Portfolio Management

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Equity and Fixed Income Strategy

COVID-19 Morphing into the Flu? Positive Implications for the Recovery Trade

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The omicron variant is now a household name all over the world only a few short months after having been discovered in South Africa. It is hard to see the positive in this outcome as many Canadian Provinces are once again shutting down gyms and restaurants. We do believe there is a silver lining however as Omicron is fast crowding out all other forms of the variant and appears to have milder health implications. The symptoms –at least for vaccinated individuals- are very much like the flu, fever and headache as opposed to much more serious respiratory issues. This has been widely reported in initial scientific studies but we can vouch for it empirically, based on our family's own experience with the nasty bug.

Our research partners at Cornerstone Macro in December hosted a call with noted Epidemiologist Glenn Grossman in which he made the bold prediction that Covid –as we've known it to date- could effectively be over in the Spring (in North America) and be replaced with something more akin to a common cold as opposed to a death virus. He noted that as variants develop, they appear to become more contagious but less severe. Omicron is a case in point as the virus is much more prevalent in the bronchus and much less prevalent in the lungs which is a critical distinction because impact in the lungs is far more dangerous (and can require ventilators in a hospital setting). The data so far appears to bear this out with hospitalization rates much lower for Omicron than previous strains. The other good news is that vaccine booster shots appear highly effective against this strain. If previous waves are indicative, once we are past the initial surge in Omicron infections, we could see a very sharp reduction in cases in the not too distant future. In fact, reports indicate that infections have peaked in South Africa and may have plateaued in London.

We believe the investment implications of this scenario are profound and likely quite positive, especially for so called "recovery stocks" which have been under pressure for months. By this we mean travel and hospitality related companies (i.e. Air Canada, McDonalds). More generally, we remain bullish on stocks, particularly in Canada which has a strong valuation advantage over the U.S. and a market composition that actually BENEFITs from inflation. We expect consumers to remain strong (see comments below on the robust jobs market) and businesses to continue investing in technology, automation and to generally bolster their supply chains, which will help give more momentum to the rising capital expenditure cycle.

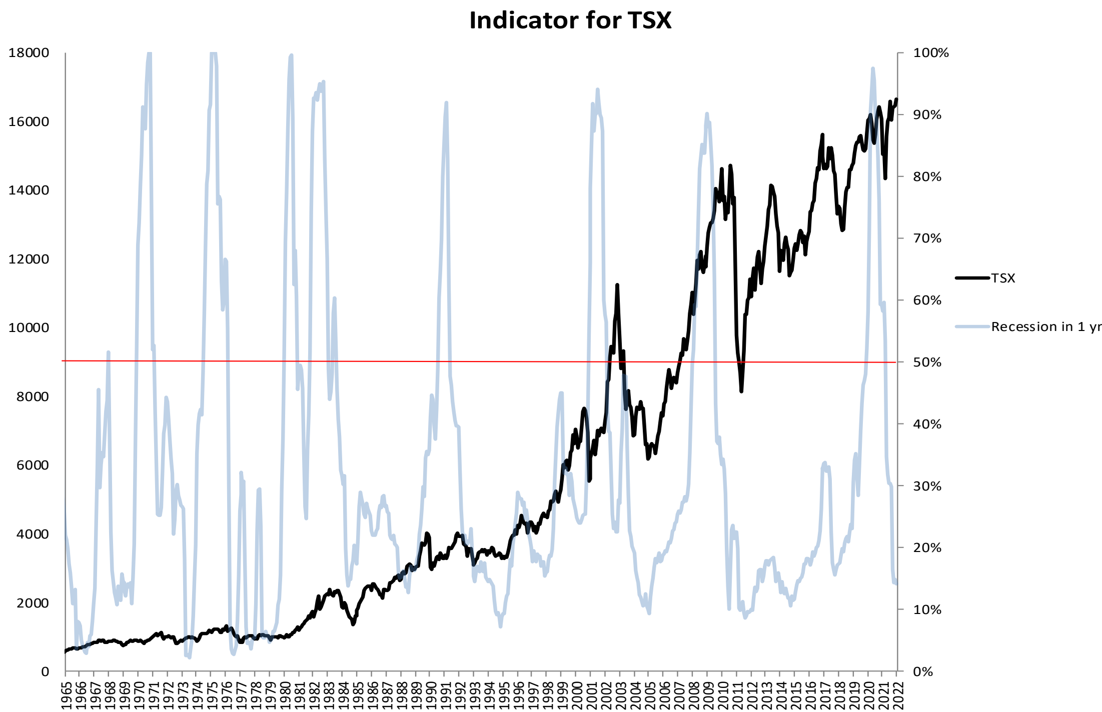
Taking a step back, our bullish call on equities is anchored by our still positive view of the economy. While it would be far too optimistic to expect a repeat of 2021's 20%+ stock returns, we believe we are transitioning into a continued –albeit slightly slower- economic recovery in 2022. Most importantly, our models show a very low probability of recession in North America. Specifically we get odds of 12% but adjusting for the most recent data and the bullish yield curve move we have seen so far this year, we believe the true probability is even lower and certainly below 10%.

Figure 1: Recommended Asset Allocation by Investor Type

	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	5	5	5	5	5	5	0	5
Fixed Income	65	70	35	45	15	25	0	0
Equity	30	25	60	50	80	70	100	95
Canadian Equity	20	15	30	25	40	35	45	40
U.S. Equity	10	5	25	15	25	20	35	30
EAFE Equity*	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

* Within EAFE, we specifically recommend Continental European equity.

