*, however, the Portfolio Advisory Team broadens their scope to include other sub-sectors (such as life insurance) and geographies (such as Europe). European Financials seem like great value investments right now, given the continuing economic recovery for major European countries. The Euro-area unemployment rate is on a continued downtrend, and positive structural reforms (such as labour and land reforms) are making their economies more competitive.

Key reasons for the Portfolio Advisory Team's bullish call:

1) The credit outlook remains positive both in North America and Europe

The positive credit outlook for North America and Europe is crucial, since increased loan loss provisions have historically been toxic to stock performance, as it crushes profitability. Within the Financials sector, bond spreads are generally well behaved, which indicates that the fixed income market does not foresee any looming threats (as it did before the financial crisis). Capital ratios and risk management have improved substantially, thereby lowering the potential downside risk.

2) The synchronized global economic recovery remains strong

The biggest potential risk to Financial stocks is a recession. The Portfolio Advisory Team's models show that in North America, recession risk remains quite low over the next year. This is important given that these stocks are sensitive to economic and market shifts.

Diversified Financials should perform strongly if U.S. economic momentum holds up. Increasing long-term interest rates are generally a positive for Financial stocks, particularly for life insurers whose long-term liabilities decrease and generate higher investment income in this environment.

3) Lower regulation and tax cuts in the U.S.

The current U.S. congress and administration appears intent on lowering industry regulation, and the recently passed tax cut will have a material positive impact on the earnings power for the Financials sector. Operating results generally continue to improve and the credit environment is still constructive.

Since the U.S. Senate recently passed the Economic Growth, Regulatory Relief and Consumer Protection Act, this regulatory reform should slow regulatory/compliance expense growth, and increase flexibility to return excess capital through dividends, buybacks, and mergers and acquisition activity.

Additionally, **the recently passed tax cut will have a material positive impact on earnings power for the Financials sector**. As noted in the January 2018 *Monthly Market Commentary*, the impact of the tax cut will vary greatly by industry. Generally speaking, profitable and U.S.-focused companies will benefit most, and Financials will be one of the top beneficiaries.

4) The technicals are supportive

There's a concept in technical analysis called "proportionality," which means the bigger the pattern a security or index breaks out of, the greater the implications. Back in 2012, the Consumer Discretionary Index broke out of a massive trading pattern, leading to total returns of more than 100% over the following five years. In early 2017, there were similar-sized breakouts in large-cap U.S. Financials. For example, Bank of America and Citigroup have broken out of extremely large eight-year base patterns. The initial upside targets for these

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breakouts measure US$38 for Bank of America and US$110 for Citigroup. However, given the size of the patterns they broke out of, much higher targets are likely on a two- to four-year basis. Even more astounding are the twenty-year trading range breakouts in companies like J.P. Morgan and U.S. Bancorp. Initial upside targets are US$120 and US$67, respectively, but they too will rise significantly higher within this emerging secular (multi-year/multi-decade) bull market. Finally, this trend is not limited to U.S. Financials either. Many European Financials have either broken out of similar-sized patterns or are poised to do so.

5) Valuations remain attractive

Most of the stocks mentioned within this article trade at – or just below – book value. As well, their Return on Equity is projected to increase for most of these companies.

Fixed Income Strategy

It looks like the 3% target on the 10-year treasury yield will have to wait

After months of relative underperformance, fixed income investors were faced with the potential impact of tighter monetary policies and higher rates. The combination of favourable U.S. fiscal policies and better global growth prospects meant the end of the low rate era for many market pundits. There remains a disconnect between central bank actions and investor expectations. Central banks are reducing stimulus, which is pressuring short-term rates higher, while low inflation expectations are keeping long-term rates low. This is leading yield curves to flatten. There is no doubt that the slow and gradual removal of monetary stimulus is easing the transition to higher rates, but the general optimism experienced earlier this year may have faded, particularly in Canada.

The contraction in the Canadian economy in January (compared to the surprisingly strong start in 2017) supported Bank of Canada governor Steven Poloz's view that there remains some slack in the labor market and the economy. The contraction also suggests that the need to further reduce accommodative monetary policy may not be as pressing as it may have felt months ago. Canada's gross domestic product miss was a surprise for many, and while BMO Economics believes it was sector-specific weakness and not broad-based, it nonetheless demonstrates the relative softness of the Canadian economy. Furthermore, concerns over the North American Free Trade Agreement ("NAFTA") and the nagging issue of weak exports further weighs down the odds of another rate hike this spring.

So far, these factors look to be primarily a Canadian story, as the U.S. does not necessarily share the same supporting factors for lower rates. The latest data may have been somewhat softer, but the economy still remains on solid footing, especially compared to Canada. After raising interest rates last month, the U.S. Federal Reserve remains on course for at least two more rate hikes in 2018, with upside risk to that forecast.

Surprisingly, however, the U.S. market remains unfazed, and mid- to long-term rates are struggling to break out of their recent trading range toward new highs. Arguably, U.S./China trade concerns and the significant increase in volatility in equity markets may have led some investors to shift their allocation to more conservative assets, in order to mitigate the rise in interest rates. However, the Portfolio Advisory Team has not seen a significant increase in the demand for safe haven assets, like U.S. treasuries and Canadian bonds, which have historically been associated with larger equity market pullbacks.

At time of writing, the 10-year U.S. treasury yield is currently trading within a 25 basis point range between 2.70% and 2.95%. It appears the 3% target yield that many expected may not come for a little while longer. The same could be said for Canada where, after reaching close to 2.40%, the 10-year Government of Canada bond yield is now below 2.20% again. While a trade war, NAFTA negotiations, and inflation surprises could help break the range to the upside, the Portfolio Advisory Team doubts the market has enough thrust to significantly move above the range. At best, the current environment and outlook will likely continue to support both Canada and U.S interest rates in the current trading range, for the time being.

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

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