

CIO Strategy Note

Economic Outlook

Portfolio Positioning

- Asset Classes

- Equity

- Fixed Income

- Style & Factor

- Implementation

Disclosures

November 2023
BMO GAM's Monthly House View

Stocking Up for a Holiday Rally

Presented by BMO GAM's
Multi-Asset Solutions Team

BMO  Global Asset Management

Stocking Up for a Holiday Rally

The technical recession we've been waiting on for months finally seems to have arrived in Canada.

The United States, however, is not there yet, and we don't anticipate a recession in the next quarter or maybe even the quarter after that. Higher interest rates are clearly having an impact on the economy, and while there are cracks in the consumer, nothing is broken just yet. We do expect consumer spending patterns to change more dramatically at some point, but the timing of that change is uncertain. That's why we haven't gone underweight Equities at any point recently—there hasn't been enough concrete evidence of a spending slowdown to warrant a shift to a risk-off stance.

Looking ahead over the next couple of months, we're somewhat more optimistic than we have been recently. The latest announcement from the U.S. Federal Reserve (Fed) provided greater clarity and, by extension, market positivity. Recent earnings announcements have been a mixed bag for some of the heavyweight names, but there has been enough of a bounce-back to showcase their resiliency. Ultimately, we believe that the pullback we saw in September and October only makes valuations look more attractive, especially with the end of the interest rate cycle in sight, and sets things up nicely for a holiday rally.



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

With this positive shift in investor sentiment, we're ready to cautiously push down on the accelerator.

Before the most recent Fed announcement, we were neither braking nor putting our foot on the gas pedal. Now, with this positive shift in investor sentiment, we're ready to cautiously push down on the accelerator.

ECONOMIC OUTLOOK

An Economic Decoupling

North America's two largest economies diverge, as Canada likely enters a recession while the U.S. weakens more gradually. Meanwhile, European growth remains stagnant, and China takes steps to reignite momentum.



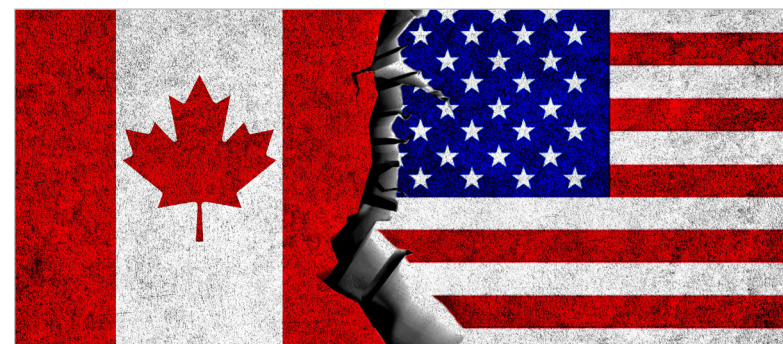
Frederick Demers
Director, Multi-Asset
Solutions

U.S. Outlook

The economic picture in the United States remains fairly strong, even as evidence of cooling continues to emerge. We don't see signals that would indicate an imminent recession, but the cooling phase is important nonetheless as it keeps a lid on interest rates. Very strong momentum could cause the Fed to raise rates further, but instead, momentum is slowing, with nonfarm payrolls normalizing below 200,000 per month. This is critical to avoiding a reacceleration of inflation. Overall, the moderation in the data is a positive for risk assets and for investors in general, as it may help avoid a 6% federal funds rate scenario.

Canada Outlook

The decoupling of the Canadian economic outlook from the U.S. continues; north of the border, the question is not about cooling, but rather about whether the recession has arrived or not. The GDP data is certainly on the weak side, with a technical recession—two consecutive quarters of contraction of real GDP—more likely than not. On the job front, unemployment is rising, standing now at 5.7% from the lows of sub-5%. Job losses aren't yet piling up, but there is certainly some acceleration underway. Going forward, that should bring down wage pressure and ensure that the Bank of Canada (BoC) is done raising interest rates. The next step will be rate cuts, though their timing remains uncertain.



