Global Investment Forum 2015 — 2020

Secular Outlook

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Shifting gears

BMO Global Asset Management is pleased to present our 2015-2020 Global Investment Forum Secular Outlook. This secular outlook is a product of our annual global investment forum: a full day and evening of sharing, collaboration and debate among our organization's investment leaders and strategists from around the world, in addition to select outside experts. This year we welcomed as forum participants our newest colleagues from F&C Investments in London who joined the BMO Global Asset Management family in May 2014.

This secular (longer-term) outlook informs our strategic portfolio allocations and establishes guidelines for active asset allocation opportunities that may arise from our ongoing tactical strategy work.

In last year's inaugural Secular Outlook we described three different paths the global economy and markets might travel over the next five years. We sketched scenarios, including implications for investors, and assigned a probability of each occurring. This framework, which proved effective for our clients' understanding and decision-making, was used again in this year's publication.

As a testament to both the longer-term nature of our outlook and short period of time that has passed since establishing our set of initial views, the core of last year's scenarios remain quite relevant today, albeit with a few select developments.

Some of these changes are seen as modifiers to last year's scenario titles. "Shifting Gears" is a modestly positive change to our central scenario of "The West Rides Again" yet not enough to raise its probability from last year's 60%. On the bookends of this scenario we've trimmed back the probability of an upside scenario, "Synchronized Growth," from 30% to 25% believing it will be more difficult to achieve and require "Threading the Needle" through increasingly challenging global policy and geopolitical issues. And the "Broken China/Eurozone" downside scenario is slightly more likely to occur, up from 10% to 15%, as conditions in both China and the Eurozone remain challenged. Our outlook scenarios and probabilities are:

1. The West Rides Again — Shifting Gears (60%)
2. Synchronized Growth — Threading the Needle (25%)
3. Broken China/Eurozone — Bend But Do Not Break (15%)

As we now have one year under our belt with our secular outlook, we added a short narrative in the following Scorecard to highlight how our positioning worked out, to date.

BMO Global Asset Management

Scorecard

Obviously with a three- to five-year time horizon, it is premature to assign success or failure. However, we felt a brief review/update on the key themes to be worthwhile. As time passes, a more comprehensive evaluation of our viewpoints will emerge.

Our assumption last year that the U.S. economy would take its first steps back from quantitative easing (QE) without a crisis has been on target. Our recommendation to overweight U.S. stocks and the cyclical sectors in particular was a good call, for the most part. While we had lesser exposures to Europe and emerging markets, both underperformed U.S. equities. We did overestimate the progress the European Union would make, as it has remained on the cusp of recession. The U.K., however, delivered better-than-expected results across multiple economic metrics.

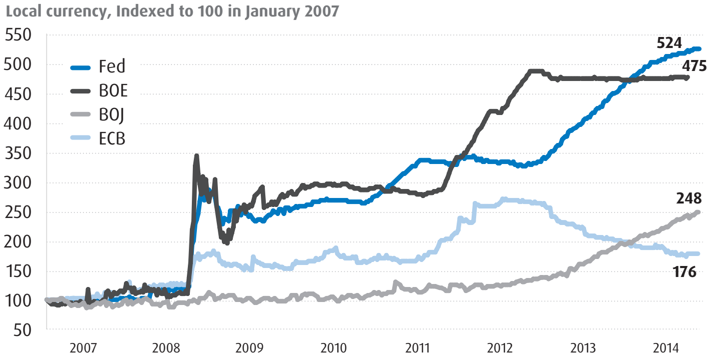
On the fixed income side, our defensive tilt detracted somewhat from our performance, although the barbell strategy we advocated did capture both some credit and duration/maturity rewards.

The West Rides Again — Shifting Gears (60%)

We've added "Shifting Gears" as a tag line this year, as it characterizes a few important developed world countries that seem to be picking up economic speed while conditions in much of Europe remain stagnant.

