Multi-Asset Solutions Team (MAST)

Asset Allocation Outlook

- The Fed folded, rate hikes may be done for the year unless we get a sharp pickup in growth and inflation. Removing the threat of future rate hikes helped drive equity markets to a third consecutive monthly gain. Macro-economic data remains mixed, but early signs of bottoming are starting to arise.
- The extent of the Fed pivot caused the 3m-10y yield curve to invert as rate cut expectations surged. Market bears cheered loudly for the R word. Outside of the gloomy fixed-income markets, it was business as usual with oil extending its 2019 rally to over thirty percent.
- Recession fears abated in Canada following a stronger-than-expected GDP report. But we continue to think Canada will lag the U.S. in this cycle, which should weigh on the loonie and take it closer to $0.73.
- No major change of view last month. We remain slightly overweight equities, in particular in the U.S. In fixed income, duration is still unattractive given the flatness of the yield curves in Canada and U.S. We think rates fell excessively in March.

"Fear and euphoria are dominant forces, and fear is many multiples the size of euphoria." – Alan Greenspan

Recession Fears: Déjà vu All over Again

Once again, investor fear has taken a life of its own while global stock prices grinded a little higher in March. Instead of hitting equity markets as in December, the fear sparked a rally in bond markets. The inversion of the 3m-10y part of the U.S. yield curve added fuel to the imminent-U.S.-recession narrative. As much as the bond market cheered up the bears (link), it's not surprising global stocks rallied despite all the drama over the inversion: correlation is not causation. For the S&P 500, this was the strongest quarter since 2009, rising 13.7% whereas Canada's S&P TSX 60 climbed 13.3%.

Such quarterly performance is a good reminder of the importance for long-term investors to stay invested and not react to forebodings of recessions. Why investors have generally failed to embrace this rally coming out of the Great Financial Crisis (GFC) is puzzling given the persistence of the long-term equity premium, but **Chart 1** illustrates an interesting market-based fear gauge for the S&P 500. It shows a clear regime shift post GFC with fear significantly higher in the past 10 years than prior to the GFC. We've said it before, but it's easy to find things we don't like about the macro environment, whether it's the large government deficits or central-bank interventions. Those influential forces won't disappear anytime soon. More importantly, such powerful forces can support risk assets over the medium term because wealth effects play a central role to policy-transmission mechanisms.

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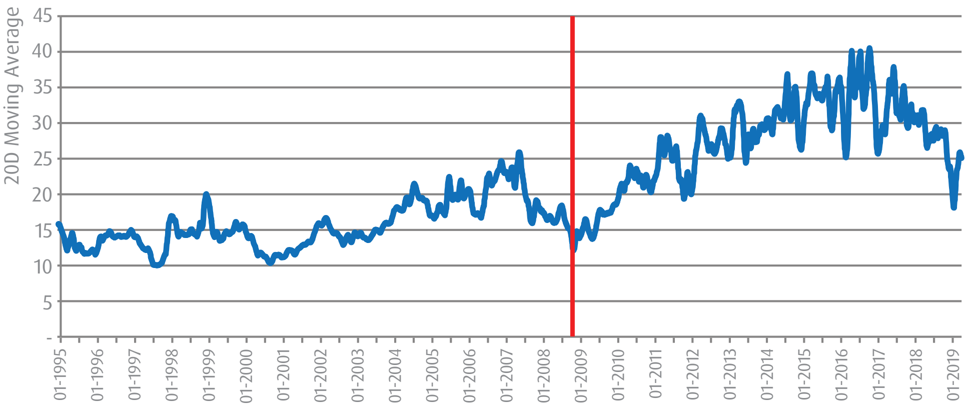
Chart 1: Incessant Fear behind the Most Hated Rally of all Times (Credit Suisse Fear Barometer)



Source: Bloomberg, Credit Suisse

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Higher Stocks Defy Recessionary Fear Mongers