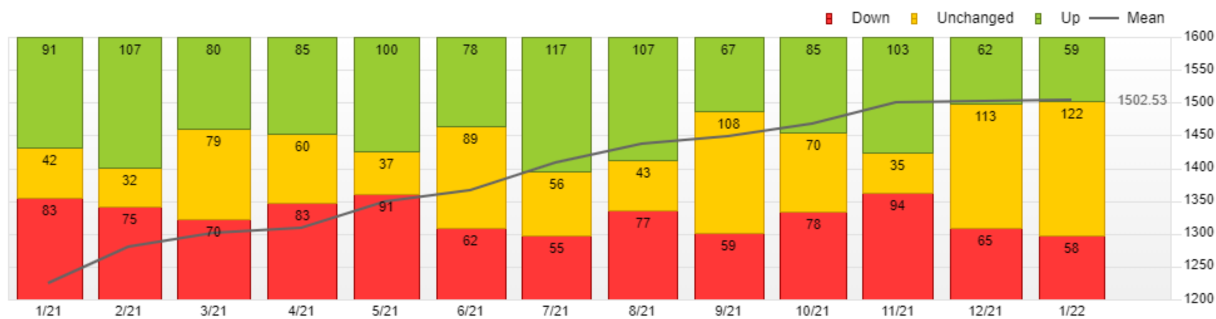
Figure 2: Probability of Recession for the Next Year (in Blue) vs. TSX (in Black)



Source: BMO Nesbitt Burns Private Wealth, FactSet, FRED, Bloomberg

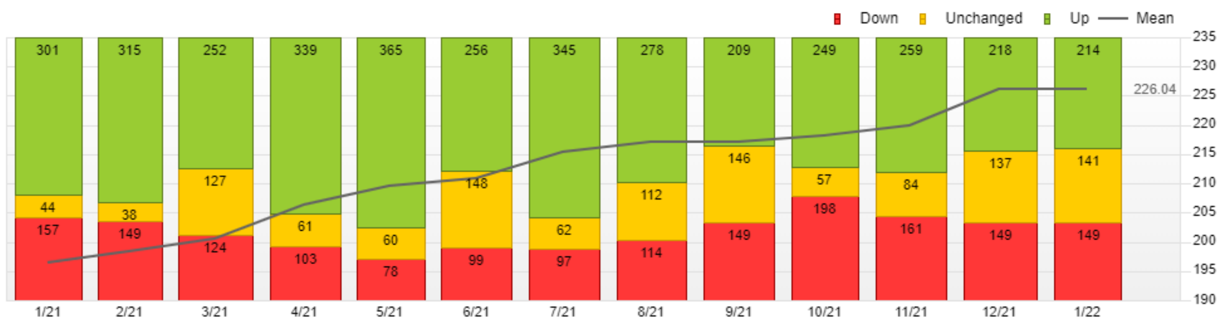
On a related note, corporate earnings estimates have increased relentlessly over the last year and recent public company quarterly reports support a continued upward trajectory, especially for energy, financial, consumer and industrial companies which happen to carry the biggest weight in the TSX Index.

Figure 3: S&P/TSX Composite Earnings Estimates



Source: FactSet

Figure 4: S&P 500 Earnings Estimates



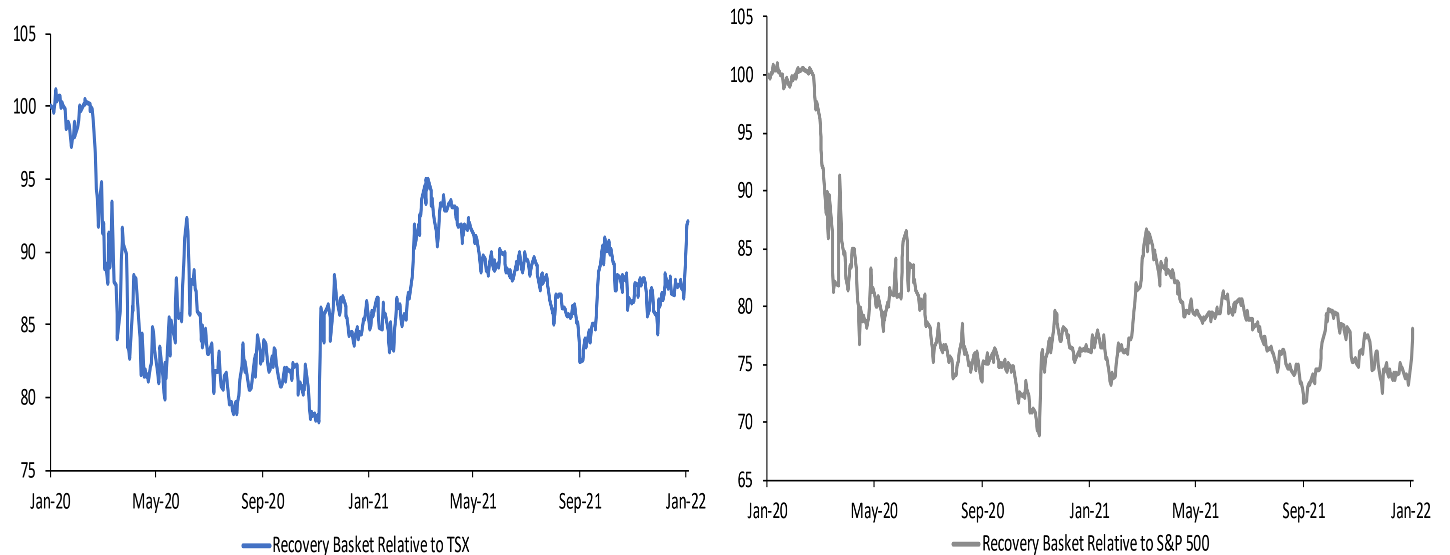
Source: FactSet

The charts below show that "COVID recovery stocks" are catching a bid as we enter 2022 after several months of performance stagnation against the TSX and S&P 500. We think there is considerably more to go and also included the 2 years relative performance chart to show just how significant the underperformance has been due to COVID and the kind of catch-up potential investors are playing for.

