

CIO Strategy Note

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Silicon Valley Bank

March 2023
BMO GAM's Monthly House View

Banking and Bad Apples: The Aftermath of SVB

Presented by BMO GAM's
Multi-Asset Solutions Team

BMO  Global Asset Management

Banking and Bad Apples: The Aftermath of SVB

Looking back, February was almost the reverse of January for markets: optimism reigned to start the year as the U.S. Federal Reserve hinted at a potential pause, but in February, those hopes were dashed as concerns about high inflation, and more interest rate hikes reasserted themselves.

Now, in March, the bulls and the bears are continuing to fight it out, and there's a new major development: the collapse of Silicon Valley Bank (SVB). This has created new risks, but some concerns have already been addressed—U.S. Treasury Secretary Janet Yellen, the Fed, and the Federal Deposit Insurance Corporation (FDIC) have announced that the government will backstop all of SVB's deposit accounts, while across the pond, HSBC has acquired SVB's UK operations. We will continue to evaluate the situation on an ongoing basis and what other ramifications this might have on the broader markets.

Overall, the economy is slowing down. But the question remains—will a recession arrive sooner in the year or later? We continue to anticipate that it will be later in 2023, or potentially even 2024. The Fed will continue to push interest rates higher for as long as inflation remains relatively high or relatively sticky, though a new wildcard is the SVB failure and financial sector fallout. Our original thought was two or three more rate hikes but with new events, perhaps only one or two might now be in the cards. However, market expectations have been changing almost on a weekly basis.



Sadiq S. Adatia,
FSA, FCIA, CFA
Chief Investment
Officer (CIO)

Overall, the economy is slowing down. But the question remains—will a recession arrive sooner in the year or later? We continue to anticipate that it will be later in 2023, or potentially even 2024.

The pace of the slowdown could quicken, but we don't think that's likely given the relative health of the U.S. economy, including the labour market and corporate earnings.

With these conditions in mind, the word of the month is **balance**. A recession is still on the horizon, there will be fallouts from the financial sector and geopolitical risks remain. But we see opportunities to potentially buy those dips, and whenever the Fed does announce a rate-hiking pause, markets' reaction is likely to be exceptionally positive. This is no time to take on excessive risk. But it's also no time to take off excessive risk, even if some short-term pain is likely. We see a balanced approach as the wisest course, and we'll be keeping an eye on the jobs and inflation numbers.

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Has SVB's Collapse Changed the Economic Story?

History tells us that the Fed hikes till something breaks, and SVB's failure may be the first sign of that. While negative for the economy, it suggests the Fed's policy rate is sufficiently restrictive and reaching its peak.

U.S. Outlook

After the January jobs report spooked investors and reignited inflation fears, all eyes were on the February job numbers, which showed another stronger-than-expected rise in employment. That, coupled with still-elevated job openings, suggests to us that the labour market is still very tight and that mild weather conditions did not drive the January strength as much as hoped. These resilient labour market conditions, along with our view that inflation will remain sticky in the near-term, suggest that the Fed will keep raising interest rates in the coming months. But there are two factors that suggest that the Fed's key interest rate may peak soon, keeping hopes alive of a rate cut before the end of the year. The first is the new financial stability risks that have emerged in the wake of SVB's collapse, which fall under the Fed's unofficial mandate to address contagion risk; higher interest rates do have financial and economic consequences, and this is likely to keep Fed policy more cautious in the near term, limited to 25-basis-point increments or even a pause. And second is the expected weakening of labour markets later this year as the lagged impact of past rate hikes and tighter credit conditions continue to feed through the economy.



Brittany Baumann
Vice President,
Investment Strategist



Canada Outlook

Like the U.S., the Canadian labour market remains tight, as signaled by the February jobs report. Job growth is continuing at a solid clip, and Q1 GDP growth is also tracking to be positive, underpinned by private domestic demand. Overall, the picture is similar to the U.S. in that consumer spending, while slower than it was previously, is not crashing as a result of resilient labour market conditions. This labour market strength, as well as positive GDP growth, calls into

ECONOMIC OUTLOOK

question the Bank of Canada's conditional pause on interest rate increases. That being said, concerns over contagion risks in the banking sector following SVP's failure mean that the BoC's policy rate will likely remain stable for now. Canada's relatively high rate of population growth is also worth noting. It provides an important growth backstop for the country's economy moving forward, albeit at the price of potentially higher inflation risk.

International Outlook

The narrative of improving economic activity in Europe continued to build in February, as Purchasing Managers' Indexes (PMIs)—measures of trends in manufacturing and service—rebounded further. At the same time, there were new peaks in Eurozone core inflation, which have reignited overall inflation fears—a growing global theme. This development suggests that the European Central Bank (ECB) has more work to do with rate hikes. One implication of this better growth backdrop, coupled with rising inflation in both Europe and the rest of the world, is that the strength of the USD is capped on the upside by hawkish central banks outside of the U.S., including the ECB. In general, a hawkish ECB, which we expect going forward, is likely to help the Euro.

