Outlook for Financial Markets

Positioning review: An international adjustment and mid-cap affirmation

"The investor of today does not profit from yesterday's growth."
– Warren Buffett

Upgrading emerging markets

We recently recommended moving to an overweight position on emerging market equities while simultaneously underweighting non-U.S. developed large-caps and raising a small cash position. We believe this positioning provides a better risk-reward tradeoff, given that Europe faces multiple headwinds, China's stimulus is showing signs of bolstering its economy, and the cash position slightly reduces risk after the significant year-to-date rally. Europe's challenges include continued declines in forward-looking business activity readings ***(Exhibit #1)***, sharply reduced growth estimates, declining banking activity for the first time since 2012, and the possibility of President Trump soon turning his trade war focus in that direction. Brexit uncertainty, while not a primary driver of this tactical repositioning, is also unhelpful to European growth.

Much of the reduction in our recommended allocation to non-U.S. developed large-cap equities is directed toward an overweight in emerging market equities. Within emerging markets, China holds the largest sway, both due to the sheer size of its domestic economy and to its important trading relationships with other emerging market countries. Recent stimulus measures in China include accelerated fiscal spending, reduced reserve requirements for banks, and tax cuts to both consumers and corporations. While some economic readings continue to be mixed, Chinese data on credit growth and consumer spending have turned positive. More broadly, we expect the recent stimulus measures to stabilize global growth going into the latter part of 2019.

Finally, equity markets across the globe have gotten off to a strong start in 2019, and Non-U.S. developed and emerging markets are no exception. The rebound from the Q4 selloff was both expected and welcome, and increasing our cash allocation takes advantage of this swift reversal while also positioning for future opportunities. Despite the sharply positive trajectory to kick off the year, it is unlikely that 2019 will see a straight ride up in the equity markets.

U.S. mid-cap preference remains intact

Recent equity market volatility – both on the downside in Q4 2018, and on the upside in January and February of this year – highlighted the fact that large-cap, mid-cap, and small-cap[1] equities can experience meaningfully different returns. While all of these groups fell significantly in Q4 2018, and then rebounded sharply to begin 2019, the magnitudes of both the declines and rebounds differ by as

Executive Summary

Chinese stimulus drives emerging market equity upgrade

Weak business activity gauges prompt reduction in non-U.S. developed markets

U.S. mid-caps remain attractive as small-cap debt burdens build

Yield curve flattening not yet cause for concern

[1] According to the FTSE Russell indices, the "large-cap" Russell 1000 index has an average market capitalization of approximately $196 billion (median $10 billion), the "mid-cap" Russell Mid-Cap index has an average market capitalization of $16 billion (median $8 billion), and the "small-cap" Russell 2000 index has an average market capitalization of $2.4 billion (median $0.8 billion).

much as 5% *(Exhibit #2)*. This dispersion is one reason our asset allocation framework often includes specific positioning references to large-cap, mid-cap and/or small-cap U.S. equities. Today, for instance, we advocate for an overweight positon in large and mid-caps, while taking a more neutral view on the small-cap space.

Before delving into the forward-looking risks and growth prospects of these different size categories, it is worth understanding some longer-term historical trends. Panel A on *Exhibit #3* shows the annual returns and standard deviations from 2000 through 2018. As a quick aside, this period has lower equity returns than most others of similar length due to the fact that it begins on the eve of a recession. What is more noteworthy, however, is that both small-caps and mid-caps have higher average returns and higher risk (i.e., volatility) than their large-cap counterparts. Panel B of *Exhibit #3* includes the late 1990s go-go years, and this longer period shows only mid-caps outperforming relative to large-caps. As expected, large-caps continue to exhibit lower risk, but only modestly so in this particular period. Nonetheless, large-caps remain the foundation of an equity allocation and allow for exposure to the world's leading companies.