Figure 5: Recovery Basket[1] 1-Year Relative Performance vs TSX and S&P 500

Source: BMO Nesbitt Burns Private Wealth, FactSet

Figure 6: Recovery Basket[1] 2-Year Relative Performance vs TSX and S&P 500



Source: BMO Nesbitt Burns Private Wealth, FactSet

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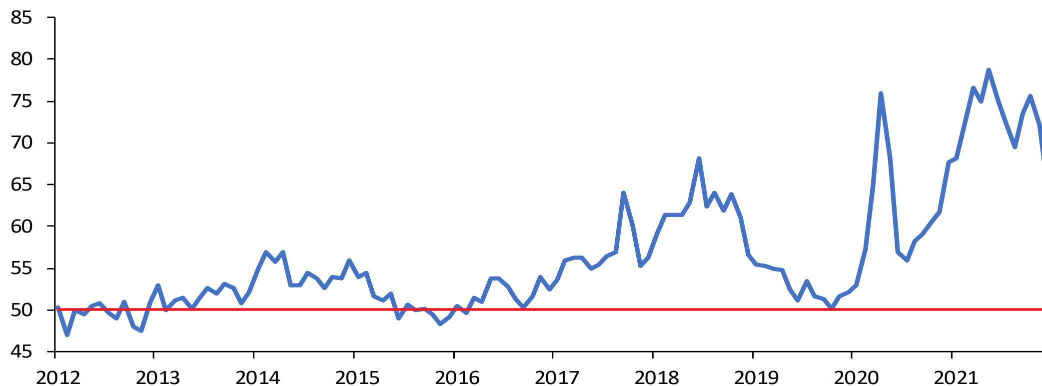
[1]Stocks in the basket include: CAE-TSE, AC-TSE, H-USA, MGM-USA, LVS-USA, MA-USA, AXP-USA, BAC-USA, RY-TSE, DAL-USA, SU-TSE, CNQ-TSE, COP-USA, QSR-TSE, PKI-TSE, DRI-USA, LNR-TSE, GM-USA, BA-USA, CGX-TSE

Just this week, the all-important U.S. ISM report (which is a real world gauge of economic activity) was released and it was unequivocally bullish. Most importantly, New Orders (the most forward looking of the sub-components and also the one most positively correlated to stock performance) stayed above 60 and Supplier Deliveries and Prices Paid continued to decline.

As noted by BMO Economics: Against a backdrop of sturdy demand, both supplier delivery delays and prices paid for materials took a big step down, suggesting capacity constraints started to ease at the end of 2021. And while Omicron will likely add to supply pressures over the next few months, factories are still expected to stay in expansionary mode, even as overall momentum slows. Some corporate anecdotes include: "Price increases appear to be slowing. Lead times are shrinking slowly, and inventories are growing." (Fabricated metals); "Overall performance by suppliers has improved. On-time deliveries have improved." (Machinery); and "Chemical supply chains are filling very slowly. Still not full, but (my) gut feeling says it’s getting easier to source chemical raw materials.” (Chemicals).

Figure 7: ISM Mfg: Supplier Deliveries Index

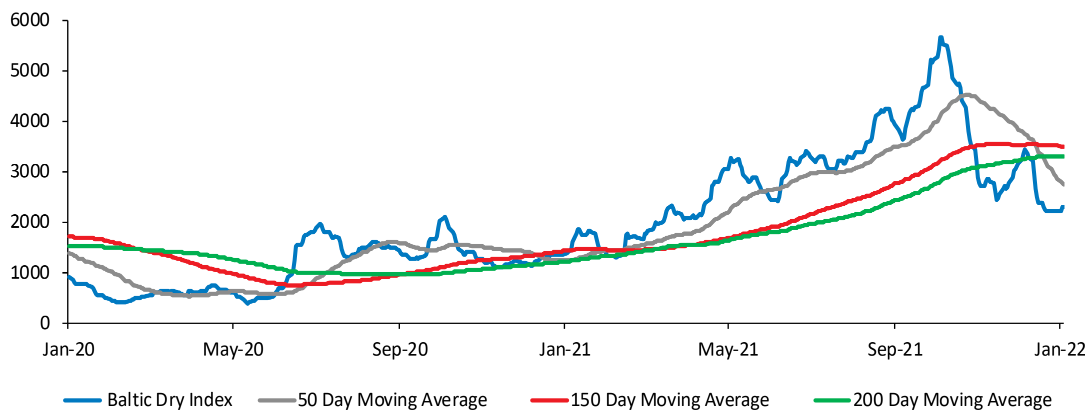


Source: ISM/Haver, Bloomberg

There was also relief on the labor front. What the ISM describes as an "overwhelming majority of panelists" who are hiring (or trying to), 37% say that workers are harder to come by, which is fewer than November. So people are coming back.... because they want to, or because they have to. Regardless, they're coming back. The private sector increased hiring (in all major industries except manufacturing, oddly), as did the government. The quits rate in the private sector jumped 0.3 ppts to 3.4%, suggesting more confidence to leave one's job for another. This data is highly supportive for consumer spending and the housing market at least for the next few quarters in our view.

Backing up the supply chain improvement narrative is the sharp decline we have seen since last October in the Baltic Dry Index[2] which provides a benchmark for the price of moving major raw materials by sea. The index has come down more than 60% and now sits close to its historical average.

