January 2023

BMO GAM's Monthly House View **Special Edition**

10 Big Investment Trends for 2023

Presented by BMO GAM's
Multi-Asset Solutions Team

BMO Global Asset Management

10 Big Investment Trends for 2023

This is a special issue of BMO GAM's Monthly House View. Our usual format will return in February.

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2022 has been a challenging year for markets, with interest rates rising, inflation hitting record highs, the Russian war in Ukraine causing geopolitical turmoil, and a recession now likely on the horizon. As we look ahead to 2023, questions on these and other issues remain, and new questions will surely present themselves. What forces will shape markets and economies over the next 12 months? And how will they affect investment portfolios?

This represents our best insights into what the coming year may hold—based on extensive research, hard data, and our team's experience and expertise. With topics ranging from purchasing power and corporate profits to energy and cryptocurrency, these are 10 big investment trends to look out for in 2023.

#1: INFLATION

Loss of Purchasing Power Is Transitory

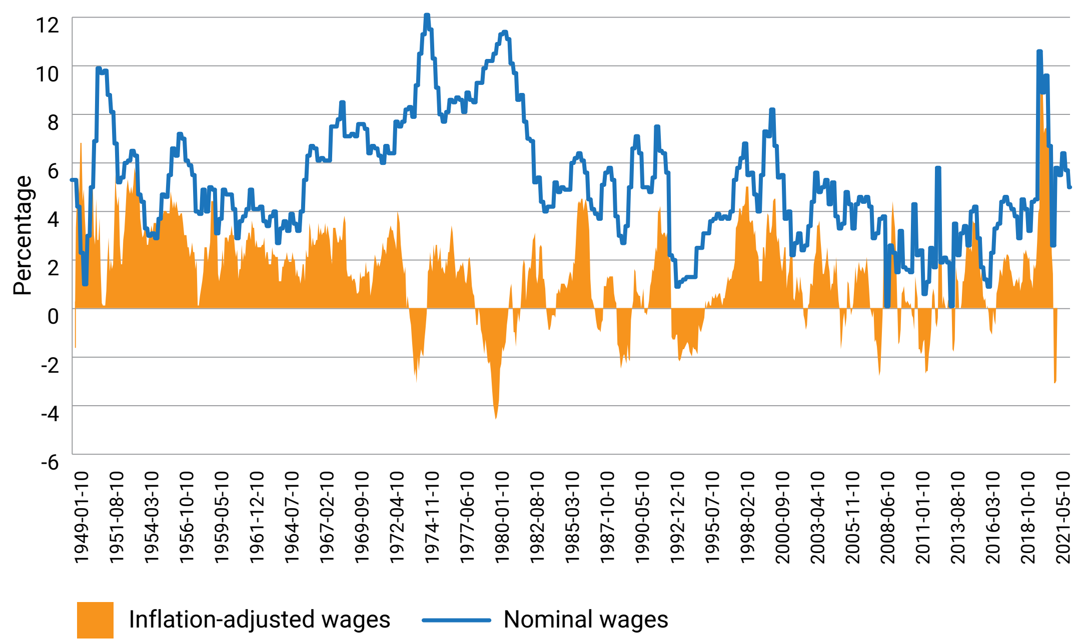
In 2022, wage growth fell behind inflation, eroding consumers' purchasing power.

Not only was this development taxing for households, but it also increased the odds of labour conflict and social unrest in the year ahead—especially in Europe, which has underperformed relative to its peers, and in developing economies.

But as 2022 came to a close, inflation numbers cooled somewhat. This decline means that wage growth will likely outpace inflation in 2023, potentially creating a tailwind for the economy into 2024.

A repeat of the historic inflation pain of 2022 would be devastating. Thankfully, we don't see it happening.

Negative Real Wage Growth Erodes Purchasing Power



Source: Bloomberg, BMO Global Asset Management, as of Q3 2022.

