Global Investment Forum

Five-Year Outlook

2018 – 2023

BMO Global Asset Management

Contents

Global Investment Forum

Toronto, Canada
26-27 September 2017

Welcome to BMO Global Asset Management's Five-Year Outlook 2018-2023. Each year our Global Investment Forum (the 'Forum'), attended by a group of BMO's international investment leaders and strategists, gather for two days of intensive briefing and debate stimulated by the input of independent experts.

Looking to the future, we consider a number of likely scenarios and the opportunities that they may present for our investment managers. We believe that this era of rapid change offers opportunities as well as threats, rewards as well as risks. As global investors with responsibility for the stewardship of our clients' capital, we are committed to sharing our investment insights across the business as a whole, to ensure we all benefit from our collective knowledge.

Our scenarios contain forward-looking statements which can be identified by the use of terminology such as 'may,' 'should,' 'expect,' 'anticipate,' 'outlook,' 'project,' 'estimate,' 'intend,' 'continue' or 'believe'. These do not constitute investment advice or recommendations to buy or sell investments and you should not to place undue reliance on such returns and statements, as actual returns and results could differ materially due to various risks and uncertainties.

Any investment involves risk as market conditions and trends fluctuate. Accordingly, investment values may fall as well as rise and investors may receive back less than originally invested.

Editorial summary

In this year's Forum, our discussion centred on a handful of topics and we debated their potential impact over the coming five-year period. Interestingly, we are seeing themes identified in previous Forums exercising their influence over the future investment environment as they continue to evolve and play out. Topics included:

- **Balancing act** – whether policymakers could achieve and maintain the critical balance that delivers growth, addresses interest rate pressures and controls inflation in the face of unpredictable influences, including varying populist agendas and concerns that the threat of recession is once more a possibility.

- **Demographics and the supply of labour** – this is becoming an important issue for some developed markets as the 'baby boomer' generation start to retire. Furthermore, a disaffected, less-skilled labour force is highlighting the so-called 'inequality theme', fuelling a rise of extreme political movements and unexpected voting results.

- **Power of populism** – we see this being exploited and manipulated by leaders across many regions. From the political gamesmanship of President Xi in China and Prime Minster Abe in Japan, to the public rhetoric and display of protectionism being expressed between President Trump and Kim Jong Un of Korea as well as European politicians facing Brexit, domestically focused agendas are being pushed at the cost of cross-border collaboration.

- **Rise of globalisation as a monopoly power** – this is growing within the corporate sector, at the cost of dynamism.

- **Innovator or disruptor?** – as technology delivers productive solutions to ease the labour issues and push a new agenda in global energy use, we are seeing a cost to the traditional market leaders.

1

Steady as she goes

Within this context, we have arrived at our base case scenario for the coming five-years of 'Steady as she goes' (60% probability), in which we see the global economy continuing to enjoy steady growth with modest inflation, despite the slight headwinds created by the gradual withdrawal of quantitative easing and higher interest rates.

2

Policymakers pull the punchbowl

However, we do believe that the risk of a downside is heightened (relative to previous years). In our 'Policymakers pull the punchbowl' scenario (30% probability) we are concerned that there will be policy errors. As either past monetary policy over stimulates markets, which then coincides with the tapering of quantitative easing, exaggerating their impact; or central banks take a more aggressive approach, tightening the expansionary policy too early and starting the chain reaction that leads U.S. and then the rest of the world into a recession.

3

Perfect policy prevails

Finally, for the optimists amongst us, our 'Perfect policy prevails' upside scenario (10% probability) takes a look at what happens when the policies all go according to plan and the policymakers get it right.

‘Our Outlook report provides an important contribution to our investment teams’ decisions, as well as informing our clients about how we view global markets over the mid- to longer-term."

Richard Wilson, Chief Executive Officer and Chief Investment Officer, BMO Global Asset Management

Annual scorecard: a look back at 2017

In last year's discussion, we had a base case scenario entitled 'Slow and Steady Wins the Race', which focused primarily on the prospect of continued marginal incremental improvements in global economic growth (70% probability). Our two alternative scenarios were 'Power to the People', reflecting the negative implications of populism and its associated ramifications (20% probability); and 'All Pulling Together', in which collectivism triumphed and centralised policies were successful, stimulating global growth (10% probability).

When we look at how the themes that were identified in previous years' scenarios are evolving, we observe:

- **Economic growth** – as anticipated, the steady continuation of this is evident across global economies as the world economy achieves an unusual state of stability. We have also seen that China is avoiding a hard landing, and developing countries such as India are increasingly attractive.
- **Policymakers' evolving roles** – the potential new paradigm of central banks becoming quasi-governmental in their function has played out a little differently and we are seeing that both 'teams' are working together and managing the economy with a mix of policies.
- **Debt** – as predicted, levels of global debt are remaining sustainable for the foreseeable future and not having an impact on risk assets, a previous concern. Although in this year's report, we have identified concerns regarding China's corporate credit growth and the diminishing benefit to its economy.
- **Populism and the people** – this correctly remains a principal theme, with increasing influence and unpredictability regarding the scope of its impact. The global connectivity of our societies through technology significantly increases the likelihood of previously disparate forces combining into activist movements with unpredictable outcomes.
- **Protectionism and the leaders** – this theme also remains centre stage as we are seeing leaders demonstrate their powers to their populations and governments. However, the reality has yet to be tested and it currently appears to be a case of 'sabre-rattling', with diplomats continuing to work at securing trade agreements behind closed doors.
- **Disruptive technology** – we anticipated the impact of disruptive technology on long-standing business models, however, there are growth opportunities for existing producers of technical components and consumers, such as Japan and China, who have the flexibility and drive to migrate workforces into the new working practices.
- **Energy** – previously we've been concerned about the impact on productivity of lower oil prices, however, these concerns appear to have been over-estimated in recent years. The adoption of electric vehicles looks set to be a future theme, especially the role of batteries for energy storage.

"

Our Five-Year Outlook is a reflection of our commitment to add value through innovative ideas, solutions, support, and access to the insights of renowned global thought leaders.

State of the world

The world economy has reached an unusual state of stability. Almost every country is seeing positive growth – shown as a green square in Chart 1 – but nowhere is growth booming out of control. Inflation is also firmly in 'goldilocks' territory.

Goldilocks rules

With the exception of those countries, such as the UK, which have suffered significant currency weakness, inflation is low throughout the world but the number of countries in or close to deflation is low and falling. Inflation, like growth, is neither too hot nor too cold. In addition, there are few financial imbalances within or between the major economies. Geopolitics remains a worry but the immediate economic threats to the world economy are few and far between.

