WEEKLY STRATEGY
Perspectives

BMO Private Wealth

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Buckle Up

"The true investor welcomes volatility."
– Warren Buffett

The Through Line: With the inauguration of America's 47th president less than two weeks away and a newly seated Republican congressional majority intent upon providing him quick action on campaign promises, markets have already reacted to an excess of near-term headlines. It is premature for investors to respond to the noise; the coming weeks will provide ample time to explore the potential long-range impacts as issues like tariffs, taxes, immigration, energy policy and regulatory relief move closer to implementation. In the meantime, we suggest investors focus on the solid underpinnings already in place, which have the potential to tee up another year of economic and market gains.

Cutting through the noise

In contrast to the risk-on markets that dominated much of last year – and accelerated markedly after the U.S. elections in November – equities have struggled over the last month, with the S&P 500 and S&P/TSX both down 2%. Bonds, currencies, crypto currencies and select commodities like gold and oil have also gyrated sharply in both directions relative to the shifting commentary around policy priorities, structure, sequencing and sizing.

The U.S. Federal Reserve Federal Open Market Committee's last policy meeting and press conference on December 18 didn't help either as watchers took in a more modest number of potential interest rate cuts embedded in the Fed's forward-looking expectations.

Largely ignored by both short-term storylines, however, is the underlying strength in the U.S. economy where Gross Domestic Product was still chugging along at a 3.1% real rate as of Q3 2024 – the envy of the industrialized world.

A variety of factors have contributed to sturdy economic growth, including corporate adaptability, durable consumer spending and substantial industrial policy stimulus targeted at supporting key industries such as infrastructure and manufacturing.

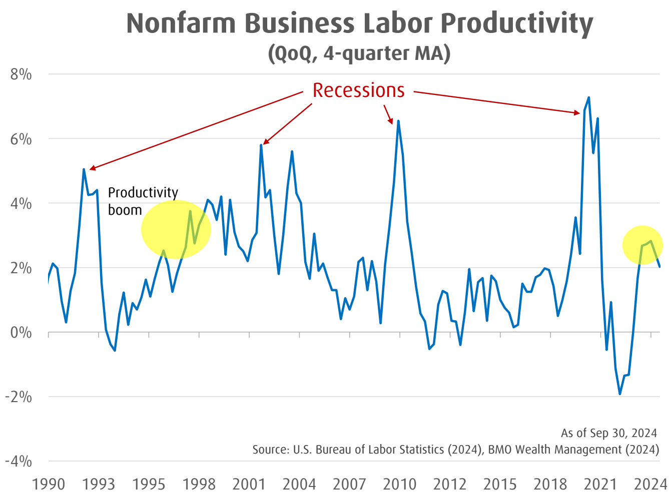
America's productivity miracle

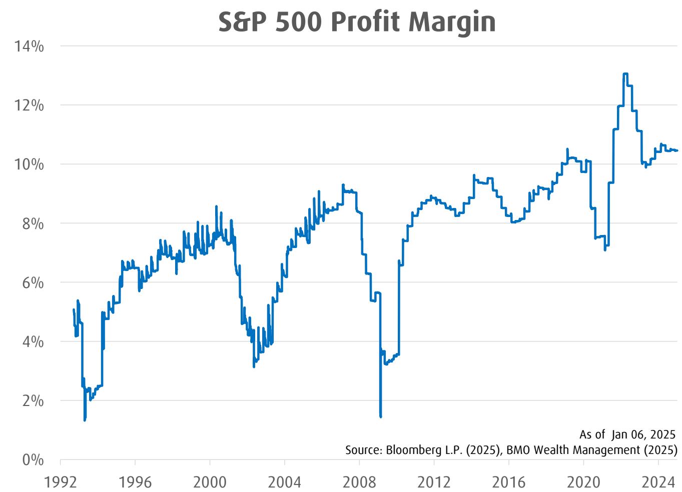
Another pillar supporting U.S. growth is shown in the chart below: **the productivity of the U.S. workforce has been growing at a 2% clip for more than five years**. Productivity growth means more can be produced from the same amount of input capital and comes from such things as the upskilling of workers, which helps boost overall growth in a less-inflationary way.

