

Investment Strategy

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More of the Good and Less of the Bad

Global equities performed well over the course of July. The strength can be attributed to a number of factors, but a key driver has been an economic, trade, and monetary policy backdrop that's had more positive than negative developments of late. For example, U.S. trade policy has become a bit more clear with several deals having been negotiated, economic growth has remained relatively resilient despite pressure in certain industries and some moderation in job growth, and inflation has perked up modestly in some goods but cooled elsewhere. Moreover, central banks continue to suggest they are leaning towards reducing rates in the future even though they have not done so in recent months. In sum, there remain things to be watchful for, but the list of concerns has been shrinking rather than growing.

We are starting to see some encouraging trends in commodity prices, particularly precious metals, copper and natural gas. While oil briefly spiked on Middle Eastern tensions, the fundamental supply/demand outlook is still relatively weak. On balance, though, strength in commodities has historically been associated with relative strength for the Canadian dollar and for the S&P/TSX. At this point, our conviction is higher for gold and natural gas, and we would encourage investors to look at high-quality stocks in those areas (i.e., strong balance sheets, low cost of production, productive assets in politically safer regions, and high free cash generation).

Earnings results serve a reminder that businesses are growing

The second quarter earnings season is more than half-way complete. As usual, there have been hits and misses, with some companies reporting better than expected results and others weaker and/or projecting lower guidance going forward. Overall, the blended earnings growth rate (actual

results so far plus those that are expected over next few weeks) in the U.S. is over 10%. That stands in contrast to forecasts from a month ago, when investors expected an earnings growth rate closer to 5%. Moreover, the profitability of companies in aggregate in the form of margins has not necessarily been affected yet by tariffs and cost pressures.

As has been the case for some time, the large technology-related businesses continue to drive a disproportionate amount of the earnings growth. If one excludes the Technology and Communications sectors, the blended earnings growth for the S&P 500 Index would be reduced by more than half. In other words, the growth rate may be less inspiring than headline figures would suggest. However, the pace of earnings growth has broadened with most sectors seeing a better pace of growth versus last year. And that is an accomplishment on its own given the unusual operating environment this year.

Not out of the woods

While investors should feel relieved and comforted by the earnings results delivered by businesses, there remain some challenges that lie ahead. According to BMO Economics, the U.S. average effective tariff rate on imports could rise to close to 20% when all is said and done. In other words, many goods being imported into the United States will cost more. This is not expected to necessarily cause a recession, but it is expected to present a drag on activity that mounts through the second half of the year in the form of higher prices, less spending, and potentially a hit to corporate profit margins. Moreover, there remain some questions on the trajectory of inflation. The pressure on services prices has shown signs of abating which has been encouraging, but there have been recent signs of inflationary pressures reemerging in manufactured goods, largely as a result of tariffs. Any upswing in inflationary pressure this fall will complicate the jobs of central bankers.

Equity valuations: some challenges for long run

Global equities have performed well since the lows reached back in April, leaving many global equity indices sitting near all-time highs. Naturally, some investors can get uncomfortable at moments like this. But history has demonstrated that new highs are often followed by other new highs as momentum can be a strong force that only changes once investors are forced to reassess their assumptions about the future.

New highs also don't necessarily mean stocks are expensive. The Canadian stock market, for example, is not terribly expensive despite a valuation that is above average. The same can be said about markets overseas, with various indices across Europe and Asia hovering within reach of their longer-term averages. That leaves the U.S. stock market as a bit of an outlier. Its forward Price to Earnings multiple (a common valuation gage that measures the value investors are willing to subscribe for a dollar of earnings) stands at over 23x. That level is quite elevated relative to its long-term historical average. However, as with the earnings story described previously, the valuation of the U.S. market is being disproportionately affected by many of the large-cap technology companies in the index. If one excludes some of these stocks, the U.S. stock market sits at less extreme levels, albeit still above its long-term average.

In sum, stocks are more expensive today than they were just a year or two ago, as price gains have outpaced earnings growth. Nevertheless, they are not at extremes, particularly if you exclude Technology. We frequently undertake this exercise because high valuations can lead to below average longer-term (i.e., 5 to 10 year) returns, and vice versa. As a result, valuation can be one of several tools that help in making asset allocation decisions across portfolios, although it tends to provide very little value in assessing the near-term, which is often dictated by momentum more than anything.

Technical Analysis

The medium-term trend for North American equities remains positive, accompanied by steady improvement in all aspects of our medium-term timing model. For example, weekly momentum gauges for both the S&P/TSX Composite and the S&P 500 remain "4 for 4" bullish after giving new buy signals in April, from the steepest oversold readings since the 2022 bear market low.

Breadth indicators such as the various advance-decline lines we follow are also at all-time highs as are other broad measures of equity participation such as the NYSE Composite and Value Line Composite indexes (and don't forget about that breadth

thrust back in April, too.) So, while the mega-cap tech names are getting all the headlines, the vast majority of stocks are also doing quite well. The same is true for global stock markets where countries like Germany, the UK, South Korea and Japan are also breaking out to 52-week or all-time highs.

