Market and Economic Insights

Quarterly review and outlook

Each quarter, the BMO Global Asset Management Multi-Asset Team meets in person for two days of discussion covering the global economy, the outlook for different asset classes and upcoming events that may have a significant impact on markets. Team members from Toronto, London and Chicago participate. Through these discussions, the team evaluates risk/reward expectations over the next 12 months and determines cross-asset positioning.

At the June meeting, the team discussed the return of political risk in Europe, U.S. midterm elections and the risk of a central bank policy error. However, the primary focus was the three themes that follow below.

Trade protectionism: Still posturing or landing punches?

With recent tariff announcements by the U.S. against a broad array of countries, followed by retaliation measures from many of the targeted countries, the global trade outlook is more uncertain than it has been for quite some time. U.S. isolationism has increased and its trade policies are now disrupting the global order rather than improving worldwide economic integration. The U.S./China relationship has become particularly strained. While the announced tariffs represent a relatively small proportion of gross domestic product (GDP) for both the U.S. and China, there is no obvious catalyst likely to cause either country to back down in the short term.

In the medium term, our view is that cooler heads will prevail, as an all-out trade war would be damaging to the economies of all involved. However, the longer the arguments extend, the greater the threat becomes to global growth prospects.

The overall trade outlook does give us a bit of pause and slightly tempers our risk-on stance. If trade protectionism worsens, we feel that U.S. equities will outperform and the U.S. dollar will likely rally, particularly in the short term.

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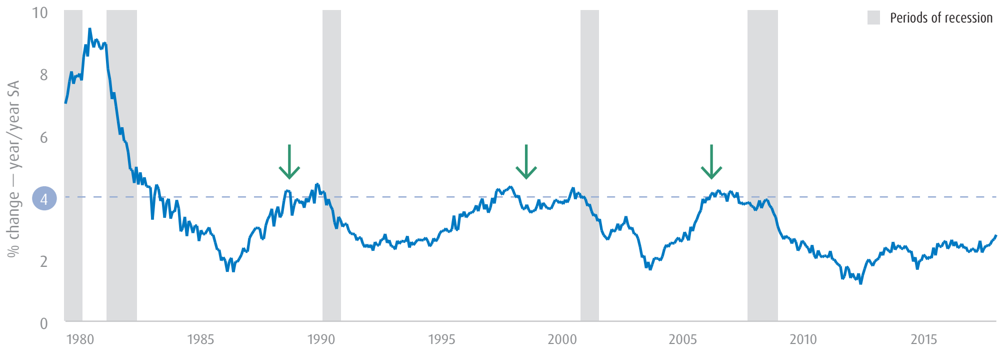
The global economic cycle: More room to run

A recent survey of fund managers found that nearly 80% thought the global economy was in late cycle. Our view differs and we think the cycle will extend for a number of reasons, including the effect of fiscal stimulus in the U.S. and the fact that inflation (wage growth in particular) remains well below levels that would be concerning. Central banks will likely remain cautious in the absence of such inflation, allowing global economies to continue their growth trajectory.

Wage growth usually hits 4% before a recession (not there yet)



Source: BLS, Strategas

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We did note the soft patch in growth in the first half of the year, particularly in Europe. However, our view is that much of the weak growth was due to temporary factors and that the global economy remains on solid footing.

We believe there is more time left in the economic cycle than what is currently priced into markets. This is a main factor in our overall risk-on stance.

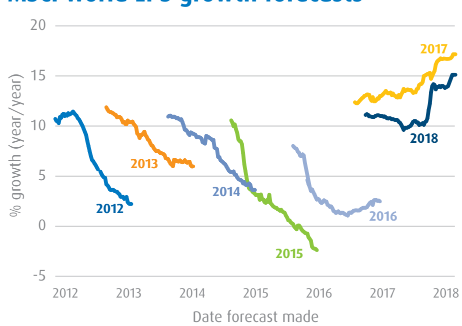
Equity earnings: Still strong globally and particularly in the U.S.

Global equity earnings have come in very strongly over the past few quarters, particularly in the U.S. S&P 500 earnings growth came in at 26.5% for the first quarter, with 19% expected in the second quarter. While earnings growth is partially attributable to temporary factors such as U.S. fiscal stimulus and the corporate tax cut, corporate earnings growth is spread broadly and appears poised for further strength. Our assessment of the behavioral factor, which encompasses shorter-term factors such as technicals and momentum, is quite strong. This is particularly true in the U.S. — where record buybacks, combined with strong dividend and M&A growth, provide a supportive backdrop — and Japan.

The strength and positive momentum of global equity earnings underlines why we are overweight equities relative to fixed income.

In addition to the three global themes cited above, the team also discussed economic data and key events from a regional perspective.

MSCI World EPS growth forecasts



Source: Datastream as of June 2018

U.S. economy: Resilient but looking a little lonely

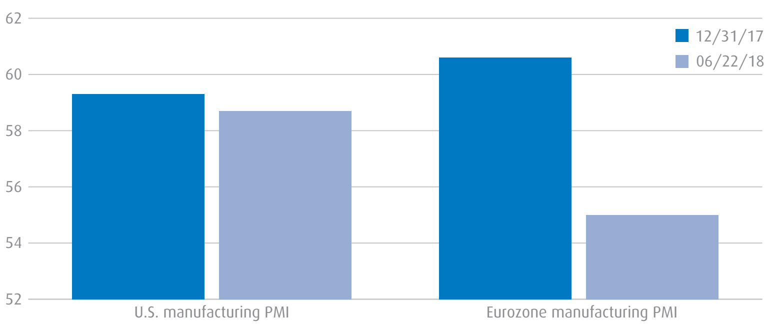
The second quarter saw U.S. economic indicators showing further strength while other areas of the world weakened somewhat. In May, U.S. unemployment dropped to 3.8%, the lowest rate since April 2000. We saw some signs of a further upward move in wages but not in a way that raised inflation concerns. Core inflation rose 0.2% in April and remains close to the Federal Reserve's 2% target on an annual basis, making it fairly easy for Chair Powell to announce another widely expected rate hike at the Fed's June meeting.