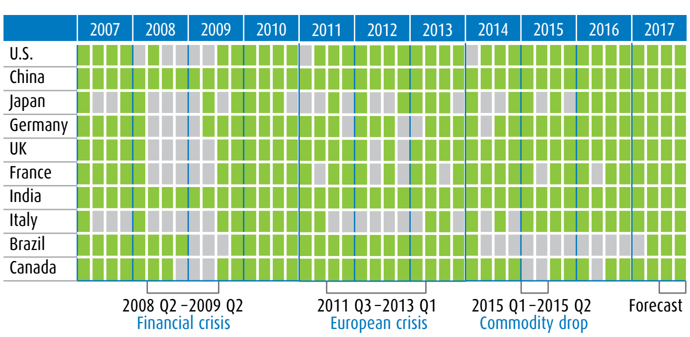
What does this environment mean for investors? Analysis of similar scenarios over the last 50 years suggests that a 'goldilocks' backdrop favours risk-on investing, particularly in equities. Bonds, both government and corporate alike, typically fare less well. However, there are always risks in projecting past performance trends forwards.

Regional perspectives

We are now well into the Trump presidency and he has found the process of transferring his pre-election rhetoric into policy reality to be a challenging task. Tax cuts were among his commitments and they remain firmly on the agenda. The likelihood of tax reform has increased in recent months, but if a bill is eventually passed, the size and scope of it may look underwhelming after it has made its way through Congress.

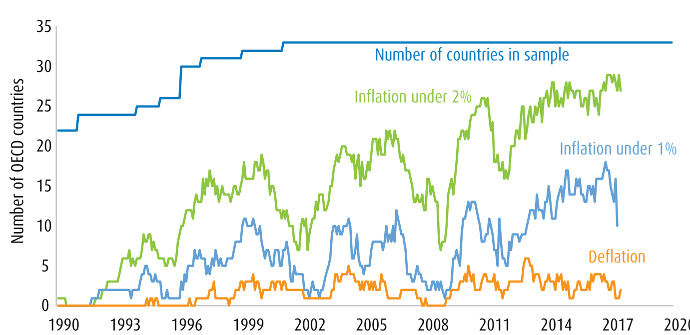
Of course, cutting corporate taxes may have positive economic implications down the road but they don't fundamentally tackle the challenge faced by a sizable section of the U.S. population – a segment to which Trump owes much of his support. As shown in Chart 3, those who failed to graduate from high school have experienced a significant fall in real incomes over the last decade. The causes of this wage stagnation are numerous – outsourcing due to globalization, technological changes in manufacturing, transition to a services economy, just to name a few – and the solutions are broadly long-term structural changes rather than short-term fixes.

Chart 1: World growth in sync



Source: BMO Global Asset Management, Barclays Research as at 12.09.2017. Green = positive quarter on quarter growth. For illustrative purposes only.

Chart 2: Number of OECD countries with low core inflation



Source: Minack Advisors as at September 2017. OECD = Organisation for Economic Co-operation and Development.

Without Europe's recent pick-up, it is likely that the UK would be flirting with recession.

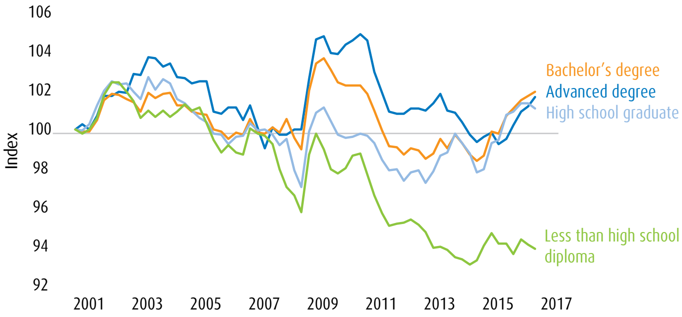
Overall, the U.S. economy is in reasonable shape and inflation remains relatively subdued, particularly as rents – which comprise over a third of the core consumer price index – have stabilised. This, combined with gently rising wages, means that the Federal Reserve is likely to continue to gradually raise interest rates. This is a headwind for markets but for our central scenario, where inflation pressures are moderate, it is more of a gentle breeze than a disruptive gale.

China has its challenges: the trend growth rate is slowing and credit growth is excessive, as we discuss in our central scenario. Yet persistent forecasts of a hard landing have not materialised and China looks set to 'muddle through'.

Even in a world of synchronised growth, the improvement in Europe's economies stands out. The reasons behind the upturn are self-evident. The era of fiscal austerity in Europe is over and this, alongside massive monetary expansion, is feeding through into a sustained economic upswing. Italy's election next spring and key wage negotiations in Germany loom on the horizon but we do not foresee either derailing Europe's cyclical upturn.

There is, of course, one notable outlier in Europe – and that's the UK. Negotiations around its withdrawal from the European Union (EU) are proving difficult and whatever the outcome, the country faces a challenging period of readjustment to life outside the single market. More immediately, the pound is still weak but to date it hasn't done much to enhance the UK's trading position. It has, however, reduced real incomes and squeezed consumption investment. Ironically, the UK is benefiting from the strength of the eurozone economy and its proximity to it! In fact, without Europe's recent pick-up, it is likely that the UK would be flirting with recession.

Chart 3: U.S. real median weekly pay by education level



Source: Minack Advisors as at September 2017. Rebased in December 2000.

Back to basics: the Phillips curve

The Phillips curve posits a relationship between unemployment and wage or price inflation. The theory is that when unemployment falls below a certain level, wage and price inflation begin to accelerate. That level is called the Non-Accelerating Inflation Rate of Unemployment or 'NAIRU'. It cannot be observed directly and must be estimated. The problem is that it changes over time, influenced by demographics and market structure, amongst a host of other factors.

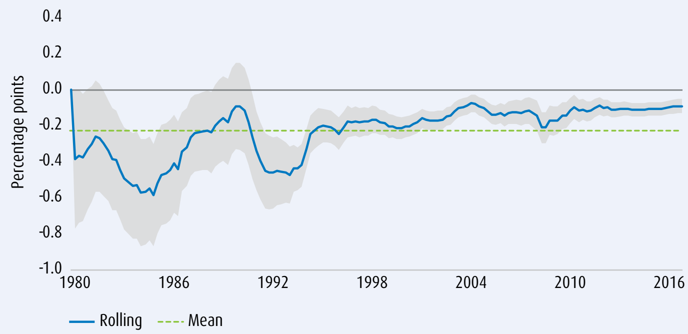
In the 1970s the NAIRU rose in the U.S.; the Federal Reserve misjudged the situation and allowed inflation to rise substantially. Restoring it to a reasonable level required time and much sacrifice in terms of lost growth and employment. Today the situation is reversed. Unemployment has fallen to exceptionally low levels, well below previous estimates of the NAIRU, while wage and price inflation have been subdued. Some have questioned whether the Phillips curve concept is still relevant.

After much analysis and discussion, we at BMO Global Asset Management have concluded that, while the relationship between unemployment and inflation is weaker than in the past and the NAIRU has fallen, the Phillips curve remains a useful tool for predicting inflation. In particular, there is a degree of non-linearity whereby marginal falls in unemployment from very low levels have a more powerful impact on inflation. Supporting evidence for these conclusions comes from work by Goldman Sachs' economists, depicted in Charts A and B. Chart A shows that the slope of the Phillips curve has decreased: the relationship still holds but is weaker. Chart B combines time series and cross sectional data on U.S. cities over the last 20 years and appears to suggest that the Phillips curve is steeper at low levels of unemployment, something that is expected and was evident in the original work.

