Macro Investment Strategy Chartbook

November 2014

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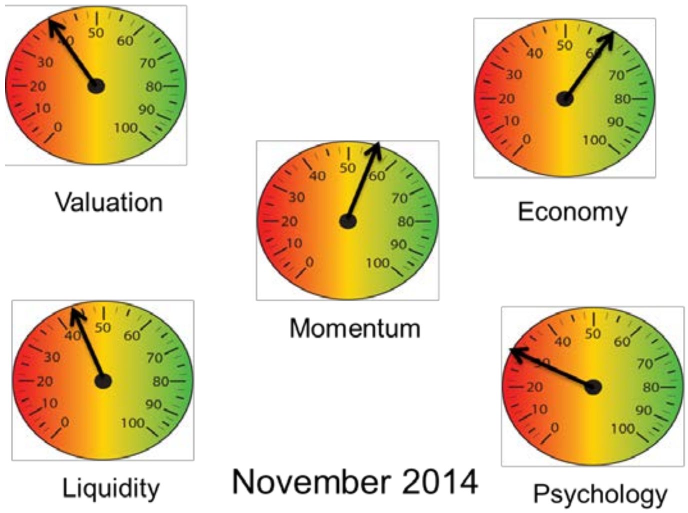
BMO Private Bank



- The U.S. economy is expanding at a moderate pace, led by manufacturing and exports. Housing continues to disappoint as family formations trail demographic expectations. Auto sales are strong. Oil price weakness will curtail the energy boom, but lower pump prices will mean more discretionary dollars in consumers' wallets.
- Despite the recent dip, U.S. equities remain expensive by historical standards, held up by liquidity and an economic tailwind. We continue to monitor changes in liquidity and momentum for clues to reduce our risk exposure. Third quarter earnings season so far has been encouraging.
- Historically low interest rates have made the long dated, fixed rate bonds vulnerable to growth and rising inflation expectations. While rates are below what fundamentals would suggest, deflation fears in Europe and slowing growth in China and Japan will likely keep a lid on rates.
- Scarred by the financial crisis, millennials are loath to accumulate consumer debt, including mortgages. This poses a problem for the Fed which has predicated its stimulus strategy on debt growth.
- We've become incrementally cautious on credit risk. While the fundamentals remain strong, the yield differential between high quality and low quality bonds narrowed to cyclical lows and are beginning to widen.
- Technological innovation has boosted our country's standard of living while creating jobs as the rising tide tended to lift all boats. Since 2000, however, technology has destroyed more jobs than it has created.

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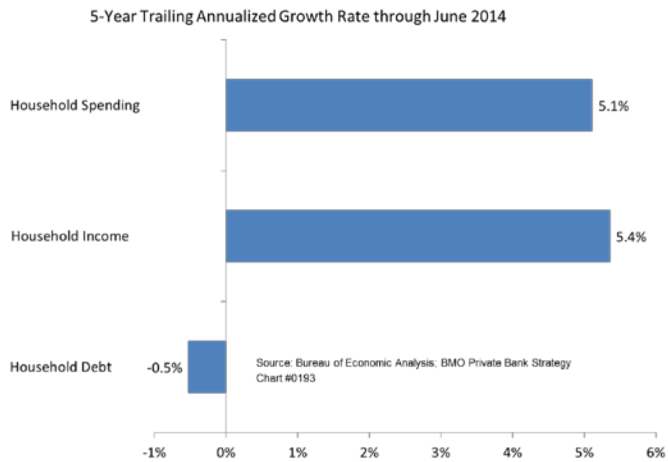
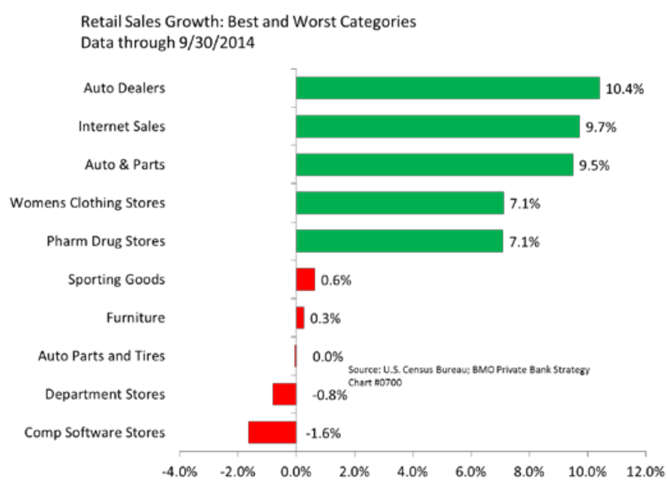
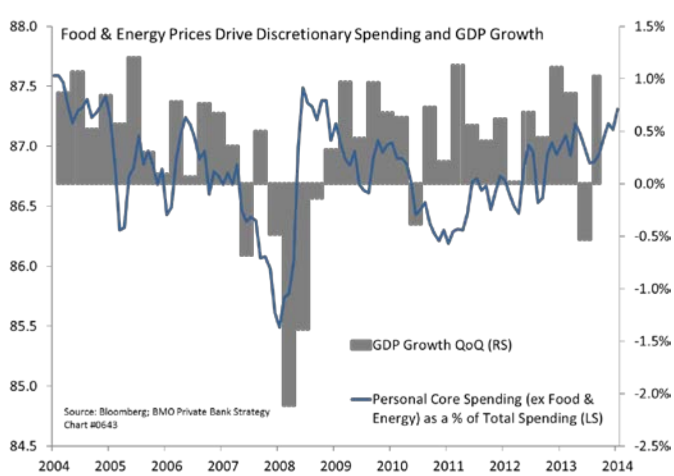
Consumers



Households have done a good job getting their balance sheets in order. Income growth has exceeded spending growth and debt loads have declined.



Discretionary spending is robust and auto sales have spiked. The big losers are furniture, due to the lack of new home purchases, and outmoded department stores.



Now that pump prices have broken below $3 per gallon, expect a discretionary spending boost. Citigroup estimates that $80 crude is worth almost $600 on average to every US household.

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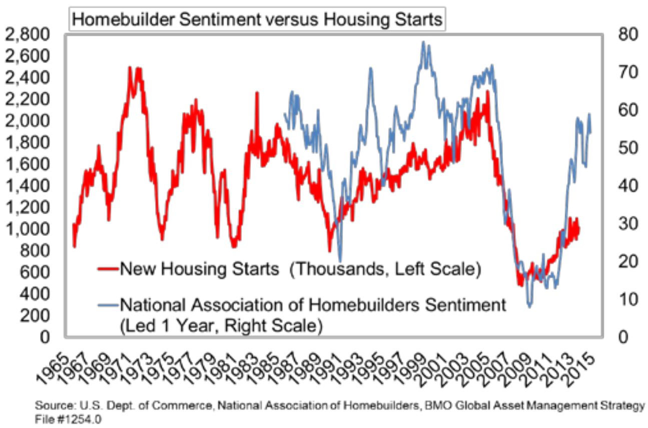
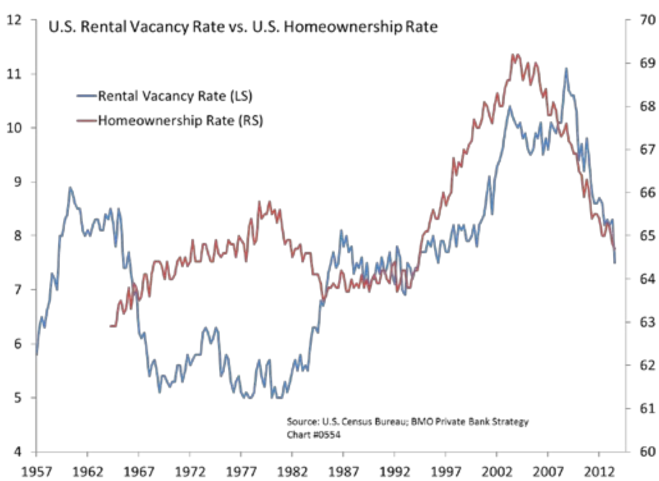
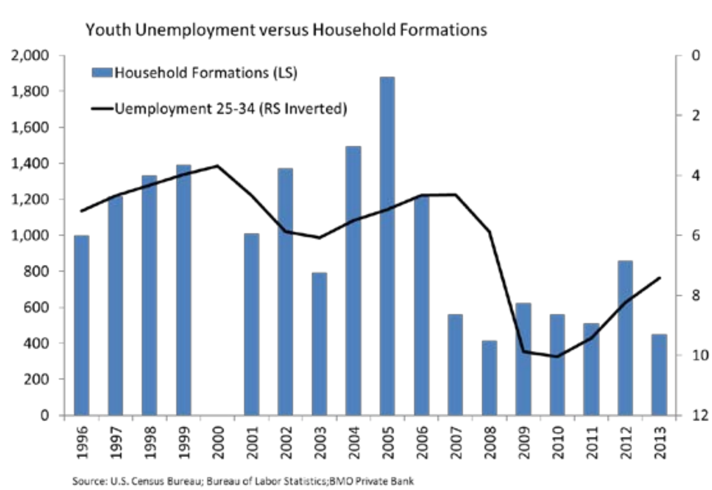


New home sales are running about 400,000 below median annualized. Homebuilder optimism suggests housing activity will pick up.

