

# The Volatility Strikes Back

Stéphane Rochon, CFA, Equity Strategist  
Richard Belley, CFA, Fixed Income Strategist

Market volatility has picked up significantly over the last week based on two related factors: (1) the continuing slowdown in global economic growth; and (2) relentlessly lower interest rates. In particular, the brief inversion of the U.S. 10-year / 2-year yield curve (when long-term rates are lower than short-term rates) was clearly the catalyst for the broad equity selloff experienced on Wednesday, August 14. Still, to be fair, overall market returns are more than adequate year to date in North America, with the S&P 500 up 13%, and the consistently lagging S&P/TSX up a respectable 12%. However, the important point is not to look in the rear view mirror, but to try to determine where we go from here. While we don't pretend to have a crystal ball, our objective in this short missive is to frame the risk/reward for bonds and equities for the balance of 2019.

It is true that an inverted yield curve has historically been an ominous sign of a recession, but we remind our readers that the yield curve in isolation is not a perfect predictor. In fact, a negative yield curve did not lead to recessions in the mid-60s, mid-80s and mid-90s. And, importantly, on the several occasions where this was a valid signal, recessions tended to follow 12-24 months later, which means that the stock market typically rose for the next few quarters, even after the inversion. With over 46%<sup>1</sup> of the global bond market, including corporate bonds (ex Canada/U.S.) trading with negative interest rates (a situation that would have been unthinkable just a few years ago), we believe that part of the current downdraft in North American interest rates is being driven by demand for our bonds from overseas, as opposed to the bond market warning of an imminent economic collapse.

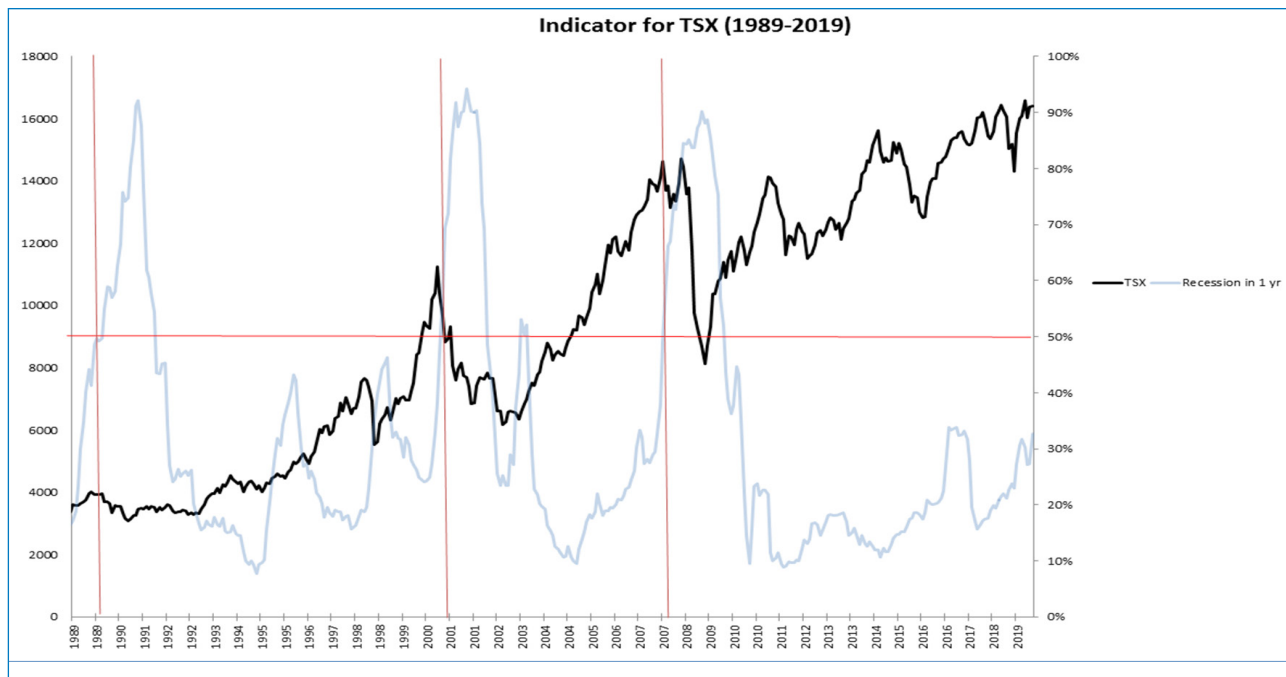
It is also true that growth has slowed since the start of the year, a phenomenon exacerbated by Trump's instigated trade wars (at least the White House announced they will delay imposing additional tariffs on a number of imported consumer goods from China until December). Among very large economies, the ones most reliant on manufacturing/exports have been hit disproportionately with Germany and the UK at the forefront of the slowdown. In the case of Britain, a no-deal Brexit would amplify economic pain given the tight integration of supply chains with Continental Europe. So yes, there are a number of risks on the economic and investment landscape, but risks will always exist.

