Equity and Fixed Income Strategy

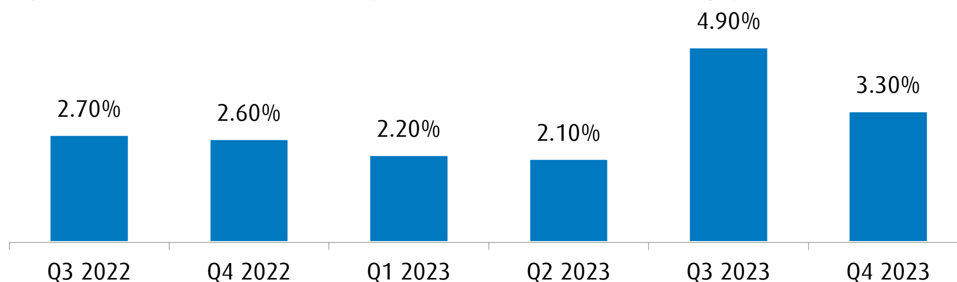
BMO Nesbitt Burns | February 2024

Stéphane Rochon, CFA Equity Strategist
Richard Belley, CFA Fixed Income Strategist
Russ Visch, CMT Technical Analyst
Eric Yoo, Associate
Ernad Sijercic, Associate

The amazing resilience of the U.S. economy and AI trade

The long-promised U.S. recession is not even close to materializing. Case in point – and as noted by the excellent BMO economics team – just-released "Q4 GDP data showed yet another year of solid activity, while price pressures eased (which strengthens the case for interest rate cuts later this year). Growth in the fourth quarter came in much stronger than expected at 3.3%, providing a nice handoff to Q1, and setting the stage for the expansion to continue in 2024. But, with the mighty consumer still fueling economic activity, we're not expecting a pivot any time soon and are comfortable with our July rate cut call". Higher-than-expected growth and lower-than-expected inflation! That, in our experience, is not a recipe for a major market pullback. Quite the opposite, in fact.

Figure 1: U.S. Real GDP Growth (Quarter-Over-Quarter % Change) – No Recession Here



Source: BMO Private Wealth Portfolio Advisory Team, Factset

Figure 2: BMO Nesbitt Burns Investment Strategy Committee's Recommended Asset Allocation (%)

	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	0	5	0	5	0	5	0	5
Fixed Income	70	70	40	45	20	25	0	0
Equity	30	25	60	50	80	70	100	95
Canadian Equity	25	15	35	25	45	35	50	40
U.S. Equity	5	5	20	15	20	20	30	30
EAFE Equity	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

Source: BMO Nesbitt Burns Private Client Strategy Committee

We have often stated that looking at GDP figures is akin to reading ancient history as far as financial markets are concerned, but we find this economic resilience remarkable, and it certainly argues for further increases in consensus growth expectations for 2024 with very positive implications for corporate earnings and the stock market. While Canada's performance has been weaker, the fact that our largest trading partner (by far) is still so strong should help boost our own economic momentum.

As our technical analyst Russ Visch noted last week: "The best part of (Monday's) action was how broad-based the price

strength was (greater than 3:1 advancers to decliners on the NYSE) where small- and mid-cap stocks actually outperformed the S&P 500. Overall, the broadening out of the rally is the best confirmation of the sustainability of last week's breakouts." We could not agree more and note that while the market has had a strong run, last year's very narrow focus on "Magnificent 7" and AI-related stocks has left many investment opportunities in less sexy, more prosaic areas.

Among these are Financial stocks, particularly strong banks with cost cutting/margin expansion potential such as Citigroup, for example. Also interesting are Railroad stocks (e.g., Union Pacific, CP Rail, CN) which should benefit from an inflection point in volumes this year and an associated acceleration in EPS trends. Other interest sensitive stocks which should act well in 2024 include Pipelines, Telcos (especially Verizon in the U.S. which is trading at less than half the multiple of Canadian telecom giants), Utilities, and REITs. While still a bit early, copper and oil also seem poised to recover with the prospects of increased demand in the back half of the year.

