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April 2023

BMO GAM's Monthly House View

Panicky Markets and the Power of Patience

Presented by BMO GAM's
Multi-Asset Solutions Team

BMO  Global Asset Management



Panicky Markets and the Power of Patience

Over the first quarter of the year, markets have reacted sharply to shifts in the economic landscape—perhaps too sharply, in our view. That's been tied, in part, to recession risks that keep being kicked down the road. And it's also tied to back-and-forth interest rates expectations. In January, markets did well on the possibility of interest rate cuts later in the year. But February brought a sell-off, followed by a rebound in March.

Looking ahead, we expect to see something of a sideways market, though that doesn't mean that markets can't go higher—the potential is certainly there. But it's not an environment where investors would be wise to take on excessive risk, because the reward for that risk isn't high, and downside risk could be significant if the U.S. Federal Reserve veers from the market's expectation or the economy weakens faster than expected. That's why we're remaining overweight fixed income.

From a big-picture standpoint, we see a gradually weakening economy in Canada, the United States, and other parts of the world, with some potential upside stemming from China's reopening and the possibility of a rate-hiking pause from the Fed, which could prompt markets to become more bullish. If a potential recession ends up being relatively short-lived, markets may keep humming along. But the wild card is the job picture. If it remains relatively strong, a 'soft landing' is likely. But if it suddenly worsens, then a longer, drawn-out recession becomes a possibility and markets will likely head significantly lower. We still believe, however, that the most probable scenario is a relatively brief recession later in 2023 or early in 2024.



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

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So, could a recession mean buying opportunities? It depends. If the downturn reduces inflation and increases the probability of rate cuts, then yes, it would be a good chance to jump into the equity space. But if it's a slow-developing recession and inflation remains relatively high, then the Fed is unlikely to cut rates any time soon, and in that environment, we could see a downturn in markets. It boils down to what kind of recession we get, what the job picture looks like, and when the inflation numbers tell us—those factors will dictate whether it's time to buy or sell. For now, we continue to remain balanced, and will adjust depending on the data.

ECONOMIC OUTLOOK

Resilience Remains Watchword for North American Economy, but Cracks Are Emerging

Overall growth continues to defy expectations amid a still-tight labour market. But under the hood, the data is pointing to a slowdown and eventual recession.

U.S. Outlook

The Fed appears to have confirmed to investors that financial stability risks surrounding Silicon Valley Bank (SVB) and other sudden bank failures were the confirmational signal that monetary policy is sufficiently restrictive and that rate hikes are nearly done.

We remain focused on the extent of rate cuts this year and next, rather than debating whether the Fed hikes once or twice more. If anything, we believe that the yield curve, as measured by 10-year and two-year Treasury yields, has bottomed out. As a result, rate cuts could be around the corner.

The banking crisis has been stabilized, as evidenced by a slowing of deposit outflows from smaller banks as well the shrinking usage of the Fed's facility. That's good news, but credit is very tight and could well tighten further, hampering the broader economy. Indeed, recent data is sending more signals that the economy is slowing. In particular, we've seen new lows in the ISM manufacturing Purchasing Managers Index (PMI) (March, 46.3) as well as rising jobless claims. The March jobs report was in line with expectations, with 236,000 net jobs added, but was weaker under the hood. Both manufacturing and construction sector payrolls contracted.

Financially, the impact of rate hikes and tighter credit conditions will take time to be felt—liquidity across firms and households is



Brittany Baumann
Vice President,
Investment Strategist



still elevated, but that is changing. Our belief is that a recession is coming, it's only the timing of the onset that is uncertain.

Canada Outlook

On the economic data front, it's been more of the same, with continued resilience. Our first-quarter GDP growth expectations have now been revised higher, to the 2-3% range, which is well above the Bank of Canada's (BoC) projections. The data continues to test the BoC's conditional pause on interest rates. The March jobs report recorded a whopping 55,000 new additions. The unprecedented rate of population growth is driving strong job gains, while underpinning demand for housing. This suggests that, all else being equal, the extent of rate cuts that should be priced in to Canadian rate-path expectations may be smaller than in the United States.

