July 2023

BMO GAM's Monthly House View

Staying the Course Through Choppy Waters

Presented by BMO GAM's
Multi-Asset Solutions Team

BMO Global Asset Management

Staying the Course Through Choppy Waters

As we enter the second half of 2023, choppier markets appear to lay ahead—though the timing of that turbulence remains an open question.

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

Expect central banks to play a leading role in any market disturbance. With the economy holding up better than many had anticipated, there is the potential for additional interest rate hikes, which may spook investors. The economy is likely to continue to gradually soften, but there's not yet any sign that it will sharply decline in the near term. Given these factors, our expectation is that markets will be a bit more turbulent in September and October. If that does occur, it could result in a rally in Q4, as we traditionally see. But if there isn't a decline in the fall, that's when the situation might get worrisome; markets could get overly inflated as investors wonder when the other shoe will drop, with nervousness potentially spilling over into 2024.

It's important to note that in any scenario, there are certain themes that aren't likely to go away--the AI boom, the Quality bias, and the need for downside protection in advance of a potential recession, for instance. Going forward, we expect these three themes to continue to resonate within our portfolios. In our view, the chances of a recession remain elevated, with a soft landing—which could take either the form of a technical recession that people don't really feel, or a recession that people do feel but is limited to only a couple of quarters—still the most likely outcome. The chance of no recession has gone up, while the probability of a hard landing has gone down. With that in mind, a more balanced portfolio continues to be the appropriate way to navigate going forward. It has served us extremely well so far this year and we expect it to continue to do so.

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Cooling Into a Recession

North American economies gradually slow as European growth remains stagnant and China's rebound disappoints.

Frederick Demers
Director, Multi-Asset Solutions

U.S. Outlook

The U.S. will have to wait a bit longer for a potential recession. For nearly a year now, analysts have been predicting a downturn as being about six months away—but that time frame keeps getting pushed further and further down the road. Recent U.S. job numbers have remained fairly healthy, with payrolls rising by 209,000 in June and the unemployment rate declining slightly to 3.6%. Looking at the broader picture, there's no doubt that the economy is cooling. But cooling is different than crashing—and generally speaking, you don't crash into a recession, you cool. It's a several-quarters-long process, and given the resilience of the economy, it's unlikely that we see a recession this year. The consensus has been that we could finally see the downturn emerge in the first half of 2024, though we think it could be delayed even further.

Canada Outlook

It's a similar story for Canada. The key driver for an optimistic outlook remains the labour market, with year-to-date job creation numbers remaining very strong. Labour shortages are still an issue, just like the U.S., and while rate hikes are biting, consumers are coping with them so far. The extension of amortization periods has helped some homeowners manage their monthly budgets. Overall, while rate hikes are having an impact, consumers are managing

that hardship more wisely than some analysts were fearing. Like Canada's neighbour to the south, the economy is cooling but not crashing, and we could see a growth trend of between 1% and 2% in the second half of the year—certainly not a pace that would indicate an imminent recession.

International Outlook

EAFE remains the weak region globally—especially Europe and the U.K., which are mired in stagnation. The Eurozone experienced a technical recession starting at the beginning of this year, and the economic outlook for the second half of 2023 remains challenging; at best, growth can be expected to be flat, with a small contraction the most likely scenario. The good news is that this came as no

ECONOMIC OUTLOOK

surprise to markets. That's why we haven't seen as much concern about recent economic numbers as one might expect—the bar had already been set very low, and the numbers were in line with expectations.

In emerging markets (EM), the big story has been the disappointing rebound of China. Growth came back strongly after the country's initial reopening, but it failed to build momentum, and we're now getting a clearer picture of China's economy. First and foremost, it is built on trade, which is dependent on global demand for manufactured goods; that demand has been relatively weak. There are also lingering concerns around the Real Estate sector, and it's difficult for policymakers to inject stimulus because it's an economy that has an excess of supply of manufacturing capacity and real estate properties. An excess supply situation makes it more challenging to engineer sustainable growth, and any stimulus plan will have to be meaningfully different than previous ones in order to have a chance at success. The weakening of the yuan in recent months speaks to the vulnerability of the Chinese economy at the macroeconomic level.

Key Risks	BMO GAM house view
Inflation	• It's coming down nicely, but the easy part is likely behind us • If core inflation remains sticky, it could remain an issue for markets, thought not at the level of 2022
Interest rates	• A resilient economy and delayed recession have caused interest rates to drift up (but not spike like in 2022) • We're likely at or near the peak of Bank of Canada (BoC) and the Federal Reserve (Fed) policy rates
Recession	• The good news: it's delayed • The bad news: it's likely not cancelled and will remain a lingering concern for markets
Geopolitics	• BRIC countries, especially Russia and China, are facing major economic and geopolitical headwinds • The US dollar (USD) is like a moving train, and the BRIC countries are unlikely to challenge it in any meaningful way
U.S. Politics	• U.S. debt has ballooned since the debt ceiling crisis was resolved • That kind of aggressive fiscal policy has further delayed the onset of a recession
Consumer	• A strong labour market means little consumer weakness, creating a strong tailwind for the Canadian and U.S. economies • Real wage growth means that households are slowly rebuilding their purchasing power after declines last year
Housing market	• Prices rebounded in the second quarter in both the U.S. and Canada, but interest rate hikes could prompt another pause from buyers • Supply is tight while demand remains strong • Uncertainty remains, but the market is moving in the right direction
Banking crisis	• The healing process is underway • A lot of the calculus around a potential late-2023 recession was on the basis of a credit contraction, but measures taken by the Fed were generous and have helped regional banks return to business as usual