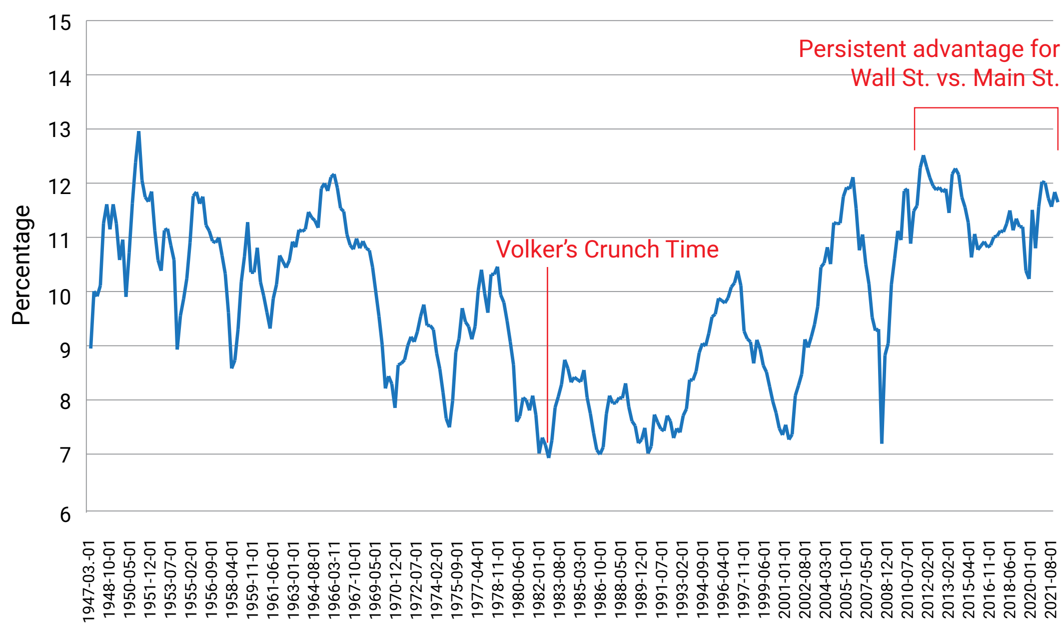
Corporate Pricing Power Is in High Gear

Pricing power—companies' ability to increase the price of its products or services without a proportionate reduction in demand—is one of the key attributes of equities that amplifies the compounding of returns.

To put it simply: if a company can successfully exercise its pricing power, it's good news for Wall Street and not as good for Main Street, as consumers' pocketbooks have to bear the burden of rising costs.

Corporate profit margins have been exceptionally strong during the COVID-19 pandemic, and as we enter 2023, we expect some cyclical moderation of those numbers. But overall, pricing power remains strong, and this is likely to prevent a repeat of the "Volcker Crunch" of the early 1980s—a reference to former U.S. Federal Reserve chairman Paul Volcker, who tamed inflation with high interest rates but "crunched" the economy (and corporate profits) in the process.

U.S. Aggregate Corporate Profits as Share of GDP (%)



Source: Bloomberg, BMO Global Asset Management, as of Q3 2022.

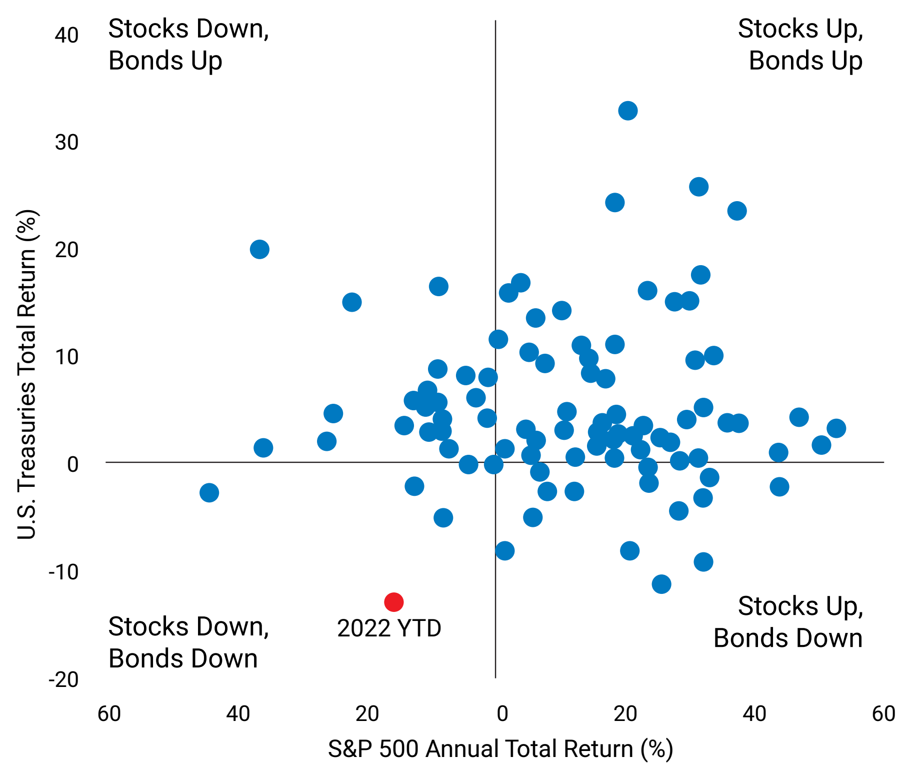
Are We in a New Regime of Monetary Policy?