ECONOMIC OUTLOOK**International Outlook**

Similar to Canada, solid PMI readings in the Eurozone and UK demonstrate a theme of resilience. First quarter GDP for both regions is tracking in positive territory, further diminishing recession fears. Meanwhile, core inflation in the Eurozone made new highs while UK inflation has rebounded but remains below peak. The European Central Bank and the Bank of England are facing more relative pressure to continue hiking compared to central banks elsewhere. For Emerging Markets (EM), China's reopening remains in full gear. Their services PMIs were well above 50, signaling solid expansion, although questions remain about the durability of the consumer-led recovery and the extent of momentum from fiscal stimulus. Growth will likely remain stronger in China and Asian countries with the closest trading ties rather than Western economies. Amid this growth divergence, Asia remains our favourite region.

Key Risks	BMO GAM house view
Inflation	<ul style="list-style-type: none"> • Can be expected to be sticky in the near term • We expect more pronounced disinflation in the second half of the year
Interest rates	<ul style="list-style-type: none"> • Further significant increases to terminal rate in question • Yield curve has likely bottomed
Recession/unemployment	<ul style="list-style-type: none"> • Recession risks have been marginally brought forward due to financial stability risk • Job losses are still likely later this year • Wage growth appears to be slowing
Geopolitics	<ul style="list-style-type: none"> • U.S./China relations are likely to remain strained • No significant change in the Russia-Ukraine situation
Consumer	<ul style="list-style-type: none"> • Ongoing risk from financial tightening • Steady earnings crucial for debt servicing in higher-rate environment
Housing market	<ul style="list-style-type: none"> • Home price declines anticipated, lagging falling sales • In Canada, population growth will continue to underpin demand
Earnings	<ul style="list-style-type: none"> • Markets more sensitive to downside surprises than upside • Earnings growth likely to continue falling

PORTFOLIO POSITIONING

Asset Classes

A simmering financial crisis represents an overhang on equities and makes the upcoming economic data all the more consequential. We're also approaching a likely final hike from the Fed, and therefore an important inflection point in our view on stocks relative to bonds.

We remain neutral on equities with an overweight to fixed income and cash. There's a financial crisis to contend with, alongside a distinct about-face in terms of Fed policy and rate expectations. The financial tightening stemming from bank stress has, by some measures, tightened monetary policy by the equivalent of 50 to 75 basis points. What does that mean for the Fed funds rate? There's an 80% chance priced in for another 25 bp hike in May, after which we may see a pause. The question then would be—how long does the Fed sit at that level before starting to cut rates? Historically, it has been fairly quick, but the still sticky level of core inflation may require them to hold off longer than usual.

In terms of equities, even though financial system shocks have not been systemic like they were in previous crises, there will be an overhang that persists for some time. We've reduced our equity positions in our Income and Conservative ETF portfolios as a result, to ensure those allocations serve investors more focused on preserving capital. But we haven't moved off an overall neutral position yet. We'll be weighing the upcoming data, including inflation prints. We've seen job numbers that have remained pretty positive relative to predictions of heading into a recession. Market interest rates have started to come down a bit, and while we think rates will come down further through a shallow recession cycle,

the timing is uncertain. History has always shown that selling the last rate hike is typically where you want to be—lightening up on equities while going a little bit longer fixed-income like Treasuries. We also have gold in our portfolios as a defensive position, which has served us well.

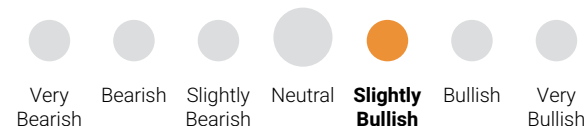


Steven Shepherd, CFA
Director,
Portfolio Manager

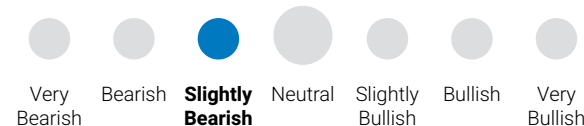
EQUITIES



FIXED INCOME



CASH



PORTFOLIO POSITIONING

Equity

EM, and China in particular, are seeing accelerated growth thanks to looser monetary conditions at a time when developed markets, and the U.S. in particular, are headed in the opposite direction