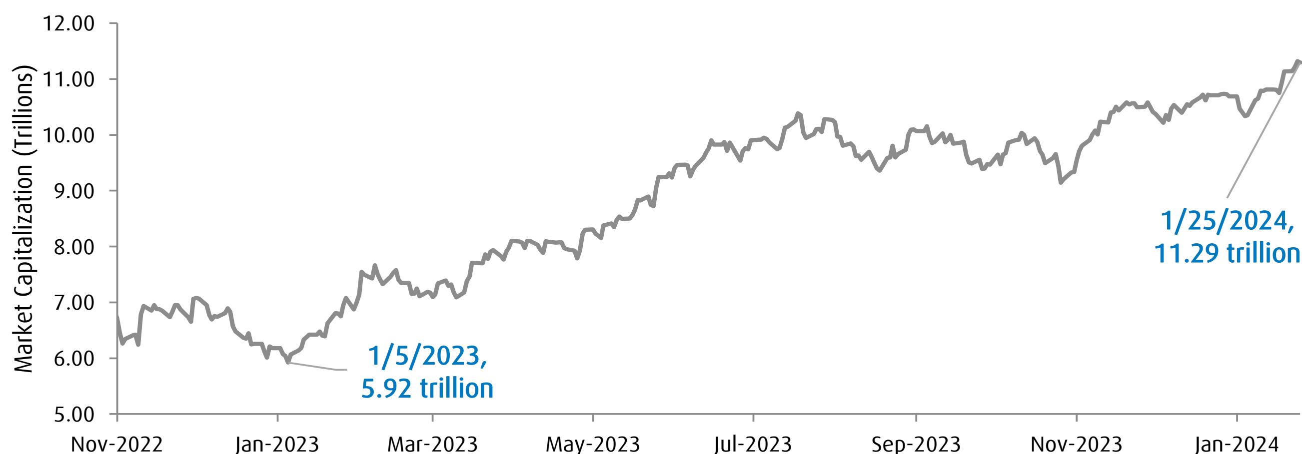
Artificial intelligence mania

In a now familiar annual pilgrimage, business luminaries congregated to the city of Davos in Switzerland to discuss the emerging trends and their world views. Artificial intelligence figured prominently in the discussions – and for good reason.

Taking a step back, while the concept of AI has been around for over 50 years, we are at a pivotal point for its adoption today due to the availability of big data, high-powered computing, and advances in algorithms – all of which make AI cheaper and faster to implement. In simple terms, AI is the simulation of human intelligence by machines. It is the development of computer systems with human-like capabilities such as visual perception, speech recognition, decision making, and language translation. In practice, AI is a group of technologies that help facilitate the discovery and analysis of information for the purpose of making predictions and recommendations, support decision making, facilitate interactions, and automate certain processes (taken from the latest AI Primer by our team, please contact your BMO Investment Professional if you would like a copy).

Undeniably, the growth curve for AI is very steep with chip makers such as NVIDIA, AMD, and Broadcom being early beneficiaries of business enthusiasm for this compute-intensive technology. The stock market has already rewarded those stocks handsomely, discounting a very optimistic scenario in a very short time. Having witnessed the 2000 Tech Bubble first-hand, we note that this follows the historical script for sexy emerging themes – stocks moving well ahead of fundamentals – and certainly argues for being selective and not overpaying for "hype". To illustrate, the chart below shows that the market capitalization of Magnificent 7 stocks has risen by over $5 trillion since the launch of ChatGPT in November 2022. This is against a $1.3 trillion sales opportunity in almost a decade (forecast below, these almost always tend to be on the bullish side in our 25 years of experience, by the way). Assuming Microsoft maintains its magnificent 35% net profit margins and applying that to the sales opportunity yields about a $450 billion profit opportunity. In other words, the stocks are already applying a 10x+ multiple to an opportunity that may or may not materialize almost 10 years from now.

Figure 3: The Market Capitalization of the Magnificent 7 Has Increased by Over US$5 Trillion Since its January 2023 Trough



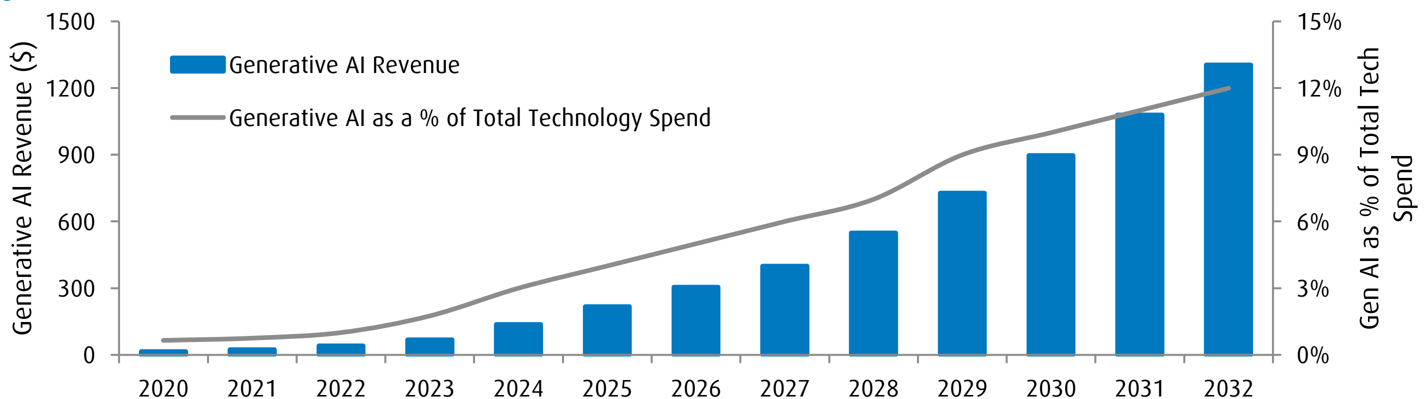
The "Magnificent 7" consists of Facebook, Alphabet, Apple, Netflix, Tesla, NVIDIA, and Microsoft
Source: BMO Private Wealth Portfolio Advisory Team, Factset

That said, we still see investment opportunities in AI with some reasonably valued stocks that are clear leaders in developing the technology. Amazon and Google come to mind in this respect while other inexpensive Tech stocks such as Qualcomm and IBM also stand to benefit as shown by recent management comments and the positive increase in order trends.

