February 2025

BMO GAM's monthly house view

Opportunity in crisis: An active manager's dream come true

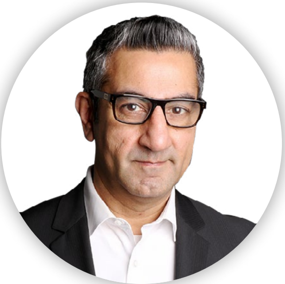
Presented by BMO GAM's
Multi-Asset Solutions Team

BMO | Global Asset Management

CIO strategy note
Economic outlook
Portfolio positioning
• Asset classes
• Equity
• Fixed Income
• Style & factor
• Implementation
Disclosures

Opportunity in crisis: an active manager's dream come true

Welcome to volatility[1]—let's put our seatbelts on but enjoy the ride.



Sadiq S. Adatia, FSA, FCIA, CFA
Chief Investment Officer (CIO)

January was a newsworthy month for markets to say the least. From President Trump's new tariffs to the DeepSeek bombshell that rocked the artificial intelligence (A.I.) world, there was no shortage of opportunities to go bearish and pull money off the table. But that would have been a mistake—at the end of the month, markets were up. We expect this kind of volatility to continue throughout the year. In January, it was tariffs. Next month, it might be geopolitics, or inflation, or the interest rate trajectory. Fundamentally, markets are still bullish, so they're likely to overreact to any news that is perceived to be negative. For investors, the key is to see through the noise, stay invested, and buy on the dips when prudent.

Why are we so confident in markets despite the ups and downs? For one, the U.S. economy is still strong. Secondly, corporate earnings still matter, and Q4 results have generally been good. And finally, Trump hasn't yet done anything to truly upset markets, as some feared he might. The tariff situation was a flashpoint, but the end result—a minimum 30-day delay on tariffs on Canada and Mexico, and a new 10% tariff on China—was toward the milder end of the range of possibilities. Despite the temporary relief, however, Trump did introduce new 25% tariffs on all steel and aluminium imports, including those from Canada. This suggests that the tariff discussion isn't over, but rather may just be beginning. Trump himself is an unpredictable character, which adds to our skepticism. So far, outcomes have been fairly bullish for markets. But we still believe that hedging/protection should be a part of investors' portfolio for the "just in case" scenario.

For investors, the key is to see through the noise, stay invested, and buy on the dips when prudent.

International markets appear to be next on Trump's tariff agenda. We know from Trump's recent spat with Colombia that he's likely to go after any country that irritates him, which creates uncertainty. But that crisis, as well as the tariff situations with Canada and Mexico, were resolved—or at least reached a temporary truce—relatively quickly. It's a situation worth monitoring.

We'll also be listening closely to comments from the U.S. Federal Reserve (Fed) and Bank of Canada (BoC). The key here is the tone of their messaging—if central banks continue to hint at more interest rate cuts, markets will be okay. On the other hand, if the Fed comes out and suggests that they're considering raising rates, markets are not going to behave. The underlying strength of the economy means that investors shouldn't be too worried. But from interest rates and inflation to trade tensions and geopolitical risks, there are plenty of potential sources of volatility that could play out throughout 2025.

Economic momentum meets trade uncertainty

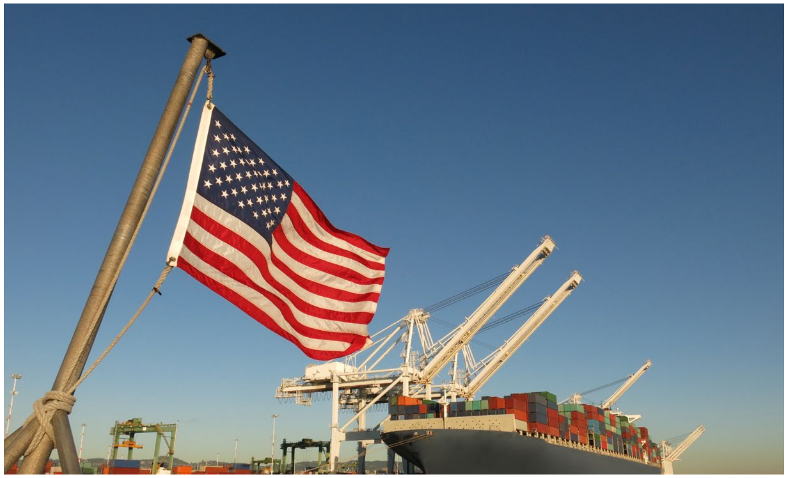
U.S. fundamentals remain strong while Canada's economy hums along and Europe, Australasia, and the Far East (EAFE) and Emerging Markets (EM) continue to struggle. The question now is: will Trump's tariffs rock the boat?

