Disciplined Equities

Market Update

Overview

U.S. equities recovered sharply after the fourth quarter's selloff, with the S&P 500® delivering its best start to the year since 1998 and best quarter overall since 2009. Drivers of the first quarter's reversal included renewed optimism regarding a U.S.-China trade deal and a dovish Federal Reserve.

Low-quality, risk rally

Consistent in a high-returning market environment, higher-risk companies with lower financial quality were some of the best performers. Pro-risk sentiment was largely evident at the sector level, where technology and industrials led on an improved outlook for China and trade, while energy and consumer discretionary were not far behind, in part due to the recovery in oil prices and improving U.S. consumer confidence.

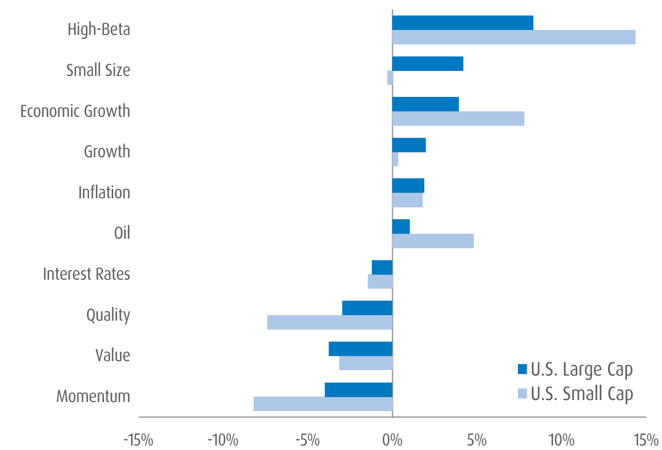
Momentum correction

The quarter's market reversal triggered a momentum correction, as market leadership transitioned from the fourth-quarter's flight to quality. Market breadth, a metric that measures the degree of concentration in market leadership, has historically been a reliable predictor for momentum corrections. In particular, some of the most challenging environments for price momentum have occurred in narrow markets. After the first quarter's momentum correction, market breadth in the Russell 1000 and Russell 2000 universes has broadened, suggesting that the momentum correction has stabilized.

Underperformance of value

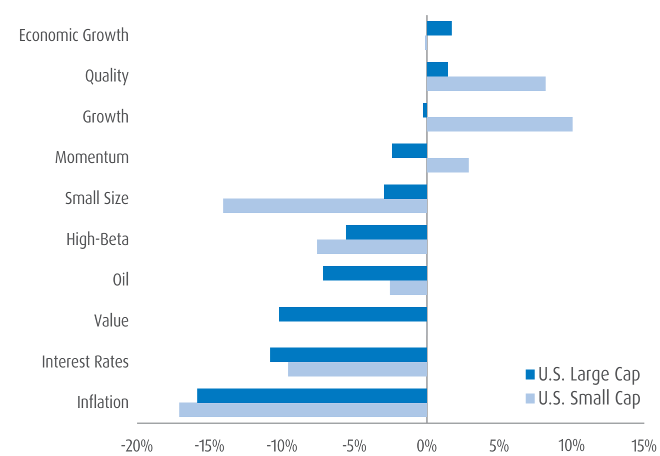
A consistent theme from last year was the continued underperformance of attractively valued securities in the market. More expensive growth companies quickly recovered from their December low, resulting in the underperformance of value.

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

Continued

Insights from Market Monitor

Value investing has had its fair share of challenges in recent years. 2018 was no exception, as the most expensive ten-percent of companies within the Russell 1000® and Russell 2000® universes outpaced the cap-weighted benchmark return by 16.1% and 11.6%, respectively (chart 1 and 2). However, as we look ahead, the relative attractiveness of valuation factors has greatly improved. Following such extreme levels of outperformance by the most expensive stocks in the market, a dislocation has developed, which has historically been a reliable predictor for the forward returns to valuations.