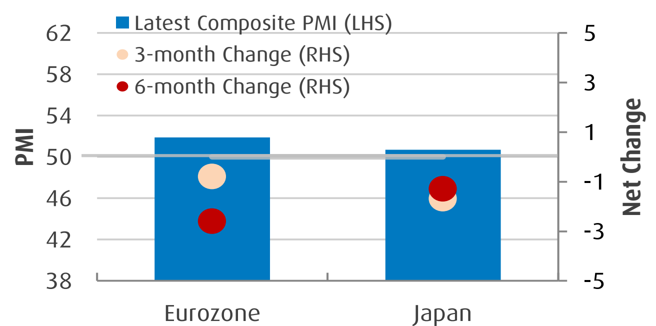
Although the general consensus is that small-caps should experience higher returns relative to large-caps due to their greater risk, only periods prior to the 1990s consistently support this idea. Even in those earlier episodes, the additional return to small-cap stocks was concentrated in those companies with the highest level of default risk based on debt levels and business volatility.

If exposure to default risk is the primary driver of any small-cap expected outperformance, the forward-looking environment may not be particularly kind to this segment if market risk increases or the economy slows. Corporate debt buildup is often cited as a major concern given that U.S. corporations are facing a "maturity wall" of over $4 trillion worth of debt that needs to be either refinanced or repaid over the next five years.[2] Corporate debt accumulation since 2010 has been most pronounced in small-caps *(Exhibit #4)*, and the additional cash flow cushion to meet interest payments is far weaker in small-caps compared with large or mid-caps *(Exhibit #5)*. While we believe that the elevated level of impending debt maturity can be absorbed by a steady and growing U.S. economy, it is a risk factor that would likely add fuel to any economic downturn over the next few years. If corporate debt concerns do come to bear, mid-caps are likely to have much less negative "tail risk" than small-caps.

On the positive side for small-caps, the future earnings growth expectations are a few percentage points higher than those of mid-caps *(Exhibit #6)*. This growth differential, however, is already well-reflected in prices, as shown by the 2019 forward looking price-to-earnings ratio and also the "out years" P/E ratio that is based on projected 2021 earnings *(Exhibit #7)*.

[2] https://www.bloomberg.com/news/articles/2018-05-09/corporate-america-s-staring-down-4-trillion-wall-of-refinancing

Exhibit 1 » Eurozone & Japan Manufacturing Purchasing Managers' Index (PMI)



Source: Bloomberg Financial; BMO Wealth Management Strategy

Exhibit 2 » Recent Returns to Large, Mid, and Small-Caps

	Q4 2018	Jan-Feb 2019
Russell 1000 Index	-14.07%	12.05%
Russell Midcap Index	-15.10%	15.54%
Russell 2000 Index	-19.09%	17.02%

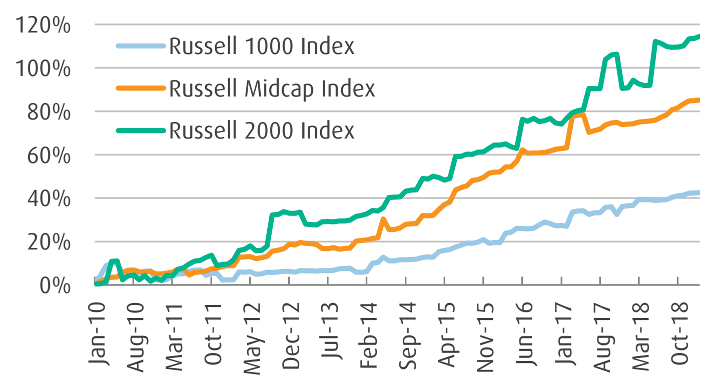
Source: Bloomberg Financial; BMO Wealth Management Strategy

Exhibit 3 » Longer-term Returns and Risk to Large, Mid, and Small-Caps

Panel A: 2000 to 2018			
	Russell 1000 Index	Russell Midcap Index	Russell 2000 Index
Average Compounded Return	5.12%	7.95%	6.70%
Risk (standard deviation)	17.97%	20.03%	20.00%
Panel B: 1995 to 2018			
	Russell 1000 Index	Russell Midcap Index	Russell 2000 Index
Average Compounded Return	9.62%	10.88%	9.09%
Risk (standard deviation)	18.45%	18.84%	18.72%

