Portfolio Advisory Team

Portfolio Management

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Equity and Fixed Income Strategy

Positioning for a Continued Recovery in the Second Half of 2021

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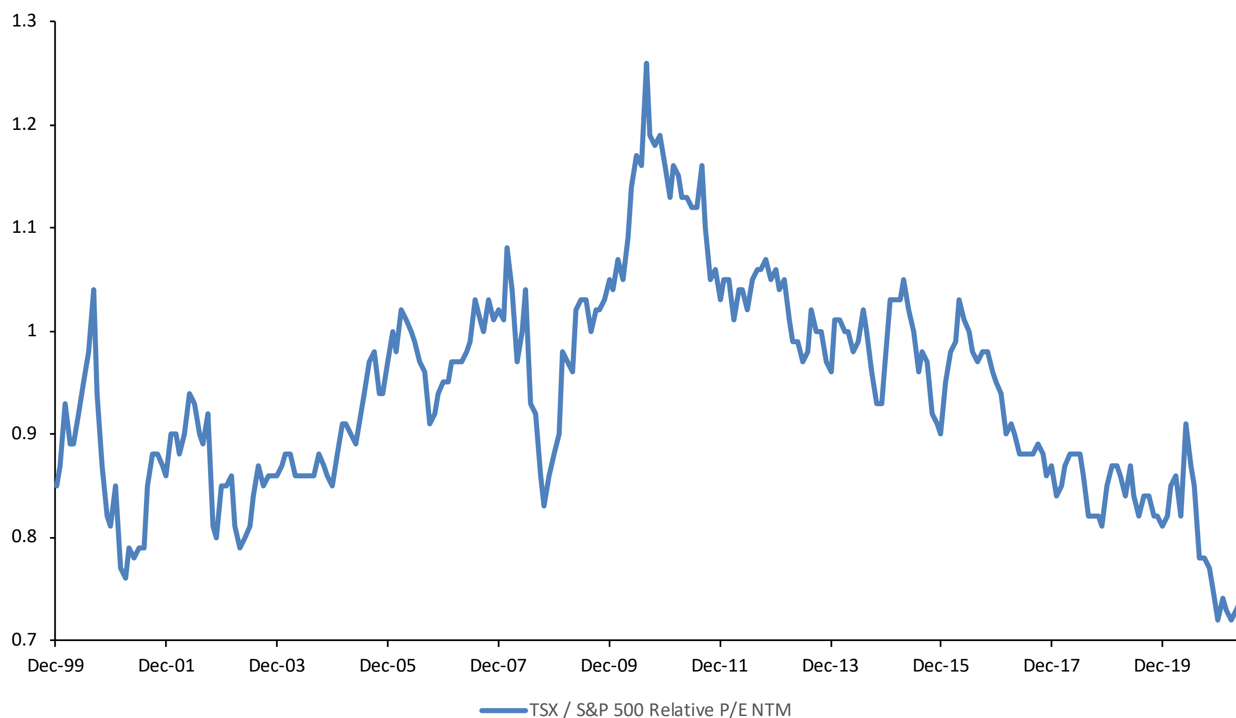
We believe investors should be positioned for a continued recovery in the second half of 2021. We feel confident in our increased "fair value" estimates from two months ago for the Canadian and U.S. Markets of 24,000 (from 21,000) for the TSX and 4600 (from 4100) for the S&P 500. This implies considerably more upside for the Canadian Market which jibes with the view we have expressed since the beginning of the year. Recall that the TSX has a far greater proportion of cyclical and "value stocks" -think Financials, Energy, Basic Materials including Mining, which trade at low multiples of earnings. Specifically, these three sectors account for over 55% of the value of the TSX vs. 17% for the U.S.

Our conviction is driven by the relative undervaluation -the chart below shows that TSX stocks are at their cheapest level vs. the S&P 500- of the Canadian Market but more importantly by the COVID 19 recovery we are witnessing and associated broad based earnings recovery. While lockdowns were very uneven in terms of timing and severity throughout North America, it is fair to say that we went through a "nesting with the family" environment that was characterized by low social interaction and seemingly insatiable demand for bigger houses, backyards, games, recreational vehicles, speedboats, motorcycles, cars etc. (and booze of course, lest we forget that classic cure for boredom!).

Figure 1: TSX Relative to S&P 500 Price/Earning NTM



Source: FactSet

Figure 2: 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	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.

Source: BMO Private Wealth

At this point, thanks to accelerating vaccination rates, virtually all North American Provinces and States are reopening, and we are about to see the kind of pent up demand there is for traveling, going out to restaurants, road trips etc. A great example of this comes from CNBC which reported on June 21 that Delta Air Lines told staff that it expects to hire more than 1,000 pilots by next summer, the latest move by an airline to cater to a rebound in travel demand. American, United Airlines, Spirit Airlines and other carriers have restarted or plan to resume pilot hiring this year. There are also countless anecdotes from Halifax to Seattle about restaurants struggling to find enough staff to meet the current surge in demand.

What does all this mean from an investment perspective? We continue to believe clients have to be selective and increasingly focused on sectors that have attractive growth vs. valuation propositions. We submit that the much-maligned oil and gas producers, financial stocks and some select stocks in other sectors continue to fit the bill (e.g. NFI Group, a leading electric bus manufacturer).

