Last year at this time, the BMO Multi-Asset Solutions Team remarked that the approximately 7% return for a typical 60/40 balanced portfolio in 2016 was slightly above our expectations. In 2017, that same portfolio was up around 13% and went even further beyond what we expected going forward. Some may argue that markets have managed to compartmentalize policy risks and focus on positive global economic data. While we all might like to gather around the punch bowl and sing a holiday chorus of “synchronized global growth,” it is important keep some risks in mind and be judicious about exactly how much of that eggnog we are consuming.

**Inflation: The gift that never seems to start giving**

Investors have grown weary of the Federal Reserve’s (Fed’s) inability to offer a comprehensive explanation for persistently low inflation. We’ve noted previously that market participants are seeking answers elsewhere and have developed expectations that diverge from the Fed’s guidance for gradually increasing inflation to their 2% target. Complacency in the market increases the chances of a market correction in the event of an inflation surprise. In the short term, we are watching prices within the inflation components of health care, telecommunication services and housing, which have dragged down inflation over the prior year. In the long term, globalization and technology will continue to raise questions about how inflation is currently measured and whether new ways of doing so would be more appropriate for evolving global markets.

**Market expectations diverge widely from the dot plot**

![Graph showing market expectations diverge widely from the dot plot.](source: Federal Reserve)
Fed leadership: From Janet to Jerome

In November, President Trump nominated Jerome Powell to succeed Janet Yellen as Fed chair when her term expires in February 2018. Most observers expect Powell’s Fed to continue along the policy course laid out by the Yellen Fed. Powell does diverge from Yellen in terms of his views on regulation. Under his leadership, the pace of new regulation could slow and we may see some relaxation of the rules put in place following the financial crisis. While Powell is regarded as the “continuity candidate” who will mitigate market uncertainty regarding the transition, it is important to remember that three Fed governorships remain unfilled and thus offer President Trump the opportunity to further reshape the board. Moreover, the widely expected December rate hike, the last under Yellen, lacked the support of two members (Charles Evans and Neel Kashkari) in part because of low inflation. The risk here is that dissent concerning inflation broadens and causes deeper fractures within the Fed, causing monetary policy to become even less predictable.

ECB: Mario meets the money markets

The European Central Bank (ECB) plans to reduce the pace of its bond buying in 2018, and potentially end quantitative easing (QE) completely later in the year, but President Mario Draghi has consistently stated that the ECB is prepared to continue QE if necessary and expects to keep interest rates at their present levels “well past the horizon of the net asset purchases.” However, with economic indicators in the eurozone remaining quite strong, yields on the short end of the curve have begun to rise. Low inflation remains the bête noire here too, but we are very interested in whether market sentiment will diverge further from ECB rate guidance in the first half of 2018. The European interest rate market remains well behaved under the ECB’s direction but looks quite vulnerable to a correction if markets question the direction or will of the central bank.

European policy: Was that the Grinch I just saw?

Markets appear to have skirted policy risk in 2017 but there remains a chance of a reversal for a number of reasons. The prelude to Brexit has finally concluded, but the next phase of negotiation includes the crucial component for markets: the trade agreement between the U.K. and the European Union. While fears of an inexorable populist wave spreading across Europe subsided earlier in 2017, the recent alliance between mainstream conservatives and the nationalist, anti-immigration far right in Austria is an important development. Austria holds the EU’s rotating presidency in the second half of 2018 and will thus figure prominently in the discussions of fiscal policy and bloc integration. Meanwhile, the path forward for Germany’s government remains murky, though the country’s Social Democrats recently approved talks to potentially rejoin Chancellor Angela Merkel’s CDU in a continuation of their coalition. These factors and the upcoming elections in Italy will clearly influence policy discussion in the EU and serve as a reminder that Europe’s economic course in the coming years has yet to be fully charted.
U.S. policy: Giving generously (at least to corporations)

