Monthly Market Commentary

Equity Strategy

Still bullish, but beware of high duration stocks when rates really start to rise

The BMO Nesbitt Burns Portfolio Advisory Team remains bullish on stocks, and maintains the overweight stance on equities that they have held for the last 6+ years. The reason for this is that economic and earnings momentum remain very strong. Corporate profitability in the U.S. is rising at the fastest rate since 2010, primarily because of continuing strong economic momentum and the U.S. corporate tax cuts that were enacted at the beginning of the year. In Canada, continued strength in the Financials Sector and the rebound in oil prices have been a helpful tailwind.

That being said, the team does recommend a more selective approach to sectors and stocks, given that we are later in the cycle and inflationary pressures are building.

The drivers of stock returns

While multiple expansion[1] was the key driver of market returns up to the beginning of 2018, the baton has been passed to earnings growth. So far this earnings season, profit growth is approximately 20%, the highest level since 2010. Furthermore, forward-looking guidance is very strong. Looking at the market's valuation, its price earnings ("P/E") valuation expanded from just under 12x in 2011, all the way to a little more than 19x at the beginning of 2018. The multiple then compressed in February 2018, leading to a pronounced pullback in stocks. The team believes inflation fears drove this compression, since a surge in inflation has been associated with lower valuation multiples for decades.

Inflation fears and long-term interest rates

Wage inflation, partly offset by productivity growth, is one culprit for inflation fears. Another is Trump's trade policies. Higher inflation leads to higher rates, and with U.S. 10-year rates flirting with the 3% level, pundits are pondering whether we are on the cusp of seeing a more sustainable move higher. When rates do move up, it will require an important shift in the way investors manage portfolios and risk. The team's 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 high single-digit range (the S&P has historically struggled once the 10-year rate goes above the 6-8% level). Rising interest rates 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, Telecommunication Services 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. Perhaps less well understood is the impact to "high duration stocks." In simple terms, these are typically very high multiple stocks where the bulk of the value comes from expected future growth in cash flows. As interest rates go up, that reduces the present value, implying significant downside risk for some stocks that trade at very high multiples.

BMO Risk Appetite Index: Continues to move up

Looking at the Portfolio Advisory Team's proprietary BMO North American Risk Appetite Index (introduced last year), the continued earnings-led recovery in stocks has helped risk appetite rise for the last three months. While we are above average at this point, we are still a long way from a more dangerous "euphoria zone," which has historically been followed by sharp pullbacks.

[1] A valuation multiple is simply a ratio of the market value of a stock or the market relative to a key metric. While imperfect (the BMO Nesbitt Burns Portfolio Advisory Team prefers using free cash flow), in stock trading, one of the most widely used multiples is the price-earnings ratio ("P/E ratio"). The price/earnings ratio is the ratio of a company's stock price (or the market level) to the company's earnings per share (or the market's overall earnings). The higher the ratio, the more expensive are stocks, and vice-versa.

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Fixed Income Strategy

Stronger growth, rising inflation should lead to higher rates...gradually

Only weeks ago, the team was questioning whether Bank of Canada ("BoC") Governor Stephen Poloz had convincing arguments to raise rates in July. The free trade agreement negotiation was cited ad nauseam as a major risk to growth. Fast forward to today, and the economic data from May and early June is painting a very different picture that supports tighter monetary policy in Canada.

Inflation has been rising, supporting higher interest rates. As a result, Canada short-term real rates (nominal rates stripped of the inflation component) have remained in negative territory. This is still a very stimulative environment considering the strength of the economy, and supporting the notion that the BoC's re-normalization work is not over. But this begs the question as to why rates still do not reflect the general positive tone about the economy and the bullish equity narrative?

The BoC's gradual approach to its monetary policy adjustments help explain short-term negative real rates as the central bank tries to slow the ascent and limit negative impact. However, the Bank's actions have had less of an impact on long-term rates which remain low by historical standards. Yields did rise since the BoC began tightening, but not as much or as fast as initially anticipated.

There have been numerous forecasts for higher rates, but with the exception of short-term rates, they have yet to materialize. From a fundamental perspective, rates should be higher, but it's important to realize that today's market environment is different than the past and many new domestic and global factors are now more predominant in explaining the current state of interest rate markets. Central banks bear a lot of the responsibility for the persistent low rates. Over the last 10 years, major central banks have provided extraordinary monetary stimulus, which will still take years to remove from our economies.

So, while some remain puzzled as to the muted response to better economic fundamentals, today's environment of active central banks, demographics, globalization and increased market correlation is likely distorting traditional forecasting of interest rates. The economy is stronger and inflation is rising; both of which should lead to higher rates gradually, at least short-term rates.

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Please contact your BMO Nesbitt Burns Investment Advisor if you have any questions or wish to discuss your investments.

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