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**February 2023**

BMO GAM's Monthly House View

# A Winter of Sunny Surprises

Presented by BMO GAM's  
Multi-Asset Solutions Team

# A Winter of Sunny Surprises

As we approach the second quarter of 2023, the big questions investors are facing are—where are we in the economic cycle, and what does that mean for markets?

The consensus view, which we share, is that the economy is starting to weaken. But the outcome remains unclear. Will the downturn be bad, meaning a potentially long and deep recession? Or does the economy weaken more modestly, resulting in a soft landing or even no landing? There also remains the question of timing. Going back to last year, expectations were that the impacts of a weakening economy would be felt by the latter part of Q1. Now, that's been pushed back to late 2023 or even 2024. In short, the pain has been delayed by six months or more. This is good news for the economy but leaves the future somewhat uncertain.

The other question we've been considering is whether the recent market rally means it's time to lock in gains, or if there's room for markets to move even higher. To put it another way—after a punishing 2022, will markets recuperate their losses? That debate has led us to reiterate our preference for balance at this time. You might call it a goldilocks position: not too much risk, not too little risk, but rather a risk profile that's just right for the current environment. With the economy slowing down and job losses



**Sadiq S. Adatia,**  
FSA, FCIA, CFA  
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mounting, the downside risk is evident. But there are also positive signs: an announced rate hiking pause by the Bank of Canada (BoC); a likely pause from the Federal Reserve (Fed) later this year; and earnings numbers that weren't as bad as some were expecting, which gives investors three months to breathe before the next round. As a result, we think there's room for markets to move higher in the near term, which means that staying the course is the right strategy. It's likely that volatility will continue as the bulls and the bears fight it out. But overall, we think that the bull case is short-term and the bear case will occur later this year, which might explain the good start to the year.



**ECONOMIC OUTLOOK**

# Hard Landing, Soft Landing, or No Landing?

The big story, in North America and internationally, is the diminishing odds of a deep recession and the improving odds of a soft landing—or maybe even something better.

**U.S. Outlook**

January's U.S. job numbers came as a major surprise, with job creation remaining strong despite expectations of a slowdown. This has delayed the onset of a likely recession, which we think will force upward revision of growth estimates, which remain fairly low for the year. Originally, many analysts were predicting a recession in Q4 of 2022. Then, that was changed to Q1 or Q2 of this year. Now, we've seen it pushed back even further to late 2023 or beyond. As a result, a soft landing—which had been viewed in some circles as a pie-in-the sky scenario—now looks more and more credible. There are still challenges, of course—interest rate tightening has hurt housing, and rate-sensitive sectors are starting to stabilize but still experiencing pain. But overall, it's shaping up to be a better year for the U.S. than we had feared.

**Canada Outlook**

It's a similar picture in Canada. The job numbers for January came in very strong: north of 150,000 jobs created, which is outstanding given that in a good year, the country tends to create around 225,000 jobs—that's the regular 'cruising altitude,' so to speak, and we almost hit it in just a single month. This is particularly surprising because, unlike the U.S., the Canadian labour market had already fully recovered from COVID-related losses. In my mind, the big



**Fred Demers, MA**  
Director,  
Multi-Asset Solutions



story is the underappreciation of labour shortages combined with strong population growth fueled largely by immigration. In the third quarter of 2022 (the most recent quarter for which we have data), the population grew by 0.9%. This is very strong when you consider that in an average year, the Canadian population grows by a little more than 1%. Such high population growth means that Canada now has the people necessary to fill vacant jobs. Our expectation is for continued surprise on the upside in the Canadian labour market because it's going to take some time before labour demand

## ECONOMIC OUTLOOK

cools to the point of weakness. Overall, this is good news—it likely means stronger economic growth for the year and could be a boon to the Canadian housing market, as job security and regular paycheques are crucial for people's ability to make their monthly payments. Another positive effect is that more people entering the labour force means an expansion of the supply side of the economy, which is not inflationary; Canada will be able to produce more goods and services because people are available to do the work instead of the cost of the labour being bid up through higher wages. That's why we've seen wages starting to moderate, which is good news for the inflation outlook.