The financial system stress is starting to move on from being an acute crisis and so far appears to be effectively contained and controlled. However, the market is now turning attention to other corners or sectors that could be particularly exposed, two of those targets being highly leveraged companies or sectors and firms with high interest-rate sensitivity, like non-bank financial services such as Charles Schwab. A third area that is particularly exposed is commercial real estate. But with that said, the Fed is committed to financial stability, so we don't think that there's going to be widespread mass contagion from this. What SVB has shown is that the Fed and other regulators will act very swiftly.

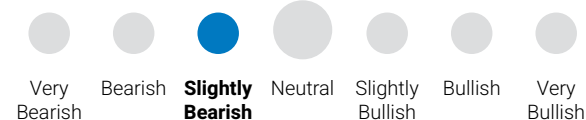
Regionally, we didn't make any changes from last month—we're still underweight North America, which helps fund our overweight to EM. China and Asia, in particular, remain our favorite regions based on their economic growth momentum. In China, the data continues to be good with credit growth expanding—new bank loans have actually surged to an all-time high. Absolute money supply growth is starting to slow, but we're still seeing a double-digit year-over-year clip. China's looser monetary policy is feeding the reopening in the real economy. All of this is in contrast to the U.S., where there is falling liquidity and the money supply is actually contracting for the first time since they began collecting data in the 1950s—for the first time in history, we're seeing negative year-over-year money supply growth. So, there are more downside risks. In



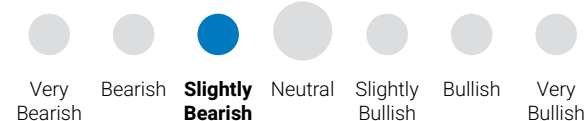
Marchello Holditch,
CFA, CAIA
Portfolio Manager

Canada, we remain underweight based on the fact that it's a very cyclical market with extensive economic linkages to the U.S.; their recession risks threaten the domestic outlook as well.

CANADA



U.S.A.



EAFE



EM



PORTFOLIO POSITIONING

Fixed Income

Expect the yield curve to steepen further, with the short end falling faster than longer dated bonds. Our favoured position remains in Investment Grade, which is offering historically attractive yields.

The yield curve has likely bottomed at about 100 basis points on the 2-year/10-year inversion on U.S. Treasuries. From here, we're likely to continue to see the steepening we've been observing. A further flattening would require the Fed to turn very hawkish again, which we think is unlikely given recent inflation data and the economic and financial sector backdrops. We think it's going to be a "bull" steepening, meaning that rates generally are going to fall and the 2-year Treasuries are going to fall faster than 10-year U.S. government bonds as the market continues to challenge the central bank's resolve to keep rates this high for a longer period of time.

Our view on Investment Grade debt is unchanged; the spreads remain relatively attractive on a risk/reward basis when you factor in the level of absolute yields. They've got a positive carry. If you look at some investment-grade bonds, they're actually yielding more than the S&P 500 earnings yield. Suffice to say, investment grade bonds of high-quality companies are quite attractive on a historical basis. We also remain neutral on High Yield credit, but we do believe the risk of an economic downturn is not fully reflected in sub-investment grade fixed income, which is why we're staying away from those bonds for the moment.

Similarly, we've stayed neutral on EM debt. There are competing forces to consider: stronger growth relative to developed markets, as well as the general weakening of the U.S. dollar being offset with by a relatively hawkish Fed and financial stability concerns. That keeps us



Marchello Holditch,
CFA, CAIA
Portfolio Manager

more tempered on EM bonds. On duration, it remains attractive, but we've resisted going overweight given the strong repricing we've seen in the wake of the SVB collapse. We do believe monetary policy is very restrictive and the "higher for longer" mantra will be tested, so our bias is to gain exposure to longer duration.

