OUTLOOK 2016

BMO Global Asset Management (Canada)

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Outlook 2016

We want to take this opportunity to provide our capital markets outlook for the calendar year 2016. Our asset allocation process is chaired by Paul Taylor, Chief Investment Officer, Asset Allocation, and includes the expertise of a team of seasoned investment professionals focused on creating long-term value for our clients.

A brief reflection on 2015

Hopes for a US economic rebound were dashed right out of the gate in the first few months of the year when record cold weather in the Northeast stalled GDP growth and pushed Fed rate intervention further out. By early summer, evidence emerged that consumer activity was on a firm upswing as both housing and auto-related indicators were markedly stronger and top-line economic growth was relatively robust. It appeared that conditions were solid enough for the Fed to begin raising interest rates at September's Federal Open Market Committee (FOMC) meeting. Then fears of a sharp slowdown in Chinese economic activity caused a sell-off in global equity markets in August, including the US, and the Fed set its sights on a rate increase later in the year. As stronger economic data re-emerged, both in the US and in China, equity markets rallied and the Fed began the process of interest rate normalization.

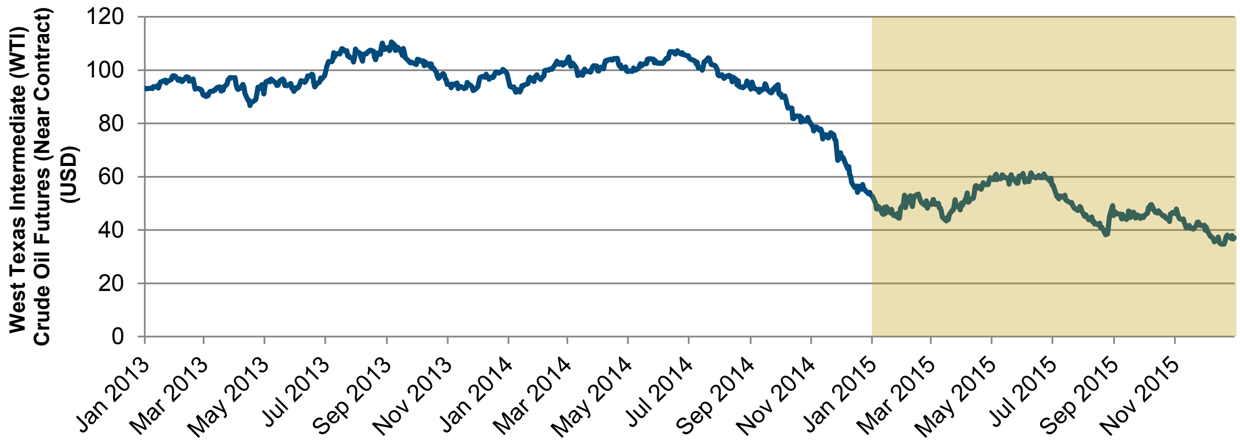
Here in Canada, 2015 was an *annus horribilis*, both for Canadian equities and the Canadian dollar. The Canadian equity market, as represented by the S&P/TSX Composite Index, was one of the worst performing equity markets globally, down 8.3%, and significantly behind the returns of the S&P 500 and MSCI EAFE Index returns of 21.0% and 18.3% in Canadian dollar terms, respectively. As well, the Canadian dollar registered one of its sharpest single year declines, down 16.2% versus the US dollar. The common denominator for both assets was the plunge in the price of oil. See the highlighted area in Exhibit 1, which shows that the commodity price fell from USD 53.27 to 37.04, demonstrating continued weakness over the period. The price of oil fell as additional supply from the US shale industry was not offset by production cuts from the OPEC producers in a period of only very moderate demand growth.

Widely divergent economic and market performance was experienced within the EAFE complex. A slump in manufacturing output weighed on Eurozone GDP for the first half of the year, while Japan fell back into outright recession. In the U.K., Bank of England Governor Mark Carney was forced to back away from his previous trajectory of rate increases as slowing domestic growth in construction and consumer demand eased core inflation pressures.

