Monthly Market Commentary

Equity Strategy

Echoes

Despite the S&P/TSX Composite's best start of the year since 1987 – which pushed the Index higher by 8.5%, compared to the 7.87% gain of the S&P 500 – the brutal end to 2018 remains an overhang on investor sentiment. And, since 2010, outperformance of the Canadian market, over the U.S., has only occurred once, in 2016. Further, in analyzing over 100 years of historical data, found that Canada only tends to outperform the U.S. market on the back of strong commodity pricing. Given the current favourable commodity environment, the Portfolio Advisory Team believes there is a good chance that Canada may break its losing streak in 2019.

Many investors currently underappreciate the potential of China's economic momentum. Several easing measures, that range from tax cuts and lower reserve requirements, to infrastructure, have been implemented since June 2018, which amount to a significant 3% of GDP. Given that these impact the economy with a lag, official data may be close to turning positive in the near future. China continues to be, by far, the most important driver of base metal prices, and also has a significant impact on oil prices. While it is difficult to predict the outcome of the trade discussions, the fact that these talks are being held at a high level is a positive. As such, the Portfolio Advisory Team's base case scenario is that a partial agreement will be reached, which could address key U.S. concerns on the trade deficit and intellectual property rights protection.

As the team has previously stated, copper prices and oil prices are most highly correlated to the performance of the S&P/TSX Composite Index, as well as the Canadian dollar. As a result, the recovery in oil, including Western Canada Select, and copper are encouraging. Furthermore, U.S. sanctions on Venezuela could further help oil sands producers, translating to strength in heavy oil pricing benchmarks at the U.S. Gulf Coast. Heavy oil producers in Canada, therefore, stand to benefit. BMO's commodity strategist, Colin Hamilton, also has a positive view on copper for 2019, given the expected improvement in Chinese growth, led by infrastructure spending.

Another corroborating piece of evidence is the strong performance of Emerging Markets, also closely correlated to Canadian market performance, with the Brazilian Bovespa at record highs.

Also very helpful for equity markets as a whole is U.S. Federal Reserve ("the Fed") Chairman Jerome Powell's increasingly dovish stance. The Bank of Canada ("BoC") is similarly expected to "follow the leader" and wait for the Fed to act first, increasing the Portfolio Advisory Team's confidence in a low rate environment that is supportive for economic activity.

In comparing the 2015 to 2016 progression in markets to the 2018 to 2019 period; we find that while the two time horizons are not a carbon copy, a continuation of 2016 trends would be very positive for Canada, energy and commodities.

Fixed Income Strategy

Patience

The importance of the Federal Reserve's role in global financial markets is demonstrated by the amount of scrutiny each official commentary and statement receives. And, January 2019 was no different, as the introduction of the term "patience" was interpreted by many investors as "pause," somewhat surprising markets. While there was no expectation of a rate hike in the January meeting, the Fed's sudden change of tone eliminated its strong tightening bias. Highlighting the rise in global economic and financial risks, the Fed said that it

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is prepared to modify balance sheet normalization, while also removing the reference for further gradual rate increases.

As a result, this patience provided further support for markets to remove any expectations of future rate hikes in 2019, helping drive bond yields lower. Interestingly, it led to markets now pricing in a rate cut as the next move by the Fed this year. While rising uncertainty justifies lower yields, the Portfolio Advisory Team believes that the market may be prematurely pricing in this rate cut by the Fed. The team does not argue against this possibility if the economic landscape deteriorates significantly, however, the team believes it's too early to confirm whether the Fed is done tightening. Interest rates may already have factored in a lot of potential negative outcomes, which should limit further declines in the short term. While the Portfolio Advisory Team's models indicate that the risk of a more pronounced deceleration of economic growth has risen, the U.S. economy remains on strong footing. So why pause now?

In the current environment, and in consideration of the Fed's willingness to shy away from forward guidance, it seems only routine that it would remove policy tightening from autopilot. This allows the central bank more time to assess domestic and global risks, as well as parse through incoming data that had been delayed because of the government shutdown. The team expects the near-term focus to be on risks to the U.S. economy, including the debt ceiling negotiations and the risk of another shutdown, the U.S./China trade spat, along with global economic slowdown, especially in Europe.

There is no doubt that consumer, corporate, and government debt levels remain elevated, and an uncertain political and financial landscape have increased the odds of a more pronounced economic slowdown. However, overall conditions would suggest that the economy may have a bit more room to grow, albeit at a slower pace, before the Federal Reserve could even contemplate cutting rates. It is too early to gauge the impact of the government shutdown, but economists at BMO anticipate U.S. GDP to decelerate to a more sustainable 2.4% rate, from 2.9% in 2018. Labour markets continue to be strong, with low unemployment and positive wage growth, which should help support expectations for inflation to remain around the Fed's target of 2%. When combining expectations for slower growth and low inflationary risks with the planned balance sheet reduction of $600 billion this year, a softer stance on policy may be warranted, but it hardly calls for rate cuts just yet. In fact, the Fed's promise to promote effectively the goals of maximum employment, stable prices, and long-term interest rates, supports a more patient Federal Reserve.

The Portfolio Advisory Team believes, however, that the current low interest rate level and tighter corporate spreads may offer limited upside potential in the short term. The team continues to advocate for selectiveness when adding corporate exposure, and favours a quality bias. The outlook for corporate credit remains positive, but given the expectation of an increase in issuances in the first quarter, better opportunities may lie ahead.

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

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