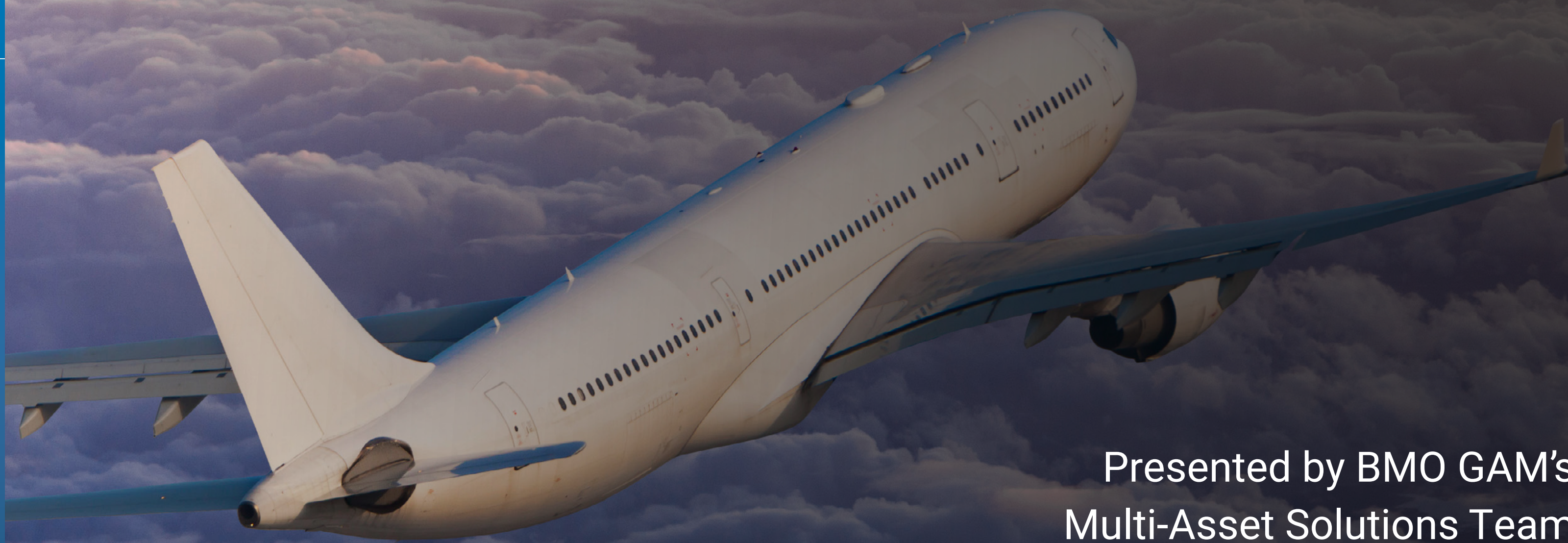
April 2024

BMO GAM's Monthly House View

Delayed Again: The Soft Landing that Never Comes



Presented by BMO GAM's
Multi-Asset Solutions Team

BMO | Global Asset Management

Delayed Again:

The Soft Landing that Never Comes

The view from 10,000 feet is that the economy is still in fairly good shape. That said, it is important to understand that we are beginning to see more signs of underlying economic weakness.

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

Three indicators in particular stand out to us. The first is the quits rate, which is slowing down. This typically means that people feel it would be harder to find a job if they were to leave their current one. Second is the number of jobs available, which has also been decreasing. And third is corporate earnings, with Lululemon serving as a case in point: its poor results reflected weakening consumer demand as spending gradually shifts from Consumer Discretionary to Consumer Staples. Of course, Lululemon is not in the same category as top-end luxury retailers like Louis Vuitton, but its recent struggles nonetheless demonstrate that consumers are beginning to step down their discretionary purchases.

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With these early indicators in mind, we remain slightly overweight Equities, but we are looking at utilizing options within our portfolios for protection; both calls and puts are relatively cheap at the moment. The goal is to minimize our exposure to downside risk in the coming months, especially if inflation remains higher than expected and the U.S. Federal Reserve (Fed) is forced to push out interest rate cuts even further. For now, however, the current economic picture remains relatively robust.

America Remains the Exception

U.S. economic data continues to surprise on the upside while Europe shows modest improvement, China seeks stability, and Canada braces for a looming mortgage renewal storm.

Frederick Demers
Director, Multi-Asset Solutions

U.S. Outlook

The now-familiar story continues. Strong economic data continues to flow in across the board, not only delaying fears of a recession in the U.S., but effectively crushing them. The news has been decidedly one-sided: virtually every indicator has come in better than expected. The downside is that the economy is so strong that it's keeping inflation sticky. The global economic picture is beginning to change as various encouraging signs emerge. But for now, the story of American economic exceptionalism remains intact.