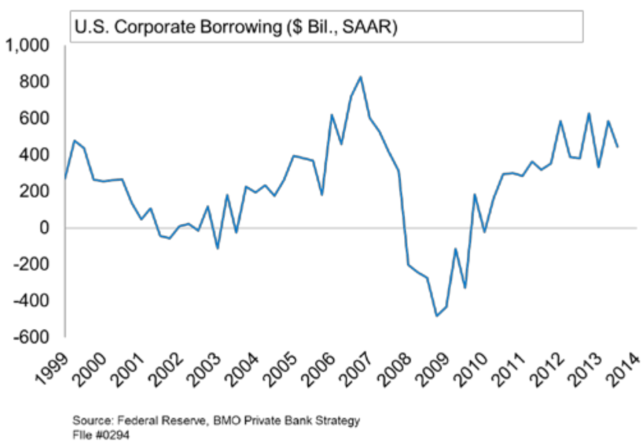


Would-be homeowners are opting to rent instead. Rental vacancy rates are declining along with the homeownership rate.

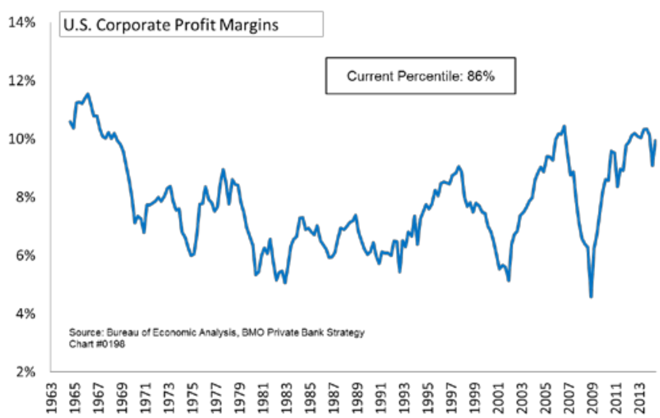


Household formations are trailing expectations. They appear to be influenced by the jobs market for young people.

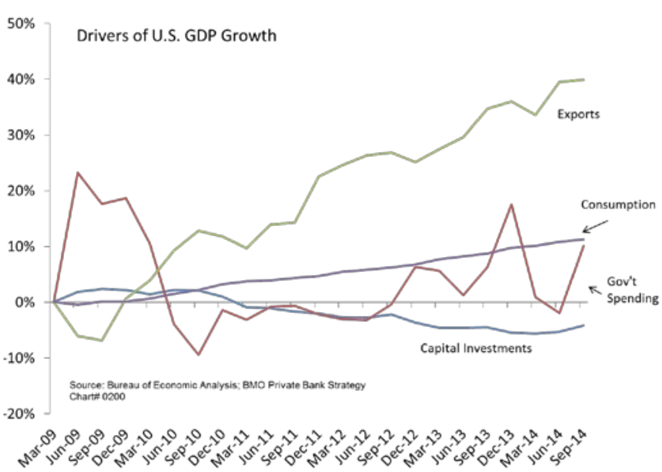
Corporate America



Corporate borrowing has expanded with low interest rates and meager credit spreads. It appears to be rolling over though.

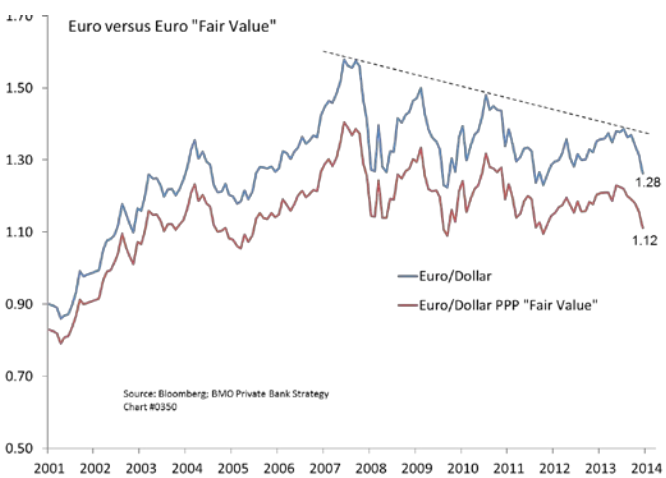


Corporate profit margins appear to have peaked. Maybe lower energy prices will help push profits higher.

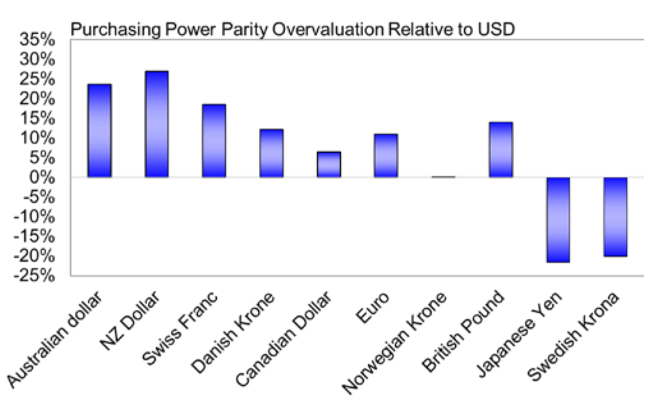


Exports have been one of the most incremental drivers of GDP growth since the downturn. Capital expenditures, meanwhile, have lagged.

The dollar is closely tied to U.S. Treasury rates. Rising yields should bolster the greenback.



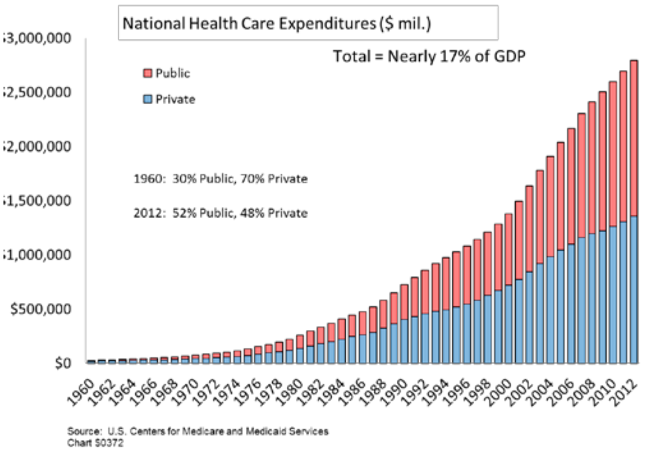
Notwithstanding its recent weakness, the euro remains above "fair" value.



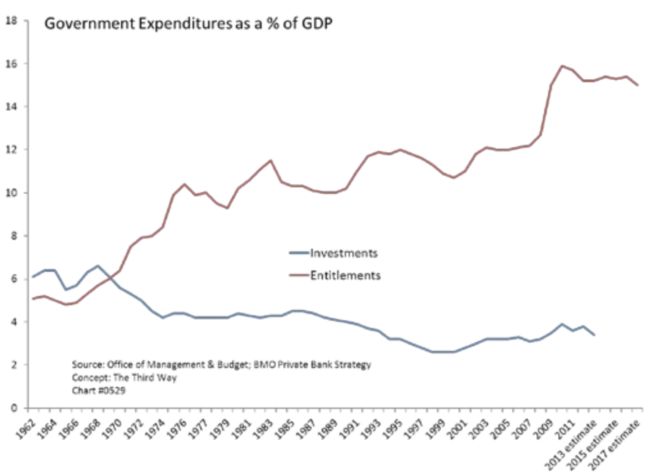
Source: Bloomberg, BMO Global Asset Management Strategy. Uses a long-run averaging methodology to estimate PPP values based on inflation and exchange rates relative to their Jan. 1982- June 2000 avg. values.
File #1515

The dollar looks cheap against most major currencies. Australian and New Zealand dollars are vulnerable.

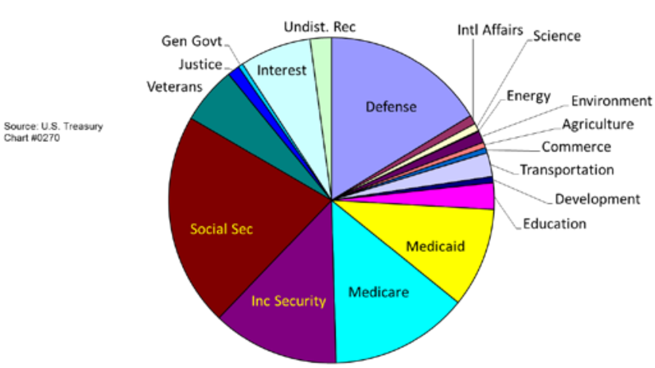
Public Policy



The public share of America's health care costs are growing faster than health care costs overall.