Predictions of regime change in monetary policy are frequent, but they are extremely rare.

In recent years, the economy has experienced an intense cycle characterized by unanticipated headwinds, including COVID-19 and the Russian invasion of Ukraine. This has some analysts asking the question—have we entered a new regime?

Our short answer is 'no'. While imperfect, the benefits of the current inflation-targeting regime are widely accepted by policymakers. Typically, central banks play the role of 'banker-of-last-resort', acting contra-cyclically to moderate economic ups and downs—lowering interest rates when the economy is slowing down and raising them when the economy is revving up. But in 2022, they acted pro-cyclically, hiking into an economic slowdown and thereby hurting both stocks and bonds simultaneously. This is a historical rarity, as the chart at right demonstrates. In 2023, we expect central banks to return to their role of leaning against the economic cycle.

S&P 500 & U.S. Treasuries Annual Performance Since 1928



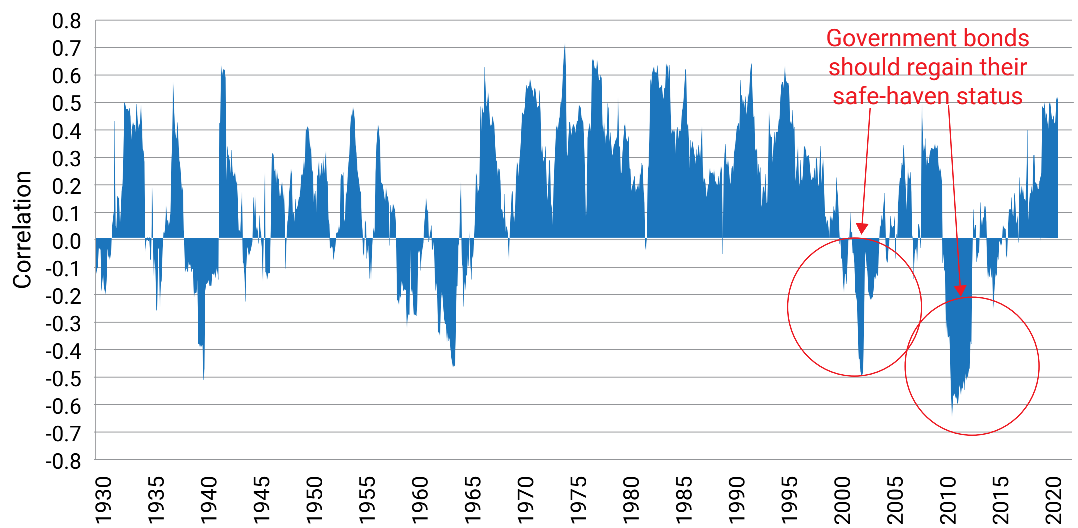
Source: Bloomberg, BMO Global Asset Management, as of October 2022.

The Future of the Balanced Portfolio

To paraphrase Mark Twain: Rumours of its death have been greatly exaggerated.

The normalization of interest rates—meaning their increase from a low of less than 1% during the pandemic—has strengthened the future of the traditional 60% stocks/40% bonds balanced portfolio. We expect that a return by central banks to their counter-cyclical approach to monetary policy will help government bonds regain their safe-haven status, as they did after previous economic downturns.

If History Is Any Guide, Government Bonds Should Regain Their Safe-Haven Status



Source: U.S. Federal Reserve, Bloomberg, BMO Global Asset Management, as of November 2022.

