Market Perspectives - Q2 2017
Quarterly Review and Outlook

The term "Icarus trade" flew around a bit in the first quarter of 2017 to describe the markets' optimism — and potential skydive. We're still looking for a Greek myth in which leaders make ambitious plans and then get tied up in a maze of complicated details, while the plans recede ever further on the horizon. The maze Icarus's father built comes to mind, and maybe the monster it held: in its own way, the Minotaur too was fairly bullish.

High hopes, high prices, low certainty

The BMO Multi-Asset Solutions Team's disciplined process is to develop views through a framework of valuation, the economy and policy (both monetary and fiscal) around the world. Here is a review of how this framework shaped our views in the first quarter and a look ahead at what we expect in the months to come.

In March we modestly reduced risk, bringing down the overall global equity and U.S. high yield weights to what we consider to be neutral levels. The proceeds of these modest reductions went into U.S. core fixed income, which has become more attractive after a recent pickup in yields.

These tactical positions added significant value to portfolios over the past year. Both U.S. equities and U.S. high yield performed exceptionally well over the past year, returning 21% and 18%, respectively (as of March 15, 2017). High-yield spreads peaked above 8% in February 2016, and are now near 4%, close to cyclical lows reached in 2014.

At the same time, U.S. core fixed income has sold off sharply, with the 10-year Treasury yield moving from 1.75% before the election to as high as 2.60% in late March.

We are comfortable keeping a neutral position in both global equities and U.S. high yield due to favorable economic growth prospects and improving fundamentals. The decision was the result of a thorough evaluation of the investment thesis behind these positions. Valuation is no longer attractive in either equities or high yield, as we feel the improved economic outlook, which we cited in our original theses behind these positions in early 2016, has now been priced in to both asset classes. In high yield, spreads likely cannot fall much more, and they could widen significantly in the event of a broad flight to safety in the market: there is more downside risk than upside risk. However, we still find the carry an attractive holding in our diversified portfolios.

Table of contents

Economic strength still a foundation

Economic data has continued to rebound from the fourth quarter of 2016 through the first quarter of 2017, both in terms of economic data and earnings growth, both in the U.S. and globally. It is difficult to recall a piece of economic data in the past few months that has surprised to the downside. Quite the opposite, in fact: global economic surprises have increasingly exceeded market expectations over the past year.

From an investor's perspective, however, it seems most likely that the improvement in economic growth has been fully priced in at this point, which makes betting on further rises more difficult.

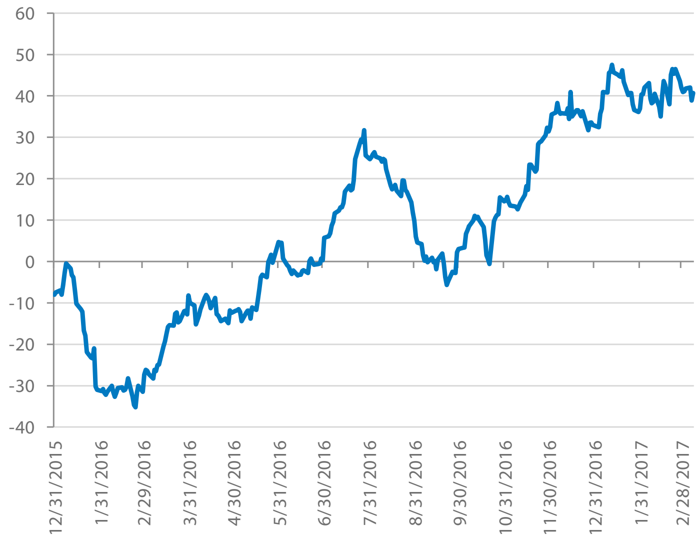
One potential reason for concern is that in the U.S. data surprises have so far been concentrated on the soft data: the Institute of Supply Management's Purchasing Managers Index has risen sharply and steadily since September 2016, while consumer sentiment remains near a 13-year high. Many such measures of economic growth are based on sentiment, in the form of surveys.

We feel these should be weighed with at least two other factors. First: uncertainty, which is at near-record highs, as measured by the National Federation of Independent Business's small business uncertainty measure. Is it possible small business optimism and uncertainty can simultaneously be so high? Evidently, though there seems to be something missing. In most areas of life, confidence and uncertainty make for curious bedfellows.

High business confidence and uncertainty

Source: Cornerstone Macro Research

Global economic surprises



Source: Citigroup, Bloomberg

Second, the improvement in soft data has yet to be followed by a commensurate improvement in hard data, such as industrial production or retail sales, which might confirm the sustainability of economic growth.

The two points are related. The high uncertainty may help to explain one major gap in the overall picture: capital expenditures, which could help the hard economic data considerably. That is, while the survey data look good, businesses do not yet seem ready to make any investments. This sort of business spending has been something of a missing link in the recovery from 2008. We've brought this up before, citing it as a necessary link in a virtuous cycle that might boost wages, consumer spending and business profits, and ultimately raise aggregate productivity.

A waiting game for capital expenditures

The stall today may continue as further tax reform gets pushed out on the legislative horizon. As the Trump administration grapples with a complicated repeal-and-replace of the Affordable Care Act as its first major undertaking, it is becoming likely that tax policy will have to wait until later in 2017 at the earliest, and likely 2018.

One key provision in the tax policy is the permission for firms to fully expense capital expenditures up front, instead of depreciating the expense over time. As businesses are not sure what the tax implications of their investments will be, we could see more of a delay than is typical between higher confidence and the spending orders that should follow and allow that confidence to filter through to the real economy.

