

Outlook for Financial Markets

Global backdrop and tactical recommendations

*"A bend in the road is not the end of the road...
unless you fail to make the turn."*

- Helen Keller

Global backdrop and tactical positioning

This month we are introducing several changes to our tactical positioning that fit within the themes outlined in our 2020 Outlook – namely, that the U.S. and global economies remain on solid footing, trade headwinds have eased, the manufacturing slowdown has likely run its course, and interest rates will remain low for the foreseeable future. It's an environment that, despite 2019's strong equity rally, supports continued risk taking.

Our specific tactical recommendations include an upgrade to neutral positioning for International Developed Equity (from underweight), a new overweight to Extended Fixed Income via preferred stocks, as well as a shift within our U.S. Equity overweight to traditional equities from a more specific REIT allocation. From a funding perspective, in addition to any dedicated REIT exposure as a source of funds, we are downgrading cash to neutral and also recommending that any existing overweight to liquid alternatives/hedge funds be reduced to neutral.

The U.S. economy – it keeps going and going

Labor market strength in the U.S. is well known and continues to be a key source of economic stability. Now that the "phase 1" trade deal between the U.S. and China has been signed, we expect a modestly improved environment for business investment. Small business surveys continue to point positively in this regard (*see Exhibit 1*), and the lifting of trade war fog should lead to follow-through with actual business spending.

As to the removal of our dedicated REIT exposure, while the sector had a very strong 2019, this performance was primarily driven by the fall in interest rates (given REITs are an income substitute for many investors), which is unlikely to be repeated in 2020. This year we expect interest rates to remain relatively steady, but note that the Federal Reserve maintains a dovish bias. In particular, Chairman Powell has put forth the high bar requirement of "significant and sustained inflation pressures" being required before he would consider an interest rate increase. This backdrop should continue to support

Executive Summary

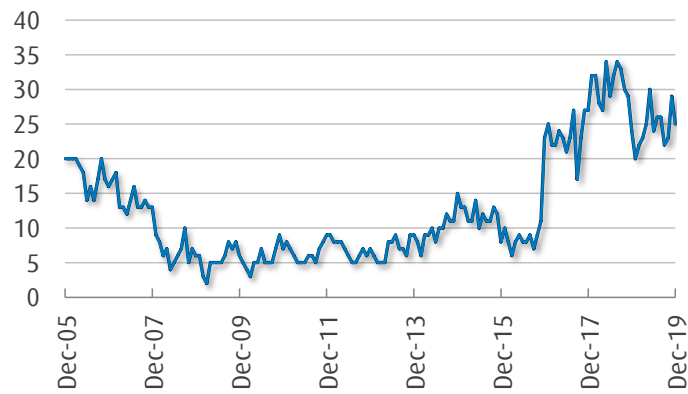
We are introducing several changes to our tactical positioning.

The U.S. and global economic environments still appear favorable to taking equity risk.

Preferred stocks are an attractive hybrid amid steady but restrained economic growth.

Recent events have highlighted that risk can take many forms.

Exhibit 1 » NFIB Small Business “Good Time to Expand?” Index



Source: National Federation of Independent Business

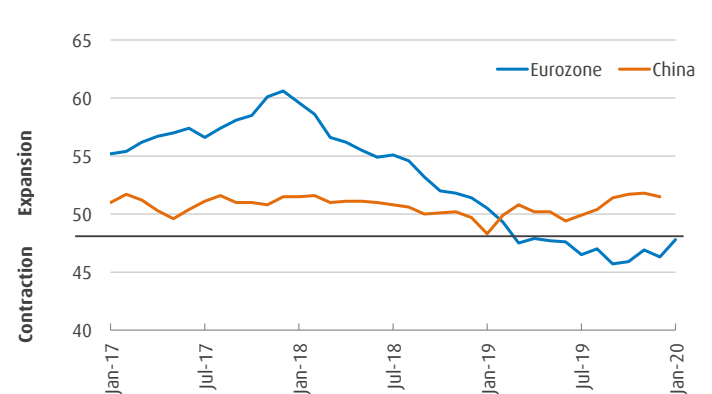
the equity markets in the form of higher multiples, which adds to our rationale for the equity overweight.

Europe looks to be turning

European equity markets trade at a valuation discount to U.S. markets primarily because their economies have considerably lower weighting to technology and greater emphasis on sectors such as industrial, financial, and consumer defensive. And while we are not expecting the valuation gap to close considerably, the European economy has shown early signs of turning the corner.

European purchasing managers’ index (PMI) readings, for example, have stabilized after a dramatic decline from their early 2018 peak, and appear to be reaching a positive inflection point (see Exhibit 2). It is also likely that the global manufacturing sector, and Europe in particular, will benefit from U.S.-China trade war de-escalation. And finally, business sentiment in Europe is showing signs of turning upward after almost two years of declines. Similarly, the recent rise in European bond yields points to the unlikelihood of an economic downward spiral in the region. Of course, the wildcard here would be a more pronounced focus on auto tariffs by the U.S. administration. With the election so close on the horizon, however, we think President Trump is most likely to refrain from measures that may undermine an already shaken business community.

