Monthly Market Commentary

Equity and Fixed Income Strategy

Equities still hold decent value despite yield curve and trade war risks

The BMO Nesbitt Burns Portfolio Advisory Team remains overweight equities for balanced portfolios; believing that over the next year the odds of a North American recession are still low, even after factoring in the trade war between the U.S. and China, and the inverted yield curve in Canada and the U.S. In order to diminish the influence of opinion and bias when determining an appropriate asset allocation, the team launched its proprietary Recession Probability Model. The Recession Probability Model shows an approximate 30% probability of a North American recession in the next year, which is relatively low by historical standards. Consequently, at this point, it would be premature for the team to lower its broad equity recommendation.

Relative value is the other major consideration when determining asset allocation. Stocks are more expensive than they were five years ago, but so are fixed income markets. The team believes that high quality, dividend growing stocks present far better relative value than government bonds. Case in point, more than a quarter of the global bond market still trades with a negative yield-to-maturity — meaning less-than-zero per cent interest rates, before accounting for inflation. North American yields remain positive, but the limited inflationary pressures have also contributed to the flattening of yield curves. If you combine the limited-term premium paid on longer-term bonds, with reduced compensation paid on corporate bonds, fixed income investments represent limited relative investment value.

That being said, the Portfolio Advisory Team has been adjusting the composition of their equity portfolio allocation. They are increasing the defensiveness of their recommended portfolios and focussing on companies with solid balance sheets, ample free cash flow generation, and strong competitive positions within their industries. At the beginning of May, the team increased exposure to companies with long duration assets and high dividend yields, given their view that interest rates will remain range bound (i.e., will not go up meaningfully) for the foreseeable future. This means that the present value of future cash flows from such assets should be well supported, and high dividend yields will be comparatively attractive in a market where Canadian 10-year government bonds yield less than 1.6%. At the same time, the Portfolio Advisory Team adjusted its sector exposure and reduced its weighting in Energy — a sector which could come under pressure as a result of trade tensions and generally slower global growth.

The team has also adjusted the composition of its bond portfolios to better reflect the rapidly declining yields and their concerns towards corporate credit spreads. While they have not changed their recommended fixed income allocation, they acknowledge that the economic and interest rate environment warrant a shift in portfolio composition and risk allocation. The team continues to recommend a focus on higher quality investments, and limiting exposure to corporate bond issuers with a credit rating of BBB or lower, including non-investment grade securities (i.e., Junk Bonds and Senior Loans). Credit spreads have been widening since April as trade negotiation deteriorate, and could lead to further weakness and underperformance for the sector in the near-term.

It is important to note, however, that an underweight allocation to fixed income should not be construed as a call to reduce interest rate sensitivity (portfolio duration), nor to increase the cash and cash equivalent allocation. Overreliance to short-term fixed income investments would be detrimental to portfolio performance. First, interest rates on cash remain low and unattractive. Second, trade uncertainties can negatively impact economic growth, leading interest rates even lower, especially longer-term rates. Third, the combination of sub-par economic growth and limited inflationary pressure supports Central Banks' neutral policies, but could also justify interest rates cuts. The risk is for rates to be lower in the next six to 12 months, which would greatly increase the portfolio reinvestment risk, hence

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supporting the team's call not to increase cash allocation and remain invested.

The inverted yield curve revisited

As noted in April's Monthly Market Commentary, a more defensive tilt also makes sense given the very flat/inverted yield curve. The Portfolio Advisory Team's key conclusions still hold: 1) the 10-year – 2-year curve (a preferred indicator) never inverted; 2) a flat-to-negative yield curve did not result in a recession in the mid-'60s, mid-'80s and mid-'90s; 3) on the several occasions where this was a valid signal, recessions tended to follow 12–24 months later, which means that the stock market typically rose for the next few quarters, even after the inversion; 4) interest rates normally trended lower in anticipation of further central bank stimulus; and 5) while the S&P and TSX have done better during cycles when the yield curve is steepening, some sectors have actually generated very attractive returns, even in a flattish environment.

Turning to the all-important and economically sensitive global banks, some analysts have noted that the banks' Credit Default Swaps ("CDS") have been widening.[1] While Canadian Bank CDS continue to be well behaved, if they continue to widen, stocks could face more pressure in the short-term. Given the uncertain macro environment, steadily declining interest rates, and relatively "tired" domestic banking trends, including growth in mortgages (i.e., growth clearly becoming harder to come by), the Portfolio Advisory Team would not be putting fresh money into banks at this point. This being said, it is premature to sound the alarm on this group, which has a great track record of shareholder value creation.

The Portfolio Advisory Team continues to be big fans of oligopolies or companies with very high "barriers to entry." This means it is very hard to compete against them, thereby reducing the odds of being disrupted by emerging technologies or destructive price wars. History has shown that such companies tend to generate outsized profits over a long period of time, and also act more defensively in tough environments. Examples of such companies include pipelines, railroads, stock exchanges, credit card companies, and dominant companies such as Amazon and Palo Alto Networks, who are leaders in their respective fields. The story is slightly different from a fixed income perspective. The limited debt offering from these oligopolies and their good credit quality, in general, has contributed to significantly reducing the yield compensation offered to investors; at current levels, the team prefers to focus on state, provincials and municipal issuers.

1 Credit Default Swaps are essentially insurance contracts, which pay off if the bonds default. When they widen, it is seen as a sign of stress in the credit market.

Donald J. Trump: A Closet Environmentalist?

Could Trump's trade war with China, and now Mexico, in fact be a masterplan to ween Americans from their overconsumption habits and reduce plastic use? It's not very likely. Still, the team is hard pressed to find any other positive from the situation. Trade wars are a lose/lose proposition, since they negatively impact economic growth and raise inflationary pressure (accelerating inflation is just about the worst thing for bond and stock returns). Most investors were expecting a positive resolution to the standoff, which did not happen when the U.S. President followed through on his threat to increase tariffs to 25% on $200 billion worth of Chinese imports. Predictably, China retaliated by imposing more sanctions of its own. We are now in a position where neither party wants to lose face, which reduces the odds of a rapid resolution to this conflict, in our view. Generally, companies with high sales exposure to China, or the ones which import a lot from the Middle Kingdom, will be most vulnerable (think of Boeing, Apple, Semi companies, and Retailers).

The silver lining is that according to BMO Economics, the global economy is still robust enough to take this hit without falling into recession, and inflationary pressures remain mild, so this is not as bad as it could have been in a weaker macro backdrop.

Given that the Portfolio Advisory Team believes interest rates will resume their rising trend (albeit slowly) over the next several years, they have updated their fair value estimates for the TSX and S&P to incorporate a higher 10-year bond risk free rate, now using 4% to be conservative. They have also updated the models with 2019 consensus earnings-per-share estimates, but used lower growth estimates for the next few years to incorporate the risk of an economic slowdown. The team's fair value estimates stay roughly even, as higher corporate profitability largely offsets the rise in interest rates.

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

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