Figure 8: Baltic Dry Index

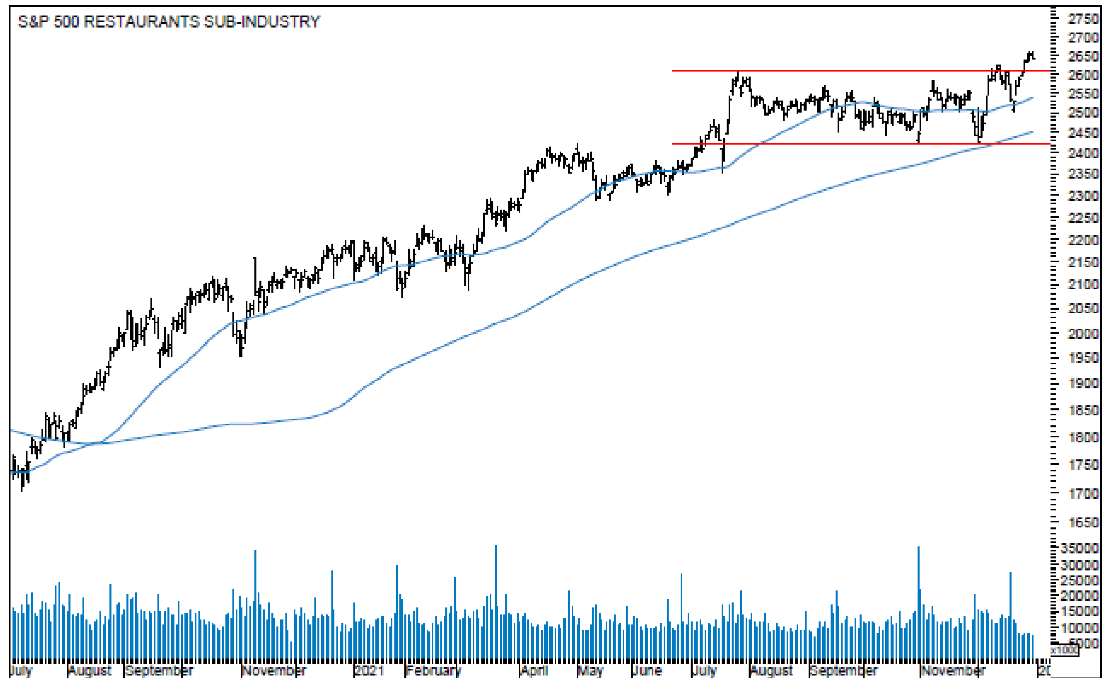


Source: FactSet

Technical Analysis – Russ Visch

Chart-wise, the "Covid reopening" trade has been on pause throughout much of the second half of 2021 with most sub-industries trading sideways since the summer as the Delta and now Omicron variants raged around the world. We're starting to see signs of life again though with the S&P 500 Restaurants sub-industry recently breaking out of a six month consolidation pattern and signaling a resumption of the long-term uptrend.

Figure 9: S&P 500 Restaurants Sub-Industry



Favorite names in the sector include:

McDonald (MCD-NYSE): Steady long-term uptrend accompanied by persistent net money inflows, a stock which has continued to make fresh all-time highs despite recent broad market volatility.

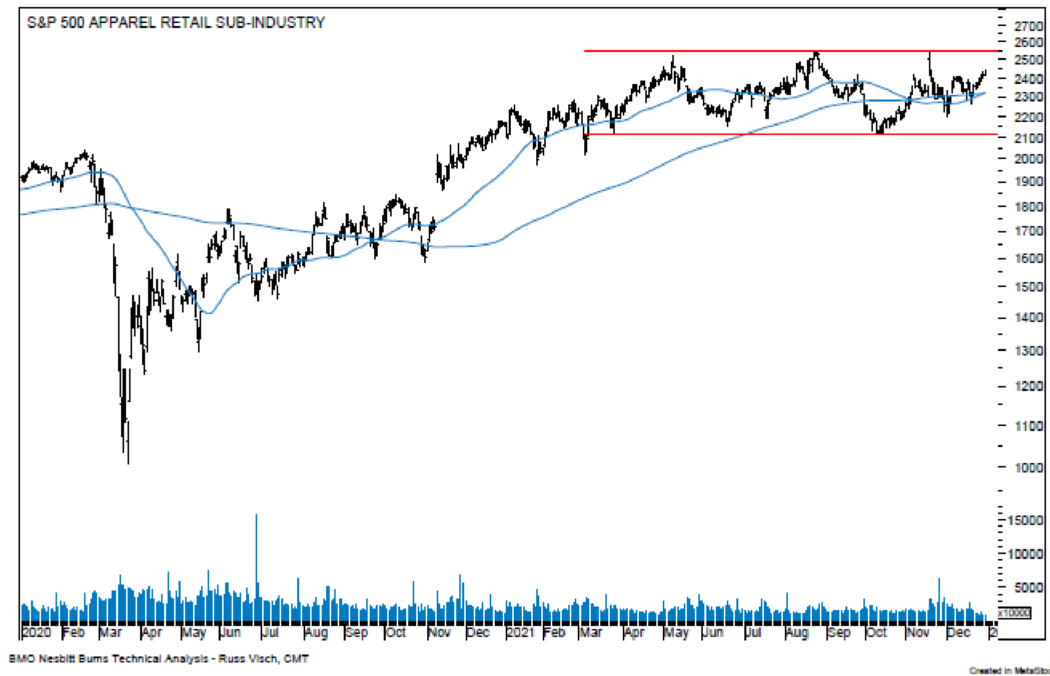
Chipotle Mexican Grill (CMG-NYSE): Reversing back to the upside from a successful test of its rising 200-day moving average (i.e. – a normal medium-term pullback.) accompanied by new buy signals in momentum gauges. A close above the September peak at $1958.55 would open a new upside target of $2350.

Dominos (DPZ-NSDQ): Recently reversed back to the upside from a successful test of its rising 200-day moving average. The close above the summer peak at $547 opened a new upside target of $645.

The S&P 500 Apparel Retail sub-industry also looks to be headed for a challenge of the upper end of a nine month consolidation pattern. A close above resistance at 2553 would open a new upside target of 2986 which would represent a gain of nearly 25% from the current level.

[2]The Baltic Dry Index is reported daily by the Baltic Exchange in London. The index provides a benchmark for the price of moving the major raw materials by sea. The index is a composite of three sub-indices that measure different sizes of dry bulk carriers: Capesize, which typically transport iron ore or coal cargoes of about 150,000 tonnes; Panamax, which usually carry coal or grain cargoes of about 60,000 to 70,000 tonnes; and Supramax, with a carrying capacity between 48,000 and 60,000 tonnes. The Baltic Dry Index takes into account 23 different shipping routes carrying coal, iron ore, grains and many other commodities.