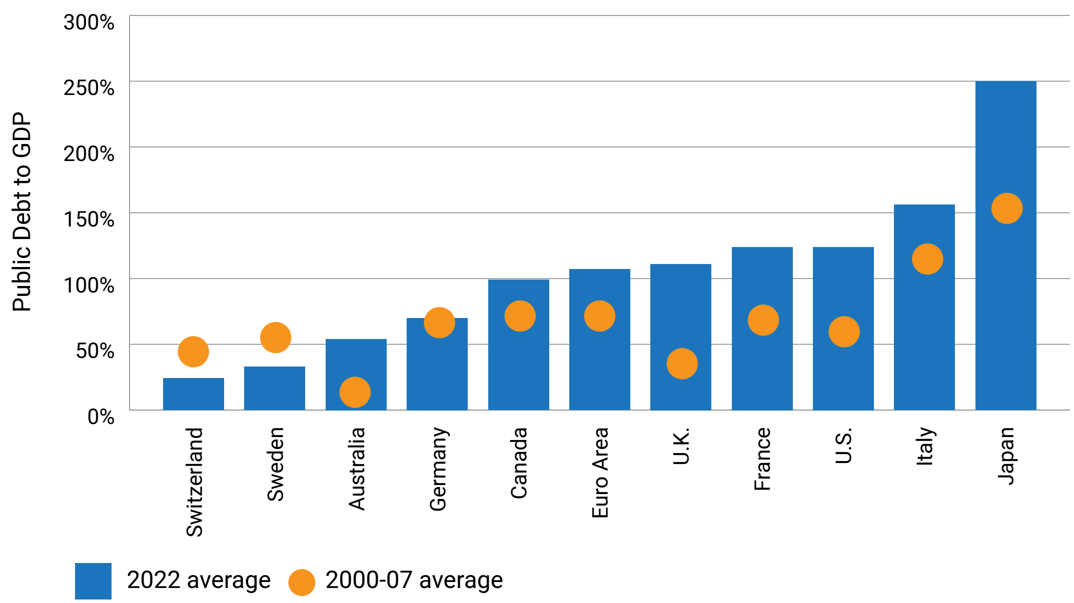
#4: INTEREST RATES

Rising Debt Servicing Costs Will Cap Interest Rates

The public finances of major economies cannot endure sustained high interest rates.

As the chart at the right shows, public debt is already on the rise in major economies, and the increasing cost of servicing that debt is likely to put the brakes on excessive fiscal deficits. Governments' elevated debt loads should put a ceiling on interest rates and prevent a regime shift in monetary policy.

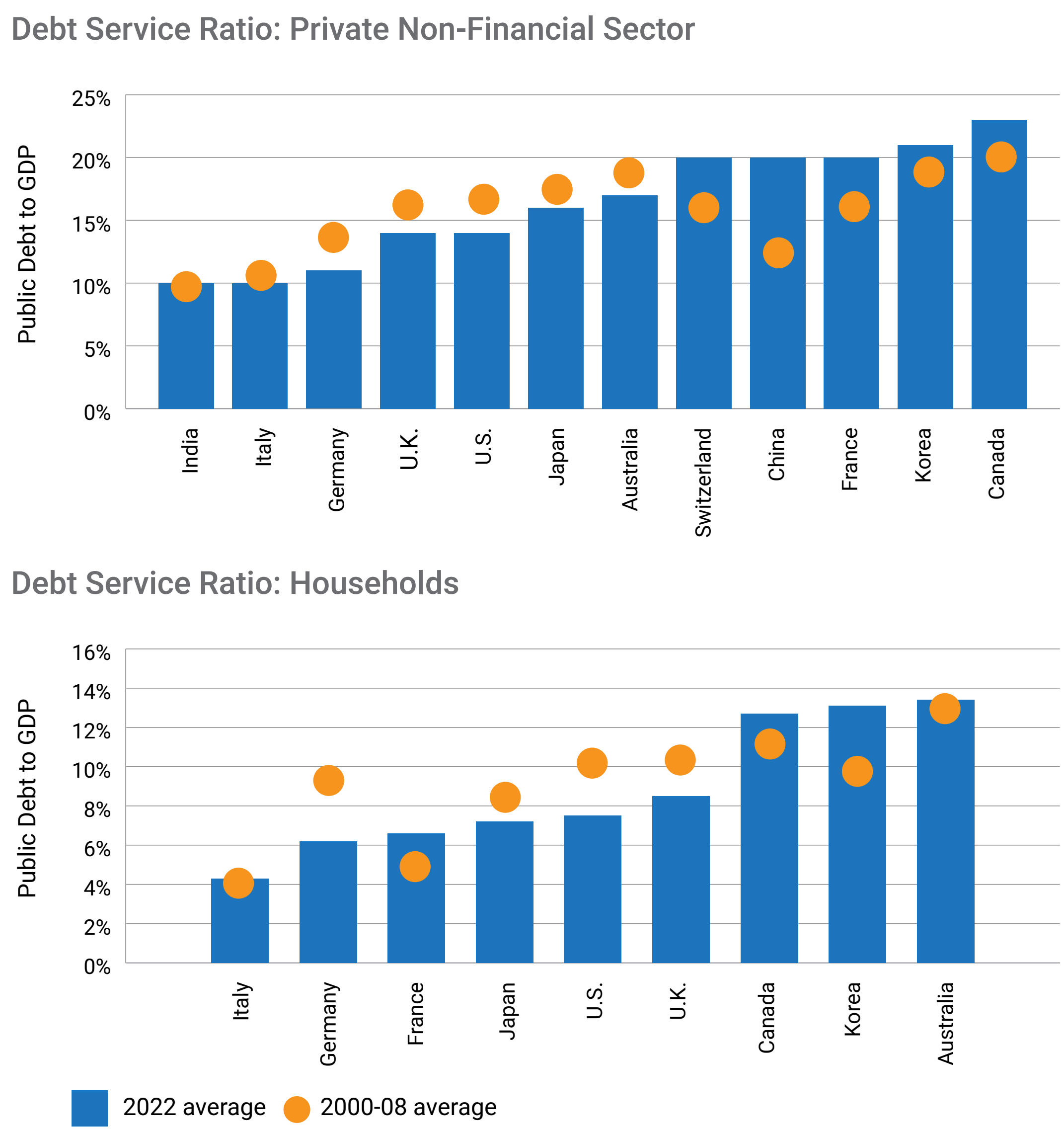
Public Debt on the Rise Across Major Economies