Chart 1 | 2018 valuation performance (Russell 2000®)

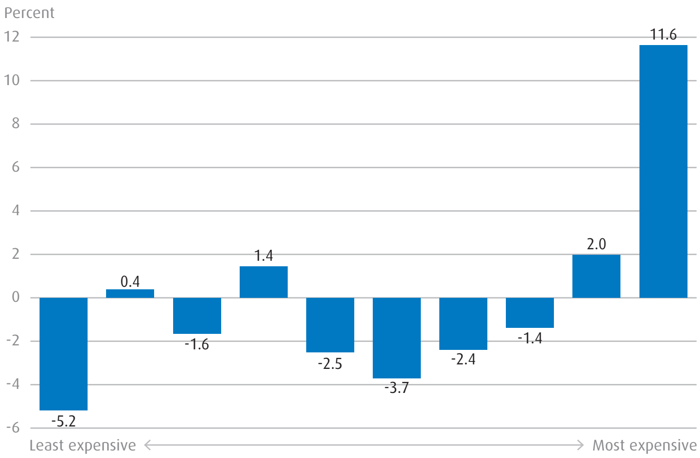
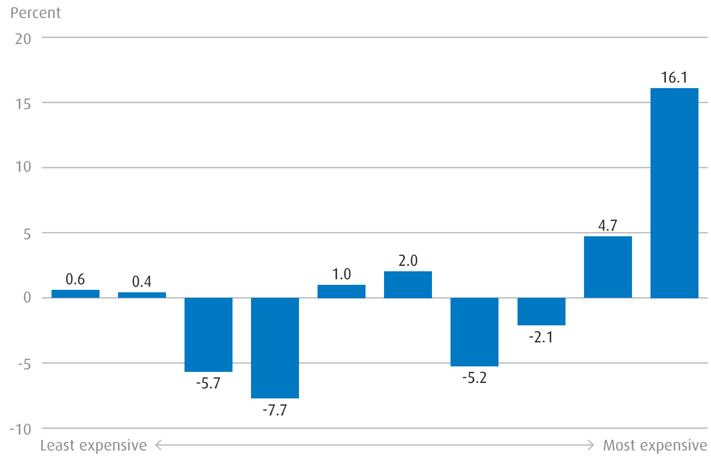


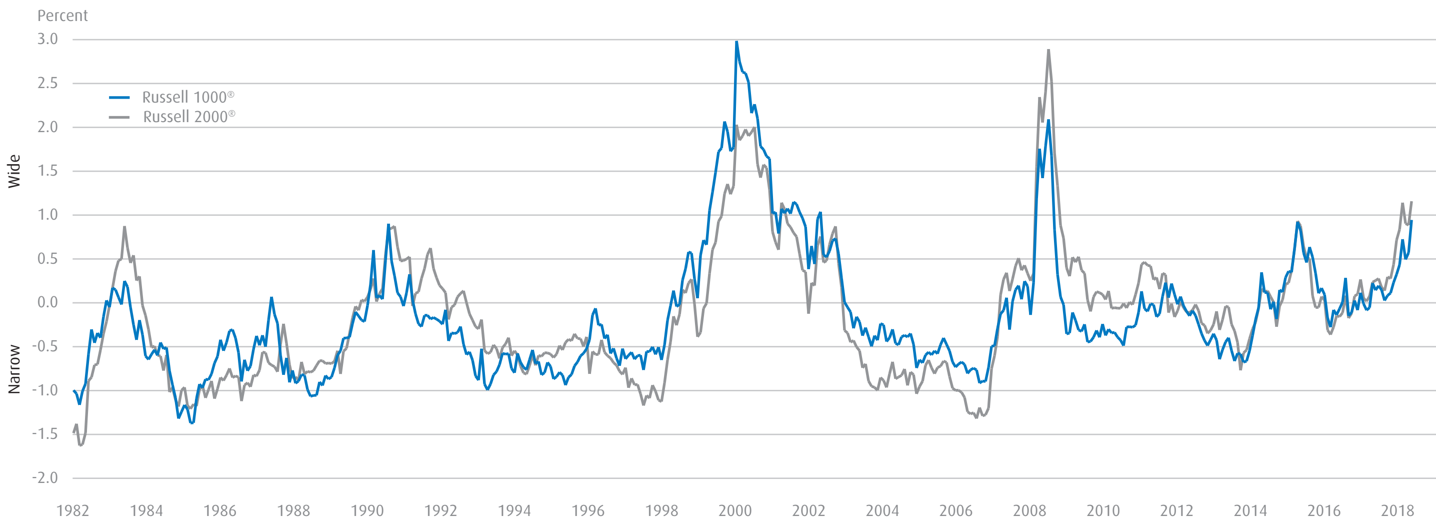
Chart 2 | 2018 valuation performance (Russell 1000®)



