

Disciplined Equities

Market Update



Overview

U.S. equities posted gains during the second quarter, despite a steep sell-off in May due to mounting concerns over trade wars between the U.S. and China, coupled with the possibility of U.S. tariffs on Mexican imports. U.S. stocks swiftly recovered in June, supported by expectations of rate cuts by the Federal Reserve, and a more optimistic outlook for U.S. and China relations ahead of the G20 summit.

Rate sensitivity

Despite a flattening in the yield curve, stocks with positive sensitivities to interest rates were some of the best performers during the quarter. This was largely driven by the financial services sector, which led market returns following a positive assessment of capital spending plans by the Federal Reserve, in the face of what would have otherwise been a challenging interest rate environment.

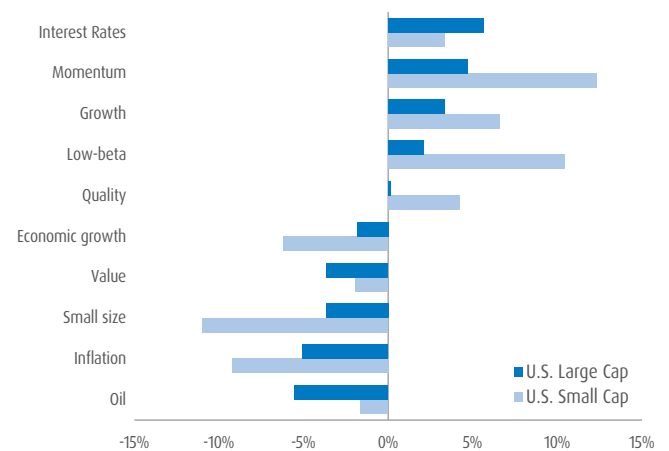
Low-beta outperforms

While equities finished the quarter in positive territory, increasing market volatility, a sharp decrease in interest rates and the influence of macroeconomic risks continued to drive the outperformance of lower-risk stocks.

Momentum and growth

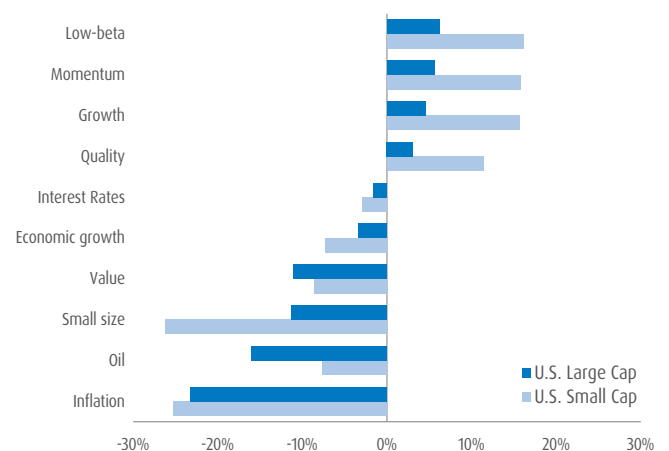
Investors continue to favor stocks with higher sales and earnings growth, with no regard to valuations. This also helped support returns for stocks with positive price momentum, as many themes driving returns for the last 12 months (such as low-beta and growth), persisted throughout the quarter.

Factor performance — most recent quarter



Source: FactSet, Axioma, Russell and BMO Global Asset Management

Factor performance — trailing one year



Source: FactSet, Axioma, Russell and BMO Global Asset Management

Insights from Market Monitor

In previous quarters, we have explored the recent underperformance of valuation, which has now reached 30 months in duration across both the U.S. large cap and small cap markets (charts 1 and 2).

Chart 1 | Valuation drawdown (Russell 1000® universe)