The benchmark MSCI EAFE Index was volatile over the year, rising as high as 7% in local currency terms by the end of April, drifting down in choppy spurts throughout the summer, only to fall over 11% from mid-August to the end of September; a result of a global sell-off of equities following the August 10th devaluation of the Chinese yuan. The Index then recouped half of the sharp decline before investor disappointment over the scale of additional monetary policy announced by the ECB in December dragged equities down to finish the year virtually unchanged in local currency terms.

Among the key regional markets within the EAFE Index, the divergence was even more pronounced, with Japan's Nikkei rising 9.1% over the year, the Eurozone's blue chip Euro Stoxx 50 up 8.0%, while London's FTSE 100 Index fell 4.9% (all in local currency terms). Among the four largest Eurozone countries, Italy's FTSE MIB Index rose the most, up by 12.7%, followed by Germany (9.6%), France (8.5%), and Spain, which declined 7.1%, reversing its 2014 leadership among the group. For unhedged Canadian investors, rising foreign exchange rates played a major positive role over the year, boosting returns, as the Euro (7.5%), UK pound (13.0%), and Japanese yen (19.0%) all rose versus the loonie.

Exhibit 1 **Continued Plunge in Oil**



Source: Bloomberg

Outlook for 2016

Back to the Past

In the Robert Zemeckis produced film "Back to the Future", seventeen-year-old Marty McFly was accidentally sent back in time from 1985 to 1955 in a time machine built around the "flux capacitor" technology embedded in a DeLorean sports car. Soon after his arrival in 1955, Marty's mother Lorraine fell in love with him, rather than with his father George McFly, threatening to cause a paradox that would result in Marty's nonexistence. There was, wait for it, a Hollywood happy ending and all was well in the world.

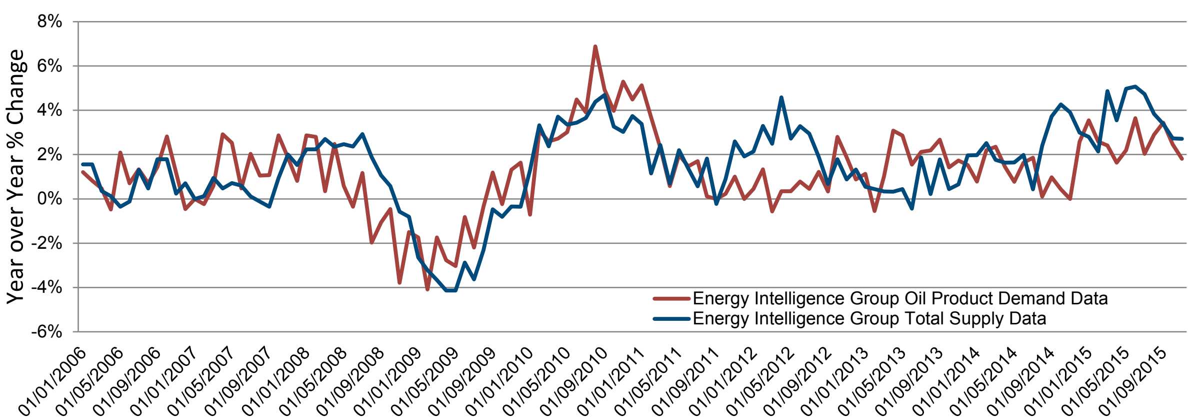
The coming year may very well be a "Back to the Past" period where many of the themes that provided the direction for the global economy and capital markets in 2015 set the direction in 2016. The first theme, economic divergence, will see the US, the UK and the Eurozone deliver stronger performance versus the trend since the onset of the Great Financial Crisis (GFC) in 2008, whereas other commodity-producing regions will struggle. In the US a number of factors support a prolongation of the moderate growth trend of the past few years. Firstly, lower oil prices act as a de facto tax decrease in that it puts more money into the pockets of consumers. Secondly, the recent federal budget agreement brokered in the US Congress is a source of moderate stimulus and fiscal policy that will, for the first time in a number of years, be a tailwind for the US economy. Finally, consumption is likely to benefit from pent-up demand (due to stalled consumption in the years immediately after the GFC), as well as expanded employment and rising wage gains.

