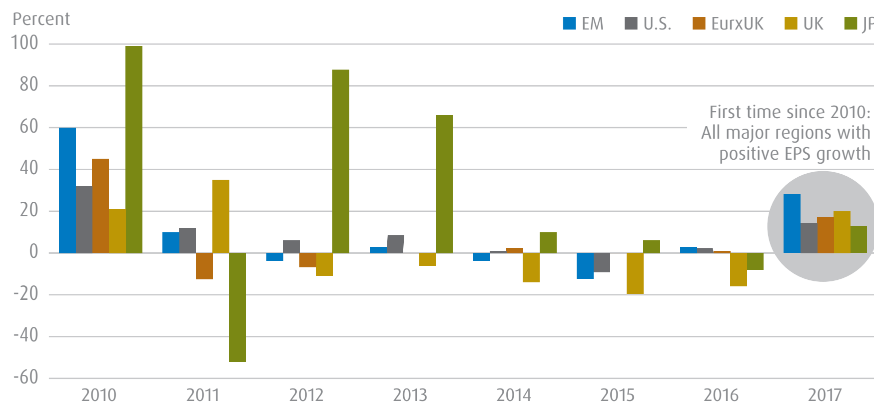
Market Perspectives - Q3 2017
Quarterly Review and Outlook

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. While we didn't make any changes to portfolio strategy in the third quarter, we retain our conviction in being modestly overweight global equities and underweight core bonds. Here is a review of how this framework shaped our views in the third quarter and a look ahead at what we expect in the months to come.

Global economic growth: Synchronized across markets

Economies around the world have experienced synchronized growth in 2017 and many economists expect this to continue in 2018. According to the Organization for Economic Cooperation and Development, all 45 countries that are tracked are poised to grow this year. Of those countries, 33 are forecast to accelerate from a year ago. This is the first time in a decade that the world's major economies are growing in sync. Earnings growth reflects this development, with 2017 earnings-per-share (EPS) growth positive across all major regions for the first time since 2010.

EPS growth



Source: Citi Research, Factset

This bodes well for stock returns across both developing and emerging markets, but risks remain. In addition to a Federal Reserve (Fed) misstep on inflation, any tightening of global trade policy could threaten emerging markets.

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Fare thee well, Janet?

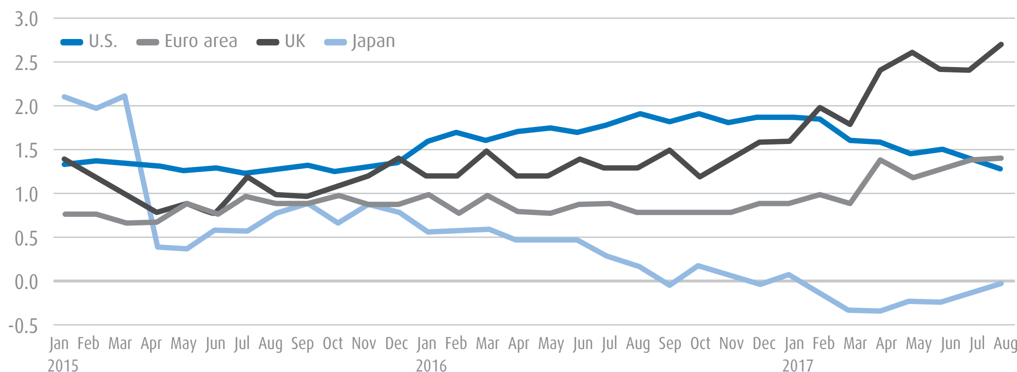
Recent comments from President Trump have struck a friendlier tone toward Janet Yellen and kept her name in the running for reappointment as Fed chair in 2018. However, it would not be surprising to see a candidate with more hawkish tendencies claim the post, especially as the administration looks to stamp its mark on the central bank. If February brings Yellen's tenure to an end, how do we appraise the Fed's actions under her leadership?

Chair Yellen's term has been characterized by a deliberate normalization process: ending quantitative easing, lifting rates and shrinking the Fed's balance sheet, which expanded significantly in an effort to stimulate markets following the financial crisis. Yellen and the Federal Open Market Committee announced an October start to the balance sheet reduction, with a goal of putting the process on autopilot over the next few years. Despite this communication, markets remain quite sanguine, which is somewhat surprising given that a balance sheet reduction of this size and scope is unprecedented. While we expect the process to proceed smoothly, we can't help but wonder if markets have been lulled into complacency, especially as the European Central Bank will likely slow down asset purchases in 2018.

Inflation: Too hot or too cold?

As if the balance sheet was not complicated enough, Chair Yellen, or her successor, face the real risk of a policy mistake due to surprisingly persistent low inflation.

Core inflation



Source: Ipsos, Pollytix, Peil

While the Fed has not changed its expectation that inflation will stabilize at its target of 2% per year, and Yellen has been careful to state that the Fed is not certain that "the factors that have lowered inflation are going to prove persistent," the market seems to think that low inflation is a more permanent condition. These divergent views underline the lingering policy risk: inflation remaining low despite evidence that the labor market has little in the way of slack, making it easy for the Fed to misread. Indeed, there is an unusual level of dissension at the Fed currently, with more dovish members like Kashkari, Brainerd, Evans and Bullard contrasting with the so-called "core" of the Fed. The argument of the more dovish members is essentially that the Fed should wait for more proof of inflation before hiking rates further. Yellen and the rest of the core argue that the Fed cannot allow itself to get behind the curve on inflation and that conditions no longer warrant the current exceptional degree of monetary stimulus.

