Equity and Fixed Income Strategy

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Inflation, Slowing Economy and Flattening Yield Curve — Focus on Defensive and Commodity Stocks

We have often said that official Gross Domestic Product data is akin to ancient history in market terms. Still, we were taken aback when the U.S. contracted in the first quarter with Real GDP declining 1.4%. As the BMO Economics team put it: "The economy is still showing some resilience, but the Q1 report signals the start of more moderate growth this year and next, largely in response to higher interest rates. Despite the contraction, the Fed has little choice but to hike aggressively in May to corral inflation."

While the U.S. market and, in particular, high multiple tech stocks are being badly oversold —which can lead to powerful temporary rallies— we continue to think the spectre of inflation and higher interest rates will be powerful headwinds weighing on potential asset returns for some time.

It is clear that we are in a flat (and flattening) yield curve environment, with a distinct possibility that it will become inverted given the newfound aggressiveness of the Federal Reserve and Bank of Canada, which will be raising short-term rates more quickly to fight inflation. While it is true that the S&P 500 and S&P/TSX have done better during cycles when the yield curve is steepening, some sectors have actually generated attractive returns even in a flattening environment, such as the current one.

Those sectors; however, tend to be either defensive and less economically sensitive, like Consumer Products, Healthcare, Utilities, etc., or commodity related when inflation is problematic.

This development, combined with peaking economic —and corporate earnings— momentum, reinforces our call that investors should get more defensive in their asset and sector allocations.

At the start of April, we reduced our U.S. equity allocation by 5% for the first time in a decade and put that into cash. We see room for the S&P/TSX to continue outperforming since the Canadian market composition is well suited to withstand inflation (we have a far higher proportion of Energy and Basic Material stocks), and our market still trades at an attractive discount to the S&P 500.

At a more micro level, we continue to emphasize quality companies with sufficient growth and pricing power to offset the toxic impact of inflation. As we have noted, valuations are becoming increasingly important in this environment, so we strongly urge investors not to overpay for stocks (i.e., there are still many U.S. technology stocks which we consider overvalued despite significant declines).

U.S. Economic Momentum Has Likely Peaked — Important Sector Implications

It is becoming clearer that economic momentum has peaked. Economic activity is still robust, but the best days of the post-COVID rebound are behind us. Investors have to be far more selective in this environment to make money in the market. We are not calling for a recession in 2023, but the odds have increased considerably.

The Shape of the Yield Curve and Sector Performance

Investors should pay heed to the shape of the yield curve since it vastly increases the probability of getting stocks right over a multi-year time frame.

The market does best when the yield curve is steeper, with cyclicals being the predominately top performing sector. When the yield curve is flat, the market tends to be as well, with both cyclicals and defensive stocks performing best. When the yield curve is inverted the market tends to struggle, with the top performing sectors being all defensive.

Our conclusions are to focus on traditionally defensive sectors such as REITs, utilities, food and beverage, pharmaceuticals and medical equipment.

Specifically, we believe there are a number of stocks in those areas that could outperform, such as CAP REIT, Altagas, Boralex, Coca-Cola, Procter & Gamble, Wal-Mart and Pfizer, for example.

We Continue to Favour Commodities Over U.S. Stocks Right Now

U.S. stocks remain expensive right now given very worrisome inflation trends which are accelerating interest rate increases.

Conversely, commodities are well supported, not only technically but also because of the Russian aggression and the still very low valuation and capital return potential for many companies in the energy, agriculture and metals spaces.

The Technical Picture — Russ Visch, CMT Technical Analyst

We are now 25 months into the cyclical bull market as measured from the March 2020 low. Looking back over the past 70+ years of history for the S&P 500, a cyclical bull market has lasted an average of 30 months, when the index is trading within a bigger, secular, bullish uptrend, such as we are now.

History tells us we are in the late innings of this current cycle, and there is plenty of evidence of this in sector performance in recent weeks. Specifically, we are starting to see sectors that are more traditionally defensive in nature starting to outperform.

Don’t Look Yet, But Fixed Income Markets Are Becoming More Attractive, At Least Relatively Speaking

In a world of price inflation at a decade’s high (6.7% Canada, 8.5% U.S.), one can hardly say that 3% to 4% bond yields, on average, are attractive, especially not on a real return basis (net of inflation). With limited signs of inflation peaking just yet, and central banks definitively on an aggressive tightening path to fight it, why would bonds become a valuable option now?

We admit that some uncertainties continue to weigh against adding fixed income investments or lengthening portfolio maturities. On top of price and wage pressures, the persistent Russia-Ukraine conflict, Covid’s sixth wave and the risk of central banks surprising markets beyond current expectations, could still lead interest rates higher.

We are now seeing some silver linings for bond investments, including: 1) significant monetary policy tightening already priced in; 2) multiple months of coupon income still to earn this year; and 3) more attractive reinvestment rates. We can add to the list the lower interest rate sensitivity of bonds in general as well as the higher yields compared to four months ago which provides additional protection in case interest rates continue to rise in the near term.

The perfect storm of rising rates and widening credit spreads have resulted in the yields of most fixed income sectors becoming more attractive than equities. For corporate bonds, these are the highest yields since the financial crisis.

While inflation and bond rates may not have yet peaked, we believe investors are better positioned today to mitigate that risk. It may not yet be the time to significantly increase fixed income allocation, but it is certainly not the time to reduce and/or liquidate holdings either.

As with any repositioning strategy it is important to start early, in order to not only increase overall yield, but explore opportunities to become more tax efficient.

Please contact your BMO financial professional if you have any questions or would like to discuss your investments.

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