February 2024

BMO GAM's Monthly House View

The American Exception

How U.S. Markets Beat the Bears…Again

Presented by BMO GAM's
Multi-Asset Solutions Team

BMO | Global Asset Management

CIO STRATEGY NOTE

The American Exception

How U.S. Markets Beat the Bears...Again

Last month, I mentioned that we'd be closely monitoring the U.S. Federal Reserve (Fed) and the statements of its chair, Jerome Powell, for clearer indicators on the timing of interest rate cuts.

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

At the Fed's meeting in January, we received just that. For the first time in this rate cycle, Powell stated that rate hikes are effectively off the table, while also reiterating that the Fed's March meeting may be too soon for a rate decrease. It was mixed news for markets, but it did provide the one thing we've been seeking for months: greater clarity.

Chairman Powell's statements didn't stop there. Only days after the Fed's January rate announcement, he made an appearance on *60 Minutes*, saying that while the "time is coming" for rate cuts, the Fed wants "more evidence that inflation is moving sustainably down to 2%" before acting.[1] This kind of direct appeal to Americans is rare, but it does underscore the Fed's data-dependence—and the likelihood that we may not see lower rates before the summer.

In overseas markets, interest rates are the big story as well, with the European Central Bank (ECB) opting to hold policy steady rather than lowering rates in January. Both the ECB and the Bank of Canada (BoC) arguably have a clearer case for cutting rates than the Fed given the U.S.'s continuing economic resilience. But central bankers are understandably worried about making a mistake; moving too early could cause inflation to spike back up. Neither the ECB nor the BoC need to wait for the Fed to move first, though they may opt to.

It was mixed news for markets, but it did provide the one thing we've been seeking for months: greater clarity

Regardless, once the Fed cuts rates, it's likely that other central banks will follow suit—because just like in any great mystery novel, there is safety in numbers.

America Stands Alone

The U.S. economy shows unambiguous strength while much of the rest of the global economy gradually cools.

Frederick Demers
Director, Multi-Asset Solutions

U.S. Outlook

The economic outlook for the United States is unambiguously strong—in fact, we're not even sure we can accurately speak of a gradual cooling of the American economy anymore. The key indicators have exceeded even the most optimistic expectations, and momentum is looking good to start the year. Two percent gross domestic product (GDP) growth for 2024 could be easily attained, and 3% growth is certainly a possibility for the first half of the year. This kicks a potential recession even further down the road, opening up a recession risk narrative for 2025. Fed Chairman Jerome Powell has made a point of lowering expectations for a rate cut in March,[2] and if the economic data remains strong, hopes of a cut in May could also prove overly optimistic. However, the cooling of inflation is also key for the Fed's policy outlook, and encouraging progress continues to be made on that front, opening the door for policy easing.

Canada Outlook

In contrast to the U.S., the Canadian economy is definitely cooling. Recent data suggests that Canada is doing just well enough to avoid an outright recession, but it's still a weak economic backdrop, with best-case-scenario GDP growth for the year likely to come in at around 1.0%-1.5% compared to the 2.0%-2.5% range for the U.S.

It's no mystery that interest rate hikes have taken their toll and that it's an unpleasant environment for Canadian consumers facing mortgage refinancing. The good news is that while the Canadian economy is cooling, it's not crashing. While the labour market can largely be expected to move sideways, the unemployment rate is rising due to strong population growth from immigration—on the order of 50,000-60,000 new people per month joining the labour force.[3] That should translate into looser labour markets, which in turn could help assuage fears about inflation going into the year-end.

International Outlook

For Europe, it's the status quo—which is to say that economic activity remains stagnant, neither going up nor going down. That said, given expectations of a gradual weakening, flat numbers represent good news. Looking ahead, the Eurozone's economic picture could start to improve as the ECB begins to cut interest rates. In Japan, there has been a degree of cooling, though that may be due to the fading effects of a tourism boom; in 2023, the post-COVID reopening of the tourism industry was an important channel for economic rebound, but that temporary boost now appears to be dissipating. As a result, the Japanese economy is now normalizing.

