Monthly Market Commentary

Equity Strategy

A trifecta of good news for Canada

The United States-Mexico-Canada Agreement ("USMCA") is a clear positive for Canada, as it removes a major overhang from the economy. This trade agreement gets rid of the uncertainty with our largest trading partner and, in particular, the threat of crippling auto tariffs, which could have had a materially negative impact on economic growth and jobs, with an outsized hit to Ontario.

The net result is that the BMO Nesbitt Burns Portfolio Advisory Team ("the team") thinks the conditions are right for a "catch up trade" for the Canadian market, which has underperformed the S&P 500 by approximately 13% (on a total return basis) in 2018. Canadian stocks are trading at an unusually big discount to their U.S. counterparts, meaning there is currently a relative value opportunity. Specifically, the TSX is trading at 14x the expected next 12-month profits, which corresponds to only 80% of the S&P 500 valuation. This is the biggest discount in over 10 years.

Inflation expectations are rising, leading to higher interest rates[1]

Inflation expectations are rising globally. This is not overly surprising, given we are now almost 10 years into the economic recovery that followed the financial crisis. President Trump's policies, which are inherently inflationary, exacerbate this trend. The Portfolio Advisory Team's research, looking back to the early 1960s, shows that a stable or declining consumer price index is very positive for stocks, and is associated with multiple expansion.[2] The team's work also shows that the stock market can tolerate higher inflation, up to about the 3% level, after which it becomes a significant headwind to performance.

While inflation trends and the associated interest rate increases are not overly alarming so far, this risk needs to be monitored. This issue is critical for investors, since U.S. 10-year Treasury yields are the foundation of all finance. Interest rates directly impact the price of bonds (higher rates mean lower bond prices, and the longer the maturity, the more pronounced the impact); interest rates also have a significant impact on equity sector valuations and performance. Typically, rising interest rates have a nefarious impact on the performance of defensive, lower growth sectors such as Utilities, Telecommunication Services, and Real Estate Investment Trusts ("REITs"). Ultimately, from an equity perspective, the best defense against higher rates is to build a diversified portfolio comprised of stocks with outsized dividend growth potential.

Fixed Income Strategy

Global monetary policies are becoming less accommodative

Finally, after testing the 3% level multiple times over the last year, the 10-year U.S. Treasury yield rose firmly above last May's peak of 3.11%, entering the fourth quarter at the highest level since 2011. This move pulled global rates higher, including the Canada 10-year yield. The question should not be about *why* it happened, but really *why now*?

This time around, we face the same questions, but the drivers seem to have changed. Despite the perception that the current economic cycle is maturing, there is no denying that the U.S. economy remains strong, led by a tight labour market and a strong service industry. This is enough to sustain economic growth, and continue to lead rates higher (net of inflation).

[1] Inflation trends directly impact the fixed income market, since bond investors demand higher rates to compensate them for the erosion of value from higher inflation (i.e., the present value of any investment is worth less in today's dollars in an inflationary environment).

[2] Since the present value of future corporate profits (or free cash flow) is worth more today in a low inflation environment. The BMO Nesbitt Burns Portfolio Advisory Team looked at the impact of inflation on stock returns going back to 1963. Ultimately, the team believes looking at the relationship between inflation and stock returns provides a timely gauge, since the consumer price index is, after all, one of the best leading indicators of interest rate increases. The conclusion from this work is that the market performs best when inflation is neither too high (i.e., above 4-5%), nor too low, which is where it currently resides.

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However, there is more to the story. First, the renewed free-trade agreement is removing a cloud of uncertainty that was hanging over markets and the economy, which should help business investment and overall growth in the second half of the year; and, it is also a definitive catalyst that will help lift real rates. Second, recent hawkish remarks from Jerome Powell, Chair of the U.S. Federal Reserve ("the Fed"), are supporting further rate increases. Lastly, the Fed is no longer alone in its tightening exercise, as other central banks are joining in the task of gradually removing excessive monetary stimulus, helping to push global rates higher, a trend that is likely to persist for the moment.

Market recap

Unfortunately, the interest rate movements have resulted in increased volatility and weak performance – fixed income portfolio returns have been on a rollercoaster so far this year, and the third quarter was no exception.

The Canadian and U.S. corporate bond markets have performed very well in the last couple of years, but credit spreads have failed to re-test their tightest levels of the last two years. This makes some sense for Canada, as the pace of economic growth has slowed down since 2017, reflecting higher business risk, but not for the U.S., where growth has improved. What may be limiting further spread improvement, beyond the fact they are already relatively tight, is that the general level of interest rates has also risen.

Worse, there is another trend that is becoming more concerning: the average quality deterioration of the corporate bond universe. We have not only seen significant growth in non-investment grade securities, like high yield (junk) bonds and senior loans, but also in the lower quality sector of the investment grade securities, such as those rated BBB.

The Portfolio Advisory Team may have been early in recommending a transition toward higher quality investment grade securities, given their outperformance this year, but they continue to believe the combination of tighter monetary policies, higher rates, rising funding costs, and a maturing economic cycle will reduce the return prospects for the corporate bond market. The team continues to advocate an overweight corporate allocation, but with two distinct tilts: they favour shorter-term exposure, and a focus on higher quality securities.

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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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