Disciplined Equities

Market Update

Market overview

The S&P 500® finished the fourth quarter with a 13.5% loss, marking the worst quarter of performance since the financial crisis. This brought the calendar year return to -4.4%, ending a stretch of nine consecutive years with positive performance.

Risk-off

Risk-off sentiment was the most dominant theme driving stock returns, resulting in the outperformance of lower risk stocks in the market. This was evident at the sector level, where utilities was the only positive performing sector for the period. While risk-off was by far the most important factor, to a lesser extent, high-quality companies outperformed as companies with lower profitability lagged the market.

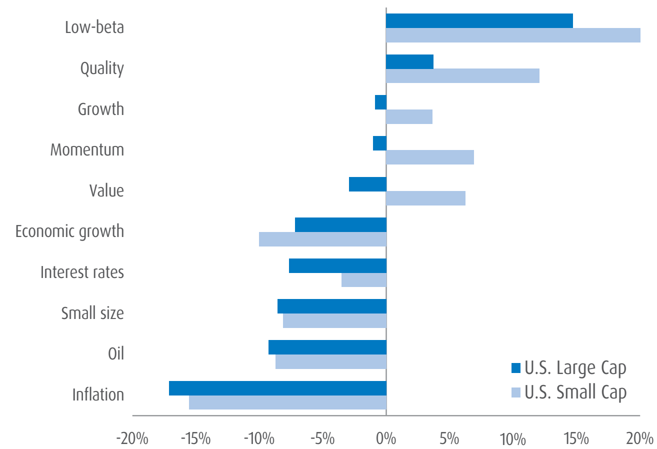
Momentum slows

Returns from momentum were mixed during the fourth quarter's market reversal. While the inflection point in the market may have suggested a momentum correction, factor underperformance in large cap was somewhat modest. Looking across the longer 12-month horizon, many themes that have previously been in favor (e.g., low-beta and quality) held strong during the quarter, which ultimately helped support momentum. This is particularly true in the U.S. small cap market where growth continued to outperform.

Macro uncertainty

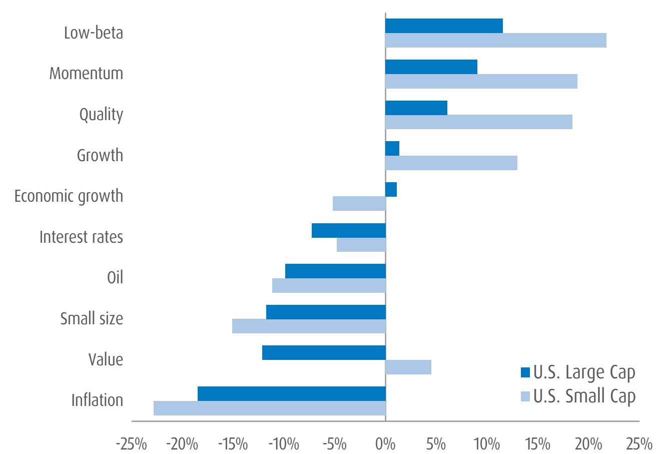
The quarter's sell-off was greatly influenced by instability at the macro level, which included continued trade tensions between the U.S. and China, concerns over tightening by the U.S. Federal Reserve, Brexit and the U.S. government shutdown. Consequently, stocks with sensitivities to macro-economic factors such as inflation, interest rates and oil were among some of the worst performers. This partially explains the continued underperformance of valuation factors, as following the outperformance of growth and lower risk, many attractively valued stocks also share cyclical exposure.

Factor performance — most recent quarter



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

Factor performance — trailing one year



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

Fourth-quarter observation

With consistent themes driving market returns for most of the year, momentum was the best performing factor in 2018. However, we have observed market leadership narrowing during the year, which accelerated greatly with December's volatility. Market breadth, a metric that captures the concentration of leadership in the market, made a relatively quick move from a positive 0.5 standard deviation "broad" observation earlier in the year, to approximately -1.5 standard deviations "narrow" by year-end (charts 1 and 2).

Chart 1 | Market breadth (Russell 1000® 1986-2018)