Over the past six years, central banks in the developed world took monetary steps of monumental proportion to help loosen national and regional economies from the gravitational pull of the Great Recession. During this time, central bank balance sheets multiplied rapidly. The balance sheet of the U.S. Federal Reserve (Fed) and the Bank of England grew four- to fivefold, while the Bank of Japan nearly tripled its balance sheet — including their most recent round of QE in November. Adding to the abundant liquidity across these central banks, the European Central Bank (ECB) is about to initiate a QE program that could double their balance sheet.

Liquidity remains ample: assets on central bank balance sheets



Sources: U.S. Federal Reserve, Bloomberg L.P., Strategas Research Partners, BMO Global Asset Management

These and other measures helped move the economic engine from reverse to neutral, or even first gear. Perhaps some notable economies are doing even a bit better (U.S., U.K., Canada). A key attribute of this scenario is that the post Great Recession economic recovery is not synchronized. Visibly improved, though still moderate, growth is evident in the aforementioned countries, while each of the other major world economies (Japan, China, the Eurozone) remain sluggish. However, the global recovery continues to be quite protracted and characterized by:

- low growth
- low inflation
- low yields

The first table below documents this low inflation and low yield environment that is in common across five developed world economies. However, the second table details recent economic (gross domestic product [GDP]) results and projections. Here you can see select countries shifting to a higher rate of growth: U.S., U.K. and Canada.

CPI, Yields, GDP

Widespread low inflation (CPI), low yields (10-year government bond yields)

	U.S.	Canada	U.K.	EU	Germany	France
CPI (y/y%)						
September 30, 2014	1.7	2.0	1.2	0.8	0.8	0.5
December 31, 2014e	2.0	2.2	1.5	0.7	1.0	0.7
December 31, 2015e	2.1	2.0	2.0	1.0	1.7	1.1
Yields (%)						
September 30, 2014	2.49	2.14	2.42	—	0.95	1.28
December 31, 2014e	2.67	2.48	2.78	—	1.06	1.38

Economic growth (GDP)

	U.S.	Canada	U.K.	EU	Germany	France
Economic growth (%)[1]	Better GDP			Lower GDP		
December 31, 2013	3.5	2.9	2.6	1.5	1.8	0.8
June 30, 2014	4.6	3.6	3.2	1.0	-0.3	-0.4
September 30, 2014	3.9	2.5	3.0	1.2	0.3	1.1
December 31, 2014e	2.2	2.3	3.0	0.8	1.4	0.4
December 31, 2015e	3.0	2.5	2.6	1.2	1.4	0.9

[1] Q1 skipped due to polar vortex; GDP annualized quarter-over-quarter through Sept. 30, 2014; Dec. 2014 and Dec. 2015 estimates are year-over-year

Sources: Bloomberg L.P., ECB, Eurostat, United Kingdom Office for National Statistics, BMO Global Asset Management

Additional granular evidence of this shift by some countries and not for others shows up in the surveys of manufacturing and service activity. When these surveys run above a reading of 50, they suggest expansion and below 50, a cause for concern.

Manufacturing and service surveys: the better results and trends belong to the U.S., U.K. and Canada

Better readings and trends		Q4'13	Q1'14	Q2'14	Q3'14
U.S.	Mfg	55.0	55.5	57.3	57.5
	Svcs	55.7	55.3	61.0	58.9
U.K.	Mfg	57.1	55.5	56.7	51.5
	Svcs	58.8	57.6	57.7	58.7
Canada	Mfg	53.5	53.3	53.5	53.5
	Svcs[2]	64.9	64.8	64.0	66.2

More worrisome readings and trends		Q4'13	Q1'14	Q2'14	Q3'14
Eurozone	Mfg	52.7	53.0	51.8	50.3
	Svcs	51.0	52.2	52.8	52.4
Germany	Mfg	54.3	53.7	52.0	49.9
	Svcs	53.5	53.0	54.6	55.7
France	Mfg	47.0	52.1	48.2	48.8
	Svcs	47.8	51.5	48.2	48.4

[2] Average of Canada Business Barometer Index components.
Sources: Bloomberg L.P., Markit, Royal Bank of Canada, HSBC, Strategas Research Partners, BMO Global Asset Management

On top of better GDP growth and the faster pace of manufacturing and service activity, the currency markets have noticed it, as well. The euro has weakened significantly relative to the U.S. dollar, and to a lesser extent, the British pound and Canadian dollar. These currency moves are fairly recent (since mid-August) and are certainly not yet a trend. If they persist, however, they could carry significant economic and investment implications. As a side note, Japan's currency has weakened about 12% relative to the U.S. dollar during the same period — triggered by substantial monetary stimulus.

