OUTLOOK 2015/2016

BMO Global Asset Management (Canada)

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We want to take this opportunity to provide our capital markets outlook for the twelve months following Q2 2015 and our recommended asset allocation positioning. Our asset allocation process is Chaired by Paul Taylor, Chief Investment Officer of 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

During the first half of 2015 US equities were volatile, falling in the first weeks of January and then rising in February. By June, concerns over imminent Greek default risk drove them back down again by 6%. A negative first quarter gross domestic product (GDP) print was mostly attributed to cold weather, and shortly forgotten as reveries in residential housing starts, retail spending, and continued strong job creation pushed expectations for Q2 GDP back over 3% (annualized). With this renewed momentum consensus estimates for the US Federal Reserve's (the Fed) first interest rate increases moved back to September, despite continued lower energy prices and modest wage inflation.

Canadian equities, as represented by the S&P/TSX Composite Index, were up very slightly in the first half of the year, up just 0.9%. The Canadian economy continues to show the wear and tear of the faltering Energy and Mining sectors as GDP contracted 0.1% in April, for the fourth consecutive month of negative growth thus far in 2015. Canada underperformed most other major indices as the Canadian dollar slid lower versus the USD. The slide of the loonie began when the Bank of Canada shocked markets with an unexpected interest rate ease in January – the easing was intended to off-set the dulling effect of low oil prices. None of the "big three" sectors were up meaningfully in the first half of the year, not a surprise given that they each have some degree of correlation to the economic cycle. The most notable contribution was Valeant Pharmaceuticals with a 66.7% year-to-date return and a large weight increase in the Canadian equity market (about 4.8% of the S&P/TSX Composite Index).

As for European equities, they were almost singularly influenced by the dramatics of Greece's debt negotiations. European equities gave back more than half of their peak gains over the six months by the middle of June until rebounding on news of positive progress in negotiations, only to end in yet another stalemate with the announcement of Greece's July 5th referendum which ultimately would reject creditors' demands. Fortunately for Canadian investors, the Euro strengthened versus the loonie by 2.4%, alleviating some of the damage.

Trading in Asian equity markets was also volatile, particularly so in China where the Shanghai and other indices shot up very sharply in the first quarter and then corrected at the end of the second quarter. Retail investors pushed valuations to very expensive (and seemingly unsupportable) levels, aided by actions by policymakers to make credit readily available to avoid a "hard landing" of the stock market. Policymakers suspended new-IPOs, prohibited selling by company insiders, and forced broker-dealers to buy stocks all in an attempt to limit the downside. The concern was that a large equity market correction could result in weaker economic growth and social unrest. In Japan, continued corporate governance reforms, a reallocation of the government Pension Investment Fund assets from bonds to equities, and the tailwinds from low oil and a low yen spurred the local equity markets higher. India, the other large player in Asia, registered better economic growth and is now likely growing at a faster pace than China.

