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BMO GAM's Monthly House View

Know When to Hold 'Em

Presented by BMO GAM's Multi-Asset Solutions Team

BMO Global Asset Management

Know When to Hold 'Em

When is it the right time to bet big? That's the big question this month, both in markets and at the annual World Series of Poker, taking place in Las Vegas throughout the months of June and July. Poker players know that before you go all-in, it's crucial to have as much information as possible. It's no different for investors.

Sadiq S. Adatia, FSA, FCIA, CFA
Chief Investment Officer (CIO)

This month, after much consideration, we upped our Equity allocation from underweight (-1) to neutral (0). There were three themes that influenced our thinking. First, a potential recession continues to be pushed further and further out, with a relatively soft landing sometime in 2024 still the most likely scenario in our view. That means that in the near term, the economy can be expected to grind lower, but at a pace that is still sufficient for consumers to feel alright and continue to spend. Second, job losses are occurring, but not at a magnitude that is worrisome, and there are still many job openings to facilitate those who are laid off. And third, as we take stock of markets, we can't ignore last year's massive downturn. It has led to more attractive valuations, and we believe there's room for markets to grow—especially in non-tech names, since they haven't participated as much in markets' performance year to date, which has been driven almost entirely by the top six or seven mega cap names.

"We believe there's room for markets to grow—especially in non-tech names."

For now, we don't have enough data to say that markets will take off strongly from here, and we don't have enough data to say that markets could crash imminently. When information is that limited, you simply don't want to be making massive bets, hence our shift to a neutral position on Equities. We do believe that inflation is going to remain stubbornly sticky in the near term. The Bank of Canada's (BoC) interest rate increase in June highlights the fact that even if the U.S. Federal Reserve (Fed) decides to pause, it won't necessarily mean the end of the rate-hiking cycle—rather, a pause is merely a pitstop as central banks wait until they can act confidently one way or the other. It's not so different for investors. For now, a cautiously optimistic view is warranted, as we wait and see what the economic data tells us about which direction markets may move.

North American Economies Remain Resilient

The Fed and Bank of Canada eye further interest rate increases as China stalls and Japanese equities rebound.

Brittany Baumann
Vice President,
Investment Strategist

U.S. Outlook

Another month, another solid jobs report. May's payroll numbers strongly surprised on the upside, with 339,000 jobs being added. That underscores the resilience of the U.S. economy. The unemployment rate moved higher, but in our view, this reflects the fact that employment in the household survey tends to be noisier. We place more weight on payroll growth, and that along with Q2 real gross domestic product (GDP) tracking near 2% and jobless claims remaining low suggests that a recession is still at least a quarter or two away.

Not all the data is rosy, however. The Manufacturing Purchasing Managers Index (PMI) remains weak, and Services is slowly losing steam as well. This weak sentiment amid resilient hard data will therefore keep the recession debate alive. The probability of a downturn remains elevated in our view, particularly as tighter credit and ensuing bank stress slowly feeds through the economy. But the timing continues to be pushed out, and macroeconomic resilience suggests at least one more interest rate hike from the Fed this summer. Barring a significant upside surprise in inflation data and/or another energy price shock, we suspect the Fed is inclined to set a higher bar for further hikes, suggesting that we are near the peak. But at the same time, and as investors have been repeatedly reminded, the Fed is data dependent, which means that incremental rate hikes can continue to be priced in going forward.

Canada Outlook

Canada's economic resilience has finally given way to another rate hike by the BoC, which increased rates by 25 bps in June. The combination of steady job growth, above-trend real GDP growth in Q1, and sticky inflation data largely drove the Bank's decision, with the bottoming of the housing market perhaps also playing a role. We anticipate that another hike is in store, but like the Fed, the BoC will be cautious and are unlikely to frontload rate increases like they and other central banks did last year.

Going forward, record immigration will continue to be a key buffer to the economy, underpinning job growth and housing demand. But relatively high consumer debt levels and more variable shortermaturity mortgages means that Canada is not immune to tighter financial conditions. In the near term, growth is unlikely to crash, but it's also unlikely to accelerate significantly.