Canada Outlook

Despite some good news on the gross domestic product (GDP) front, headwinds for Canada persist. Thus far, we've avoided a recession scenario, but the economic slowdown continues. The recent public sector strike in Quebec introduced some noise into the data, weakening Q4 before a rebound in Q1. The question now is—where do we land in Q2? Our expectation is that the pace of growth will be modest but still positive. Looking ahead, the mortgage reset storm—which will see homeowners experience the full burden of higher interest rates—remains a significant headwind. We're likely to reach the peak of that storm within the next 12 months, which makes it difficult to be particularly upbeat about the Canadian economy overall, at least in the mid-term.

International Outlook

The outlook for Europe is still soft, but the big story over the past six months has been a bottoming out of economic data followed by some modest improvement. By any definition, growth is still moving at a sluggish pace, but the fact that it's no longer deteriorating is an important development for markets. That's one reason why we've seen better equity performance in the region of late—the gloomiest economic scenarios were avoided. Japan, meanwhile, continues to hold up. With no particular economic strengths or weakness, it remains something of an outlier, chugging along at a steady pace. That type of stability is generally good for investors.

Emerging Markets (EM) continues to be driven by news out of China, which has been a source of weakness recently. There are some indications that the situation has begun to turn around, which would make sense, given the significant policy measures that have been introduced in an effort to establish a floor for growth. But overall, the situation remains challenging, especially with a U.S. presidential election on the horizon; trade is likely to be a hot topic, meaning that China's geopolitical headwinds will probably get worse before they get better. For investors, stability in the growth outlook and preventing further weakness remain top priorities.

Key Risks	BMO GAM house view
Recession	• Risks are not entirely dead, but it's hard to find a traditional macro scenario where you have to worry about a significant recession
Inflation	• Remains sticky due to strong U.S. growth • That said, it's not the kind of inflation we saw in 2022, which prompted rate hikes; instead, it's just delaying rate cuts
Interest rates	• If positive U.S. economic surprises continue, rate cuts from the Fed might get delayed further • Elsewhere, the case for rate cuts is still very much alive
Consumer	• The Canadian consumer is bruised • The U.S. consumer is strong
Housing	• The demand is there because of the income and employment picture • But the market is still struggling because it needs rate cuts
Supply Chains	• The Baltimore bridge collapse, while tragic, is more signal than noise from an economic perspective • Conflict around the Suez Canal has limited implications for U.S. supply chains
Geopolitics	• A persistent risk that may be slightly deteriorating every week • The conflict in the Middle East may be slipping in the wrong direction, however, which we can see in oil price
Energy	• It doesn't respond well to geopolitical risk, which is why oil prices have been trending upward • The good news is that there hasn't been a sudden surge in prices, so markets haven't been taken by surprise

Asset Classes

A case is building for U.S. interest rates to remain unchanged heading into the latter half of 2024, and with an election looming, the window to lower them may closing. Relatively buoyant economic data continues to be supportive of Equities while we are neutral (0) across the board on Fixed Income.

Steven Shepherd, CFA
Director,
Portfolio Manager

With a few exceptions, economic conditions are growing more and more sanguine: we have ISM manufacturing data turning positive, Purchasing Managers Index (PMI) data turning up as well, and labour markets that continue to show unexpected strength. In the U.S. in particular, all eyes remain on monetary policy. It may be a stretch at this point to suggest there will be no interest rate cuts this year—but a case is building, especially with the March jobs report giving an upside surprise (303,000 vs. 181,000 estimate) without any corresponding acceleration of wage inflation, a result of higher labour-force participation. Chairman Jerome Powell has been firm in his conviction that the Fed intends to loosen policy later this year, and he is typically true to his word. The continued upward grind of equities suggests markets are warming up to the idea of no cuts. As the year has progressed, markets and the economy have been resilient. Timing of any potential cuts is also fast becoming an issue; if Powell is committed to getting interest rates down off current levels, there is a window that likely closes after July heading into the U.S. election.

For stocks, the current view is: if it is not broken, don't fix it. A recent statistic we came across that falls firmly in the column of 'be careful what you wish for': If you look at the S&P 500 going back to the 1970s, on average, an interest rate pause—where we are currently—is far better than a cutting cycle. The average cutting cycle has been 200 days longer on average, and was associated with a 23% market decline. (Credit to Strategas and their continued excellent macro work, a regular contributor to our quarterly Macro Forum.) In other words: do not fear the pause—but rather, fear the first cut. "New highs" fatigue is also a broad phenomenon, and much like the last snowfall in April, we've kind of had enough of it. However, it was a very strong first quarter, the fifth in a row of consecutive gains, so we are beginning to discuss ways of being A) more defensive, B) more diversified, and C) having more hedges in place. In general, we're still comfortable being overweight Equities with many reasons to support stocks at this point.