Energy, we think, happens to be one of the best “plays” for the next phase of the recovery. Clearly planes burn a lot of fuel, as do speed boat, RVs and most cars (probably for a long time to come). Oil and gas are classic supply/demand driven commodities and the surge in demand we are witnessing has not been met with sufficient investment over the last few years given the dreadful conditions the industry experiences. While the stocks are well off their lows, they remain at historically cheap valuations. Our excellent BMO Energy Analysts have noted that at current price levels, many companies generate free cash flow yields of 25-30%. This means that all things being equal, they could buy back all their shares in the next four years and “go private”. Of course, the alternative is for stock prices to continue rising. This is what we expect to happen.

Let’s hear it from our BMO sector experts themselves. This is an extract from a recently published report entitled “You Ain’t See Noting Yet”. While we certainly appreciate the Canadian classic rock reference, their arguments are compelling in our view.

The Bottom Line: “Crude oil prices have surged over the last several months as global oil demand recovers from the COVID-19 pandemic while supply stagnates. In the short term, we believe that demand could overshoot expectations as pent-up consumer demand is unleashed, leading to further upside in crude oil prices and oil and gas equities. We believe that the oil market is in the early stages of a multi-year up-cycle. Despite the best hopes of environmental groups and many OECD governments, global oil demand will likely continue to grow over the next decade, while oil supply could fall short of demand requirements as growth in supply is discouraged. The improvement in commodity prices has translated to a significant improvement in the financial position of the North American oil and gas industry with many companies poised to achieve record-low debt levels, improving returns on capital, and surging free cash flow… Since its peak in 2014, non-OPEC capital spending has fallen by more than 60%, creating a potential supply shortfall within the next five years that could drive crude oil prices above the peak set in 2008.

Natural Gas Following Oil Higher: Natural gas prices have also outperformed as lower supply and strong demand have brought storage levels below five-year averages. Based on current weather forecasts and strong international markets, we believe that Henry Hub prices could remain relatively strong over the balance of the year before moderating somewhat with normal weather conditions. We believe that consolidation will translate to better capital discipline and a stronger price environment.

Strongest Financial Position in 15 Years: The recovery in commodity prices together with newfound capital discipline has positioned the oil and gas group in the strongest financial position since the mid-2000's. At the same time, investor exposure and valuations are at multi-decade lows. We believe that oil and gas equities offer investors considerable upside due to rising commodity prices and improved valuations stemming from soaring free cash flow and strengthened returns on capital”.

We have already established that better commodity markets are positive for the relative performance of Canadian stocks. However, with the inflation debate raging we wanted to reiterate our conclusion that our historical rule of thumb has been that stocks suffer real multiple compression when inflation rises sustainably above 3%. In Canada, on the other hand, the performance has actually been better when inflation was rising, no doubt because of our market's very high exposure to Basic Materials and Energy which are traditional inflation hedges.

Figure 3: U.S. CPI and U.S./Canadian Market Returns

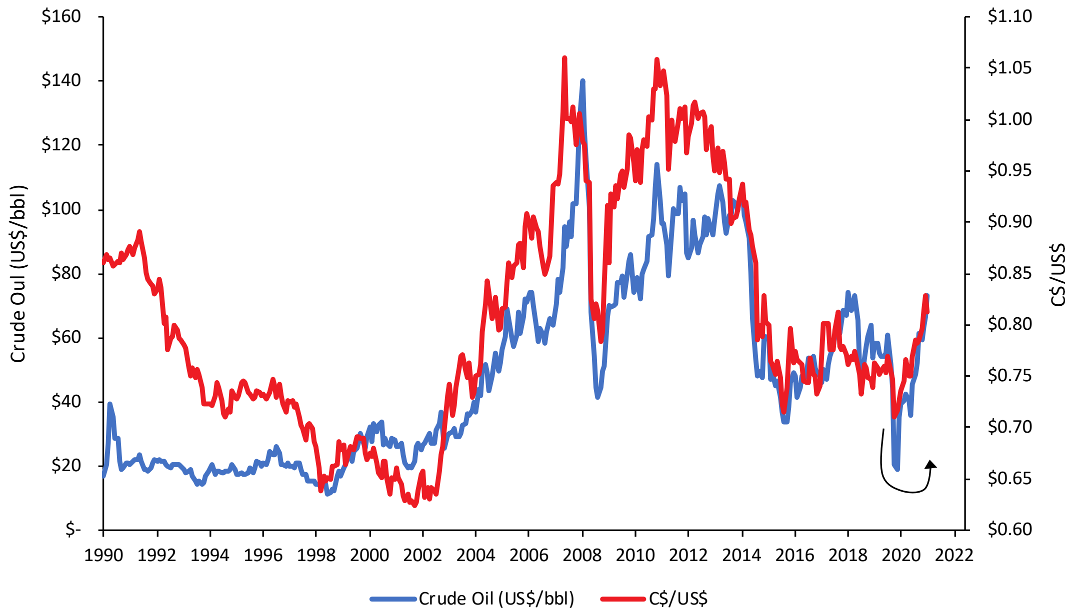
U.S. CPI (1994-Present)	S&P 500		S&P/TSX Composite	
	Average	Median	Average	Median
CPI Rising	4.2%	4.2%	6.0%	4.0%
CPI Declining	9.4%	15.3%	4.6%	8.5%

Source: Bloomberg, BMO Private Wealth; shows annual price return; S&P 500(1963-Present), S&P/TSX Composite(1966-Present)

Higher oil prices are also clearly bullish for the Canadian dollar. From our perspective, the weakness we saw in the Loonie last week was a short-term overreaction to Federal Reserve messaging, not a break in the uptrend we have witnessed since the end of last year.