International Outlook

The manufacturing outlook in Europe continues to look grim, with weak factory order data prompting more calls for a recession in Germany, the continent's economic powerhouse. In the U.K., a massive upside surprise in core inflation is pulling forward more rate hikes by the Bank of England. And, in general, more entrenched inflation in the region means a greater likelihood of a hard landing brought about by rate hikes. Japan remains a bright spot, as easier financial conditions thanks to its yield curve control (YCC) framework, together with its delayed reopening, means better growth momentum ahead. But for EAFE as a whole, we tread cautiously.

For emerging markets (EM), Chinese growth momentum remains lacklustre amid structural challenges, a weak property sector, weak foreign demand, and very cautious consumers. But one positive development in the past month is talk of stimulus targeting the Real Estate sector. This, along with steps to boost housing demand, should help to restore investor confidence. But the question is—will it be enough? Additional Chinese stimulus is key to our still-positive view on EM, but if there is further disappointment, we'll be quick to reassess.

Key Risks	BMO GAM House View
Inflation	• Headline inflation is trending in the right direction • Core inflation will remain sticky
Interest rates	• We appear to be near the end of a long and brutal hiking cycle in North America • The bar is set very high for a negative interest rate surprise over the next few months
Recession	• You cannot have a recession without job pain • Canada and the U.S. are still creating jobs at a high pace, meaning a recession may be several months off • The labour market remains tight
Geopolitics	• U.S.-China relations can be expected to remain strained • We're monitoring a potential executive order that could restrict U.S. investment in parts of the Chinese economy
U.S Politics	• Liquidity is on our radar as the Treasury General Account (TGA) is rebuilt • The lack of clarity on who will run in the 2024 presidential election creates uncertainty
Consumer	• Wage growth is now outpacing inflation • If we don't see job losses, the consumer will be fine • This recession is likely to be triggered by the business side rather than being consumer-driven like it was in 2008
Housing market	• The market is bottoming out earlier than expected • In Canada, there is still a huge imbalance between supply and demand • Housing is likely to shift from a headwind to a tailwind as we head into 2024
Banking crisis	• Likely to remain a source of concern for markets • Smaller, regional banks tend to be more exposed around the recessionary cycle

Asset Classes

A narrow rally that is beginning to broaden out has us reconsidering our Equities exposure. Adding to our longer duration fixed income provides a suitable counterbalance, while we continue to favour short-term bonds over cash.

Steven Shepherd, CFA
Director,
Portfolio Manager

This market rally reminds me of the old joke about getting chased by a bear while on a hike: you don't have to outrun the bear; you just have to outrun the guy next to you. We've been slightly underweight (-1) Equities throughout the first part of this year, but with Technology really taking off due to the recent artificial intelligence (AI) mania, it's led to a very narrow market rally. There are differing opinions as to whether narrowness is a good or bad sign for a durable rally. But it has certainly made it more difficult to decide whether to take a longer-term view, especially with an impending recession, or to re-evaluate our medium term outlook to participate in the melt-up currently occurring. To cut to the chase: we've moved our rating back to neutral (0) on Equities, from slightly bearish (-1). The fact that it's only 10 or fewer names leading the charge is concerning, but it's not unheard of considering those 10 names reside in the largest sector of the S&P 500. In Canada, banks are trading about 20% off their historical value after a series of disappointing Q1 results, while Energy stocks are also yielding value. Those sectors, in combination with the performance of U.S. Technology stocks, are why we've gone back to neutral.

In fixed income, the Fed is increasingly expected to "un-pause" its hiking cycle—even before the widely anticipated pause has officially occurred. The BoC has already resumed hiking, with an additional move possible in July as well. It certainly has made us reconsider our long-duration exposures. But since we've moved Equities back to neutral and are adding to that side of our portfolios, having duration as a counterbalance isn't the worst thing in the world, either. In terms of our cash position, we've been moving out onto the short end of the curve—we're seeing good yields in short term bonds, so we'd rather be there.