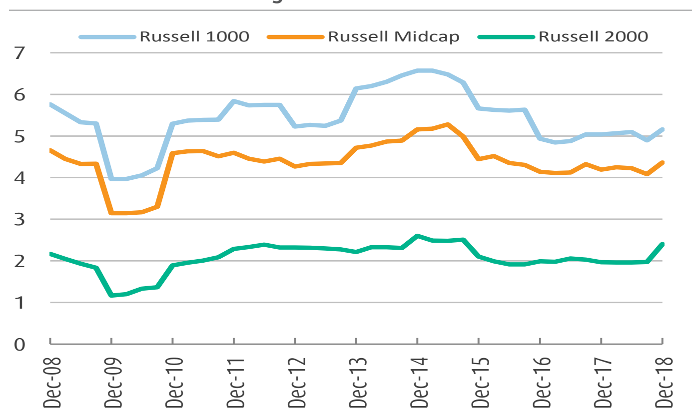
Source: Bloomberg Financial; BMO Wealth Management Strategy

Exhibit 4» Percent Increase in Total Debt since 2010



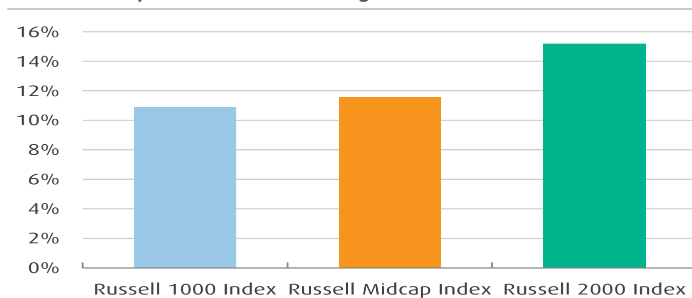
Source: Bloomberg Financial; BMO Wealth Management Strategy

Exhibit 5» Interest Coverage



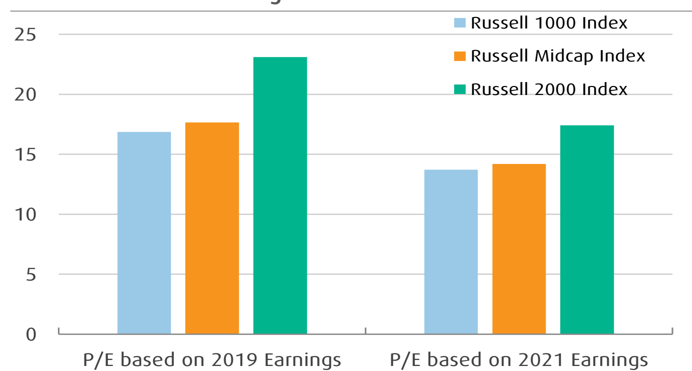
Source: Bloomberg Financial; BMO Wealth Management Strategy

Exhibit 6» Expected Annual Earning Growth: 2019 to 2021



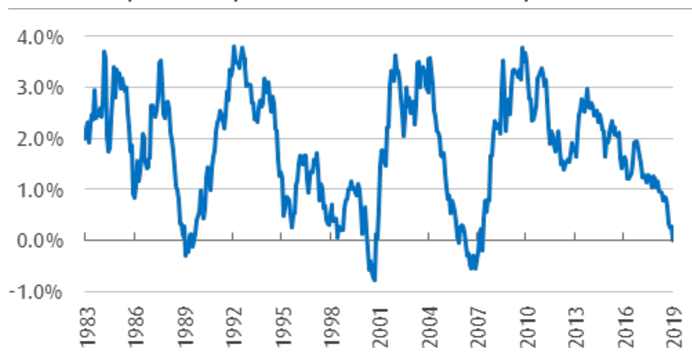
Source: Bloomberg Financial; BMO Wealth Management Strategy