International Outlook

For International (EAFE) markets, it's been almost a year of stagnation and virtually no growth. Interestingly, though, we are starting to see some increases in the unemployment rate. For a long time, resilience and labour shortages were big stories across the world's major economies. Eventually, however, growth stalls and firms have to rethink their expenditures. Cutting jobs after a couple years of expansion has been a key theme to maintaining efficiency and profit margins, and that trend has started to translate into EAFE's economic picture.

ECONOMIC OUTLOOK

In Emerging Markets (EM), the Chinese economic story continues to be characterized by small disappointments across the board. Real Estate is a structural headwind, but even outside of that crisis, it's been challenging for momentum to re-emerge. That, in turn, is feeding the longstanding narrative of the trickling of economic stimulus. Over the past month, we've seen Beijing's marginal measures starting to add up. But it will still be a tough battle to establish a floor for the growth outlook, let alone jump-start the growth cycle.

Key Risks	BMO GAM house view
Inflation	<ul style="list-style-type: none"> • The battle against inflation is largely over • The U.S. and Canada's situations are not identical, but cooling demand is evident in both economies
Interest rates	<ul style="list-style-type: none"> • Data is likely to confirm that we've reached a peak in interest rates, at least in Canada and Europe • The U.S. is still in the early phase of cooling, so there is slightly more uncertainty
Recession	<ul style="list-style-type: none"> • In Canada, it's likely already arrived; the next question is how hard the landing will be • The U.S. may have to wait a while longer
Consumer	<ul style="list-style-type: none"> • In Canada, retail sales have been buoyed by immigration, but are declining on a per capita basis • In the U.S., the consumer is going okay, with wage growth outpacing inflation
Housing	<ul style="list-style-type: none"> • A weak point for Canada more than the U.S. • Likely to get worse before it gets better
Geopolitics	<ul style="list-style-type: none"> • The U.S. is motivated to try to prevent the further escalation of the Israel-Hamas conflict • If the conflict remains local, that would be positive for inflation and investors' risk appetite
Labour	<ul style="list-style-type: none"> • Recent strikes have captured a lot of media attention, but unionized workers are a relatively small and diminishing share of the U.S. labour force • Job actions represent a catch-up phase following years of low wage growth

PORTFOLIO POSITIONING

Asset Classes

Equity markets appear to be pricing in a top to the interest rate cycle, while we foresee stocks rallying into year-end. Bond markets, meanwhile, are abruptly adjusting to monetary policy that's starting to work as intended.

Markets appear to be at a turning point. The idea that bad news is good news is still in place, but this is the first time in a long time we've gone overweight Equities. We are past the seasonal lows we expected, where markets grew extremely pessimistic in terms of bearish sentiment, evidenced by the dearth of stocks that were trading above their 200-day moving average. That is classically a setup for a technical rally, and we want to participate in that. We've begun adding risk back in the portfolios through a combination of all five lenses, but the biggest upgrade this month is to go long Equities. Recent labour market numbers reinforce the notion that the economy is cooling off sufficiently to meet Fed inflation goals, with not only the number of jobs created of late coming in lower, but more importantly, the participation rate has dropped, pushing unemployment up. Average hourly earnings are posting their weakest annual advances since mid-2021. Wage growth pressure—which the Fed is most concerned about—is easing as well, which, taken together with the other data, is driving positive market sentiment as expectations of further rate increases fell and cuts were priced a full month earlier by the futures market.

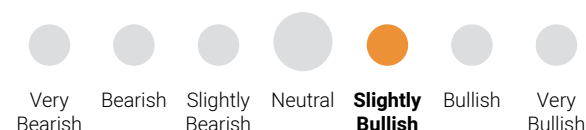
In terms of Fixed Income, everybody had been watching the benchmark U.S. 10-year yield and, whether we've seen the peak or not, the trend is breaking. As a rule, we don't try to perfectly time a market top. Are we there yet? If we aren't, we're certainly close. At the short end of the curve, if you have a choice between three-month

money or two-year bonds, you probably want to be in the latter because we are seeing yields pull in. Overall, what we're seeing is a flattening or 'dis-inversion' of the yield curve. Everybody has been moving into cash because it seemed like central bank policy wasn't working. The numbers are beginning to confirm, however, that it is.