Entitlement spending has crowded out investments in Washington.



U.S. Budget Breakdown as of August, 2014

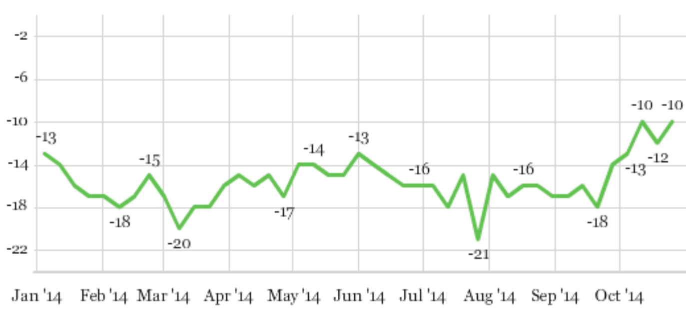
Only about 15 percent of the budget is discretionary. That leaves little room for policy.

Public Opinion

Most Americans agree that our nation's debt is too high.

Gallup's U.S. Economic Confidence Index -- Weekly Averages Since January 2014

Latest results for week ending Oct. 26, 2014



Gallup Daily tracking

GALLUP

Confidence in the U.S. economy is steadily improving, reaching the highest level of the year.

Crime Worries in U.S.

How often do you, yourself, worry about the following things -- frequently, occasionally, rarely or never? How about ...

	% Frequently or occasionally worry
Having the credit card information you have used at stores stolen by computer hackers	69
Having your computer or smartphone hacked and the information stolen by unauthorized persons	62
Your home being burglarized when you are not there	45
Having your car stolen or broken into	42
Having a school-aged child physically harmed attending school	31
Getting mugged	31
Your home being burglarized when you are there	30
Being the victim of terrorism	28
Being attacked while driving your car	20
Being a victim of a hate crime	18
Being sexually assaulted	18
Getting murdered	18
Being assaulted/killed by a coworker/employee where you work	7

Oct. 12-15, 2014

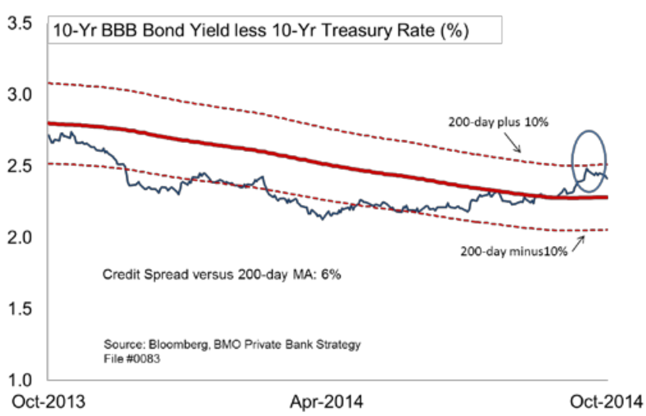
GALLUP

Hacking tops list of crimes Americans worry about most.

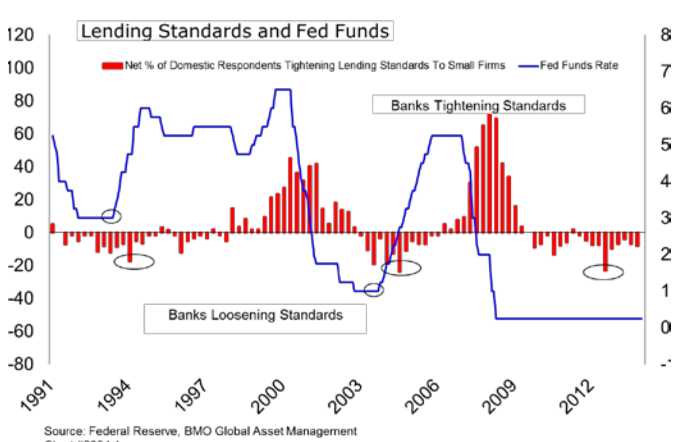
Liquidity

BMO Private Bank Liquidity Barometer
October 29, 2014

Liquidity Indicators	Percentile Now	1 (EASY)	2	3	4	5 (TIGHT)	Percentile Last Month
Japanese Yen	48%			▼			45%
Stock Market Volatility	25%		▼				33%
Bond Market Volatility	17%	▼					10%
Implied Inflation/Deflation	13%	▼					17%
Triple-B Bond Spread	11%	▼					10%

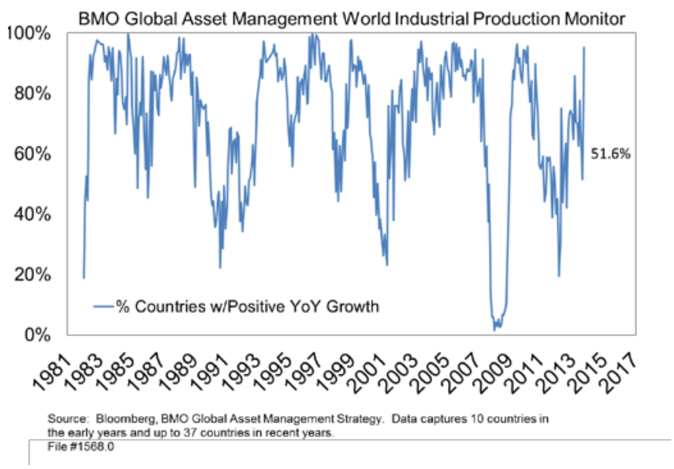


This liquidity metric is an early warning indication that investors are scaling back their risk level. So far, our band has not broken.

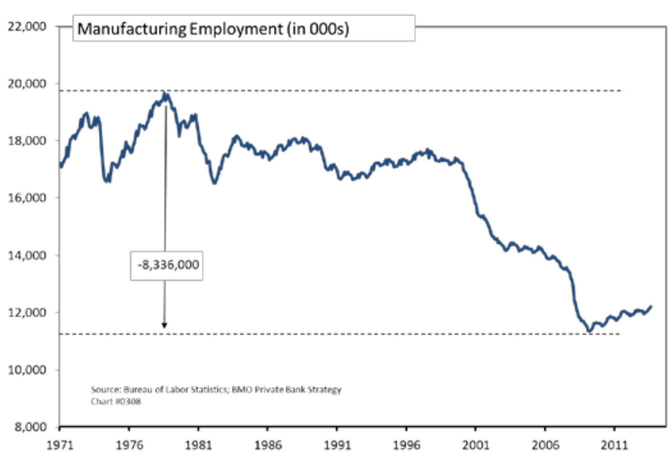


Banks have loosened their lending standards, but loan demand has been tepid.

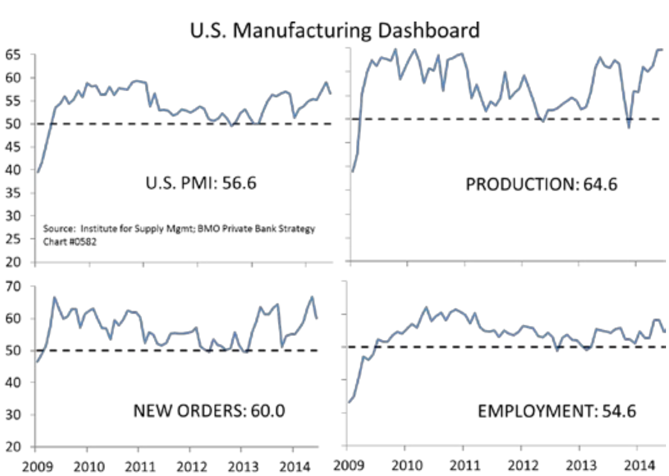
Manufacturing



World production is growing, but fewer economies are participating. 51 percent of countries have positive year-over-year production growth.

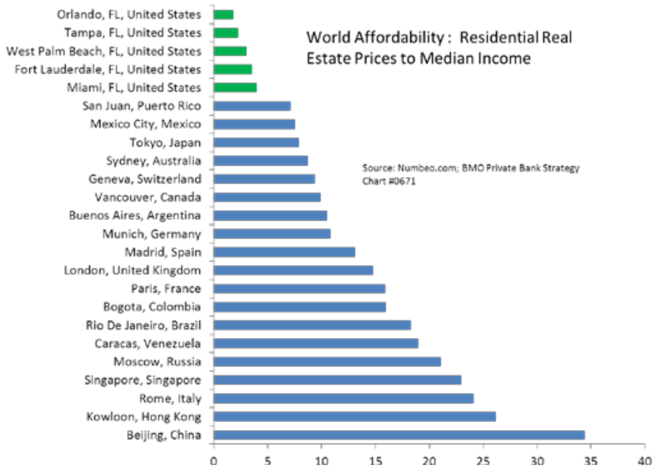


Hiring has improved, but output has been fueled by fewer employees. It's all about productivity.