In Emerging Markets (EM), China is the key story. While growth is not necessarily cooling, it is continuing to disappoint relative to hopes of an economic reacceleration, which has failed to materialize since the country's post-COVID reopening over a year ago. Though stimulus continues to slowly work its way through the economy, headwinds from Real Estate continue to pile on, which further dampens hopes of a sudden growth rebound.

Key Risks	BMO GAM house view
Inflation	• Stronger U.S. growth means a slower path to the Fed's 2% target and maybe even a small reacceleration of inflation, but not at the level of 2022
Interest rates	• Resilient U.S. growth likely means slower, shallower cuts from the Fed
Recession	• Delayed, but the bears refuse to fold • Fear of a recession could roll into 2025
Consumer	• The U.S. consumer and Canadian consumer are two different species at present • The U.S. consumer is fully employed and doesn't have to worry about higher rates unless they're buying a new car or home • For Canadian consumers, mortgage refinancing is the big pain point
Housing	• The market has come off the lows in both Canada and the U.S. • No longer a drag on the outlook, but delayed rate cuts mean delayed recovery
Geopolitics	• For the U.S. administration, the goal is to avoid an inflationary escalation • Such an escalation should be considered a low-probability, high-consequence risk
Energy	• The market is not convinced that conflict in the Middle East will escalate • That's why oil is struggling to trade above $75 per barrel on a sustained basis[4]

PORTFOLIO POSITIONING

Asset Classes

Both stocks and economic indicators are telling us that markets and the economy are moving in a positive direction. There are things that concern us as we look further into the year. But for now, we like what we're seeing.

Steven Shepherd, CFA
Director,
Portfolio Manager

The news that the Fed isn't lowering rates in March was about the worst kept secret in financial market history—a rate cut is not only off the table, it's out the door and into the lake. Chairman Jerome Powell went so far as to go on *60 Minutes* to explain to the "average person" why it's not happening. That's virtually unprecedented for a Federal Reserve official. What has truly been surprising is persistent U.S. economic strength. Overall growth blew the doors off in Q3 with very little giveback in Q4. Now the Atlanta Fed's GDPNow is forecasting 3.4% growth for Q1. If there is weakness coming, it certainly doesn't look like it. That said, there are things we're concerned about, such as the U.S. election; it's going to be noisy with a lot of rhetoric, and we are already hearing about significant tariffs on everything that comes from China if Donald Trump is elected again.

What really matters is what companies are able to do. The reality is that things are moving in a positive direction, which certainly pushes off recession fears. In terms of earnings, we've seen about 70% of companies report upside surprises in earnings-per-share, or about four percentage points above the long-term average.[5] Revenues are also up. Technology continues to dominate, and when you factor in potential growth, it is not that unreasonable to see why. The difference between now and the dot-com era is that these mega-cap names are actually making money—Meta Platforms, Inc.'s introduction of a dividend is big step forward for these stocks.

In terms of re-rating cash to slightly bearish (-1), our view is that the overriding trend is downward for interest rates—whether it is March, May, or sometime thereafter, the direction is still down. We are not prepared to go short duration at this time.[6]

