BMO Global Asset Management

June 24 to 28, 2024

Chairman Powell: The Ultimate Bond Villain?

Weekly Commentary

Canada vs. U.S.

If you look beyond this month, or even this year, it's been a difficult time for Canadian equities relative to the United States. In fact, it's been challenging for just about every market versus the U.S. The comparative lack of Technology in the Canadian market and stronger overall U.S. economic momentum are among the factors contributing to the gap between the two countries' equity markets. Concerns about trade wars are also rising, with a second Trump administration potentially on the horizon and the Biden administration already increasing tariffs on Chinese electric vehicles (EVs). These tariffs are theoretical in a sense because China isn't exporting many EVs just yet, but the writing is on the wall—soon, they'll be flooding the market, and retaliation is possible. This ratcheting up of trade tensions is part of the broader trend of 'reshoring'—the U.S.'s attempt to shift manufacturing away from places like China and back to America and its close allies. Canada isn't currently benefitting from those efforts; it's more of a Mexico story, with the U.S. investing more in that country. (Interestingly, China is also investing more in Mexico in an attempt to get around U.S. tariffs.) To return to Tech: it is shielded somewhat from these trade tensions because China isn't a core market for its products. That's contributed to its market-leading performance and is another reason why U.S. equity markets have outpaced their Canadian counterparts.

Bottom line: U.S. economic resilience and the relative lack of Technology in Canadian markets are driving the gap between U.S. and Canadian equities, with Canada also failing to benefit from U.S. reshoring efforts.

Expert

Fred Demers
Director, Multi-Asset Solutions

Before joining BMO GAM, Fred was Chief Macro Strategist for Canada at TD Securities since 2017. Prior to that, he was at Credit Suisse Asset Management in New York where he worked as a Portfolio Manager focused on systematic, global-macro trading strategies. Before moving to capital markets in 2008, Fred was a Principal Researcher at the Bank of Canada, building various short-term macro forecasting models for the Canadian economy and wrote several working papers documenting his empirical research.

Bond Volatility

Recently, we've seen more volatility in bonds than in equities. What does this imply for asset allocators, and should investors expect it to continue for the rest of the year? It's important to first consider the source of the volatility. Equity markets have been forced to digest the fact that the U.S. economy will likely remain stronger for longer, and that corporate earnings will therefore also be stronger. As a result, the fear of the impact of high rates has diminished. That leaves the bond market on its own to evaluate the potential timing of rate cuts. It's this uncertainty that has caused volatility in fixed income—predicting the U.S. Federal Reserve's (Fed) actions is rarely easy, and it's been especially challenging lately because economic data over the past couple of months has been more ambiguous. There does appear to be increasing comfort in bond markets that two rate cuts can be expected this year, most likely in September and November or December. Talk of a rate hike appears to be over, which means that asset allocators should feel more comfortable coming back to bonds. That said, the duration play will not be easy to execute; the yield curve remains inverted and the 10-year rate is a real question mark because a mild rate-cut cycle could leave long-term yields little changed. Duration plays tend to be most beneficial during hard-landing scenarios, which appears unlikely in the U.S. By contrast, in our view, slower growth makes Canadian duration potentially more attractive.

Bottom line: Economic resilience and strong earnings have given equity markets the luxury of ignoring the interest rate debate to a degree, while bond markets have had no choice but to play the Fed's game, leading to heightened volatility.

Europe

Political winds are changing in Europe. Polls show that the Labour party is likely to secure a majority government in the U.K. general election on July 4, while Marine Le Pen's National Rally are the favourites to win France's parliamentary elections, to take place in two rounds in late June and early July. This increases uncertainty in both of those countries and, to a certain extent, the rest of Europe as well. The good news for investors is that, as we saw with Brexit, contagion from domestic political developments tends to be limited across the continent. Despite political noise, both the U.K. and France are on the path of improving growth outlooks. The political risks for markets have also changed—it used to be that right-wing parties gaining steam meant the potential breakup of the European Union (E.U.). More recently, however, the platforms of parties like Le Pen's National Rally have shifted somewhat towards the middle. Italy is a good example: in the past, some in Italy's right wing have supported "Italexit"—Italy's proposed departure from the E.U. But since the election of right-wing prime minister Giorgia Meloni in 2022, her party hasn't made it a priority.

Bottom line: From a market perspective, elections in the U.K. and France are likely to be more signal than noise, though they may cause some short-term volatility.

Positioning

For a detailed breakdown of our portfolio positioning, check out the latest BMO GAM House View Report, titled ***Shifting to Neutral: The Case for Optimistic Caution***.