Brittany Baumann
Vice President,
Investment Strategist

U.S. outlook

Removing the tariff noise, the fundamentals of the U.S. economy remain strong. Q4 gross domestic product (GDP) growth clocked in at 2.3%, and we're continuing to see strong growth momentum into Q1 of 2025. Job growth continues at a solid clip and the inflation trajectory remains on track, though some slowing in the latter is possible in Q1. Winter weather could have a mildly negative effect on Q1 growth numbers, but in general, we expect growth to meet or exceed expectations for the year ahead. One concern had been that the labour market might be overheating and that Fed interest rate cuts should therefore be fully priced out, perhaps even to the point of pricing in a rate hike. We continue to push back on that view, as we think the labour market is much more balanced than payroll numbers would suggest. Moreover, we believe the data is not as inflationary as it seems, and that there is still a path for inflation to move marginally lower.

How will Trump's trade policies affect this outlook? To start, we think it's a very positive sign that tariffs were not immediately implemented on Canada and Mexico but were instead delayed 30 days. Uncertainty persists, but broadly speaking, we believe the end result will be lower-than-announced tariffs or limited tariffs targeted to certain products. Broad tariffs on Canadian and Mexico goods continue not to be our base case. China is a different story—a new broad 10% tariff on imports from the country has now been implemented, in addition to tariffs that were already in place. In general, we think this represents a reignition of trade tensions between the two countries. While China was spared the worst for now, the announced 10% tariff being lower than Trump's previously proposed 60%, it's possible that the tariffs will climb over time as tensions ebb and flow.



In our view, U.S.-China trade relations are distinctly different from American relations with Canada or Mexico, which offer more opportunity for near-term deals. There are also other factors that hang in the balance, including the joint review of the United States-Mexico-Canada Agreement (USMCA) that needs to be completed by July of 2026. That said, we expect the U.S. economy's momentum to continue, and even if the Trump administration resorts to its maximum threat of 60% tariffs on China, the growth hit and the effects on inflation are likely to be marginal. A greater risk would be some kind of significant universal tariff, but that is not our base case.

Canada outlook

There's no question that Canada dodged a bullet with regard to tariffs, and while a delay is not the same as a cancellation, we do not believe that a broad tariff on Canadian goods is Trump's endgame. Negotiations themselves do create uncertainty that could impact business investment, however, which may be a negative for growth. In general, Canadian growth is on a weaker trajectory than it is in the U.S. but is not as dismal as other regions like Europe. We think the Canadian economy will continue to hum along and, if anything, the Bank of Canada still looks underpriced for rate cuts. That means there's more they can do to stimulate the economy if negative news does emerge on the tariff front.

International outlook

Europe appears to be Trump's next target for tariffs, and we expect negotiations between the U.S. and E.U. to be less positive than between the U.S. and its North American neighbours. This looming trade war is set against a very weak growth backdrop for Europe. The European Central Bank (ECB) is expected to continue to cut rates, and we think markets may still be underestimating the number of cuts to come.

From the standpoint of economic outlook, EM is perhaps the weakest region, especially since the Trump administration's trade negotiations with China may be far from over. In fact, given Trump's apparent obsession with trade deficits, other areas of EM could also be at risk—Trump knows from his first term that China diverted some exports through other countries, and he's stated that he doesn't want to allow that again this time around. Trump has ordered a review of U.S. trade policy, with reports expected to be delivered on April 1. That could prove to be a key date for the EM region, as these reports could provide Trump with the justification needed to implement targeted tariffs on specific EM countries, especially in Asia.

Key risks	BMO GAM house view
Recession	• Low odds in the U.S. for the next six to 12 months • Rate cuts required in Canada; but should avoid recession
Inflation	• Not a threat, though stickier than expected in the U.S. • Tariffs are an upside risk, but their impact is likely to be modest at best
Interest rates	• Fed calculus is perhaps shifting to fewer cuts amid stronger backdrop and trade uncertainty • The BoC still requires many cuts to alleviate pressure on households
Trade policy	• Tariffs on China have been implemented, and there's room for more • Broad tariffs on Canada and Mexico remain unlikely, but sectoral tariffs and rocky trade relations are a risk
Consumer	• Job strength underpins strengthening U.S. consumer • Canadian consumer will remain bruised by mortgage resets through 2025
Housing	• Prevalence of elevated long-term U.S. mortgages means market stagnation until lower rates arrive • Canadian buying activity picking up as lower rate expectations spur demand
Geopolitics	• President Trump may in fact improve things (in his own way) • Stickiness remains, but wider conflict risk is momentarily lessened
Energy	• Trump is seeking cheaper oil and gas prices for U.S. households, but oil tariffs are a risk • Lid on geopolitical risks (i.e., a potential deal with Russia) may tamp prices further

