Market and Economic Insights

Quarterly review and outlook

Feel the fear and do it anyway

Trade tensions, recession fears and slowing growth indicators permeated the air in the second quarter but were not enough to dampen a record-setting first half for equities. Despite a gloomy May in which the S&P 500 fell more than 6%, the index is up 18.5% for the year, its strongest first half since 1997. With U.S. high yield returning more than 10% over the same period, risk assets have had a stunning start to 2019.

Though the magnitude of these rallies is surprising, our positioning this year remains underlined by the belief that the current business cycle still has some room to run. This belief strengthened in the first half of 2019 as global central banks signaled that they are willing to step in to help lengthen the cycle. Getting euphoric about the recent returns on risk assets, however, would likely be a mistake given the seriousness of the risks around global trade and Brexit. We maintain a measured optimism regarding resolutions to these issues. Combined with dovish central banks and still-solid U.S. economic data, this outlook continues to support a modest overweight to equities.

Trade policy: Two steps forward, one step back, no giant leap

Momentum toward a U.S.-China trade agreement stalled this spring and it is still difficult to envision a swift resolution or specific terms for such an agreement. Both sides seem to have dissension in the ranks and many observers are skeptical of either country's willingness to make the kinds of meaningful concessions that will bring about an authentic deal. President Trump's May 5 decision to announce tariffs against Mexico not for economic reasons but to demand action on immigration caused trade fears to spike, as markets became concerned that protectionist policies could tip the U.S. into recession. While the president did not ultimately impose the tariffs, trade uncertainty continues to linger in the market.

Though these are justifiable concerns, we were not surprised by the U.S.-China "truce" reached over the last weekend in June and still expect a relatively benign outcome on trade. President Trump's use of tariffs has come under increasing criticism from U.S. business leaders and may also negatively affect his core supporters. Tariffs have already eroded support in rural areas and an increase in consumer impact could further imperil his reelection prospects. In addition, with prominent U.S. companies (e.g., Apple, Amazon, Microsoft) considering supply chain changes, the incentive for China to cut a deal has increased.

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Though we believe further U.S.-China escalation is unlikely, both sides have been testy at times and there remains a concern that talks could break down at any time. Further retrenchment on trade could ultimately drag down U.S. business and consumer confidence. These metrics remain at healthy levels, though they have dipped lower in recent months after broadly peaking last year. We view this continued uncertainty as the ultimate risk in President Trump's high-wire trade act, which could stifle business investment and delay consumer purchases over the coming quarters.

With regard to some key factors in the U.S.-China situation, what we observe today is in line with our base case. We expect the U.S. to delay tariffs and allow some exports to Huawei, and we anticipate China buying U.S. agricultural products. While the president boasted of progress regarding the latter, he did not provide any detail to assess the potential effects on U.S. farm production.

Closer to home, political pressure may help the president finish off a revised trade deal in North America. With Mexico having ratified the "new NAFTA" on June 19 and Canada on track to do the same, President Trump can point to congressional Democrats as the only impediment to what he would call a beautiful deal.

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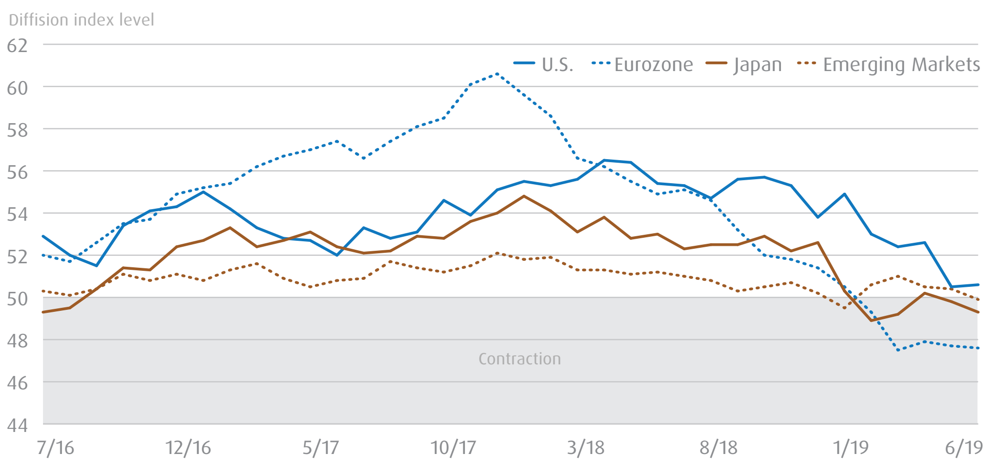
Global growth: Is the U.S.-China tail wagging the dog?

Ongoing trade uncertainty has likely contributed to recent metrics indicating a slowdown in global growth. Manufacturing activity has declined, with global PMIs softening in 2019, particularly in the trade-sensitive manufacturing sector. This slowdown is particularly apparent in the eurozone, where manufacturing appears to be in contraction.