The key market catalyst in March was the U.S. Federal Reserve, yet again. The Fed surprised us and a dovish market with a full capitulation, lowering its guidance (the so-called dot plot) to no hikes in 2019 (link). Although equity markets still seem confused as to what this 180 degree policy pivot (**Chart 2**) means for the outlook, stocks were mostly up for a third consecutive month. The S&P 500 regained its leadership, adding 1.9%, just ahead of European shares (MSCI Europe) which rose 1.6% on broad regional strength. The S&P TSX 60 gained a respectable 1%, but the oil rally provided little support to Canadian stocks. EM shares lagged again this month with a modest increase of 0.6%, while Japan's Nikkei shares were flat last month as the Japanese economy struggles to regain momentum ahead of the upcoming tax increase later this year and the ongoing supply disruptions due to trade wars.

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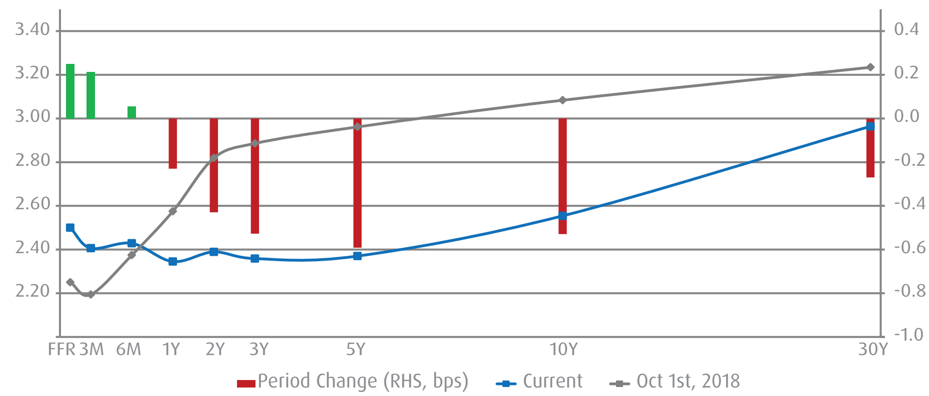
Chart 2: What a Quick Pivot: U.S. Government Bond Term Structure: March 31st 2019 vs October 1st 2018



Source: BMO Global Asset Management, Bloomberg

In fixed-income markets, a mix of soft production data in Europe and Fed Chair Powell throwing in the towel send government yields sharply down as investors began pricing in rate cuts in Canada and the U.S. Yield on 10-year government notes dropped a full 31bp and 33bp in the U.S. and Canada, respectively. More importantly, U.S. and Canada saw their 3-month to 10-year treasury curves invert, which helped spread fear of the R word. Outside of the bond market, fear was nowhere to be found as oil rose 5.1%, bringing the year-to-date gains to a stunning 32.4%. WTI prices now sit above $60 per barrel, topping the range we had anticipated this year. The loonie lost 1.3% in March but downside was limited by a surprisingly positive GDP report late in the month (link), which pointed to a bottoming for Canadian economic growth.

Equity-Factor Styles Aligned with Late-Cycle Goldilocks

From an equity-factor style's global perspective, Quality maintained its leadership in March (+3.0%) as the late-cycle narrative gained traction with the inverting yield-curve dynamics, which is driving equity investors to prefer firms with stable profits and lower financial leverage, features which characterizes "quality" firms. The goldilocks environment also meant pro-cyclical factors such as Momentum (+2.5%) and Growth (2.3%) performed well, whereas the defensive-growth narrative also supported the Low-Vol (+2.1%) tilt. Interestingly, all of these style outperformed the MSCI ACWI benchmark (+1.0%) in March, whereas Value (+0.2%) lagged as the economy continues to evolve toward a greater role for intangibles, which does not score high in a "value" world. In Canada, our favourite late-cycle exposures, Low-Vol (ticker: ZLB, +1.4%) and High-Dividend (ticker: ZDV, +0.8%) outperformed the broad market (ticker: ZCN, + 0.3%).