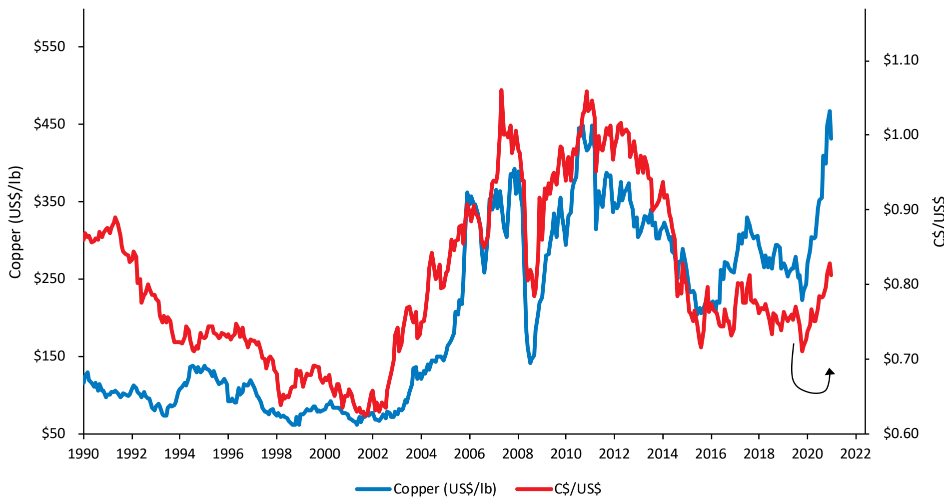
Our BMO Currency Strategist notes that "while the correlation between copper and CADUSD is impressive (and has been for most of 2021), copper and metals generally are not nearly as important for Canada's trade balance as energy… WTI above $70 would continue to argue for CADUSD at or below 1.20 (83 cents U.S.)."

Figure 4: Crude Oil vs. C$/US$



Source: BMO Private Wealth; FactSet

Figure 5: Copper vs. C$/US$



Source: Bloomberg

Value Stocks – Turning the Corner

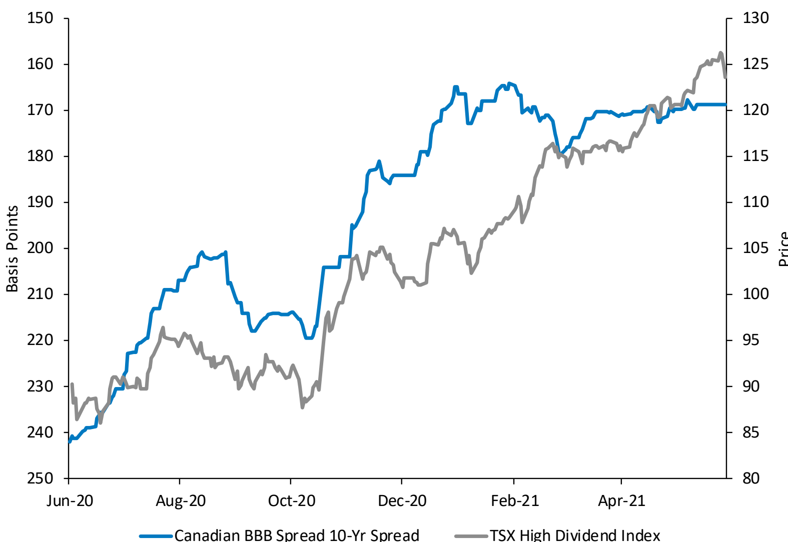
We continue to think that the cyclical backdrop for Value remains very attractive as earnings estimates, interest rates, and inflation all march higher. This is also good news for Canada given our market has a far higher weighting in these kinds of stocks (Financials and Energy at this point are inherently low multiple "value sectors").

The bond market is a great leading indicator for sector rotation and style performance. Generally, and notwithstanding short term trading volatility, growth stocks outperform when interest rates are falling -since these stocks are typically expensive "high duration" assets where much of the value comes from long term expected cash flows- and corporate bond spreads are widening (since these types of stocks generally have very little debt so they are not harmed nearly as much by higher borrowing costs).

Conversely, value stocks do better when yield are rising (since this is a sign of economic strength where more sectors and companies benefit from strong corporate earnings growth) and corporate bond spreads are falling.