The second theme that will persist is the likelihood that the price of oil will remain severely depressed versus its high in mid-2014. As we enter the new year, oil (currently trading at between USD 30-40) trades at a level that is uneconomic for many conventional and non-conventional producers here in North America. As it becomes clear that a sharp price upswing is not imminent, producers will pull back production and the commodity price will firm modestly. It is highly likely that a sharp rise in the commodity price will not occur, as non-conventional producers are nimble and anything beyond a modest uptick in the commodity price will release pressure on production cuts. See Exhibit 2, which shows that on a year-over-year percentage basis oil supply has fallen, but has not fallen as much as demand, leaving an over-supplied environment. Our full 2016 forecast calls for the commodity price to approach a high USD 40 target by year end.

Canada

Our overall outlook for Canada is less bearish than it has been over the past year through this period of unprecedented commodity price weakness. While we expect commodity prices, and the price of oil specifically, to remain weak, we are likely near the bottom. Canadian economic performance and Canadian equity prices are likely set for a period of slightly better absolute and relative returns. Stronger performance than that is unlikely, given the structural headwinds of weak productivity growth and an over-levered consumer balance sheet.

Exhibit 2 **Oil – Supply continues to outpace demand**

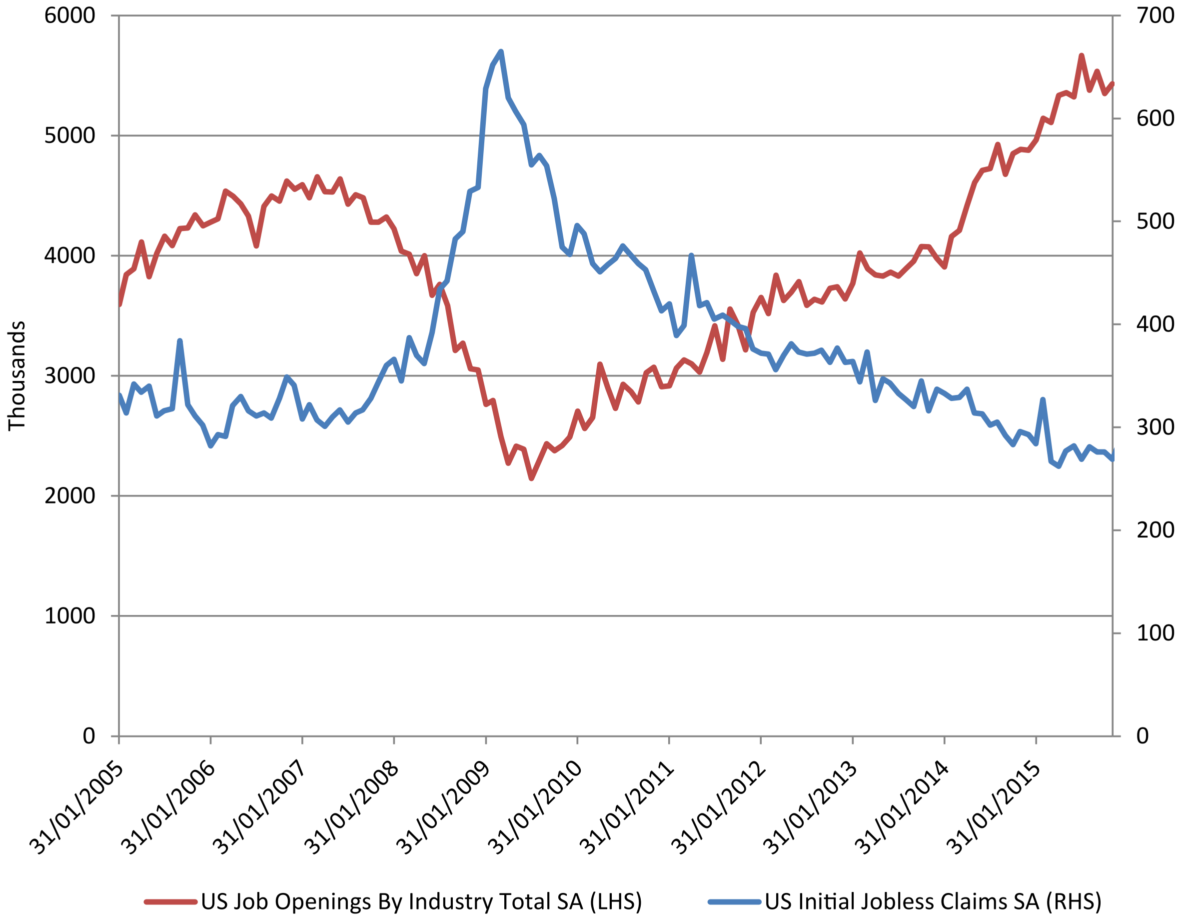


Source: Bloomberg

United States

The strong dollar and rising interest rates are headwinds that will cap the pace of US economic growth in 2016, likely at 2.0 – 2.5%, similar to the trajectory in each of the past two years. Bolstering the economy are two related factors: strong job creation and consumer spending. At the current pace of non-farm payroll job additions, the US is fast approaching full employment, where anyone who seeks a job has a job. See Exhibit 3, which shows that Initial Jobless Claims have fallen steadily since they spiked in 2009, and are now lower than levels prior to the GFC. Additionally, job openings in the US have been growing since the trough in 2009 and are now well above pre-GFC levels. This environment has, and will provide the basis for continued stronger consumer spending, particularly on big ticket items such as houses and cars. In 2016, the US economy will be the engine of growth for the global economy, which has been the case since the GFC.