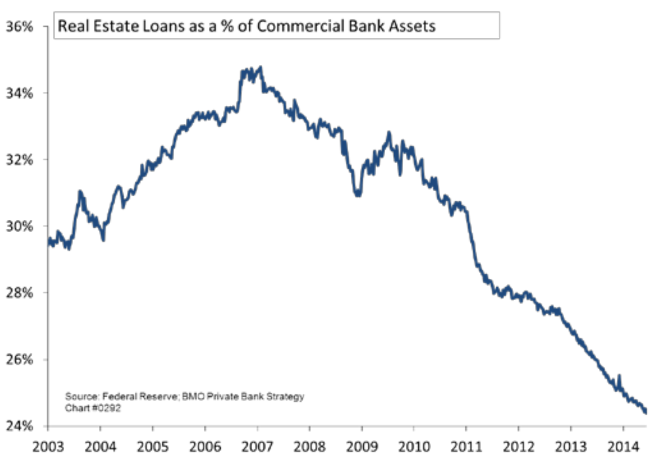


U.S. manufacturing is strong on all fronts. Production levels are pushing all-time highs.

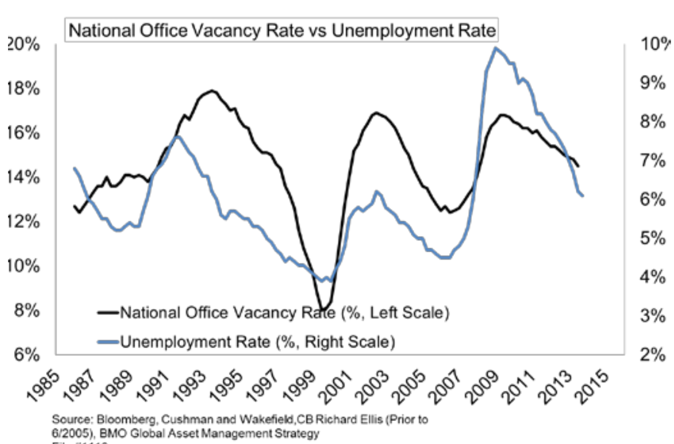
Real Estate



American residential real estate is relatively cheap globally. The chart compares the median home price to median income.



Regulations and the financial crisis are weighing on banks' willingness to extend credit on real estate.



Office vacancies are trending lower, tracking the declining unemployment rate.

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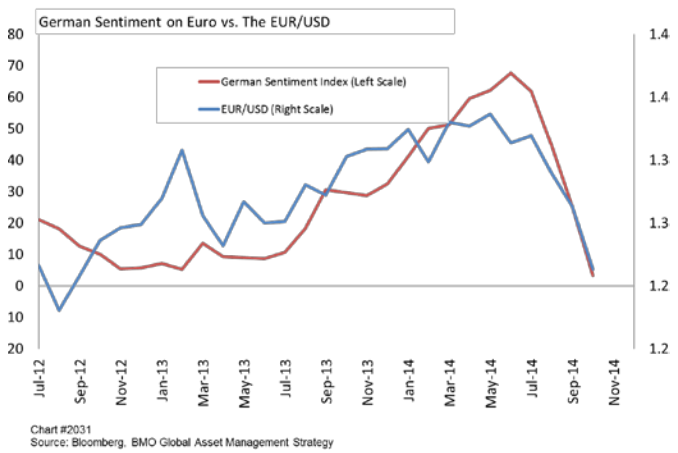
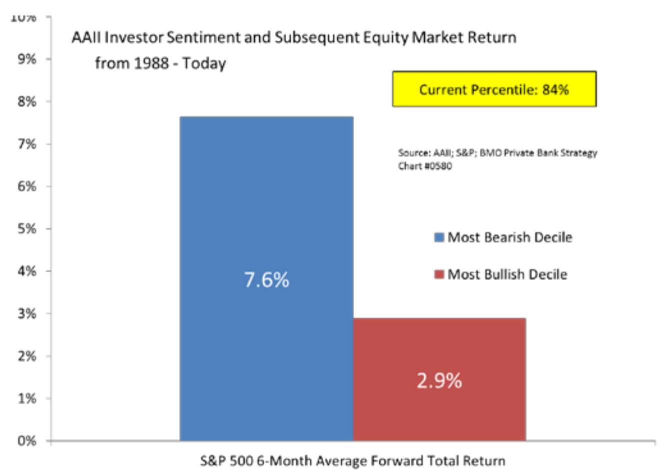
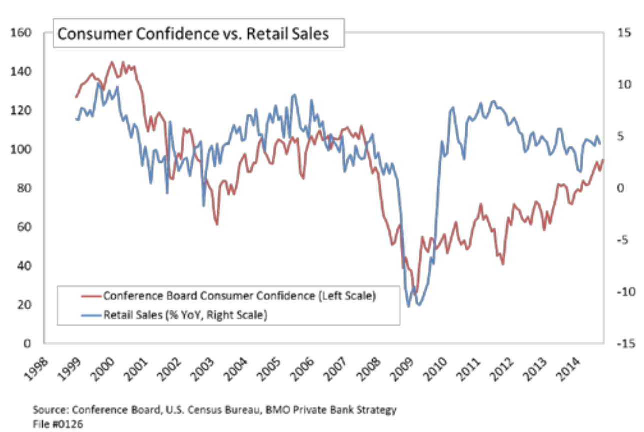
Psychology



German investor sentiment has fallen from its June peak, reflecting economic and geopolitical uncertainty.

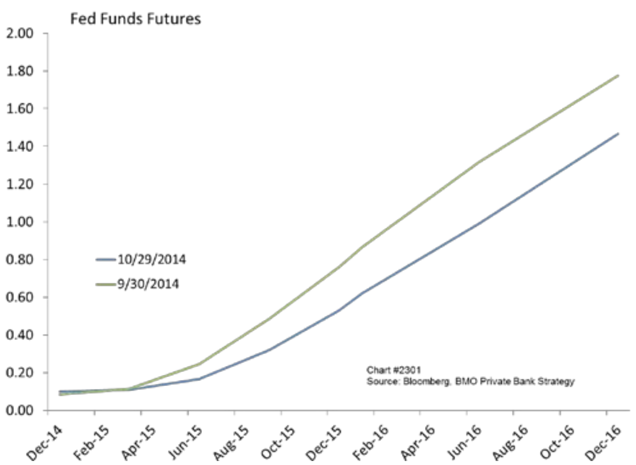


Investor bullishness is just below the top decile of its historical range. Generally top and bottom decile sentiment is a contrary indicator.

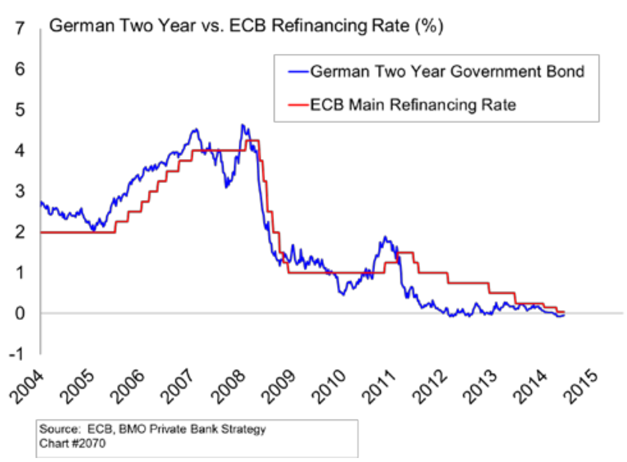


Consumer confidence has caught up to retail sales activity.

Central Bank Policy



A more hawkish Fed has raised the specter for spring tightening.



A deflation threat in Europe will keep a lid on ECB overnight rates.

While the trend is downward, Europeans are accumulating Treasury securities.

