Keeping an eye on your investments

Many of the themes we have been focusing on took centre stage in the first quarter of 2015. The divergence of economies, driven by varying central banking policies, has been a major factor for global economic growth. Persistently lower inflation has also become increasingly relevant. And with oil prices remaining in the sub-$55 per barrel range as we forecasted, we continue to maintain that any risks to inflation are to the downside.

In terms of economic performance, it has been encouraging to see the European Central Bank (ECB) move forward with its Quantitative Easing (QE) program. This will benefit companies in the Eurozone and help close the performance gap with the U.S. Similar stimulus initiatives in Q1 from Japan and China helped to provide liquidity to markets. In turn, global investors can take some comfort that the divergence between U.S. and global economies is starting to slowly diminish, which equates to a positive back-drop for global equity returns.

Lower inflation remains pervasive and has only been exacerbated by lower oil prices. West Texas Intermediate (WTI) prices are down more than 50% over the last 8 months and energy markets remain volatile. This has resulted in headline inflation, which includes food and energy components, reporting as negative on a year-over-year basis. Lower oil in the U.S. was expected to boost economic activity as consumers use the money saved on gasoline to spend on other goods and services. However this has not been the case as retail sales have been weak while the savings rate has risen to 5.5%.

Over the first 3 months of 2015, the U.S. economy has delivered mixed economic performance. Even though many indicators have weakened, the all-important jobs market continues to remain robust (as we predicted). These varying factors have prompted the U.S. Federal Reserve (the Fed) to not remove the extraordinarily accommodative monetary policy regime currently in place. A similarly dovish stance was taken by the Bank of Canada when Governor Stephen Poloz stunned markets with a 0.25% interest rate cut, citing the negative implications of lower oil prices as the rationale for a change in policy stance.

At the beginning of 2015 we identified the themes of divergence, lower inflation and lower oil as important to the outlook for the year. While we continue to focus on these factors, we will be keeping an eye on two additional factors. We plan to closely monitor the strength of the U.S. dollar and what implications its rapid ascent will have on global economies. Secondly, we will also examine the Eurozone's reaction to the ECB's QE program and pay close attention to the value of the Euro.

The first quarter of 2015 saw severe foreign exchange volatility emerge as a big issue for the global economy. Despite the Fed's dovish stance, the U.S. dollar firmed against virtually all other currencies. Future relative economic prospects and monetary policy clearly favour the U.S. This can be witnessed by both the Yen and Euro's recent slide in value versus the U.S. dollar. A stronger U.S. dollar is good news for U.S. importers who can purchase goods from other countries with a stronger currency.

Keeping this in mind, we expect the U.S. economy to maintain momentum through 2015. The consumer and business sectors are in relatively good condition and this should usher in a period of more normal U.S. economic momentum with real gross domestic product (GDP) growth in excess of 2.5% for the first time in five years.

Outside the U.S. we expect a modest acceleration in the Eurozone and Japan, while China should decelerate slightly. Similar to the U.S., the Eurozone is expected to benefit from its QE program as well as from lower oil prices. Another point in favor of the Eurozone is a lower Euro, which benefits their export sector since it makes goods become relatively cheaper. As mentioned earlier, we anticipate that global economic growth will converge somewhat, and Europe will contribute to this.

Lower oil prices are expected to persist perhaps through the end of 2015, with a wide range of implications for the global economy. We foresee a reduction in supply as inevitable; however this is proving to be elusive as production levels have actually risen over the past 6 months. We will eventually approach a market clearing price of $65-80 per barrel, but it may take 12-18 months to get there.

Overall, what's crucial for us is keeping an eye on whether a strong U.S. dollar (relative to most other major currencies) is causing disruption to either economic growth or corporate earnings within America. We will also note the effect it has on the global economy, with close attention to the Eurozone. We will also be assessing whether the ECB's QE program is having success in stimulating the economy.

At BMO, we express our views through the following five "lenses", which we believe are the key decisions that our portfolio managers should focus on to ensure strong portfolio returns:

Lens 1

Equities versus bonds

Overweight equities over bonds – with high confidence we can predict that bond returns will be weak, in both absolute and real terms, for the year ahead. While we see more modest equity returns going forward, we see relative outperformance versus bonds as highly likely for the balance of 2015.

Lens 2

Within equities

Developed markets versus emerging markets

Neutral. While opportunities exist in select emerging market countries (i.e. India), prospects for the emerging markets as a whole are less favourable (i.e. Russia and Brazil).

Lens 3

Within developed markets equities

US versus Canadian and non-N.A. equities

Overweight both U.S. and non-North American equities while modestly underweighting Canadian equities. The acceleration of economic and corporate earnings growth prospects is most compelling in the U.S., Eurozone and Japan.

Lens 4

Within bonds

Core Canadian bonds versus US high yield, global and emerging markets bonds

Neutral. We have no strong bias at this time.

Lens 5

USD versus the CAD, Euro and Yen

Overweight the USD versus all other currencies because both relative economic prospects and relative monetary policy favour the U.S. dollar.

Paul Taylor, CFA, MBA
Senior Vice-President
and Chief Investment Officer, Asset Allocation
BMO Global Asset Management