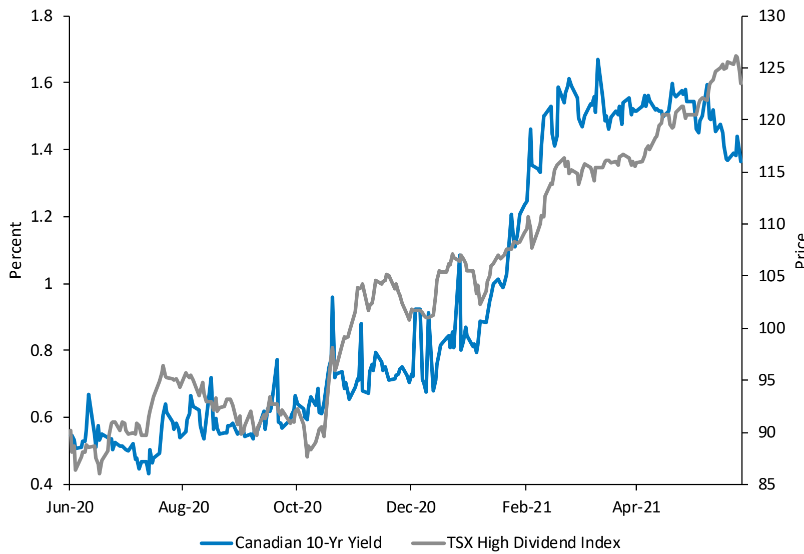
The charts below show this relationship graphically:

Figure 6: Canadian High Dividend Stocks (Grey Line – RHS) vs. BBB Corporate Bond Spreads (Blue Line – LHS Inverted)



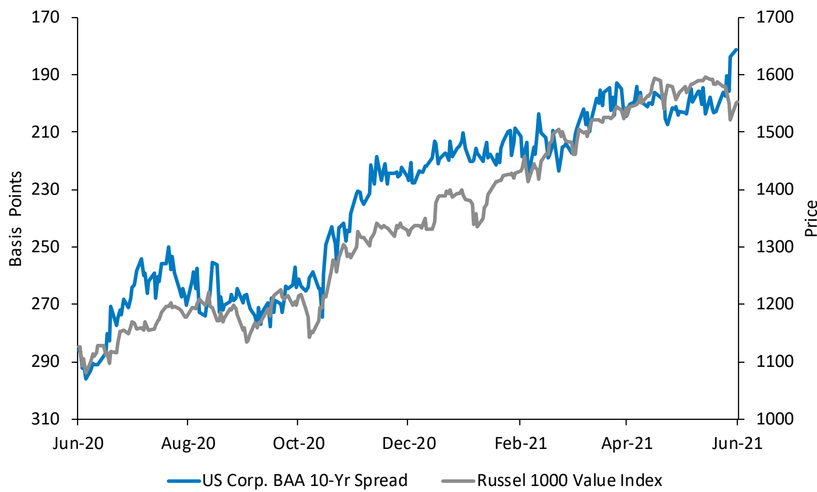
Source: FactSet

Figure 7: Canadian High Dividend Stocks (Grey Line – RHS) vs. 10 Year Canadian Bond Yields (Blue Line – LHS)



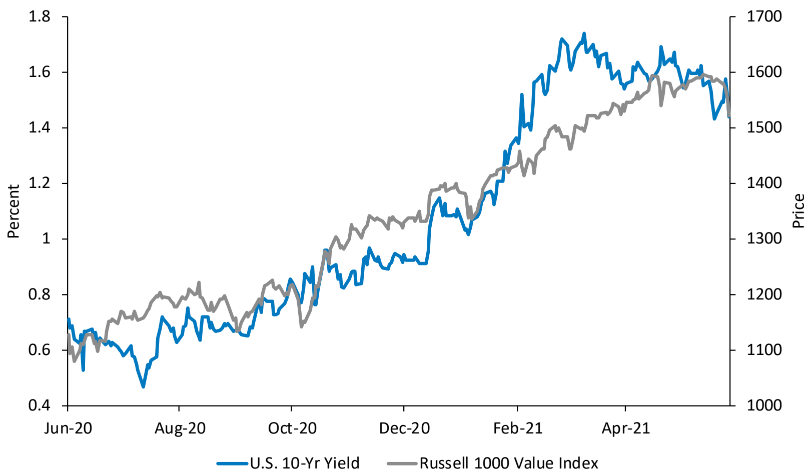
Source: FactSet

Figure 8: U.S. Value Stocks (Grey Line – RHS) vs. BBB Corporate Bond Spreads (Blue Line – LHS Inverted)



Source: FactSet

Figure 9: U.S. Value Stocks (Grey Line – RHS) vs. 10 Year U.S. Bond Yields (Blue Line – LHS)