Taking a more macro view, we are enthused about the positive growth and productivity implications of AI. This could be very significant because we believe sustained productivity growth is the Holy Grail in economics as it increases the potential growth rate of the economy while keeping inflation in check. Back in Davos, the CEO of IBM shared some particularly interesting insights. As noted by Forbes, he believes economic expansion and productivity growth will follow the proliferation of AI. He also focused on the critical importance of trusted AI and that the technology industry is focused on delivering not only rapid innovation but considers safety and governance to protect risk that can be associated with a Technology as powerful as artificial intelligence. Krishna also shared that he believes generative artificial intelligence ("GenAI") and AI at large will be a net job creator and it can increase productivity. In trying to quantify this impact, consulting firm McKinsey recently stated that current GenAI and other technologies have the potential to automate work activities that absorb 60-70% of employees' time today and that it could enable labour productivity growth of 0.1-0.6% annually through 2040, depending on the rate of technology adoption and redeployment of worker time into other activities.

Predictably, there are many estimates for the potential market size and growth of this technology. According to Statista & Bloomberg Intelligence, the market size for GenAI is projected to grow at a 40% compound rate in the next decade reaching US$1.3 trillion in 2032.

Figure 4: Generative AI Growth Potential



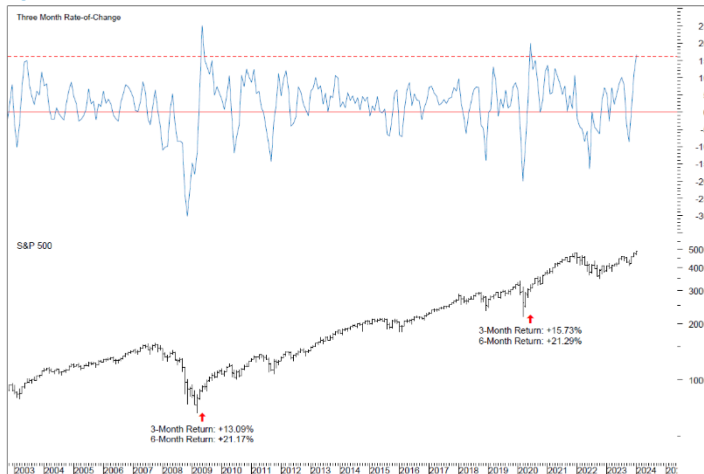
Source: Bloomberg Intelligence, IDC, eMarketer, Statista

Using another methodology, noted consulting firm McKinsey suggests that AI adoption could raise global GDP (through direct and indirect effects) by as much as $13 trillion by 2030, about 1.2% additional GDP growth per year. Their survey respondents expect significant business disruption from GenAI with companies predicting meaningful changes to their workforces. They anticipate workforce cuts in certain areas and large reskilling efforts to address shifting talent needs.

Technical analysis

As we gather our thoughts here in late January for the upcoming strategy report, the S&P 500 is on the cusp of completing its best three-month rally in nearly four years. In fact, there have only been two other instances of bigger three-month rallies in the past 15 years: 1) the lift-off from the pandemic bear market low; and 2) the lift-off from the credit crisis low in early 2009, so we've experienced something truly special and rare. Of course, now that the S&P 500 is at an all-time high it has prompted many to ask if there's much more upside left in this rally. While the sample size is much too small to make any strong statistical inferences, the 2009 and 2020 rallies can still provide a decent guide as to how the next few months are likely to play out. For example, the average three-month return in the S&P 500 following those big gains in 2009 and 2020 is +14.41% and the average six-month return is +21.23%.