The Canadian Perspective: the mid-to longer-term outlook for Canada depends significantly on the external environment. Economic performance in the external environment (both in the U.S. and in the non-U.S. major markets) affects domestic conditions in Canada in two ways. Firstly, as an open economy where trade represents a relatively large share of total gross domestic product (GDP), a rise in the pace of import and export flows tied to the global economic cycle will act as a tailwind for the domestic economy. Secondly, as a resource dependent country, elevated global economic activity that spurs the demand for the commodities that we produce here in Canada (such as energy products, lumber and base and precious metals) will aid the domestic economy.

Chart A: Inflation Potpourri – Slack Effect Isn't Huge But Should Ultimately Prevail

Impact of unemployment on inflation, OECD countries, 1970 - 2017



Note: Shaded area indicates +/-2 standard error band.
Source: Goldman Sachs Global Investment Research.

Chart B: 'Bad things' happen when policy is too loose for too long

Average core CPI inflation sorted by unemployment rate buckets, 1997-2017 quarterly for 13 biggest cities

Source: Goldman Sachs Global Investment Research.

Named after the influential New Zealand economist William Phillips, it describes an historical inverse relationship between rates of unemployment and corresponding rates of inflation that result within an economy.

Our scenarios

To help us prepare for changes in the economic landscape or global markets, our investment teams look at many sources of analytical data, listen to our experts within BMO Global Asset Management as well as the opinions of other industry leaders.

From this we create a set of possible scenarios for the future. We 'shake the tree', challenging our own, our colleagues' and our peers' views. We try to anticipate how a realistic set of events could unfold over time, and also consider some of the extreme outcomes of these events – both positive and negative.

Our scenarios contain forward-looking statements identified by the use of terminology such as 'may,' 'should,' 'expect,' 'anticipate,' 'outlook,' 'project,' 'estimate,' 'intend,' 'continue' or 'believe'. Investors should not place undue reliance on such returns and statements, as actual returns and results could differ materially due to various risks and uncertainties, and this material does not constitute investment advice.

Although nothing is certain, against each scenario we assign a probability that reflects the likelihood that we believe it will happen, given a variety of political and economic factors occurring over the next five years.

This in turn gives us a framework to challenge our existing strategies to ensure we are as prepared as possible. It enables us to consider what might happen – and look at the impact on various asset classes. We consider what to under-or over-emphasise across our investment portfolios for each of the scenarios.

It means we can face the future with increased confidence, knowing that we have considered what might be on the horizon as well as over the horizon.

This year we have reached the following three scenarios:

60% probability
Steady as she goes

30% probability
Policymakers pull the punchbowl

10% probability
Perfect policy prevails

The improvement in Europe's economies stands out. The reasons behind the upturn are self-evident. The era of fiscal austerity in Europe is over and this, alongside massive monetary expansion, is feeding through into a sustained economic upswing.

1 Steady as she goes (60% probability)

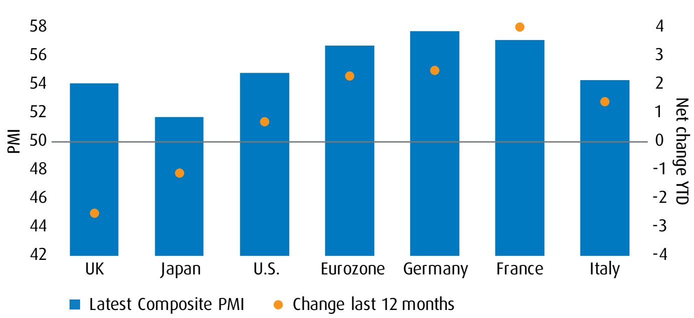
In this, our base case scenario, we see the global economy continuing to enjoy steady growth with modest inflation. The gradual withdrawal of monetary accommodation in the form of higher interest rates and reduced quantitative easing (QE) is a headwind. Yet muted inflation pressures and flexible markets mean that this is likely to be a gentle breeze rather than a disruptive gale.

Europe moves from laggard to leader in the global growth race

For this scenario to be achieved, Europe must take over the lead in world growth. The U.S. has grown by a little over 2% p.a., since the end of the Global Financial Crisis. But even this modest pace of expansion has involved a reduction in unemployment of close to six percentage points. Unemployment cannot fall much further and even with a pick-up in productivity, growth in the U.S. is likely to be lower in the next five years than it has been in the last eight. By contrast, Europe has ample spare capacity and can enjoy several years of above-trend growth without hitting the labour supply buffer.

Politics has been a key influence on Europe's economy. A year ago, a series of political events loomed large in continental Europe, with confidence having been shaken by the recent Brexit vote in the UK. The UK remains mired in Brexit-related uncertainty but challenges in the rest of Europe were resolved in a market-friendly manner and the European project seemed firmly back on track. More recently, the German elections, which saw the right-wing nationalist Alternative for Germany (AfD) party sweep into the Bundestag, followed in Spain by the move to declare independence in Catalonia, suggest that the pendulum may be beginning to swing back the other way. Italy's general elections must take place by May 2018; were the Five Star Movement to gain an overall majority, their anti-Europe stance could provoke a crisis. Although they have been moderating their views of late, they are unlikely to win an overall majority, particularly given the new electoral system.

Chart 4: Global PMIs are strong, Europe's are stronger



Source: BMO Global Asset Management, Bloomberg as at 21 September 2017. PMI = Purchasing Managers' Index. YTD = Year To Date.

Most peripheral eurozone countries, facing the challenges posed by European Central Bank (ECB) tapering, can respond by reducing the maturity of their new issuance. However, in the case of Italy, many of the long-term fundamentals are positive: it has a primary fiscal surplus, a wealthy private sector and a current account surplus of 2% of gross domestic product (GDP). What Italy and the other peripheral countries desperately need is sustained economic growth. Recent data and the financial environment suggests that is exactly what they are likely to get. Europe's cyclical recovery is a key component of our relatively optimistic base case.

The European Union may chart a different course without the UK

The UK is struggling as it adjusts to the reality of Brexit preparations and the markets' focus has been on the immediate

> Europe's cyclical recovery is a key component of our relatively optimistic base case scenario.

political and economic woes facing the UK. Yet Brexit has major implications for the balance of power within the remaining 27 countries in the Union. As one of the 'big three', the UK was a significant counterweight to the federalist, corporatist tendencies which characterise the founder members. The UK often led the way in international trade talks and was a prime mover behind the single market. Post Brexit, the EU may push hard towards further integration. Freedom within its borders would be maintained but a response to the rise in populism is likely to see increased barriers to migration from outside.

The ECB, like the U.S. Federal Reserve, has more than tripled its balance sheet through QE. This has been a successful strategy, and looks set to continue at a reduced pace. It is anticipated that Europe may have a slow exit from QE but this is not without risk as there are signs of core inflation picking up and fiscal policy may be turning pro-cyclical. Re-investment of existing holdings and dovish forward guidance from the ECB tightening will aim to minimise market nerves as proceeds.

