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The October Effect

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October has historically had a bad reputation for stock performance. This is not overly surprising when one considers a few historical examples such as the catastrophic losses which occurred in October 1929 (during the depression), and Black Monday, on October 19, 1987 which still holds the record for the largest one day percentage drop in history (22.6%). The last few days of trading have certainly renewed fears of a return of the so-called "October Effect," with the Dow Jones Industrial Average dropping a sizable 830 points on October 10 alone. From the BMO Nesbitt Burns Portfolio Advisory Team's perspective, we are not particularly alarmed at this point. First and foremost, the global economy remains on solid footing, with corporate profitability and cash flow generation very strong, particularly in the U.S. For Canada, higher oil prices should become quite supportive when the discount for our oil narrows to more normal levels. Credit and money markets, often the proverbial "canary in the coalmine" for more dangerous market action to come, remain very well behaved, indicating that fixed income does not see a big deterioration in creditworthiness.

Pundits are trying to find proximate causes for this decline. Escalating trade concerns have been cited but we find this argument unconvincing since Trump-induced trade conflicts have been a constant fixture for more than a year, with little market impact. In our opinion, the actual cause of the decline rests squarely with higher interest rates which have forced investors to adjust the discounting algorithm for future corporate free cash flows (higher) leading to lower stock prices, particularly for more cyclical and more expensive stocks. In August, we warned that high duration[1] stocks were vulnerable to higher rates. In simple terms, these are typically very high multiple stocks (e.g. a stock trading at a forward price to earnings multiple of 50 to 100 times), where the bulk of the value comes from expected future growth in cash flows. At the time, we noted that, *"We do 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 is the massive disparity in performance and valuations we have seen over the last few years. The so called FAANG (Facebook, Amazon, Apple, Netflix and Alphabet aka Google) stocks have been the poster children for this phenomenon over the last two years."*

Our BMO Nesbitt Burns fixed income colleagues mentioned that the most recent increase in U.S. interest rates has seen the U.S. 10-year Treasury yield (the single most important driver of financial instrument valuation in the world) finally trading above 3%, and entering the third quarter at the highest level since 2011. This move pulled global rates higher including the Canada 10-year yield which rose above this year's peak of 2.52%.

With inflation expectations relatively stable, the recent lift has been mainly driven by rising real rates, a sign of a stronger economy and less accommodative central banks. A combination of at least three important factors help explain the latest move.

First, the renewed free-trade agreement is removing a cloud of uncertainty which should help business investment and overall growth in the second half of the year (including Canada), a definitive catalyst that will help lift real rates.

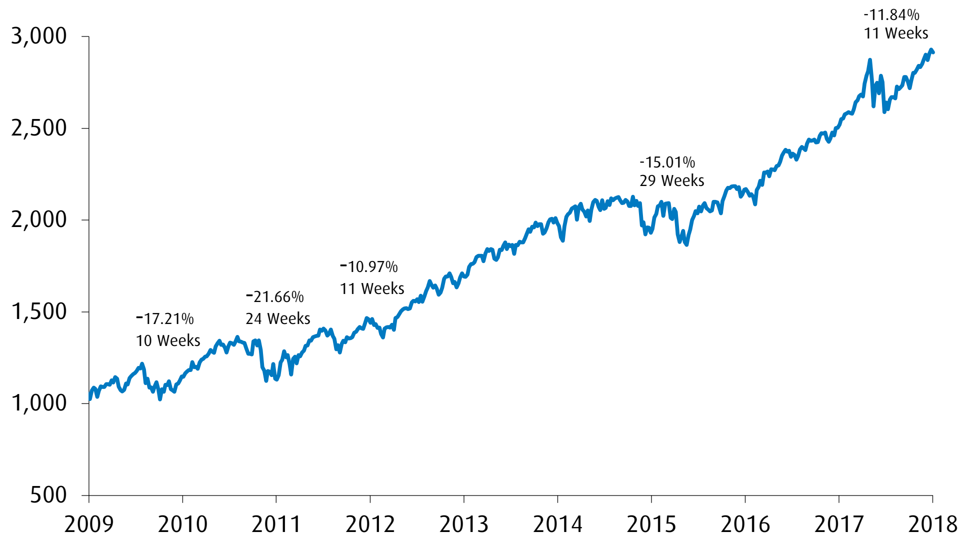
Second, recent more hawkish remarks from the U.S. Federal Reserve ("the Fed"), Chair Jerome Powell, who expressed an upbeat view of the economy and limited concern over inflation are supporting further rate increases.

[1] Duration is an approximate measure of a bond's price sensitivity to changes in interest rates. If a bond has a duration of 10 years, for example, its price will rise about 10% if its yield drops by a percentage point (100 basis points), and its price will fall by about 10% if its yield rises by that amount (source: www.thestreet.com).

Lastly, the Fed is no longer alone in removing excessive monetary stimulus. Not only has the Bank of Canada been tightening for over a year and is expected to make a hike this month, but the European Central Bank and the Bank of Japan have either reduced asset purchases or indicated a willingness to do so.

In times like these it is critical to remember that markets never go straight up and even relatively large pullbacks are a normal phenomenon. Since the recovery from the financial crisis began in 2009, there have been five major corrections ranging in length from 10 to 29 weeks, and peak to trough pullbacks of 12% to 22%. Even if the current correction were to be more serious – and that is not a given – it is important to note that in both the 2011 and 2015 cyclical bears, the S&P 500 went on to make a new all-time high less than a year after the bear market began.

Figure 1: S&P 500



Source: FactSet, BMO Nesbitt Burns Technical Analysis

Taking a step back, rising 10 -year interest rates directly impact the price of bonds as higher rates mathematically lead to lower bond prices. The longer the maturity of the bond, the more pronounced the impact. They also have a significant impact on equity sector valuations and performance. It is well understood that rising interest rates have a nefarious impact on the performance of defensive, lower growth sectors such as Utilities, Telecoms and REITs since: 1) these sectors are typically very capital intensive so as interest rates rise, their costs of funds go up; and 2) it makes the typical dividend yield advantage of these sectors less attractive relative to bond alternatives. They also increase the cost of buying large ticket items such as housing and cars, sectors we would avoid currently.

While the popular perception is that rising interest rates are negative for stocks, our analysis shows that this is not necessarily the case, at least at first. While the median annual return for the S&P 500 has in fact been better when interest rates are declining, our analysis of interest rate cycles going back almost 60 years shows that the market can absorb interest rate increases as long as they are gradual and do not go much above the middle single-digit range. Ultimately, the best portfolio defense against higher rates is to emphasize companies with outsized dividend growth potential and very high quality defensible business models. Specifically, several Pipeline, Financials and Healthcare companies fit the bill, in our view.

Please contact your BMO financial professonal if you would like to discuss your invesment portfolio.

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