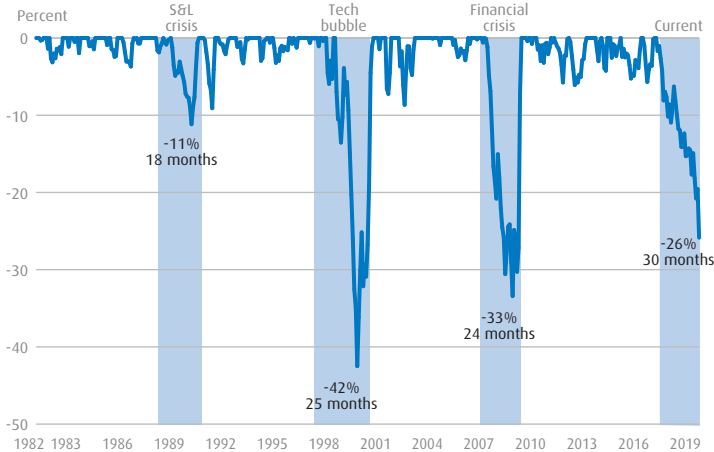
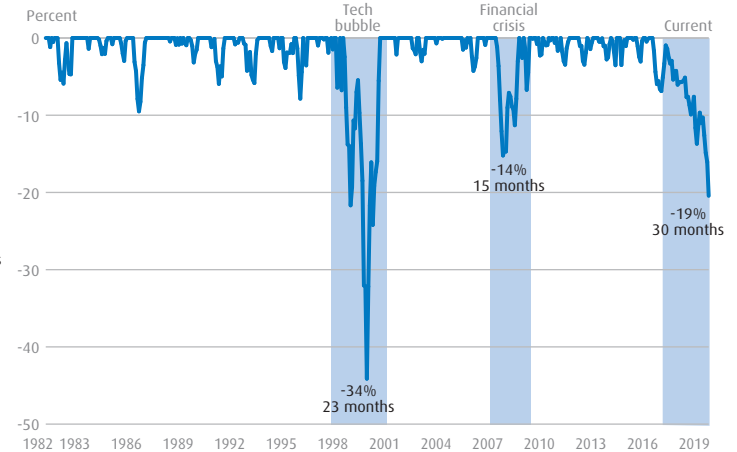


Chart 2 | Valuation drawdown (Russell 2000® universe)



Source: FactSet, Axioma, Russell and BMO Global Asset Management

As investors continue to favor more expensive stocks in the market, valuation spreads, which measure the spread between cheap and expensive stocks, have widened to 1.5 and 1.7 standard deviations in the Russell 1000® and Russell 2000® universes, respectively (chart 3). This has created an opportunity for more attractively valued stocks in the market, as wide valuation spreads have historically led to above-average returns to valuation (charts 4 and 5). However, does this relationship suggest that investors should be rotating their portfolios from growth into value?

Chart 3 | Valuation spreads (Russell 1000® and Russell 2000®)



Source: FactSet, Axioma, Russell and BMO Global Asset Management

Chart 4 | Large-cap universe (Russell 1000®)

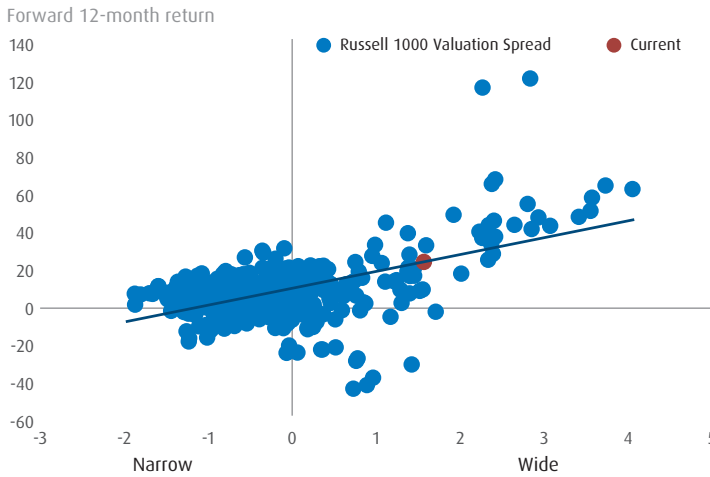
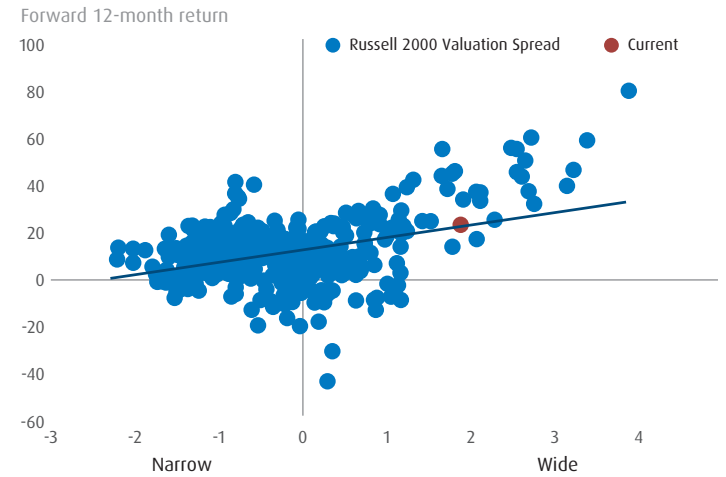