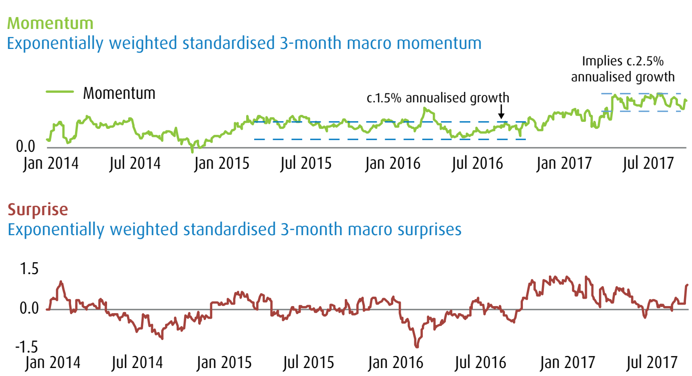
Emerging economies to continue to recover

Emerging economies also have the capacity to grow more rapidly. But trend growth in China is slowing. Labour supply has peaked and is set to decline; China has reached maturity in this respect particularly quickly as a result of their 'one child' policy. Productivity has also been falling – following the path previously trodden by other Asian 'growth miracle' stories. The era of 8% annual economic growth is over and we expect to see annual Chinese growth settle down to a 5% pace over the next five years.

> Emerging economies continue to recover and have the capacity to grow more rapidly.

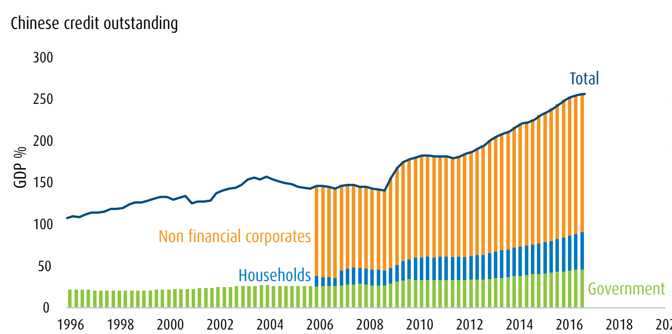
China also faces a major challenge in tackling corporate credit growth, which has been excessive and often misallocated. Much of the problem stems from loss-making, state-owned enterprises kept afloat by state-owned banks, encouraged by provincial governments keen to protect jobs. Many of these same indebted companies are responsible for pollution, another key challenge for the authorities. The central government is fully aware of the problem and has taken measures in response but whenever the economy has slowed, the credit spigot has been opened again and the economy duly responds. But each additional dose of credit seems to induce a diminishing amount of extra growth.

Chart 5: Euro area economic data: strong and getting stronger



Source: Deutsche Bank, SIREN index as at 3 October 2017.

Chart 6: China has a credit problem



Source: Deutsche Bank, SIREN index as at 3 October 2017.

We don't believe that a hard landing is in store for China. Companies continue to expand and are moving up the value chain, and growth, now less focused on the congested 'tier one' cities, is spreading out more broadly.

Having said all this, we don't believe that a hard landing is in store for China. Companies continue to expand and are moving up the value chain, and growth, now less focused on the congested 'tier one' cities, is spreading out more broadly.

India too faces many challenges, with demonetisation and the introduction of a goods and services tax having led to a significant economic slowdown. But the slowdown is likely to be temporary and these plus other reforms should deliver long-term benefits. We are positive about the long-term outlook for India.

Canada's growth spurt unlikely to endure

Canada grew by 3.7% over the last year, producing the biggest upside growth surprise among OECD countries, moving from the bottom of the list a year ago. This can be attributed to a number of temporary one-off factors including a strong come back from the wild fires in Alberta and fiscal changes giving a one-off stimulus. Expectations for the coming year are more modest at 2% growth.

The 'Steady as she goes' scenario is a favourable backdrop for the Canadian economy and Canadian assets. Canada is torqued to the global economic cycle and the environment described in Steady As She Goes is a durable global economic expansion.

Japan fights deflation and demographics

Japan's continued recovery has been driven by net exports but domestic demand has also been firm of late, making this the third longest expansion post-war (56 months and counting – in October 2017). The impact of Japan's declining population of working age has been muted by increased participation by women, a trend we expect to continue. The Bank of Japan has repeatedly failed to achieve its 2% inflation target but it cannot be faulted for lack of effort as it continues to pursue an aggressive and extensive QE programme. Inflation may be below target but it is above zero and the threat of a return to deflation has receded.

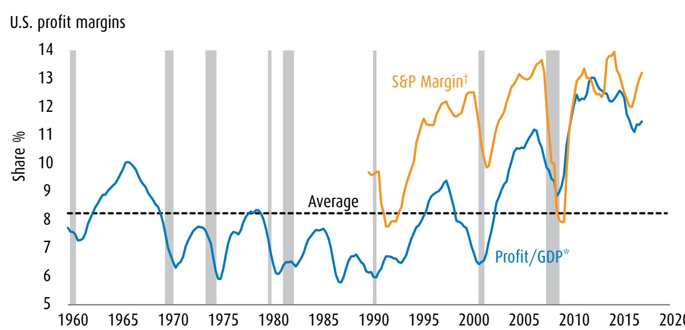
Global corporates

What of the prospects for companies and importantly, the profits they make? Currently, profits are well above historical averages and although some analysts and investors fear that a substantial decline is imminent, we disagree. We believe that the near-term outlook for profits is good given the positive economic background and there are several factors which should support profits in the longer term, including:

- Low interest rates meaning it is relatively cheap to secure finance and service debt (even given likely rate hikes).
- Corporate taxes are low and, in countries like the United States and France, are heading lower.
- Labour power is weak.
- Monopolistic conditions prevail in many sectors with barriers to entry that allow companies to maintain margins.

Looking forward, we expect earnings to grow. As a result, we are reasonably upbeat on the prospects for equities but less so on the outlook for bonds, where much of the market looks expensive.

Chart 7: Profits are high ...will they revert to the mean?



Source: Minack advisors as at September 2017. *After-tax profits as share of corporate GDP (4 quarter average) † S&P 500 operating margin. S&P, Copyright 2017, all rights reserved.

Political change and uncertainty

The rise of populism that we saw last year has made world leaders attentive to the needs of their voters and sensitive to the impact of unexpected influences. Leaders are implementing domestic reforms and targeting improvements in corporate governance, tax and international trade.

U.S.

In the U.S., President Trump remains a wild card and while his policies are typically fairly conservative, he is not always predictable and may change course on a whim. We are seeing that he is finding the implementation of some of his election promises a challenge; however, his current focus is on his tax plan, and we believe that here he may eventually be successful. He remains conspicuous and outspoken in his protectionist stance regarding various international trade agreements as well as in his hard-line defence rhetoric.

