Multi-Asset Solutions Team (MAST)

Asset Allocation Outlook

- Global stocks disagreed with President Trump that tariffs are "beautiful" and fell sharply in May after trade tensions escalated and spread beyond China. Fixed-income markets are throwing a rate-cut party in Canada and the U.S., but we think Poloz might not show up.
- Trade wars are clouding the outlook, but we think Trump cannot afford a weak stock market or economy heading into the 2020 Presidential elections. We expect a more positive tone from the White House over coming months.
- While no country wins from trade wars, Canada appears less exposed than most countries. Lingering global trade tensions should benefit Canada relative to trade-sensitive countries like China, Germany or Mexico. Low-Volatility Canadian equities are attractive in this uncertain market environment.
- We remain marginally overweight to equities as our base-case remains that we will see enough improvement on the trade front in upcoming months and the fact that economic fundamentals remain healthy.

"The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them." – Peter Lynch

Tariff-Man is Back

President Trump's trade-war tactics surprised markets once again by threatening Mexico with tariffs if Mexico could not limit the flow of migrants to the U.S. (link). Such an unorthodox move disappointed investors on the prospects for a trade deal between the U.S. and China, and drove global equity markets lower in May.

Global stocks (MSCI ACWI) were hit hard (-6.2%) as the S&P 500 lost 6.4% while the Nasdaq 100 fell 8.2% as concerns over the fear of the negative impact from trade wars culminated alongside softer macro-economic data releases. Elsewhere, it was also tough in Japan (-7.4%) and in emerging markets (-7.5%) as hope for a trade truce melted with rising tariffs on China and other U.S. trading partners. Canadian stocks were down too, but only -3.1% as investors perceive Canada as being less exposed to trade wars, a point which we address below. The downbeat investor sentiment shook off oil prices last month as WTI (West Texas Intermediate) oil prices lost 16.5%.

Amit Prakash
Managing Director, Multi-Asset and Alternative Investments

Fred Demers
Director, Multi-Asset Solutions

Jon Adams, CFA
Director, Multi-Asset Solutions

Brittany Baumann
Senior Analyst, Multi Asset Solutions

Continued

Renewed recession fears fueled demand for safe haven assets. The yield on 10-year government bonds collapsed a full 38bps and 22bps in the U.S. and Canada, respectively. Globally, the sum of negative-yielding debt in bond issues hit 11 trillion USD. Late May, several segments of the U.S. yield curve went into inversion, but the 2-10 yield curve was relatively stable. The curve has steepened early this month on rising odds for an imminent Fed rate cut. In Canada, the inversion is deeper as the overnight cash rate yields more than all maturities up to 30 years. Finally, the loonie lost nearly a percent driven by the sell-off in oil prices and risk-off sentiment, which dominated the improving macroeconomic data. The Canadian job numbers are very good this year with gains of +222k from January and April.

Low-Vol Equities Helps on Slippery Roads

Global equity-factor styles showed a lot of dispersion in May, but the stories behind some of the relative movements is not that clear. Quality (-6.4%) and Size (-6.8%) were the hardest hit compared to the less severe losses experienced for Growth (-5.7%) and Momentum (-3.6%), which is the opposite of what we would usually expect in a typical risk-off environment. However, Low-Vol (-1%) outperformed every other factor by a significant margin, as expected in this uncertain environment. More interestingly, a simple equal-weighted factor-based portfolio would have generated nearly 130bps of outperformance relative to a traditional benchmark. The Low-Vol factor remains our favourite factor tilt in this highly uncertain environment.

In Canada, Low-Vol (ticker: ZLB, +1.2%) shined when the broad market (ticker: ZCN, -3.1%) suffered losses as oil tanked. As part of an investor's Canadian equity holding, we believe that investors should consider a strategic allocation of 10% to 20% to the Low-Vol factor as a way to mitigate the influence of the more volatile energy sector and instead focus on stocks with lower market beta. We think this view is supported by both strategic and tactical considerations.