Source: Bloomberg, BMO Global Asset Management, as of September 2022.

#4: INTEREST RATES (continued)

Rising interest rates are likely to send debt-servicing costs back to the highs of the early 2000s. Private debt loads are also much higher now than before the Global Financial Crisis of 2007-08. Debt service is like a tax—money spent on servicing the debt is money not spent on goods and services. We expect greater scrutiny over public finances as the burden of interest rates is revealed in government budgets.



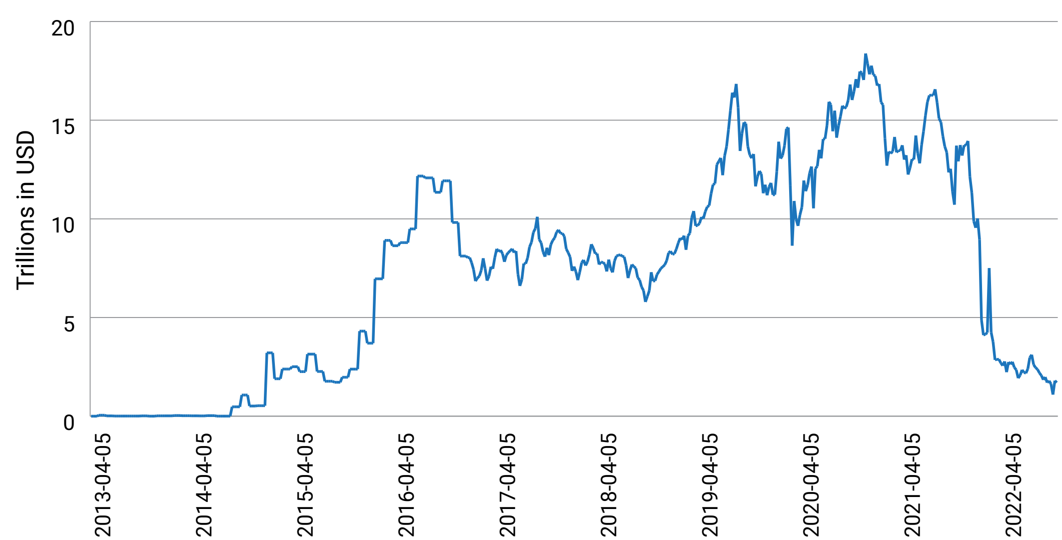
Source: Bloomberg, BMO Global Asset Management, as of September 2022.

Negative Interest Rates Are Gone. Will They Come Back?

Ideally, the world is past the regime of negative interest rates; as the chart below shows, the market value of negative yield debt has been declining steeply since a peak in 2020-21.