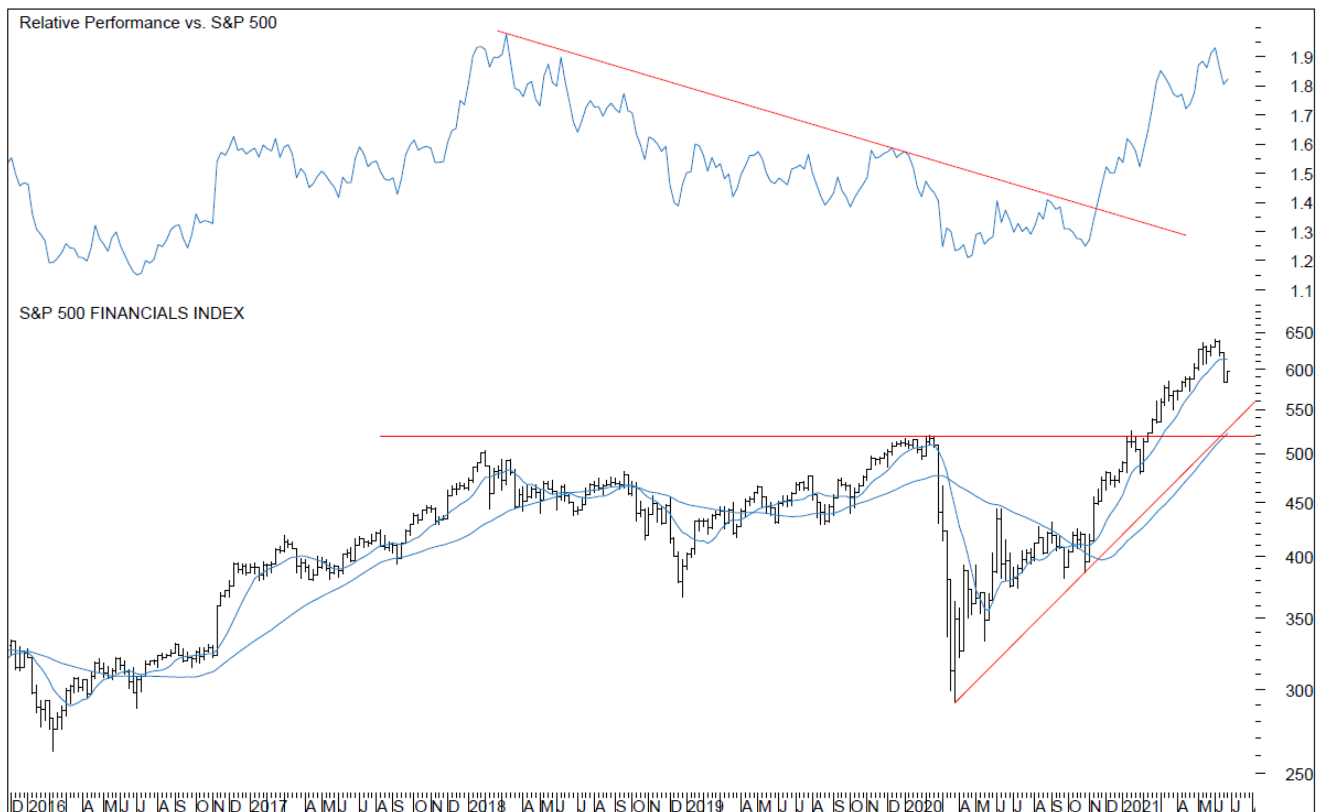


Source: FactSet

Technical Analysis – *by Russ Visch, Senior Technical Analyst*

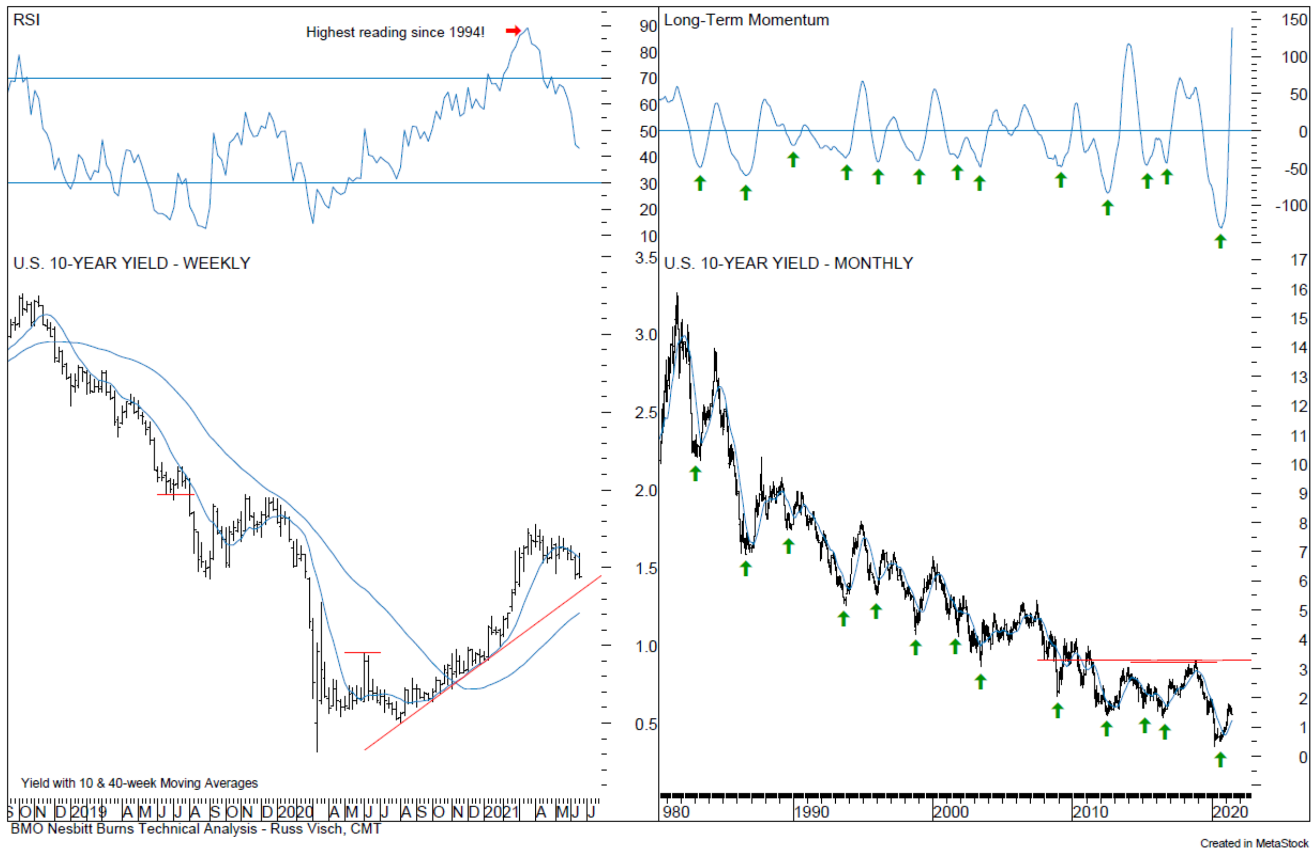
One of the most bullish developments for equity markets in the past few months is the breakout in financial stocks. The S&P 500 Financials index, for example, recently broke out of a massive four-year trading range and reversed a multi-year trend of underperformance vs. the S&P 500. That breakout above resistance at 520 signaled a resumption of the long-term uptrend and opened an initial upside target that measures to 750. That would represent a 25% gain from current levels but given the magnitude of the pattern it broke out of, higher targets are likely. It's not just a U.S. phenomenon either as the S&P/TSX Composite Financials index also broke out of massive multi-year trading range. The recent close above resistance at 3050 opened new upside targets that measure to 3700 then 4275. Like its U.S. counterpart, higher targets are likely given the size of the pattern it broke out of.