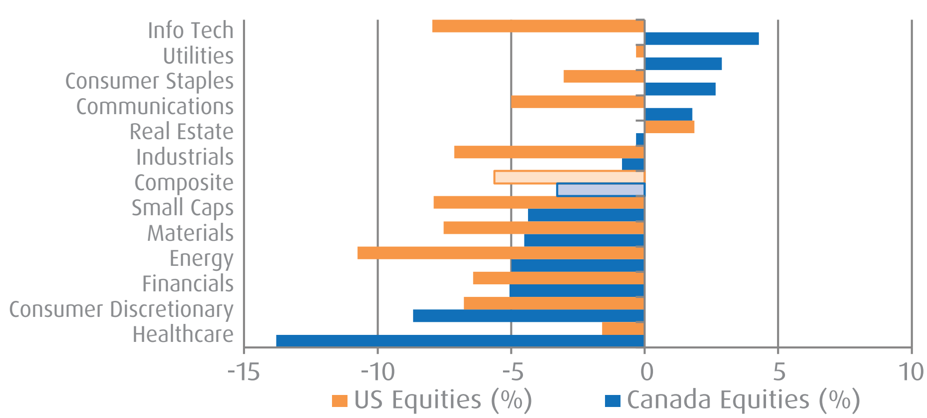
As part of an investor's Canadian equity holding, we believe that investors should consider a strategic allocation of 10% to 20% to the Low-Vol factor as a way to mitigate the influence of the more volatile energy sector and instead focus on stocks with lower market beta.

Tariffs are not "Beautiful" for Equities, But Canada Well Positioned

Since Trump's May 5th tweet, trade tensions have shown limited signs of resolve and if anything have escalated, which left equities in the red in May. The most trade-exposed sectors underperformed across North American equities, notably energy, info tech, materials, industrials, and consumer discretionary. These key categories are targeted or threatened by Trump tariffs. Most of these sectors have also underperformed on a year-to-date basis. Furthermore, looking at a basket of firms most exposed to revenues from Asia shows that these firms also underperformed the benchmark.

The most trade-exposed sectors underperformed across North American equities, notably energy, info tech, materials, industrials, and consumer discretionary. These key categories are targeted or threatened by Trump tariffs.

Figure 1: Relative Equity Performance in May: US vs Canada (%)



Source: Bloomberg. Exchange rate adjusted.

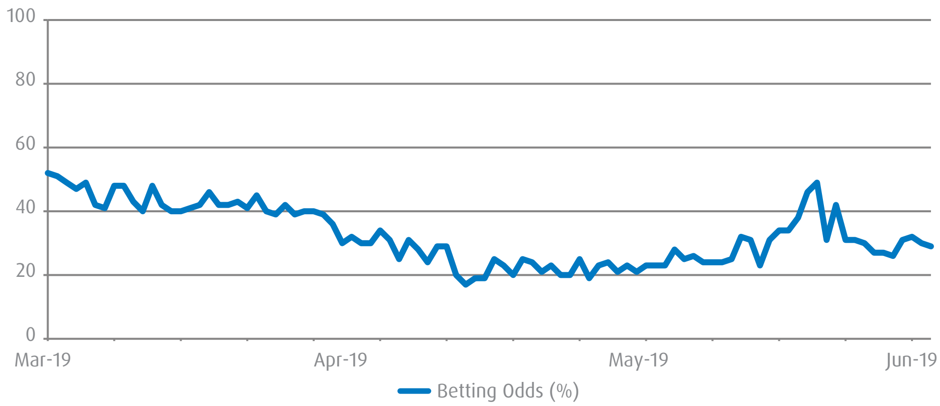
Canadian stocks, however, have outperformed their US counterpart since the trade war erupted last month (**Figure 1**). Similarly, the loonie, while having weakened, outperformed other open-economy, risk-correlated currencies like the Australian Dollar or the Korean Won. In our view, this is because Canada is relatively less exposed to U.S.-China trade tensions. For one, the share of Canadian publicly-listed firms that derive more than 15% of their revenues from Asia or China is smaller than in the U.S. In addition, we note that Canada is one of the largest beneficiaries among advanced economies from a U.S.-China or U.S.-Mexico trade war, as it would gain the most from trade diversion.

