Monthly Market Commentary

Equity and Fixed Income Strategy

The BMO Nesbitt Burns Portfolio Advisory Team has made their first strategic asset allocation change since June 2017; decreasing the weighting in bonds by 5%, and increasing Canadian equities by this amount. The team believes the timing is right following the relentless decline in interest rates, which makes high quality, dividend growth equities much more attractive. In particular, the Canadian market offers better upside potential.

The confluence of risks, in particular the U.S.-China trade war and Brexit, have raised global uncertainty. As a result, many major central banks have turned dovish and eased monetary policies — pressuring rates lower in anticipation of slower economic growth. In addition, the trade war salvos in August helped fuel one of the biggest bond rallies since the 2008-09 financial crisis as yields resumed their downtrend. This further exacerbated the negative interest rate situation outside of North America, prompting investors to buy Canadian and U.S. bonds in their search for positive yield and safety.

Considering the significant decline in yields in a relatively short period of time, the Portfolio Advisory Team is concerned that current bond valuations have been primarily driven by global factors that do not reflect domestic fundamentals. Yields can certainly continue on this down path, but short-term gains may be limited in comparison to the strong year-to-date performance.

Increasing equity allocation

Looking at the current economic environment, clearly, accelerating growth would be better, but any improvement on the trade war front and additional stimulus from Europe, Japan and China should have a positive impact in the next few quarters. In July, the Portfolio Advisory Team increased their fair value estimates for the S&P 500 and TSX to 3,300 and 18,500 respectively — implying low double digit return potential in the U.S. and Canada based on the impact of lower for longer interest rates. Despite concerns over the economy, and slowing global growth the U.S. consumer (which accounts for two-thirds of GDP) remains resilient, led by low unemployment and healthy wage growth. The recent dip in stocks has done nothing to lower our confidence in that call.

The biggest purchase a consumer can make is a house, and with the 30-year mortgage rates in the U.S. falling to 3.60% (from 4.94% in November 2018), and only 29 basis points from all-time lows, this is going to be supportive for the consumer and the stock market longer-term, given housing's significant multiplier effect.

Put another way, the reduction in mortgage rates has improved housing affordability by over 10% in the U.S. and Canada since the start of the year. If we were truly on the edge of a recession, it is highly unlikely homebuilders would be making 52-week highs and outperforming the market.

With investors flocking to bond funds given worries about a recession, the massive fall in bond yields has made stocks look that much more attractive to investors who are looking to beat the lowered returns offered by bonds. Since 1990, on average, 17.5% of stocks carried dividend yields exceeding those of the U.S. 10-Year Treasury yield. Today, that number is closer to 60%, making stocks that much harder to ignore. It is important to recognize, that along with other central banks, the move by the U.S. Federal Reserve ("Fed") to cut interest rates could signal that interest rates will stay lower for much longer than anticipated. The undoing of interest rate hikes should be good for the market, and make investors more willing to pay for long-duration assets such as Utilities and Technology stocks, which have a negative correlation to long-term interest rates. The one exception would be banks, which make more money when the yield curve is steeper (meaning short-term rates are below long-term rates) and interest rates are generally higher (making earnings growth more constrained). Lower interest rates are particularly problematic for European Financials, where they are negative across the yield curve, and short-term rates are likely headed lower.

Unsurprisingly, the technical profile for banks is currently deteriorating. BMO technical analyst Russ Visch notes that: "The long-term trend for the Canadian Bank Index remains neutral, since it continues to trade within a sideways range in effect for nearly three years now. During that time we have seen a number of negative developments occur including a long-term trendline reversal, the 50-day moving average crossing below the 200-day moving average, followed by the 200-day moving average rolling over and going negative. This 'checklist' of developments typically only occurs as a security is transitioning from a bull market uptrend to a bear market downtrend. It's also important to note that the decade-long trend of outperformance in banks stocks was also broken earlier this year, which by itself suggests this is a sector that should be market weight at best in portfolios."

Reducing fixed income allocation

Negative interest rates are a relatively new concept, and it is difficult to fully comprehend and forecast the future consequences and risks of this central bank experiment. A short five years ago, the fixed income world had only seen a handful of negative interest rate brief occurrences in the early 1940s, and then again during, and after, the financial crisis. From being an exception, negative interest rates are becoming the norm in the Eurozone and Japan, with the government yields of a record 19 countries now in negative territory. It may be hard to believe that at the end of August, the highest yield in the developed-country government bond market was the U.S. Federal Reserve Funds Rate at 2.25%.

When compared to the global fixed income market, Canada and the U.S. offer some of the most generous yield curves of developed countries, and should continue to be attractive to global investors in search of positive yields and safety. Interest rate markets also benefited from a record shift in global bond funds net flows; after record outflows in Q4 2018 as interest rates peaked, global bond flows have seen net flows swing into record positive territory on a three-month rolling period basis.

While global growth has slowed, the Canadian and U.S. economies remain relatively strong. Still, expectations are for both the Fed and Bank of Canada to cut rates. With this additional stimulus, the Portfolio Advisory Team expects liquidity-driven demand to continue to be supportive of low interest rate and risky assets. However, the team believes that at this juncture, further rate cuts and stimulus will not help with the global growth issue, and central banks may become less aggressive with stimulus. Already, the Bank of Japan has announced a reduction of its bond purchases to mitigate the risk of pushing yields too low; and contrary to expectations, the European Central Bank may have limited appetite for another asset purchase program to help support growth.

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

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