Exhibit 2 » Manufacturing Purchasing Managers’ Index (PMI)



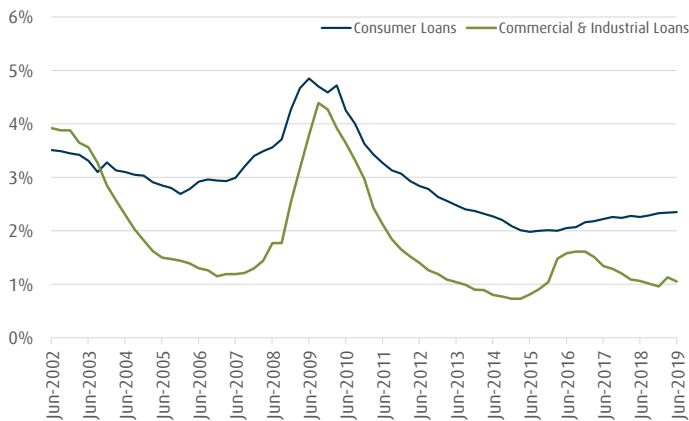
Source: IHS Markit; BMO Wealth Management

Preferred stocks – an attractive hybrid

As hybrid securities, preferred stocks sit between debt and equity in a company’s capital structure, and we consider these securities as part of the Extended Fixed Income asset class. The overwhelming majority of preferred stocks are issued by the financial sector, which we believe is in a very healthy position given post-financial crisis regulation and capital requirements. The low level of loan delinquencies (see Exhibit 3) speaks to the sector’s health.

One positive aspect of preferred stocks is an attractive yield, the majority of which typically constitutes “qualified dividend income” and receives preferential tax treatment. Other qualities include modest volatility and relatively low correlation to other assets in the portfolio, which helps reduce overall risk. In the current economic environment of steady but restrained economic growth, we believe preferred stocks represent a way to pick up extra yield without taking an undue amount of additional risk. As such, we are upgrading to overweight the Extended Fixed Income asset class with a specific recommendation to preferred stocks.

Exhibit 3 » Loan Delinquency Rates



Source: Federal Reserve; BMO Wealth Management

Risks can come in many forms

The recent U.S.-Iran conflict highlights the reality that risks can come in many forms. After trading military strikes, the U.S. and Iran have thus far pulled back from direct military conflict. The U.S. will, however, continue to pressure Iran with sanctions, and future attacks by Iran's proxy forces in the region remain a distinct possibility. From an economic perspective, absent a full-blown war, which neither side looks likely to pursue, the impact is likely to be contained. The speed with which the oil markets shook off both this recent conflict and the September 2019 bombing of major Saudi oil installations – also blamed on Iran – highlights the shifting dynamics in the oil market, not the least of which being that the U.S. now ranks as the world's largest oil-producing country.

Another item at the forefront of "difficult-to-quantify" risks is the Wuhan coronavirus outbreak. It is likely that we are still in the early stages of the outbreak as health officials believe the incubation period is around 14 days¹. So far, the World Health Organization ("WHO") is not deeming the coronavirus a "global health emergency," but has referred to it as "an emergency in

China." On the positive side, China is taking firm action that, as of January 24 includes a quarantine of about 25 million people near where the outbreak is centered, and the cancellation of Lunar New Year festivities in major cities².

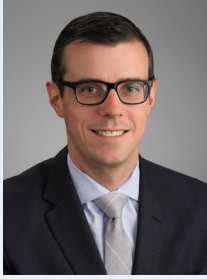
So far, the brunt of the market impact has been felt in commodities and emerging markets. This is similar to what happened in 2002 during the SARS outbreak, where commodities initially fell and then struggled to recover for several months. We believe that the current coronavirus remains difficult to predict at this stage, but are encouraged by the actions and relative transparency that China is taking to combat the outbreak.

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¹<https://www.wsj.com/articles/spreading-chinese-coronavirus-death-toll-rises-as-more-cities-are-locked-down-11579860808>

²https://www.washingtonpost.com/world/coronavirus-china-wuhan-latest/2020/01/23/2dc947a8-3d45-11ea-afe2-090eb37b60b1_story.html



Michael Stritch, CFA®
Chief Investment Officer &
National Head of Investments
BMO Wealth Management – U.S.

As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our

clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments for our Ultra High Net Worth group, and became National Head of Investments in 2015. In January 2018, Michael took over the role of Chief Investment Officer. With close to two decades of experience in money management, Michael has a deep background in economic analysis, portfolio construction and risk management.

Michael earned a BA in economics from Northwestern University and an MBA with distinction in finance and decision sciences from the J.L. Kellogg Graduate School of Management at Northwestern University in Evanston, Illinois. He is a member of the Beta Gamma Sigma International Honor Society, holds a Chartered Financial Analyst designation, and is a member of the CFA Institute, CFA Society of Chicago, and the Chicago Quantitative Alliance. He is also a graduate of the American Bankers Association – National Trust School.



Yung-Yu Ma, Ph.D.
Chief Investment Strategist
BMO Wealth Management – U.S.

As Chief Investment Strategist, Yung-Yu is responsible for performing macroeconomic analysis, valuation modeling and market analysis across asset classes to guide strategic and tactical asset allocations for client portfolios.

Prior to joining BMO Wealth Management, Yung-Yu was a finance professor at Lehigh University, where he taught courses in fixed income, equities and derivatives. His academic studies have been cited in the *Wall Street Journal*, in leading finance journals, top law journals, the *Handbook of High Frequency Trading*, and in *Oxford Handbook of Corporate Governance*. During his tenure at Lehigh, he was awarded the Staub Outstanding Teacher Award, awarded to one faculty member by a vote of faculty and students. Prior to his academic career, Yung-Yu worked for a global consulting firm performing financial and market analysis for global companies with operations in Hong Kong, Taiwan and Mainland China. Later, he oversaw the operations at a Fortune 500 subsidiary in Taipei and Mainland China.

Dr. Ma earned his Ph.D. in Finance at the University of Utah and his B.A. in Economics and Political Science, *magna cum laude*, at Williams College.

Yung-Yu lives in Portland, Oregon with his wife and two children. He is a basketball fan and enjoys cheering on his children's teams.



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