But elevated debt loads and policy makers' eagerness to steer the economy means that we cannot rule out the return of unorthodox monetary policies of negative interest rates or quantitative easing—especially given central's banks 'whatever-it-takes' approach to taming inflation. Going forward, central banks might support raising inflation targets to 3% from the standard 2% in order to reduce the odds of hitting interest rates' zero-bound (i.e., 0% interest rates, from which point they can't go any lower) too quickly during an economic downturn.

Bloomberg Global Aggregate Negative Yield Debt Market Value in USD



Source: Bloomberg, BMO Global Asset Management, as of November 2022.

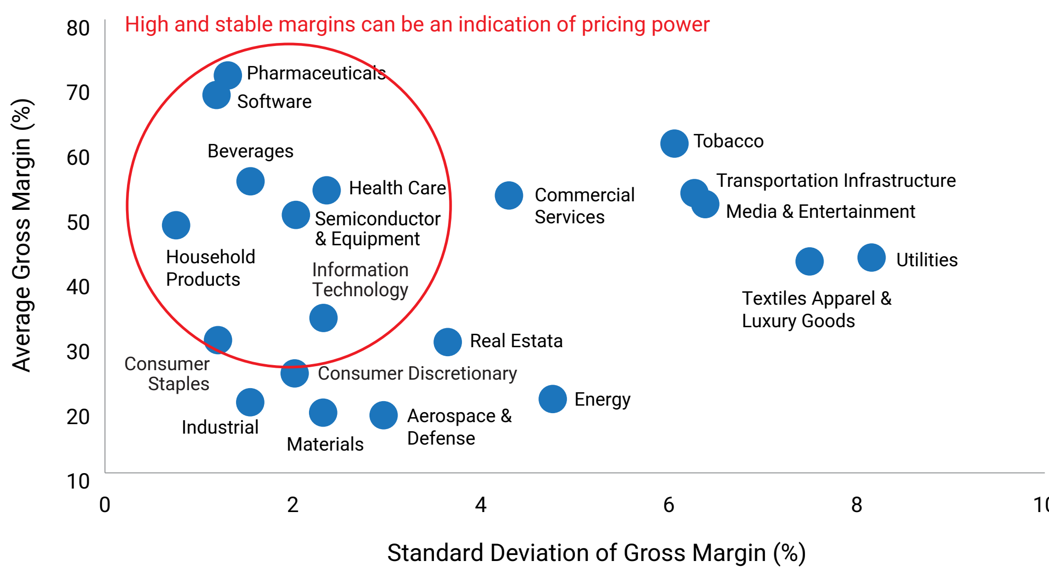
#5: QUALITY

Navigating Turbulent Markets with Quality

Quality is the foundation of a portfolio's strong equity core, and this is especially true for 2023.

Quality sectors and companies are characterized by high and stable profit margins, as demonstrated by the sectors at the top-left of the chart at the right. Resilience to fluctuations of the business cycle is also key during periods of elevated uncertainty, like the one we've experienced recently. With interest rates rising and the end of the era of free money over, we expect markets to refocus on the role of strong fundamentals as a driver of long-term performance.

Industry/Sectors Pricing Power



Source: Bloomberg, BMO Global Asset Management, as of October 2022.

#6: CRYPTOCURRENCY

The Beginning of the End of the Wild West Era

Recent cryptocurrency-related debacles, including the collapse of crypto exchange FTX in November, mean that crypto will likely be subject to increased scrutiny and additional regulations in coming months.

Crypto is already banned in China, and as more instances of fraud become public, the likelihood of broader restrictions—in North America and around the world—increases.

The events of 2022 have proven that cryptocurrencies have failed at providing investors with a store-of-value. As the market froth around crypto evaporates, we expect hard assets—meaning tangible assets with intrinsic value—to continue to regain popularity.

#7: GEOPOLITICS

Elevated Tensions are the New Normal

The war in Ukraine and rising geopolitical tensions around the globe have shone a new spotlight on conflicts' potential effect on portfolios.

The relevant question for investors, however, is not whether geopolitical instability can impact risk assets, but whether pre-emptive portfolio tilts or hedges are beneficial for long-term investors. The opportunity cost of portfolio hedges is rarely cheap, and to successfully pull off such a strategy requires superior timing—and luck. For many investors, day-to-day conversations about geopolitical risk can be a drain, fuelling fear with no realizable benefit to their portfolios. While elevated tensions do appear to be the new status quo, historically—and even more recently, in the case of U.S./Russia tensions—conflict between superpowers has largely been limited to proxy wars, rhetoric, and commercial or political posturing. For investors, there's little reason to lose sleep.