In China, the PMI showed another month of better-than-expected improvement. This is important because stronger PMI in the region will help growth elsewhere, including the United States—it's an important backstop for global growth. The big question is the sustainability of the rebound, which will depend on how consumers spend down their savings, and how much policy support the government will offer. On something of a negative note, the recent National People's Congress was a bit of a disappointment for investors, with an announced growth target of around 5% and fiscal targets also on the conservative side, suggesting a less expansionary stance than in 2023. But in general, we still prefer China to other regions as the lifting of its Zero-COVID policy further underpins demand conditions, and we'll continue to be attentive to how this reopening process is playing out.

Key Risks	BMO GAM house view
Inflation	<ul style="list-style-type: none"> • Can be expected to be sticky in the near term • We expect more pronounced disinflation in the second half of the year
Interest rates	<ul style="list-style-type: none"> • Further significant increases in the terminal rate are being called into question • The peak is still likely approaching
Recession/unemployment	<ul style="list-style-type: none"> • Recession risks have been marginally brought forward due to financial stability risk • Job losses are still likely later in the year • Wage growth appears to be slowing already
Geopolitics	<ul style="list-style-type: none"> • U.S./China relations are likely to remain strained • No significant change in the Russia-Ukraine situation
Consumer	<ul style="list-style-type: none"> • A risk that doesn't go away • Having a steady paycheck remains crucial for consumers' ability to service their debt in a high-rate environment
Housing market	<ul style="list-style-type: none"> • We expect housing prices to decline; that usually lags falling home sales • But in Canada, strong population growth should be a boon to demand
Earnings	<ul style="list-style-type: none"> • Slightly more negative, driven by banks and tighter credit conditions • We expect earnings growth to keep falling this year

PORTFOLIO POSITIONING

Asset Classes

The sudden onset of financial system instability has injected some uncertainty into the Fed's policy trajectory, but not enough in our view to deviate significantly away from Chairman Powell's core mission: lifting interest rates until inflation is in check.

The big caveat in any discussion surrounding markets at the moment is the short-term repercussions from SVB's default and Credit Suisse's difficulties. We saw the market move 20% down on U.S. banks and then snap back overnight—that makes it difficult to maintain focus on a longer-term outlook. We were neutral (0) on equities in February and we're still neutral, keeping in mind that our outlook horizon is typically 6-12 months. What we continue to see from the U.S. Consumer Price Index (CPI) is inflation remaining an issue. The month-to-month rate came in at 0.5% in February, a tick higher than the consensus estimate, which underscores the important question of how high and how hard Fed Chairman Jerome Powell will need to keep raising rates. To paraphrase what Mr. Powell said in Jackson Hole last fall: "We're going to keep raising rates, and we know some pain will be felt in parts of the economy, but we can't stop until we fix the inflation problem." But throw a systemically important bank failure into the mix and suddenly, that rate path becomes a lot more difficult to predict. The reality is, we've experienced a near-term hiccup while the Fed is fighting a longer-term problem. Is this the first sign that the Fed has gone too far too fast? The details below the headlines would suggest no. The way SVB ran their business is pretty idiosyncratic from the broader banking sector. Do we think that Jerome Powell is going to stop raising rates because of SVB? Probably not.



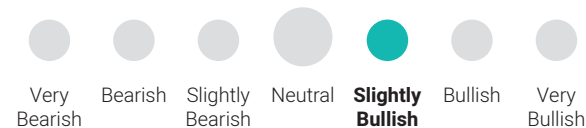
Steven Shepherd, CFA
Director,
Portfolio Manager

We remain slightly underweight (-1) cash in favour of bonds, which has worked quite well defensively as we saw rates sharply down due to this near-term banking crisis. Curiously, the softer rate outlook was relatively beneficial to growth-oriented technology stocks, and the gold sector, which is also a large part of the Canadian Materials sector. Both of these are present in the portfolios.

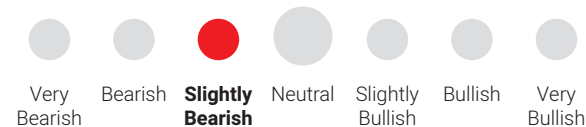
EQUITIES



FIXED INCOME



CASH



PORTFOLIO POSITIONING

Equity

The U.S. was already beginning to look sluggish before the banking crisis rattled lenders. It's time to take some profits from the early-year rally as high interest rates tighten their grip on the economy.

