# Market Perspectives - Q1 2017

# Quarterly Review and Outlook

After a year of surprises, many may be struggling to understand how and why 2016 ended the way it did: a typical broadly diversified 60/40 balanced portfolio finished the year with a gain around 7% (net of fees). In our view this is a very strong return for the year and even slightly above what our capital market assumptions lead us to expect from a balanced portfolio in the next several years. In this review and outlook, we look at how this came about and grade some of our active positioning in 2016. We also share our expectations for 2017's looming policy risks and opportunities and examine whether and how 2016's gains may be sustainable.

## 2016: A little more flag captured

Asked to explain a good year for returns, some might cite an unexpected business-friendly election result: the S&P climbed 5% after November 8. Yet despite a couple shocks, in early February and again following June's Brexit vote, equities gained steadily most of the year. Analyzing as part of our investment process the meaningful economic and valuation trends as well as the projected policy developments behind this movement, we find other equally compelling stories illuminating 2016 results and 2017 expectations.

It's also worth noting the value added by asset allocation in a year like 2016. Recall that a year ago, investors tallying year-end returns for 2015 saw flat-to-moderate returns across most asset classes. Conservative, moderate and aggressive allocations likely finished 2015 about the same: close to even.

Not so in 2016. This year investors saw much more differentiation between asset classes. Some areas did very well — high-yield bonds returned 17.3%; U. S. equities returned 12.0% — and others, like core bonds, which returned 2.7%, plodded along.

It was, in our view, a year when thoughtful asset allocation mattered. More precisely, it was an environment in which relative value positions made a difference, increasingly within rather than across asset classes, and 2017 looks like it will be no different in this regard.

| Asset class (% returns) | 2015 | YTD 2016 | 3 Year | 5 Year |
|---|---|---|---|---|
| **U.S. stocks** | | | | |
| S&P 500 | 1.4 | 12.0 | 8.9 | 14.6 |
| Russell 2000® Index | -4.4 | 21.3 | 6.7 | 14.4 |
| **International stocks** | | | | |
| MSCI EAFE Index (Developed Markets) | -0.3 | 1.6 | -1.0 | 7.1 |
| MSCI Emerging Markets Index | -14.6 | 11.3 | -2.3 | 1.5 |
| **U.S. fixed income** | | | | |
| Barclays U.S. Aggregate Index | 0.5 | 2.6 | 3.0 | 2.2 |
| Barclays High Yield Index | -4.5 | 17.1 | 4.7 | 7.4 |
| **Alternatives** | | | | |
| Bloomberg Commodity Index | -24.7 | 11.8 | -11.2 | -8.9 |
| MSCI US REIT Index | -3.6 | 2.5 | -0.6 | 1.6 |

Source: Morningstar.
Returns as of 12.31.2016
For Illustrative Purposes Only.

## Table of contents

2016: A little more flag captured
Grades are in
Year-end rally: Survival odds
Back to the future for growth
Valuations not overdone yet
Conclusion

# Grades are in

A good way to look at performance from an asset allocation perspective is to isolate key tactical positions, or views, either held as the year began or made during the course of the year, and to analyze their effectiveness. In our case, we held or initiated six positions in 2016, which we grade below.

As the year began, we had three main positions:

- First, judging Europe and Japan to be earlier in the economic cycle than the U.S., and seeing opportunity there in the form of a valuation discount that would soon dissipate, we overweighted international developed market equities and underweighted U.S. equities.
- At the same time, a slow but steady domestic economy, supported by low unemployment, GDP growth at or above its trend level compared to global growth, room for consumer spending, and an accommodative Federal Reserve led us to overweight U.S. equities against core bonds.
- Finally, within fixed income, seeing wide high-yield spreads yet expecting moderate high-yield bond defaults outside the energy sector, we overweighted high-yield bonds and underweighted core bonds to capture the dislocation.