GAM Monthly House View

May 10, 2024

Read Article

Market Update

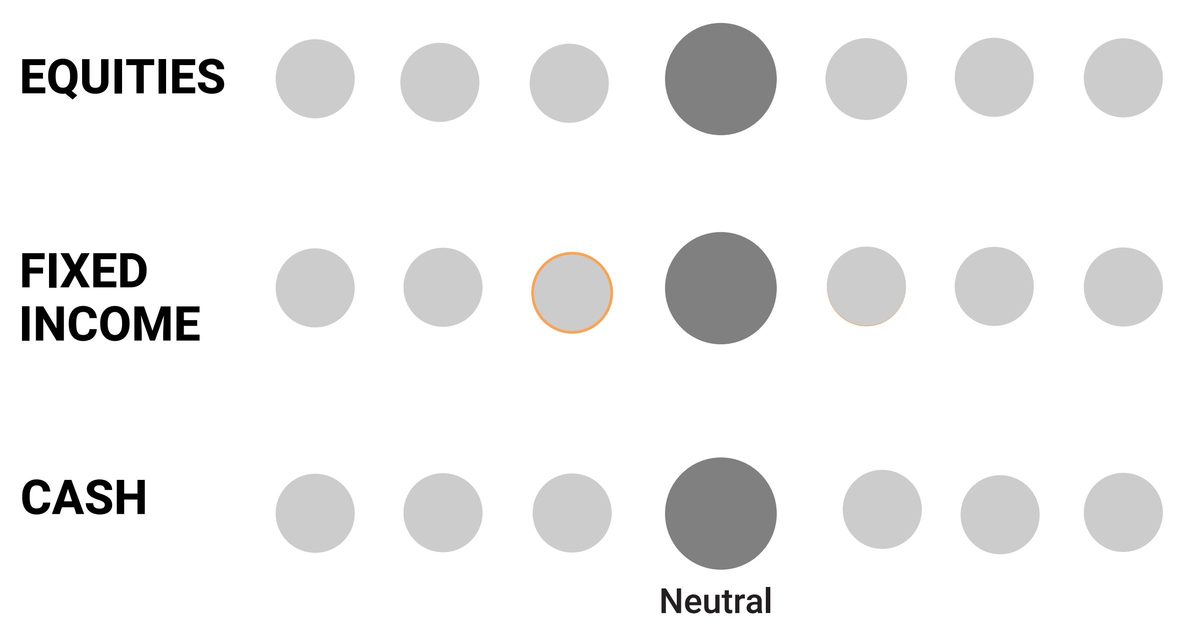
- Equity markets were mixed this week alongside a quiet and mostly subdued run of economic data.
- The S&P 500 rose 0.6%, led by Consumer Discretionary and Energy, while Technology took a back seat for a change. The index is now up a hefty 25% in the past year amid disinflation and sturdy growth.
- Meantime, the TSX dipped 0.4%, with Technology, Utilities and banks weighing. While still solid, the 10% one-year gain in Canadian stocks continues to lag their U.S. peers.