Figure 10: S&P 500 Apparel Retail Sub-Industry

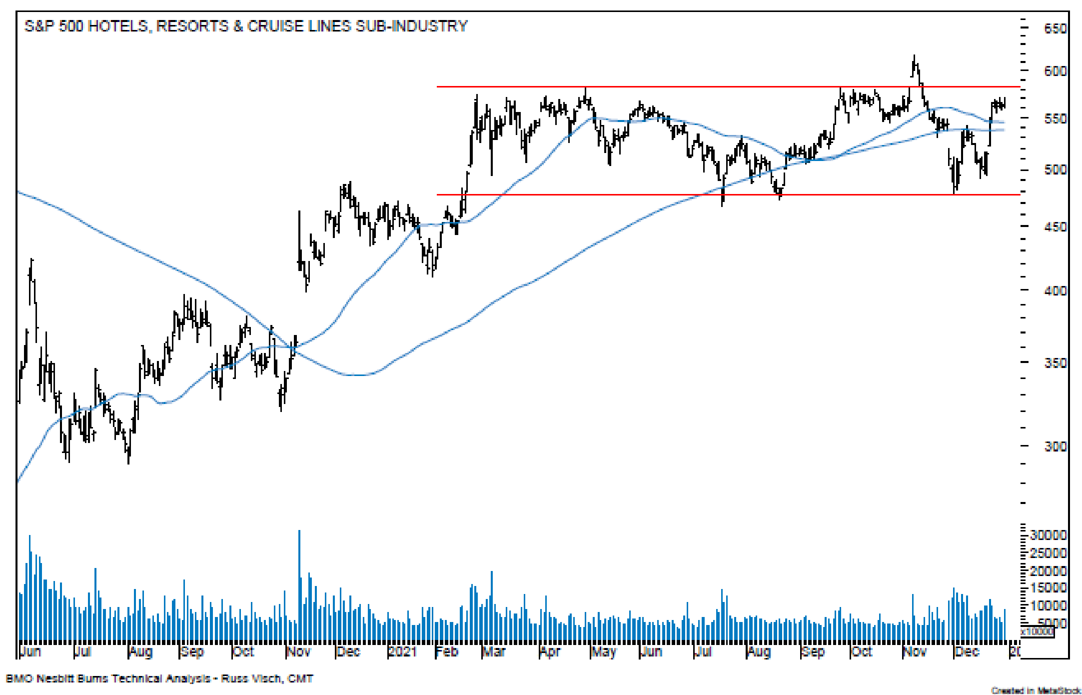


Favorite names in the sector include:

The TJX Companies (TJX-NYSE): Challenging the upper end of a year-long consolidation pattern at $76. A breakout there would signal a resumption of the uptrend and open a new upside target of $85 with higher targets likely on a 6-12+ month basis.

And last but not least, the Hotels, Resorts, and Cruise Lines sub-industry also looks set to challenge the upper end of a year-long consolidation pattern as well. A close above resistance at 582 would signal a resumption of the long-term uptrend and open a new upside target of 697 which would represent a gain of 25% from today's level.

Figure 11: S&P 500 Hotels, Resorts & Cruise Lines Sub-Industry



Favorite names include:

Expedia (EXPE-NSDQ): Challenging the upper end of a year-long consolidation pattern at $188. A breakout there would signal a resumption of the uptrend and open a new upside target of $240 with higher targets likely on a 6-12+ month basis.

Marriott International (MAR-NSDQ): Recently reversed back to the upside from a successful test of its rising 200-day moving average accompanied by new buy signals in daily momentum gauges. Tradable back to the recent peak at $172. A break above that level would open a new upside target of $205.

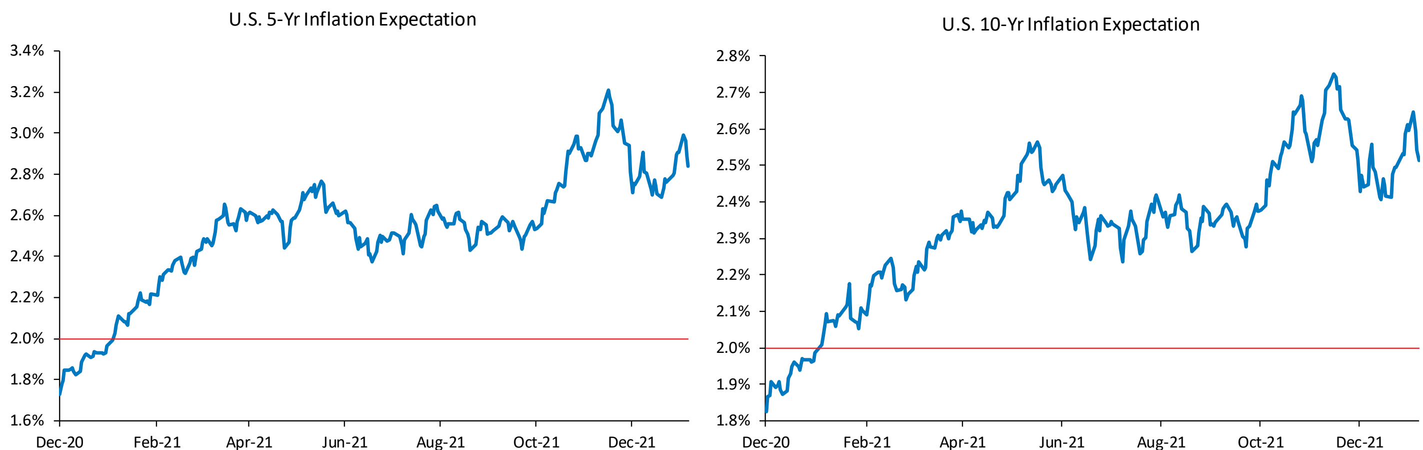
Hilton Worldwide (TLR-NYSE): Recently reversed back to the upside from a successful test of its rising 200-day moving average. The close above the summer peak at $154 opened a new upside target of $177.

Groundhog Year for Interest Rates?

With every New Year comes updated expectations and forecast but for fixed income markets, this may not be the case. After a challenging year that resulted in negative total returns for bond investments, the 2022 consensus view for interest rates trajectory remains higher still, as central banks turn their focus to combating inflation. While similarities between forecasts are concerning for investors, there are important differences to last year which could lead to different portfolio total return outcomes.

First, inflation is admittedly past its transitory nature and overall market expectations are now well above early 2021 levels. Upside surprises remain possible but with consumer prices already close to 7% in the U.S. and 5% in Canada, we believe markets are better positioned for this risk; US 5 and 10 year inflation expectations have been rising to between 2.50% and 3% after barely reaching 2% a year ago (the Fed's long term target for consumer prices is 2%).