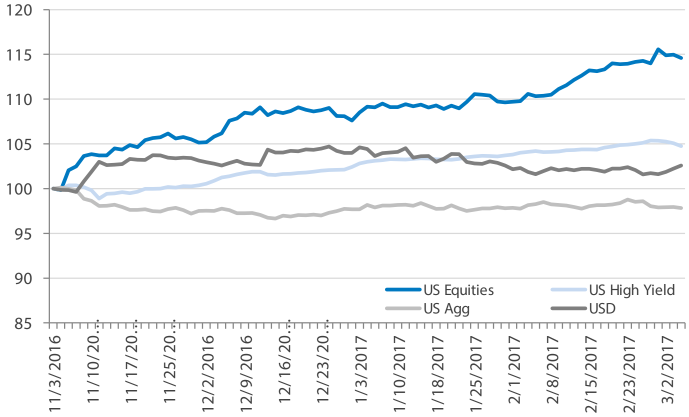
Stronger U.S. policy outlook, but how far out?

While we find ourselves still waiting for business investment to justify market optimism, it is illuminating to compare where we stand today with where we were a year ago. In March 2016 the buzzwords were deflation and secular stagnation. Now growth expectations have shot up, due to drivers like stronger economic data, earnings growth, and the potential for growth-oriented economic and political policy in the U.S.

These changes have helped equities rally, but there is good reason to believe the policies investors are pricing in are further out than many think. The real drivers — lower and simpler personal and corporate taxes, infrastructure stimulus — may not filter through the economy until 2018. In the meantime, it is anyone's guess how trade and foreign policy will solidify. Government spending, based on the budget proposed in March, will be less stimulative than we had supposed, though we know the budget will likely change.

So it is reasonable to ask whether the returns we have seen since the election are sustainable: will they be confirmed by business spending and policy? And if they will be, when will this happen, and can they be sustained in the interim?

Post-election returns: Too far too fast?



Source: Bloomberg, BMO Asset Management.

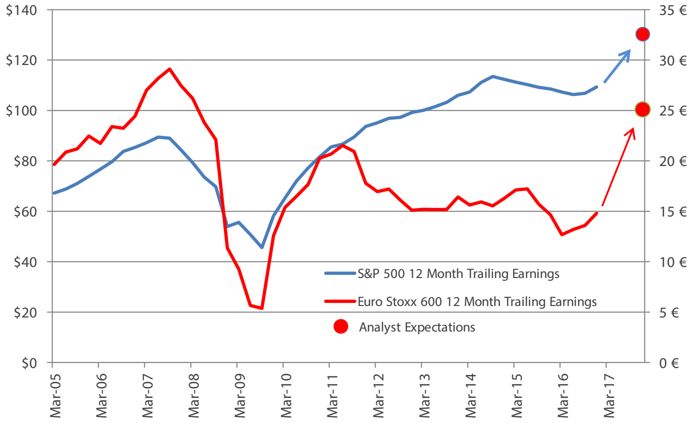
Asymmetric policy risk in Europe

The rise of populism in Europe suffered a minor setback in March after the far right in the Dutch general election failed to gain meaningful ground. But there are potentially farther-reaching elections to come in 2017 in France and Germany along with potential early elections in Italy and Spain that pose an asymmetric risk, offering more downside than upside risk — a major reason for our underweight to international developed equities. Expectations in France and Germany are for centrist victories, though a win for far-right Marine Le Pen and the National Front in France could lead to an EU referendum vote, causing major disruption.

While European equities look modestly attractive from a valuation perspective, this perspective is predicated on very strong earnings growth in Europe. Earnings growth forecasts for 2017 in both the U.S. and Europe are quite elevated: 15% in the U.S. and over 50% in Europe. While in Europe's case earnings are starting from a low base, and there is some potential for these expectations to play out, it will be difficult.

So while the European Central Bank remains accommodative and committed to quantitative easing through December 2017, and while valuations are modestly attractive, we find that, given the large policy tail risk, these factors do not support a risk position: stock prices are modestly cheap for a good reason.

Significant earnings growth expected



Source: Bloomberg L.P., BMO Global Asset Management

Risk-neutral, but U.S. looking better

Fair to modestly expensive valuations, policy risk in Europe, and policy uncertainty in the U.S. recommend a more risk-neutral position overall, but within equities we maintain an overweight to U.S. equities, where the economy looks to be on solid footing.

Watchers of the Federal Reserve may have noticed how the implied probabilities of a rate hike in March went on a wild ride in the first quarter. They began around 30% in January, dipped a month later, and between February 27 and March 3 leapt from 50% to 94%, the result of what seemed like a coordinated effort from the Fed at broadcasting its intentions.

Yet investors hardly seemed to notice, and this is an important point. In the past two years Fed hawkishness had been met with stock selloffs. Today, the market appears to think the Fed is hiking for the right reasons, so the hikes are not necessarily bad for equities. Initially, the prospect of three rate hikes in 2016 was met with skepticism: now it is the base case, with four hikes not out of the question. The expectations of the market and the Fed now seem aligned, and this offers tentative evidence of the market's comfort level with rising rates, a positive for U.S. equities.

It is also hard to argue that the Fed is not close to achieving its dual goal of maximum employment and inflation near 2%: unemployment has been below 5% for the past year; and the Fed's preferred measure of inflation has risen to 1.7% while headline inflation has risen to 2.7%.

At the same time, wages have been slowly increasing along with the most recent economic data. They appear to be in a good spot: growing enough to put a few more dollars in pockets, which helps consumption and consumer spending, but not fast enough to hurt corporate profit margins yet.

Conclusion

Within an overall risk-neutral position from a strategic perspective, we remain comfortable with an overweight to U.S. equities relative to international developed equities. In Europe, markets are underestimating policy risk related to upcoming elections. In the U.S. a solid economic foundation and positive earnings trends bode well, and we will look for more business investment to sustain this momentum.