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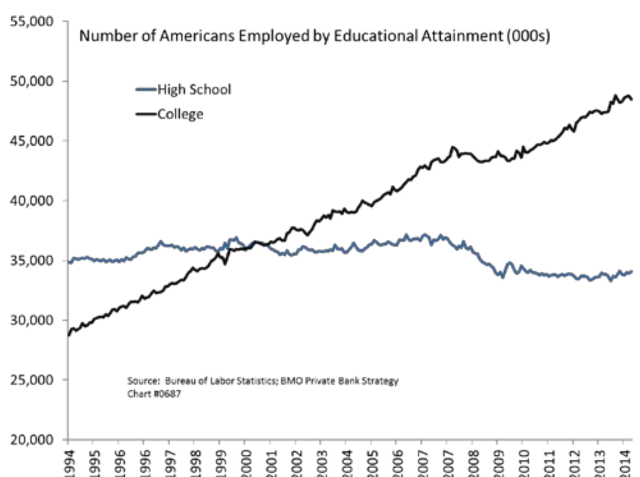
Technology and Jobs

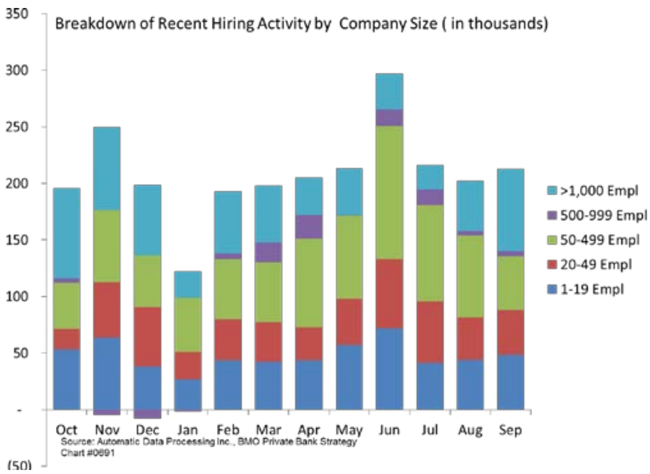
Technological advances had been the tide that raised all boats. Lately through, technology has destroyed more jobs than it's created.

Productivity gains have gravitated to capital rather than labor. Minimum wage, if adjusted for productivity, would be over $15/hour; not $7.25.

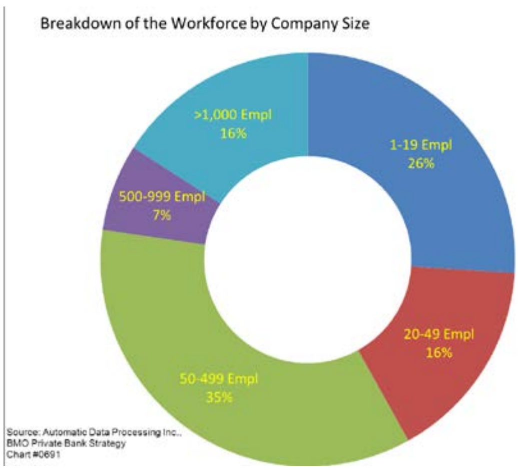


College-level job growth continues to expand while high school-level jobs have declined over the last 20 years.

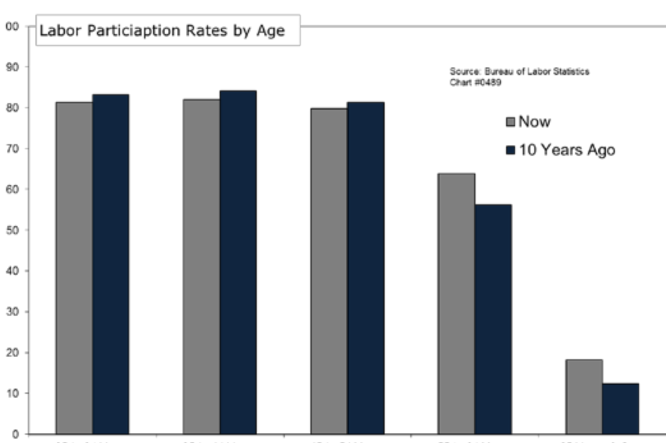
U.S. Labor Market



Job growth has remained steady since February, adding roughly 200,000 private jobs per month. Private payroll growth relies on small companies.

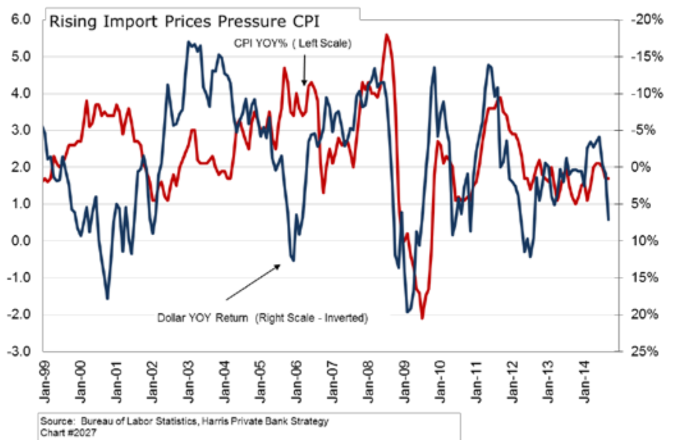


Companies with 50 or fewer employees comprise nearly half of the private workforce.

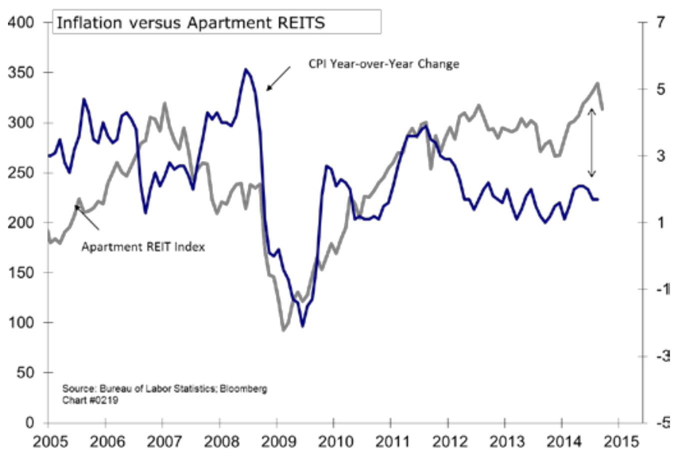


Labor participation is falling among younger people. It's significantly higher among Americans aged 55 and up, though.

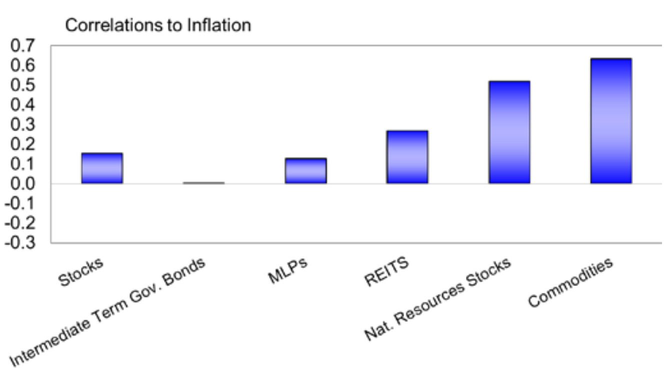
Inflation



Dollar strength will keep a lid on inflation. It will certainly keep import prices under control.



Apartment REITs are a good rent proxy. Housing costs comprise nearly one-third of the CPI calculation.

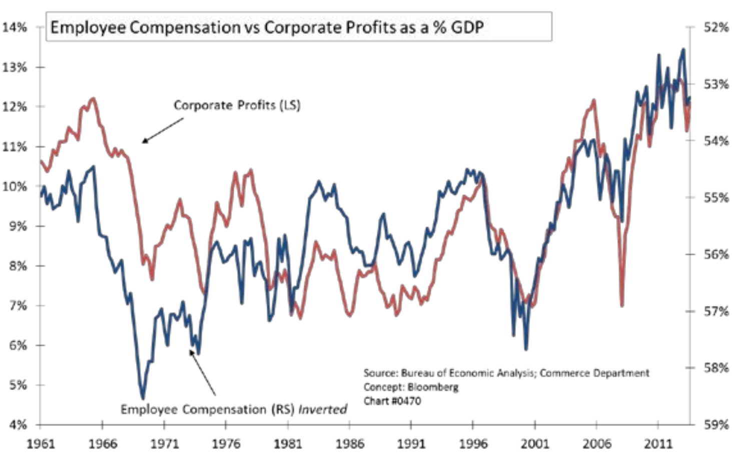


Source: Bureau of Economic Analysis, Zephyr, Bloomberg, Harris Private Bank Strategy. Data from 1997- Mar. 2012. Correlation use rolling annual returns.
File #1560.1

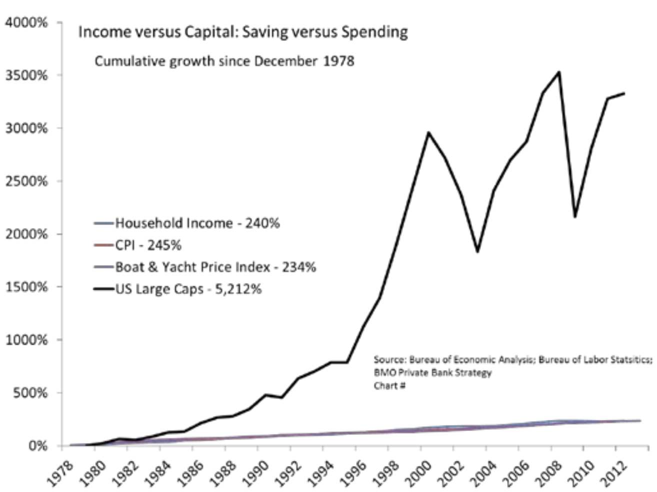
With little or no inflation on the horizon, commodities, natural resource stocks and REITs may have little appeal.