And last, but not least, bullish sentiment continues to expand for all segments of the market, resulting in the biggest three-month expansion in our Composite Sentiment indicator since the lift-off from the credit crisis bear market low more than 15 years ago. (One of the components in that indicator – the Investor's Intelligence survey – just saw its biggest one week gain in the percentage of bulls since 1980, which is bananas.) It's also important to note that despite the recent improvement in our Composite Sentiment indicator it's still well below levels that would become any sort of headwind for equities. That's a 2026 story at the earliest. Recall that these indicators give you a sense of what the next 3 to 6+ months looks like, which suggests the general bias for equities should remain to the upside through the remainder of the year and likely even into 2026. All things considered the improvement in our medium-term timing model since April is consistent with the performance of these indicators at the beginning of every cyclical bull market since (and including) the credit crisis.

As for upside expectations, the S&P/TSX recently broke out of a six-month consolidation pattern above resistance at 25,875. That breakout opened an upside target that measures to 29,523. Favorite areas for new money here in Canada remain the Financials, all of which are either challenging their recent all-time highs or have already broken out. On the commodity front, precious metals (both gold and silver) are the most compelling given the solid uptrends in their underlying products, which is something we've been highlighting for a few months now.

The S&P 500 also broke to a new, all-time high above resistance at 6,147 back in late June. That breakout shifted the long-term trend back to bullish and opened a new upside target that measures to 7,460. While that might seem a bit ambitious, it would still be well below the historical average. If you view the April swoon as a fairly textbook cyclical bear market (as we do), then the gains over the next two years should be nothing short of fantastic. Cyclical bull markets within bigger secular bulls tend to last about 30 months and the average gain in the S&P 500 during those cyclical bulls is 86%. If you apply that 86% to the April low, that would give a target of 8,993 sometime out in 2027. If we just use the data since the credit crisis – where the average returns are only about 80% – that would give us a target of 8,718. Granted, that's more of an exercise in statistics and not our actual market call at this point. But, given the state of our medium-term timing model (which is fully bullish and supportive of more upside) the remainder of 2025 should be quite constructive.

In terms of what to buy in the U.S., pro-cyclical “risk on” sectors (Industrials, Consumer Discretionary, Technology, Financials) are outperforming the “risk off” areas (Health Care, Staples), which is common for this phase of the cycle and we expect that to continue throughout the remainder of 2025, at least. That’s what is referred to as the “all offense, no defense” trades over the years coming out of cyclical bull markets since the credit crisis. In fact, both Discretionary and Industrial indexes broke to new, all-time highs recently, opening upside targets that measure 22% higher for each index.

Lower rates are an exception, not the norm

The focus on policy rates has been more predominant lately in part due to all the noise around President Trump’s wish for a much lower rate to help a slowing economy and to hopefully reduce borrowing costs. The theory presumes that tweaking short rates translates cleanly to stimulate or reduce economic activity – but this is seldom the case. In practice, the transmission of these rates often works with a considerable lag that could vary from 6 to 18 months.

From a homeowner’s perspective, looking at a mortgage renewal and consumer loans, a lower Bank of Canada rate would be welcomed. But unlike the U.S. where policy rates remain above 4%, the Bank of Canada (“BoC”) has already cut rates 225 bps to 2.75% over the last 12 months, and we should start seeing some of the positive impact in the second half of 2025.

Central bank policy is an important starting point, but longer-term rates also play an integral role in financial markets and can be more informative for economic growth, inflation expectations and debt. Assuming that a central

bank cutting rates will lead to lower longer-term yields over time can also be misleading. Despite talks of rate cuts, Government of Canada mid- to long-term bond yields have gradually risen fueled by stronger than feared economic data, stickier inflation, and the prospects for a higher government deficit.

Higher longer-term rates explain the recent pullback in bond portfolio performance but returns remain healthy so far this year. More importantly, the positively sloped yield curve continues to offer attractive yields at a time when cash and cash equivalent sectors become less attractive. The BoC may still resume its easing cycle, but this does not mean that the 10-year rate should be much lower unless economic expectations are not as optimistic and inflationary trends significantly reverse. It is also important to recall that the low rates of the last decade were not the long-term norm, and our expectation continues to call for Canada 10-year yields to range between 3.25% and 3.75%.

Tactically, we can still make the case for why mid-to long term Canada yields could continue to rise which supports our current defensive portfolio positioning – maintaining a lower interest rate sensitivity. However, for every reason supporting higher rates, we find ones for why they should be lower; meaning the fixed income market offers a better balance in terms of valuation. From a strategic perspective it means bond investments are retaking their place as not only providing some portfolio ballast to riskier investments, but also offering attractive income to hold them.

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



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