The disruption caused by SVB and Credit Suisse's woes is going to be temporary. This is not the financial crisis. The fundamental stability of the broader market will not be affected, but it's going to have some knock-on effects, particularly to some other banks. Some institutions might take a small hit to earnings, as they grow more conservative to protect liquidity; they could pull back on lending which could hurt their earnings-per-share. In the U.S., this could also have implications for the consumer credit cycle. We've already seen a tightening in lending standards, even before SVB's default. The financial ripple effects add incrementally to the headwinds to the economy and to the consumer credit cycle and spending. The consumer has been resilient over the last few months, but pandemic savings have come down, credit card usage is climbing, and when you see banks tightening standards, it's going to drag on the economy. So, we have downgraded the U.S. to slightly bearish (-1). The growth outlook started to look sluggish even before the whole SVB issue, while the market was pricing in a terminal interest rate of around 6%--which is far higher than other central banks. We've taken some profits and now hold a more cautious view on the U.S. market.

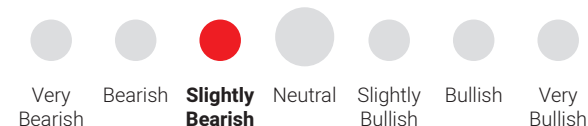
Internationally, we think there's more room to run. We have upgraded our Emerging Markets score to bullish (+2)—our conviction in EM is increasing with China overcoming its winter COVID surge faster than most observers thought. The main



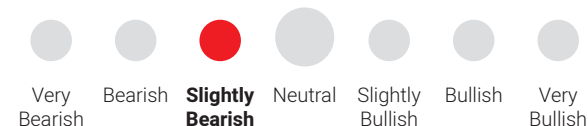
Marchello Holditch,
CFA, CAIA
Director,
Portfolio Manager

change over the last month was their growth projections for the year coming in at 5%, which was under consensus. But we don't think that's a major issue—they've set a target they should overshoot. All our high-frequency indicators are showing positive signs. Looking at Europe, we're keeping our neutral (0) rating for now. They've rebounded but we don't think there's much upside from here.

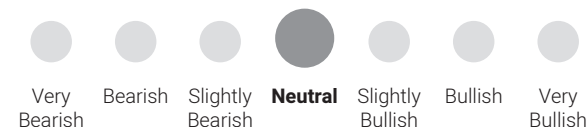
CANADA



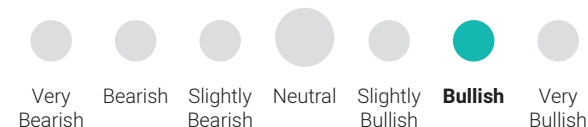
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EAFE



EM



PORTFOLIO POSITIONING

Fixed Income

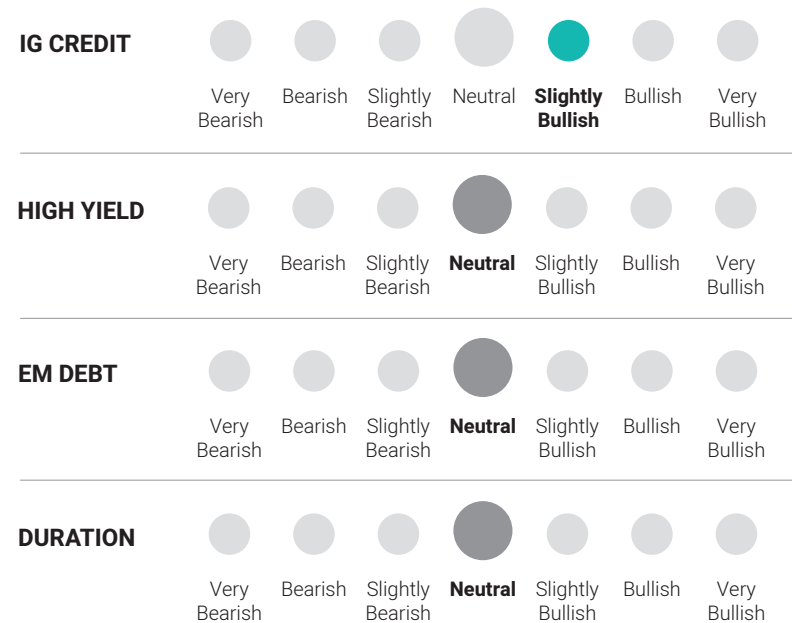
The market remains convinced the Fed will move to cut rates later this year. We disagree. The most likely scenario is for U.S. rates to go modestly higher and remain there for a sustained period.