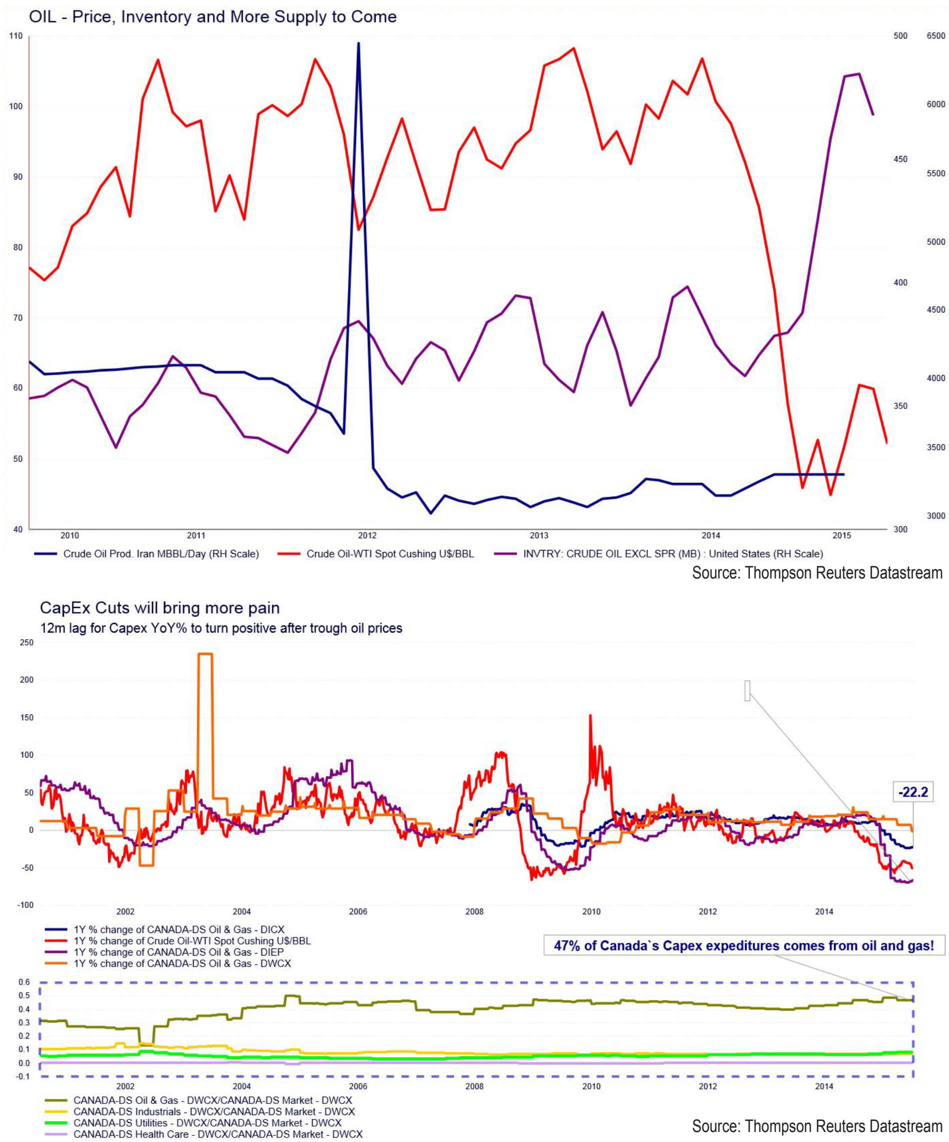
Our key themes of low oil, low inflation and economic divergence persist, but market focus has evolved somewhat. Certainly oil prices are likely to remain meaningfully below the levels of a year ago, but a firming appears to be emerging at or near the current pricing level as the supply/demand equation is more equally balanced. Inflation remains subdued but the beginning of interest rate "normalization" in the US is likely only months away. Finally, economic divergence has given way to slightly better economic prospects across most major regions.

Outlook for 2016

Our outlook for the balance of the year centres on the following three updated themes: persistently low oil pricing; a modest improvement in consumer, business and investor sentiment; and central bank actions and reactions.

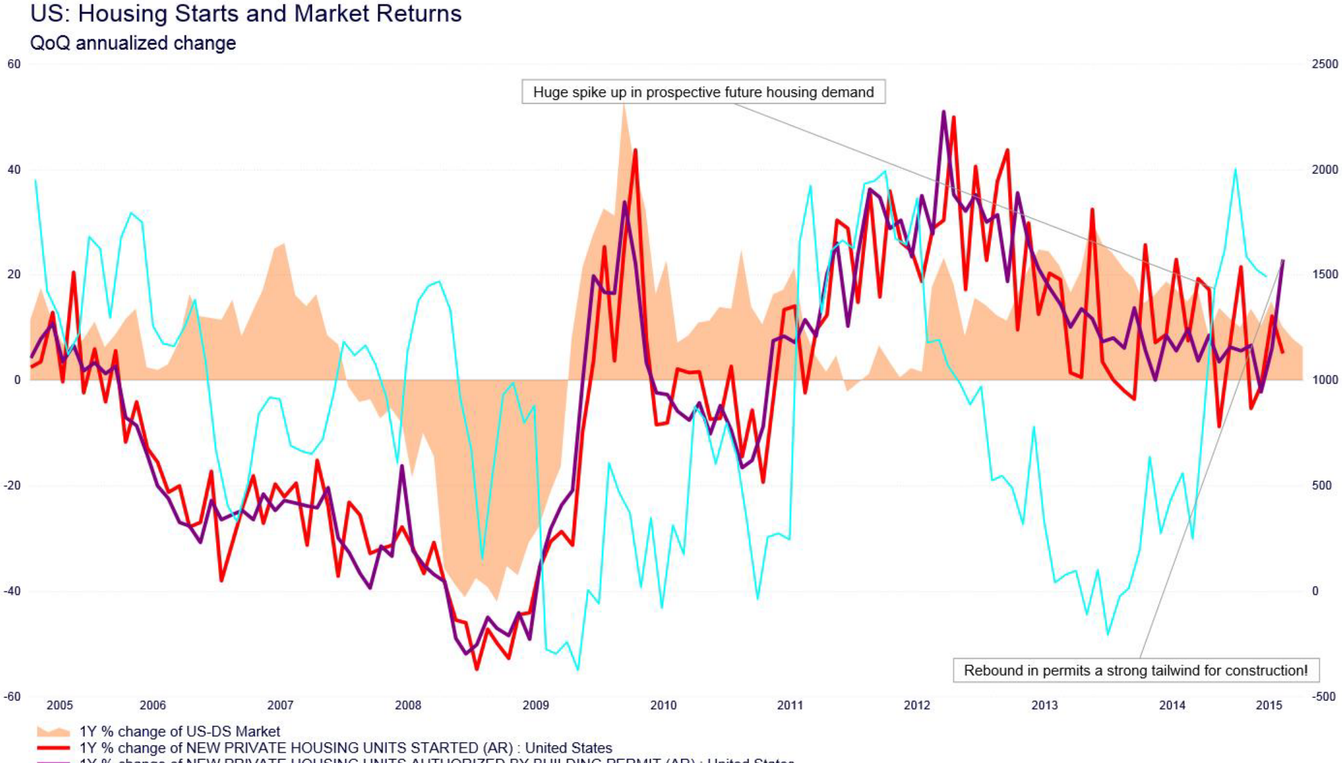
First, no longer is oil the guaranteed wealth creating liquid asset that it once was. While we have seen some behavioural change on the part of producers with meaningful cut-backs in capital expenditures and production here in North America, the market remains well supplied with inventories significantly higher than their prior peaks. See Exhibit 1 which indicates that inventories are elevated even prior to additional Iranian oil hitting the market. As a result, and without clear visibility on sharply stronger demand levels, oil is likely to remain range bound within about $55 - $65 per barrel. This should spur economic activity in economies that are net oil importers (the Eurozone, Japan and the US) and suppress headline inflation. In contrast, net exporters and oil-focused economies should see limited GDP and earnings growth (i.e. Canada, Russia and Saudi Arabia).