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

Equity

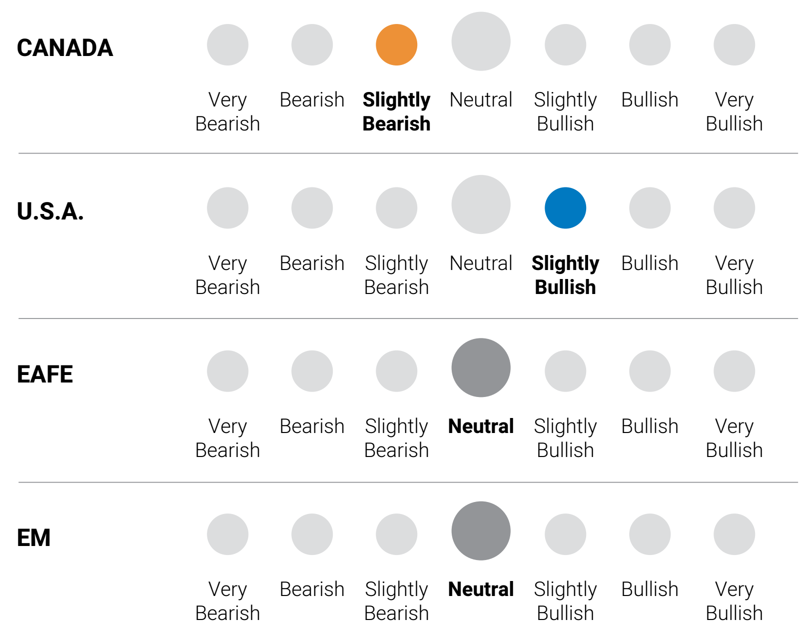
The Magnificent Seven remain market darlings—with good reason. Those names (and sectors) are where almost all earnings growth is occurring. The Canadian market continues to lag, while we are growing more constructive on International (EAFE) equities.

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

Earnings season has gone well overall, surprising to the upside. One area worth highlighting is the Magnificent Seven, which was a bit of a mixed bag. Both Tesla and Apple underwhelmed, but Amazon and Meta seem to have taken the reins, posting very strong results. Overall, the "Mag 7" story continues to be about earnings growth, not the surprises. If you look at the market excluding that group, it was another quarter of muted earnings growth. For 2023, earnings excluding the Magnificent Seven were actually negative. Growth still remains largely confined to the Technology, Communications, and Consumer Discretionary sectors, and the market continues to reward that growth. Another situation we're monitoring revolves around New York Community Bank, whose earnings report some took as a sign of small U.S. banks and commercial real estate causing wider concerns, which momentarily spooked the market. But when you look under the hood, their earnings were really poor because of the acquisition of Signature Bank, which made them a bigger bank that has to bolster the cash position of its balance sheet, in turn hurting their profitability. We are still monitoring for contagion, but aren't expecting any. More broadly speaking, those tremors may further delay a cyclical rally or a widening out of market strength into small caps, because you would need participation of the bank stocks for that to transpire.

In terms of the Canadian market, we're continuing to see a bifurcation with U.S. indexes. Canada looks to have avoided recession, but it is still not a strong backdrop for equities amid a fragile economy.

We are neutral (0) on international markets. EAFE (Europe, Australasia, and Far East) has also narrowly avoided a recession, and we are now starting to see more of a pickup in positive surprises—some green shoots, if you will—which keeps us more neutral on Europe and Japan. We are still neutral (0) on EM, and China in particular. It needs stimulus and is now getting it. The problem is that it hasn't resulted in in a positive market reaction just yet.



PORTFOLIO POSITIONING

Fixed Income

The bond market has been forced to play catch up to a more realistic rate path from the Fed. Our expectation is that the loosening cycle commences this summer, with Duration to benefit. For now, however, our view on longer dated fixed income is neutral (0).

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

We pulled back on our slight overweight (+1) to Duration at the start of 2024 on the view that markets were getting ahead of themselves in expecting the Fed to cut in March. Jerome Powell has now officially put it off the table, and we've seen markets react accordingly. That is a material shift, but we nevertheless still maintain a neutral (0) view on Duration. We like it longer term, but admittedly the jury is out on the timing. The most likely scenario, in our view, is that the Fed will commence reducing benchmark rates in the summer. That is when you may see us go outright bullish on longer dated fixed income. The market has just moved from March to May on a Fed cut, and it is likely that May expectations will probably get pushed out as well. We know cuts are coming, but we're not going to try and perfectly time it as economic data continues to come in hot. At this stage, the appropriate view for us is to remain neutral (0).

