Equity and Fixed Income Strategy

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Rome wasn't built in a day – and inflation won't be defeated in that timeframe either

Investors are grappling with several risks and concerns at this point of the cycle. Continued geopolitical tension with Russia and China, a debt ceiling showdown coming in the U.S. (although our expectation is some type of agreement – as always – since a U.S. default serves neither party), economic and earnings deceleration, and higher-for-longer inflation and interest rates. This has mired the market in a so-called risk-off period, but from our perspective not much has really changed, and we continue to like a number of high-quality stocks, particularly in Canada. Selectivity remains key, however.

A narrative took hold in late 2021/early 2022, whereby inflation would quickly and "magically" come back down to 2% - 3% as supply chains normalized post COVID lockups. We never believed it then (primarily because wage pressures were accelerating) and we still don't believe it now. In fact, we expect it will take until at least 2024 before we see a more acceptable inflation range. However, the point we have repeatedly made since late last year is that inflation has peaked and that the trajectory is now generally on the way down.

Consistent with that view, we also never believed that the U.S. Federal Reserve (the "Fed") or the Bank of Canada ("BoC") would cut interest rates this year, a view that the market has largely come to accept. But again, the silver lining is that the BoC is officially on pause while we are looking at another 50 basis points or so of increases down South. The bottom line is that we are much closer to the end than the beginning of monetary tightening.

We continue to recommend a more selective approach to sectors and stocks given the massive disparity in performance and valuations we have seen over the last few years. Grouping stocks in growth vs. value buckets is far too simplistic in our view (since growth is an integral component of the algorithm which increases the value of stocks), and yet some sub-sectors and stocks are still clearly overvalued in our opinion. For example, Technology and some parts of the Communication Services sectors. Conversely, there are many Financials, Industrials, Consumer, Energy and Basic Materials stocks whose earnings power remains strong and are still attractively valued.

If these trends hold – and we believe they will – they are highly supportive of our call that the Canadian stock market is poised to continue outperforming the U.S. in 2023, based on the following: 1) A more favourable sector mix for this point of the cycle (i.e., Industrials, Financials and Basic Materials and Energy as noted above); 2) We are especially bullish on base metals and energy long-term trends (demand is outstripping supply growth with Chinese manufacturing data reaccelerating and no end in sight to the Russian invasion of Ukraine); 3) A far lower valuation for the S&P/TSX Composite Index versus historic levels, and the S&P 500 Index; 4) A more dovish monetary policy with the BoC "officially" on pause; and 5) A fundamentally undervalued Canadian dollar.

Inflation trends: Advantage Canada but pressure on loonie

As noted by BMO Chief Economist, Douglas Porter, "The re-re-pricing on the Fed outlook has given the U.S. dollar yet another charge. After retreating steadily from the 20-year high hit last fall, the greenback has snapped back up since early February lows to reach its highest levels of 2023. For example, the euro has pulled back by more than 4% after nearly touching $1.10 at the start of February. The yen is also on its back heels again, sagging more than 6% in a month to above ¥136. And the Canadian dollar has certainly not escaped the broader downdraft, weakening below 73.5 cents (or $1.362/US$), down two cents in February. In the 15 years prior to the pandemic, the loonie was only weaker for one brief spell – when oil prices crashed below $30 in late 2015."

The Canadian dollar is being undercut by the broader strength of the U.S. dollar, a related risk-off move, but also by some specific home-grown factors. The sudden reassessment of the potential for even more Fed rate hikes follows soon after the BoC rather publicly planted its flag in the on-pause field. True, the pause was billed as "conditional" on inflation's performance. But just as U.S. inflation surprised to the high side in January, Canada delivered a rare downside surprise with headline inflation cracking below 6% (at 5.9%) for the first time in nearly a year, leaving Canada with one of the lowest inflation rates in the industrialized world. Even Japan's inflation rate is not that much lower at 4.3%, and the Bank of Japan is sticking with *negative* interest rates. Moreover, Canada's core inflation displayed some encouraging signals, with ex-food and energy prices rising only 0.1% month/month in seasonally-adjusted terms. That's the smallest monthly rise in nearly two years, clipping the 3-month trend to a manageable 3.1% (the similar measure in the U.S. was 4.6%).