China

In October 2017 at the 19th National Congress of the Communist Party of China, President Xi Jinping, one of the most powerful Chinese leaders since Deng Xiaoping, has further consolidated his authority, establishing his agenda for the coming five years of power. His goal appears to be to secure the Communist Party legacy and continued stability in China. Xi wants to be a 'Moderniser' rather than a 'Reformer', casting himself as a 'Davos Man', in contrast to Trump, on the world stage. To do this he needs to push through domestic market reforms that do not conflict with Party control and so avoid a 'stalled transition' as China moves from being perceived as a low value manufacturer to becoming a preferred producer for high value-added sectors and global brands. The focus is less on the quantity of economic growth and more on the quality, with a reduction in pollution a key goal. In our base case scenario, we believe that his conflicted reform agenda will face significant headwinds in the medium term (3+ years) as industrial policies will test the limits of political and economic sustainability.

> The global connectivity of our societies through technology significantly increases the likelihood of previously disparate forces combining into activist movements with unpredictable outcomes.

Japan

In Japan, Prime Minister Abe called a snap election in October 2017 to take advantage of his higher opinion poll rating and has secured a stronger mandate. Recent years have seen him oversee the implementation of a number of structural reforms spanning corporate governance and tax, so called 'womenomics', boosting in-bound tourism, trade liberalisation, agriculture reforms, foreign workers and electricity deregulation. Corporate governance is also being transformed, with greater involvement of independent directors and accountability. Industry consolidation is occurring which is likely to lead to better returns moving forward. Domestic tax reforms have seen the introduction in 2016 of the first Japanese tax-payer ID system targeting the many individuals who used to evade paying tax as well as the

70% of Japanese firms who also paid no income tax by shifting the basis of taxation from profits to revenues and capital. While enforcement is still weak, it is felt to be moving slowly in the right direction.

Europe

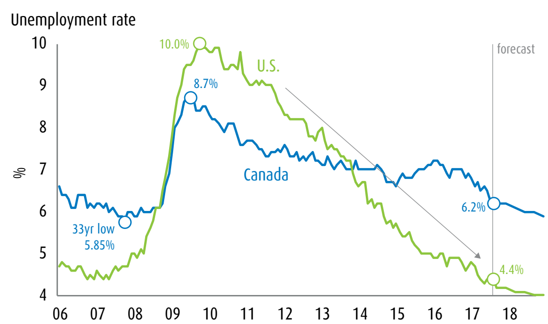
We have already discussed the political changes in Europe, with the German election result certainly presenting Angela Merkel with challenges. She will likely end up forming a 'Jamaica' coalition, named for the party colours of the Christian Democratic Union (black), Free Democratic Party (yellow) and the Greens. Yet these parties have conflicting positions on issues ranging from eurozone integration and immigration, to the economy and the environment. It remains to be seen how the Franco-German alliance develops. President Macron is unlikely to achieve his goal of a European Finance Ministry with a budget designed to redistribute funds from rich countries to poor. Chancellor Merkel is likely to push for a strengthened European Stability Mechanism with powers to curtail imprudent financial policies in the periphery, a European version of the International Monetary Fund (IMF). Further measures to free up markets and deepen integration are necessary if Europe is to avoid a repeat of their recent problems.

> Political change and uncertainty continues, making world leaders attentive to the needs of their voters and sensitive to the impact of unexpected influences.

Demographic headaches: might robots ease the pain?

There is a common trend across developed markets regarding the demographic profile of their labour markets. Baby boomers, the most experienced labour group, are retiring, contracting the talent pool and in turn putting pressure on wages and production costs. Japan is seen to be the first developed market to get close to full employment, with 50% more jobs than Japanese seeking work (industry average).

Chart 8: Jobless rates – U.S. still falling, Canada improving again

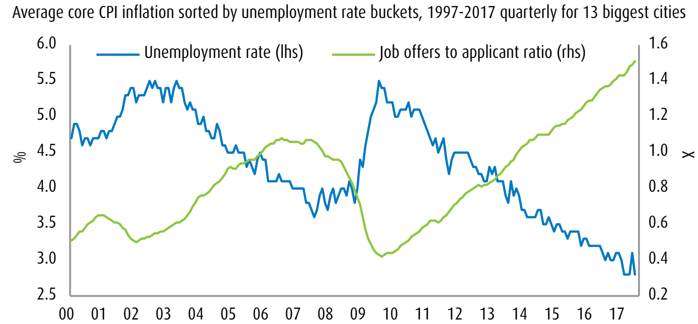


Greece	21.2
Spain	17.1
Italy	11.3
France	9.8
Portugal	9.1
Ireland	6.3
Canada	6.2
Australia	5.6
U.S.	4.4
UK	4.3
Germany	3.7
Japan	2.8

Source: Bureau of Labor Statistics and Statistics Canada.

Chart 9: Labour Market/Wage Trends

Average core CPI inflation sorted by unemployment rate buckets, 1997-2017 quarterly for 13 biggest cities



Source: MLIT. As of June 2017.

Developments in robotics and artificial intelligence are seen as one of the main solutions to contracting labour pools, impacted by shifting demographics as baby boomers start to retire.

As a consequence, they have been exploring various solutions, and seeing some success in addressing the attrition rate, especially through initiatives aimed at encouraging women back to work. There is a higher proportion of women in the workforce in Japan than in the U.S. They are typically in part-time roles (70% are held by women), with part-timers now accounting for 40% of Japan's total workforce.

Developments in robotics and artificial intelligence are seen as one of the main solutions to this problem, although in some markets there is a worry that this will lead to more problems as we disenfranchise untrained workers. Governments remain sensitive to this impact as it links to the rise in populism, driven by concerns regarding quality of life and wage inequality.

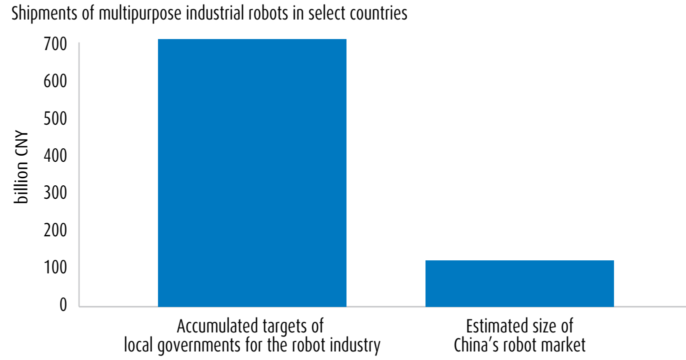
Japan is embracing technology versus the other developed markets who have some concerns regarding the low-paid and unqualified workers. It is also anticipated that some Japanese companies would be beneficiaries of this phenomenon, providing components for the machines and equipment.

We are also seeing that China has committed to this 'robot race', investing very heavily in robotics, artificial intelligence and quantum computing projects at a high cost, without necessarily determining the true value of the businesses and without the benefits of a free economy efficiency to hone the business proposals. However, China cannot afford this level of waste and inefficient allocation of resources indefinitely and we believe this overinvestment will be a core issue when political constraints become more urgent.

“China has committed to this `robot race', investing very heavily in robotics, artificial intelligence and quantum computing projects at a high cost.”