Exhibit 7» Price-to-Earnings Forecasts



Source: Bloomberg Financial; BMO Wealth Management Strategy

Exhibit 8» Spread: 10-year minus 3-month Treasury Yields



Source: Bloomberg Financial; BMO Wealth Management Strategy

This premium reinforces our preference for mid-caps over small-caps at this stage in the economic cycle. Mid-caps have more established business, better access to capital, less default risk, and lower valuations than small-caps, while still retaining some of their higher growth characteristics. Historically, small-cap risk has not been consistently rewarded with higher returns, and the association of small-caps and default risk is undesirable given looming debt maturities. Mid-cap risk, however, has been adequately compensated in recent decades with higher returns than that of either large-caps or small-caps. Possible reasons why small-caps may not have the same degree of additional compensation for risk as seen with mid-caps includes investors' willingness to pay a premium price for the possibility of a "home run" small-cap investment. It is also possible that small-cap dedicated strategies have grown too large relative to the size of the market.

Yield Curve Inversion: Canary in the coal mine or idle threat?

The week ending March 22nd saw the yield curve flatten considerably with the rate on the 10-year treasury note reaching approximately the same level as the annualized yield on the 3-month T-Bill ***(Exhibit #8)***. Concern about an "inverted" yield curve, where the 10-year rate actually falls below that of the 3-month bill, is grounded in historical precedent. Such an inversion has taken place before the past six recessions, with only one false-positive reading occurring in the mid-1960s. An inverted yield curve decreases the incentive for banks to lend, and potentially signals the bond market is pricing in economic weakness in the quarters ahead.

In today's economic environment, however, it is important to note that interest rates are starting from a structurally lower point than in the past due to slower growth, demographics, and other factors. This suggests a curve flattening – and potential inversion – doesn't carry the same level of significance as seen in previous episodes. Additionally, looking out to the very long end of the yield curve, the 30-year treasury bond yield remains well above short-term interest rates. However, while a flat curve or slight inversion may not carry the same weight as in the past, we are monitoring the developments closely. Economic and market implications would increase if a sharper inversion occurred and persisted for an extended period of time.

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As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments for our Ultra High Net Worth group, and became National Head of Investments in 2015. In January 2018, Michael took over the role of Chief Investment Officer. With close to two decades of experience in money management, Michael has a deep background in economic analysis, portfolio construction and risk management.

Michael earned a BA in economics from Northwestern University and an MBA with distinction in finance and decision sciences from the J.L. Kellogg Graduate School of Management at Northwestern University in Evanston, Illinois. He is a member of the Beta Gamma Sigma International Honor Society, holds a Chartered Financial Analyst designation, and is a member of the CFA Institute, CFA Society of Chicago, and the Chicago Quantitative Alliance. He is also a graduate of the American Bankers Association – National Trust School.

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As Chief Investment Strategist, Yung-Yu is responsible for performing macroeconomic analysis, valuation modeling and market analysis across asset classes to guide strategic and tactical asset allocations for client portfolios.

Prior to joining BMO Wealth Management, Yung-Yu was a finance professor at Lehigh University, where he taught courses in fixed income, equities and derivatives. His academic studies have been cited in the *Wall Street Journal*, in leading finance journals, top law journals, the *Handbook of High Frequency Trading*, and in *Oxford Handbook of Corporate Governance*. During his tenure at Lehigh, he was awarded the Staub Outstanding Teacher Award, awarded to one faculty member by a vote of faculty and students. Prior to his academic career, Yung-Yu worked for a global consulting firm performing financial and market analysis for global companies with operations in Hong Kong, Taiwan and Mainland China. Later, he oversaw the operations at a Fortune 500 subsidiary in Taipei and Mainland China.

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Yung-Yu lives in Portland, Oregon with his wife and two children. He is a basketball fan and enjoys cheering on his children's teams.

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