WEEKLY STRATEGY
Perspectives

BMO Private Wealth

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Adjusting to the new (old) normal

"Everything old is new again."
– generally attributed to Jonathan Swift, 17th century English author

The Through Line: For much of 2024, stock and bond prices rose as investors reacted to solid economic progress and the prospect of central banks launching rate-cutting campaigns. Oddly, in the U.S. and Canada equity and fixed income markets began to diverge when the campaigns started to gather steam. Intermediate and long-term bond prices moved down (which pushed interest rates *up*), causing stocks to wobble. Part of the problem is that interest rates have been abnormally low for much of the last 15 years thanks to central bank intervention in the wake of various crisis periods. Moving forward, our U.S. Wealth Chief Investment Officer Yung-Yu Ma expects longer-term U.S. interest rates and inflation to migrate back toward longer-term historic norms rather than the near zero rates that prevailed in the more recent past. It will take time – and perhaps a bit more volatility – for markets to anchor to a more realistic "new" normal.

When good news is bad

Last Friday's U.S. jobs report should have been worthy of celebration on Main Street, with approximately 100,000 more jobs created than experts had projected and a downtick in the unemployment rate to 4.1%. Wall Street didn't see it that way, however, staging a large sell-off that hit risk assets particularly hard. Canada also reported an unexpectedly robust employment report, throwing additional Bank of Canada rate cuts into question (Cold Weather, Hot Jobs).

Since last September, intermediate U.S. government bond yields have *increased* more than 100 basis points even though the Federal Reserve *cut* its short-term policy rates by 100 basis points. In Canada, where the BoC cut policy rates by a world-leading 175 basis points, the reaction in longer term rates was more customary as 10-year Canadian bond yields moved down 100 basis points.

Despite both central banks cutting, the end of 2024 saw U.S and Canadian bond yields rising. Stocks tried hard to look past these rising yields and had a modicum of success, climbing to new highs in late fall. Then came the Federal Reserve's December meeting of its rate setting body, the Federal Open Market Committee (FOMC). Projections and commentary accompanying the meeting called into question how much and when the Fed might cut rates going forward. Last week's jobs report added to the nervousness, lending support to the "somewhat-higher-for-a-*whole-lot-longer*" thesis.

Why are long-term rates up if central banks are cutting?

Central bank policy is applied to short-term rates. In contrast, rates of intermediate and longer term debt are influenced by market forces. Upward migration in those longer rates can be problematic for consumers and businesses since many key lending rates, including mortgages and car loans, are tied to longer term debt. When longer rates move up even as short rates are being lowered, fixed income investors are demanding more return for committing their money for longer periods. Many explanations can lead to this difference including:

- Continued U.S. economic growth buoyed by solid employment and consumption
- Growing concern over mounting national deficits and record-high total debt-to-GDP levels
- Concern about the order, magnitude and timing of incoming Republican administration policy proposals relative to debt/deficits/tariffs
- Sticky inflation

What is normal for rates or inflation?

Global economies have spent much of the last decade navigating several systemic shocks including the Global Financial Crisis and the pandemic. Reaction to these periods prompted central banks and federal governments to shift course as countries deployed various fiscal and monetary policies in an effort to stave off the most serious economic consequences. During much of this period, inflation was very low in most industrialized countries as central banks took their policy rates to zero (or below). It was often a struggle to coax inflation up toward 2%. **The sheer length of time that these low rates and inflation persisted (2008-15) allowed investors to become too accustomed to what will go down in the historical record as an outlier – not the norm.**

The pandemic and aftermath was a bit different in that it was a medical crisis, not a meltdown in a critical sector. Many were caught off guard by the rapid inflation that emerged when the globe reopened, and consumption ramped up dramatically. **As markets settle back into a post-crisis mode, investors are struggling to figure out what "normal" is – for inflation or interest rates.**

