Third Quarter 2017

Disciplined Equity Market Update

Third quarter overview

While it's not evident when looking at the quarter in aggregate, the key market event this quarter was a factor reversal in September. For most of the year through August, factors such as growth and low-risk had led the way. September saw re-emergence of the reflation trade and a rotation away from growth and low risk into value and high risk.

Growth and value reversal

- For the first two months of the quarter, the fundamental landscape supporting equities was fairly consistent with the first half of the year, with sales and earnings growth being rewarded over company valuations. However, many attractively valued cyclical stocks outperformed in September. In aggregate, both growth and value underperformed during the quarter.

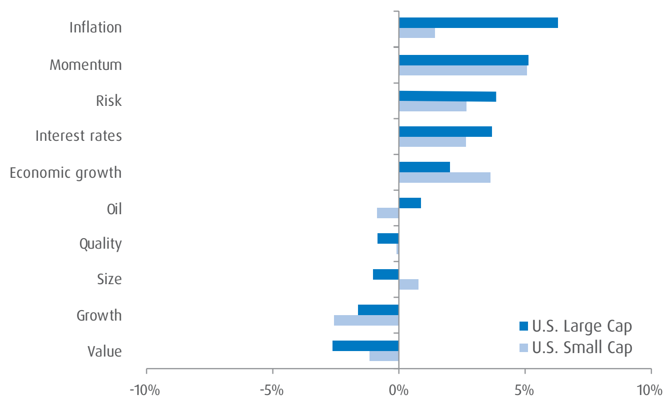
Re-emergence of the reflation trade

- Companies with business models that have positive exposure to inflation, economic growth, and interest rates outperformed during the quarter, as the reflation trade re-emerged with the reprioritization of U.S. tax reform. Additionally, higher-risk companies outperformed lower-risk companies, in contrast to YTD performance.

Resiliency of momentum

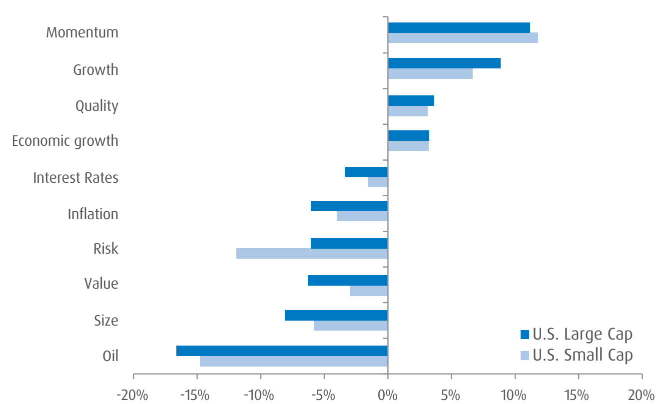
- Despite a factor reversal in September, previous winners continued to outpace previous losers, resulting in positive performance for momentum. Our research shows momentum is more broadly led compared to prior instances where market leadership changed course, which is why momentum displayed resiliency during a dynamic quarter.

Most recent quarter



Source: FactSet, Axioma, Russell and BMO Global Asset Management

Year to date



Source: FactSet, Axioma, Russell and BMO Global Asset Management

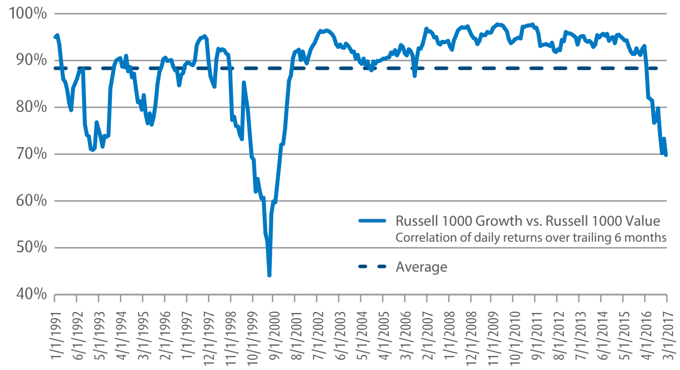
Third quarter observations

This year, the market has rewarded companies based on sales and earnings growth while paying little attention to valuations. This is evidenced by the outperformance of the Russell 1000 Growth Index over the Russell 1000 Value Index of nearly 13%. While we have observed large divergences in return between Growth and Value benchmarks in the past, it appears that growth is behaving much differently than value in today's market environment.

Historically, the Growth and Value indices have an average correlation of 90% over a trailing 6 month period, but this correlation has recently deteriorated. Since the end of 2016, we have observed a breakdown in correlations between the Russell 1000 Growth and Russell 1000 Value benchmarks, with the 6 month correlation dropping below 70% for the first time since 2001 (chart 1).

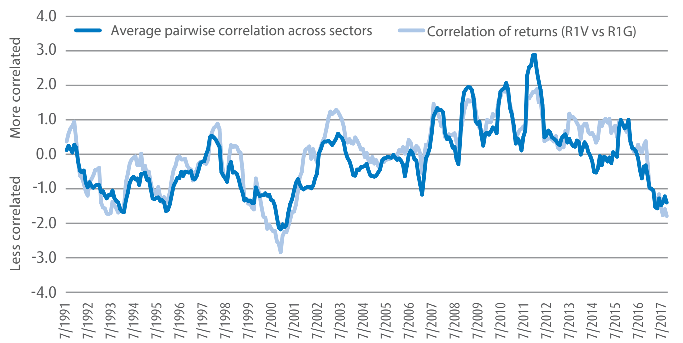
As we dissect this relationship, we see that correlations across sectors play an important role in explaining the correlation between Growth and Value. This year in particular, we have witnessed a significant decoupling in sector returns. Higher growth areas of the market, such as Technology, have outpaced lower growth sectors like Energy by nearly 35%. In fact, chart 2 suggests that lower average pairwise correlations across sectors are primarily responsible for the lower correlation between the Russell 1000 Growth and Value benchmarks. We are encouraged by current levels of dispersion, both within and across indices, as this creates opportunities to add value through active management.

Chart 1 | Correlation breakdown of growth and value



Source: FactSet, Axioma, Russell and BMO Global Asset Management

Chart 2 | Sector correlations impacting value vs. growth



Source: FactSet, Axioma, Russell and BMO Global Asset Management

Chart measures z-scored correlations of daily returns over a trailing 6 month period. Average pairwise correlation across sectors measures the normalized average correlation of sectors in the Russell 1000 against all other sectors within the index. Positive numbers along the y-axis represent periods of higher than normal correlations, while negative figures represent periods of lower than normal correlations.