Thus, central banks like the Fed and ECB must seemingly contend with the potential for two downside scenarios: inflation running too hot and inflation running too cold. In typical times, one of these scenarios is much more likely than the other (and the policy response straightforward: raise rates in the former and cut rates in the latter). However, a compelling case can be made (and is in fact being made within central banks right now) for either scenario. We will be closely monitoring inflation readings over the next few months.

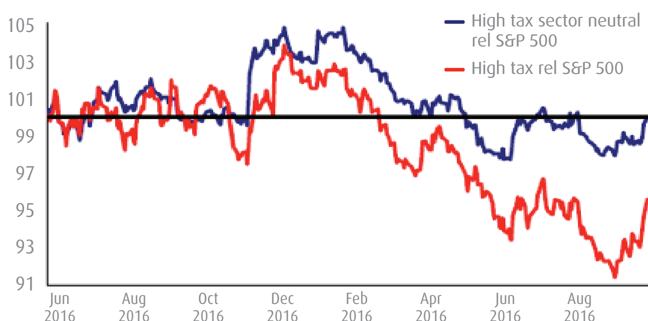
Increasing clouds

If we have not yet convinced you that the life of a central banker is difficult, note that the Fed must also contend with a brutal hurricane season that is making economic data more challenging to understand and forecast. Hurricanes Harvey, Irma and Maria have exacted a heavy toll and the season is not yet done. The impact of these storms is so large that the U.S. economy could face repercussions for years. In the short term, the Fed will have a hard time disentangling the hurricane effect from economic data. We may see a bump in inflation due to rising oil and basic material prices or perhaps some odd unemployment numbers, which could make it difficult for the Fed to determine what data to act on in the short term. Over the long term, however, rebuilding could contribute to further boosting of the economy, especially in 2018.

U.S. policy: Anything is better than nothing

With the weather dominating the news in August and September, it is important to note the small steps toward actual governing taking place in Washington. President Trump held discussions with prominent Democrats and managed a temporary solution to the debt-ceiling issue. Although the deal wrong-footed his fellow Republicans, any bipartisan action in Washington could be a sign of a more functional government and may raise hopes for tax reform.

Strategas high tax portfolios relative to the S&P 500®



Source: Strategas Research Partners

Certain stocks, especially U.S. small-caps, jumped following the election on expectations of tax reform and other business-friendly policies. The effect faded throughout 2017 but has rebounded recently with the administration's release of a tax-reform blueprint.

The "Big Six" blueprint has already received its share of criticism, in part for offering no plan on how to pay for tax cuts, but its release is nonetheless an important step. While we still think tax reform is unlikely in 2017, perhaps it is realistic now to expect it in 2018, even if the process will be contentious and marked by fits and starts. In an economy that still seems to need further support for capital expenditures, a lower corporate tax rate, immediate expensing of investment and a one-time low tax rate on repatriated earnings might do the trick.

European populists: We're still here

Results from the German election on September 24 should remind investors not to become complacent about political risk in Europe. While Angela Merkel's victory ensures that an essential pro-integration, pro-euro voice will remain prominent, the election also saw the far-right Alternative for Germany (AfD) capture more than 13% of the vote, up from less than 5% in 2013. Moreover, a poor showing by Social Democrats led to the party's withdrawal from Merkel's coalition. Any new coalition is likely to remain centrist under Merkel's influence, but achieving such a coalition, along with a more cohesive fiscal policy in Europe, may now be more difficult.

The 2019 change in ECB leadership may infuse some additional uncertainty into Europe in the coming months. While President Mario Draghi still has time, the jockeying to replace him will start next year and there is sentiment that Germany feels it is time for one of their own to lead the ECB. Of greater concern in the near term are rumors that the ECB lacks consensus on whether to taper its bond buying. These issues will grab headlines and have implications for market prices worldwide.

It's a mad, mad world

Hurricanes, earthquakes, threats of nuclear war and unwinding central bank balance sheets further remind us that the world is full of tail risks, despite actual market volatility remaining quite low in 2017. For this reason, in addition to relatively elevated valuations, we have been cautious about adding too much risk to our portfolios. However, taking a medium-term view, the world looks like a relatively benign place. Synchronized global growth has taken hold, which is a boon for investors as strong economies augur better company profits. As a result, we have a modest pro-risk tilt within our portfolios, seeking to capitalize on a global economy that continues to expand in the face of these tail risks.

More to come: BMO Global Investment Forum

Each year, BMO holds a forum that brings together senior investors from around the world to debate and discuss themes that we think will impact markets over the next five years. This year's forum was held in Toronto at the end of September and themes included balance sheet unwinding, the death of dynamism, the long-term price of oil and the validity of the Phillips Curve. The group formed three potential scenarios following these discussions. We look forward to sharing these forecasts and other highlights from the forum with you over the next couple of months.

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