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

Valuation spreads, which measure the degree of separation between cheap and expensive stocks in the market, have widened in the Russell 1000 and Russell 2000 universes to a 0.9 and 1.2 standard deviation dislocation, respectively (chart 3). Historically, wide valuation spreads have been a positive indicator for the forward returns to valuation factors. In fact, some of the most notable value rallies have occurred in market environments where valuation spreads have exceeded a reading of 1.0 standard deviation wide (charts 4 and 5).

Chart 3 | Valuation spreads (Russell 1000® and Russell 2000®)



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

Chart 4 | Large-cap universe (Russell 1000®)

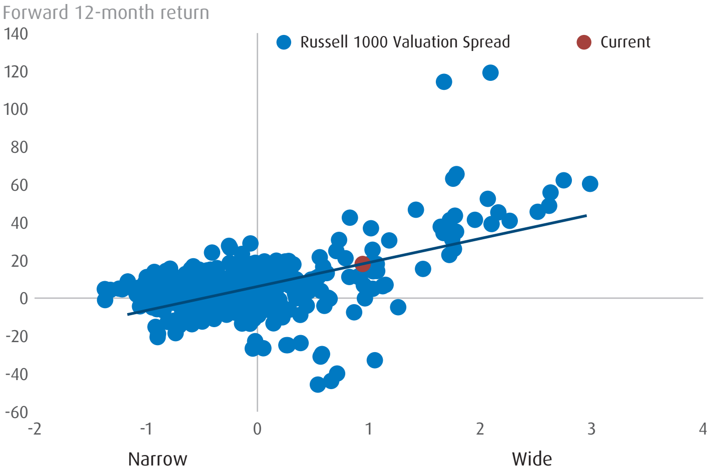
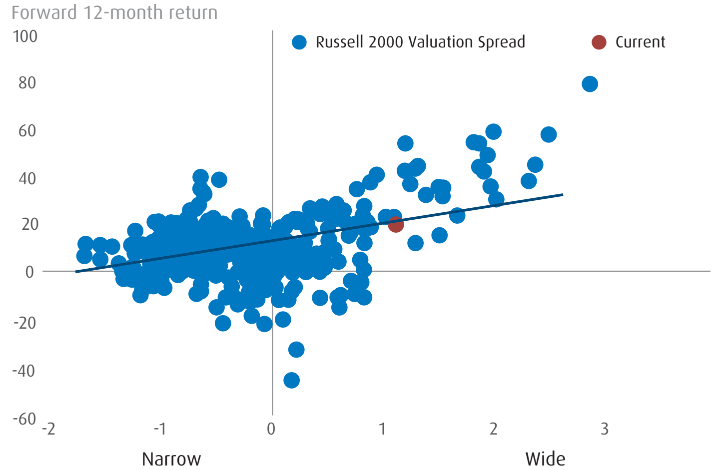


Chart 5 | Small-cap universe (Russell 2000®)



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

While valuation factors have had a difficult stretch of performance, 2018's dominance by the most expensive stocks in the market has created a dislocation in valuation spreads, which has historically been a prelude to outperformance valuation. We continue to stay true to our time-tested beliefs by emphasizing company valuations as a part of our multi-dimensional stock selection process.

BMO Global Asset Management