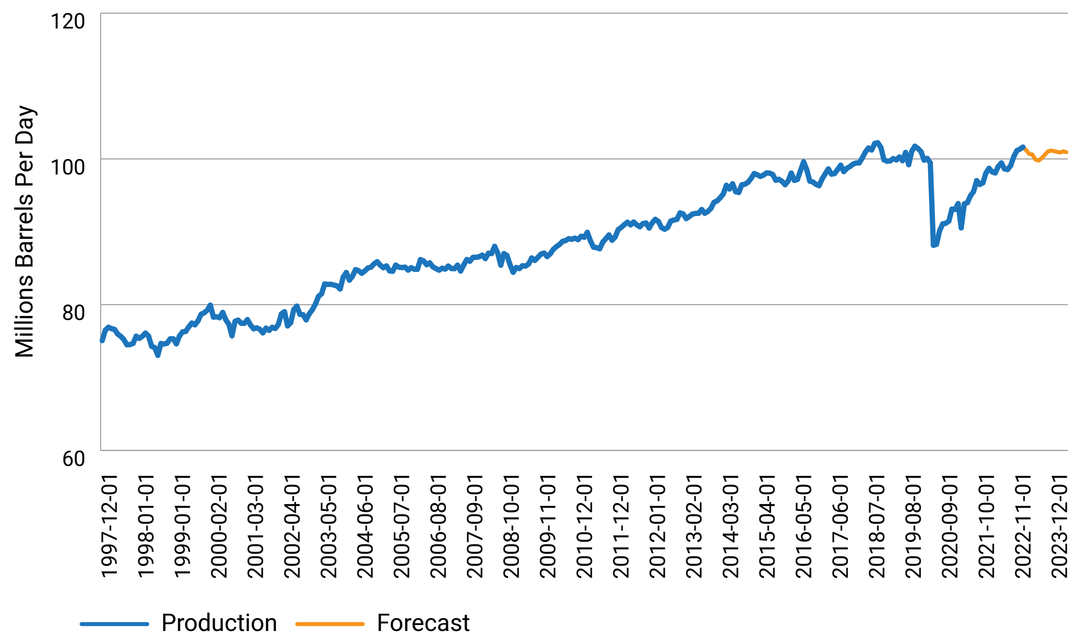
#8: ENERGY

Peak Oil Production, New Oil Cycle?

The Energy outlook, now highly influenced by geopolitics, remains a vulnerable factor for the global economy.

Decarbonization efforts are accelerating, but conventional energy demand remains elevated. The reality is clear: replacing fossil fuels will be a huge, generational task. We suspect that the energy transition will be slower than expected, and the scarcity of oil supply leaves energy prices exposed to persistent tailwinds.

U.S. Oil Production and Outlook



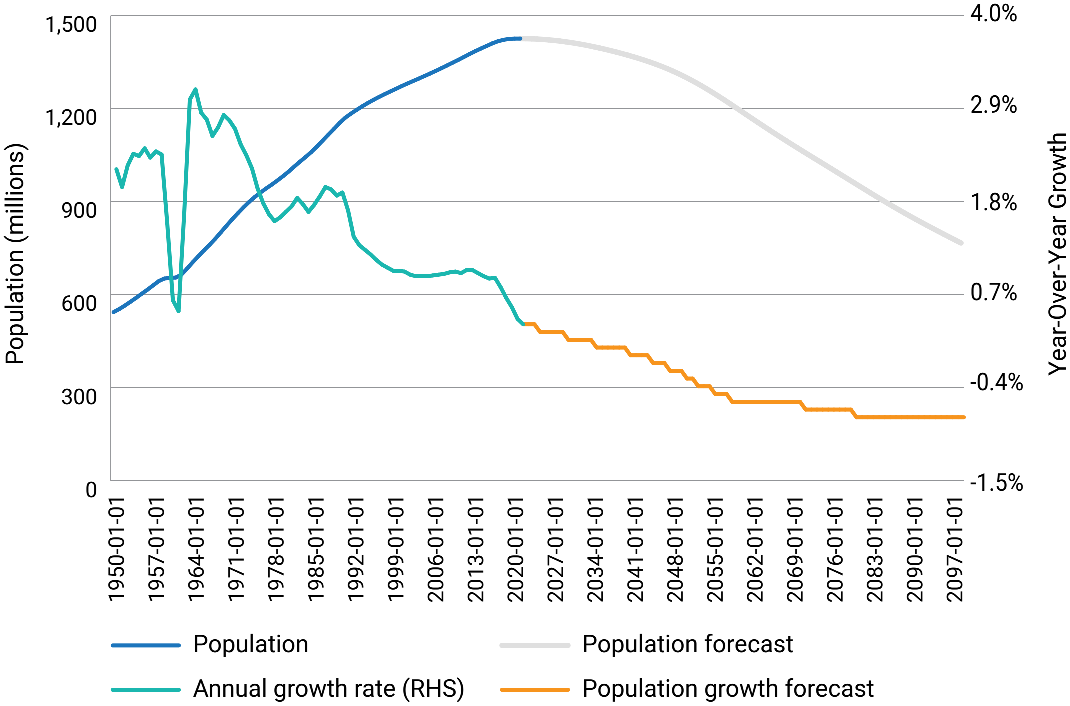
Source: U.S. Energy Information Administration (EIA), BMO Global Asset Management, as of October 2022.