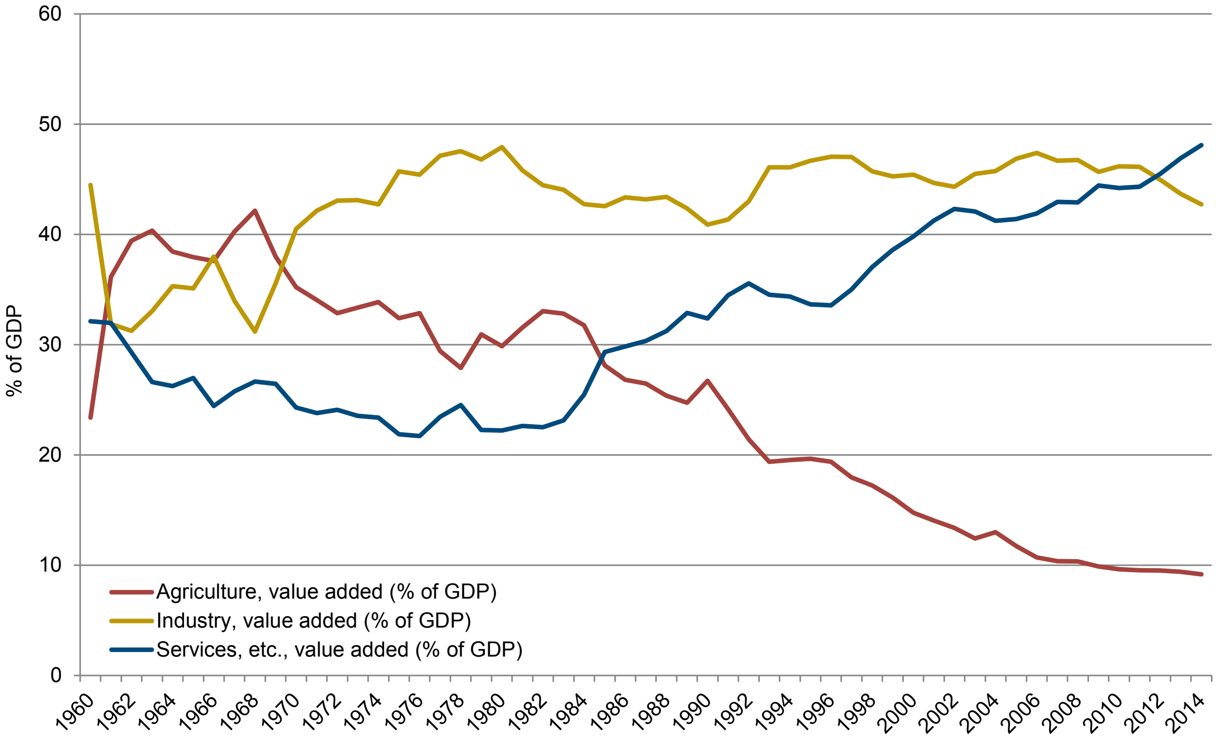
Exhibit 3 **Strong Job Creation**



Source: Bloomberg

International From an economic perspective, a slightly stronger tone should emerge in the Eurozone and Japan where weak oil prices, policy stimulus, soft currencies and pent-up consumer demand will deliver above-trend performance. Key challenges in 2016 include the possibility of a "Brexit", where the United Kingdom exits the Eurozone, and struggles with the massive flow of Syrian refugees. In China, policymakers will struggle to guide the economy and equity markets to a "soft landing". The transition from an export, manufacturing-based orientation to an internal, services-orientation is a slow transition that will take many years to engineer. See Exhibit 4, which shows that over an extended period of time the Chinese economy has become less agriculturally focused, while industry has taken a greater role and the services sector has risen from approximately 20% to nearly 50%, as a percentage of GDP.

Exhibit 4 **China – Slow transition to consumer-led economy**



Source: Capital Economic

Investment Strategy

At BMO Global Asset Management (Canada), we have distilled the broadest investment decisions into the following five “lenses” which, we believe, are the key decisions our portfolio managers must focus on to ensure strong portfolio returns.

Lens 1 – Equities vs Bonds

Modestly overweight equities versus bonds – Upon entering a “normalization” phase for interest rates, bond returns are expected to be weak. As for equity valuations, most major indices trade at “fair value” and not at the discounts available a year or two ago.

Lens 2 – Within Equities, Emerging Markets vs Developed Markets

Neutral – The outlook for emerging market countries differs across regions. Recessionary conditions are likely to persist in Brazil and Russia as both are highly dependent on firmer commodity prices. In China, the outlook rests on the efficacy of policy measures introduced to engineer a “soft landing”. The bright spot is India. There, the reform agenda and positive demographics provide a more favourable economic and capital markets back-drop.