In addition to these three initial positions, we also made three tactical changes during the year:

- In January, when high-yield spreads rose even further, we increased our overweight to high yield and underweighted both U.S. equities and cash. This was a risk-neutral trade, meaning the shift to high yield did not increase our overall risk exposure.
- Also in January, we overweighted global equities versus core bonds, supported by our belief that the drop in the stock market was not supported by economic fundamentals and that easy monetary policy would continue.
- Lastly, in June, we reversed our previous overweight to international developed market equities as populism's potential turned reality in the U.K. and we felt there were a number of policy risks throughout Europe, including upcoming elections in France and Germany, that were not being priced into the market. Our conviction in this position later increased in December and we grew the overweight to U.S. equities at the expense of international developed equities.

As the table shows, we feel most of these calls went our way and added significant value. While, like many, we did not fully appreciate the potential for populism in Europe, we find our views of the economic outlook to have been correct, and the positions resulting from them positive.

| | Equities vs. Core Bonds | U.S. Equities vs. International Developed Equities | Bonds |
|---|---|---|---|
| VIEW COMING INTO 2016 | • Modestly overweight equities<br>• Supportive central bank policy<br>• Improving, but below trend growth. | • Favored international developed over U.S. equities<br>• European economy earlier in the cycle<br>• Valuation discount would unlock | • Overweight high yield<br>• Defaults would not spread much outside energy<br>• Spreads attractive in a low-return world |
| GRADE | A- | C- | A |
| CHANGE DURING 2016 | • Added to equities in late January after large decline<br>• Decline not supported by fundamentals | • Post Brexit vote we reversed<br>• Populism in the eurozone to drag on growth and prevent necessary reforms | • In January we added to high yield from a mix of equities and core bonds<br>• Captured the inherent "cheapness" of high yield vs. equities |
| GRADE | A | B | A |

# Year-end rally: Survival odds

So where do we stand today? While it is clear that stocks benefited after the unexpected U.S. election result, it is less clear how much they benefited *because* of them. We must ask: how much of the rally in November and December is due to Trump's election, and how much of it is merely a continuation of good economic data that had been coming at least since August?

The rally is likely due to a confluence of at least three factors: a business-friendly president elect in the U.S., strong economic data developing throughout the year (U.S. GDP growth of 3.5% in the third quarter), and the 6.7% jump in U.S. corporate earnings in the third quarter. This is important to note because a strengthening U.S. economy and relatively attractive valuations have been part of the foundation of our risk-friendly positioning throughout 2016.

Investors betting on growth in 2017 will need to sort out what elements in 2016's rally will have staying power. Much is in the air. So far markets seem to have shrugged off the shock of Brexit, but the U.K. has not actually left the EU yet. Likewise, business-friendly optimism following Trump's election may be based on policies that will take some time to be enacted (or may never be, given Trump's frequent about-turns).

Below are our expectations for Trump's main policy plans, and our thoughts on their likely effect on the aggregate economy.

- **Trade**: We expect protectionist measures, particularly in the manufacturing sector. For certain sectors this could be positive at least in the short term, but overall we view this as negative in both the short and long term.
- **Taxation**: We expect cuts for both individual and corporations, and we expect the corporate side to have a potentially larger effect. Lowering the corporate tax rate and simplifying the code could boost investment while increasing repatriation of foreign profits, which could help Trump fund some of his promised infrastructure spending.
- **Government spending**: Deficit spending should increase, which should boost growth in the short term, but in the long term such spending will need to be paid for. The best-case scenario is that it will begin a virtuous circle, substantially increasing economic activity. But, given long-term demographic and productivity trends, which we think spell lower long-term growth, we expect the overall effect to be slightly negative.
- **Regulation change**: Some regulation will likely be scaled back, and the results should vary by industry. Anti-trust regulations, for example, have proven over the long term to be beneficial to the economy, so scaling these back would likely have a negative effect. Overall, however, it should be positive for the economy in the short term.
- **Foreign policy**: We expect a more hawkish administration, though longer term there is more downside risk in entanglements in the Middle East and China.
- **Immigration**: Trump will likely target lower-skilled workers in any deportation measures, and removing these will bring up the cost of labor, although certain groups among lower-paid workers may see some benefits.