Figure 10: Relative Performance vs. S&P500



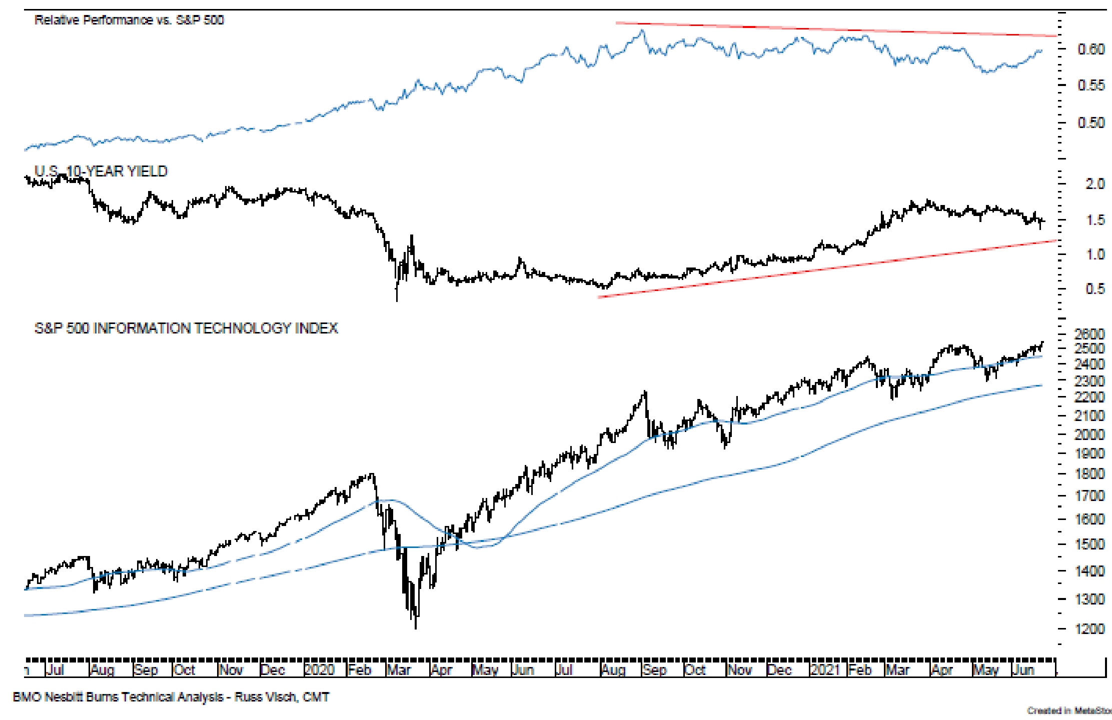
The key driver for financial stocks has been the recent turnaround in interest rates and the impact it's had on credit spreads. Late last year our long-term momentum gauge for the U.S. 10-year yield turned positive from the deepest oversold reading in nearly 60 years so we expect the bias for rates should be to the upside well into 2022. Granted, rates have backed off in recent weeks but that's likely nothing more than a countertrend pullback which should serve to unwind a deep overbought reading that developed during the surge in rates through the first half of the year. Following that, our expectation is that the U.S. 10-year yield challenges the 2018 peak near 3.25% at some point in the next year or two.

Figure 11: U.S. 10-Yr Yield Weekly/Monthly



There are always puts and takes in the markets, of course, so there will be areas negatively affected by the rise in interest rates in the months ahead. The most obvious impact is in utilities stocks, where companies which traditionally carry high debt loads usually come under pressure when rates begin to rise. It may come as a surprise to some, but technology stocks have also been negatively impacted and there is a clear correlation between when rates began to climb and when the S&P 500 Information Technology index began to underperform. Given our call for the 10-year yield, this trend of underperformance should persist for the foreseeable future. Our call since late last year is that this sector should be market weight at best going forward.