Inflation remains front and centre. Taming consumer prices still outweighs financial stability concerns, and we believe the Fed will keep raising rates. Does the financial system risk change the specific calculus? Perhaps a bit. The predictions of the Fed moving to a 6% terminal rate now appear overly aggressive, but we still believe they will stick to their guns and go somewhere between 5.0%-5.5%. It's our view that the Fed will move forward with a couple more rate hikes. More importantly, they're going to keep them there. The market continues to price in at least one interest-rate cut before the end of 2023, but we are firmly not of that belief. Our view is that the intention is to keep rates elevated for a sustained period of time.

We have left our views largely unchanged—we're neutral (0) on High Yield and Emerging Market Debt (EMD), while still slightly bullish (+1) on Investment Grade (IG) bonds. In terms of duration, we have been getting more positive as the Fed moves closer to its terminal rate. Two-year Treasury yields have been volatile in light of the current financial tremors, but in general we are beginning to see the diversification of bonds work again. Short-end yields are moving lower, and we are seeing bonds behave in a more traditional way. That is the signal to us that we're reaching the end of this tightening cycle.



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PORTFOLIO POSITIONING

Style & Factor

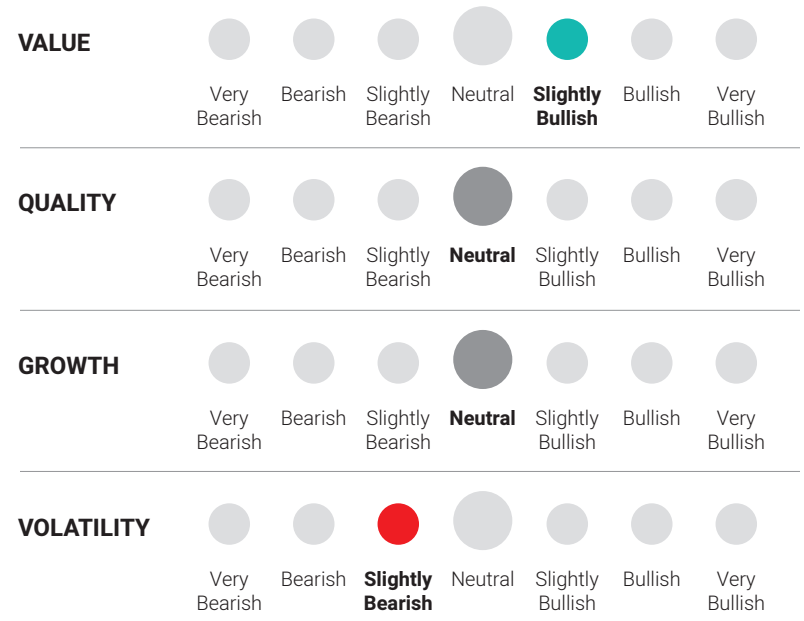
Gold is proving its worth under current market conditions, while we've also identified opportunities in base metals and industrials. Our covered calls strategy also continues to generate income and enhance returns.

We've been trying to add value at a more granular level. Being neutral on bonds and equities isn't too exciting, but that's the reality of this market, where a more granular approach has worked. That's meant more selective active management as opposed to broad beta index exposure. We have taken specific tilts toward a few key individual sectors. Materials has been one, and within that, we've built a significant position in gold which has done well given this momentary turmoil. We like gold and have been adding it across portfolios. The other half of our Materials position is comprised of base metals and commodities, which should benefit from a weakening US dollar (USD). Our base metals position is an extension of our EM outlook. As China and others gain momentum, they will require commodities such as copper to continue industrial expansion.

IWe have also opened a position in Industrials, which includes aerospace and defense, given that G-7 defense budgets are rising in light of the Ukraine conflict. And lastly, we are still owners of our U.S. energy position. We've taken the opportunity in recent weeks to write some covered calls. In a sideways market, covered calls do two things: first, they generate income from call premiums, and second, they act as forced-selling discipline. This is a market where we're going to win by inches, not home runs.



Steven Shepherd, CFA
Director,
Portfolio Manager



PORTFOLIO POSITIONING

Implementation

With investors showing some appetite for risk, the greenback's rally continues to fade, which is good news for the loonie.

The CAD has been weakened by expectations of further rate increases from the Fed as the Bank of Canada pauses. Yet from a fundamental valuation standpoint, the USD is still overvalued

We've downgraded the Canadian dollar (CAD) to neutral (0). That's a reflection of the shorter-run volatility the USD has experienced of late. The market has been pricing in further interest rate increases from the Fed while the Bank of Canada has hit pause on its tightening cycle, which is also supportive for the greenback. However, from a fundamental valuation standpoint, the USD is still overvalued. That overvaluation will help sustain some fundamental tailwinds for some of our equity exposures as the USD weakens, as we expect. That being said, our view does not support an outright hedge of USD versus the CAD at this point.

CAD

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Portfolio Managers



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