Significant domestic infrastructure and technology investment (think grid enhancement, data centers, robotics and advanced manufacturing) is in the early innings of what could be a protracted cycle similar to the 1995-2000 buildout of the internet. U.S. Government data shows seasonally adjusted aggregate private sector manufacturing spending of over $235 billion in November 2024, up nearly 100% from five years earlier.[1]

An amenable business environment

Companies in North America moved quickly to adapt to the many challenges thrown at them in recent years. These challenges included the pandemic-driven changes to workforce and consumer patterns; inflation; rising interest rates/cost of capital; and the need to adjust supply chains in response to tariffs, port strikes and war-induced route disruptions. Through it all, margins have held up amazingly well.





Policy changes, depending on size and scope, could require a period of adjustment as managements are forced to sort through knock-on impacts. However, Corporations seem to have built the muscle memory that will enable them to adapt well with time.

Aggregate earnings for the S&P 500 came in above expectations for the first three quarters of 2024. **According to FactSet, the estimated growth for Q4 earnings is expected to be 11.9% which, if achieved, would mark the best year-over-year rate since Q4 of 2021. TSX earnings have been volatile, but here too estimates are constructive. The 2025 consensus estimate from FactSet sits at 12% growth, the highest forecast since 2022.**

While a bit too much is made of quarter-to-quarter corporate earnings (longer time periods and trends are more instructive for stock prices), investors will nonetheless be searching for clues in company commentary on a broad array of topics, including:

- **Capital expenditures** – particularly examples of how AI and other tech spending is aiding business profitability and resiliency
- **Hiring**
- **Margin health** – and factors such as commodity inputs and sourcing challenges or opportunities
- **Supply-chain plans** relative to potential tariffs and possible work stoppages at East Coast ports
- **Merger, acquisitions and joint venture** plans
- **Technology investments** including data center, AI, robotics deployment
- **Preparations for policy changes** – insights relative to how the company has prepared for, or will respond to, policy changes floated by the incoming administration

Hearty Consumers

Another core support to the solid economic story has been the notable resiliency of U.S. consumers. Accounting for more than 70% of GDP activity, they are employed and spending. Admittedly, those aggregate numbers mask significant stress in the lowest tiers, but the combination of rising home and investment values, and an extended period of below-average unemployment have kept spending steady. Even the just-ended holiday season came in a bit stronger than projected, though consumers were discerning in what, how and when they spent.

Implications for Investors

Famed investor Warren Buffett has made many quotable comments about volatility, including the one at the top of this article. In another, he observes that an investor *"can be hurt by such volatility only if he is forced, by either financial or psychological pressures, to sell at untoward times."* We are fully expecting provocative headlines to continue, meaning it will be helpful to find strategies to counteract an innate urge to respond. For example:

- Stay nimble, using pull-backs in stocks as entry points for sidelined cash.
- Stick to high-quality fixed income. There is no need to pay up for riskier credits as spreads are historically tight.
- In the U.S., we have been recommending fixed income investments with shorter maturities, believing intermediate rates would drift higher. A push by 10-year yields to 5% or more could warrant greater consideration of longer-maturity fixed income.
- In Canada, the story is a bit different for fixed income. The Bank of Canada has been the world leader in its rate-cutting campaign; 10-year government yields hover in the 3.3% area. Given political uncertainty and unknowns around U.S. tariff policy, continue to stay shorter.
- Seek out less-correlated assets.
- Actively harvest tax losses throughout the year, not just at year-end.

Investors will have plenty to think about in the coming year. The key will be to constructively use volatility in the pursuit of personal financial goals.

In focus in North America

Jon Borchardt, Sr. Analyst
George Trapkov, CFA, VP and Portfolio Manager

This week

Political happenings – both expected and unexpected – and a raft of economic reports on both sides of the border dominated the first full week back from the year-end holidays.

Canada – PM Trudeau resigns – Canadian Prime Minister Justin Trudeau announced on Monday that he plans to resign as a Prime Minster and leader of the Liberal Party. Upon his request the Parliament was prorogued until March 24. The shutdown assures that the minority Liberal government can govern until at least that date. Upon resumption of parliament sitting, there is going to be a confidence motion which is likely to bring the government down and elections are likely to come sooner than scheduled (latest is October 2025 by law).