Some commentators have spotted a few warnings signs in these numbers. The Wall Street Journal recently noted that the last three times unemployment dipped below 4%, a recession ultimately followed. We're not quite ready to talk downturns, however, with some recent forecasts projecting U.S. economic growth of nearly 5% in the second quarter and consumer spending picking up. Monthly U.S. retail sales rose 0.8% in May, well ahead of the market forecast of 0.4% and the largest gain since November of last year. Moreover, despite the apparent tightness of the labor market, wage growth remains well below concerning levels.

Europe: The odd symptom or something more serious?

Softer economic data across Europe brought some interesting theories as to the cause, along with worries that synchronized global growth may be less resilient than many had hoped. The timing of the Easter holiday and poor weather may have contributed to the decline, but the question is whether growth will return to 2017 levels or whether the numbers indicate a slowdown. In the first quarter, European GDP grew at 0.4% after coming in at 0.7% for the previous five quarters. The IHS Markit Eurozone Composite PMI, often cited as a leading indicator for economic growth, has dropped off significantly this year, though it has managed to stay in expansionary territory (i.e., readings above 50). After peaking in January at 58.8, the PMI hit an 18-month low in May (54.1) before recovering to 54.8 in June. We think European growth will struggle to regain the highs of 2017 but should remain on a steady course, albeit at a lower trajectory.

U.S. and eurozone manufacturing



Source: BMO Global Asset Management

> The June meeting added some details to the ECB's plan to end quantitative easing (QE) but also advised that interest rates will not rise through next summer. This forward guidance was somewhat of a surprise to markets, which expected a hike in June 2019, while the ECB statement appeared to suggest a hike wouldn't occur until the fall at the earliest.

Italy became the focal point for European political risk in late May when it appeared that the lack of a governing coalition there would lead to another round of elections. With both the Five Star Movement and the Northern League having floated the idea of issuing short-term notes, it did not take long for bond markets to react. The yield on the Italian two-year note jumped 189 basis points in one day, driven in part by fears that a future government could undermine the euro through the bond issue, along with speculation that another round of elections could become a referendum on the euro altogether.

Snap elections were avoided when the two parties agreed on May 31 to form a government. While this calmed markets, in part because new finance minister Giovanni Tria expressed a commitment to the eurozone, we still expect the coalition to push for higher spending and lower taxes. While the coalition has softened some of its more hard-line populist positions, uncertainty will likely persist in Italy, if for no other reason than Italian governments tend to be short-lived to begin with.

Earlier this year, we wrote that we expected the European Central Bank (ECB) to continue its very slow journey toward normalization. The June meeting added some details to the ECB's plan to end quantitative easing (QE) but also advised that interest rates will not rise through next summer. This forward guidance was somewhat of a surprise to markets, which expected a hike in June 2019, while the ECB statement appeared to suggest a hike wouldn't occur until the fall at the earliest. The following week, ECB President Mario Draghi reiterated that ending QE and raising rates are still dependent on satisfactory growth and inflation data. With the June statement and Draghi's remarks reinforcing that rates may remain unchanged for "as long as necessary," it is easy to understand why markets viewed the overall message as dovish even with the clearer commitment to ending QE.

Asia and emerging markets: Pockets of concern amid shifting political winds

We've seen pockets of concern in some emerging economies such as Brazil, South Africa and Turkey. The Bank of India recently raised questions concerning the global impact of a more hawkish Fed. With the U.S. economy on more solid footing and rates rising, emerging markets may suffer as a result. At the very least, the bank raised important questions: How should central banks respond if the U.S. grows while other nations slow or stagnate? Is the Fed in effect the world's central bank due to its impact on emerging markets? In a recent speech, Chair Powell responded by downplaying the Fed's impact on emerging markets, suggesting that rate hikes by the Fed should be manageable for these economies.

Japan saw its fair share of political drama, as Prime Minister Shinzo Abe and his administration continued to fight off scandal and remain in power. Abroad, Abe's personal outreach to President Trump — and many rounds of golf — proved ineffectual in the face of steel and aluminum tariffs, as the U.S. refused to exempt Japan. Despite the noise, Abe saw a bounce in his polling numbers toward the end of the quarter, which provided investors some comfort that the trajectory of Japanese politics and fiscal policy would remain on the current path. Despite strong political winds, central bank policy in Japan remained calm and stable. In the face of persistently low inflation, Bank of Japan Governor Haruhiko Kuroda reassured markets that BOJ policy would remain highly accommodative for the foreseeable future.

The Korean summit drew headlines and much of the news from the event was positive, with Kim Jong Un and President Trump agreeing to some very high-level points such as new relations reflecting the countries' desire for "peace and prosperity." The agreement certainly reduces tension and lessens tail risk, though the absence of specifics leaves little comfort over the long term.

Current positioning

Taking all of these themes and risk events into consideration, we favor a moderate overweight to global equities, funded by underweights to rates and credit. Within equities, we have a preference for developed-market equities relative to emerging-market equities and a preference for U.S. equities relative to international developed equities. Within fixed income, we retain an underweight position to both sovereign bonds and credit. On currency, our core view over the intermediate term is that the U.S. dollar will weaken modestly versus the euro and yen but rally against the Canadian dollar.

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