Euro/USD: then vs. now

Sources: Bloomberg L.P., BMO Global Asset Management

It is important in our West Rides Again scenario for the U.S., U.K. and Canada to hold their higher ground, and for Europe to generate at least a modicum of growth and not backslide into recession.

In addition, Japan remains a bit of wild card in the global story. After several rounds of QE, their currency, as mentioned above, has fallen significantly; but recent economic activity has been erratic, and the direction and impact of tax and other fiscal reforms remain unclear.

At the same time, we assume China sustains a growth rate in the 6.5 — 7.5% range. Indicative of its commitment to steady GDP, China recently cut interest rates in an overt effort to support growth. In our pessimistic scenario presented later, we profile the conditions in China and Europe that could trigger far more serious consequences.

One development that could be additive to world economic growth is the recent and dramatic fall in oil prices. At the time of this writing, prices had fallen from over $100 to $65 per barrel. The initial $20 drop was estimated to potentially lift global GDP by 0.25% in one year and 1% in three years.

The fall in oil prices, in general, is good news for oil consumers but bad news for producers.

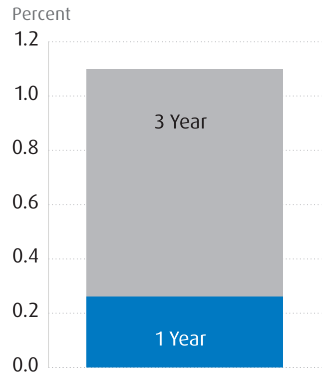
Investment implications

Equities

In this central scenario of low growth, inflation and low yields across much of the developed world but with a few notable exceptions, our position would be to overweight equities relative to fixed income. While we would overweight equities, the path to the success of those opportunities has narrowed, as discussed below.

Coming out of the Great Recession stocks were cheap across the board. By cheap we mean from a valuation perspective, e.g., metrics like prices relative to earnings (P/Es) were depressed. As the recovery gained its footing, surging liquidity helped to push the general equity markets around the globe higher. It was easy to go along for the ride. Now, however, in this backdrop of slow growth, stocks are no longer cheap. Across a number of valuation metrics, including P/E ratios, equities are at or near "fairly priced" levels.

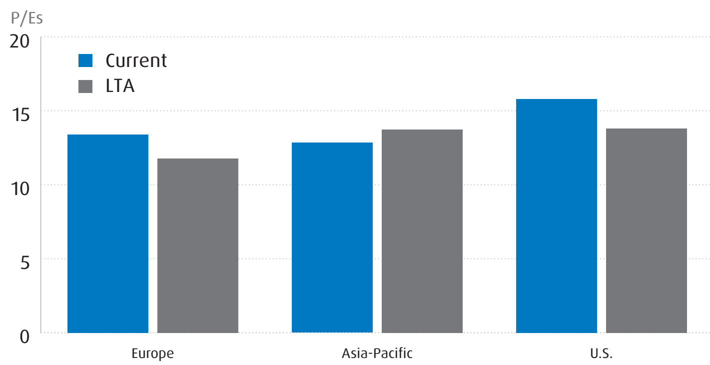
Multi-year impact on world GDP from $20/bbl price decline



Sources: Societe Generale, F&C Investments, BMO Global Asset Management

As you can see in the chart on valuation by region, the United States is slightly more expensive than either the Asia-Pacific region or Europe. But all three regions have not strayed too far from their historical "norms." So cheap valuations are not the same engine they were earlier in the recovery. However, given recent revenue and earnings growth, the opportunity for some limited expansion in P/Es could still be achieved.