Yield-Curve Flattening: This time could be different

Since 2014, the U.S. yield curve has been on a steady flattening motion as the economic cycle is ageing and the Fed has made progress (9 hikes!) toward monetary policy normalization, but an inversion is always shocking given its track record at leading recessions (see here and here). When interpreting the nearly mystic yield-curve's predictive power, the relationship of the term spread is silent about the fundamental causes which could trigger a recession. Great caution is therefore warranted in interpreting the inversion, especially with the massive central-bank interventions of the past decade, which we believe have caused a compression of the term premium in global government bonds.

Of course, reflexivity (link) alone could trigger the self-fulfilling prophecy of the inverted yield-curve. But every recession has a clear external trigger, and it's hard to see exactly what that could be.

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Outlook and Positioning: Steady Equity Overweight

No significant changes were made to our portfolios last month and we remain slightly overweight to stocks. We are on a more cautious stance regarding the outlook, and respect the inversion of the yield curve, and therefore we have modest portfolio tilts. While many areas of uncertainty have disappeared (link) recently, a central pillar of our bullish investment thesis calls for a re-acceleration of U.S. and global growth in the second half of the year. However, beyond some early positive signs from leading indicators, notably U.S. commercial and industrial (C&I loans) credit growth shown in **Chart 3**, or U.S. and Chinese PMI indicators bottoming out, the pace of growth is the most important source of uncertainty at the moment for investors, though the upcoming earning seasons could move the macro to the passenger seat.

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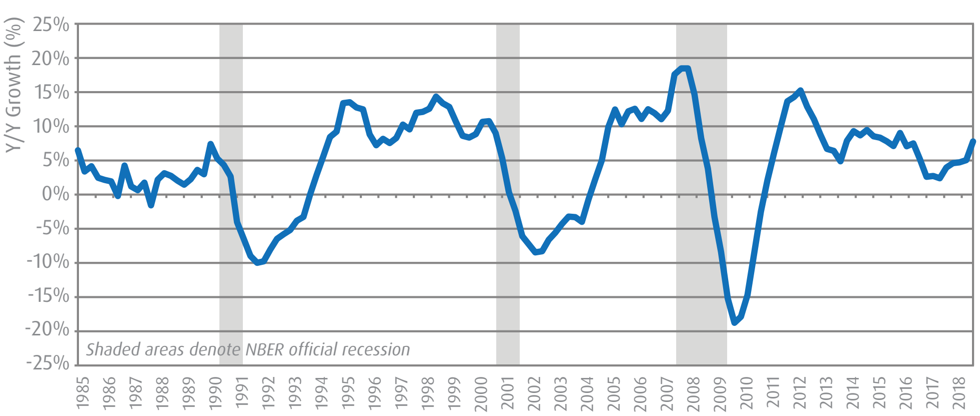
Chart 3: U.S. Credit Flows Picking Up



Source: FDIC, Bloomberg

On duration, we've been surprised by the rapid fall in yields across the curve in March, but we think the market overshot and therefore remain slightly underweight given our positive outlook. Because we think the down move in yields this year is overdone, we think the yield curve could steepen a bit form here along with rising yields across the curve as markets push out rate cuts to 2020. If U.S. growth averages above 2% heading into the summer, we think the Fed could resume talking up rate hikes. Before cutting rates, we think the Fed would probably end its balance runoff earlier than September, unless the urgency level suddenly spiked. But we are far from that. For the Bank of Canada (BoC), the recent data supports the neutral stance as long as the Fed is patient.

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The corporate credit market is where we prefer to express our cautious stance with an underweight. If we are wrong on our bullish call for the re-sparking of growth and the extension of the bull market this year, credit looks more sensitive to downside than equities given where rates have moved back to.

Canada remains exposed to both domestic and external headwinds and our earlier call for a $0.73 loonie for the summer holds. The BoC's approach to data-dependence can make the path bumpy, as we saw following the surprisingly strong January GDP report. For the greenback, it's been stronger than we expected this year. Fading U.S. leadership is never easy, even in a slowing cycle.

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