Multi-Asset Solutions Team (MAST)

Asset Allocation Outlook

- Economic pain from trade wars is starting to take a bigger toll on the U.S. economic outlook. The global manufacturing sector is near recession while the more crucial service sector is slowing though still growing.
- We expect trade tensions to linger and a U.S.-China deal seems unlikely before next spring. Our belief that Canada is better positioned to navigate lingering trade uncertainty and the global slowdown is intact. We remain overweight U.S. and Canadian stocks, in particular Low-Volatility stocks, and maintain our underweight to EAFE as the economic slowdown in those regions has yet to bottom because of Brexit and the global trade slowdown.
- We continue to expect the Bank of Canada to be lagging the Fed's policy response and expect to see Canada become the highest yielding country in the G10 soon. We expect at least one more 25bps cut by the Federal Reserve, in October or December, and for the Committee to sound increasingly concerned over the outlook instead of looking in the rear view mirror.
- Lack of clarity on trade policy and mounting signs of economic pain still leaves us very modestly overweight stocks versus fixed-income. We believe the odds of a U.S. recession in the next 12 months remain modest near 30%, but are slowly creeping up.

"People who succeed in the stock market also accept periodic losses, setbacks, and unexpected occurrences." – Peter Lynch

Is the U.S. Catching a Cold?

October scarecrows came out a bit early this year after U.S. manufacturing activity unexpectedly dipped deeper into contraction last month (link). The U.S. is catching up with the global trade and manufacturing slowdown (link). The biggest risk to the outlook remains the U.S. - China trade wars and the absence of a swift fiscal response, particularly in Europe and China. Investors also face additional uncertainty as President Trump faces impeachment (though we think it is unlikely he will be removed from office) and we are about to embark onto another earnings season. These factors must be weighed against a continued solid labor market and strong consumer in the U.S.

For investors, stocks remain an attractive asset class in the world of negative interest rates where central banks are acting to extend the cycle by lowering interest rates and increasing asset purchases. Because of the various sources of political uncertainty investors are facing, a cautiously optimistic positioning remains key as we approach the end of a roller-coaster year.

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Global Stock Markets Remain Resilient to Recession Risks

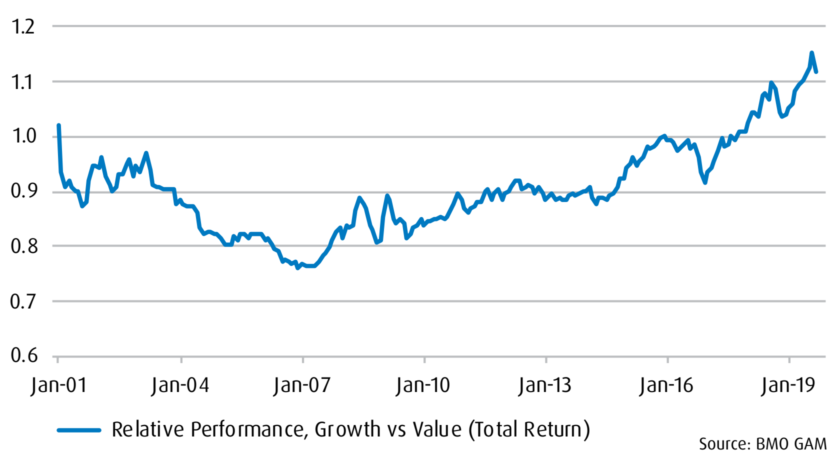
While global economic developments were lacklustre last month, stocks proved resilient and ended the month in positive territory (MSCI ACWI, +1.9%) with every key region gaining. Japanese stocks were the clear winner (Nikkei, +5.8%) on hints of further easing from the Bank of Japan, but its year-to-date performance (+10.8%) remains well below other markets (MSCI ACWI, +14.3%). European shares performed well (MSCI Europe, +3.7%), led by Germany (DAX, +4.0%) as investors welcomed ECB easing. The S&P 500 rose more modestly (+1.9%), but this is the best year-to-date performance (+15.2%) since 1997. Meanwhile, concerns over potential reforms regarding tech oligopolies limited gains for Nasdaq 100 shares (+0.8%). Finally, Canadian stocks climbed 1.7%, a fourth consecutive monthly gain which took the benchmark to an all-time high.

Yields on government bonds finally rose after a relentless downward trend that began in October last year, but the move had more to do with a technical bounce from the August lows than being driven by the not-so-great news flow. U.S. inflation showed signs of life (link), but remains benign whereas Canadian inflation is holding steadily near the 2% target rate. Investors also digested a rate cut by a hesitant and split Fed (link). Meanwhile, the Bank of Canada kept rates unchanged, which further narrowed the Canada-U.S. interest-rate differential, thereby supporting the loonie which gained 0.5% in September. The U.S. Dollar also gained 0.5% as growth outside of North America is cooling faster.