## International Outlook

The theme of positive surprises continues with Europe, which has avoided a recession that everyone assumed was a done deal. That doesn't mean that we're suddenly bullish on EAFE—the economic numbers from Q4 were not strong. But when you manage to avoid a recession, that's a good sign. The situation remains challenging for the U.K., which likely stands as the weakest of the world's developed economies. But Germany, the core economic engine of Europe, avoided a technical recession, and business sentiment is improving from the lows of 2022. The energy situation is still fragile, but it has been managed well this winter, with energy needs being reduced by over 20% and alternate sources of natural gas being developed. The bottom line is that Europe will make it through what remains of the winter without it inflicting more economic pain, which is a positive outcome. The European Central Bank has had to lean against inflationary pressure, putting upward pressure on the Euro. But that's good for international investors, which is why we've become a bit less negative on the region overall.

Across the Pacific, the rapidity of China's post-COVID recovery is driving Emerging Markets, with travel activity already back to pre-COVID levels; a process that took months in Canada and the U.S. months is playing out there in mere weeks. The surprise is that, unlike in North America, there's been little stop-and-go—

the Chinese reopening has thus far been very smooth. Further significant lockdowns are unlikely, and the continued unleashing of one of the world's premiere economies should be a key tailwind for the remainder of 2023.

Key Risks	BMO GAM house view
<b>Inflation</b>	Still keeping investors on their toes It's coming down, but the debate is if will it do so fast enough to avoid a 6% Fed Fund Rate
<b>Rising rates</b>	Almost done, with maybe one or two 25bps hikes remaining With a peak likely approaching, rates won't be as big of a headwind as last year
<b>Recession/unemployment</b>	A diminishing risk, but not gone entirely Job losses are still likely, but they may have been pushed down the road We may have underestimated the demand for labour
<b>Geopolitics</b>	A risk that doesn't want to go away The recent balloon fiasco has shown the sensitivity of U.S.-China relations Escalation appears unlikely in the Russia-Ukraine conflict, which is good news for markets
<b>Energy prices</b>	Remain elevated, but there's no strong sense they could explode again Sanctions against Russia have had minimal impact on energy sentiment The U.S. is being careful about replenishing their strategic petroleum reserves, not wanting to cause a spike in prices
<b>Consumer debt</b>	Another risk that doesn't go away Having a steady paycheque remains crucial for consumers' ability to service their debt in a high-rate environment
<b>Housing market</b>	Prices are cooling but remain above pre-COVID levels We expect housing prices to decline a bit further But in Canada, strong population growth should be a boon to demand

## PORTFOLIO POSITIONING

## Asset Classes

Odds are increasing that central banks will need to continue lifting rates to stem inflation. But economic data are holding firm, suggesting a soft-landing scenario that markets appear able to absorb.

With half a million jobs created in the U.S. in January while the Canadian market produced 10 times expectations, it begs the question of whether the Fed and BoC can stay on the sidelines. The Fed's implied terminal rate jumped almost 40 basis points to just under 5.2% after January's labour numbers were released. The market is now expecting rates to go higher, with 25 bps or up to 50 bps priced in. With rates moving higher, it makes sense to us to get exposure further out on the yield curve on some longer-dated bonds. Credit spreads have been well behaved, so we've gone slightly overweight credit in many of the portfolios in order to pick up some extra yield.