The prorogation of Parliament results in the termination of this session, which ends all proceedings before Parliament. Legislative bills which have not received Royal Assent before prorogation are terminated and must be reintroduced in the new session of Parliament in order to proceed. **Notably, the draft legislative proposals included in the notice of ways and means motion tabled on September 23, 2024, relating to the increased capital gains inclusion rate (including changes relating to the employee stock option deduction) and the increase in the lifetime capital gains exemption to $1.25 Million. These items will now be prorogued.** However, the Canada Revenue Agency will continue to administer the changes to the capital gains inclusion rate.

Canada – America's 51st state? – According to the Globe and Mail, incoming U.S. president Donald Trump said that he would be willing to use "economic force" to convince Canada to agree to a political union with the United States – an idea unpopular with Canadians. According to a recent survey by Leger, 82% of Canadians are opposed to the idea. Trump reiterated that he intends to place a 25% levy on all Canadian imports. The U.S. trade deficit with Canada reached US$61 Billion over the last 12 months, largely driven by Canada's significant oil and natural gas sales to America. BMO Economics estimates that the net impact on real GDP growth, without retaliation, would push above 1.5 % on a quarterly basis, and could shave 2025 calendar-year growth by roughly 1%. BMO Economics is currently at 2.0% growth for 2025 and 1.9% for 2026. Greenland and Panama Canal were also mentioned during the briefing with Trump saying the U.S. should own both for national security reasons.

U.S. inflation watch – *"Inflation is continuing to rage and interest rates are far too high"* was one message delivered by President-elect Trump at a press conference on Tuesday. Uncertainty over Trump's trade, immigration and fiscal policies have sparked inflationary fears. This view, along with continued strength in the jobs market and overall U.S. economy, has dampened investor expectation for additional Fed rate cuts in 2025. **The Federal Reserve has cut its target rate by 1% since its September policy pivot, but over the same period yields on 10-year treasuries have risen by more than 1%** putting upward pressure on borrowing costs. Headline inflation peaked in June 2022 at 9.1% and has since retreated to 2.7%. While significant progress has been made, the Fed remains adamant that its inflation target is 2%.

U.S. inflation watch part II: PMI and ISM reports show growth but still sticky inflation – The S&P Global US Services PMI Business index reading for December was generally bullish with orders, output and employment each rising as business confidence hit an 18-month high. S&P Global Chief Business Economist Chris Williamson wrote, *"Expectations of faster growth in the new year are based on the anticipation of more business-friendly policies from the incoming Trump administration, including favorable tax and regulatory environments alongside protectionism via tariffs."* Similar positive trends were reflected in the Institute for Supply Management (ISM) Services survey where the manufacturing sector continues to struggle, but green shoots may be emerging. **Both New Orders and Production Indexes showed growth.** A watch point for both the Service and Manufacturing sectors is renewed signs of inflationary pressure. **Respondents in both surveys were concerned over the potential impact of new tariffs on input costs and supply chains.**

U.S. Tariff Policy – Perhaps not all tariffs are beautiful? The *Washington Post* reported that President-elect Trump's advisors are contemplating tariff policy change. Rather than applying universal tariffs on all goods imported into the US the Administration would look to target sectors which were deemed to be critical to national or economic security. According to the article, *"The potential change reflects a recognition that Trump's initial plans – which would have been immediately noticeable in the price of food imports and cheap consumer electronics – could prove politically unpopular and disruptive."* The report was quickly denied by Trump who has promised universal tariffs on all goods imported into the U.S. plus up to 60% in additional tariffs on goods from China, and 25% on imports from Canada and Mexico. It has been BMO's House View that President Trump is using the threat of blanket tariffs to provide leverage in upcoming trade negotiations. The dollar retreated, and Asian equity markets were boosted by the prospects of a less onerous tariff policy from the incoming administration.

