Portfolio Advisory Team

Monthly Market Commentary

Equity Strategy

Positive news from Minnesota, and trade disputes

In June, Enbridge (ENB-TSX) received approval from Minnesota regulators to build its replacement Line 3 pipeline, which is very positive news. Specific reasons why the BMO Nesbitt Burns Portfolio Advisory Team ("the team") sees an asymmetrical risk/reward for ENB at current levels are: 1) This positive decision removes a key headwind, which should encourage institutional investors to raise their weighting in the stock; 2) Energy prices continue to recover; 3) There is a great need for increased pipeline capacity across North America; 4) Improving execution and balance sheet; and, 5) A fully funded almost 6% dividend yield, which is expected to keep growing at about 10% annually, for the next several years.

The team's bullish stance on oil is supported by **Russ Visch**, Vice President, and the Portfolio Advisory Team's Technical Analyst, who has an upside target of US$81-$82 per barrel. A key problem for Western Canadian producers has been the stubbornly high difference between Western Canadian Select ("WCS") crude prices, and the broadly published West Texas Intermediate ("WTI") price. The fundamental issue is that there is not enough transportation capacity (pipelines and rails are the two key vectors) to bring all Canadian oil to U.S. refineries, which can then turn it into something useful, like gasoline or jet fuel. While the Line 3 decision is not enough to change market dynamics in the short-term, it is a step in the right direction.

The implications of a continued rally in commodities are profound for Canadian equities. The S&P/TSX Index has (badly) underperformed the U.S. market since the start of 2017, despite the strength in oil and other commodities, and a robust Canadian economy. The team sees this as a disconnect, since Canada typically does well later on in the cycle, particularly as inflationary pressures start building (due to the fact our market is highly levered to "real assets"). Further, the trade tariffs issue now appears further away from resolution. While the news continues to deteriorate, there isn't a full blown trade war, yet. Though this is a clear negative, the weight of the evidence still tilts toward an overweight position on equities being appropriate. The industries with tightly integrated supply chains within the North American Free Trade Agreement ("NAFTA") and China, along with big purchasers of products, which are subject to tariffs (i.e., steel, aluminum, agricultural products, etc.), are most at risk. Specifically, the auto industry (President Trump has threatened to impose 20%+ tariffs on the auto sector), tech hardware companies (especially semi-conductors), large industrial companies (i.e., Boeing, Caterpillar), and retailers (i.e., Walmart, discount retailers). As many economists have correctly pointed out, no one wins in a trade war. The silver lining is that the amount of overall tariffs remains quite small relative to the size of the global economy, meaning that the impact on growth and inflation (tariffs increase prices for consumers) should be limited in the near-term.

Fixed Income Strategy

Sentiment shift?

The Government of Canada 10-year yield is again flirting with the low 2% level. This is a significant shift in sentiment from a month ago, when fears of rising inflation and tighter monetary policy led the 10-year yield to a multi-year high, but also two-year yields to the highest since the financial crisis. This is providing a welcome boost to performance after a relatively difficult start to the year for fixed income investments. Weaker economic growth, trade war rhetoric and evidence of slower consumption, as indicated by the sharp slowdown in retail sales were mainly behind the most recent downtrend in rates – a trend that may persist.

However, this has yet to translate into a more dovish Bank of Canada ("BoC"), which stuck to its tightening path by raising rates in July. BoC Governor Stephen Poloz made it clear that an economy that grows moderately, and inflation around the target, does not need interest rates at crisis levels. The data may not be weak enough to justify a pause yet.

We have also seen interest rates on U.S. 10-year Treasuries moving lower. While nothing has materially changed, the outlook may be a bit cloudier, and this could explain why longer-term rates have failed to rise beyond the break above the proverbial 3.00% in the 10-year U.S. Treasury. In particular, the trade war that started with words and threats is now shifting to concrete actions. For the moment, the U.S. Federal Reserve ("the Fed") remains focused on the expected strong second quarter real gross domestic product ("GDP"), the tight labour market, and both CPI and Core CPI above the Fed's target. Nothing suggests that the Fed will back away from its gradual tightening after raising the Federal Funds rate in June. In fact, despite the rise in uncertainty, the Fed will likely retain a hawkish tone, as it needs to keep the economy from overheating.

In addition, the tariffs are not yet large enough to have a significant negative impact on the economy, and there is still time for President Trump to reverse course, as he has done more than once in his term. But considering that monetary policy will impact the economy with a lag, tighter financial conditions will likely risk hitting economic growth as the positive impact of the tax cuts stimulus fades away. This has not yet translated in downward revisions to U.S. GDP growth for the second half of the year, but it is certainly not as supportive to the rising interest rates story, and is leading the flattening trend of the yield curve.

The team has witnessed some signs of exhaustion in the narrowing trend in credit spreads that started back in 2016. Most noticeably, the lower-rated securities have not performed similarly to equity markets recently. The yield compensation for high yield debts was more limited in its trading range, and did not share similar optimism with small-cap stocks, weakening a normally high correlation relationship.

Global debt levels have significantly expanded since the financial crisis, and the U.S. is no exception; not only has government debt expanded with the rise in budget deficits, but corporate debt has also risen considerably over recent years.

In consideration of the tighter monetary policies and the risks to the economy, the Portfolio Advisory Team continues to recommend improving the credit quality in portfolios on both sides of the border. They also believe the best value can still be found in the three- to five-year investment grade corporate bond sector, where the steepness of the term yield curve offers the best yield compensation for term extension.

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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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