Canada is one of the largest beneficiaries among advanced economies from a U.S.-China or U.S.-Mexico trade war, as it would gain the most from trade diversion.

Trade Wars: When will it end?

While it's become increasingly hard to predict Trump's next move, what we can learn from the past month of trade tensions is that Trump is not hesitant to act on his protectionist threats. His turn to Mexico (and India) shows that he is no longer willing to negotiate trade country by country. Moreover, he could be turning away from more pragmatic advisers (Lighthizer, Mnuchin, Kudlow) and instead leaning on more hawkish ones (Navarro, Bolton).

Figure 2: Betting Markets: USMCA Ratified by Congress in 2019?



Source: PredictIt.

Despite this rather gloomy backdrop for global growth and foreign relations, there have been several positive developments on the trade front. Progress toward USMCA ratification has been significant in recent weeks with the removal of steel and aluminum tariffs, allowing odds of a deal to rise (**Figure 2**). The U.S. also formally took the next step in the approval process by notifying Congress of the final legislative text. Finally, we think the threat of 5-25% tariffs on Mexican goods could speed up ratification by Congressional officials, such as reluctant Democrats, while a deal with Mexico is still in reach given the conciliatory response from Mexican President AMLO. Importantly, keep in mind that USMCA is one of Trump's top campaign priorities ahead of the 2020 election.

Figure 3: Trade War Scenarios

Scenario	Likelihood		Details
Best Case	15%	Trade resolution no tariff escalation	• No further tariffs imposed, U.S. reaches deal with China this summer
Neutral to Positive	40%	Small increase in tariffs, trade deals reached in 2019	• No further tariffs imposed, U.S. reaches deal with China in late 2019 • Tariffs rise briefly to 5% on Mexico, USMCA still ratified in late 2019 or 2020 • U.S. refrains from auto tariffs, negotiations with the EU and Japan drag into 2020
Negative	35%	Significant increase in tariffs, negotiations continue	• Tariffs rise to 25% on all Chinese goods, U.S. reaches deal with China in 2020 • Tariffs rise above 5% on Mexico, USMCA not ratified until 2020 • U.S. imposes 5-10% tariffs on autos, negotiations with the EU and Japan drag into 2020
Worst Case	10%	Full blown trade war	• U.S. raises tariffs to 25% on all Chinese goods, U.S. and China impose non-tariff barriers, Trump targets other countries • Tariffs rise to 25% on Mexico, USMCA not ratified in 2019-2020 • U.S. imposes 25% tariffs on autos, negotiations with the EU and Japan break down

Source: BMO Global Asset Management.

The main conclusion for investors is that odds for a near-term trade resolve with China are lower and the risk of rising tariff rates is higher versus what we assumed earlier this year. Growth expectations are also lower, but only marginally so. We summarize the key trade scenarios above (**Figure 3**) for 2019. The main implication is that risks still skew toward trade resolution later this year, though tensions are more likely to drag on through the summer.

The main conclusion for investors is that odds for a near-term trade resolve with China are lower and the risk of rising tariff rates is higher versus what we assumed earlier this year.

The main implication is that risks still skew toward trade resolution later this year, though tensions are more likely to drag on through the summer.

Continued

Figure 4 below shows how we think key markets would perform in that scenario and how we would potentially seek to tilt our portfolios in the event trade wars persists and escalate slightly this summer.

Figure 4: Trading the Trade War

Asset category	Outperformers	Underperformers
Cross-asset	Government bonds	Equities, corporate bonds
DM Equities	US, Canada, Switzerland	EM, Euro area (Germany)
EM Equities	EMEA	China, Taiwan, South Korea
Sectors	Consumer staples, utilities, real estate, health care	Consumer discretionary, energy, materials, industrials, info tech
Fixed Income	Extended government bond duration, curve flattening	EM corporates, high yield
FX	USD, Japanese Yen, Swiss Franc	Chinese Yuan, Korean Won, Canadian Dollar
Equity Factors	Low-Vol, Quality, Small-Cap	Growth, Momentum
Commodities	Gold	Industrial metals, energy

Source: BMO Global Asset Management

Fixed-Income Markets are throwing a Rate-Cut Party: Will central bankers show up?