This is why it's so important to keep things in perspective. The silver lining is that lower interest rates – and by extension mortgage rates – are highly supportive for the huge real estate market and consumers. Also, since the present value of future corporate cash flows goes up with consistently lower rates, the relative value of high quality dividend-paying stocks has further improved relative to bonds. The BMO Economics team still forecasts approximately 3% global GDP growth in 2019 and 2020, with China and the U.S. offsetting continued weakness in the Eurozone. These numbers are largely consistent with the conclusion of our BMO Private Client Recession Probability Model. This model shows a relatively low 30% probability for a North American recession in the next year given the strength in employment which supports the consumer economy (far larger than manufacturing). In other words, the odds of a severe economic contraction and associated bear market in stocks have not materially increased since we introduced the Model in May of this year.

<sup>1</sup>Source: Bloomberg/Barclays Global Aggregate Bond Index ex Canada/U.S.

Our Model has provided an important warning on every upcoming U.S. recession (and, by extension, most Canadian recessions) since 1950, with a lead of two to three quarters. This is important because the market is a leading indicator and discounts improving and worsening business cycles in advance. Remember, it is when our one year probability rises above 50% that we get a powerful “risk off” signal that argues in favour of lowering the equity allocation of portfolios. As the chart below shows, since the late 1980s, the S&P/TSX Composite Index started steep declines almost exactly when the Model’s probability hit 50%. Clearly, we will be keeping a very close watch on this level as we progress through 2019 and 2020.

We strongly recommend against overreacting to the current bout of volatility. The key is to maintain a well diversified portfolio including bonds, cash and high quality stocks. Of course, since market turbulence could continue for a while longer, the key is to hold on and accumulate the right types of equities. Key characteristics include very high barriers to entry (a competitive advantage), strong balance sheets (low or no debt), and strong consistent dividend growth potential. 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.



Source: BMO Nesbitt Burns Private Client Strategy



As a reminder, it is always important to maintain a long-term perspective on your investment strategy. Please contact your BMO financial professional if you would like to discuss your investment portfolio.



### General Disclosure

The information and opinions in this report were prepared by BMO Nesbitt Burns Inc. Portfolio Advisory Team ("BMO Nesbitt Burns"). This publication is protected by copyright laws. Views or opinions expressed herein may differ from the views and opinions expressed by BMO Capital Markets' Research Department. No part of this publication or its contents may be copied, downloaded, stored in a retrieval system, further transmitted, or otherwise reproduced, stored, disseminated, transferred or used, in any form or by any means by any third parties, except with the prior written permission of BMO Nesbitt Burns. Any further disclosure or use, distribution, dissemination or copying of this publication, message or any attachment is strictly prohibited. If you have received this report in error, please notify the sender immediately and delete or destroy this report without reading, copying or forwarding. The opinions, estimates and projections contained in this report are those of BMO Nesbitt Burns as of the date of this report and are subject to change without notice. BMO Nesbitt Burns endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Nesbitt Burns makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Nesbitt Burns or its affiliates that is not reflected in this report. This report is not to be construed as an offer to sell or solicitation of an offer to buy or sell any security. BMO Nesbitt Burns or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Nesbitt Burns, its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. BMO Nesbitt Burns or its affiliates may act as financial advisor and/or underwriter for the issuers mentioned herein and may receive remuneration for same. Bank of Montreal or its affiliates ("BMO") has lending arrangements with, or provides other remunerated services to, many issuers covered by BMO Nesbitt Burns' Portfolio Advisory Team. A significant lending relationship may exist between BMO and certain of the issuers mentioned herein. BMO Nesbitt Burns Inc. is a wholly owned subsidiary of Bank of Montreal. Dissemination of Reports: BMO Nesbitt Burns Portfolio Advisory Team's reports are made widely available at the same time to all BMO Nesbitt Burns investment advisors. Additional Matters TO U.S. RESIDENTS: Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. ("BMO CM") and/or BMO Nesbitt Burns Securities Ltd. ("BMO NBSL") TO U.K. RESIDENTS: The contents hereof are intended solely for the use of, and may only be issued or passed onto, persons described in part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001. BMO Wealth Management is the brand name for a business group consisting of Bank of Montreal and certain of its affiliates, including BMO Nesbitt Burns Inc., in providing wealth management products and services.

BMO Nesbitt Burns Inc. is a Member-Canadian Investor Protection Fund. Member of the Investment Industry Regulatory Organization of Canada.

BMO CM and BMO NBSL are Members of SIPC. © BMO and the roundel symbol are registered trade-marks of Bank of Montreal, used under license. © "Nesbitt Burns" is a registered trade-mark of BMO Nesbitt Burns Inc. If you are already a client of BMO Nesbitt Burns, please contact your Investment Advisor for more information.