CIO strategy note
Economic outlook
Portfolio positioning
• Asset classes
• Equity
• Fixed Income
• Style & factor
• Implementation
Disclosures

Asset classes

As the tariff situation evolves, our preference is to remain slightly overweight Equities (+1) until we have greater clarity on potential economic impacts.

Steven Shepherd, CFA
Director,
Portfolio Manager

The tariff situation is continuing to unfold, but we can now say one thing for certain: Donald Trump wasn't bluffing—at least not entirely. While new 25% tariffs on Canada and Mexico have been delayed by a month (China and its new 10% tariff weren't so lucky), it is clear that Trump is trying to accomplish something. The question is: does that merit a wholesale change in asset allocation? We think the answer is no, because we just don't have enough information at this juncture. In our view, it would be premature to completely abandon our prior overweight to Equities, especially given that we have already pared it from bullish (+2) to slightly bullish (+1) based on our evaluation of tariff-related risks when they were still hypothetical.

Tariffs aside, the economy remains in fairly good shape, especially in the United States. Interest rates are still on a downward trend, though the pricing of monetary easing has faded somewhat, and we expect that the BoC will join the Fed by pausing and lowering rates at a more measured pace. What shook the market in January was the notion that DeepSeek may have revealed the valuation of A.I.-related companies to be extremely exaggerated. The reality is that sometimes, having a better product is not necessarily the same as having a better business. Dislodging giants like Microsoft, Meta, Google, and even Nvidia—with their research capabilities, distribution, and partnerships—means you've got to be more than a one-trick pony. There is also the open question of whether DeepSeek was developed fairly or if it benefitted from the unauthorized use of competitors' data. DeepSeek does provide another reason to reconsider one's portfolio positioning, but that was already happening in the market, as we've seen with the rotation trade; we began to position for that early through allocations to Financials and Industrials.

On the Fixed Income side, we remain neutral (0). Compared to the U.S. yield curve,[2] it's more predictable that policy rates on the Canadian curve are going to come down. If tariffs do materialize, they are likely to have more impact on the longer end of the curve in the form of inflation.

Overall, we think the asset allocation message for February is that less has changed than many investors assume. For now, we are content to remain overweight Equities, while taking advantage of other ways to hedge against risk.

	Very Bearish	Bearish	Slightly Bearish	Neutral	Slightly Bullish	Bullish	Very Bullish
EQUITIES					**Slightly Bullish**		
FIXED INCOME				**Neutral**			
CASH			**Slightly Bearish**				

Equity

Marchello Holditch, CFA, CAIA
Head, Multi-Asset Solutions

We continue to prefer the U.S. to other regions despite having trimmed our U.S. Equities position to slightly overweight (+1) from overweight (+2). Meanwhile, China avoids harsh new tariffs—for now—and we remain slightly underweight (-1) EAFE despite European markets outperforming their economic fundamentals.

Though uncertainties remain with regard to tariffs, our downgrade on U.S. Equities to slightly overweight (+1) from overweight (+2) last month has more to do with profit-taking and an acknowledgment that valuations are high and volatility could persist. We continue to prefer a U.S. Equities exposure to any other region. Our expectation is that if significant tariffs do come into effect (or persist, in the case of China), they are likely to affect growth and increase inflation outside the United States more than within it. At the sector level, it's the goods-heavy, trade-oriented areas that are most likely to be hit, including Industrials, Technology, and the Consumer sectors. As a service-oriented but typically economically-sensitive sector, Financials falls somewhere in the middle, while areas like Energy are less vulnerable, especially given the exemption (a 10% tariff rather than 25%) that Trump's proposals cut out for Canadian Energy.

