February 24, 2021

Canadian Strategy Snapshot

Rising Interest Rates and the TSX

Bottom Line

Given the traditionally yield-centric nature of the Canadian stock market, many investors are becoming increasingly concerned about the recent rise in US and Canadian interest rates. While the higher yielding sectors do tend to underperform during periods of rising rates, our work shows that higher US interest rates are not an impediment to broader TSX performance. In fact, we found that some of the strongest periods of S&P/TSX performance have coincided with rising interest rates over the past few decades, especially when rates increase from below-average levels. Thus, while the broad market is likely to continue to rally as interest rates rise, there are potential areas where caution is warranted. As such, we believe it is important for investors to maintain an active approach when making decisions with a focus on more cyclical areas that will benefit from an improving economy.

Overview:

- Cyclically Rising Interest Rates Are Positive for the Broad Market
  - ✓ Increasing US interest rates traditionally have benefited Canadian stocks with the S&P/TSX posting double-digit returns on average during periods of escalating US rates.
  - ✓ Furthermore, the TSX performs even better when interest rates are rising from trough levels and still below the 3-year average.
- Caution Is Warranted Within the Higher Yield Sectors
  - ✓ As one would expect, higher yielding ("bond proxy") sectors carry the most risk from a rising rate environment, with both Utilities and Communication Services significantly underperforming through periods of rising interest rates.

Please refer to pages 5 to 7 for Important Disclosures, including Analyst's Certification.

BMO Capital Markets

Investment Strategy

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CDN Strategy – S&P/TSX Targets

S&P/TSX Price Target	
2021 Calendar Year End	19,500
S&P/TSX EPS Target	
2021 Calendar Year End	$1100

Source: BMO Capital Markets Investment Strategy.

CDN Strategy – Recommended S&P/TSX Sector Weightings

Sector	Opinion	Tgt. Wgt.
Communication Services	MW	5.0%
Consumer Discretionary	OW	5.0%
Consumer Staples	MW	4.0%
Energy	MW	11.0%
Financials	OW	31.0%
Health Care	MW	1.5%
Industrials	OW	13.5%
Information Technology	MW	9.5%
Materials	OW	14.5%
Real Estate	UW	3.0%
Utilities	UW	2.0%

Source: BMO Capital Markets Investment Strategy.
OW: Overweight
MW: Market Weight
UW: Underweight

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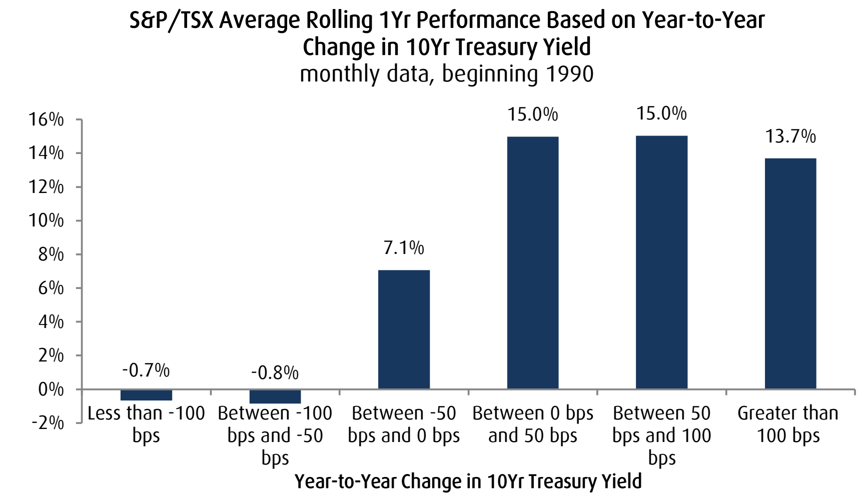
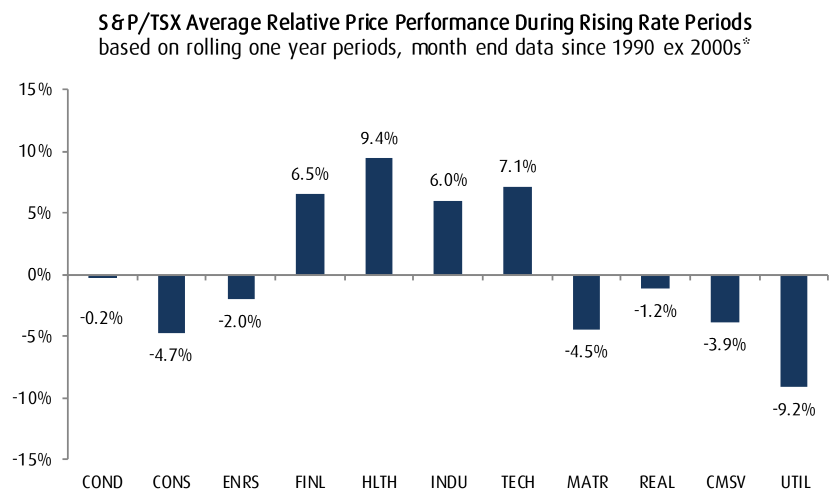
Cyclically Rising Interest Rates Are Positive for the Broad Market