Asset class views, as of June 2024

Monthly Perspectives

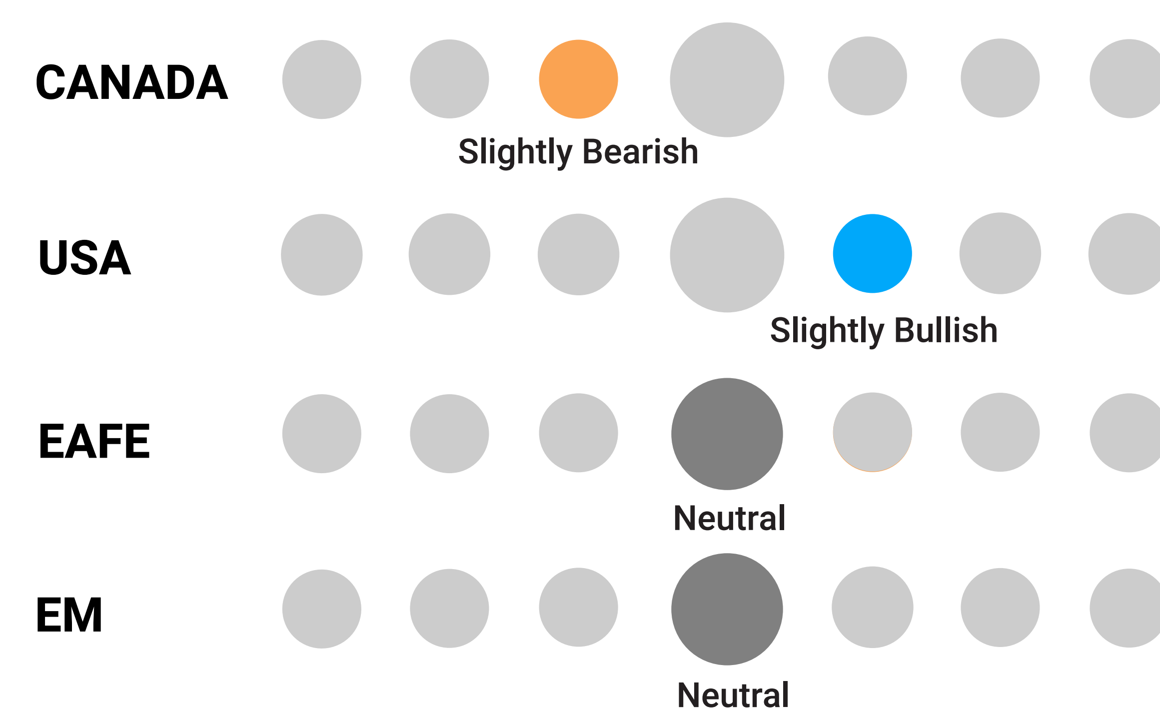
Asset mix

- We downgraded equities to neutral this month as we think sticky inflation fear and delayed cuts from the U.S. Federal Reserve (“Fed”) could turn into headwinds for equities this summer.
- We increased fixed income back to neutral and we are now neutral across our asset mix between stocks, bonds and cash.



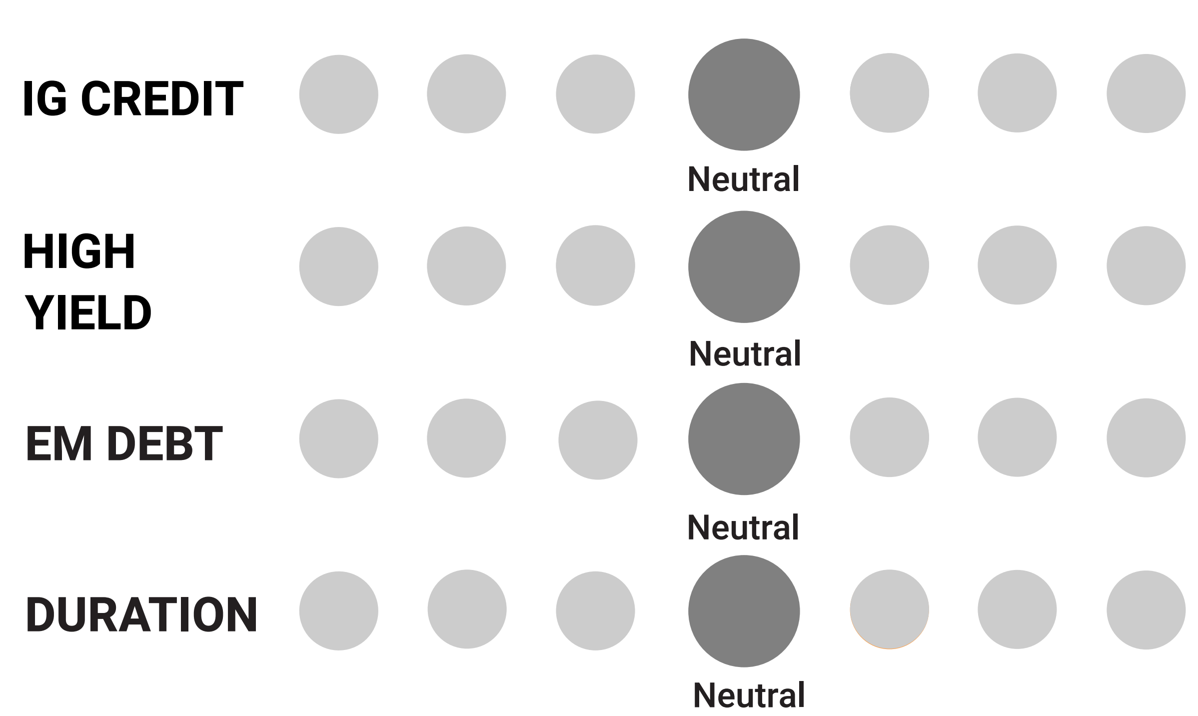
Equity

- Our regional equity mix remains unchanged this month.
- We remain underweight to Canadian equities.
- We prefer to be tilted toward U.S. equities with its bias for higher quality and benefit from the far more robust U.S. economy.
- We expect the Canadian economic outlook to continue to soften in 2024 as rate hikes are weighing on the economic outlook and the loonie.