Figure 12: Relative Performance vs. S&P 500 – U.S. 10-Yr Yield

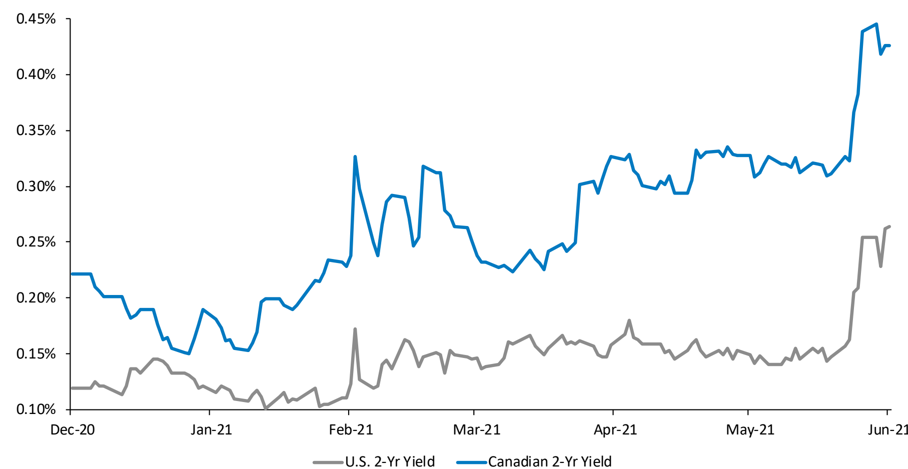


Shouldn't Interest Rates Be Moving Higher?

If markets believed mainstream media, interest rates would be higher. Strong commodity markets, high producer and consumer price indices, strong economic recovery, elevated inflation expectations, record fiscal and monetary stimulus, and record supply of government and corporate debt should, intuitively, lead interest rates higher. Instead, the U.S. 10-year Treasury yield has gradually trended lower since hitting 1.74% at the end of Q1, prompting many to revise upward their forecasts. A similar trend was observed in the Canadian rates market, with the 10-year Canadian yield falling by more than 25 basis points over the quarter. Not even the U.S. Federal Reserve's (Fed) more hawkish tone in June could pressure long term rates higher.

However, the Fed did impact short-term rates. Tapering talks (Fed reducing their asset purchases) and concerns that inflation could be a bit more persistent than initially thought led short-term rates significantly higher. In addition, an indication that some Fed members had pulled forward their expectations for the start of the rate lift-off, pushed the 2-year U.S. Treasury yield to almost double, trading at over 0.25% for the first time since March 2020 and leading the 2-10 year yield curve to flatten significantly.

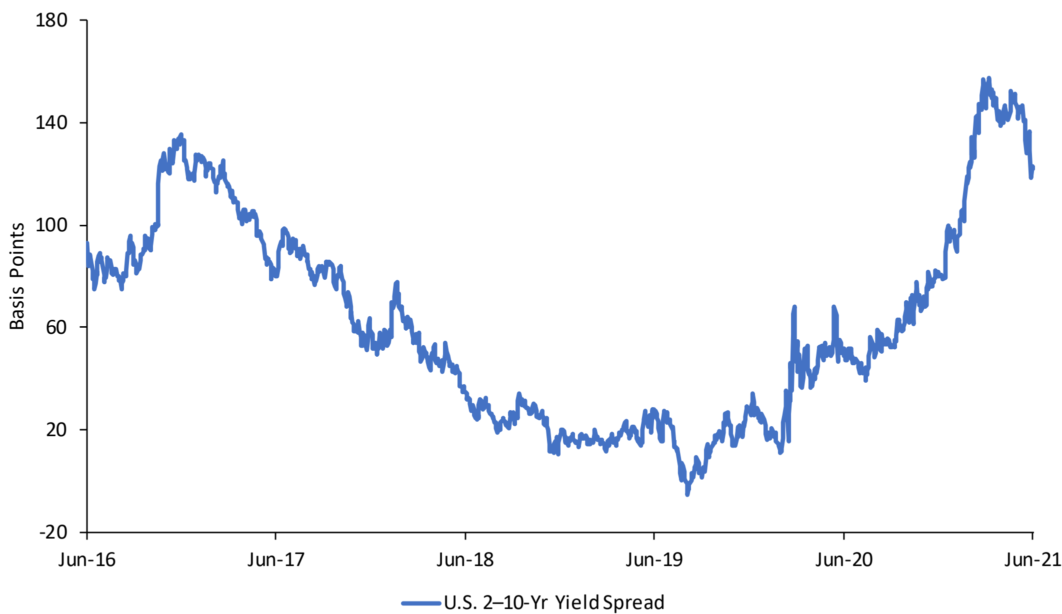
Figure 13: The Fed's Negative Impact on Short-Term Rates