PORTFOLIO POSITIONING

Asset Classes

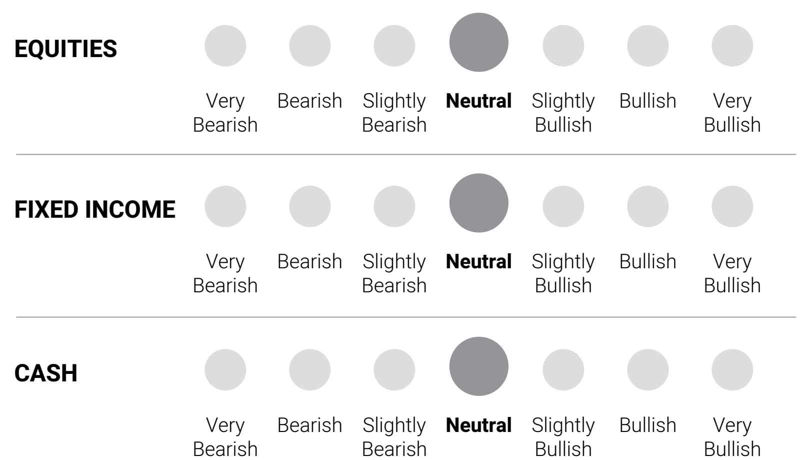
Steven Shepherd, CFA
Director,
Portfolio Manager

The rally in U.S. equities is broadening out, with some cyclical sectors joining the party. The push into even higher rates from central banks has us feeling less bullish on bonds, yet with the end of the tightening cycle near, we're not prepared to go underweight fixed income.

We remain neutral (0) on equities for the moment, as the current market rally broadens out. Since June 1, the equal-weight S&P 500 Index has actually overtaken the tech-heavy cap-weighted index, underscoring the widening of the rally beyond the mega-caps into other sectors and names. Consumer Discretionary and Industrials have had turns leading the performance—again, reflecting the surprising resilience we've seen in the U.S. economy and markets since the start of 2023. The number of S&P 500 companies now trading above their 200-day moving average is above 70%—with four in five constituent stocks beating their 50-day average.

On the fixed income front, the push into even higher rates from central banks has us feeling less bullish on bonds. Despite slowing headline inflation, core consumer price index (CPI) remains sticky on both sides of the border—hence why we saw another hike from the BoC to 5%. In addition to softening consumer price gains stateside, we are also seeing renewed upward pressure on rates, with the 10-year U.S. government bond breaking out of a downward-sloping range that had been intact since last October's highs of around 4.25%. The current downdraft in inflation is partly base effect, so we know there could well be an upward bounce in the next few months.

Ultra-short-term bonds and cash instruments are offering some of the best yields in decades—5.3% or more on 3-month U.S. government notes, the highest since January 2001. Still, with the end of the tightening cycle near, we're not prepared to go underweight bonds for cash.



Equity

Can a rally fueled primarily by improving sentiment be sustained? We expect a more challenging backdrop for stocks in the second half amid margin pressures. Canadian stock valuations meanwhile appear attractive.

Marchello Holditch, CFA, CAIA
Portfolio Manager

The widespread anxiety that gripped investors following the U.S. regional banking sector crisis proved short lived, with the S&P 500 rising almost 17% on a local basis since the start of the year[1]—and that's on the back of flat to negative earnings if you filter out the mega-cap outliers. So where have returns come from? A material expansion in price to earnings (P/E), i.e., investors simply willing to pay more for a stock than they were as sentiment recovers from last year. Will that sentiment hold through the remaining months of 2023? It remains to be seen.

While the economy has performed better than feared in recent months, we still anticipate a slower pace of economic activity in the second half. The Service sector tailwind is fading as restrictive monetary policy bites further into consumer spending. We remain neutral Equity but expect a more challenging backdrop for stocks in the second half of the year given the decelerating economy and as margins compress, in part because wage growth will prove sticky.

As for the Canadian market, immigration's seemingly relentless support for housing as well as a strong labour market is providing stability for stocks, which are now poised to benefit from a resilient U.S. economy, as well as attractive valuations compared to U.S. equities.

Looking further afield, Europe's growth has surprised to the downside of late, while inflation has surprised to the upside—not a good combination, which should keep the market challenged. China's reopening has admittedly differed markedly from the West, without the same fiscal support during the lockdown nor the much-hoped-for consumption burst that was expected this year.