EQUITIES	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
FIXED INCOME	Very Bearish	Bearish	Slightly Bearish	Neutral	**Slightly Bullish**	Bullish	Very Bullish
CASH	Very Bearish	Bearish	**Slightly Bearish**	Neutral	Slightly Bullish	Bullish	Very Bullish

PORTFOLIO POSITIONING

Equity

Mega-cap growth stocks have dominated the market in Q2, though high expectations are once again getting priced in. Regionally, the U.S. is looking far sturdier than it was, while Europe is further down the road to recession.

Marchello Holditch, CFA, CAIA
Portfolio Manager

First quarter earnings delivered some well-above-average surprises, with results much better than feared. On the flip side, the overall profit growth rate was still negative, so one might say that overall, it was a strong earnings season despite the earnings contraction. For Q2, it's really been a bifurcation: if you look at the S&P 500 as a whole, you'll see that earnings revisions are starting to tick back up. Since last summer, we've seen earnings revisions ticking down, but now they're starting to turn the corner. However, if you remove the top five names, they're still getting revised down. That's the bifurcation—a lot of that uptick is coming from the likes of Nvidia and Meta. So, the second quarter really has been a tale of two markets. It remains to be seen whether they can meet those perhaps-not-lofty but certainly higher expectations.

The near-term threat for markets is interest rate risk. Recession isn't likely a next-quarter issue, nor is it likely in the next six months; we consider it a medium-term risk. Recently, the economic data has been strong, and inflation has been stickier. The risk is of further hikes. We saw the Bank of Australia surprise with a hike, and the same with the BoC. It's not out of the question that the Fed continues to raise rates.

Regionally, we've kept Canada at neutral (0). For the U.S., we've gone from slightly bearish (-1) to neutral (0), and EAFE we moved from neutral (0) to slightly bearish (-1), effectively swapping those two markets. What's changed our thinking is that we're seeing positive economic surprises. The U.S. economy is proving more resilient than feared, despite all the interest rate hikes. Another factor is the AI frenzy we're seeing. That momentum doesn't tend to just happen in one month and go away. It could be a bubble, but even bubbles last typically longer than one month. So, we think that you could continue to see some of these large-cap Tech names in the short term continue to do well. On the flip side is Europe, where we're seeing economic momentum wane. So that prompted us to downgrade European markets and EAFE overall despite an overweight to Japan.

CANADA
Very Bearish | Bearish | Slightly Bearish | **Neutral** | Slightly Bullish | Bullish | Very Bullish

U.S.A.
Very Bearish | Bearish | Slightly Bearish | **Neutral** | Slightly Bullish | Bullish | Very Bullish

EAFE
Very Bearish | Bearish | **Slightly Bearish** | Neutral | Slightly Bullish | Bullish | Very Bullish

EM
Very Bearish | Bearish | Slightly Bearish | Neutral | **Slightly Bullish** | Bullish | Very Bullish

PORTFOLIO POSITIONING

Fixed Income

Investors are betting that central banks will continue tightening through the summer months, but that interest rates will be back to current levels by year end. Our view is that inflation will fall more slowly than markets are expecting.

Marchello Holditch, CFA, CAIA
Portfolio Manager

Debt markets have been repricing for a higher Fed terminal rate based on the slew of positive surprises in the economy: lower unemployment, the waning bank crisis, the debt-ceiling deal, and so on. Markets are braced for one or two additional hikes from here. Could it go higher? Yes, but we'd say the terminal rate is back to somewhere that's approximately fair. We don't see a lot more fixed income repricing from here. And if we look at what the market thinks in terms of cuts, investors expect the year to end where we are now—so one more hike and then possibly one cut by the end of the year. We think it's fair to assume that we're going to be around these levels for the next few quarters. If we look at longer-term yields, 10-year bonds have been in this 3.25-3.75% range for awhile, and we're now at the high end of that range, which means we like Duration at these levels. In our view, we're at the high end of what that fair value range is.