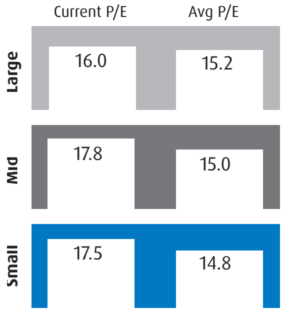
Global P/Es still near the previous cycle's average[3]



[3] 12-month forward P/Es last 10 years, U.S. per S&P 500® Index, data as of 11/12/14

Sources: Pavilion Global Markets (MSCI, IGA data via Datastream), BMO Global Asset Management

Current P/E vs. long-term average*



* Data as of 10/31/14. Data begins in June 1988. Based on Russell-style indices. Earnings are estimated earnings for the next 12 months (NTM).

Sources: FactSet, BMO Global Asset Management

If we dig deeper into just the U.S. story and examine this same P/E metric across large, medium and small companies, we find a similar pattern. The current P/Es for these subgroups sell at valuations at or near their historical levels, too. Again, with the general rise in equity prices, stocks hover near "fair value."

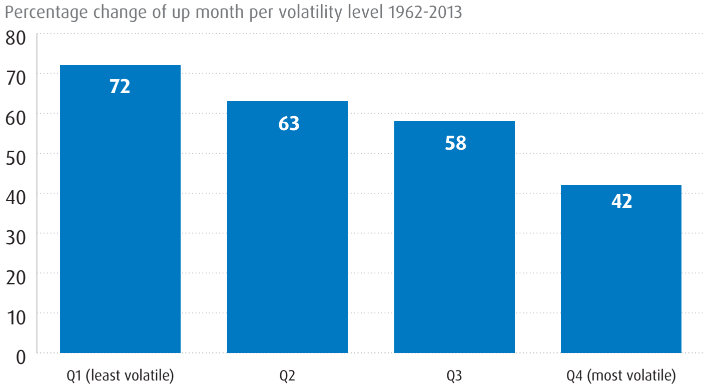
As a result going forward, attractive returns from stocks will be generated less from valuation and general market rise and more from execution. That execution means finding specific securities where companies have a sustainable competitive advantage to generate growth and drive earnings — yet where prices are not outsized relative to the prospects. In other words for equities, stock selection will be critical and generalized systematic risk taking should be less rewarding.

One more macro point on common stocks. We have restated the economic theme of low growth, low yield and low inflation several times. There is one more "low" that is important for stocks: low volatility.

As you can see in the chart, when looking at periods of volatility since 1962, chances for stock gains are typically greater when volatility is lower. As you would expect, lower volatility provides less downside exposure, as well. Low volatility could be a frequent market companion in our West Rides Again scenario. However, there will undoubtedly be spikes in volatility along the way, which could make the ride quite choppy.

S&P 500 Index volatile periods

Percentage change of up month per volatility level 1962-2013



Sources: Crestmont Research, F&C Investments, BMO Global Asset Management

Fixed income

One of the consequences of low yields is the pressure on investors to find other sources to provide the level of income they want or need. The danger here is quite clear: stretching for yield means adding duration/maturity and/or credit risk to the fixed income component. If the pursuit of yield becomes too aggressive the traditional role of bonds as a means to lower risk may be turned on its head. In our primary, go-slow scenario, if economies improve slowly to incrementally higher levels, we would expect rates to also trend higher incrementally. Presently, the consensus view is the Fed would act gradually in raising rates, and only after further evidence of economic progress. Most investors bracket this initial move from between the first and third quarters of 2015. But, again, economic data will be the driver. As a consequence, more defensive, higher-quality fixed income positions are likely to provide greater protection to investors as rates rise.

However, in this scenario rates may rise gradually over the next one to two years, but the percentage rise in short-term rates may be significantly greater than for longer-dated maturities. In that environment, longer maturities/durations could still post positive returns.