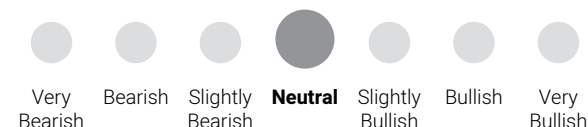
Inflation is still coming down, with the three-month annualized rate at around 3.5% in February. A recession is still the most likely scenario, but the timing is stretching further and further out. The job market is exceptionally strong and the consumer is still in good shape. There are still many green flags that suggest we're not near the brink of a contraction. The likely scenario is two or three quarters of shallow negative growth. If we do see a technical recession of around one per cent, markets could be relatively fine because a downturn has been expected and baked into forecasts. In fact, risk assets again have some momentum, as do speculative assets like Bitcoin and meme stocks. It all points to a return to a risk-on appetite. Overall, it's difficult to get too concerned when you've got half a million jobs a month still being created



**Steven Shepherd, CFA**  
Director,  
Portfolio Manager

and consumers continuing to put money in the bank. When the American worker has money to spend, the economy does alright. That said, we remain neutral on stocks for the time being (0) while we've moved some cash (-1) off the sidelines and into fixed income, which we've upgraded to slightly bullish (+1).

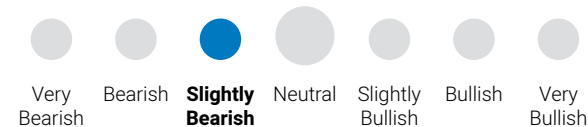
## EQUITIES



## FIXED INCOME



## CASH



## PORTFOLIO POSITIONING

## Equity

All signs point to a strong rebound for China in the coming quarters, in contrast to other regions—including Canada, where elevated interest rates will be a material drag on economic prospects.

We remain neutral (0) on the U.S., where the economy has proven resilient and we're seeing growing evidence that because of ongoing labour shortages, the scope of damaging layoffs may be limited. It appears that a soft-landing scenario is playing out. What keeps us underweight North America overall is Canada. The interest-rate increases made over the past year are flowing into an economy that has high debt levels and an elevated risk of a housing slump. We have moved to underweight (-1) Canada as the effects of previous rate hikes begin to take hold. It doesn't mean we'll see a hard landing, but we will likely see a slowdown in consumer spending and in the housing market, which makes up a meaningful percentage of the Canadian economy.

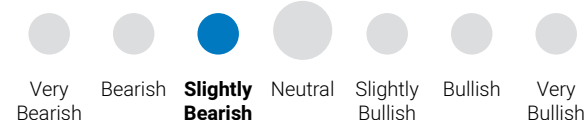
Overall, we've become more bullish on international (EAFE) and Emerging Market (EM) equities compared to North America, and EM in particular. Europe has proven more resilient than initially feared at the outbreak of the Russia-Ukraine conflict: warmer weather has helped alleviate an energy crisis, and we've seen a continued flow of Russian oil despite sanctions. Those developments have spared Europe from the worst-case scenario. EM, and particularly China, is where we have our highest conviction right now. The high-frequency economic data is spiking, which is consistent with our expectations for a post-COVID bounce.



**Marchello Holditch,**  
CFA, CAIA  
Director,  
Portfolio Manager

Concerns regarding the Chinese property and technology sectors continue to abate. We remain overweight (+1) EM, with China providing a significant tailwind. We've shifted to neutral from slightly bearish on EAFE.

## CANADA



## U.S.A.



## EAFE



## EM



## PORTFOLIO POSITIONING

## Fixed Income

Bond markets are once again heeding the Fed's words, pricing in the prospects of a higher terminal rate than investors believed.

The blow-out labour market numbers in both the United States and Canada have increased the probability that central banks will need to go higher for longer. Tight labour markets mean more upward pressure on wages. All else being equal, that means we're going to need a more aggressive Fed and BoC. The Fed will raise rates in March and likely May, and now possibly June as well. But even with these hikes, it's important to note that the terminal rate will still probably fall within the range the Federal Open Market Committee has talked about, which is around 5.25% to 5.5%. The market got a bit ahead of itself in terms of not believing that the Fed would take rates to where it said it would. The strong labour numbers have jolted investors into pricing back in what the Fed said it would do. It's uncertain if the Fed will grow more hawkish from here.