Income/Wealth Inequality

Public and private debt growth has helped America paper over the income inequality problem that's been in place since the early 1980s.



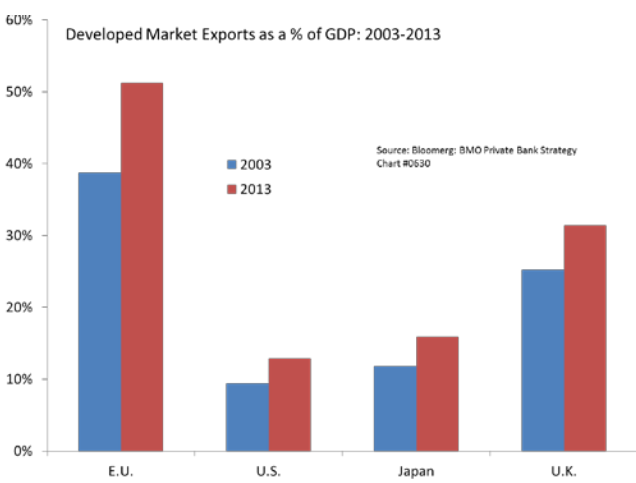
The pendulum has swung in favor of capital. Corporate profits as a % of GDP is at an all-time high, while employee compensation as a % of GDP is at an all-time low.



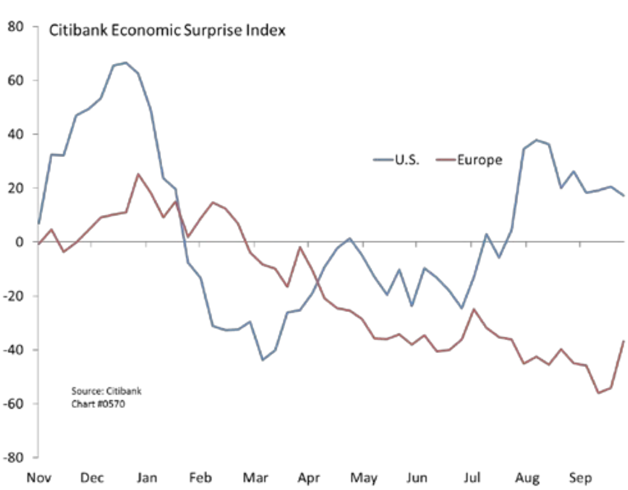
Since 1980, capital growth, as represented by the S&P 500, has far outpaced income growth. Household incomes have advanced 240% since 1974, the S&P has expanded by 5,212%!

Eurozone

The European banking picture, while not perfect, has calmed down substantially. Recent ECB stress tests were aimed at assuaging investors.

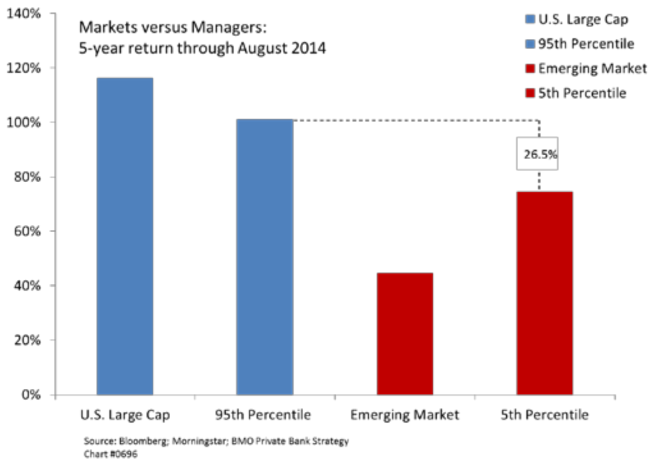


E.U. exports account for more than half of overall economic growth, making the region extremely sensitive to the global economy. U.S. by comparison is insulated.

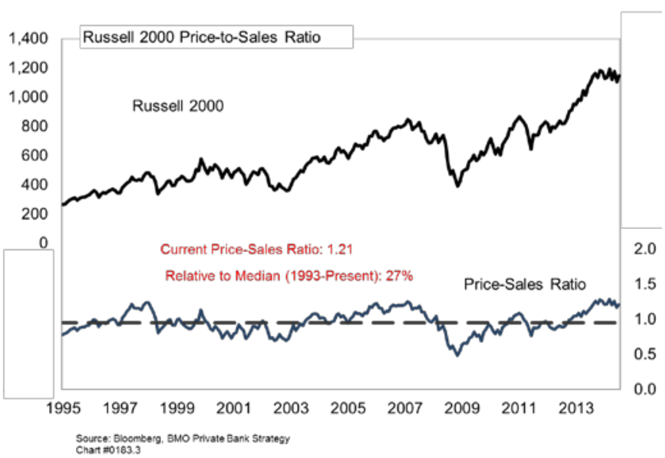


The U.S. has surprised economists on the upside. Europe continues to disappoint. We hope that further ECB stimulus will power the continent higher.

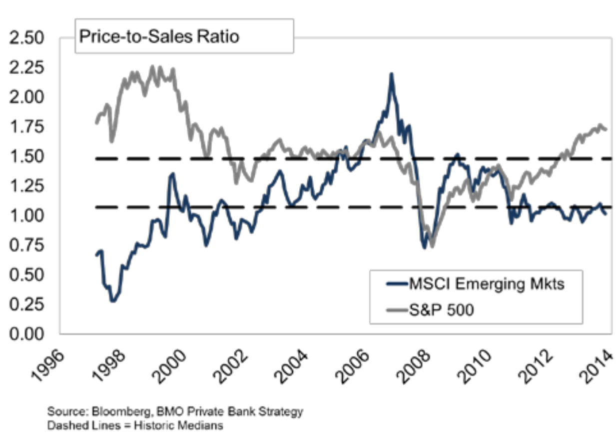
Asset Classes



Asset class selection is far more important than manager selection. The worst performing large cap manager outpaced the best performing emerging manager over the last five years.

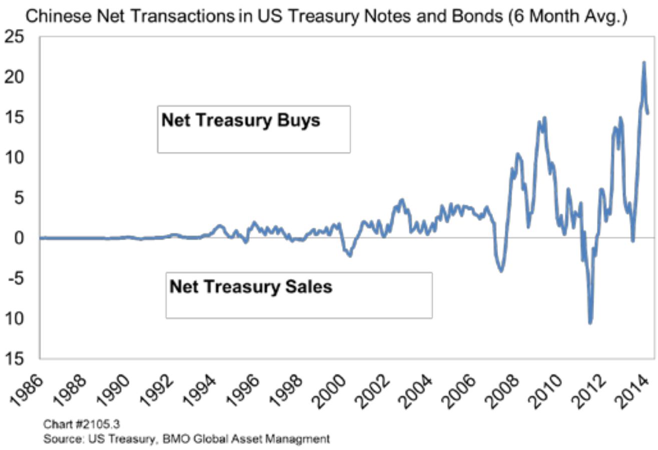


Notwithstanding the September swoon, small caps remain expensive relative to their history. The global capital glut has pushed into U.S. equities that are insulated from the vagaries of the global economy.

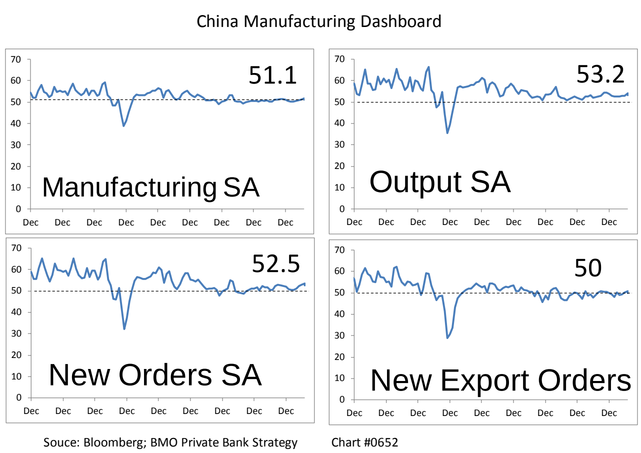


Emerging market equities are significantly cheaper than the S&P on a price-sales basis. While the S&P is expensive to its own history, EM equities are slightly below their price-sales median.

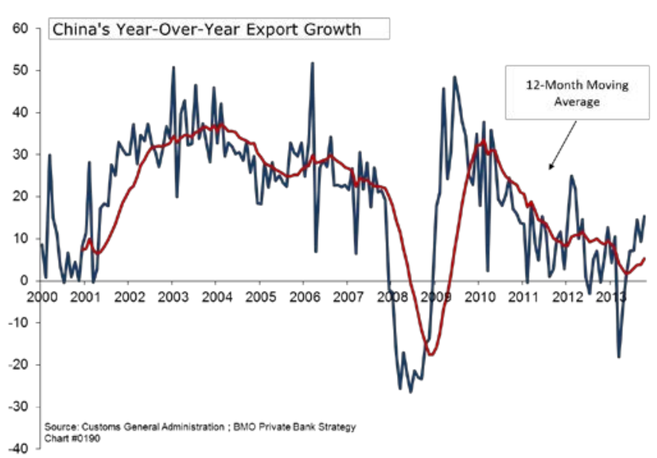
China



Even though the Fed has ended its bond-buying program, the Chinese remain big buyers of Treasurys in an effort to weaken the yuan.