Equity Factors: Value Squeezed Higher, Pause for Momentum

Dispersion across global equity-factor returns continued, but the leadership saw an abrupt shift from Growth (+0.6%) and Momentum (-0.7%) to Value (+3.7%) and High-Dividend (+3.4%). Given that the underperformance of Value versus Growth has been so persistent in recent years (**Figure 1**), we don't think this is the time to load up on Value and expect a trend reversal from here. For Low-Volatility, it was another positive month (+1.0%). Year-to-date, the top 3 factors are Low-Volatility (+19.6%), Growth (+20.4%), and Quality (+20.8%), whereas Value (12.0%), Small-Cap (+13.4%) still underperform the broad index (MSCI ACWI, +14.3%).

Figure 1: Growth Outperformance Stalls in September



Source: BMO GAM

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In Canada, the BMO Canadian Low-Volatility Equity ETF (ticker: ZLB, +1.0%) continued to outperform the broad market BMO S&P/TSX Capped Composite Index ETF (ticker: ZCN, +0.4%), and has been up every month so far this year. Rising concerns regarding the global economic outlook and rising recession risks solidify our conviction for overweighting Canadian Low-Vol stocks heading into year-end and help smooth the path of what has been bumpy ride in the past couple years.

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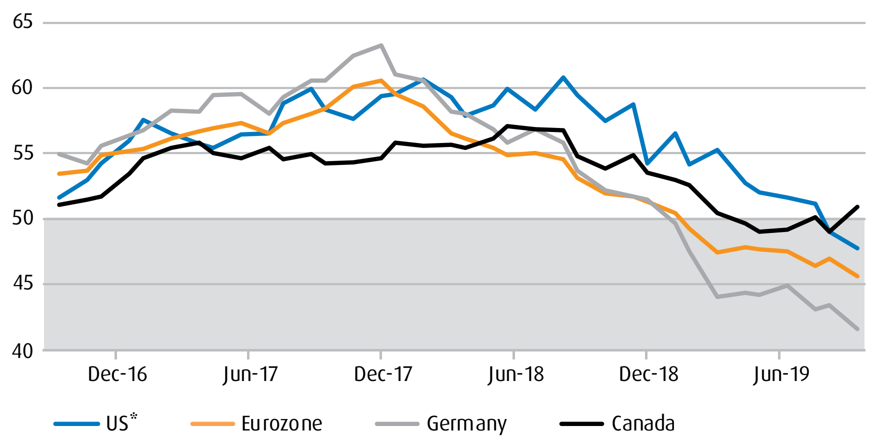
Getting Used to Trade Wars, But Economic Pain Probably Increasing

One step forward, two steps back is how the U.S. - China trade discussions are going and our base-case remains that there won't be a deal before next spring. For Canada, the impeachment drama also means the U.S. ratification of USMCA could be delayed until next year, though we doubt a prolonged delay will negatively impact Canadian businesses for now.

The recent dip in ISM manufacturing marginally increases the odds of a U.S. recession in the next 12 months and reinforces that the U.S. economy is increasingly running on a single engine, the consumer. Further, the global trade slowdown is unlikely done (link).

Figure 2: US Catching Up to Global Slowdown

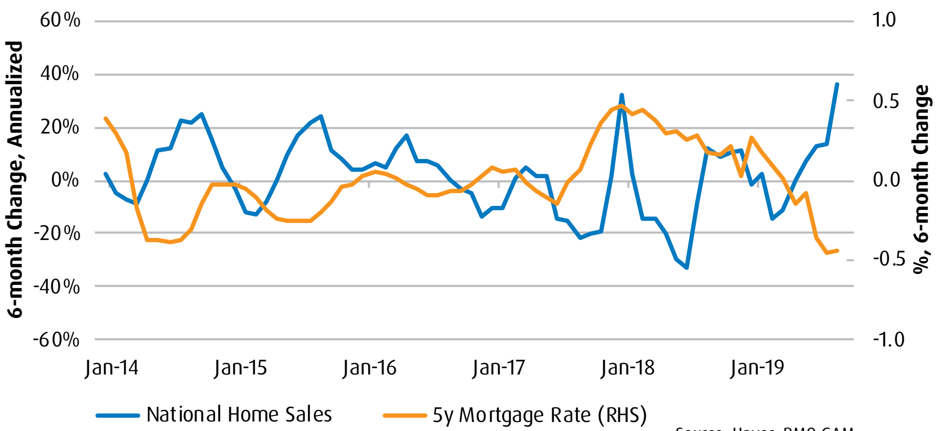


Source: Markit, Haver. *ISM.

Fed Outlook: "Don't Bring a Knife to a Gun Fight"

With U.S. growth set to decelerate near or slightly below its 2% trend-pace into year end, mounting headwinds on future growth, and U.S. interest rates well above other major currencies like the Euro and Japanese Yen, the Fed has more cutting to do in the next 12 months. Although Fed Chair Powell faces a divided committee, the balance of risk for the Fed is increasingly moving towards more easing rather than simple fine tuning of policy of just one more cut this year. That said, the recent fall in interest rates is starting to have a positive impact on the housing markets in both Canada and the U.S., which should help avoid a recession and maintain growth above 1.5% over the next 12 months (**Figure 3**).