Lens 3 – Within Developed Markets Equities, US vs Canadian vs non-N.A. Equities

Overweight non-North American equities and neutral US and Canadian equities – US equity returns and S&P 500 earnings growth are likely to be positive, but modest. Returns will be meagre as top-line revenue growth stalls and margins are stretched. Canadian equities will firm modestly due to a bottoming and a slight rebounding in oil prices. Non-North America equities are likely to experience stronger earnings growth as their economic expansion (in both the Eurozone and Japan) is beginning to develop some modest momentum.

Lens 4 – Within Bonds, Core Canadian Bonds vs US High Yield, Global and EM Bonds

Overweight investment grade corporate bonds and maintain duration-neutral position – We favour credit strategies (high yield and investment grade corporate bonds with an overweight to investment grade issues) as a yield enhancement strategy. With respect to duration, we favour a neutral position relative to an appropriate benchmark based on the expectation that bond yields will remain range bound over the forecast period.

Lens 5 – Currency, USD versus CAD, Euro and Yen

Overweight the USD versus other major currencies in the near-term, followed by a reversal strategy as we near mid-year – Relative monetary policy favours the USD in the near-term as the US Fed moves interest rates higher in the first half of the year. In the second half of the year, economic growth and monetary policy should be more balanced across regions and the USD ascent should stall and reverse slightly.

We thank you – our clients, partners and prospects for your continued support!

BMO Global Asset Management

For more information about our line-up of Equity, Fixed Income, Currency and ETF solutions, please contact:

Marija Finney

Senior Vice President, Head of Institutional Sales & Service

Tel: (416) 359-5003 marija.finney@bmo.com