U.S. – What the Fed was really thinking – The minutes from the December Federal Reserve Open Market Committee meeting highlight a shift in thinking among members. Participants proceeded with the much anticipated 25 basis points rate cut for the month, but concluded it was appropriate to slow the pace of further cuts. **Moving forward the FOMC will take a more gradual and careful approach to policy decisions. Progress on inflation has decelerated, recent readings have been hotter than anticipated and a few committee members see a growing risk of persistent inflation.** The labor market remains solid, but there is now greater perceived downside risk. New to the conversation was greater economic uncertainty due to pending changes to trade and immigration policies from the incoming administration. The consumer remains cautious, which weighs on companies' ability to increase prices, and consumer credit metrics are showing signs of strain. Business contacts have become more optimistic, expecting deregulation and lower taxes will help foster economic growth. At the end of the day, the meeting minutes highlight a Fed which has taken a more hawkish posture.

Big week for U.S. employment data – a bird in hand appears to be the mantra for both workers and employers. ADP payroll data showed 122,000 private sector jobs were created in December. The number was below consensus expectations and indicates the pace of hiring appears to be moderating. The Job Openings and Labor Turnover Survey (JOLTS) report was stronger than anticipated with 8.1 Million jobs available, the highest level since May 2024. This data point was negative for market sentiment as continued strength in the job market gives the Fed time to pause on additional rate cuts.

The Federal Reserve has increased its focus on the full employment side of its dual mandate and indicated a rise in the unemployment rate would be unwelcome. The most recent data shows slowing job creation and reduced expectations among workers in their ability to find a new job, but at the same time a reluctance by employers to let go of current employees. Overall, the job market remains strong, but the underlying currents make overall visibility a bit murky. All eyes will be on Friday's Nonfarm Payrolls report – we will have more to report on that as well as upcoming inflation data in next week's issue.

Next Week

Earnings season starts in earnest next week with big banks kicking off the action on Wednesday. There will also be a raft of economic updates including business optimism, CPI and PPI indexes, manufacturing reads and retail sales for December. The U.S. Fed's Beige Book on Tuesday always gives interesting anecdotes for regional and sector specific trends.

- **Tuesday 1/14** – U.S. PPI, the Fed's Beige Book and NFIB optimism Index
- **Wednesday 1/15** – U.S. CPI and manufacturing indexes from the Philly Fed and Empire State | Canada Manufacturing Sales
- **Thursday 1/16** – U.S. Initial Jobless Claims and Retail Sales for December | Canada Housing Starts
- **Friday 1/17** – U.S. Housing Starts, Capacity Utilization and Industrial Production

Data scorecard as of January 8, 2025

Market Total Returns					
	WTD	YTD	2024	2023	2022
S&P 500	-0.4%	0.6%	25.0%	26.3%	-18.1%
NASDAQ	-0.7%	0.9%	29.6%	44.7%	-32.5%
DOW	-0.2%	0.2%	15.0%	16.2%	-6.9%
Russell 2000	-1.3%	0.4%	11.5%	16.9%	-20.5%
S&P/TSX	0.0%	1.4%	21.7%	11.8%	-5.8%
MSCI EAFE	0.7%	0.4%	3.8%	18.2%	-14.5%
MSCI EM	-0.2%	-0.4%	7.5%	9.8%	-20.1%

Government Bond Yields					
	Current	Last Month	2024	2023	2022
U.S. 10-Year Treasury	4.69%	4.57%	4.6%	3.88%	3.88%
Canada 10-Year Government	3.34%	3.23%	3.2%	3.11%	3.30%
U.K. 10-Year Gilt	4.79%	4.56%	4.6%	3.53%	3.66%
German 10-Year Bund	2.55%	2.36%	2.4%	2.02%	2.57%
Japan 10-Year Government	1.17%	1.09%	1.1%	0.61%	0.41%

Currencies						
	2025-01-08	WTD	YTD	2024	2023	2022
USD Index	$109.09	0.1%	0.6%	7.1%	-2.1%	8.2%
CAD:USD	$0.70	0.5%	0.1%	-7.9%	2.3%	-6.7%
Bitcoin	$94 457.90	-3.9%	0.8%	120.5%	157.0%	-64.3%
Gold	$2 661.94	0.8%	1.4%	27.2%	13.1%	-0.3%
Oil (WTI)	$73.32	-0.9%	2.2%	0.1%	-10.7%	6.7%

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[1] US Census Bureau Manufacturing Data