Steven Shepherd, CFA
Director,
Portfolio Manager

EQUITIES



FIXED INCOME



CASH



PORTFOLIO POSITIONING

Equity

The U.S. market continues to post resilient results, driven by surprising margin expansion. Our outlook factors in a slowdown in 2024, yet compared to the rest of the world, U.S. stocks look attractive and are where we are overweight.

We had three down months for the S&P 500—the market was clearly overly pessimistic, which had a lot to do with the fact we had a huge move in rates upwards in matter of a few months. There's now some relief that bond yields are at least stabilizing within the current range, which justifies the equity market moving higher—especially when it's on the back of cooling-not-crashing economic data.

Our models are showing a high probability of a shallow recession in the U.S. in 2024; however, the macro backdrop is stronger than other parts of the world. Is the U.S. economy slowing? Yes, but everywhere else in the world is slowing faster. We are seeing resilient growth translating into resilient earnings, which is translating into more resilient stock market performance, and we think that should continue in the near term. In the third quarter, the average S&P 500 earnings beat was by 7%, which is above the historical norm (3-4%). That's positive. However, revenue growth is effectively flat or just meeting expectations, meaning profits are now being driven by margins, which is not as sustainable as earnings growth driven by revenue. In terms of sectors, the "Technology-plus" group (Consumer Discretionary and Communication Services), continues to surprise to the upside, contrasted by cyclical sectors like Energy where we are seeing less impressive results.

For the Canadian market, there is a much weaker macro backdrop, but growth is similarly cooling not crashing. The market is performing as if we're in a slowdown, not a recession. Our view on Emerging

Markets (EM) is neutral; there's concern over China's growth, which is keeping us from going overweight. We don't see a catalyst at the moment, but we also don't see systemic risk.



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

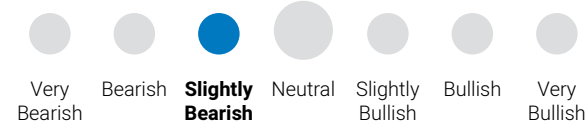
CANADA



U.S.A.



EAFE



EM



PORTFOLIO POSITIONING

Fixed Income

The U.S. Federal Reserve has struck a notable shift in tone, going from looking for reasons to hike to reasons not to lift rates again. With the cycle close to peak, we are legging into longer duration bonds.

The key message is that we have moved to overweight Duration. It might be slightly premature to call the end of the hiking cycle, but we are definitely near it. The Fed sounds like they are now looking for reasons not to hike rather than looking for reasons to hike. That sentiment came through in their commentary around the tightening in financial conditions doing the Fed's work for it, and in their discussions around the macro data starting to cool. The notable shift in tone means we're almost certainly near the end. Our view is: it's time to start legging into longer duration bonds simply because Fixed Income tends to shine after we hit peak yields and peak monetary policy. This is when investors get the best returns from bonds historically.

It should also be said that you don't need a recession for bonds to rally. Sure, they would have even greater upside in a recessionary scenario, but all the market requires for a material rally in longer duration bonds is for rates to come off peak, like we're starting to see—which also means our view is not predicated on a recession call. Another reason for our shift toward favouring Duration is that up until now, long bonds in this market haven't really provided an offset to Equity risk, because we've had such persistently high inflation. That's changing, and as inflation moves lower, we think you're going to start to see bonds act more and more like they historically have: as a hedge to Equities.



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

IG CREDIT



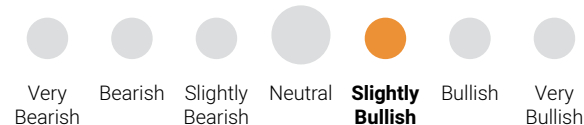
HIGH YIELD



EM DEBT



DURATION



PORTFOLIO POSITIONING

Style & Factor

With an Equity rally underway, we are taking a more tactical short-term approach, but still favour Quality as we look into 2024 and see the high potential for recession, where cash-rich balance sheets will likely be rewarded.