Figure 3: Drop in rates a boon for sales



Source: Haver, BMO GAM

Canada: Soon the Highest yielding G10 Country

While Canada's economy has cooled significantly over the past year, a rebounding housing market should provide ample buffer against export-driven recession risks. Although the Bank of Canada had not eased since hiking in October last year, the 5-year mortgage rate, which matters most for the Canadian housing market, has fallen by nearly 100bps since its 2018 peak. Job creation has also been very strong so far this year with 304k jobs created through August. With an estimated 429k private-sector job vacancies (link), we believe persistent labour shortages will underpin the job numbers over the next 6 months, at least.

In this context where inflation is hovering near the 2% target and housing activity is set to support growth, it's no wonder Governor Poloz is not in a hurry to cut interest rates and add fuel to the debt overhang of Canadian households. Interest-rate markets for major advanced economies are expecting that Canada is set to soon become the highest yielding market, which will help support the value of the loonie (**Figure 4**).

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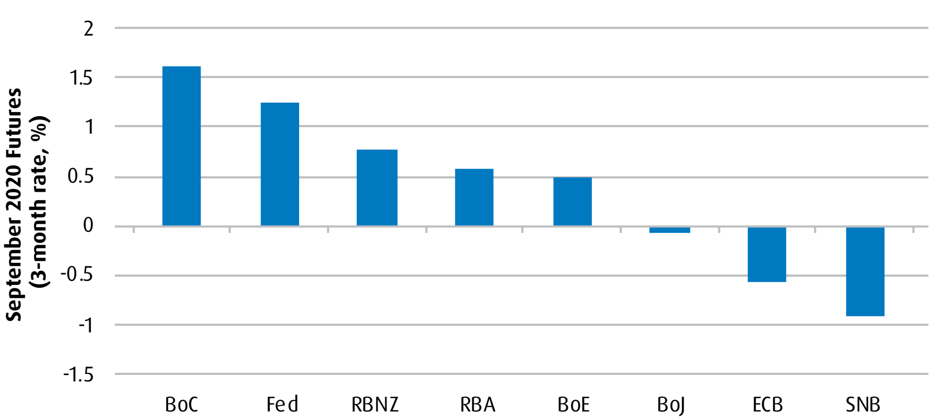
Figure 4: Canada Priced in to be the Highest Yielder in 2020



Source: Bloomberg,BMO GAM.

Outlook and Positioning: Caution in Reaching the Finish Line for the Year

Our core asset-allocation positioning was little changed last month with a modest overweight to equities versus bonds as we continue to lack clarity on various policy issues, from Brexit to trade wars. We also maintain our overweight to U.S. and Canadian stocks while underweighting EAFE, where the economic slowdown is more pronounced.

A deeply inverted yield curve in Canada makes bond duration highly unattractive, but with Canadian debt offering a relatively higher yield than most other developed countries and an appetite for yield supported by global central-bank easing, demand for safe-haven assets could run further, despite 10yr Canada Federal debt yielding almost 50bps less than the overnight rate. The return of quantitative easing in Europe and the scope for the Fed to rebuild its balance sheet later this year has made us less pessimistic on credit. Credit spreads are tight for a late-cycle dynamic, but we expect the reach-for-yield to keep on lid on them.

Finally, we continue to think the narrowing of the Canada-U.S. interest differential will support the loonie to climb toward $0.78 over the next 3-6 months (**Figure 5**). Risk sentiment and trade wars, which are starting to impact U.S. growth outlook a bit more, however remain the key headwinds.

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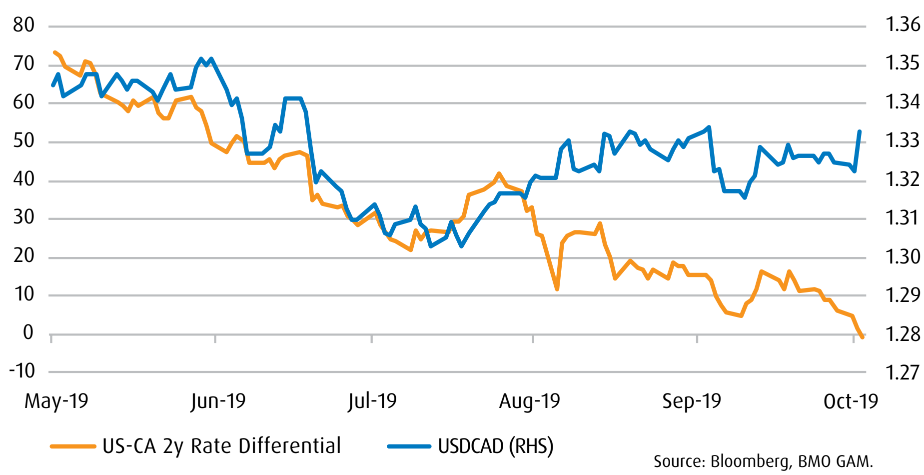
Figure 5: Loonie Decoupling from Interest-Rate Differential Looks Stretched



Source: Bloomberg, BMO GAM.

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