IG CREDIT



HIGH YIELD



EM DEBT



DURATION



PORTFOLIO POSITIONING

Style & Factor

The current growth rally still has room to run as long as the market continues to price in rate cuts later this year or early next. The question is, can the rally support the broader market as economic conditions slide further toward an economic downturn?

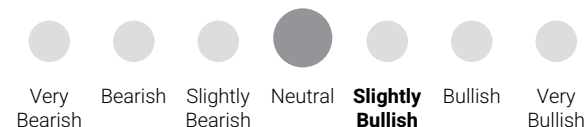
The market dynamics are shifting, with the current period now reflecting a neutral outlook on Value, relative to Growth. The change is more a function of the uncertainty of the timing of a downturn, because the present Growth trade, in our view, still has legs as long as people continue to expect that interest rates will head lower. The question is—if that's on a relative basis versus Value, will that be enough to sustain the entire index or do equities get sold off if and when we do head into a recession, and markets get a little bit softer? First quarter earnings are commencing, and it will be an important reporting season to see what happens with some of the technology mega-caps. Compression of valuations is one thing, but if the E (earnings) underneath the P (price) comes down more than people expect, that's going to change the market's view on the Growth rally pretty fast. Apple reported PC shipments that were down 40% year-over-year in Q1. We may already be seeing softening in Consumer Discretionary technology spending. Manufacturing PMIs are softening up. Service PMIs are holding up better—but even there, there is some weakness. So overall, what does that mean for factors? It means Growth might have a bit more runway, but do not expect to see the beginnings of a breakaway rally from here. There's no change in our volatility rating, but Quality has been moved up to +1. In Canada, Quality means banks, and while it hasn't been a great stretch for



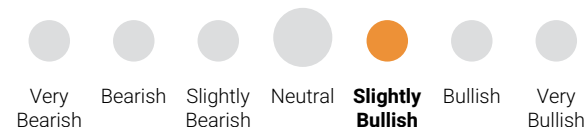
Steven Shepherd, CFA
Director,
Portfolio Manager

lenders in March, Canadian banks aren't down as much as most of the U.S. regionals. Moreover, domestic banks didn't really deserve any of the recent declines—they're purely based on sentiment stemming from the broader banking crisis.

VALUE



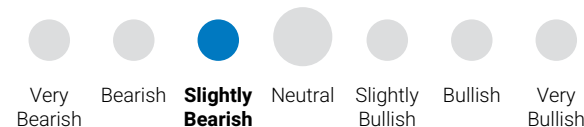
QUALITY



GROWTH



VOLATILITY



PORTFOLIO POSITIONING

Implementation

With expectations mounting for U.S. rates to move lower, the policy divergence that drove near-term U.S. dollar strength this year is fading, providing a renewed tailwind for the CAD. We've also formally added gold into our monthly outlook, and are bullish on its near-term prospects.

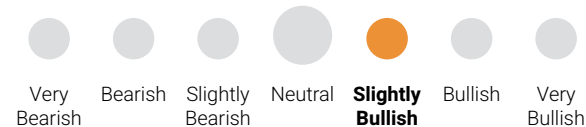
Our score on the Canadian dollar has gone back to a +1, or slightly bullish, which means we see a softening of the U.S. dollar as rate expectations fall and the rate divergence between the Fed and BoC shrinks. We will be watching closely whether the BoC can stick to their guns and hold on their conditional pause. So far, they've been successful, but if we continue to see sticky inflation through the summer, they might have to end up raising rates. If we head into a U.S. recession before year-end, which is largely our base case, the BoC can probably hold the line, and we won't see any more rate increases. As of right now, our expectations are they're done their rate-hiking cycle, and we're waiting for markets to catch up. We've also formally added gold as a +1 (slightly bullish). Bullion is finding support from record central bank demand, as well as greater physical demand from private consumers overall, and we expect macroeconomic uncertainty to continue to fuel its outperformance. As the Fed begins to pivot to lower rates and we see real rates decline, we expect that will give gold a further boost. We've seen it in past cycles.



Steven Shepherd, CFA
Director,
Portfolio Managers



CAD



GOLD



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