Exhibit 1 **Oil: More Supply to Come**



Next, modest improvement in consumer, business and investor sentiment across most major developed markets, in particular the US, could be on the cusp of entering the self-reinforcing stage. If this emerges, better economic conditions lead to better investment returns and create a wealth effect for consumers. See Exhibit 2 which points to an increase in household formation as the potential catalyst for stronger housing activity in the US.

Exhibit 2 **The US Housing Market Changes**



Source: Thompson Reuters Datastream, BMO GAM

Lastly, one of our key assumptions is that central banks globally, including the US Fed, will remain extremely accommodative. This is clearly the case in the Eurozone, Japan, China and Canada. Most importantly, we are below the market consensus in terms of our expectations for the Fed to move administered rates up much over the next twelve months. We do expect the process of normalization to begin in the US as monetary policy is inconsistent with the current pace of recovery. We do not, however, expect that the Fed's actions will be the key from which capital markets take their direction over the next twelve months.

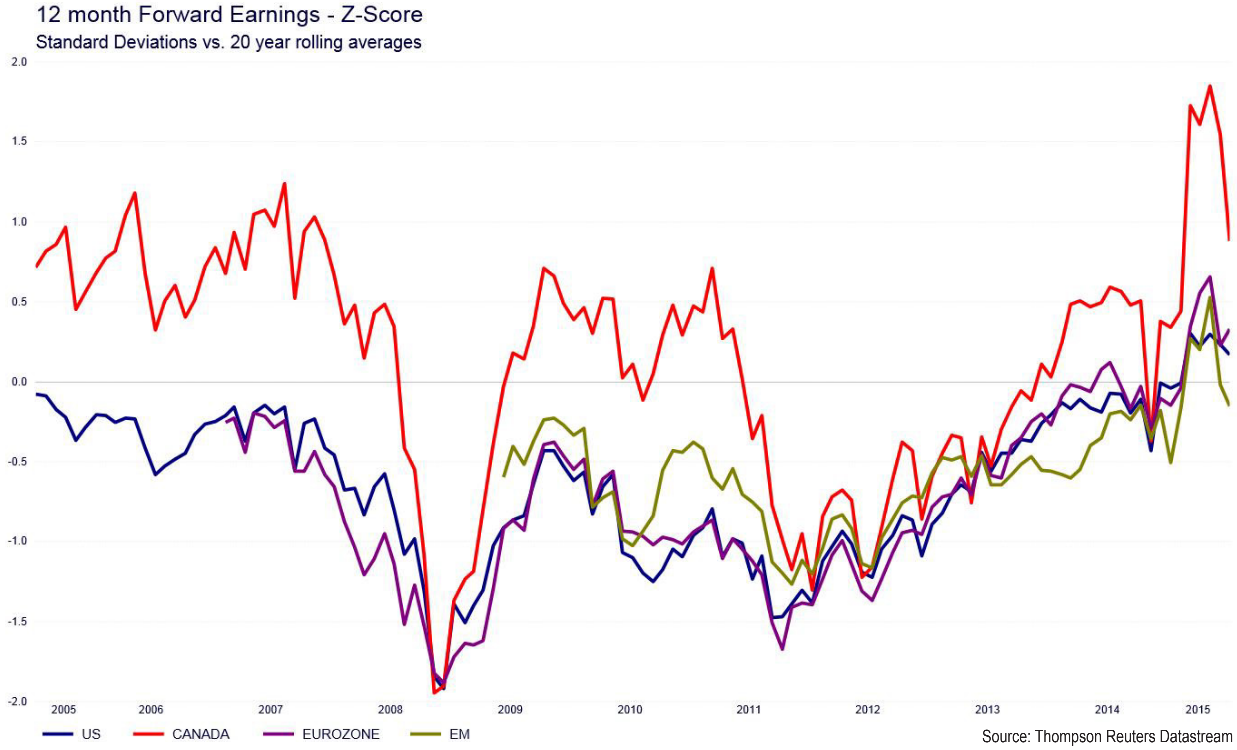
Canada

Canada's continued struggles amid lower oil prices are now bringing the possibility of a return to recession back into view, which may perhaps see another rate cut from the Bank of Canada. Given the anemic ex-energy trade balance that exists, a softening of the loonie to below $0.80 USD for an extended period would be necessary to counteract the loss of oil revenue, capital investment, and job creation that had been fueling the Canadian economy up to last October.

United States

US economic data continues to reassure investors with retail sales, consumer confidence, and home construction all surprising to the upside in June. While valuations are still remaining above average, the potential for additional upgrades of earnings estimates and low inflation pressures would seem to indicate that any volatility should be seen as a buying opportunity as opposed to a reversal of the US bull market. See Exhibit 3 which points out that equity valuation multiples, including in the US, are not stretched relative to their own history.

Exhibit 3 **Valuations Are Not Extreme by Historical Standards**

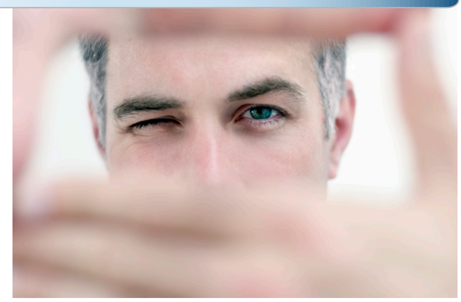


Source: Thompson Reuters Datastream

International

In Europe, while the political impact is significantly higher, the economic impact of a "Grexit" is far lower than markets seem to realize with the majority of Greece's outstanding public debt having already been absorbed into public institutions, and direct economic ties limited to specific industries, companies, and a handful of very small peripheral European countries. With consumer confidence and disposable income rising, both margin expansion and top line revenues stand to keep rising, stoked by the European Central Bank's (ECB) commitment to quantitative easing for the next nine months or more, as needed. Japanese equities offer perhaps the most upside with the weakening yen and an increased focus on shareholder-friendly cash practices.

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 are focusing on to ensure strong portfolio returns.

Lens 1 – Equities vs Bonds

Overweight equities over bonds – We remain confident that bond returns will be weak, both in absolute and in real terms as we enter into an interest rate “normalization” phase. Equity returns may well be more modest going forward albeit with greater variability as we move into a more mature phase post-GFC (Great Financial Crisis) as valuations are no longer cheap. On balance, equities represent better value than bonds.

Lens 2 – Within Equities, Emerging Markets vs Developed Markets

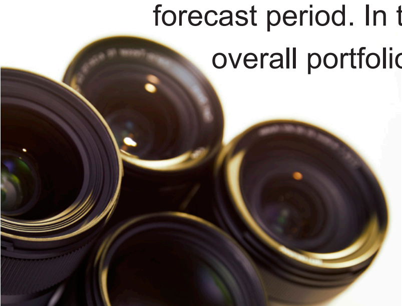
Neutral – Interest rate normalization will be troublesome for emerging markets (EM) with higher US interest rates siphoning capital to US Treasury bonds and thereby causing EM countries to move domestic rates higher to diminish a flight of capital. This process, which occurred during the “Taper Tantrum” period, will have a dulling effect on economic growth within EM countries.

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

Overweight non-North American and US equities, and underweight Canadian equities – The Eurozone and Japan will benefit from the stimulative effect of low oil prices, weak currencies and accommodative monetary policy. The US will maintain and build momentum based on continued robust employment gains while Canada will struggle in the face of weak commodity prices.

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

We favour credit strategies (high yield and investment grade corporate bonds) as a yield enhancement strategy. With respect to duration, we favour a neutral position relative to the appropriate benchmark based on the expectation that bond yields will remain range bound over the forecast period. In terms of credit, we are overweight investment grade issues in order to enhance overall portfolio yield.



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

Overweight the USD versus other major currencies – Relative economic prospects and monetary policy is tilted in favour of a stronger US dollar over the remainder of the year.

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:

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