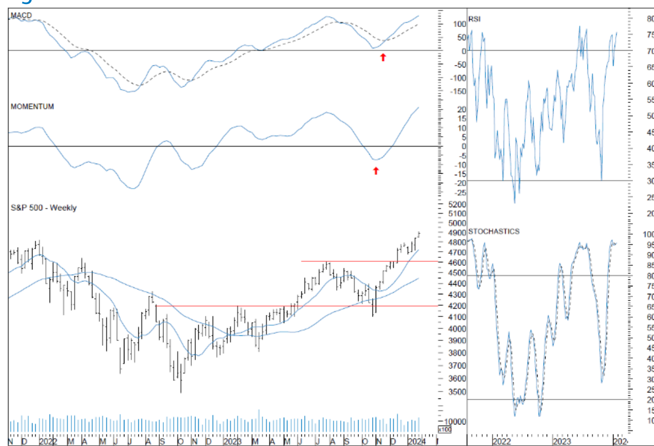
Figure 5: S&P 500



Source: BMO Private Wealth Technical Analysis

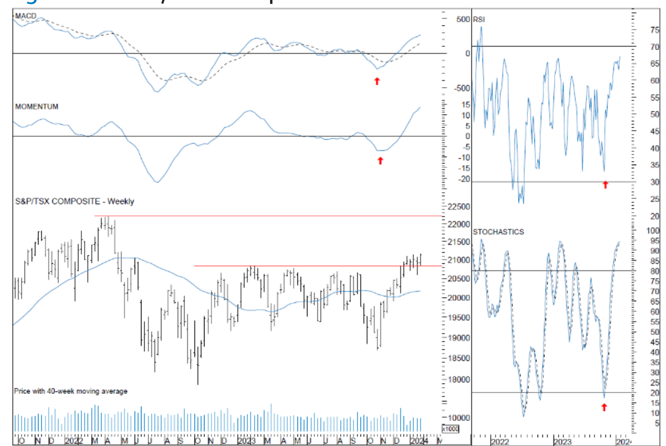
Despite the big run-up from the late October low, it's entirely possible that the S&P 500 continues to power higher in the months ahead. The good news is that's exactly what our medium-term timing model is telling us: weekly momentum gauges for all the major averages remain bullish and supportive of more upside, breadth oscillators are also improving after giving their first combined buy signals since 2020 and seasonality remains constructive well into the second quarter.

Figure 6: S&P 500 – Momentum



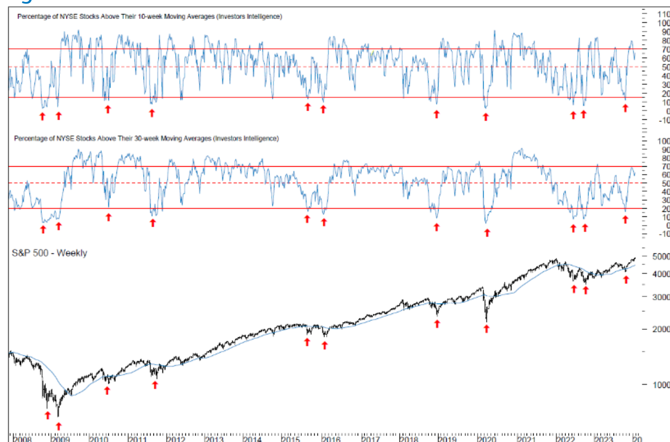
Source: BMO Private Wealth Technical Analysis

Figure 7: S&P/TSX Composite – Momentum



Source: BMO Private Wealth Technical Analysis

Figure 8: S&P 500 – Breadth



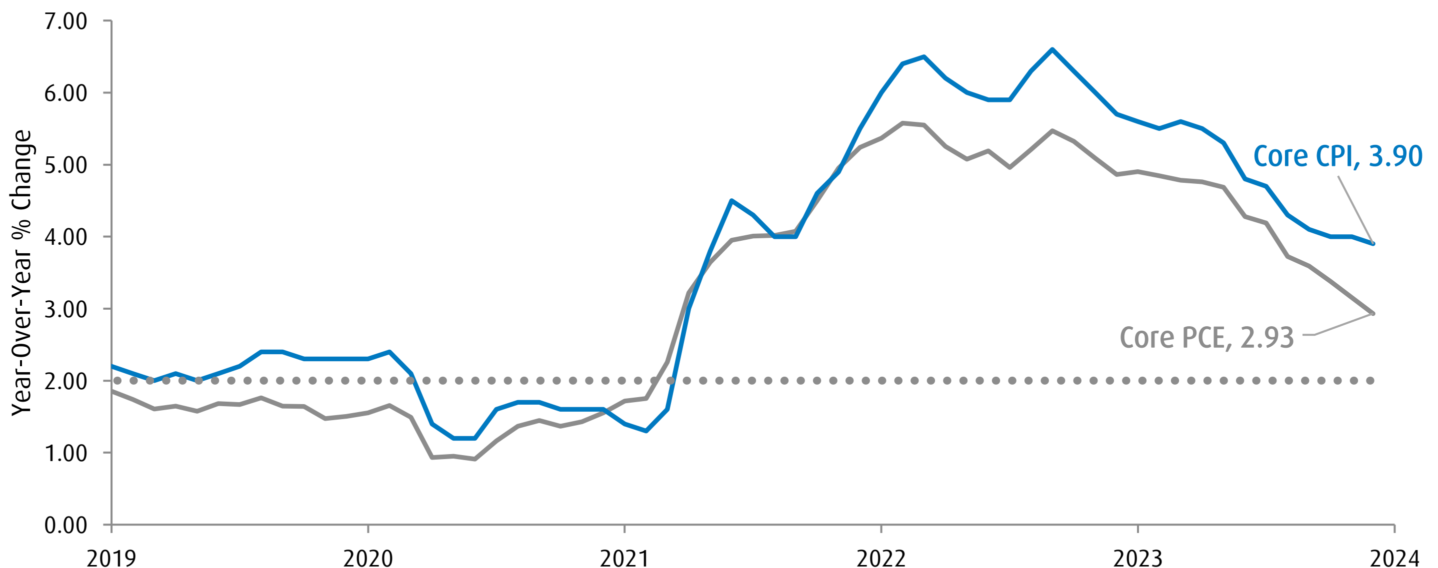
Source: BMO Private Wealth Technical Analysis