Alternative assets

In The West Rides Again, a number of select opportunities reside in the alternative solutions category. In this scenario, hedge funds and long-short equity strategies, where security selection skill makes up a greater portion of total return, would be appropriate. Private equity investments could be selectively attractive, as well. Commodities are under considerable pressure, of course, as they approach multi-year lows, in many cases. If the dollar continues to strengthen, investors may need to consider participation in or protection from currency trends.

The West Rides Again — Shifting gears

	Over emphasize	Under emphasize
Equities		
Developed markets		
U.S.	• All caps but favor large caps • Favor cyclicals: Technology, Finance, Consumer Discretionary, Industrials and select Health Care • U.S. Dollar	• Commidity-related, including select oil and gas and materials producers
Non U.S.	• Countries focused on exports • Countries with pro-growth policies • Stock selection key — companies with competitive edge and attractive valuations (e.g., in U.K., Canada and EU)	• Commodities • Materials • Currencies of commodity-based countries
Emerging and Frontier markets	• Countries with pro-growth direction (e.g., India and Mexico) • Cyclicals, non-commodity based • Companies with strong fundamentals and attractive valuations	• Commodities and materials • Currencies of commodity-based countries
Fixed income		
	• Duration: short of neutral, possible use of barbell • Select high yield (e.g., EU)	• Short-dated treasuries • Yen and euro currencies • Canadian preferred equities
Alternatives		
	• Long/short strategies • Select private equity	• Volatility-based hedge fund strategies

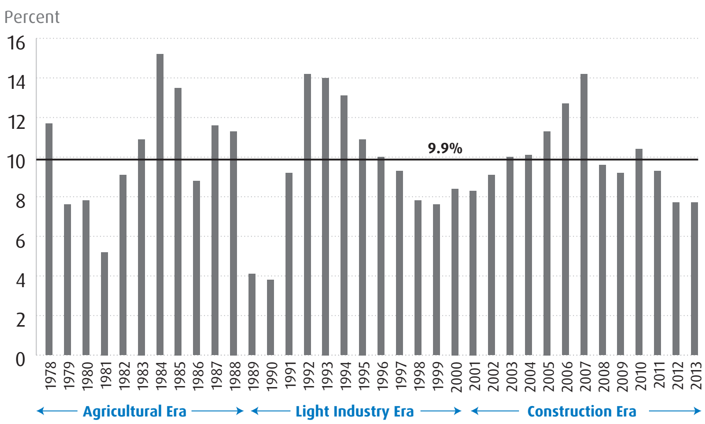
Synchronized Growth — Threading the Needle (25%)

While The West Rides Again is our central thesis, we thought it useful to bookend one side of it with a Synchronized Growth scenario. This offers a view with substantial upside surprises, which could benefit global economies and markets. As desirable as this scenario is, it unfortunately appears less likely than a year ago.

We added the phrase "Threading the Needle" this year to reflect the increased challenge of achieving synchronized growth.

In this profile, China is a key driver and the following developments would likely be a part of this secular uplift: successfully hold GDP growth around 6.5-7.5%, transition the economy from exports and foreign investment-driven to consumer-based, find ways to increase productivity, slow health hazards from pollution and avoid credit crises from housing and shadow banking.

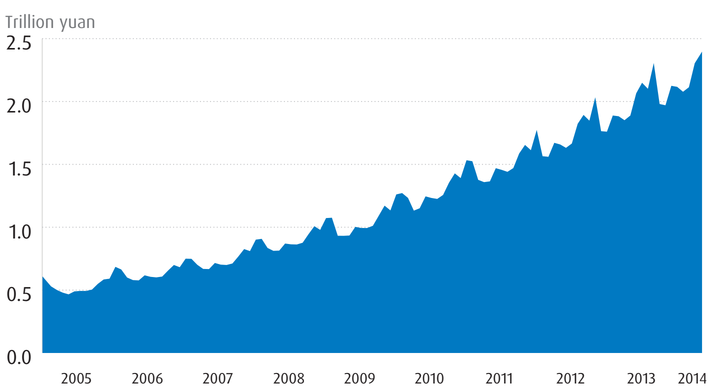
An economy in transition: China's GDP growth