The question remains of how Trump will prioritize these policy changes, and whether they will all come to pass. Like items on any to-do list, these changes will lie on a spectrum of feasibility: some may be easier to accomplish than others. Given our outlook here, an ideal scenario would be that tax, regulatory and government spending changes are enacted first, while trade, immigration and foreign policy changes take a back seat.

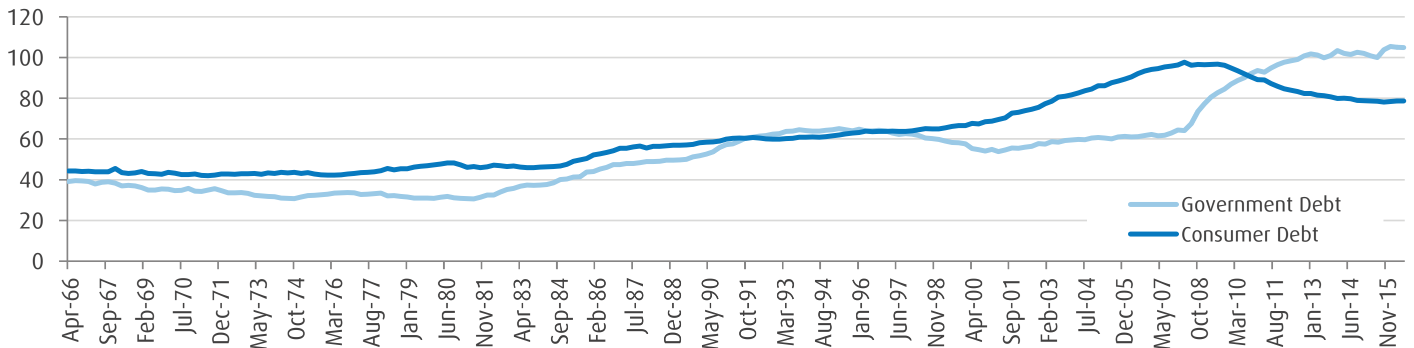
| Policy | Expectation | Short-Term Impact | Long-Term Impact |
|---|---|---|---|
| TRADE | Protectionist, especially in the manufacturing sector | − | − |
| TAXATION | Lower and simpler personal and corporate taxes | + | + |
| GOVERNMENT SPENDING | More deficit spending in the short-term | + | Neutral |
| REGULATION | Significant scale back in regulation | + | Neutral / + |
| FOREIGN POLICY | More hawkish, especially in the Middle East | Neutral | − |
| IMMIGRATION | Reduction in unskilled immigrants | − | − |

# Back to the future for growth

Tax cuts and increased government spending, in any case, will need to be paid for somehow — some say with increased growth in the future. Hopefully those predicting an eventual 4% growth rate are right, or have precognitive abilities at least as accurate as those of the creators of Back to the Future II, who in 1989 were only a year off in their prediction of a Chicago Cubs World Series (in the movie, the Cubs won in 2015). But there is evidence that shows growth may slightly decrease instead: an aging demographic is shrinking the working population and technology-driven gains in productivity, which dominated the twentieth century, are moderating.

U.S. debt levels, meanwhile, remain historically high, as the government has largely taken on debt the consumer has cast off since the Great Recession. Budget deficits are also widening on a year-over-year basis for the first time since 2010, leading to a slight climb in the closely watched debt-to-GDP ratio. The U.S. government carries little explicit credit risk and debt servicing costs are currently low, but debt could eventually act as a drag on the economy if levels continue to rise and growth stalls or falls.