Quality is great and cash is still king, but that's probably less relevant in the short term given our overweight in Equities. Looking out to 2024, as a defensive hedge if we do have a recession (a soft landing being the most likely outcome), we still like strong balance sheets, like we saw from the latest Tech earnings. We got mixed results across the bigger names, but the stocks that have held up better after reporting were the ones with higher free cash flow yields. Technology is an extension of the Duration trade. When you think about growth stocks, Duration is longer when your dividend is lower. Growth names are going to be beneficiaries of falling yields.

We still like Energy this quarter; the sector has pulled back, but there's still a material tail risk to the upside given geopolitical uncertainty. Oil doesn't have to be above \$90 USD for the sector to be cashflow positive, and it is about three times as cashflow positive versus the broader S&P 500. We have moved to underweight on Materials, which is mostly a function of finding somewhere to save money as well as short-term pressures; base materials like copper and base metals tend to be linked to inflation pressure, and that seems to be coming off with concerns as the Fed pivots and wage growth dampens.



Steven Shepherd, CFA
Director,
Portfolio Manager

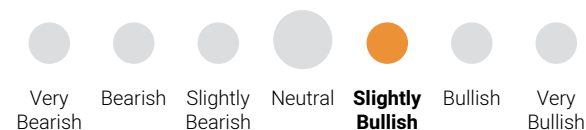
VALUE



GROWTH



QUALITY



VOLATILITY



PORTFOLIO POSITIONING

Implementation

The boil may soon come off the U.S. dollar's relative strength, which would benefit the loonie. However, our preferred USD hedge is Gold, which could be poised for a breakout.

We are still neutral CAD/USD at current levels, but if the loonie were to slip to .70 or below, that would probably change. It is not about the Canadian dollar's movement, however—it's the US dollar, which has been exceptionally strong as the Fed has pushed higher. If the market believes that this is the top of the cycle, and we are closer to rate cuts rather than hikes, that will take some of the boil off the greenback. We would want to be long the Canadian dollar in that case, but we're not entirely convinced yet that that trade is needed, and we have other hedges in the portfolio that benefit from a falling U.S. dollar, such as Gold.

Over the past several months we've seen Gold break away from its traditional relationship to real yields. It has held up remarkably well even though real yields are higher than they've been since the global financial crisis. This will probably persist owing to both long-run and short-term, as well as technical reasons. We've seen a couple of closes above \$2,000 USD, and more specifically around \$2,085—a key technical level, which if we get above could send Gold on a tear.

The other implementation being used in some of our portfolios is covered call writing. We've been able to take advantage of a strong surge in Energy, which is a prime example of what we're trying to do with the covered calls. The strategy is not driving the bus, but it allows us to get paid for volatility.



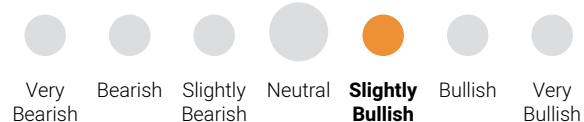
Steven Shepherd, CFA
Director,
Portfolio Manager



CAD



GOLD



ENDNOTES & DISCLOSURES

CIO Strategy Note

Economic Outlook

Portfolio Positioning

• Asset Classes

• Equity

• Fixed Income

• Style & Factor

• Implementation

Disclosures

The viewpoints expressed by the Portfolio Manager represents their assessment of the markets at the time of publication. Those views are subject to change without notice at any time without any kind of notice. The information provided herein does not constitute a solicitation of an offer to buy, or an offer to sell securities nor should the information be relied upon as investment advice. Past performance is no guarantee of future results. This communication is intended for informational purposes only.

Any statement that necessarily depends on future events may be a forward-looking statement. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions. Although such statements are based on assumptions that are believed to be reasonable, there can be no assurance that actual results will not differ materially from expectations. Investors are cautioned not to rely unduly on any forward-looking statements. In connection with any forward-looking statements, investors should carefully consider the areas of risk described in the most recent simplified prospectus.

This article is for information purposes. The information contained herein is not, and should not be construed as, investment, tax or legal advice to any party. Investments should be evaluated relative to the individual's investment objectives and professional advice should be obtained with respect to any circumstance.

BMO Global Asset Management is a brand name under which BMO Asset Management Inc. and BMO Investments Inc. operate.

®/TM Registered trademarks/trademark of Bank of Montreal, used under licence.