S&P/TSX Price Performance Based on US Interest Rate Direction



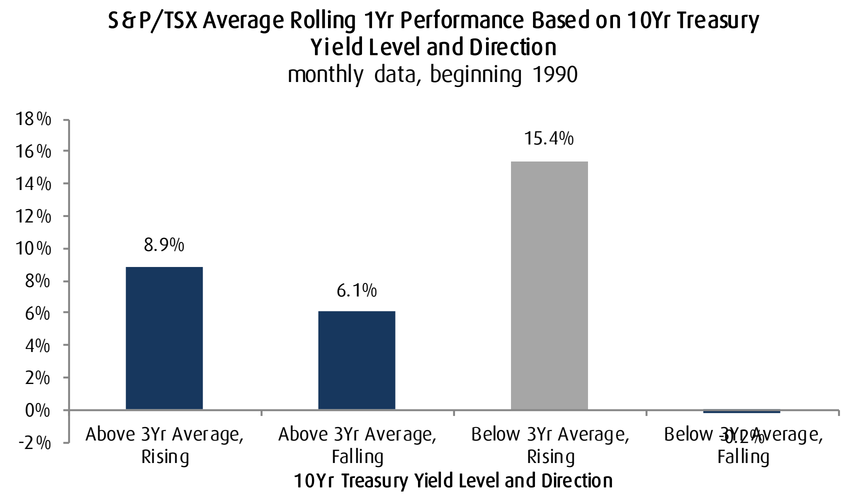
Source: BMO Capital Markets Investment Strategy Group, Haver, FRB.

Cyclicals Outperform and Bond Proxies Underperform during Periods of Rising Rates



Source: BMO Capital Markets Investment Strategy Group, FactSet, Haver, FRB. *excludes 1998-2000 periods due to distortions in Communication Services.

S&P/TSX Posts Best Returns Early in the Rising Rate Cycle



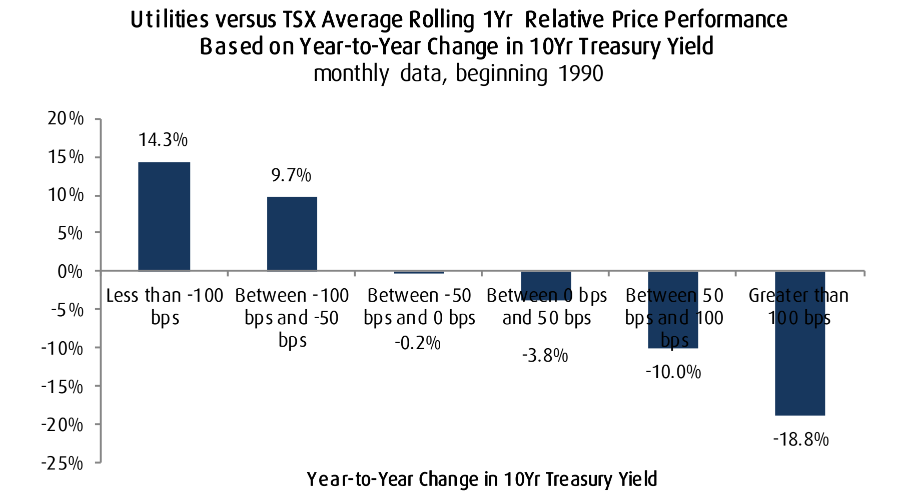
Source: BMO Capital Markets Investment Strategy Group, FactSet, Haver, FRB.

While structurally higher rates may imply a lower earnings multiple, cyclically rising rates are indicative of an improving economy and earnings growth, which are strong positives for stocks. Indeed, our work shows periods of rising US interest rates traditionally have benefited Canadian stocks with the S&P/TSX posting double-digit returns on average during these periods. This is in direct contrast to the average negative returns experienced when interest rates are declining. Furthermore, the bulk of this strength occurs early in the cycle, when US interest rates are rising but still below the 3-year average.

- While the TSX does post its best performance when interest rates are rising but still below the 3-year average, this momentum is still relatively strong even after interest rates rise above the 3-year average.
- A moderate 0 to 100bps rise in interest rates has traditionally been the goldilocks period for Canadian equities.
- However, as one would expect, higher yielding ("bond proxy") sectors carry the most risk from a rising rate environment, with both Utilities and Communication Services significantly underperforming through periods of rising interest rates.