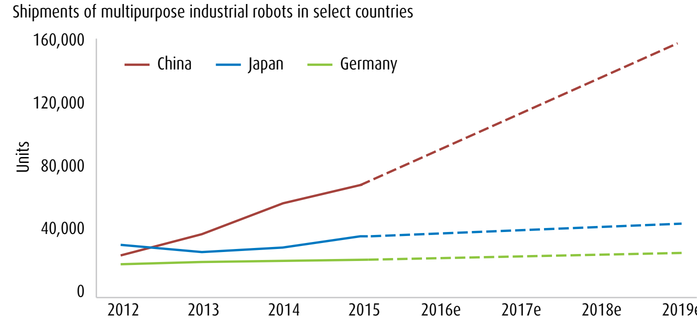
Chart 10: China's appetite for robots is growing

Shipments of multipurpose industrial robots in select countries



Source: MERICS research, MIIT.

Shipments of multipurpose industrial robots in select countries



Source: IFR (from 2016 onwards estimates only).

Monopoly power is growing within the corporate sector

There is growing evidence that companies are enjoying super-normal profits as a result of their monopoly positions. We are seeing a significant increase in concentration in some industries and that is a possible concern. The 'disruptors' of the past are becoming the new, controlling companies as they secure market share, possibly abusing their status by restricting output and limiting investment.

Global connectivity feels like a good thing when everyone is going in the same direction but this level of interconnectivity is a worry to us in this scenario, when paces of growth could differ significantly or change direction, exaggerating any gap.

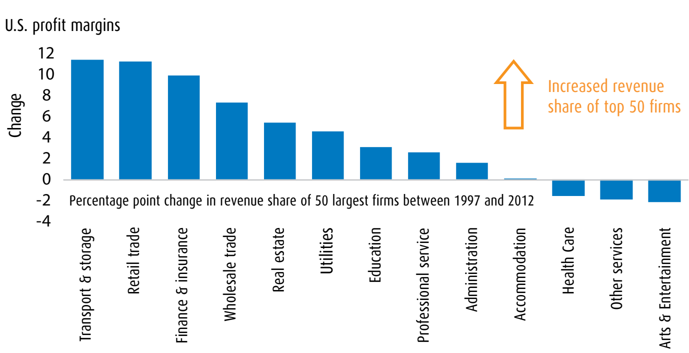
In the question of whether China is ready to take global leadership from the U.S. it is felt that, while the US does not want to give up their position, equally China is not quite ready yet to assume the role, preferring to address a domestic agenda for a while longer. Instead it looks as though we could be heading towards rival centres of power.

Similarly, China has limited its participation in the process of global financial integration because of its closed capital account, but that may change gradually as China 'liberates' capital flows. The internationalisation of the renminbi is seen to be a strategic priority, however, there will be more volatility as it transitions to become a more global currency.

Energy for change

The world energy market is undergoing dramatic change and in our base case scenario we see continued adoption of electric vehicles with spectacular growth in batteries, providing that both their weight and price continue to decline. Beyond transportation, batteries could play a key role in centralised energy storage, allowing the grid to take on a greater proportion of supply from renewables, many of which are inconsistent sources, and at the decentralised level.

Chart 11: The U.S. has seen a marked increase in concentration



Source: Minack Advisers as at September 2017.

> Global connectivity feels like a good thing when everyone is going in the same direction but is a worry when paces of growth differ significantly or change direction, exaggerating any gap.

Protectionism: a growing threat

As we've discussed, the flip side of global connectivity is the desire to remain protective of domestic industries. World leaders have a strong domestic agenda to be supported and managed.

As a major partner (both as consumer and supplier) in global trade, the voice of America is amplified and Donald Trump is very vocal in his aggressive determination to put 'America first', with particular focus on the country's deficit of exports relative to imports. He has made some controversial decisions, for example, withdrawing the United States from the Paris Agreement on climate change and threatening to tear up the North American Free Trade Agreement ('NAFTA') with Canada and Mexico.

NAFTA trade accounts for 39% of Canada's GDP and 49% of Mexico's, but just 5% in the case of the United States, the world's largest economy. Both Canada and Mexico sell more than three-quarters of their exported goods to the United States. Canada's Liberal leader, Justin Trudeau, is seeking some resolution with Trump regarding the U.S.'s protectionist trade demands that are threatening the NAFTA talks, following the U.S. decision to impose punitive duties on Bombardier jets and disputes around softwood lumber and recently Canadian dairy supply management policies.

Ultimately, however, we believe in our base case scenario that despite Trump's rhetoric the impact will be limited.

"

As a major partner in global trade, the voice of America is amplified and Donald Trump is very vocal in his aggressive determination to put \`America first'.

In the Asia Pacific region, China is a dominant player, and it is likely to dominate further, although it is a crowded region, and it may not be that simple as other countries such as India and Japan strengthen their own alliances and independence.

In Europe, as the reality of Brexit comes closer, we are seeing some spite entering into negotiations between the politicians, which is creating uncertainty regarding what will ultimately be determined. We believe in our base case scenario that any trade deal will be weaker than the current arrangements under the single market. It will take some time for the UK to adjust to its future outside the EU.

Without doubt, the next five years are not necessarily all going to be plain sailing for the global economy and we need to consider the issues that could be challenging and disruptive.

The problem of North Korea

There are a number of geopolitical risks in the Pacific area. Top of the list is the threatening behaviour of North Korea and the impact it is having, bringing Japan, U.S. and China into an uneasy coalition.

We believe that despite all the uncertainty, the chances of a catastrophic outcome are very low. China's involvement is a key factor. No one wants a war in the region. At present, it seems as though Trump and Kim Jong-un are sprinting to gain maximum leverage. Kim Jong-un wants nuclear missiles at the heart of his regime's arsenal and the only way to keep the U.S. and South Korea off his territory. Trump in turn wants the North Korean leader's eventual removal as he is a threat to stability in the region. It is a test of U.S. and China relations, as the U.S. increasingly pressurises China to push North Korean trade sanctions. China is increasingly unhappy with North Korea and does not want volatility in the region. In a major initiative, President Xi has proposed that North Korea and the U.S. both limit their military activities, the so-called 'freeze-freeze' plan. The immediate reaction of the U.S. towards the plan has been cool but if progress is made in this area, it could allow the resumption of talks.

> Over a five-year horizon, the risk of a U.S.-led recession is always there but that threat seems to us neither heightened nor imminent.

Japan, meanwhile, is leveraging the threat to push on their own defence agenda. This requires a national referendum to allow a change to their constitution enabling them to develop their own nuclear programme. This in turn would deliver a lift to their spending and give some further stimulus to their economy.

Disputes around islands in the Pacific and South and East China Seas remain a source of tension, but we believe that diplomatic solutions will be sought rather than warfare.

Middle East troubles continue to rumble on, but the declining dependence of the U.S. on oil from the region is changing the dynamic into a more regional and less global conflict.

Fears of U.S. recession

As the major economy most advanced on its economic recovery, fears of recession focus on the U.S. But recoveries do not die of old age. There are several leading indicators of recession that are worth considering. Some note that a rise in the unemployment rate of 0.5 percentage points has always been followed by recession but that begs the question of what caused the increase. At any rate, unemployment is at present on a firm declining trend and economic fundamentals do not point to any change. Another warning sign would be a sharp decline in overall corporate profitability. Once again, we see this risk as limited. Finally, there is the risk of excessive tightening by the U.S. Federal Reserve. This risk would rise if inflation were to increase markedly above the Federal Reserve's 2% target. As we discuss in the 'Back to basics' explanation, inflation pressures are likely to build only gradually and with the Federal Reserve tightening strategy well underway, there seems little risk of their falling behind the curve. Over a five-year horizon, the risk of recession is always there but that threat seems to us neither heightened nor imminent. For the rest of the world, where capacity constraints are less severe, the risk of recession seems even less.