Chinese manufacturing is slowing. The good news is all segments are still expanding.



China’s exports are trending higher, although they remain below their historical median growth.

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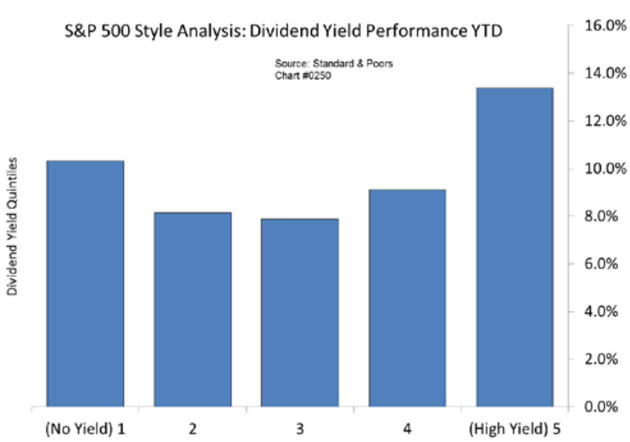
The S&P 500 is expensive relative to sales and earnings. Current valuation implies flat returns for the next three years, unfortunately.

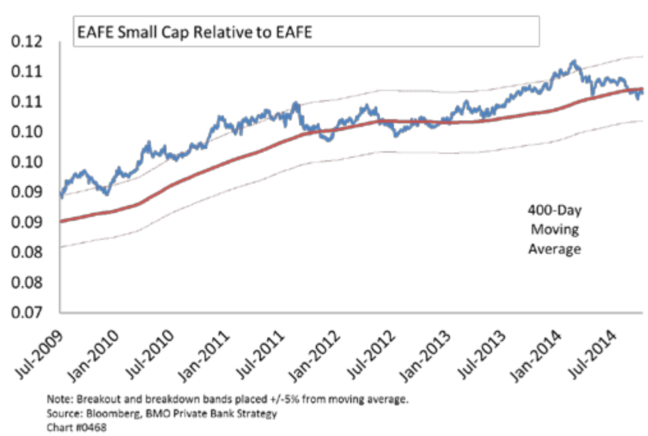
Through the lens of bonds, however, stocks appear cheap.



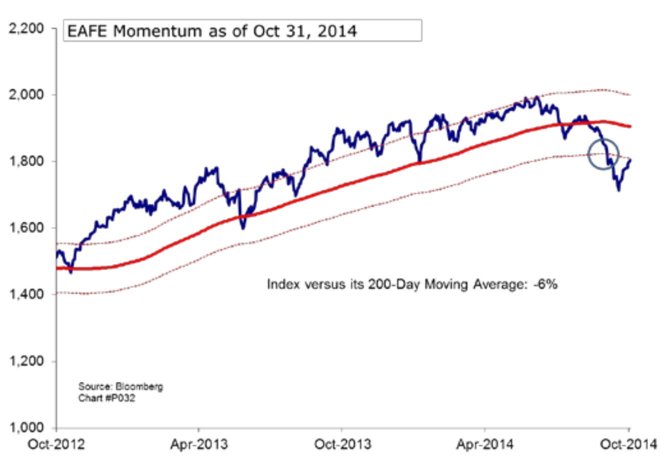
Investors prefer to derive income from equities versus bonds due to unattractive bond yields and relatively cheap valuations.

International Equities

EAFE's recent underperformance have left it substantially cheaper than the S&P 500. Relative to their history, EAFE is about at fair value.

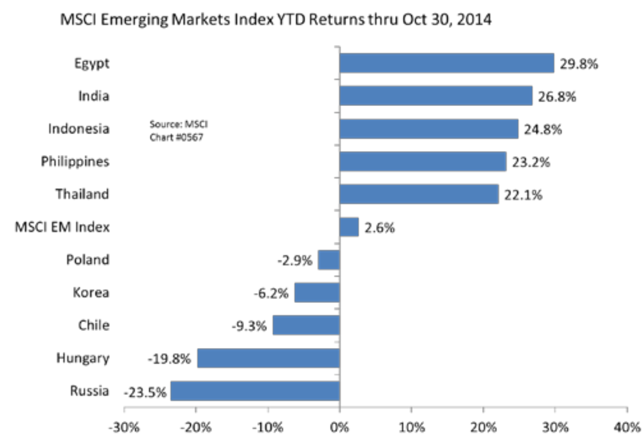


EAFE small cap has underperformed its large cap counterpart for most of the year.

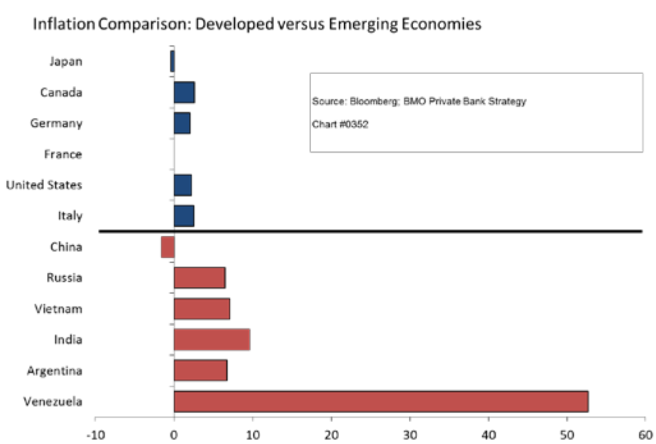


EAFE momentum broke down last month. Its 200-day moving average is rolling over too.

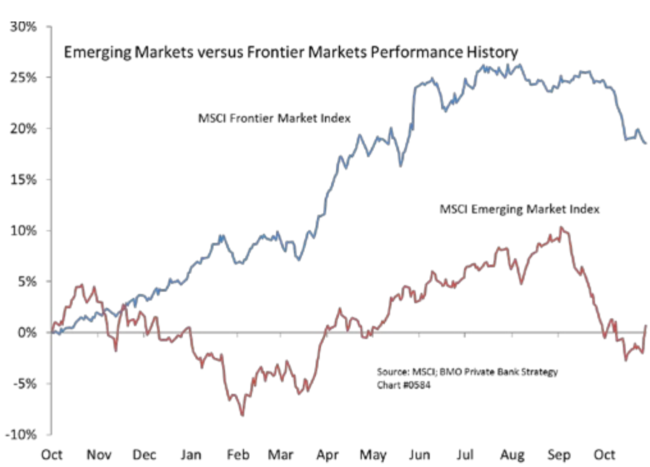
Emerging Market Equities



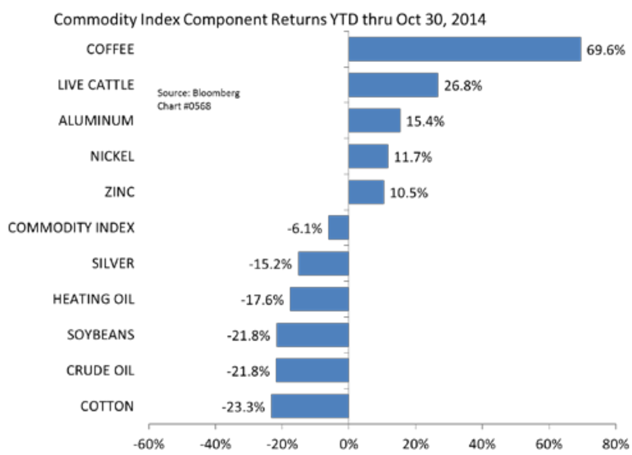
Political reformers are driving emerging country performance.



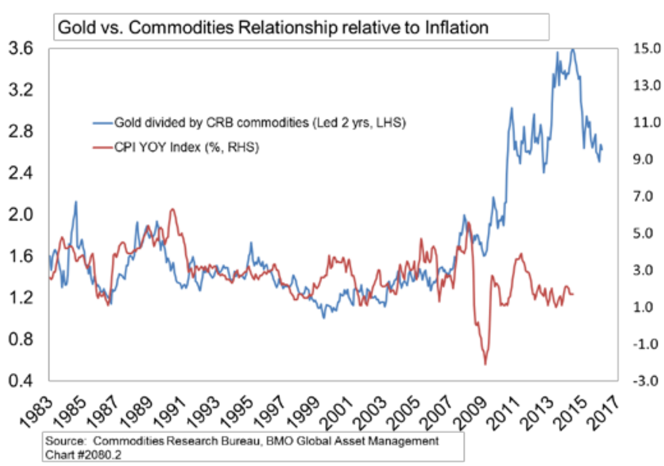
Emerging market inflation, with the exception of China, has exceeded developed world CPI.