The following charts illustrate how the decline in overall interest rates has been a decades-long affair. Inflation followed a similar path, falling to near zero in the wake of the GFC. The story changes a bit when you look longer term, however. Between 1960 and 2023, the annualized rate of inflation was 3.8%.[i]

Looking for Goldilocks rates

The long period of low rates means that a generation or two of consumers and investors haven't really experienced what average inflation and interest rates look like. **A moderate level of inflation is arguably healthy for an economy for a number of reasons: it can facilitate wage increases; give companies a modicum of pricing power; and encourage a balanced level of activity that doesn't boost inflation from too much demand, or stifle growth by spiking borrowing costs upward.** The key is finding the right or neutral level that encourages a good balance. This quest is what keeps central bankers up at night and has stock and bond markets seeking answers by obsessively analyzing Fed policy and scrutinizing each data point.

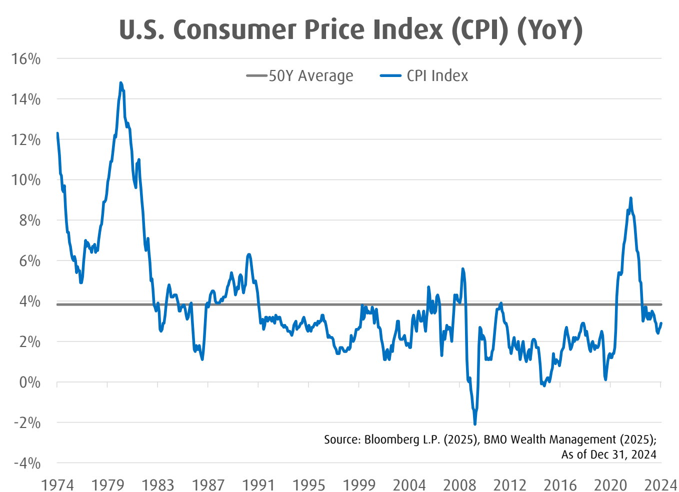
Our U.S. House View and our capital market assumption work are led by U.S. Wealth CIO Yung-Yu Ma who expects core inflation of 2.5% in coming years and a fair value range of 4.25% - 4.75% for 10-year U.S. government yield. This is above levels where they traded as recently as last fall, but more in line with long-term levels. With Canada's relatively weaker economy and tamer inflation, BMO Economics pegs year-end Canadian 10-year bond yields at 3%. Notably, this difference, along with tariff fears, are the key drivers of the weak Loonie.

As Fed Chair Jerome Powell has noted on numerous occasions, the path toward the Fed's 2% target is likely to be bumpy and long. The central bank itself is searching for the optimal neutral rate; recent commentary suggest FOMC committee participants believe the 100 basis points of cuts so far leave them closer to that "optimal" spot. They can now pause to let clarity – in data and policy – emerge in coming months.

Implications for Investors

It would not be surprising to see continued market volatility around various economic data releases until Wall Street and Main Street adjust their behavior to the notion that inflation and longer term interest rates are stabilizing back toward longer-term norms.

For some time, our House View has been to stay with shorter maturities and higher quality instruments, finding the premium insufficient to warrant taking excessive duration or credit risk. We believe fair value on the U.S. 10-year is in the 4.25%-4.75% range. While a push to 5% is not off the table, this week's tamer U.S. Producer Price Index and Consumer Price Index prompted a sharp reversal in 10-year yields, illustrating yet again the data-dependent state where we currently find ourselves. If yields did push through 5% while economic and other fundamental drivers remained constant, it could represent an opportunity to extend duration.



In focus in North America

Jon Borchardt, Sr. Analyst
George Trapkov, CFA, VP and Portfolio Manager

This week

After last week's freak out over "too good to be helpful" jobs numbers in both the U.S. and Canada, all eyes were turned to this week's inflation reads, including PPI on Tuesday and CPI on Wednesday – both of which came in more muted than worst fears. A flurry of big bank earnings also added to the happy music across stock and bond markets on Tuesday and Wednesday.