### U.S. Debt to GDP (%)

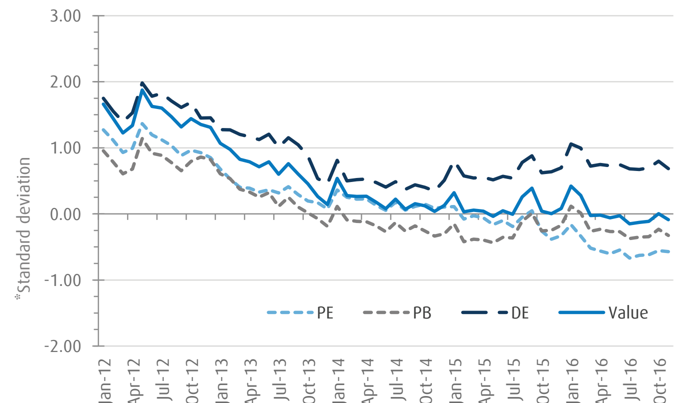



Source: Bloomberg LP, US Treasury, Federal Reserve, Bureau of Economic Analysis

# Valuations not overdone yet

Turning from the economy and policy, we find support for risk assets in 2017 in our analysis of valuations as well, particularly in our view of U.S. equities. Here it is worth pointing out the limits of judging valuations by any one metric — many assessments use price-earnings ratios and only price-earnings ratios (P/Es). We think our process goes a little deeper: it combines P/Es with price-book ratios and discounted earnings to get a composite view of value. While P/Es alone show an overvalued stock market, in our more detailed view prices are at or near fair value.

### U.S. Large Caps: Valuations




Source: Bloomberg, BMO Asset Management.

*Standard deviations from fair value. Positive value indicates undervaluation

# Conclusion

Looking ahead into 2017, we are pleased to find confirmation of our process in what we judge to be a solid record of tactical views in 2016. As well as Cubs Manager Joe Maddon seems to sum up 2016 with his line that "you have to have a little bit of crazy to be successful," investors are better served by a different Maddonism: "The process is fearless." The BMO Multi-Asset Solutions Team's disciplined process has remained steady and fearless throughout a dramatic year. We look forward to a 2017 in which stable if slow economic growth and attractive relative valuations should support an overweight to equities versus fixed income, and U.S. equities versus equities in Europe, where policy risks are more immediate.

This is not intended to serve as a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. Information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. This presentation may contain forward-looking statements. "Forward-looking statements," can be identified by the use of forward-looking terminology such as "may", "should", "expect", "anticipate", "outlook", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof, or variations thereon, or other comparable terminology. Investors are cautioned not to place undue reliance on such statements, as actual results could differ materially due to various risks and uncertainties. This publication is prepared for general information only. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investment involves risk. Market conditions and trends will fluctuate. The value of an investment as well as income associated with investments may rise or fall. Accordingly, investors may receive back less than originally invested.

Investment cannot be made in an index.

**Past performance is not necessarily a guide to future performance.**

BMO Global Asset Management is the brand name for various affiliated entities of BMO Financial Group that provide investment management and trust and custody services. Certain of the products and services offered under the brand name BMO Global Asset Management are designed specifically for various categories of investors in a number of different countries and regions and may not be available to all investors. Products and services are only offered to such investors in those countries and regions in accordance with applicable laws and regulations. BMO Financial Group is a service mark of Bank of Montreal (BMO).

BMO Asset Management Corp., BMO Investment Distributors, LLC, BMO Private Bank, BMO Harris Bank N.A. and BMO Harris Financial Advisors, Inc. are affiliated companies. BMO Private Bank is a brand name used in the United States by BMO Harris Bank N.A. BMO Harris Financial Advisors, Inc. is a member FINRA/SIPC, an SEC registered investment adviser and offers advisory services and insurance products. Not all products and services are available in every state and/or location.

Securities, investment advisory and insurance products are: **NOT FDIC INSURED — NOT BANK GUARANTEED — MAY LOSE VALUE.**

© 2016 BMO Financial Corp.