Monthly Market Commentary

Equity Strategy

Slower U.S. interest rate increases and China economic stabilization are good omens

With U.S. President Donald Trump becoming more isolated and unpredictable, trade wars weighing on corporate sentiment, Brexit, and slowing economic momentum, Canadian investors can easily be excused for taking a "glass half empty" outlook. Since early 2018, the BMO Nesbitt Burns Portfolio Advisory Team ("the team") has recommended that investors get more defensive in their equity exposure, and has advocated caution in the short-term. With several high quality stocks yielding over 3%, the team believes now is not the time to sell core holdings, but to make a list of companies with strong competitive advantages, excellent balance sheets, and superior growth potential.

The Portfolio Advisory Team's model still shows a low probability of recession in the next year, and central banks seem unlikely to raise interest rates aggressively. The credit market, while shaky, is in a different (more positive) universe than during the financial crisis of 2008/09.

The two most important economies to Canada are the U.S. (Canada's largest trading partner), and China (the largest driver of commodity prices). Trade tensions between the U.S. and China have exacerbated concerns about slowing economic growth. Given the current rhetoric, it's hard to tell *when*, or *if*, progress will be made. However, China is trying to stimulate the economy, with roughly 50 quantitative easing moves carried out in 2018 (including lower reserve requirements for banks, lower interest rates, and infrastructure spending). At some point this should lead to an inflection, where growth accelerates slightly from current levels. A slight uptick, combined with very low current expectations, could help commodity prices stabilize and boost investor risk appetite.

The team is also seeing Emerging Markets stocks starting to outperform, which is a good omen, given Emerging Markets stocks tend to be leading indicators.

Interest rates

The Portfolio Advisory Team's research partners at Cornerstone Macro make a convincing case that the U.S. Federal Reserve ("the Fed") is on a more dovish path, meaning the risk of an overshoot on interest rates has been lowered. This is quite positive for equity investors, since overly tight monetary conditions caused most recessions in the last century. This is also especially important for Canada, since the Bank of Canada ("BoC") typically takes its cue from the Fed.

Fixed Income Strategy

2019 interest rate forecasts

In a year marked by greater political uncertainty and higher volatility, the best returns in 2018 were delivered by shorter-term investments, as investors reduced not only term exposure, but also credit exposure. Overall, the Canadian fixed income market outperformed the U.S., but for many investors this may not be reflected in individual portfolio performance for three main reasons: 1) a focus on shorter investment solutions; 2) floating rate investment vehicles; and 3) overweight corporate allocation.

In 2019, the Portfolio Advisory Team will be watching U.S. politics, with the government shutdown, debt ceiling, and trade negotiations taking center stage. January's shift in the balance of power in Washington, as the Democrats took control of Congress, will definitely change the political landscape, and may help soften Trump's rhetoric. Labour markets are expected to remain strong and continue to support healthy wage gains for the time being, helping to extend the duration of the current economic cycle.

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However, recent softness of the economic data, plus the natural lag between monetary tightening and its economic impact, may allow the Fed to be more patient and flexible, potentially slowing down the pace of tightening.

In Canada, the weakness in the Energy sector is likely to have a more material impact on the economy and continue to pressure inflation lower. Real growth is expected, at least for the first quarter, to remain below 2%, while inflation should continue to trend below the BoC's 2% target. If we also consider the negative impact of higher short-term interest rates on real estate and consumer loan growth in the context of limited wages gains, this will likely translate into a more benign interest rate environment that will lead the BoC to be more patient.

In addition, the revised historical GDP data has led the BoC to believe the economy may have further spare capacity than originally expected, before economic growth becomes inflationary. This reinforces the notion that there is no urgency for the BoC to raise policy rates, and significantly reduces the chances of a rate hike in the first quarters of 2019.

Interest rate forecasts and total return expectations

The balance of risks should provide support for fixed income markets to generate positive returns in the first half of 2019, but investors should keep expectations low. The fact that inflation remains low, and the risk of further tightening from all major central banks is significantly lower (compared to the end of 2017) should help performance. The reduced probability of rising rates should help mitigate the risks of bond prices depreciating. Furthermore, after a year of rising interest rates for both corporate bonds and Guaranteed Investment Certificates ("GICs"), investors should start to benefit from a greater source of portfolio income. Also, compared to 2017, corporate bonds may not yet offer appropriate compensation normally required, assuming further economic slowdown, even despite the recent underperformance of credit markets in general. While the Portfolio Advisory Team remains constructive on short-term corporate bonds, they caution against going on a buying spree, and instead recommend not only selectiveness, but maintaining a strong quality bias.

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

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