While DeepSeek proved to be bad news for the Magnificent 7 (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) in the short term, we think it is probably a structurally net-positive story for A.I. in general. It indicates that A.I. innovation could be less expensive than originally thought, which could accelerate adoption. What has changed is the competitive landscape: you probably no longer want Nvidia to be the only name you own in the A.I. space. To express the A.I. theme, you'll now likely need to incorporate a wider set of potential winners, including other semiconductor companies, software companies, and others. Does that mean that the Mag 7 won't continue to see healthy earnings growth? Not necessarily. It simply means that investors will now have to assess their portfolio construction and adjust their A.I. thesis to account for potentially broader pickup.

In EM, the comfort is that Trump's 10% tariff on China means that it has been spared the worst-case scenario—at least for now. That's a net positive, even if the Chinese government could still do more in terms of fiscal stimulus. Valuations are very attractive, so if markets get nervous about high valuations elsewhere, EM could be a decent place to wait things out. Sentiment remains low, but it is simply an area where we no longer want to be underweight, hence our upgrade this month to neutral (0).

We remain slightly underweight (-1) EAFE. Overall, our tone on Europe is one of caution—the European Union (E.U.) went untouched in the first round of Trump's tariffs, but they may not be lucky for long. The European economic backdrop continues to look weak, but surprisingly, it was the best-performing market in January, meaning that it outperformed its fundamentals. This is among the reasons we haven't reduced our EAFE rating even further.

CANADA	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
U.S.A.	Very Bearish	Bearish	Slightly Bearish	Neutral	**Slightly Bullish**	Bullish	Very Bullish
EAFE	Very Bearish	Bearish	**Slightly Bearish**	Neutral	Slightly Bullish	Bullish	Very Bullish
EM	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish

PORTFOLIO POSITIONING

Fixed Income

As potential tariffs complicate the rate cut outlook, we remain neutral (0) on Investment Grade, High Yield, and EM debt while continuing to prefer Canadian Duration[3] (+1) to U.S. Duration (0).

Marchello Holditch, CFA, CAIA
Head, Multi-Asset Solutions

The Fed's late-January meeting was relatively uneventful, in our view, and we remain neutral (0) on U.S. Duration. The central bank acknowledged that rates are still in restrictive territory but reiterated that there's no urgency to cut because unemployment has remained relatively stable and inflation data has been fairly tame. The door remains open for additional rate cuts later this year, but the big question mark is tariffs. Their potential economic effects are tough for analysts and the Fed alike to factor in, in part because the situation is ever-evolving. So far, their impact on rates has been relatively muted—we continue to be in what we view as the fair-value range of 4.25%–4.75%. Tariffs do have the potential to bring higher inflation, but that could also be offset somewhat by slower growth.

We've held our Duration rating for Canada at slightly bullish (+1), continuing to prefer it to U.S. Duration. Currently, the market is—rightly, in our view—pricing in a lot more aggressive easing from the BoC. But we have seen a fairly big move down in Canadian bond yields, likely because the tariff-related 'higher inflation vs. slower growth' trade-off mentioned earlier would likely be amplified north of the border due to the wide range of Canadian industries whose revenues come primarily from exports to the U.S. Going forward, the BoC is likely to test the limits on policy divergence with the Fed—we're already approaching a 2% difference, which is just shy of the greatest differential we've seen in the last few decades. If growth does slow, the BoC may have no choice but to cut more aggressively, but they'll have to tread cautiously or else risk the Canadian dollar (CAD) falling even further versus the greenback.

IG CREDIT	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
HIGH YIELD	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
EM DEBT	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
DURATION (U.S)	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
DURATION (CANADA)	Very Bearish	Bearish	Slightly Bearish	Neutral	**Slightly Bullish**	Bullish	Very Bullish

PORTFOLIO POSITIONING

Style & factor

As markets grapple with the ramifications of potential tariffs and the DeepSeek bombshell, we continue to prefer Quality.

Steven Shepherd, CFA
Director,
Portfolio Manager

There's been no change to our preference for Quality—at this point, bigger is simply better, as earnings season continues to be dominated by mega-cap companies and the S&P 500. In Canada, Quality leans toward some of our predominant sectors, including Energy and banks—large-cap companies with substantial cash flow that could weather a hypothetical recession. Trump's 10% tariff on Canadian oil isn't a significant hindrance, in our view; the spread between Western Canadian crude and WTI[4] tends to run between $12 and $18 dollars per barrel, historically speaking, so a 10% difference would easily fall within that range. Our preference for Financials is mostly a U.S. phenomenon—some of our portfolios have begun to shift toward regional banks from large-caps, which are pretty richly valued at this stage.

