Monthly Market Commentary

Equity Strategy

Advantage U.S.A. (for now)

The BMO Nesbitt Burns Portfolio Advisory Team ("the team") believes their long-standing strategic overweight stance on U.S. stocks is still appropriate when looking at recent economic momentum data across the globe. It is a tale of two cities, with the U.S. continuing to see economic acceleration and most other markets slowing, particularly China. The team has been advocating that clients increase the quality of their portfolios by focusing on lowering cyclicality (recall that the U.S. has the most defensive stock market in the world), improving revenue visibility, and emphasizing dividend growth and rock solid balance sheets. While the team has been arguing that there might be a catch-up trade for the Canadian market, progress on the North American Free Trade Agreement ("NAFTA") renegotiations will have to happen first, so we are likely in a holding pattern until then. Also hurting the TSX and loonie is the aforementioned economic slowdown in China. Canada's high exposure to commodities makes our market and currency particularly sensitive to Chinese economic momentum. This has had a negative impact on the price of copper, which of course, is strongly related to the Canadian market given its economic sensitivity.

Also, the usual correlation between oil prices and the Canadian dollar has not worked this year. Even as West Texas Intermediate prices have increased, the loonie has weakened. This is mainly due to the high discount Western Canadian Select oil is suffering, the result of pipeline constraints to move it south.

U.S.A. economy still close to peak levels, unlike most other economies

BMO Economics writes that the U.S. Institute for Supply Management Manufacturing Index rose more than expected in August, up 3.2 points to 61.3 — the highest since May 2004. The headline increase is the third in the past four months, and was supported by gains in the five equally-weighted components. Real world commentary from the survey tells us that demand is still strong across most industries, and tariffs are not yet having a big negative impact, but they could compound the slowdown in the U.S. when it happens (and it is a matter of *when*, not *if*).

With consumer confidence this high, it's hard to bet against the U.S. stock market

U.S. consumer confidence just hit an 18-year high (supported by a hot jobs market), which is one of the key reasons stocks keep making new highs and that retail stocks are staging a comeback. In the U.S., consumer spending represents 70% of the US$20 trillion economy. In Canada – which is more dependent on exports – consumer spending is still a very significant 58% of our C$2 trillion economy. Despite the team's concerns on trade and the economic slowdown in China, a silver lining for Canada is that consumer confidence, while not quite as strong as in the U.S., is still in the upper range seen in the last decade.

Fixed Income Strategy

Staying the course

By the time this monthly market commentary is published, Canada and the U.S. may reach a trade agreement; but for the moment, trade uncertainty remains a primary focus for corporations and investors. This issue has also been identified by the Bank of Canada ("BoC") as a key economic risk, which likely weighed on its decision to leave the benchmark rate unchanged at 1.50% at its early September meeting.

The BoC's view has not changed yet; acknowledging the economy is growing close to, or at, capacity and higher inflation still supports further reduction in monetary stimulus. The possibility of speeding up policy tightening was discussed, but this could certainly not be considered in the absence of a trade deal.

On inflation, the spike in the July Canadian Consumer Price Index ("CPI") was attributed more to transitory factors, as it was primarily led by a 15% rise in gasoline and transportation costs. Looking at core CPI instead, which strips some of the noise created by the most volatile items, inflation remains within the BoC's target of 2%. Furthermore, the economy may be running closer to capacity, but overall economic growth has been decelerating since peaking in the first half of 2017. Finally, wage gains continued to slow after peaking around 4% in May, as the latest labor report showed the Canadian economy actually lost jobs on a net basis in the first eight months of 2018.

The bottom line is that the BoC is staying the course, and is committed to gradually raising rates, assuming the economic data is supportive. The BoC would need a compelling argument to deviate from that path. With the hope of a trade deal, the odds remain elevated for a rate hike in October, but this could change quickly.

This helps explain why the Government of Canada yield curve resumed its flattening trend in August, with the yield spread between two-year and 10-year terms narrowing further. From a domestic perspective, short-term yields are continuously adjusting to the expected tightening path, while the risk of slower growth and inflation, along with global uncertainties, is weighing on longer-term yields. In this environment, the BMO Nesbitt Burns Portfolio Advisory Team continues to believe that a mix of shorter-term (three-to-six years), quality investment grade corporate bonds and floating rate investments should be accretive to investment portfolio returns.

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

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