Conversely, the enthusiasm behind Fixed Income has waned. Part of that is the volatility[1] of interest rate trajectories and the market being uncertain on where things are going. On a risk-adjusted basis, other areas in the market are a lot clearer directionally, namely equities. We are neutral (0) across all Fixed Income.

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

CIO Strategy Note
Economic Outlook
Portfolio Positioning
• Asset Classes
• Equity
• Fixed Income
• Style & Factor
• Implementation
Disclosures

Equity

We are broadening out positions in U.S. large caps given growing earnings momentum. Tech valuations are well-supported, but we have put in place some hedges to manage our exposure. We remain slightly underweight (-1) Canada.

Marchello Holditch, CFA, CAIA
Head, Multi-Asset Solutions

The tailwinds that have driven gains this year remain in good shape. We've now seen seven consecutive quarters of upgrades for the U.S. economy, where growth has ended up higher than expected. That has been supportive of earnings and should continue to be, which is what Equities needs to maintain and elevate valuations. In short, the U.S. economy is doing its job—we are seeing earnings growth now broadening out beyond Tech (though Tech continues to lead the market). With the broader earnings picture starting to brighten up, we have spread out our exposure as well to other areas such as Financials. One caveat is that we are sticking to large caps. We remain wary of small caps given higher debt burdens and interest costs. It is the same rationale for why we are neutral (0) on longer duration[2] bonds. Both need relief from lower rates to generate sufficient returns.

On Tech, strong earnings continue to support lofty valuations. However, we are starting to look at ways to manage our technology exposure. The use of options on broad indexes like the NASDAQ is one example. In some portfolios, we are exploring options on individual names, such as Nvidia. Many market participants are looking to use calls to gain exposure. Because of that, counterparties can command high premiums for selling some upside—we're still going to participate in the rally, but we're thinking about ways to hedge it.

In Canada, broader growth has been adequate, but we are seeing unemployment rise as well as debt service costs trend up. That is a concern for us, and we are funding out of Canada our U.S. market positions, where we are slightly overweight (+1).

We remain neutral (0) on Europe, although we're seeing green shoots. In Japan, which we have been overweight on for some time, the Bank of Japan finally pulled the trigger on raising interest rates, causing some volatility. We are still positive but have started thinking about taking profits. We are seeing growth stabilize in China, but not a significant revival. We are looking at ways to play China but are contemplating a strategic shift towards India, given better economic and geo-strategic dynamics.

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

Chairman Powell remains dovish, but the Federal Open Market Committee (FOMC) hawks are circling. If headline inflation can break below 3%, we will likely see the Fed cut—and consumer prices are still trending in that direction. The Bank of Canada (BoC) is very much hoping the Fed opens the window to rate cuts as soon as possible.

Marchello Holditch, CFA, CAIA
Head, Multi-Asset Solutions

The rates market is beginning to lean toward fewer U.S. cuts this year. There are many hawks on FOMC who continue to push back against any rate cuts at all. However, Chairman Powell has reiterated that he still believes they should proceed. As long as Powell remains dovish, there is a very good chance we realize a few cuts before the end of 2024. What the Fed is really looking at is not so much economic growth but inflation. If inflation cools as expected, that opens the door for rate cuts. They are projecting a headline Consumer Price Index (CPI) reading that is sub-3% by the end of the year. In our view, there's a very good chance that we see that.

Connecting that to our positioning: given the rate uncertainty, we think the bond market is going to be quite range bound for the next few months. As such, we remain neutral (0) on Duration. On Investment Grade (IG) and High Yield, we expect spreads to similarly remain range bound. Although they are very tight historically speaking, IG and High Yield spreads need a catalyst to widen, and given that economic growth remains well anchored and inflation continues to cool, we do not see one yet.

On Canadian fixed income, the BoC could cut before the Fed but they are probably not going to get too far ahead. There are historical reasons for that. When the BoC cuts too aggressively and creates a wide rate differential between Canadian and U.S. bonds, it tends to hurt the Canadian dollar (CAD). A lower CAD creates the risk of accelerating inflation. So, the BoC is hoping the Fed goes first, to open the window. If the Fed does not, they might have to go on their own, but they will not be able to go too far or they risk hurting the currency and re-accelerating inflation.

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

Style & Factor

The market is undergoing a distinct shift that suggests a reset back to early-cycle dynamics, and bypassing recession altogether. That remains to be seen, but we are growing more biased toward Value as a result, and diversifying positions accordingly. Volatility remains low and we see no catalysts for that to change.