In Information Technology, the emergence of DeepSeek has been described as a "Sputnik moment," referring to the surprise launch of the Soviet Union's (and the world's) first satellite in 1957, which accelerated the adoption of new communication technologies. While this may be an apt comparison, it's not the technology that wins—it's the best business model. We think this situation does warrant some rotation within the sector, which we'd predicted and are already seeing. In fact, on the day the market sold off due to the DeepSeek news, more names in the S&P 500 were up than were down. Going forward, we're leaning away from the Magnificent 7 (and specifically Nvidia) a bit more and will be taking a closer look at the software space. That's likely to be the next leg of the A.I. story, just as we saw in the 1990s and 2000s, when Intel (hardware) and Microsoft (software) alternated innovations, each new hardware development demanding new software and vice versa.

In terms of Size, we continue to like small-caps, although uncertainty over tariffs may bring increased volatility in the near term. From a relative valuation perspective, small caps do offer significant value, and if we see a continuing rotation away from the Magnificent 7, we could see that value realized by the market. Small caps also benefit, on a relative basis versus large caps, from a stronger U.S. dollar (USD), since small caps tend to do most of their business domestically.

VALUE	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
QUALITY	Very Bearish	Bearish	Slightly Bearish	Neutral	**Slightly Bullish**	Bullish	Very Bullish
GROWTH	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
YIELD	Very Bearish	Bearish	Slightly Bearish	**Neutral**	Slightly Bullish	Bullish	Very Bullish
SIZE	Very Bearish	Bearish	**Slightly Bearish**	Neutral	Slightly Bullish	Bullish	Very Bullish

Implementation

After testing decades-long lows versus the USD, the CAD could be poised to rebound, but the timing is the big question. For now, we remain neutral (0). Meanwhile, we're maintaining our Gold position (+1).

Steven Shepherd, CFA
Director,
Portfolio Manager

The outlook for the CAD relative to the USD depends heavily on time horizon. From a portfolio positioning standpoint, the CAD's decline to 20-year lows in early February would statistically suggest that the direction is up for the Canadian dollar going forward. The problem is: when will that start? For now, it remains an open question, which is why we will take a dollar-cost averaging approach towards hedging that exposure. A few of our portfolios have taken small, incremental hedges of the USD back to CAD, mostly to hedge any overweight to U.S. Equities. If we see the CAD move lower from here due to the tariff issue, we will increase that hedge. Some portfolios are utilizing other ways of hedging, including currency-hedged ETFs, and our Gold position is itself a hedge against a strong USD. Looking ahead, we expect some volatility in the value of the CAD. So far, it has proven fairly resilient given the potential severity of the tariff situation. But we think it would be wise not to hold on to any position too tightly.

Little has change for Gold over the past month, and we continue to hold a slightly overweight position (+1). Prices appear to have consolidated in the $2,700–$2,800 per ounce range, with $3,000 a reasonable year-end target. One might have expected the strong USD to eat into prices a bit more, but they have held up fairly well. Longer term, if trade wars become a permanent feature of global international markets, that could accelerate the de-dollarization trend (the theme of central banks buying gold to prop up their own currency while diversifying their trade routes), a process that could play out over decades. For now, we're holding on to our Gold position, and it would likely take a significant spike in real rates—which we don't expect—for us to decrease our exposure.

In terms of implementation, a recent big win for us was buying some puts on XIU, the BMO S&P/TSX 60 Index ETF, just before Trump's new tariffs were announced. The Canadian market ended up not moving much, but that's the beautiful thing about option overlays—like motorcycle helmets, we're very happy when we don't need to use them. Any time we can spend pennies to protect dollars, that's sound risk management.

	Very Bearish	Bearish	Slightly Bearish	Neutral	Slightly Bullish	Bullish	Very Bullish
CAD				**Neutral**			
GOLD					**Slightly Bullish**		

DISCLAIMERS

[1] Volatility: Measures how much the price of a security, derivative, or index fluctuates.

[2] Yield curve: A line that plots the interest rates of bonds having equal credit quality but differing maturity dates. A normal or steep yield curve indicates that long-term interest rates are higher than short-term interest rates. A flat yield curve indicates that short-term rates are in line with long-term rates, whereas an inverted yield curve indicates that short-term rates are higher than long-term rates.

[3] Duration: A measure of the sensitivity of the price of a Fixed Income investment to a change in interest rates. Duration is expressed as number of years. The price of a bond with a longer duration would be expected to rise (fall) more than the price of a bond with lower duration when interest rates fall (rise).

[4] WTI Crude Oil, also known as light sweet crude, is considered the U.S. benchmark for pricing oil.