In terms of High Yield credit, the strong, resilient growth we've seen, particularly in the U.S., keeps us quite constructive on spreads. At the same time, a 'higher for longer' rate environment isn't great for lower-quality companies with weaker balance sheets. It is a double-edged sword where strong growth is positive, but it is also serving to push rate cuts further out, which is risky for credit-sensitive areas of the bond market.

In terms of EM Debt, we think the prospects for the U.S. dollar (USD) to strengthen are high. All else being equal, that makes EM Debt not particularly attractive. We do not currently want to bet against it, because it is offering some decent spreads and diversification.

	Very Bearish	Bearish	Slightly Bearish	Neutral	Slightly Bullish	Bullish	Very Bullish
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

Factors require catalysts, and with the exception of the vaunted Mag 7, we aren't seeing much else moving the needle for Growth. That said, as rates come down, we anticipate dividend yields to attract a lot more market attention, benefitting valuations.

Steven Shepherd, CFA
Director,
Portfolio Manager

We aren't expressing any direct views across Value or Growth; we are screening on a more sector-by-sector basis, leaning towards Technology and the earnings growth we are seeing there. Our view on the Magnificent Seven is by default a Growth tilt. But in terms of Value in the world as a whole, we're not there yet—valuations have been significantly depressed in China, but there is presently not much of a catalyst.

One significant change for this month is Yield, which has been upgraded to slightly bullish (+1). As mentioned earlier, Meta initiating a payout is an important development—think about all the dividend fund managers who wished they could have owned Meta for the past 10 years. Now they can. And as rates come down, dividend yields get more attractive, as does total shareholder yield. Company buybacks are likely to be a trend that will become more apparent as market participation broadens out. Dividend growth and buybacks will be themes to watch for going forward. When you talk about a factor, you need catalysts. With declining interest rates on the horizon, Yield is a factor that has a catalyst.

Volatility is very low, and getting close to historical averages. Bond volatility is higher than equity. What's more concerning is correlation: bonds and equities are more positively correlated, which is not the long-term norm that you would like to see in a well-diversified portfolio. But volatility is likely to increase over the span of the year as we get closer to the U.S. election.

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

We expect USD strength to persist amid glowing economic data relative to other economies. We still favour Gold as portfolio insurance despite a technical rally that has failed to materialize.

Steven Shepherd, CFA
Director,
Portfolio Manager

We've taken a more downbeat view on the Canadian dollar (CAD), downgrading it to slightly bearish (-1), coincident with the view that the USD remains stronger amid a Fed rate path that puts U.S. rate cuts further away than the market was anticipating. Further, the relative difference between Canada and U.S. economic trajectories suggest the BoC should probably cut before the U.S., prompting us to go underweight CAD.

Gold is range-bound. Real rates are coming down, but we are not seeing the same uptick in Gold that you would associate with real rates coming down because it survived real rates going up quite well. We are not seeing that symmetrical payoff that we usually do—at this point, Gold is largely portfolio insurance. We do not see a breakout in the making unless there is a huge re-acceleration in inflation.

	Very Bearish	Bearish	Slightly Bearish	Neutral	Slightly Bullish	Bullish	Very Bullish
CAD			● **Slightly Bearish**				
GOLD					● **Slightly Bullish**		

DISCLOSURES

[1] Jerome Powell: Full 2024 60 Minutes interview transcript," *CBS News*, February 4, 2024.

[2] Craig Torres, Chris Anstey, and Catarina Saraiva, "Fed Officials Signal Wariness to Cut Rates Too Soon, Despite Inflation Progress," Bloomberg, February 7, 2024.

[3] "Labour force characteristics by province, monthly, seasonally adjusted," Statistics Canada, February 9, 2024.

[4] OilPrice.com.

[5] MacroMicro.

[6] 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).