Sources: Bloomberg L.P., CNC Asset Management, BMO Global Asset Management

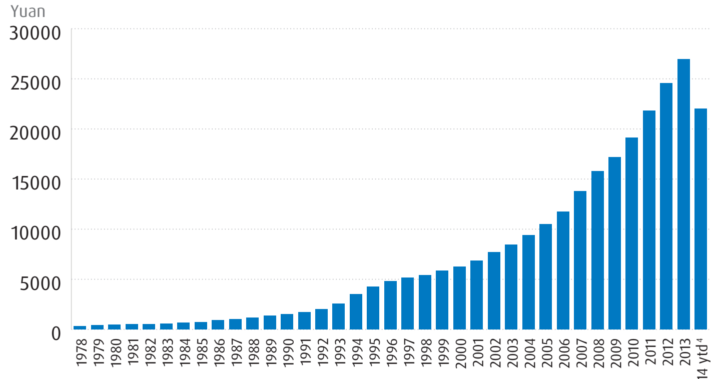
The two charts regarding retail sales and urban wages confirm China's move toward a more consumer-centered economy is underway.

China: monthly retail sales



Sources: Bloomberg L.P., BMO Global Asset Management

China: per capita urban income of urban households



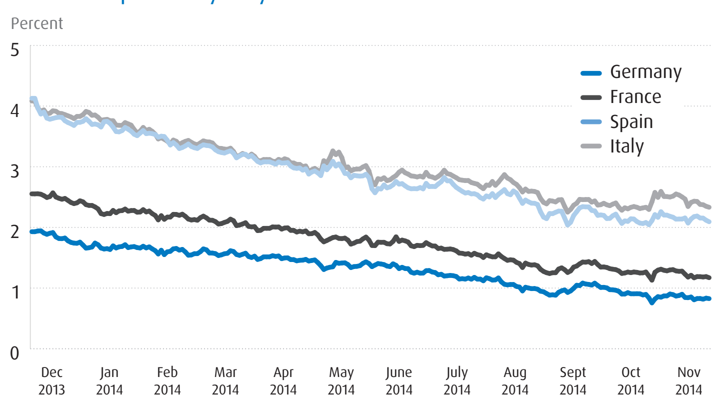
[4] As of 9/30/14
Sources: Bloomberg L.P., BMO Global Asset Management

Progress on several other fronts is showing up, as well. President Xi is pushing reforms regarding land ownership, tighter controls on financial institutions and the necessity to bring down pollution, etc.

Outside China, two important emerging market developments that could contribute to Synchronized Growth include: new leadership in India with a pro-change agenda and the Mexican government starting partial privatization of select state-owned enterprises including Pemex, their national energy company.

Continental Europe may be the biggest leap of faith in the Synchronized Growth picture. There has been progress made in Europe as current account deficits have shrunk, sovereign yields have fallen dramatically and the recent stress tests on ECB-governed banks came out better than expected, etc. In particular, the drop in rates for countries like Spain, Italy et al. has sizably reduced borrowing costs.

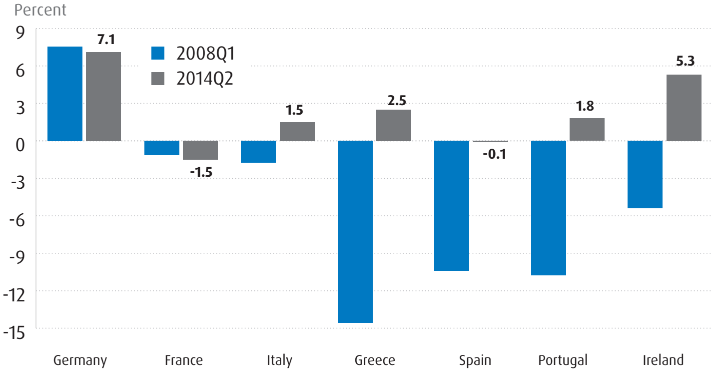
Select European 10-year yields



Sources: Bloomberg L.P., BMO Global Asset Management

One of the other accomplishments in the EU and particularly the periphery countries is the implementation of austerity measures. As you can see, current account deficits have substantially narrowed. However, now it raises the question: is austerity impeding growth?