In terms of upside potential, the recent close above the July peak at 4,607 opened an upside swing target of 5,111 for the S&P 500. Here in Canada, the S&P/TSX Composite broke out of a year-long sideways trading range in late December. The all-time high at 22,213 will provide some resistance but the swing target on the close above 20,843 measures to 22,995. Favorite spots for new money remain interest sensitive stocks such as Banks, Pipelines, Telcos, Utilities, and REITs which should continue to benefit from the persistent slide in long-term interest rates.

Is an early U.S. rate cut even probable?

One of the main drivers behind the lower U.S. interest rates these past few months has been the combination of the optimism surrounding a soft landing and lower inflation. This led the market to place higher odds of a March U.S. Federal Reserve ("Fed") rate cut, which is not surprising if we consider that on, average, the Fed had historically cut rates approximately six months after its final hike; the latest hike was last summer. We admit that if inflation measures alone would be driving the monetary policy decision, strong indication of the metrics moving toward 2% would support an earlier cut. With Core Personal Consumption Expenditure[1] ("PCE") – the preferred Fed inflation measure – trending close to or below 2% over the last three-to-six months, the door would be open for the Fed to start normalizing its policy toward the neutral rate.

Figure 9: Core CPI and Core PCE Showing Progress on Inflation at a Different Speed

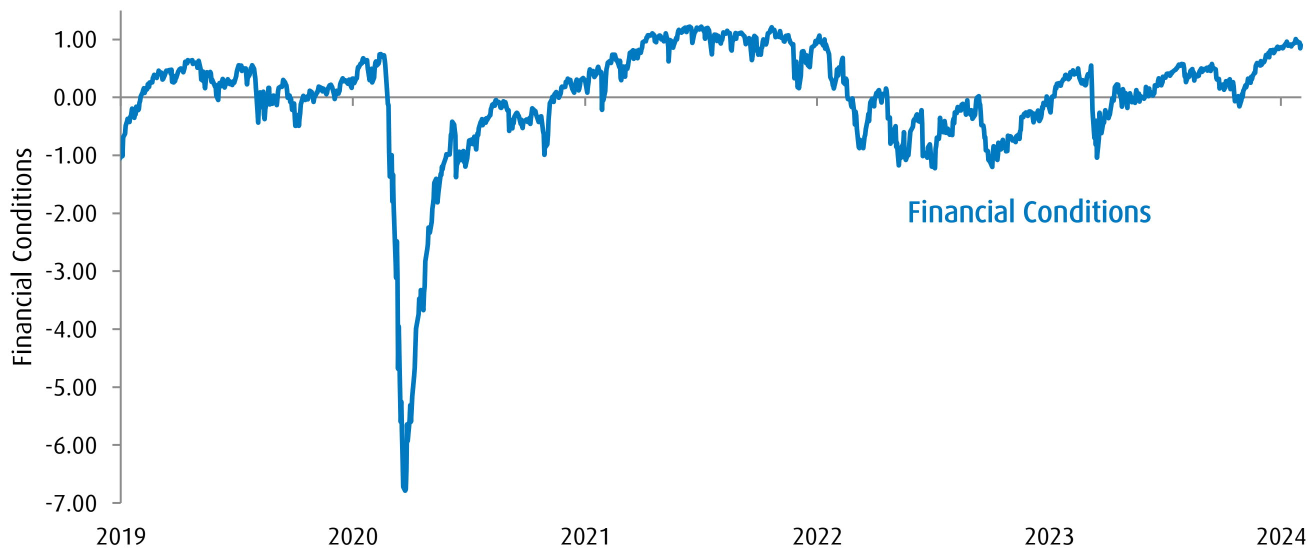


Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

However, other data may not yet align with an early pivot that could risk pushing inflation back above target. Growth, for one, continues to surprise to the upside with Q4 2023 GDP showing a faster pace than initially anticipated, prompting many to even revise 2024 expectations higher, including our BMO economists. Reports of tighter bank credit standards and higher credit card loan delinquencies are worth monitoring but are normal signs of the impact of higher interest rates and should help moderate economic growth. The labour market also continued to surprise with the January report showing another strong job creation trend at a time when we expected a more normalized report, considering we are seeing more layoffs announced. If we combine the strong wage gains (above 4%), the rebound in job openings above nine million (still higher than pre-covid levels), and the low unemployment rate (3.7%), the data is far from being all in for an early pivot. Even the U.S. Financial Conditions Index, supported by strong market performances and a tight corporate credit market, are far from being restrictive or flagging an issue worthy of an early rate cut.