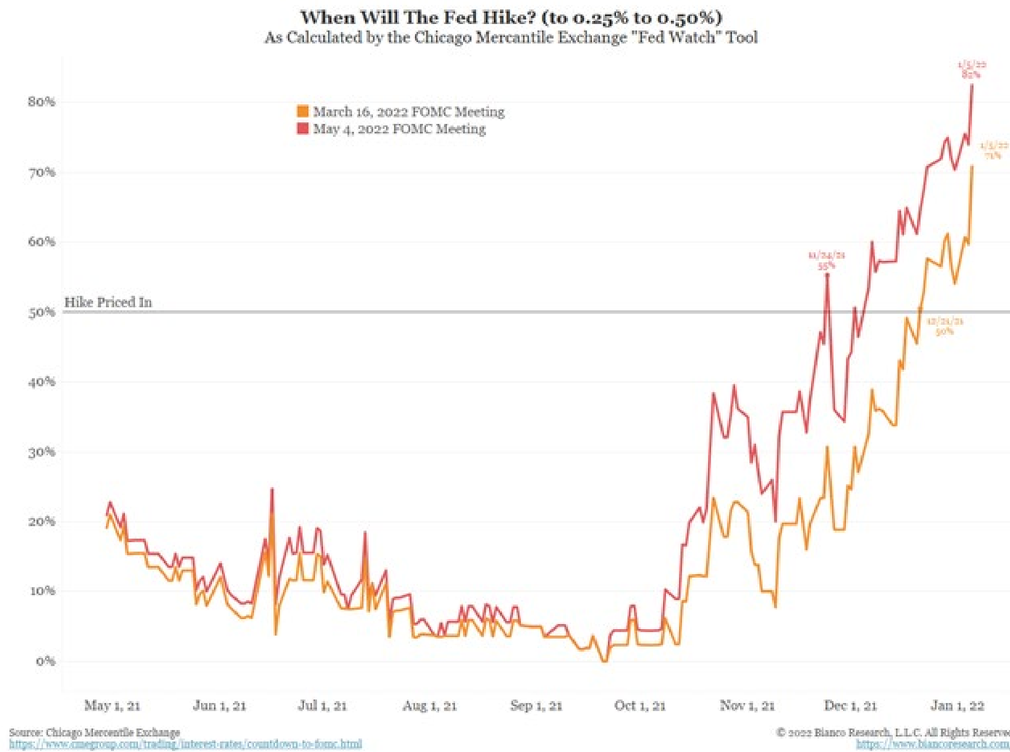
Figure 12: U.S. 5- and 10-Year Inflation Expectations



Source: Bloomberg

Secondly, unlike last year when tapering was not even a strong consideration, the risk of inflation expectations becoming un-anchored is leading many central banks on a tightening path with policy rate increases expected. With the Bank of Canada (BoC) ending its asset purchase program in October and the U.S. Federal Reserve (Fed) speeding up its tapering to end purchases this spring, the question is no longer "if" but "when" will the next tightening cycle starts. While no policy rate changes were factored in last year's forecast, the markets are now expecting 3 rate hikes in 2022 on both side of the border and more to come in 2023.

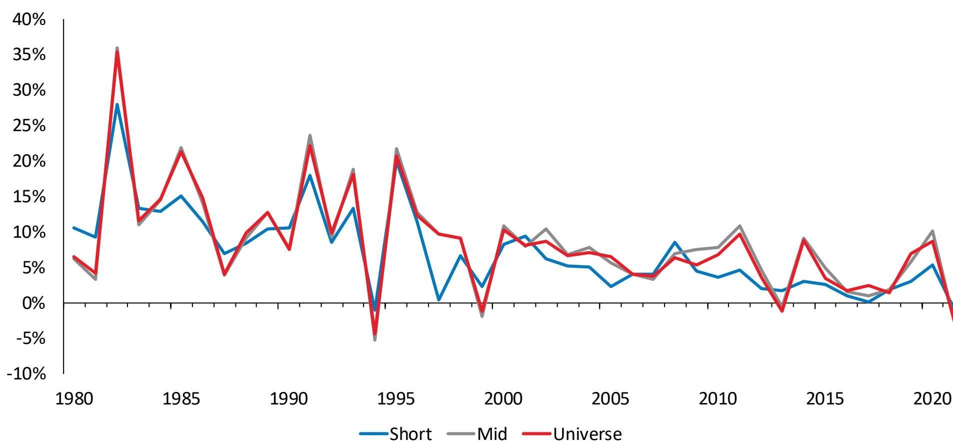
Figure 13: Probabilities of a Policy Rate Hike in The U.S.



Source: Bianco Research

Finally, despite increased number of infections, early reports suggests that there are significantly fewer severe outcomes compared to January last year or last summer Delta variant. This means that the assessment of the Omicron risk for the economy may be different as this wave and future waves could be less disruptive. This should provide further support for central banks to lift rate sooner and help manage strong overall demand and inflation risk.

Figure 14: FTSE Fixed Income Universe Indexes – Annual Total Returns



Source: FTSE Russell

Despite one of the worst yearly starts and a gloomy outlook for rates raising risks that we see a second year of negative portfolio returns – a rare occurrence in bonds (Figure 14) – we find some solace in the following factors:

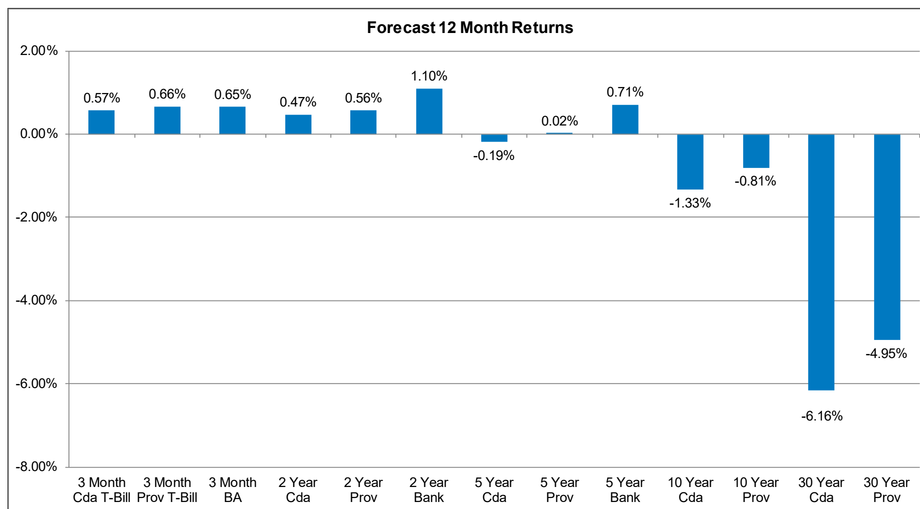
- 2022 should mark the start of the first tightening cycle, but unlike 2021, short term markets have already priced in the first 3 expected rates in 2022. Policy surprises (larger hikes / faster tightening) are possible but we see limited risk at this stage.

