Market Perspectives - Q2 2017

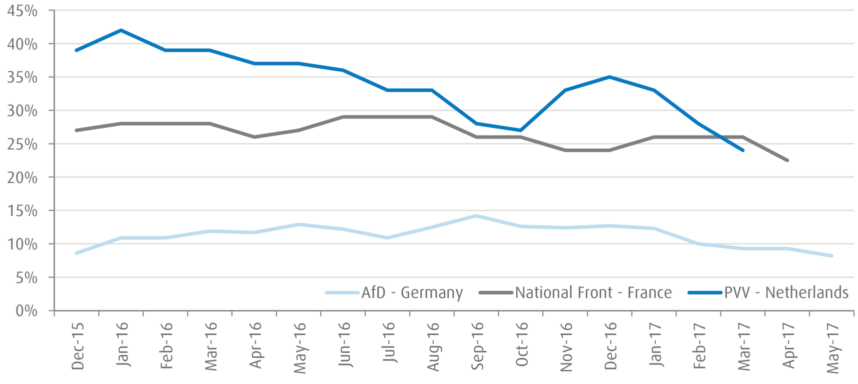
Quarterly Review and Outlook

The BMO multi-asset team comprises investment professionals located in Chicago, Toronto and London. In addition to our weekly meetings we gather every quarter for a two-day investment roundtable to share best ideas and formulate market expectations. At our June gathering, two themes dominated our discussion: interest rates, which we believe will increase over the next year but only minimally, and the state of the current economic cycle, which generated more debate. Here we discuss these and other factors in our current positioning, which remains overweight equities (equally U.S. and international developed) relative to core fixed income, given reduced policy risk, strong earnings growth and broad economic growth.

The case for risk: Hurry up and wait

It has been a year since the Brexit vote, and populism has dominated the discussion in the West. But to compare the mood a year ago and now shows a marked difference. A year ago we were talking about the National Front in France, the Five Star Movement in Italy, the AfD in Germany, and populist fringes of the central parties in the U.S., and wondering if we might see the first mainstream populist government in eons. This has not happened yet, though the populist shout is still audible.

Opinion polling for European populist parties



Source: Ipsos, Pollytix, Peil

Seeing what may be the peak of populism supports risk assets, in our view, even while some policy risk remains. The Fed's hike in June was seen as hawkish given the recent softening of inflation in the U.S. There seems to be an increased risk of the Fed making a policy mistake: with lower inflation over the past few months, it seems reasonable to question the Fed's commitment to hiking interest rates. Core personal consumption expenditures growth (PCE), the Fed's preferred measure of inflation, fell to 1.4% in May, continuing its flutter down from recent highs that started 2017.

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One big takeaway is the possibility the cycle could be extended: could we be looking at two or three more years before inflationary pressures prompt significant rate hikes from central banks around the world?

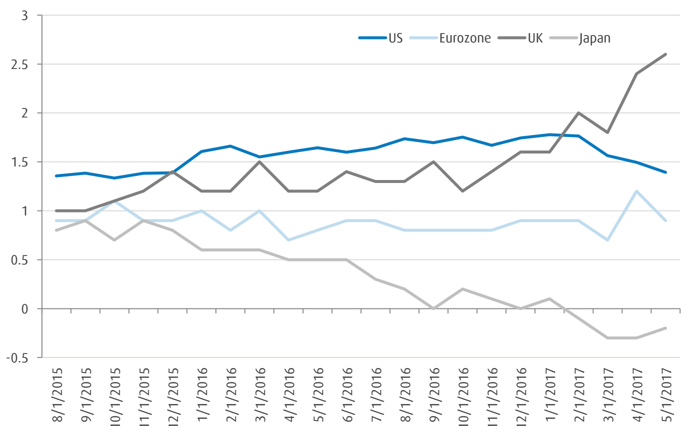
At the same time, the Fed has indicated it will begin slowly reducing its balance sheet — it holds over $4 trillion in Treasurys and mortgage-backed securities — effectively unwinding this component of post-crisis stimulus. The effect won't be as clear-cut as an interest rate hike, but it will have a similar feeling. "Slowly" may be the key word here, however: the stimulus bell may still ring for some time, allowing this phase of the cycle to continue.

Global inflation: Treading water, in sync

Taking a step back, we see inflation softening globally as well. Inflation in Europe has somewhat mirrored the U.S., falling from a high in February. In June ECB President Mario Draghi called for prudence and persistence in the ECB's accommodative policy, which he said would be normalized only as recent "nascent growth becomes sustainable" and "investments that drive stronger productivity growth" are made. And though it has scratched its way out of its most recent deflation, Japan is still caught in a low inflationary environment.

The only place in developed markets where inflation is flexing any muscles is in the U.K., but this looks more like temporary inflation due to weakness in the pound, which has fallen after showing some surprising resiliency after the Brexit vote. Lower inflation around the world does not necessarily run counter to global growth, but it does somewhat lower the bar.

Core inflation



Source: BEA, UK Office of National Statistics, ECB, Japan Ministry of Internal Affairs and Communications, Bloomberg

Trump trade: Less leaping tiger, more wet cat

Consistent with the inflationary pause is the apparent weakening of the market's "animal spirits": not long ago investors had faith the animal spirits of the market might themselves summon capital expenditures needed to boost productivity — this seems less likely now.