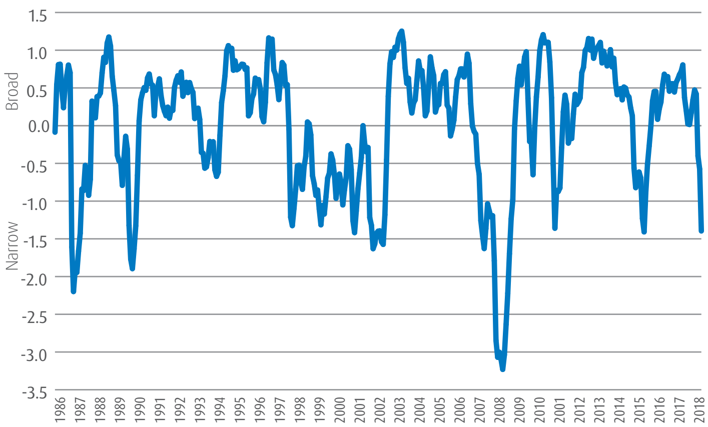
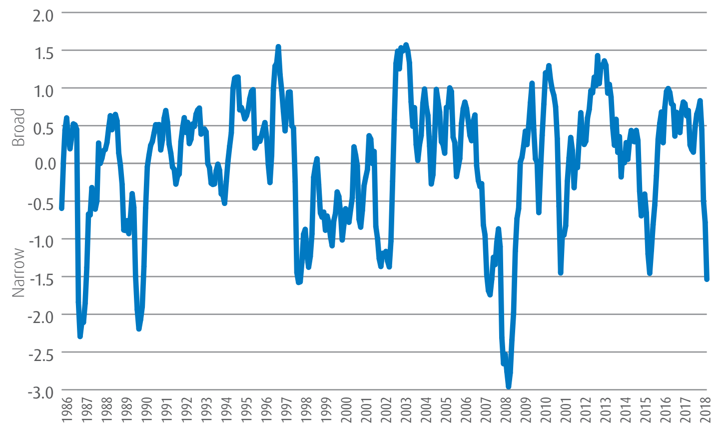


Chart 2 | Market breadth (Russell 2000® 1986-2018)



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

Historically, some of the most challenging environments for momentum factors have been in periods when market breadth has narrowed. Charts 3 and 4 illustrate the forward 12 month return of momentum factors against the corresponding level of market breadth. As the regression line on the scatterplots suggest, narrow market breadth has historically predicted periods of poor performance for momentum. More notably, some of the largest momentum corrections in history occurred when market breadth exceeded 2 standard deviations narrow.

Chart 3 | Momentum factors/market breadth (Russell 1000®)

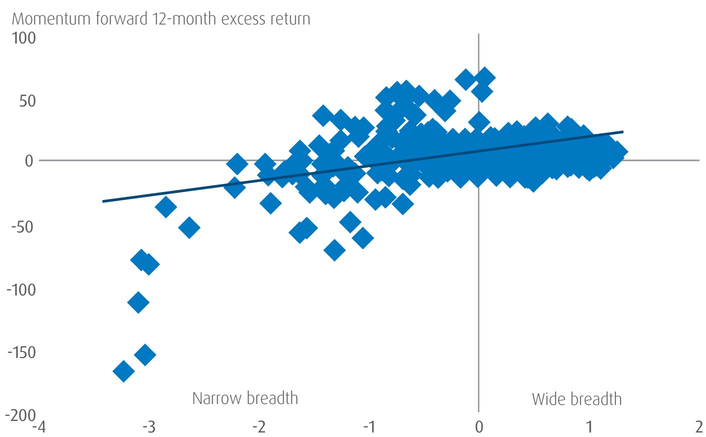
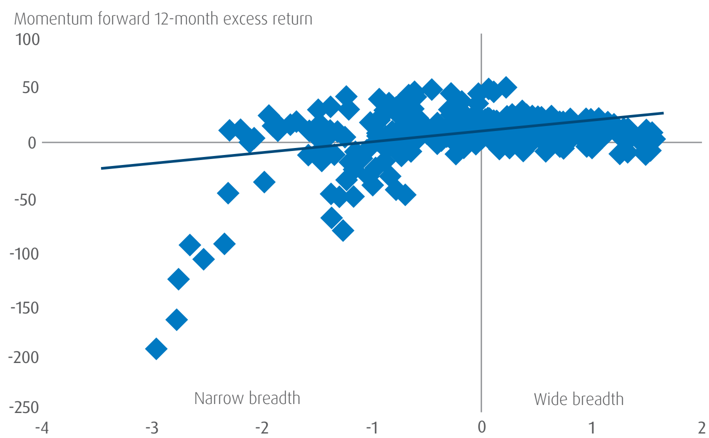


Chart 4 | Momentum factors/market breadth (Russell 2000®)



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

Jumping forward to early 2019, this relationship has preliminarily once again been a reliable predictor for momentum corrections. Through January, momentum factors have realized near double-digit losses in both the U.S. large cap and small cap universes. While this particular narrowing of market breadth and subsequent momentum reversal occurred too quickly for most managers to thoughtfully respond to, it highlights the value of understanding factor relationships in the market, and we continue to monitor this and other meaningful market dislocations as we position our portfolios.

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The S&P 500® Index is a capitalization-weighted index of 500 large-cap U.S. stocks.

The Russell 1000® Index is an index of approximately 1,000 of the largest companies in the U.S. equity market.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe.

Investments cannot be made in an index.

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