U.S. employment remains healthy – Last Friday's non-farm payrolls report showed 256,000 jobs created in December which was well above the Bloomberg consensus forecast at 165,000. The unemployment rate fell to 4.1%, its lowest reading in six months. Wage growth eased, signalling reduced inflation risk. **These data points indicate labor market fundamentals remain in reasonable balance and there is no reason for the Fed to take the finger off the pause button.** Good news for the economy was taken as bad news by bond and equity investors who fear the Fed will maintain a higher for longer policy stance.

Canadian job growth is also strong – The Canadian job market ended 2024 on an upbeat note, in line with BMO Economics' view that the broader economy was getting up off the mat. **Employment rose 90,900 in December, the largest monthly increase in almost two years,** and enough to clip the unemployment rate a tick to 6.8%. While one could quibble about a few of the details, most aspects of the report were sturdy: full-time employment rose 57,500, and hours worked jumped 0.5% month over month. Employment gains were broad-based with 12 of 16 sectors seeing job increases. Six sectors saw advances of 10,000 or more. There was also nothing especially notable in the geographic distribution, with eight of ten provinces reporting gains. Alberta was particularly robust (+35,200), carving its jobless rate to 6.7%. Quebec also had a solid rise of 14,400, leaving it with the lowest unemployment rate in the country at 5.6%.

Is the Bank of Canada on hold? – despite growing signs that the domestic economy is picking up, it's the external backdrop that may yet keep the Bank of Canada in easing mode. The threat of U.S. tariffs looms like a heavy dark cloud over the recent somewhat sunnier economic reports. Incoming President Trump again warned at a press conference this week that Canada and Mexico face "serious" tariffs, apparently wholly unsatisfied with pledges and actions to tighten border security. With the tariff threat hovering, Canadian officials are busily crafting a potential retaliatory response, which while a necessary evil, could heighten the economic pain for Canada. Partly as a result of the uncertainty, markets are still pricing in a slightly better-than-even chance of a BoC rate trim this month. For more info from our BMO Economics team see: Yield Hangry.

U.S. Small Business optimism increases – The National Federation of Independent Business (NFIB) monthly survey shows sentiment among small business continues a post election shift into high gear. The reading for December hit the highest level in over six years and surpassed Wall Steet expectations. Small Business owners anticipate implementation of Trump Administration policy priorities, including lower taxes, reduced regulatory burden, improved credit conditions and lower energy prices, will drive economic growth. We expect post election clarity will foster increased business investment in 2025, though tariff, immigration or other new policy-related disruptions could push this strength to mid-year.

U.S. Consumer Prices – Investors breathed a sigh of relief after Wednesday's inflation data signaled progress towards the Federal Reserve's 2% inflation target. Headline inflation rose 0.4% month over month, not necessarily something for consumers to cheer. Wall Street did cheer the release, though, staging a big rally. Importantly, core inflation (less food and energy) and the "super core" (core less shelter costs) came in below expectations. The super core figure strips out more volatile and lagging elements from the data and also feeds into the Fed's preferred inflation metric: core Personal Consumption Expenditure (PCE). **Signs of progress made within the super core components imply Fed rate cuts may still be on tap for 2025.** Our expectation is there will be room for two cuts, likely starting later in the year. Equity markets rallied and bond yields fell on the news.

Canada Housing Update – Canada's housing market was flashing mixed conditions at the end of 2024. While Ontario remains soggy, and the Toronto condo market is awash in supply with prices falling, much of the country is firm. Prices in at least ten major markets are pushing cycle highs. **BMO Economics expects the Canadian housing market to firm up this year, but it doesn't expect another exuberant takeoff.** Nationally, sales volumes are expected to rise 12% for the calendar year versus depressed prior-year levels. The benchmark home price looks to rise a modest 4%, as still-challenging affordability and investment calculus will keep a likely rebound in check.