Current account balance (% of GDP)



Sources: Bloomberg L.P., F&C Investments, BMO Global Asset Management

If that growth can get ignited, it is possible the EU could contribute to Synchronized Growth. Time will tell if Draghi (ECB) at the monetary level, and country leaders, particularly Merkel (Germany), at the fiscal level can pull this off.

Investment implications

Equities

In Synchronized Growth the "risk on" trade takes the lead. Equities would move higher across cyclicals, large, mid and small companies and emerging and frontier markets.

Fixed income

What feeds an equity tailwind in this scenario creates a headwind for most fixed income. Yields would, in general, be rising and defensive posturing would offer some protection. Adjustable rate securities and inflation protection instruments could be useful tools in this scenario.

Alternative assets

Commodities would be well positioned and commodity-rich countries such as Canada and Australia would benefit. Private equity in the alternatives space should also fare well.

In our West Rides Again scenario, we detailed our over- and underweights per asset class and region. For our Synchronized Growth scenario, an abbreviated table focusing on three select over- and underweights is shown below.

Synchronized Growth — Threading the Needle

Over emphasize	Under emphasize
EM/Frontier equities	Dividend paying stocks
High yield	Short-dated bonds
EM debt	Long-dated bonds

Broken China/Eurozone — Bend But Do Not Break (15%)

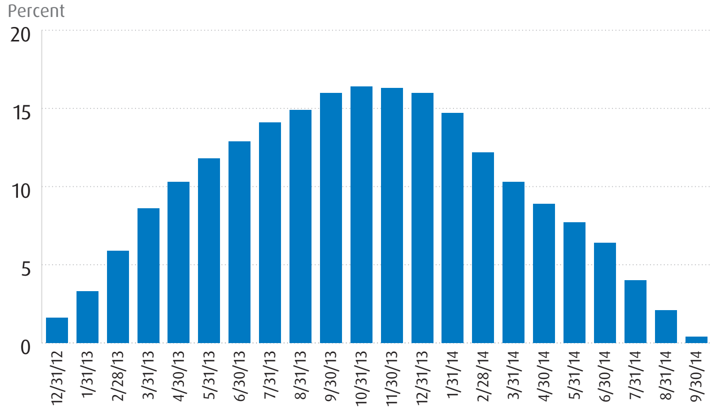
In this downside scenario, things do worsen but we do not see China or Europe break — but they could bend. Still the underlying drivers in this backdrop are troubling. The wrong combination of events in these two major regions of the world could easily undo progress going on elsewhere. As we saw in 2008-09, what starts in one country does not necessarily stay in that country.

The primary and fairly near-term concerns in China center on credit, and these have been brewing for a while: property prices and shadow banking.

Housing prices in Beijing were rising at 16-17% annual rates well into 2013. This same pattern existed in most major cities in China. The government is focused on not letting this concern become a crisis. They have placed restrictions on home ownership and raised down payments, but it remains unclear if they can guide this market to a soft landing.

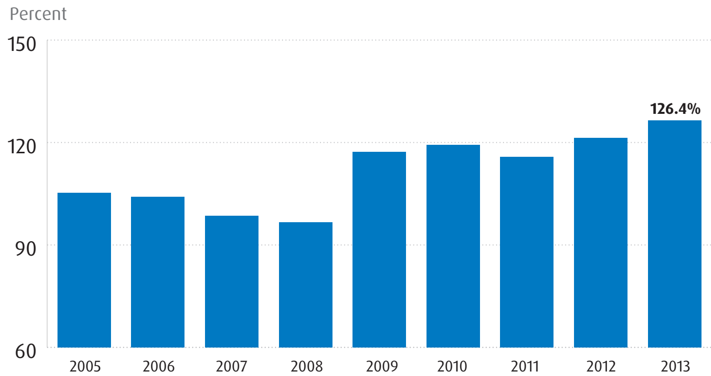
The second issue is their "shadow banking" system, which has grown drastically and now exceeds 100% of GDP. Issues here surround what could be significant defaults and what role the central government might play in the resolution of those.