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

Fixed Income

Core inflation remains sticky while wage pressure persists. As such, the Fed is highly unlikely to strike anything close to a dovish tone in the near future. That said, we maintain a slight bias toward Duration.

Marchello Holditch, CFA, CAIA
Portfolio Manager

Fixed-income investors should not read too much into the June inflation print from a policy perspective. While headline CPI is trending toward the Fed's 2% target, core inflation (which strips out more volatile items) is still running at a hot 4.8%. Moreover, wage gains remain too high, which should leave underlying inflation trends elevated. As such, it is unlikely the Fed will deviate from its hawkish posture. The current dynamics suggest that the Fed is poised to overshoot on tightening, creating economic pain to come. Central bankers target consumer prices as well as employment—both lagging indicators.

While we have moved to neutral (0) on fixed income, we see modest room for longer-dated yields to decline in the second half, so we're maintaining a slight long Duration bias (+1). As we approach the end of the tightening cycle, we expect a bull steepening scenario play out along the curve. In terms of Investment Grade credit, we remain slightly bullish (+1) with supportive economic data likely to keep a lid on credit spreads before widening out later in the year as economic conditions decelerate. We remain slightly underweight (-1) riskier High Yielding credit. We continue to be neutral (0) on Emerging Market debt.

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

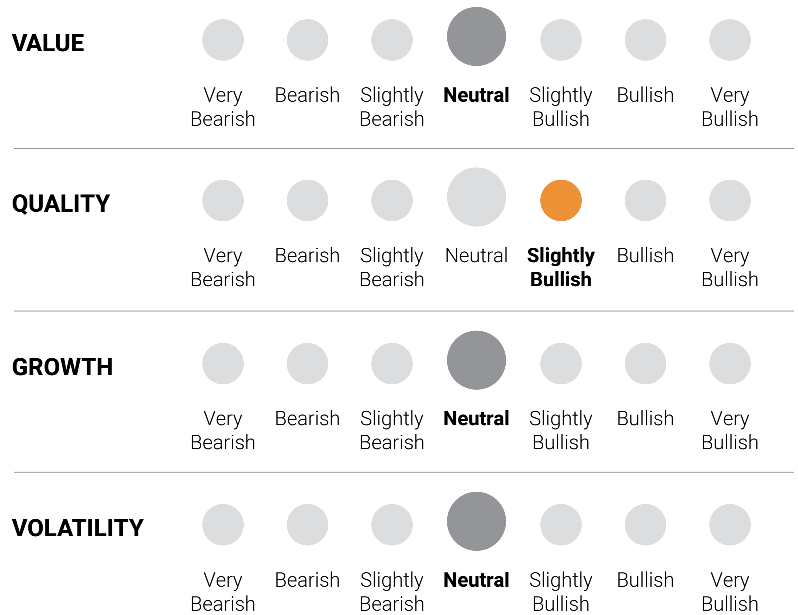
Steven Shepherd, CFA
Director,
Portfolio Manager

Investors have been lulled into a relatively summer calm, as Growth and Quality seemingly converge, for now. Third-quarter earnings season could undo all that, with a September selloff a distinct possibility.

The growth rally is still running relatively strong, and so long as Tech continues to move up, Growth should continue to outperform Value as a whole. Markets would require a substantially stronger upside surprise on inflation and subsequent course correction for interest rates to reverse that position at this point. Oddly, Quality and Growth are converging to a degree, becoming somewhat synonymous in the U.S market. We say that because the largest names are mostly in Tech, and they happen to have Fort Knox-like balance sheets and cash flows.

To some extent the market overall has been lulled into a relative calm. Volatility as measured by the Cboe Volatility Index (VIX) remains well below average at 13.7. That compares to an average of 21.6 since the beginning of 2021. Any potential disappointment from third-quarter earnings could undo it all. Combined with seasonality, which typically results in some softness in general in the early fall, we may well see a selloff.

For the time being, we're comfortable remaining slightly bullish (+1) on Quality, with a neutral (0) view on the remain factors.



Implementation

The end of the Fed tightening cycle is near, signaling a market top for the USD—which we've perhaps already met. After underperforming expectations this year, gold is at risk of further weakness.

Steven Shepherd, CFA
Director,
Portfolio Managers

There are currently no hedges built into the portfolios; with the top of the rate cycle approaching, that tells us a top for the USD is closing in too, and perhaps we've already seen it. Gold is a trickier implementation, with the yellow metal underperforming as markets have rallied this year. The resulting downdraft has brought bullion to technical levels that, if breached, could create further downside pricing pressure. However, we view real assets as an important long-term hedge within a well diversified portfolio, and continue to hold our position.

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

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

ENDNOTES & DISCLOSURES

[1] Caroline Valetkevitch, « S&P 500 ends down with banks mostly lower, indexes post weekly gains », *Reuters*, 14 juillet 2023.

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