U.S. Earnings season begins with a bang – Four of the largest banks including JPMorgan, Goldman Sachs, Citi and Wells Fargo reported above expectation results on Wednesday, adding to

the day's market cheer. Conference calls noted optimism about the potential for lighter regulation and enhanced deal making capabilities moving into and through 2025.

Next Week

U.S. markets are closed on Monday in celebration of the Martin Luther King Jr. holiday. We suspect the day will prove anything but dull with incoming President Trump's inauguration also scheduled for that day. A raft of legislation and executive orders are likely to be issued early in the term. As we mentioned last week: "Buckle Up!" (Weekly Strategy Perspectives - Week ending 01-10-2025 - BMO Wealth Management). On the fundamental front, earnings will continue to ramp with more banks reporting, as well as key health care and consumer goods titans.

- **Monday 1/20** – U.S. Markets are closed for MLK Holiday and inauguration day | Canada BofC Business Outlook Survey and Survey of Consumer Health
- **Tuesday 1/21** – U.S. Long term bond auctions | Canada CPI
- **Wednesday 1/22** – U.S. Index of Leading Indicators | Canada Industrial Production and raw materials prices
- **Thursday 1/23** – U.S. Initial Jobless Claims | Canada Retail Sales for November
- **Friday 1/24** – U.S. Global Purchasing Manager Indexes

Data scorecard as of January 15, 2025

Equity Market Total Returns						
	1/15/2025 Level	WTD	YTD	2024	2023	2022
S&P 500	5,950	2.1%	1.2%	25.0%	26.3%	-18.1%
NASDAQ	19,511	1.8%	1.1%	29.6%	44.7%	-32.5%
DOW	43,222	3.1%	1.6%	15.0%	16.2%	-6.9%
Russell 2000	2,263	3.4%	1.5%	11.5%	16.9%	-20.5%
S&P/TSX	24,789	0.1%	0.3%	21.7%	11.8%	-5.8%
MSCI EAFE	8,090	0.8%	0.1%	3.8%	18.2%	-14.5%
MSCI EM	564	-0.1%	-1.7%	7.5%	9.8%	-20.1%
Bond Market Total Returns						
		WTD	YTD	2024	2023	2022
Bloomberg U.S. Treasury		0.7%	-0.2%	0.6%	4.1%	-12.5%
Bloomberg U.S. Aggregate		0.8%	-0.2%	1.3%	5.5%	-13.0%
Bloomberg Canada Aggregate		0.8%	-1.1%	-4.6%	9.5%	-17.3%
Bloomberg U.S. Corporate		0.8%	-0.3%	2.1%	8.5%	-15.8%
Bloomberg U.S. High Yield		0.5%	0.6%	8.2%	13.4%	-11.2%
Bloomberg 1-10 Year Munis		-0.1%	-0.2%	0.9%	4.5%	-4.7%
Government Bond Yields						
	2025-01-15	Last Month End	Last Quarter End	2024	2023	2022
U.S. 10-Year Treasury	4.65%	4.57%	4.57%	4.57%	3.88%	3.88%
Canada 10-Year Government	3.42%	3.23%	3.23%	3.23%	3.11%	3.30%
U.K. 10-Year Gilt	4.73%	4.56%	4.56%	4.56%	3.53%	3.66%
German 10-Year Bund	2.56%	2.36%	2.36%	2.36%	2.02%	2.57%
Japan 10-Year Government	1.25%	1.09%	1.09%	1.09%	0.61%	0.41%
Currencies & Real Assets						
	1/15/2025 Level	WTD	YTD	2024	2023	2022
USD Index	109.09	-0.5%	0.6%	7.1%	-2.1%	8.2%
CAD:USD	$0.70	0.6%	0.3%	-7.9%	2.3%	-6.7%
Bitcoin	$99,678.90	5.3%	6.4%	120.5%	157.0%	-64.3%
Gold	$2,696.32	0.2%	2.7%	27.2%	13.1%	-0.3%
Oil (WTI)	$80.04	4.5%	11.6%	0.1%	-10.7%	6.7%

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[i] Inflation rates in the United States of America