Steven Shepherd, CFA
Director,
Portfolio Manager

Looking at the broader market, 86% of the S&P 500 is now trading above their 200-day moving average. That implies Value is catching up with Growth on a relative basis, an observation we are also seeing reflected in sector behaviour. As mentioned, we are looking for ways to diversify from the concentration of the Magnificent 7 and Technology-dominated trades. There is a rotation happening into cyclical sectors like Industrials and Financials. Even Materials have started to pick up, which underscores our shifting bias towards Value. In terms of our formal view, we remain neutral (0), but we went to the proverbial video replay—close to crossing the line, but not quite enough to push Value to +1. Things are shifting and hence, you will see a lot more diversification in our positioning in terms of sector exposure, making use of factors and derivative opportunities.

Part of the shift is this notion that we were in the seventh inning of the current cycle, to use a baseball metaphor. It turns out that we may actually be in a doubleheader—the market suddenly appears to be in the early-cycle again. Having bypassed a recession altogether, we may be poised for a cycle reset. What is certain is that we are seeing more value in pure cyclicals driven by slow improvements in manufacturing—PMIs around the world are creeping toward or even above that 50 mark, indicating expansion, which is a big psychological hurdle for the market.

Volatility is still low and there is no real reason for that to change for the moment. One might argue that it is artificially low because of the popularity of many volatility-harvesting products. But in terms of pure economic fundamentals, there is no real reason that equity volatility should spike up. We're certainly not seeing it in the options market, where the cost of purchasing downside insurance remains relatively cheap.

VALUE

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

GROWTH

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

QUALITY

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

YIELD

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

PORTFOLIO POSITIONING

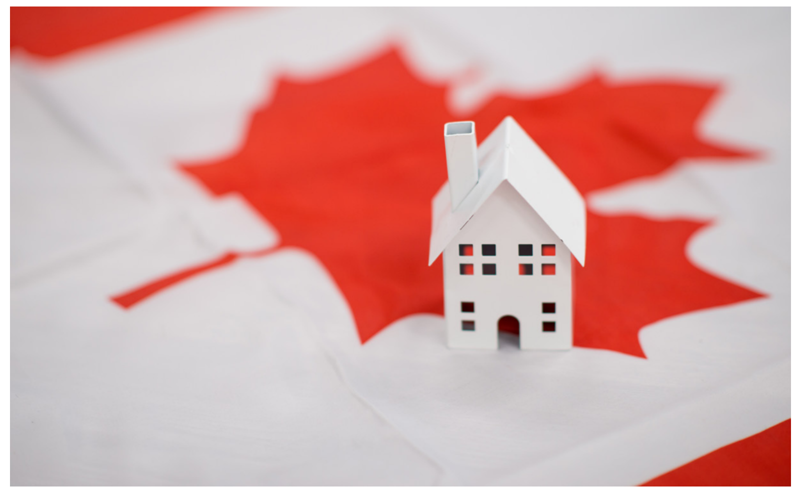
Implementation

The outlook for the CAD is bearish as the 2025-26 refinancing window for households and businesses draws closer and interest rates remain at elevated levels. The BoC may have to get very aggressive, perhaps soon. Gold remains favourable, though at current levels investors should consider averaging into new positions.

Steven Shepherd, CFA
Director,
Portfolio Manager

We are still slightly bearish (-1) on the CAD based on the relative trajectory of the Canadian economy versus the U.S. Canada needs interest rate cuts a whole lot more than the U.S. and timing is probably even more sensitive. It has nothing to do with an election but because every month and every quarter that the BoC delays, it makes the 2025 and 2026 "mortgage wall" that much steeper. If they wait too long, or unless the BoC gets very aggressive and jumps to using 50-basis-point cuts, upcoming refinancings for many households and businesses will be a real shock for Canadian homeowners. Without accompanying wage increases, there are going to be a lot of people that will have a very large increase on their mortgage payment.

We still like Gold but are taking a cautious approach on adding to our position at these levels. An investor that has been thinking about getting into Gold should not let all time highs be a barrier, in our view, but rather average into a position slowly over several weeks or a couple of months. The ongoing demand for Gold from central bank purchases combined with the precious metal's defensive qualities remain attractive. We have been in Gold since last year and we do not foresee moving out of it anytime soon.



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

[1] Volatility: Measures how much the price of a security, derivative, or index fluctuates.

[2] Duration: A measure of the sensitivity of the price of a fixed income investment to a change in interest rates. Duration is expressed as number of years. The price of a bond with a longer duration would be expected to rise (fall) more than the price of a bond with lower duration when interest rates fall (rise).

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