We don't think a 25 bps hike is going to make too much of a difference in terms of beating back inflation; it would just be the Fed, like the BoC and Bank of Australia before them, showing that they have the resolve to keep hiking if inflation is not coming down as quickly as they like. They're willing to continue increasing rates until they get inflation to where they're comfortable. Given that the recession is being pushed out, that probably means inflation falls more slowly. Wage growth is too high, U.S. job openings have actually re-accelerated, and we're seeing services inflation. All else being equal, the timeline for us getting to 2% on the consumer price index is being stretched further out, which means that it probably pushes out rate cuts.

IG CREDIT	Very Bearish	Bearish	Slightly Bearish	Neutral	**Slightly Bullish**	Bullish	Very Bullish
HIGH YIELD	Very Bearish	Bearish	**Slightly Bearish**	Neutral	Slightly Bullish	Bullish	Very Bullish
EM DEBT	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
DURATION	Very Bearish	Bearish	Slightly Bearish	Neutral	**Slightly Bullish**	Bullish	Very Bullish

Style & Factor

Growth has had an impressive rally, but given the steep jump in valuations, we're looking to other parts of the market to play catch-up. In particular, Value looks attractive, and to that end, we're moving to overweight on Japan's value-oriented stocks.

Steven Shepherd, CFA
Director,
Portfolio Manager

The question is—can growth stocks continue to appreciate? Yes. Can they continue to outpace the S&P 500 index to the same degree? We would suggest no. That sentiment ties into the rationale for increasing our Equity allocation back to neutral: the rest of the market needs to play catch-up now. Our view is that we will see that performance gap narrow—we're starting to see an uptick in participation in the rally from other sectors. Looking at metrics like how many names are trading above their 50-day moving average, those numbers are starting to tick up. That's good—a broader market is always a healthier market.

It remains to be seen whether we're nearing a valuation drop for these growthier stocks. Yes, bubbles can pop but more often they tend to deflate slowly. So, we are likely to see some steam coming off the AI-related stocks, but some of those names probably justify being bought on that weakness.

In terms of factors, one advantage Growth does enjoy is when there's an expectation of rates falling. That's being pushed further out so those stocks, again, might have to take a breather for now. But the other thing about these names is they also tend to be very high-quality. Consider Microsoft: even though it's gone up so much, they still have more cash than most companies in the S&P 500 or Nasdaq. So that gives us comfort, in terms of them being stable and defensive.

Growth remains at neutral (0); to move our rating up after this much of a run wouldn't be appropriate. Rather, we are looking to increase our exposures to equities through more Value plays. We've moved regionally overweight to Japan, which is one of the higher Value-oriented markets within the portfolio. Finally, we have moved to neutral (0) on Volatility.

VALUE	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
QUALITY	Very Bearish	Bearish	Slightly Bearish	Neutral	**Slightly Bullish**	Bullish	Very Bullish
GROWTH	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
VOLATILITY	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish

CIO Strategy Note
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Implementation

We remain slightly bullish on gold as the US Dollar (USD) stands poised as a likely safe haven asset if markets tumble.

Steven Shepherd, CFA
Director,
Portfolio Managers

The effects of the BoC's unexpected rate hike on the Canadian dollar (CAD) remain to be seen, but regardless, we aren't inclined to hedge the USD back to the CAD; if an unexpected shock occurs that upsets markets, the USD is likely to re-emerge as a safety asset. If the Fed follows the BoC's lead and returns to rate increases following a pause, that could also keep the USD a bit stronger.

We continue to like gold and hold it across all our portfolios. It's moved back below the $2000-per-ounce mark, which contributes to our slightly bullish (+1) assessment, and we'd be likely to buy it on the dips.

CAD	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
GOLD	Very Bearish	Bearish	Slightly Bearish	Neutral	**Slightly Bullish**	Bullish	Very Bullish

DISCLOSURES

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