Portfolio Management

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Two Months In

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As we enter the peak holiday season, the stock market has not given us much holiday cheer, with the S&P 500 dropping almost 100 points, and the Nasdaq almost 300 points, on Tuesday alone. Such sudden losses are always painful, but we strongly believe that we are not headed toward a repeat of the 2008/2009 financial crisis declines, and that we are more than halfway through the current correction.

It is true that since the start of the year, we have seen a broad slowdown in economic momentum (importantly, the economy is still growing but at a slower rate). This has spooked investors, and their reaction has been to sell more cyclical stocks in the Technology, Industrials, Financials, Consumer Discretionary, Basic Materials and Energy sectors has followed the historical script. By our numbers, since the early 2000s, when we've been at a similar point in the economic cycle, cyclical sectors have declined approximately 4% on average, while defensive sectors (Utilities, Telecom, Healthcare and Consumer Staples) have gained about the same amount on average.

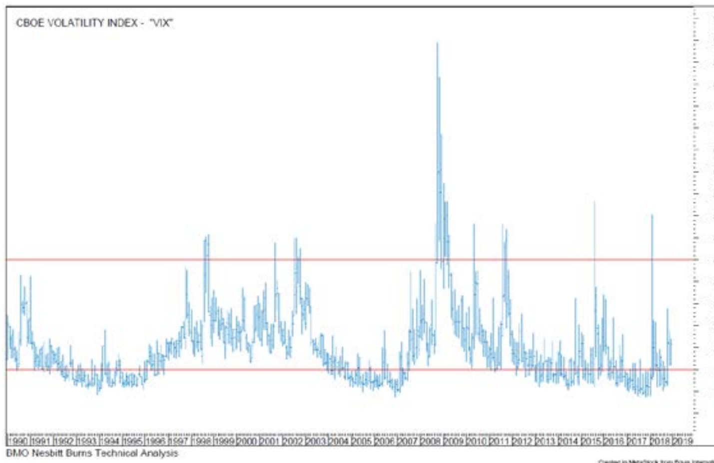
However, the latest data from most regions, including the U.S. has been more encouraging with an unexpected uptick, which further lowers the odds that the economy will experience a recession in the next year. This aligns with our models which show a very low probability for such an outcome in the U.S. and Canada in 2019. This matters greatly in trying to gauge the risk of further declines since virtually all major market corrections of more than 20% over the last 20 years have preceded recessions. The bottom line is that the global economy remains on a a solid footing, with very strong corporate profitability and cash flow generation.

BMO Nesbitt Burns Fixed Income specialists add that credit markets, often the proverbial "canary in the coalmine" for more dangerous market action to come, have also been under pressure. This is reflective of a market that is in the later stages of an economic cycle. A pullback towards the mean after reaching decade low levels early this year was not a surprise, and corporate credit spreads in general still remain marginally lower than the average over the last 15 years.

It is also important to remember that the market never goes up in a straight line and that pullbacks tend to be more violent than upward moves. The old adage is that the market "grinds up and gaps down". BMO Nesbitt Burns Technical Analyst Russ Visch states that, "To say that 2017 was a sedate year for equities is a bit of an understatement considering the CBOE Volatility Index (the "VIX") not only registered its lowest one-day reading ever, but also the lowest annual average reading in history." 2018 has subsequently been a wake-up call for investors lulled to sleep by 2017's action, as volatility has moved back into its historical range. In terms of the current price action, we've seen two cyclical downturns similar to this one since the credit crisis. The first was in 2011, and was related to the U.S. credit downgrade; while the second was in 2015 and mostly due to a collapse in commodity prices. Together, those declines averaged out to a 7-month decline and a loss of 18% in the S&P 500.

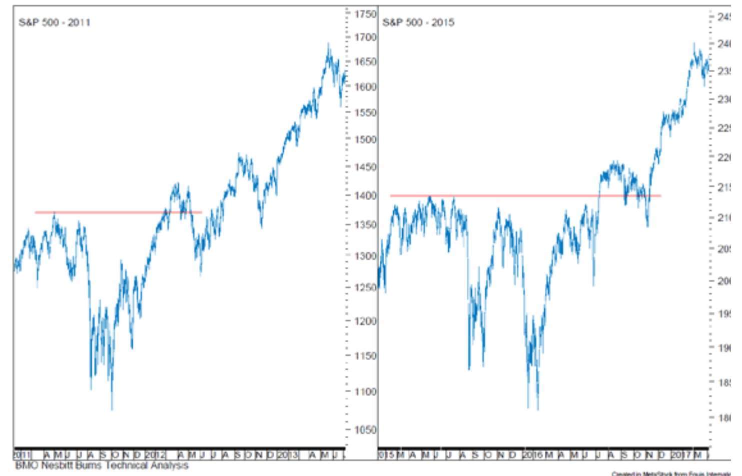
We're more than three months into this latest slide, with the S&P 500 down 11.5% peak-to-trough. So, if history is any guide we're already more than halfway through it. Going forward, investors should be preparing to accumulate stocks into a cyclical low in the weeks ahead, because during the last two cyclical downturns the S&P 500 broke to new all-time highs above those bear market peaks less than 12 months later. Additionally, the average gain for the S&P/TSX Composite Index in the 12 months following the cyclical bear market lows in 2011 and 2016, is 25%. The average gain for the S&P 500 in the 12 months following those cyclical bear market lows is an astounding 32.5%!"

Figure 1: The CBOE Volatility Index



Source: BMO Nesbitt Burns Technical Analysis

Figure 2: The S&P 500 Index: 2011 and 2015



Source: BMO Nesbitt Burns Technical Analysis

Accordingly, given our economic and market outlook, and the decline in stock prices we've already experienced, we would strongly advise against liquidating equities at this point, and to maintain a well diversified portfolio including bonds, cash and high quality stocks. Of course, since the market turbulence could continue for a while longer, the key is to hold onto, and accumulate, the right types of equities. Key characteristics include a substantial competitive advantage, solid balance sheets (low or no debt) and strong, consistent dividend growth potential. Specifically, we are big fans of oligopolies or companies with very high "barriers to entry." This means it is very hard to compete against them and thereby reduces the odds of being disrupted by emerging technologies, as well as destructive price wars among other nasty outcomes for shareholders. History has shown that such companies tend to generate outsized profits over a long period of time and they also act more defensively in tough environments such as the one we are going through right now. Examples of such companies include pipelines, railroads, credit card companies and some dominant technology companies who are leaders in their respective fields.

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

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