Getting Old Means Getting Slow

China's population is expected to peak in 2023, with Beijing's well-publicized one-child policy leaving the country vulnerable to aging demographics and a distorted distribution of population by age.

As a result, China's long-term fundamentals look increasingly challenging. In 2022, we strategically trimmed our exposure to Emerging Market equities because of our negative outlook on these fundamentals—and at this juncture, we see no reason to change our minds, despite the country's likely economic reopening post-COVID in 2023.

China Population: Historical, Projections



Source: United Nations - World Population Prospects, BMO Global Asset Management, as of October 2022.

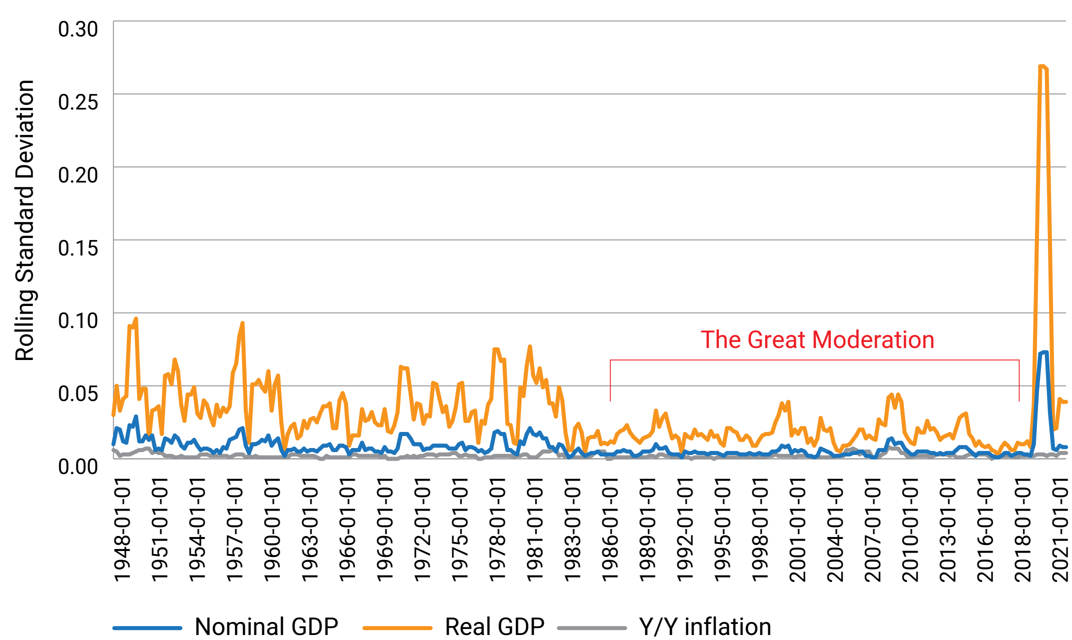
#10: MACRO OUTLOOK

A Return of 'The Great Moderation'

A key benefit to the low levels of inflation developed economies have experienced since the early 1980s has been a reduction in macroeconomic uncertainty—what economists have coined 'The Great Moderation'.

The pandemic brought an end to this period of relative calm, as rising inflation brought about increased economic turbulence. But will the Great Moderation return? Our answer is ***yes***. In 2023, as central banks stick to their inflation targets, we expect macroeconomic uncertainty to return to pre-pandemic levels.

Macro Uncertainty is Set to Moderate Once Again



Source: Bloomberg, BMO Global Asset Management, as of Q3 2022.

DISCLOSURES