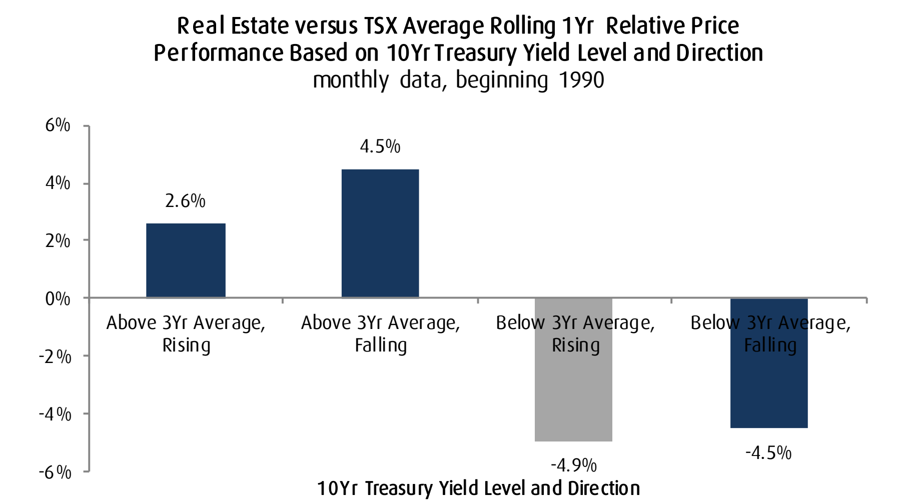
Caution Is Warranted Within the Higher Yield Sectors

Utilities Are the Most Rate Sensitive



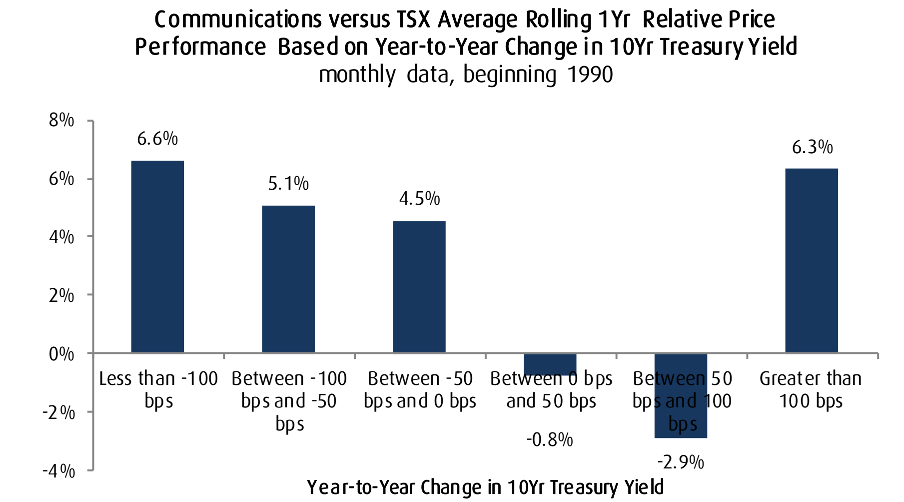
Source: BMO Capital Markets Investment Strategy Group, Haver, FRB, S&P, FactSet.

Real Estate Underperforms in Early Part of Rising Rate Environments.



Source: BMO Capital Markets Investment Strategy Group, Haver, FRB, S&P, FactSet.

Communication Services Underperformance Occurs as Rates Grind Higher



Source: BMO Capital Markets Investment Strategy Group, Haver, FRB, S&P, FactSet.

According to our work, the Utilities sector remains the most rate sensitive of the sectors, underperforming by over 9% on average through rising rate cycles since 1990. Our work shows the faster the rise in interest rates, the greater the level of underperformance, and the sharper the decline in interest rates, the greater the outperformance. This is one of the primary reasons we remain cautious on the Utilities sector.

Communication Services also shows rate sensitivity akin to Utilities, underperforming by over 3% on average through rising rate cycles. However, the pattern is not as consistent with the sector underperforming only when rates are rising moderately. Furthermore, unlike Utilities, the sector underperformed sharply in 2020 as interest rates declined, suggesting to us that the sector may be less rate sensitive this cycle as earnings and revenue recover from the impact of lockdowns. As such, we remain market weight the Communication Services sector despite “bond proxy” risks from rising interest rates.

Unlike Utilities and Communication Services, Real Estate has shown more mixed returns through interest rate cycles. However, on closer inspection, the Real Estate sector traditionally underperforms when the level of US interest rates is below the 3-year average. As such, we believe rising interest rates likely pose a challenge for Real Estate in the early part of the cycle while interest rates remain below the 3-year average.

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11/19/2020	Canadian Strategy Snapshot: 2021 Year Ahead – Canadian Market Outlook
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9/24/2020	Canadian Strategy Snapshot: Need Yield? Try Communication Services
9/17/2020	Canadian Strategy Snapshot: Select TSX Outlier Trends of 2020
9/10/2020	Canadian Strategy Snapshot: Key Canadian Sector Changes and Positioning
	Monthly Reports
2/4/2021	Canadian Strategy: Canadian Chartbook – February 2021
2/4/2021	Canadian Strategy: Canadian Factor Profiles – February 2021
	Podcasts
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Buy	Outperform	50.1 %	25.5 %	50.4 %	51.8 %	55.7 %	57.7%
Hold	Market Perform	47.4 %	24.9 %	46.6 %	45.7 %	42.0 %	37.5%
Sell	Underperform	2.3 %	25.0 %	2.3 %	2.1 %	1.3 %	4.8%

* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.

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(April 2013 - October 2016)
http://researchglobal.bmocapitalmarkets.com/documents/2013/rating_key_2013_to_2016.pdf

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