On the surface, we can see why: as the Trump Administration struggles to accomplish any tax reform and infrastructure spending, the reflation trade in the U.S. is looking less like a leaping tiger and more like a wet cat. The U.S. dollar has continued to fall more or less since the end of 2016; large-cap equities are outperforming small caps; post-November sector plays such as financials have slowed or stalled altogether. China, another driver of high global growth expectations, has continued its deceleration. Likewise, sentiment data has come off from its peaks after the election, though consumer confidence remains relatively high at 94.5 (down from 98.5 in January).

Nonetheless, equities have been fairly resilient across the board, even while investors are still looking for this confidence and strong equity performance to translate into spending in the expected areas. For business spending as well as government policy, it appears to amount to a lot of hurry up and wait. In this environment, however, it's worth noting that expectations in some areas have become so pessimistic that there is potential for an upside surprise.

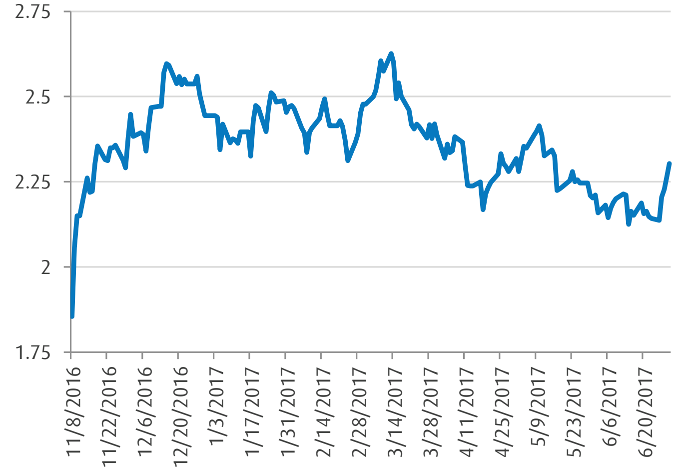
Commodities and bonds signal softening

Today we see something of a commodities conundrum. U.S. manufacturing production has been slowly picking up for almost a year in year-over-year growth, reaching as high as 1.6% and 1.4% in the second quarter of 2017, and there are indicators that global growth is in a good place now. Yet so far in 2017 commodity prices have fallen. Most of this decline is from oil, but most recent U.S. gasoline usage was also below expectation, and demand has been uncharacteristically low for industrial metals in a global expansion. This could be a temporary supply and demand imbalance, or it could be a sign global growth will be weaker than expected.

Consistent with the unwinding of the Trump trade, bond yields have been falling off, with the U.S. 10-year Treasury yield showing a slow, steady decline since late 2016 as investor appetite for risk fades.

Both commodities and bonds, then, are telling a lower-inflation, lower-growth story, while equities look poised for the opposite. This looks like an odd picture, but it is not entirely inconsistent with a slow-growth environment in which inflation nevertheless stays low, extending the business cycle and reducing wage pressures.

U.S. 10-year Treasury yield



Source: Citigroup, Bloomberg

Europe appears to steady itself

While policy risk looms in the U.S., it has begun to dissipate in Europe. Compared to the noise coming out of Washington, to which investors seem to have grown surprisingly immune, the prospect of Emmanuel Macron's election in France, looks like a clear positive for investors. Macron's win seems, oddly, to be a win both for the EU establishment and for reformists, especially business owners looking to reform France's labor market, which Macron's majority government has a clear mandate to update. The labor code in France runs to 3,400 pages, and to some employers it is just as many years old in terms of hiring and firing cost inefficiencies.

At the same time, Angela Merkel has solidified her lead ahead of the Germany's federal election in September, and there are increasing prospects for the strengthening of the Franco-German alliance in the EU. This bodes well for integration and strength in European markets.

Strong earnings help risk assets

For all the recent talk of how overvalued markets are, you wouldn't know it from recent earnings reports. In Europe, the first quarter saw the highest percentage of earnings beats in years; in the U.S., 70% of companies beat earnings expectations. U.S. earnings growth in the first quarter came in at 15%; in Europe, 28%. If companies can continue this earnings growth and continue to beat expectations, the market will look instead modestly priced. Consensus earnings expectations for the S&P 500 are for 6.5% earnings growth in the second quarter. This would mark four straight quarters of earnings growth and is in stark contrast to the earnings picture in late 2015 when S&P 500 earnings had declined for five consecutive quarters.

Conclusion: Why so modest?

Despite what looks like a policy stall as U.S. tailwinds from policy have died down, two out of three pillars of support for risk assets remain in place in our view. The other two pillars are encouraging: earnings have picked up markedly, and economic growth remains positive, if modest. These conditions contribute to our overweight equity position.

Given the current equity environment, our overweight to equities may appear modest. We believe the market is not pricing in an appropriate amount of policy risk: we are concerned with market complacency brought on by strong earnings and muted volatility. Our disciplined process sees very few valuation signals presently, and we think there is a reduced opportunity set. Lacking strong valuation signals, we're weighing policy risk, which has subsided somewhat, with lukewarm economic growth and very good earnings, leaving us with a modest tilt to risk assets while we wait for better opportunities.

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