Markit purchasing manager manufacturing indexes by country/region



Source: Markit, BMO Global Asset Management

The U.S. has suffered along with other regions in this regard, though services PMIs in the U.S. have held up better on a relative basis. We believe growth will rebound in the second half of the year, however, in part because global central banks have indicated a willingness to help extend the economic cycle. Moreover, while the terms of an actual deal between the U.S. and China remain elusive, the thawing of trade tensions around the G20 meeting in late June should improve the environment for global growth, particularly among emerging-market economies and countries heavily reliant on trade such as Germany and Japan. In addition, China's growth should pick up as the moderate stimulus enacted earlier this year continues to feed into the economy.

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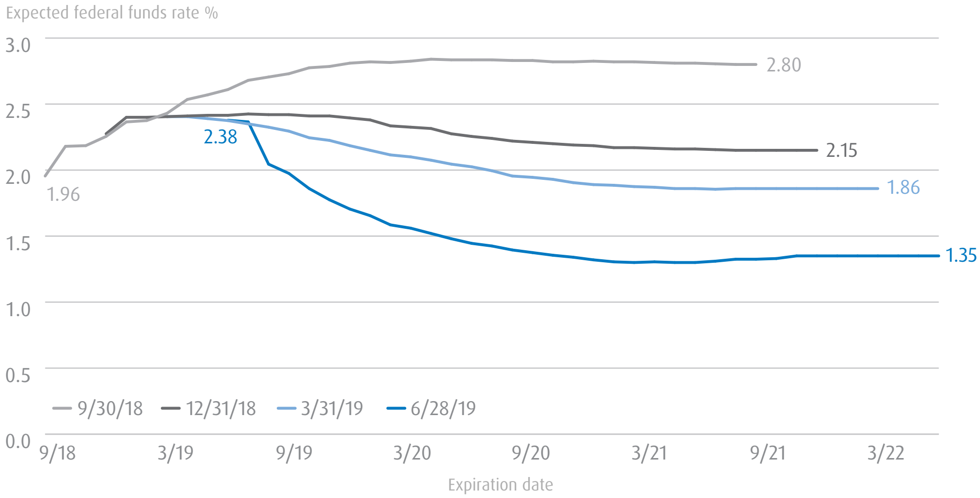
Monetary policy: The doves sing and the crowd goes wild

The Federal Reserve's dovish tone continued in the second quarter and market participants responded enthusiastically by pricing in further rate cuts over the coming year.

Fed fund futures prices



Source: Bloomberg, BMO Global Asset Management

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There has been plenty of pushback against such expectations, in part because U.S. fundamentals remain on solid footing, and we agree that the Fed will not cut this deeply. Divergent views in the market around the timing and magnitude of rate cuts indicate that Fed forecasting has gotten more complicated (and perhaps more interesting, which probably rankles former chair Bernanke), but we believe the range of possible outcomes at the moment continue to support a modest overweight to equities and underweight to bonds.

We believe the Fed may be less data dependent in potential rate cuts up to 50 basis points. An "insurance" cut would be supportive of risk assets, while a subsequent halt to cuts would presumably be the result of stronger economic growth data. Such data would likely also provide a boost to equities. The risk is that inflation increases without a commensurate boost to economic growth, which could constrain the Fed's accommodative stance. With few signs of inflation overheating, we view this risk as low at the moment, but we will continue to monitor the situation closely.

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Unsurprisingly, the European Central Bank (ECB) announced a further delay to rate hikes at its June meeting. In addition, expectations for further easing received a boost from the nomination of Christine Lagarde as the president of the ECB. Assuming she is approved, Lagarde faces many daunting challenges in Europe, from low inflation to a no-deal Brexit, but for the moment investors believe she is unlikely to diverge from the ECB's dovish course. Similar to Fed Chair Jerome Powell, Lagarde is not a trained economist and thus we expect her to lean heavily upon ECB staff for analysis and recommendations. This dynamic should also contribute to policy continuity with her predecessor Mario Draghi.

Brexit may still get worse before it gets better

Speaking of Brexit, it is difficult to imagine the uncertainty lifting over the next few months, with persistent infighting among Conservatives and flip-flopping by Boris Johnson, the leading candidate to replace Theresa May as prime minister, on the idea of a no-deal departure from the European Union. Rival parties continue to benefit from the turmoil but in a sense this only increases the range of possible outcomes. Though U.K. wage inflation has risen and the budget situation has improved, confidence remains moribund as businesses continue to wait for the end result of Brexit. We expect this dynamic to hang over the U.K. economy for the coming quarter and provide a headwind for the broader European economy.

> The U.S. economy remains on solid footing despite ongoing trade concerns, and a dovish Fed provides further support for risk assets.

Positioning

We retain an overweight to equities overall, with our modestly positive view on the U.S. economy relative to the rest of the world causing us to prefer U.S. equities. The U.S. economy remains on solid footing despite ongoing trade concerns, and a dovish Fed provides further support for risk assets. Additionally, we expect corporate earnings to beat low expectations in the coming quarters. We remain underweight fixed income. We believe the rate cuts priced into the market are overdone and that U.S. economic data will not support this level of cuts. Steadily climbing wage inflation also supports this view. We continue to see cash as attractive given persistent volatility, a flatter yield curve and narrowing spreads versus core fixed income.

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The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Purchasing managers' indexes (PMIs) are based on monthly surveys sent to senior executives at companies in key industries. The surveys include questions regarding business conditions and whether conditions are improving, deteriorating or holding steady.

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Investment cannot be made in an index.