[1] PCE is defined as a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. Core PCE and CPI are two measures of inflation that differ in their scope and methodology. Core PCE measures the change in goods and services consumed by all households and non-profit institutions, while core CPI measures the change in out-of-pocket expenditures of urban households. Core PCE is based on surveys of business, while core CPI is based on surveys of household expenditure. Core CPI tends to show higher inflation than core PCE (source: Bureau of Labour Statistics).

Figure 10: U.S. Financial Conditions Far From Being Restrictive

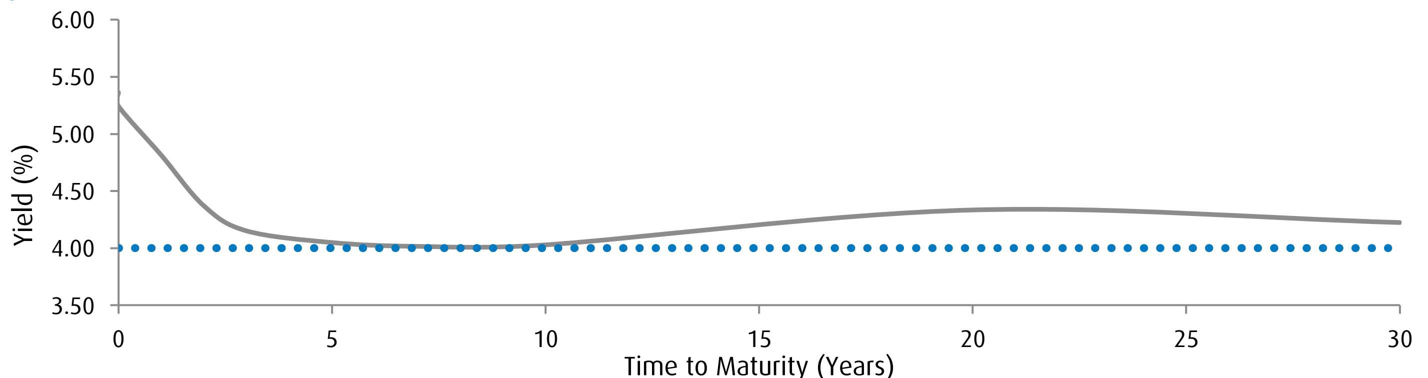


Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Some events may have distorted pricing and pressured interest rates lower, pushing odds of rate cuts higher. Examples include the confirmation of lower U.S. Treasury quarterly refunding needs and the flight-to-safety bid that followed the disappointing New York Community Bank earnings report that brought back memories of last March's regional banking crisis. Even Fed Chair Jerome Powell tried to remove some of the market ultra-optimism at their January meeting stating that a March rate cut would be "unlikely". However, these tend to have shorter-term impacts on markets until surprisingly stronger fundamentals take the lead again to push forward the Fed Pivot. Experience has shown that conditions can change quickly, but we doubt that considering the current trends, it could deteriorate quickly enough to lead to an early cut and even a potential move in May which is fully priced in. Our BMO economists have penciled down July, leaning towards a higher policy rate for longer.

Despite our views, we see no end in sight to the rate cut debate and history has shown that volatility tends to be higher at inflection points as we await the first cut. While this may complicate investment decisions, we find it prudent to remain focused on portfolio duration target over yields. A neutral to slightly defensive duration compared to an investor's benchmark should combine high income and reduced exposure to volatility but still maintain enough exposure to longer-term bonds if conditions change. As for U.S. yields, they may be off last year's highs, especially when driven by rate cut hopes, but when the whole Treasury yield curve is offering a minimum of 4%, they remain attractive.

Figure 11: U.S. Yield Curve



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 12: S&P/TSX Composite Total Returns

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Info. Technology	6.74	6.74
Telecom. Services	2.85	2.85
Industrials	2.11	2.11
Consumer Staples	1.89	1.89
Energy	1.59	1.59
Cons. Discretionary	1.31	1.31
S&P/TSX Composite Index	**0.55**	**0.55**
Real Estate	0.09	0.09
Financials	-0.26	-0.26
Utilities	-1.24	-1.24
Health Care	-3.87	-3.87
Materials	-6.27	-6.27

31-Jan-24
Source: Bloomberg

Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 13: S&P 500 Sector Total Returns