Beijing prices: newly built residential buildings (y/y%)



Sources: Bloomberg L.P., National Bureau of Statistics, BMO Global Asset Management

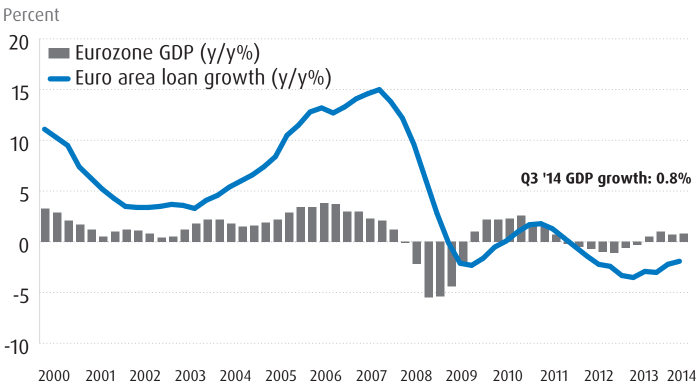
Chinese financial institution loans as % nominal GDP



Sources: Bloomberg L.P., Strategas Research Partners, BMO Global Asset Management

Europe's challenge, as we alluded to in Synchronized Growth, is restarting the economic engine. The complete absence of risk taking is a real threat as the collective psyche remains anxious. As you can see, GDP growth and lending have flat-lined and efforts to date to coax some activity have fallen on deaf ears (of both borrowers and lenders).

Euro area loan growth (y/y%)



Sources: Bloomberg L.P., BMO Global Asset Management

Impact on asset class returns

Equities

Should this scenario play out, and China and Europe each struggle and bend but do not break, it will force investors in those regions to be very targeted and won't be as easy as picking a stronger country and pairing it to its exchange-traded fund (ETF). There will be opportunities in these countries, but they will be security/company specific. So, again, this plays into the theme of the importance of selectivity. Currency protection could be an important consideration in this scenario, as well.

Fixed income

Even with current low yields, rates could decline further and offer opportunities. Inflation protection and variable rate instruments would likely be best avoided.

Alternative assets

Hedged equity and long-short equity strategies could each work, and avoiding commodities would be important. Some currency participation and/or protection could be pursued, as well.

As in our Synchronized Growth scenario, we provide an abbreviated table focusing on three select over- and underweights for Broken China/Eurozone.

Broken China/Eurozone — Bend But Do Not Break

Over emphasize	Under emphasize
Long-dated bonds	Developed & EM equities
Intermediate-dated bonds	High yield
U.S. dollar	Euro currency

At BMO Global Asset Management, we follow a solutions-based, outcome-oriented approach in developing strategies with our clients. We work directly with our clients to establish appropriate investment objectives, and then we access our global toolkit of solutions to find the best fit for both the current circumstances and future scenarios.

We are proud of our worldwide, world-class team of investment professionals, and we have an extraordinarily strong record of success. Our 98% client retention rate and solid growth in assets under our oversight are testaments to both our service and our performance.

Conclusion

Our concluding comments focus on the dominant, central thesis discussed in The West Rides Again — Shifting Gears.

In general, we believe equities should be overweighted in portfolios with a bias toward larger companies and lesser exposure to mid- and small stocks.

Opportunities in developed world markets, and in emerging and frontier markets, will require strong security selection capabilities, as the cheap valuation story has faded.

While low rates may continue for a while, if economic activity in general picks up, yields will likely rise. A fixed income approach that leans towards defensive strategies would be appropriate in that environment. However, if rates rise gradually and mostly in shorter-dated instruments, longer maturities/durations could produce positive returns. Use of a barbell strategy may be relevant in that environment.

Alternative assets of choice in this scenario would include long/short equity strategies, select private equity and perhaps negative duration strategies. Currency participation/protection may be crucial, e.g., secular dollar strength.

We believe BMO is uniquely situated with global resources to execute in this environment and our recent track record supports this belief.

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