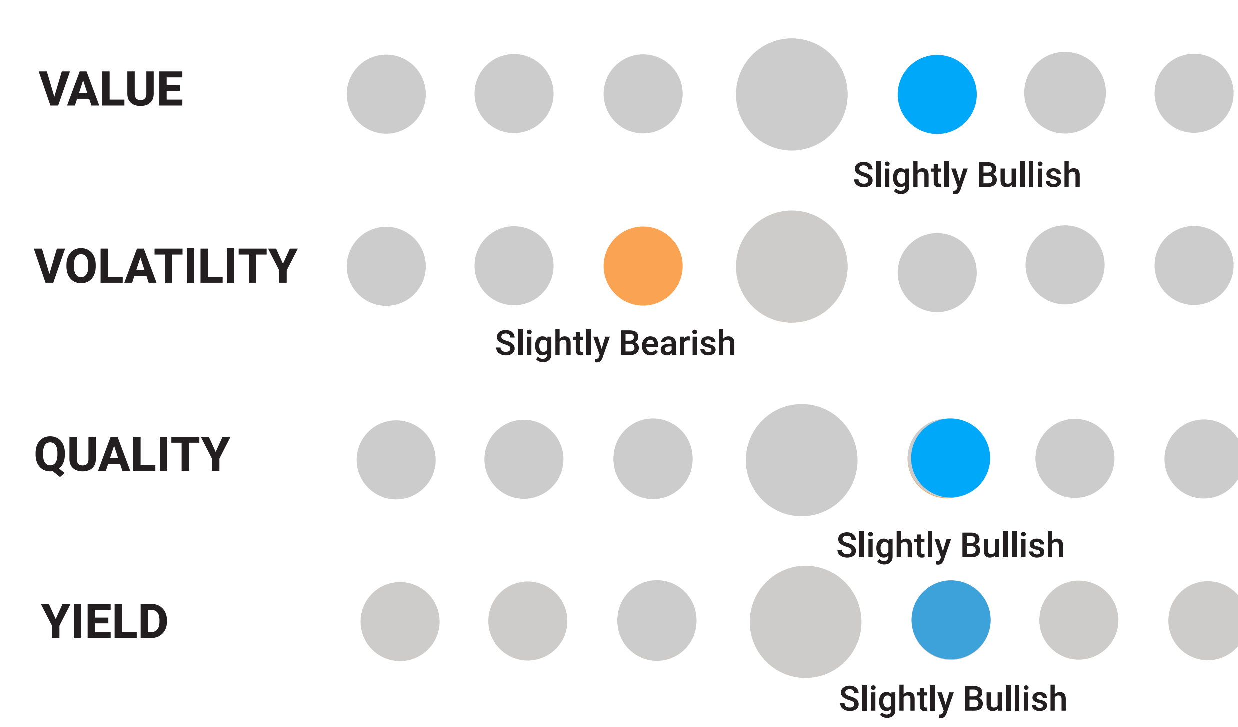
Fixed Income

- We remain neutral across fixed income as the near-term outlook for monetary policy remains uncertain regarding the timing and amplitude of Fed cuts.
- The Bank of Canada could be hesitant to ease policy more than is expected by markets, which could limit the upside from duration.
- Overall, the stronger U.S. growth outlook could threaten the improving inflation outlook, which leaves us neutral on duration for now.
- We increased our bullish view on gold as a hedge against the risk that long-term interest rates might continue to drift higher or if the U.S. economy was to cool faster than expected.



Style/factor

- We continue to prefer higher quality companies who enjoy stronger balance sheets and pricing power, which enables them to have more resilient and wider profit margins.
- We remain bullish on firms which can improve and deliver strong dividends as interest rates are likely to decrease in 2024, albeit modestly; we expect investors to rotate in favour of that sector this year.
- We upgraded our view on value companies to a moderate stance as we expect sticky inflation fear to favour value-oriented companies.
- We remain bullish on low-volatility companies to better navigate a potentially more volatile equity market as Fed rate cuts are delayed.



Implementation

- We continue to like gold as a hedge against downside macro risks.
- We think gold could continue to shine if investors were surprised with renewed recession fear or inflation anxiety which could lead to further delaying expectations for Fed rate cuts and re-ignite a risk-off U.S. Dollar rally and weigh on the loonie.
- Several central banks are steadily increasing their allocation to gold as a share of their international reserves, which is helping boost demand for gold.