The yield curve remains deeply inverted, which signals a recession, but timing and severity are big question marks. The odds of a recession are still high for this year, but for the moment, the downturn is getting priced further and further out. We have moved from slightly bearish (-1) on High-Yield bonds to neutral (0), reflecting better economic conditions, while we remain slightly bullish (+1) on Investment Grade (IG) debt.

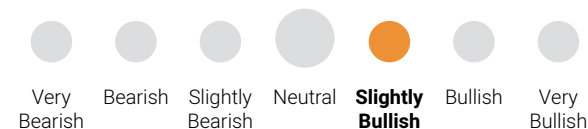


**Marchello Holditch,**  
CFA, CAIA  
Director,  
Portfolio Manager

## HIGH YIELD



## IG CREDIT



## EM DEBT



## DURATION



## PORTFOLIO POSITIONING

## Style &amp; Factor

Markets are beginning to look past immediate recession risks, presenting a near-term opportunity within early-cycle sectors and names.

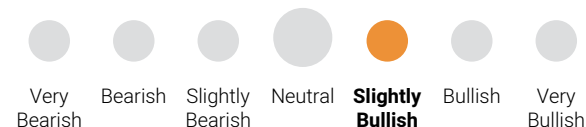
Just about everything that got beaten up last year has had a strong start to 2023. We've seen cost-cutting from the mega-cap Growth stocks as well as some valuation compression, which has helped them recover some ground. In a comparison of relative valuation between Value and Growth, the advantage that Value had through last year has levelled off—now, they're pretty much even. Our neutral stance on equities is a reflection of our view of a softer landing scenario—and if you're going to be neutral on equities and neutral on North America, that implies that you're probably neutral (0) on Growth, as it makes up 25-30% of the S&P 500.

In terms of the sectors, we've been overweight Energy for some time and continue to hold it. The sector is expected to perform at the upper end of earnings growth this year, which is the opposite of what you'd expect heading into a recession. We're looking at other cyclicals as well, including Industrials and Materials. And we're also tempering our view on Health Care as we move away from a hard-landing scenario. Equity markets are almost skipping ahead, looking past the recession risk into what's going to recover once the economy gets going again. Right now, the message is that investors don't expect a deep or drawn-out recession. To summarize, we remain slightly bullish on Value (+1), have cut quality to neutral (0), and have upgraded Growth to neutral (0) from slightly bearish (-1). Volatility remains unchanged, at slightly bearish (-1).



**Steven Shepherd, CFA**  
Director,  
Portfolio Manager

## VALUE



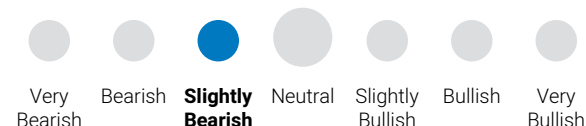
## QUALITY



## GROWTH



## VOLATILITY





## PORTFOLIO POSITIONING

## Implementation

With investors showing some appetite for risk, the greenback's rally continues to fade, which is good news for the loonie.

We're not so much bullish on the Canadian dollar (CAD) as we are bearish on the US dollar (USD). The broad view is that a softer landing means less risk aversion and less money flowing to safety assets like the USD. That's really what drove the greenback's strength last year. The general risk-on tone compared to the end of last year is a positive for the CAD. We have seen some recent bounce-back in the USD as bets move in favour of the Fed needing to hike rates further. If rates keep going up, the USD will continue to regain ground. In terms of implementation, there are various ways to take advantage of a weaker USD across our portfolios besides a straight hedge back to the CAD. Gold is one. Commodities and energy priced in U.S. dollars is another. Being overweight Emerging Markets is yet another play on a weaker USD. Different portfolios implement this view in different ways. While our current view isn't particularly high-conviction, we do expect the CAD to creep up against the USD. As a result, we remain slightly bullish on the CAD (+1).

CAD



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## DISCLOSURES

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