Investment implications

With the world economy remaining in good shape and healthy profit margins being maintained, risk assets should generally do well in this scenario. Gradual tightening by central banks is a headwind, albeit a mild one, which will limit overall returns. Government bonds are likely to underperform and with spreads likely to widen, their corporate equivalents could fare even worse.

For the potential implications of this scenario on our asset allocation, see our under- and over-emphasis tables.

While generally the central bankers in developed markets seem to be speaking in unison, we are seeing an increasingly hawkish stance dominating and interest rates coming under upward pressure for the first time in a number of years.

2 Policymakers pull the punchbowl (30% probability)

The U.S. Federal Reserve's job is to 'order the punch bowl removed just as the party is really warming up.' So said William McChesney Martin, the Fed's chairman during the 1950s and 1960s. The idea is that central banks should tighten policy before inflation pressures get out of control. Timing is key here: tighten too early and recovery may be choked off, tighten too late and inflation pressures could require an aggressive response that pushes the economy into recession.

Our base case scenario remains one of balanced and sustainable growth but we have reduced the probability from 70% to 60% compared with last year, simply because the economic cycle is more mature and the scope for further non-inflationary growth is somewhat smaller.

The risk of a downside scenario is correspondingly greater. In this scenario, we are concerned that there will be policy errors. Past monetary policy may have over-stimulated the markets, which could stoke inflation, which might then coincide with the quantitative tapering and exaggerate the impact, hastening first the U.S., and then the rest of the world into a recession.

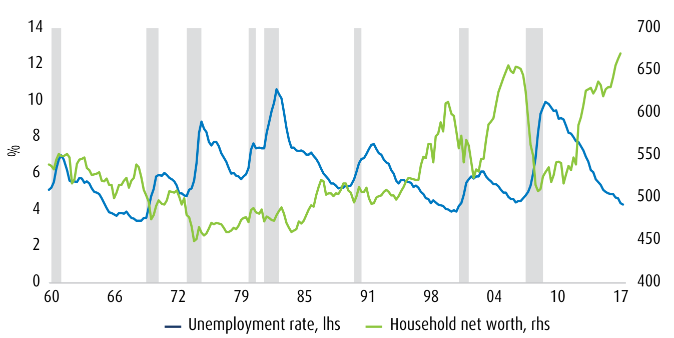
Alternatively, there is the risk that central banks will take a more aggressive approach, tightening the expansionary policy too quickly, triggering an economic downturn, a squeeze in profits and a recession.

The exact mechanics of the balance sheet normalisation are also going to vary between regions, and with mixed results. While generally the central bankers in developed markets seem to be speaking in unison, we are seeing an increasingly hawkish stance dominating and interest rates coming under upward pressure for the first time in a number of years. In particular, this could have negative implications for the peripheral eurozone economies such as Spain, Italy, Portugal and Greece as they see their borrowing costs rise significantly from current levels, resulting in a debt / GDP trajectory that appears far less sustainable in the longer term. In the U.S., the U.S. Federal Reserve's (Fed) reduction of treasuries and mortgage backed securities could put mild pressure on housing as mortgage rates increase from current low levels.

Populism and protectionism

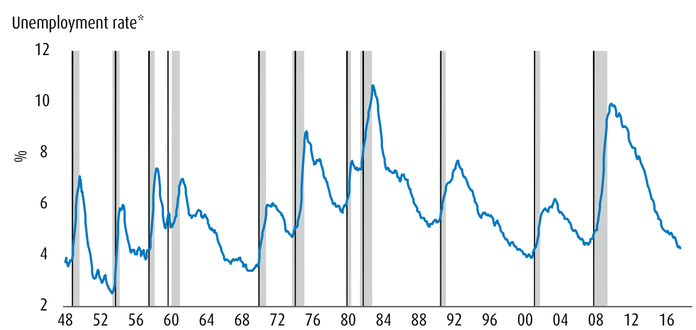
We've already identified the risk that populism could lead politicians to reach for the protectionist weapon, triggering retaliation and a downward spiral of recession and global trade implosion.

Chart 12: 'Bad things' happen when policy is too loose for too long



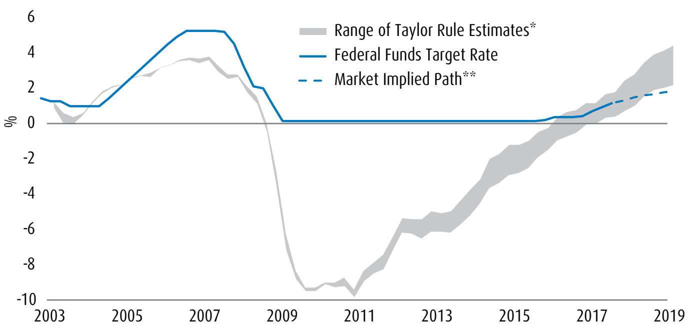
Source: BLS, NBER, Federal Reserve Board, Haver Analytics, Barclays Research

Chart 13: Fed Policy – Unemployment Risks – Overshooting Full Employment Is Risky in the U.S....



Source: Department of Labor. NBER.

Chart 14: Fed Policy – Even with Inflation Below Target, Standard Reaction Functions Call for Hikes...



Source: Bloomberg.

The early signs of this are being played through in very open rhetoric, promoted and amplified via the world media, best seen in Trump's all too public addiction to Twitter.

Undoubtedly, trade disputes will continue to erupt but it is the extent to which they lead to punitive action and provoke strong retaliation that matters for the world economy.

Within Europe, the recent election surprise in Germany could have a negative impact, as Chancellor Merkel is forced to consider tighter controls on immigration and to focus on strengthening the European Stability Mechanism ('ESM'), possibly disappointing France in the process.

Inflation remains public enemy number one

As we discussed in our base case scenario, there is concern that the U.S. economy overshoots full employment. To avoid an overshoot, policymakers will need to slow down growth but if the momentum in the economy is too strong this may require an aggressive monetary response.

> There remains a serious concern that the leaders' rhetoric spirals out of control in a tit-for-tat exchange e.g. between Trump and Kim Jong-un.

Run out the guns

In our second scenario, we place a lot of focus on the actions of the policymakers, including politicians and global leaders.

There remains a serious concern that the leaders' rhetoric spirals out of control in a tit-for-tat exchange e.g. between Trump and Kim Jong-un.

At its simplest level, this is a distraction that the world could do without, given the number of tangential regimes that would be caught up in any serious escalation. At its extreme, it could catapult the world into a volatile confrontation in a region where there are other existing territorial disputes still simmering involving China, Taiwan, Japan, U.S. and Russia.