- Interest rates in general are starting the year at more attractive levels than January 2021. Government of Canada 2, 5 and 10 year yields have all moved significantly higher in the last 12 months by between 80 and 100 bps. Credit markets also offer much more attractive levels and opportunities. Higher rates mean better portfolio yields, with investors earning higher income per dollar invested in 2022.
- Finally, the combination of reduced government funding requirements going forward and the insatiable demand for safe and positive yielding securities (re. Canada and U.S. securities) should continue to provide some support.

Total Return Expectations

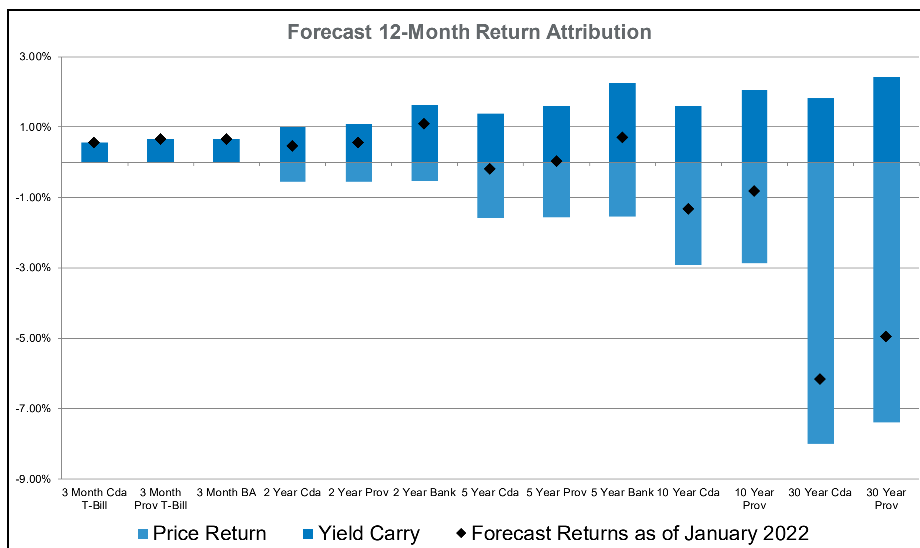
Using the latest BMO Economics interest rate forecast (mid-December) which calls for Canada 5- and 10-Year yields to top 1.80% and 1.95% respectively by the end of 2022, we calculated the expected total returns and attribution for select government and corporate securities over the next 12 months (Figure 15 & 16). Considering current market risks and the potential for these forecasts to materialize, we believe that targeting a slightly negative to neutral portfolio duration (interest rate sensitivity) compared to our preferred benchmark (50% FTSE short-term Index/ 50% FTSE mid-term Index) and an overweight allocation to credit with a focus on maximizing income should help investors navigate the market risks.

Figure 15: Total Returns for Select Securities Based on Most Recent BMO Economic's Interest Rate Forecast (December 2021)



Source: BMO Economic, BMO Private Wealth

Figure 16: Attribution of Returns for Select Securities Based on Most Recent BMO Economic's Interest Rate Forecast (December 2021)



Source: BMO Economics, BMO Private Wealth

Objectively, we haven't seen the end of this pandemic yet and Omicron and future variants will continue to apply a good dose of economic and monetary policy uncertainty. And with inflation and inflation expectations close to or potentially having peaked already, upside risk to interest rates may be more limited than a year ago despite the upcoming tightening cycle. However, what may surprise fixed income markets this year is the rise of real yields (which remain deeply negative) as central banks remove stimulus and raise policy rates. In our opinion, the net effect of rising real yields and decreasing inflation expectation should still lead nominal rates higher in 2022, but we believe the expected increases will be more limited. For portfolios, this means income should be a larger component of total return in 2022, which should help mitigate the risk of another disappointing year for bond investors.

Figure 17: S&P/TSX Composite Total Returns

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Energy	-2.89	48.71
Financials	0.72	32.16
Info. Technology	4.02	30.09
Real Estate	-0.65	29.45
S&P/TSX Composite Index	**0.68**	**24.21**
Telecom. Services	1.95	21.30
Industrials	-1.16	19.39
Cons. Discretionary	3.68	13.83
Consumer Staples	1.65	13.75
Utilities	0.02	6.56
Materials	2.71	2.11
Health Care	-5.27	-12.49

Figure 18: S&P 500 Sector Total Returns

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Energy	-2.67	53.84
Financials	-3.36	33.91
Real Estate	1.17	32.66
Info. Technology	5.36	31.38
Cons. Discretionary	3.41	26.51
S&P 500 Index	**1.21**	**25.55**
Telecom. Services	-2.24	22.23
Materials	2.02	21.32
Health Care	-1.09	18.01
Industrials	-1.00	17.96
Utilities	1.31	10.56
Consumer Staples	1.59	10.49