A little over six months ago, central bankers were contemplating further policy normalization and markets largely agreed with them. Now, investors have piled into safe haven government bonds, and the Canada and U.S. yield curves are pointing to rate cuts as soon as this summer. While recent remarks by Powell (link) keep open the possibility of a rate cut this year if financial conditions and economic data worsens, we don't think The Bank of Canada is as inclined to ease policy this year (link). Canadian growth is in a re-acceleration phase, notably underpinned by a solid labour market. This gives more room for Governor Poloz to be patient and push back against investor expectations for cuts, whereas Powell faces a more difficult, if not impossible, battle with bond investors.

Canadian growth is in a re-acceleration phase, notably underpinned by a solid labour market.

Outlook and Positioning: Steady Equity Overweight

Our overall tactical portfolio positioning was little changed last month as we remain marginally overweight to equities. We continue to see some upside to global stocks but trade tensions are clouding the macro outlook and investor sentiment. However our base-case remains that we will not see further escalation on the trade front this year.

The main changes to our tilts this month were the reversal of our April's buying of EM stocks and selling of Europe as the tariffs escalation took us by surprise and hit EM stocks hard. Meanwhile, we increased our overweight to U.S. stocks while decreasing EAFE on the basis that the U.S. is better positioned to face potential supply disruptions from firms navigating tariffs.

Although odds have increased that the Fed could cut as early as September, market expectations of 4 Fed cuts by 2020 appear too bearish in our view. And while we underappreciated the scope government yields collapse this year, bond duration is far from attractive given that we doubt the U.S. economy will roll into a recession over the next twelve months, which is what the bond market is saying. We also remain underweight to credit given narrow spreads and view that credit tends to be more sensitive than stocks when risk sentiment sours.

Finally, our call for a $0.73 loonie for the summer is intact though the recent green shoots of the Canadian economy could support the loonie and delay the pace of depreciation until year end. If the Fed starts to cut over coming months, however, the greenback could weaken and the loonie would likely benefit if Poloz can resist the market's pressure to cut.

Continued

Long-term investment decisions must be guided by goals and a clear, detailed plan to achieve them, not by one's ugly aching feeling while watching the evening news reporting on trade wars. The macroeconomic backdrop is far from bad.

Long-term investment decisions must be guided by goals and a clear, detailed plan to achieve them, not by one's ugly aching feeling while watching the evening news reporting on trade wars. The macroeconomic backdrop is far from bad.

Let's connect

bmo.com/gam/ca

bmo-global-asset-management-canada

BMO Global Asset Management

The information contained herein is not, and should not be construed as, investment, tax or legal advice to any party. Investments should be evaluated relative to the individual's investment objectives and professional advice should be obtained with respect to any circumstance.

Any statement that necessarily depends on future events may be a forward-looking statement. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions. Although such statements are based on assumptions that are believed to be reasonable, there can be no assurance that actual results will not differ materially from expectations. Investors are cautioned not to rely unduly on any forward-looking statements. In connection with any forward-looking statements, investors should carefully consider the areas of risk described in the most recent simplified prospectus.

Commissions, management fees and expenses (if any) all may be associated with investments in exchange traded funds. Please read the ETF Facts or prospectus before investing. Exchange traded funds are not guaranteed, their values change frequently and past performance may not be repeated.

For a summary of the risks of an investment in the BMO ETFs, please see the specific risks set out in the prospectus. BMO ETFs and ETF series trade like stocks fluctuate in market value and may trade at a discount to their net asset value, which may increase the risk of loss. Distributions are not guaranteed and are subject to change and/or elimination.

BMO ETFs are managed by BMO Asset Management Inc., which is an investment fund manager and a portfolio manager, and a separate legal entity from Bank of Montreal..

®/™Registered trade-marks/trade-mark of Bank of Montreal, used under licence.