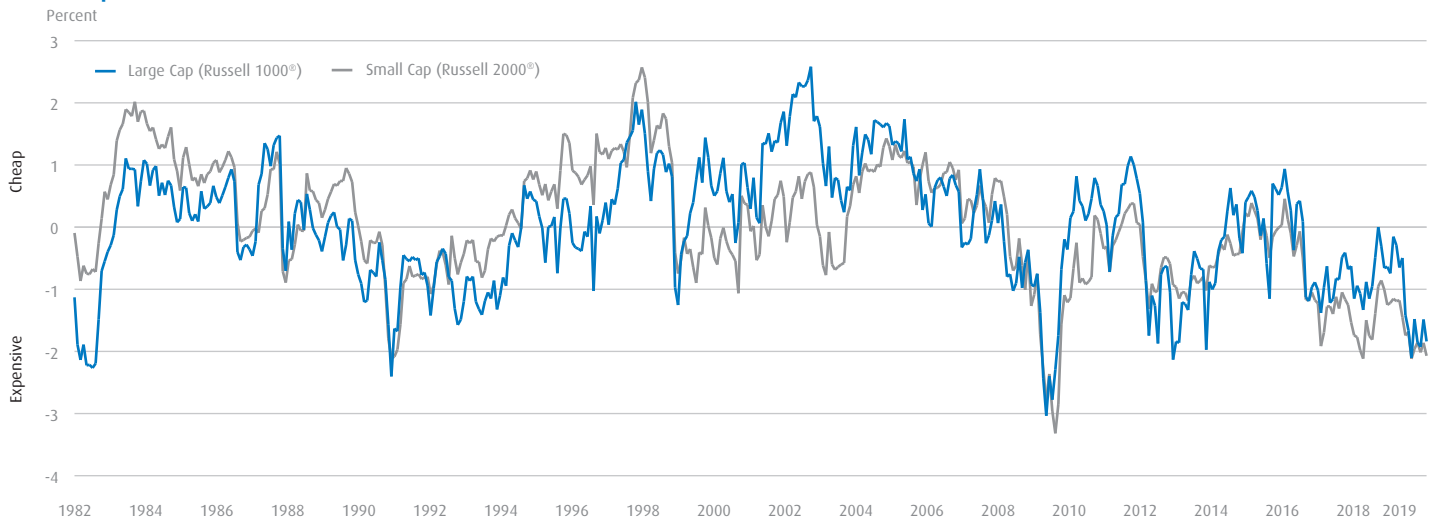
Chart 5 | Small-cap universe (Russell 2000®)



Source: FactSet, Axioma, Russell and BMO Global Asset Management

According to our research, this dislocation, and the potential payoff, applies across style boxes, as there are pockets of expensiveness in both the growth and value benchmarks. For example, the utilities sector, which has a greater representation in the value benchmarks, is trading 2 standard deviations, expensive relative to history (chart 6). This presents an opportunity for managers to extract alpha by emphasizing valuations in a more expensive segment of the market.

Chart 6 | Valuation of utilities



Source: FactSet, Axioma, Russell and BMO Global Asset Management

While the continued outperformance of more expensive stocks in the market has created a dislocation in valuation spreads, the resulting implications mean a lot more than reallocating portfolios at the benchmark-level. The potential to extract alpha from mispricings in the market applies across both the growth and value benchmarks, and we have positioned our portfolios in a manner we believe will allow them to participate in the recovery of more attractively valued securities in the market.



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Past performance is not necessarily a guide to future performance.

The Russell 1000® Index is an index of approximately 1,000 of the largest companies in the U.S. equity market.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe.

Investments cannot be made in an index.

Beta is a measure of a portfolio's volatility. Statistically, beta is the covariance of the portfolio in relation to the market. A beta of 1.00 implies perfect historical correlation of movement with the market. A higher beta manager will rise and fall more rapidly than the market, whereas a lower beta manager will rise and fall slower.

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