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Telecom. Services	5.02	5.02
Info. Technology	3.95	3.95
Financials	3.05	3.05
Health Care	3.01	3.01
S&P 500 Index	**1.68**	**1.68**
Consumer Staples	1.54	1.54
Energy	-0.38	-0.38
Industrials	-0.88	-0.88
Utilities	-3.01	-3.01
Cons. Discretionary	-3.53	-3.53
Materials	-3.91	-3.91
Real Estate	-4.79	-4.79

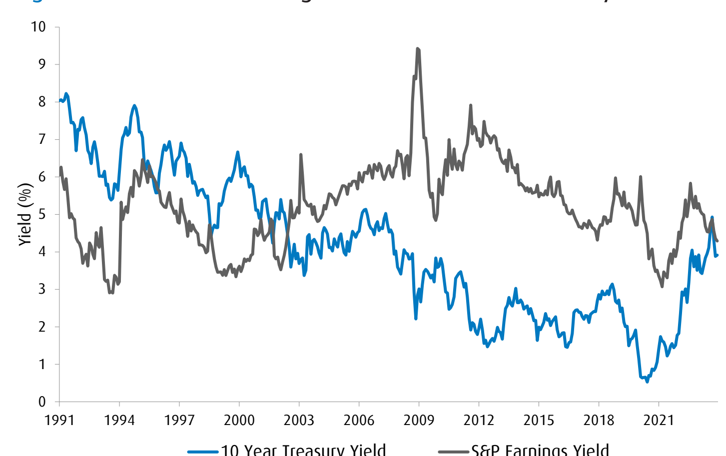
31-Jan-24
Source: Bloomberg

Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 14: S&P/TSX Composite Earnings Yield vs 10-Yr GoC Yield

Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

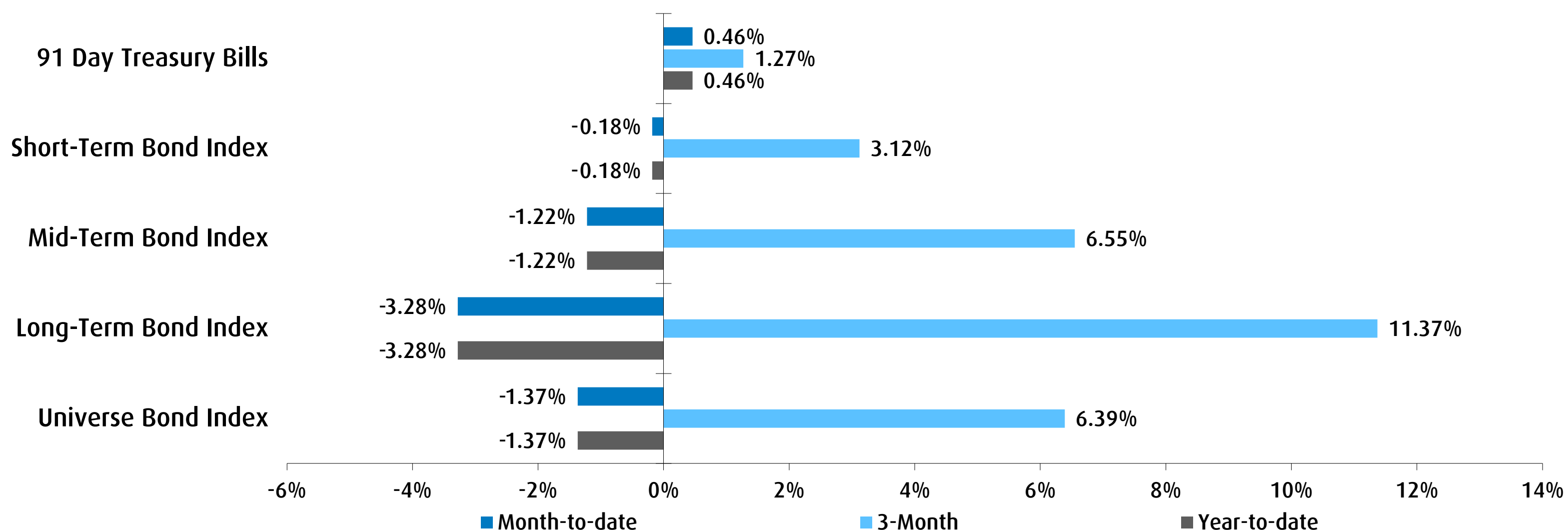
Figure 15: S&P 500 Earnings Yield vs 10-Year Treasury Yield