Frontier markets have performed consistently better than emerging markets over the last year. Volatility has been lower too.



Bad news for commodities is good news for the consumer. All other things being equal, spending should rise and margins should widen.



Despite its recent underperformance, gold is STILL predicting 9% inflation in 2016. According to our model, gold will likely continue to underperform commodities.

Crude has broken down after making lower and lower highs since reaching nearly $150 in 2008.

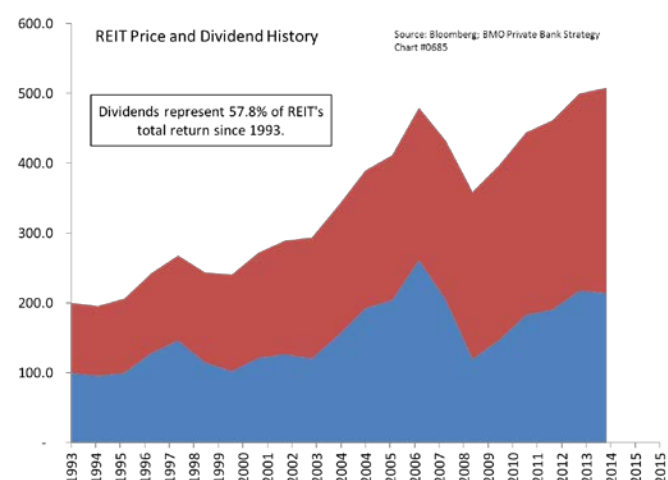
Correlation: Stocks, Bonds and REITs

trailing 1-year

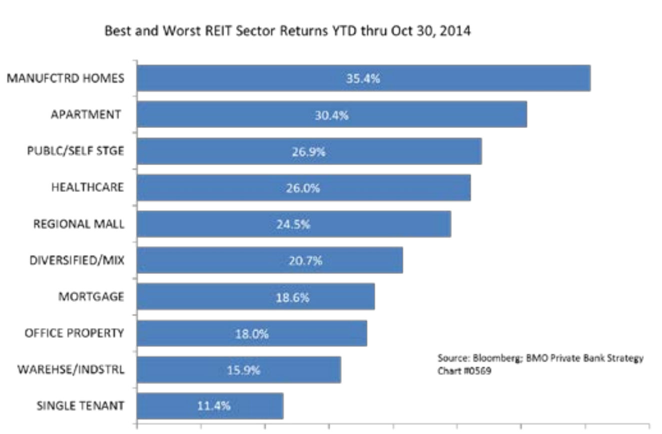
	Stocks	Bonds
Stocks		
Bonds	-0.64	
REITs	0.88	-0.86

Source: Bloomberg; BMO Private Bank Strategy
Chart #0705

REITs are about equally influenced by stocks and bonds. Among asset classes, they tend to be the biggest victim as rates rise.



It's all about the income. Dividends comprise nearly 60% of REIT returns over the years. We expect income's importance to increase over time.



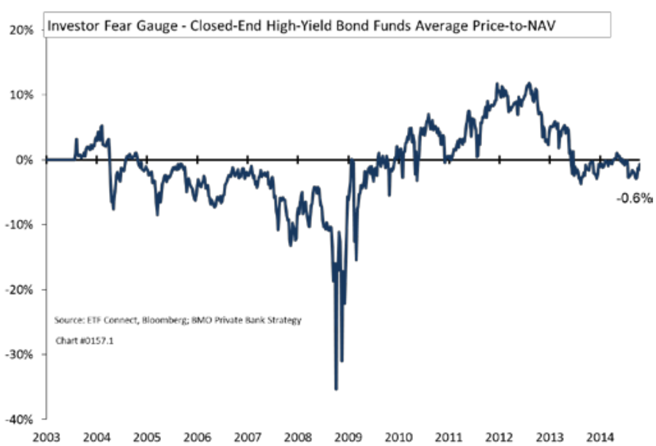
Americans are downsizing and opting to rent rather than own. That's reflected in strong performance in apartment REITs and self-storage.

10-Year Sovereign Yields

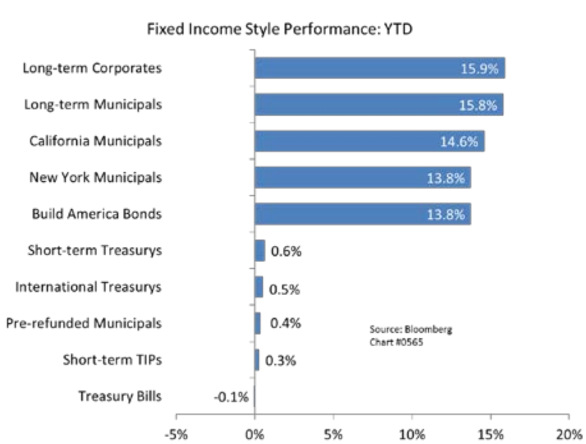
France	1.2%
Germany	0.8%
U.K.	2.2%
Italy	2.5%
U.S.	2.3%

Source: Bloomberg
Chart #0466

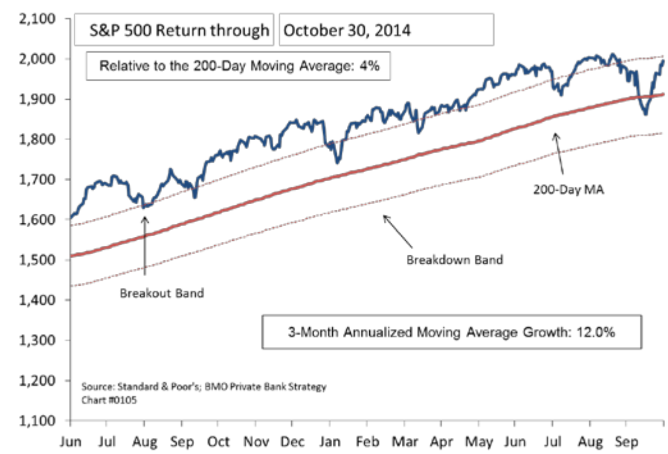
U.S. yields are among the highest in the developed world. That doesn't compute; especially since we expect dollar appreciation.



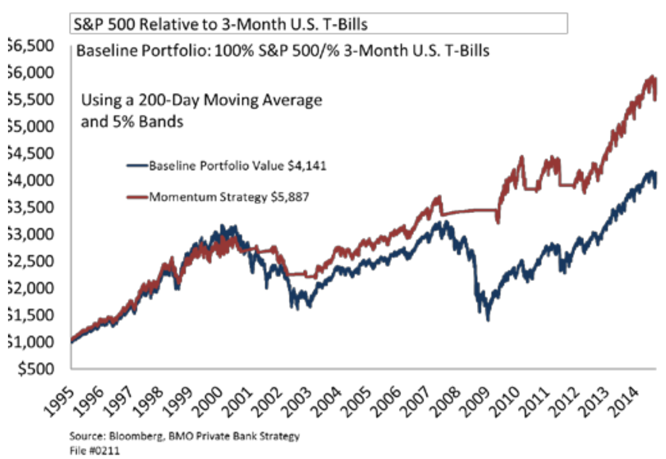
Despite recent spread widening and Bill Gross's departure from PIMCO, high-yield bond holders remain sanguine.



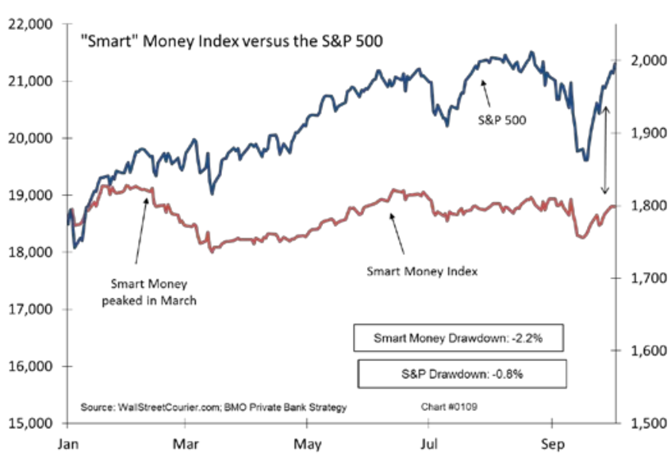
Interest rate risk trumped credit risk this year as the 10-year yield slid by 0.7%.



The September-October swoon wasn't deep enough to trip our momentum indicator. The S&P is back in healthy territory technically.



Momentum has been a strong risk circuit breaker. We're willing to miss an opportunity in exchange for avoiding big downside risk.



The "Smart Money" index peaked in March and is 2.2% off its high. This is something to watch, but it is certainly not alarming.

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