Source: Bloomberg, BMO Private Wealth; as of December 31, 2021

Figure 19: S&P/TSX Composite Earnings Yield vs 10-Year GoC Yield

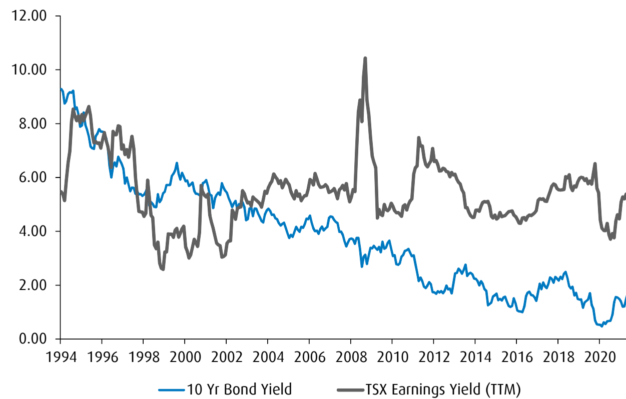
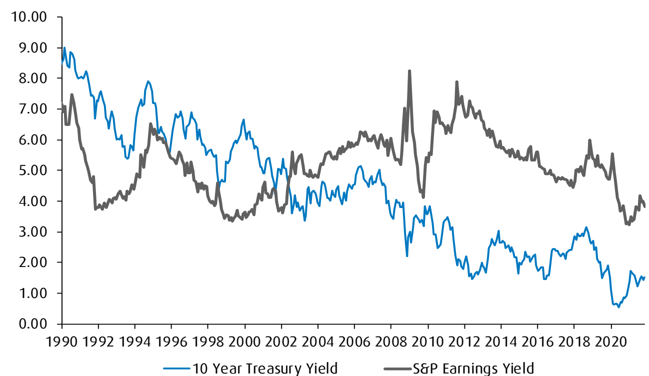


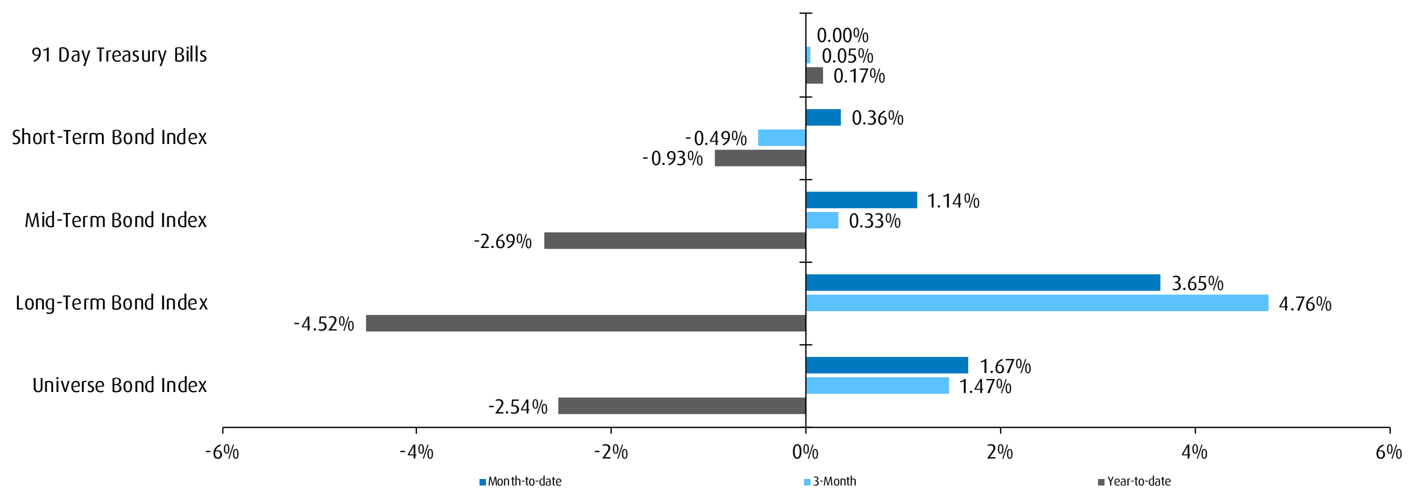
Figure 20: S&P 500 Earnings Yield vs 10-Year Treasury Yield



Source: Bloomberg, BMO Private Wealth

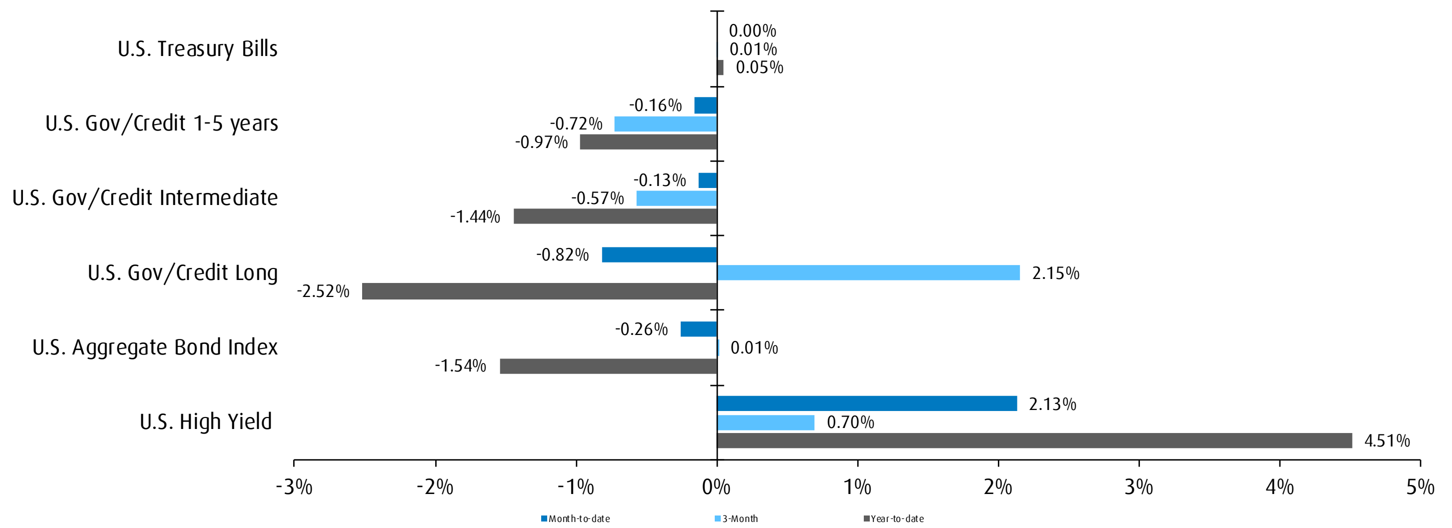
Figure 21: Canada/ U.S. Bond Index Total Returns Through December 2021

Canada



Source: FTSE

U.S.



Source: Bloomberg Barclays

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