Technical analysis

Equity markets have come under some pressure in recent weeks, but overall we don't see anything troubling about the price action. It appears to be nothing more than a routine pause following the 8% - 10% run-up that occurred during January. In fact, all of the major averages are now stabilizing at major support levels while indicators in our Short-term Timing Model have begun to turn positive from at/near oversold extremes, so the pullback appears to be complete. Over the next 2 to 3 months the S&P/TSX Composite Index looks to be headed for a challenge of its early February peak at 20,843. A breakout there would open a new swing target that measures 21,689. Above that, the next target/resistance level is the all-time high of 22,213. For the S&P 500 Index, a close above its February peak of 4,195 would open a new short-term trading target of 4,447.

Our Medium-term Timing Model is even more bullish, with weekly momentum gauges remaining constructive for both the S&P/TSX Composite and the S&P 500 indexes after giving new buy signals late last year.

Breadth oscillators such as the percentage of NYSE stocks trading above short- and long-term moving averages recently registered their best readings in more than a year and bullish sentiment continues to expand across all segments of the market as well.

We must sound like a broken record at this point, but the buy signals in these indicators that occurred at various points in the second half of last year are exactly like what we saw at the beginning of every cyclical bull market since (and including) the credit crisis, and there's no reason to think this time will be any different.

Reality check leads to yield curve upward adjustment

The combination of surprisingly stronger U.S. economic data and slow progress on U.S. and European inflation fronts was behind a major sentiment shift in fixed income markets in February. Markets came to the realization that inflation will be slower to trend back toward 2% and central banks will not cut policy rates early. In the U.S., gone are the expectations of a Fed pivot this year, and now not one, but three additional 25 basis point rate hikes fully priced in over the next three meetings (March, April and June). The re-pricing of the terminal policy rate towards 5.5% pushed the U.S Treasury yield curve significantly upward.

With the upside pressure on rates more pronounced at the shorter end, the yield curve inversion reached a new cycle low with the difference between U.S. 2- and 10-year yields dropping to -90 basis points, the most negative level since the early 1980's. While markets have toned down forecasts of a hard landing, this inversion keeps alive the odds of a soft landing.

Canada rates were also dragged upward but the policy expectation re-pricing was not as pronounced as, unlike the Fed, the BoC signaled a pause back in January. While the door remains open for further tightening, the BoC is more concerned about the interest rate sensitivity of our economy. Reports of Canada's Gross Domestic Product practically stalling in Q4 2022, and the downside Consumer Price Index surprise should provide the BoC some breathing room and raise the bar for the need for further policy action. This will obviously raise a question as to how long the BoC will be able to deviate from a more aggressive Fed policy, and this is partially reflected with markets pricing in more than 50% odds of another 25 basis point hike in the next 6 months.

With the February pullback in interest rates, markets are now better aligned with a higher-for-longer narrative. However, the rising bond yields led to a stark performance reversal as February's results almost erased the previous month's gains. Considering that the monthly rate variations were reminiscent of last year's most significant monthly fluctuations, this may be cause for concern. Interestingly

though, despite last month's setback, year-to-date results remain positive. Why? First, the correction primarily removed market exuberance in pricing an early policy shift, helping to normalize portfolio returns. A passively managed fixed income portfolio yielding 4% should return 30 to 35 basis points per month on average, not 300 basis points like we saw in January. Second, yields started the period at much higher levels than last year leading to higher accruing income, providing a greater buffer against price volatility. Finally, unlike last year's significant widening, investment-grade credit spreads (rated BBB- and higher) on average tightened slightly but remained at or above historical averages, providing an additional yield buffer.

As we opined earlier this year, the necessary reset in fixed income markets to higher yields has created attractive investment value across the yield curve, offering again optionality for greater portfolio risk diversification. We admit the market volatility is daunting, but the good news is that the back-up in yields provides another opportunity for investors to take advantage of current conditions. It also provides an opportunity to lengthen a portfolio's average maturity (duration) closer to target benchmarks after being defensive for at least the last 12 months. High yielding short-term securities are definitively compelling with risk-free Treasury Bills flirting with 5% and GICs yielding above that level. However, considering the current inversion of the yield curve, we believe that a short-term allocation should be combined with a more long-term strategy. This will mitigate future reinvestment risks and should help lock in higher returns for longer.

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

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