In the U.S., tax reform arrived just ahead of the Christmas holiday and finally gave President Trump and congressional Republicans a key legislative achievement. As we commented recently, at its core the new law is a corporate tax cut. The reduction in the federal corporate tax rate should provide a near-term boost for equities and support higher earnings in the future. In addition, the new law allows capital investments to be expensed immediately rather than depreciated over time. This provision expires after five years, which will provide a strong incentive for companies to undertake capital expenditures and thereby further support the economy in the near term. While these developments bode well for the overall economy, if they are followed with a more isolationist trade policy the positive effects could be undermined. Moreover, with the tax bill failing to gain any support from Democrats, questions remain regarding the administration’s capacity for achieving compromise on other important matters such as trade policy or infrastructure spending.

2017: Reflections and evaluations

The end of the year provides an opportunity to evaluate the tactical decisions we made throughout 2017. Below, we review our views at the outset of 2017, reflect on tactical changes made during the year and assess each decision with hindsight.

We began 2017 with three tactical positions:

1. With the global economy slowly gathering steam and yields rising to a level more consistent with Federal Reserve expectations and our economic outlook, we modestly overweighted global equities versus core bonds.
   
   **Evaluation:** ++

   **Comment:** Correctly identified the base case of solid growth and low inflation

2. The solid footing of the U.S. economy and narrowing spreads at the end of 2016 led us to overweight U.S. high yield versus core bonds.

   **Evaluation:** +

   **Comment:** Was a correct assessment of economic outlook

3. We viewed the U.S. economy favorably relative to other regions and saw heightened policy risk in Europe due to Brexit and pivotal elections in France and Germany.

   **Evaluation:** -

   **Comment:** European and Japanese economies were stronger than expected

Through November, we made three changes:

1. In March, with elevated policy risk in Europe and the potential for significant policy change in the U.S., we removed the overweight to global equities and U.S. high yield and the underweight to core bonds, with the latter intended to mitigate the risk of a global slowdown or policy mistake.

   **Evaluation:** Neutral

   **Comment:** Both equities and bonds rallied modestly though we achieved some risk reduction

2. In May, we removed the overweight to U.S. equities versus international equities due to solid earnings growth in Europe and reduced policy risk after a moderate candidate (Emmanuel Macron) won in France.

   **Evaluation:** Neutral

   **Comment:** This was a risk decision resulting from reduced policy risk in Europe

3. Also in May, we introduced a modest overweight to global equities versus core fixed income. Core bonds had rallied since March and became less attractive given inflation expectations and the pickup in growth.

   **Evaluation:** ++

   **Comment:** Equities continued to rise due to strong corporate earnings, solid growth and low inflation
We should also review two additional changes we made in December though we are not able to evaluate their effectiveness until 2018.

In December, we removed commodities from our strategic asset allocation. Commodities have lagged other asset classes for years and we do not currently see a catalyst for a sustained rebound, especially with the strong supply dynamics in the oil industry providing a cap on prices. Commodities represented 3% of our neutral portfolio allocation; this portion has been reallocated to fixed income (2%) and equities (1%). Also in December, we added an overweight to global equities and underweighted high yield and emerging-market debt (EMD). Though policy risk persists in Europe, we see further upside for global equities due to a solid economic backdrop, minimal inflationary pressure and strong earnings growth, while high yield and EMD appear overvalued and offer less potential for price appreciation.

2018: Near-term expectations

As we noted in our recently published Five-Year Outlook, our high conviction (60% probability) forecast for the coming years includes steady global growth with modest inflation. The implications are positive for risk assets, even with gradual tightening by central banks. At the same time, we will continue to monitor the risks highlighted above. Part of the rationale for the “steady as she goes” scenario stems from the lower likelihood, in our estimation, of extreme consequences emerging from geopolitical tensions, protectionism or U.S. recession fears. However, we do see policy errors as a potential threat to this scenario and will continue to carefully monitor the interplay between economic indicators and central bank actions in 2018.