New threats from new technology

The final unknown that we consider in our second scenario is the impact of disruptive technology and the number of new industries and products emerging that are challenging the existing market leaders.

Investment implications

This scenario ultimately involves a significant correction in equity markets and a rally in bonds. The journey to this end result would involve heightened volatility and could easily begin with a late, last move higher in equities. Government bonds could sell off in the early stages of this scenario as inflation and interest rates rise before rallying hard as equities crack and recession looms.

For the potential implications of this scenario on our asset allocation, see our under- and over-emphasis tables.

The 'Policymakers pull the punchbowl' scenario is a negative global economic momentum scenario where policymakers intervene aggressively to thwart rising inflation expectations and inadvertently pull forward a global economic recession. This would be very negative for global equity markets and particularly negative for a commodities-heavy market such as Canada.

Tweets

Leaders use Twitter to indulge in protectionist rhetoric, promoted and amplified via the world media.

President Trump @potus

No nation on Earth has an interest in seeing this band of criminals arm itself with nuclear weapons and missiles.

Kim Jong-un @supremeleader

A frightened dog barks louder.

President Trump @potus

The United States has great strength and patience, but if it is forced to defend itself or its allies, we will have no choice but to totally destroy North Korea. Rocket Man is on a suicide mission for himself and for his regime.

Kim Jong-un @supremeleader

Action is the best option in treating the dotard who, hard of hearing, is uttering only what he wants to say.

3 Perfect policy prevails (10% probability)

In this, our upside scenario, we look at what happens when the policies all go according to plan. However, given the number of possible factors at play, we are mindful that this is a low likelihood and have given it a 10% probability, for the optimists amongst us.

Policymakers get it right

First up, we assume in this scenario that central banks are successful at bringing their economies back to full employment smoothly and without pushing up inflation. Balance sheets and interest rates are normalised without undue hiccups and markets continue to advance undisturbed.

Trump triumphs

In this scenario, we anticipate that President Trump gets it right for the U.S. We anticipate that his tax reform bill (the first major reform since 1986), which proposes a meaningful reduction in U.S. corporate tax and simplifies the income tax structure, is successful in delivering the promise of jobs and economic growth.

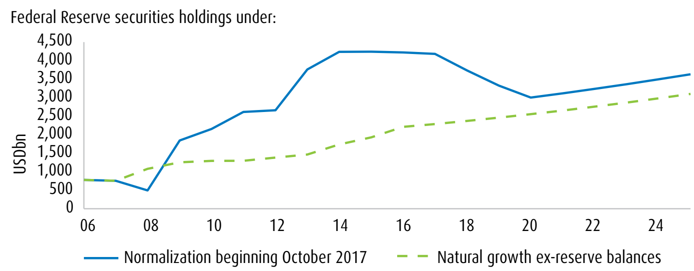
We also anticipate that the reform measures being proposed by President Xi in China and Prime Minister Abe in Japan are all successful at stimulating their local economies – covered in more detail in our base case scenario.

We consider the need for governments to deliver changes with fiscal measures rather than relying on central bank monetary measures to add stimulus. This can be achieved by investments in infrastructure, which boost supply as well as demand and relieve bottlenecks in the process. One such example is in China, where there is heavy state investment which is feeding the construction industry. We anticipate in this scenario that this in turn stimulates production and trade picks up.

Robots take the strain

A key outcome of this scenario is that global capital expenditure rises, enabling productivity to go up and be sustained. However, given the context of our ageing baby boomers, we believe that to deliver on this we will see a step-change in the integration into the workplace of software automation and artificial intelligence systems, if not robots as such at this stage. The efficient implementation of systems will help bridge the gap in the labour force, without disenfranchising the low-paid workers, who will be more easily able to transition into skilled roles with the help of the new systems in place.

Chart 15: Federal Reserve Securities holdings since start of quantitative easing



Source: Federal Reserve, Barclays Research

One other beneficiary of the rise in global capital expenditure will be emerging markets, who we believe would be drawn into a bull market, interestingly due to a domestic rally and not as a result of exports.

Talk not action

And finally, we believe diplomacy wins the day and all the talking would occur behind closed doors, enabling agreements to be reached and deals to be struck without the escalation to warfare.

Investment implications

In this 'perfect world', risk assets perform strongly and bonds come under only limited pressure; volatility remains low.

For the potential implications of this scenario on our asset allocation, see our under- and over-emphasis tables.

The 'Perfect policy prevails' scenario contemplates the potential for a much better outcome to emerge on the policy front, specifically in the U.S. where the market discounts the potential for the U.S. administration to navigate its aggressive fiscal stimulus plans through Congress. This would be a positive environment for Canadian equities.

There are growth opportunities for existing producers of technical components and consumers, such as Japan and China, who have the flexibility and drive to migrate workforces into the new working practices.

4 **Strategic asset allocation:** over and under emphasis tables

			Steady as she goes		Policymakers pull the punchbowl		Perfect policy prevails	
			Under	Over	Under	Over	Under	Over
Equities								
Developed Markets (DM)	U.S.			●				●
	Euro				●			●
	UK				●			●
	Japan				●			●
	Canada			●	●			●
	Non-resource cyclicals	Information Technology		●	●			●
		Financials			●			●
		Consumer Discretionary		●	●			●
		Industrials		●	●			●
	Commodity / cyclicals sectors	Energy			●			●
		Base metals			●			●
		Precious metals			●			●
	Income sectors	Utilities	●			●	●	
		Pipelines						
		Telecom	●			●	●	
		Health care	●			●	●	
		REITs	●			●	●	
Emerging Markets (EM)	EM overall			●	●			
	India			●	●			●
	China		●		●			
	Russia				●			●
	Brazil				●			●
	Commodity importers					●	●	
	Commodity exporters				●			●

The views and opinions expressed above reflect potential approaches to asset allocation in line with our responsibility as steward of our clients' capital. They are held at the time of preparation, are subject to change at any time and may not necessarily indicate current portfolios' composition.

		Steady as she goes		Policymakers pull the punchbowl		Perfect policy prevails	
		Under	Over	Under	Over	Under	Over
Fixed Income							
DM	U.S.				●	●	
	Euro		●		●	●	
	UK		●		●	●	
	Japan		●		●	●	
	Canada				●	●	
	Inflation-linked bonds			●			●
	Nominal Rates				●	●	
	Sovereign		●		●	●	
	Credit products – investment grade			●			●
	Credit products – high yield			●			●
	Canadian preferred equity						●
	EM – overall			●			●
Alternatives							
	Commodity related			●			●
	Fixed (non-duration and credit)				●		
	Global Macro		●		●		●
	Gold				●		●
	Infrastructure	●			●		●
	Insurance linked						
	Long-short relative value strategies						●
	Private equity	●			●		●
	Real estate			●			●
	Style premia				●		●
Currencies							
	USD				●		●
	CAD						
	EUR					●	
	YEN						
	GBP					●	

Let's connect

Institutional Investors

bmoam.institutional@bmo.com
bmo.com/gam/ca/institutional

Investment Advisors

1-800-668-7327

bmo.com/gam/ca/advisor

BMO Global Asset Management

11/17-2286