Source: Bloomberg, BMO Private Wealth

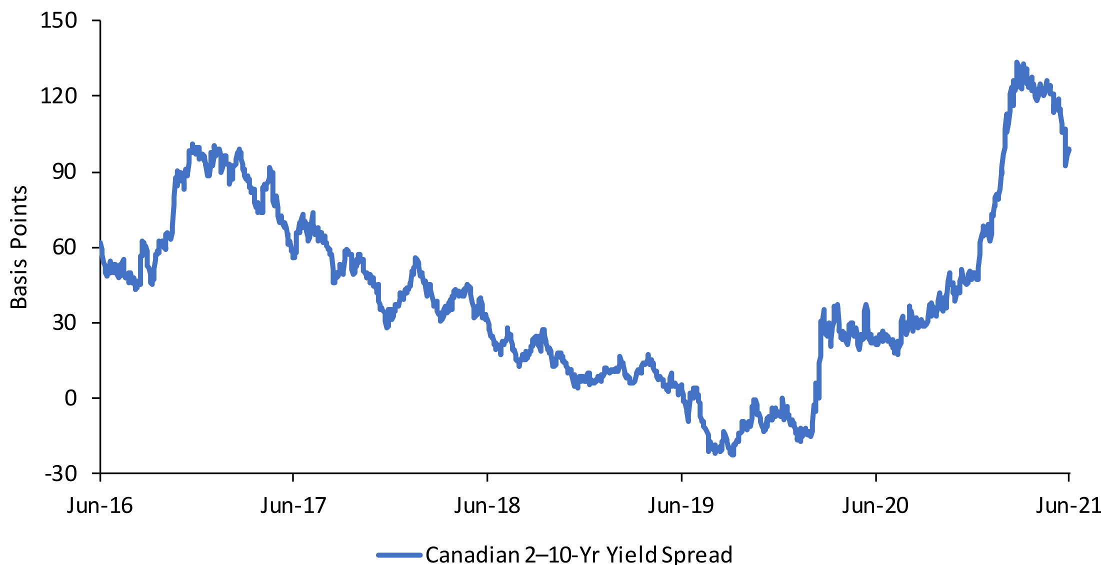
It is interesting how perception can change quickly in only a quarter. From rising long-term rates over fears of strong inflation, to now resuming their downtrend on signs inflation expectations may have peaked. The flattening of the yield curve seems to indicate that the market is ready to buy into the Fed's transitory message, but also that an earlier rate liftoff may reign in inflation risk. And perhaps the most interesting development is the fact that the market seems to be targeting a lower policy terminal rate than initially anticipated – that is, the rate at the end of the tightening cycle is being priced in lower than it had been. This helps explain why long term rates have fallen over the period and indicates that the market sees a risk of a potential policy mistake in the near future, i.e. raising rates too early and/or too fast that would force the Fed to reverse course. When combining the earlier start of the hike cycle with the extended drop in the breakeven rates of inflation lately, the market's perception is that the Fed's tightening may either come too soon or be too strong and negatively impact the economy.

Figure 14: U.S. 2–10-Year Yield Spread Curve, in Basis Points



Source: Bloomberg, BMO Private Wealth

Figure 15: Canadian 2–10-Year Yield Spread Curve, in Basis Points



Source: Bloomberg, BMO Private Wealth

In the meantime, we remain of the opinion that the combination of strong economics and stickier inflation in the months ahead may lead rates higher. This supports our recommendation to keep a slight defensive bias for fixed income portfolios. Our technical analyst, Russ Visch, notes above that he sees the potential for the U.S. 10-year yield to challenge a previous peak near 3.25% at some point in the next year or two (see Figure 11). While we agree with the trajectory, we aren't convinced that the fundamental economic backdrop will be strong enough to thrust rates much higher in a short period of time.

A Fed announcement of its dialing back of asset purchases could still lift longer-term yields higher, but considering the initial tapering discussion yielded limited market reaction, the odds of a 2013 style taper tantrum have significantly dropped. Labor market, economic growth, and inflation surprises could still help lift long term rates. However, looking beyond this year's strong recovery, all indications are that growth and inflation will likely decelerate from 2021 highs. New York Federal Reserve meaningfully lowered in June its U.S. real GDP forecast for 2022 and 2023 from 4.9% & 3.5% to 2.6% & 1.7% respectively. Assuming their forecast for core inflation is expected to settle around the 2% target and a path to tapering starting later this year or 2022, it is not difficult to see that the runway for rising rates may be shorter than initially expected.

With inflation expectations, CPI, economic growth, and now the yield curve steepness close to or having peaked already, the more muted reaction of long-term rates begins to make sense. In line with the pricing of lower terminal policy rates, we suspect that the market is also starting to price in a lower long-term rate target for this cycle. As always, the uncertainty around the evolution of the pandemic, the reopening of economies and the inherent risks with forecasting could still lead interest rates on a different path. One thing for sure though is that despite the fact that tapering and rate hikes are now closer, monetary policy remains very accommodative and will continue to be supportive for interest rates and credit spreads.

Figure 16: S&P/TSX Composite Total Returns

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Energy	8.89	38.18
Health Care	10.25	24.48
Financials	2.04	23.70
Info. Technology	19.13	22.01
Real Estate	5.39	20.28
Cons. Discretionary	1.48	18.02
S&P/TSX Composite Index	**3.74**	**17.43**
Telecom. Services	2.96	16.64
Consumer Staples	-0.49	6.54
Industrials	2.12	6.42
Utilities	2.06	4.60
Materials	-5.32	-0.16

Figure 17: S&P 500 Sector Total Returns

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Utilities	5.77	48.73
Telecom. Services	-2.94	24.95
S&P 500 Index	**3.99**	**21.95**
Materials	3.19	19.48
Info. Technology	-1.16	16.03
Industrials	1.78	14.40
Health Care	-5.67	14.19
Financials	5.12	12.00
Energy	0.93	11.11
Consumer Staples	4.21	9.33
Real Estate	-1.98	3.82
Cons. Discretionary	-3.42	2.48

Source: Bloomberg, BMO Private Wealth; as of June 24, 2021

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