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

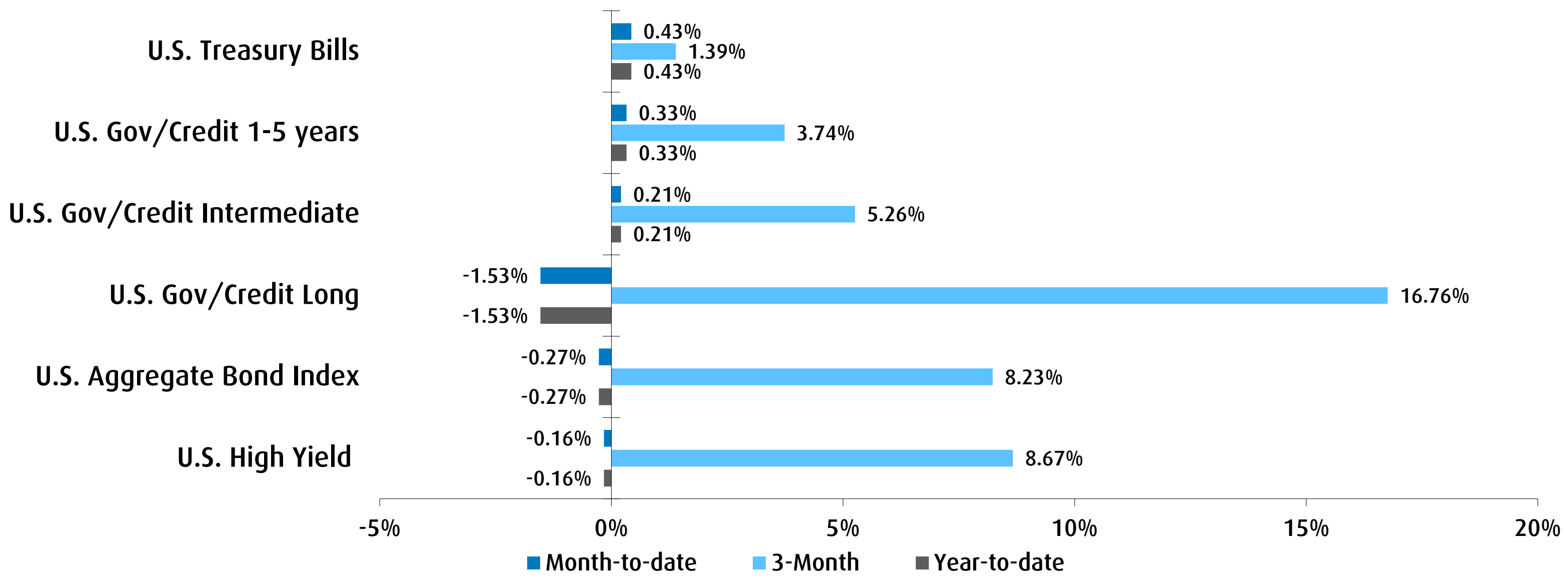
Figure 16: Canada/U.S. Bond Index Total Returns Through January 2024

Canada



Source: BMO Private Wealth Portfolio Advisory Team, FTSE

U.S.



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg Barclays

General Disclosure

The information and opinions in this report were prepared by BMO Private Wealth Portfolio Advisory Team ("BMO Private Wealth"). This publication is protected by copyright laws. Views or opinions expressed herein may differ from the views expressed by BMO Capital Markets' Research Department. No part of this publication or its contents may be copied, downloaded, stored in a retrieval system, further transmitted, or otherwise reproduced, stored, disseminated, transferred or used, in any form or by any means by any third parties, except with the prior written permission of BMO Private Wealth. Any further disclosure or use, distribution, dissemination or copying of this publication, message or any attachment is strictly prohibited. If you have received this report in error, please notify the sender immediately and delete or destroy this report without reading, copying or forwarding. The opinions, estimates and projections contained in this report are those of BMO Private Wealth as of the date of this report and are subject to change without notice. BMO Private Wealth endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Private Wealth makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Private Wealth or its affiliates that is not reflected in this report. This report is not to be construed as an offer to sell or solicitation of an offer to buy or sell any security. BMO Private Wealth or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Private Wealth, its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. BMO Private Wealth or its affiliates may act as financial advisor and/or underwriter for the issuers mention we herein and may receive remuneration for same. Bank of Montreal or its affiliates ("BMO") has lending arrangements with, or provides other remunerated services to, many issuers covered by BMO Private Wealth' Portfolio Advisory Team. A significant lending relationship may exist between BMO and certain of the issuers mentioned herein. BMO Private Wealth is a wholly owned subsidiary of Bank of Montreal. Dissemination of Reports: BMO Private Wealth Portfolio Advisory Team's reports are made widely available at the same time to all BMO Private Wealth investment advisors. Additional Matters TO U.S. RESIDENTS: Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. ("BMO CM") and/or BMO Private Wealth Securities Ltd. ("BMO NBSL"). TO U.K. RESIDENTS: The contents hereof are intended solely for the use of, and may only be issued or passed onto, persons described in part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001. BMO Wealth Management is the brand name for a business group consisting of Bank of Montreal and certain of its affiliates, including BMO Private Wealth, in providing wealth management products and services.

BMO Private Wealth is a Member-Canadian Investor Protection Fund and a Member of the Investment Industry Regulatory Organization of Canada.