WEEKLY STRATEGY
Perspectives

BMO | Private Wealth

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Navigating Volatility

"Basically, **price fluctuations** have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."
– Benjamin Graham

The Through Line: Price fluctuations are a normal (if uncomfortable) part of being an investor in public markets. However, there's a difference between knowing this in our heads and wading through it with churning stomachs. Understanding volatility and using price fluctuations constructively can be beneficial – with careful navigation.

Volatility makes a comeback

Price movements are a given for those participating in public asset markets. Volatility is defined as both up and down price changes, although investors respond with stronger emotions when the price movement is down. (Oddly, stocks seem to be the only asset we don't like to buy on sale!) Some might be surprised to learn that 2024 delivered low volatility. In fact, the number of days with price fluctuations larger than 1% was below that of an average year (chart 1, page 3).

The situation has changed in 2025 as stock, bond, currency and commodity markets reacted to:

- **surprising economic data** – a strong jobs report on January 10 instigated a sell-off of equity and fixed income, only to be followed by softer CPI and PPI reports the following week that prompted a rebound in both markets
- **emerging political policy shifts** – the lack of overt tariffs in incoming President Donald Trump's initial round of executive orders initially led to higher stock prices in both the U.S. and Canada, moderating intermediate-term U.S. bond yields, and a stronger U.S. greenback and Canadian loonie
- **pivots in the competitive landscape** – this week's rout in stocks as participants re-evaluated the belief in, and valuations of, certain AI-related companies in response to a new, seemingly low-cost Chinese competitor. At the same time as the stock sell-off, fixed income and gold rallied when traders sought safe havens

The gyrations are enough to make the sturdiest investor's head spin. Yet **swings are common (particularly when presented with unexpected developments in policy or industry dynamics) not the exception** – even in up-trending markets (chart 2). If volatility is *normal*, can we learn to take it in stride? Better yet, is it possible to put a framework around volatility – like original value investor Ben Graham did – that allows us to take strategic advantage of it?

Volatility is not inherently risky

Daily markets are often influenced by a variety of factors including unexpected headlines; underlying technical causes (e.g., a large fund shifting its investment strategy from one industry to another, algorithmic repositioning at one shop that triggers reaction at another, tax loss harvesting, index rebalancing); and raw emotions propelling the herd from fear to greed and back again. Most of this can usually be characterized as noise that may have few lasting effects on the long-term fundamentals of an asset or sector.

Volatility can work to a long-term investor's advantage if it allows the purchase of a high-quality asset at a "sale" price. The nuance is in being able to parse noise from lasting fundamental impact.

Not all volatility is the same

Volatility is often caused by a disconnect between expectations and reality – such as the market falling after a stronger-than-expected December jobs report or the market rallying when expected tariffs do not arrive on Day One of the presidency. For long-term investors, a key question is whether

the unexpected news alters the underlying fundamentals. For example, does the strong jobs report help or hurt a long-term investment case for a company?

Volatility can also be introduced by unexpected fundamental developments such as the recent announcement that DeepSeek, a Chinese AI competitor, has purportedly developed an AI app with similar function to U.S. based models – at one-tenth the cost. If core parts to the story are true, it could require a rethink of how longer-term fundamental expectations for AI deployment and infrastructure will play out. The current projected need for significant increases in data center capacity and electricity requirements, for example, may be lower than originally thought. On the other hand, cheaper access to AI models by a broader array of businesses could vastly expand end-user demand. It will take time to sort through the implications; DeepSeek may well have enduring ramifications.

A bit of context

When markets become roiled, it is important for long-term investors to take a step back and carefully consider the context.

Understand that markets – and the yardsticks (benchmarks) used to measure them – are NOT the economy. There are three concepts to understand. First, sector make-up varies greatly and matters a lot. Second, some indices are constructed counter to our intuition. Third, the most common indices are all market capitalization weighted, which brings nuances.

Canada is an excellent example of sector composition quirkiness. **The TSX is not the Canadian economy.** Tariff threats conjure up images of steel, forest products, food stuffs and auto parts. While these are important to the Canadian economy, their weighting on the Canadian stock market is minimal. These industries combined are a low single digit weight of the TSX. The big weightings on the TSX are metals and mining at 12%, energy 17%, and financials 33%. These sectors are, of course, important to the Canadian economy, but they have an outsized footprint on the TSX. BMO Private Investment Counsel's Chief Investment Strategist Brent Joyce notes that the resource and financial services industries should see a lighter (or very likely no) tariff impact.

From the realm of unique construction comes the Dow Jones Industrial Average, a price weighted average of 30 companies, where a given percentage move in a stock with a higher dollar value per share has a substantially bigger impact than a similar move in lower priced company. **In the end, the nominal price level of a company's shares has zero connection to its importance to the economy or investors.**

The S&P 500 is a capitalization (price times shares outstanding) weighted index of 500 companies selected by a committee. This is the most respected index methodology. But as a company's market cap increases that doesn't necessarily mean its economic footprint has increased equally.

Understanding the unique attributes of a given index can help put short-term moves into perspective. Monday's stock market rout, for example, was mostly limited to the largest AI-tangential names. Given the cap-weighted nature of the S&P 500, a handful of names have grown to represent a disproportionate share of that benchmark (chart 3). Obscured by the drama of Monday's decline was the fact that roughly two-thirds of the index's stocks advanced on the day – they just happened to be smaller weights than the AI-related behemoths. Similarly, the equal weighted S&P 500 (removing the large cap bias) closed the day little changed.

This context matters as near-term fluctuations in market indices may have very little bearing on the way economic fundamentals for various companies play out. **Yet it is fundamentals that ultimately drive a company's stock price over the long haul.**

As shown in chart 4, equity markets trend upward over the long term – despite wars, recessions, financial meltdowns, pandemics, supply chain snafus and a laundry list of other calamities. Chart 5 illustrates that **between 1970 and 2024, the S&P 500 return was positive in 80% of the one-year periods and over 90% of the 10-year holding periods.**

Circumventing our hardwiring

When markets move violently, it can be hard to keep our cool as the most primitive parts of our brains are hardwired for action. A few tactics can help short-circuit that innate tendency:

- **when surprising news hits – pause.** We are the only species wired with the ability to *put a space between stimulus and response*. Use it to breathe, think, educate yourself and evaluate
- **set up systems** – such as dollar cost averaging (in or out) and periodic rebalancing to alleviate the urge to react in the moment
- **own different asset classes** – understand the purpose they serve in your portfolio (e.g., volatility dampener, growth, income)
- **consider bucketing assets** – into different accounts to serve specific needs such as cash for your offspring's next few years of college tuition; fixed income to generate a set level of living or retirement expenses; a mad money stash; or a pool to fund legacy growth objectives
- **avoid anchoring to a specific price** – especially when pruning overweights or cutting losses and moving on. There is arguably a clearing price for any given asset at any given moment – it just depends on how motivated each side of the transaction is to get it done. Recognize that nobody cares what you paid.

Working with your BMO financial professional to understand and plan for volatility can help mitigate its shock value when it inevitably comes – and keep you focused. Together, we can execute wise moves that would make Ben Graham proud.

Chart 1

S&P 500: Number of Trading Days Closing with a Move of (plus or minus) 1 Percent or More

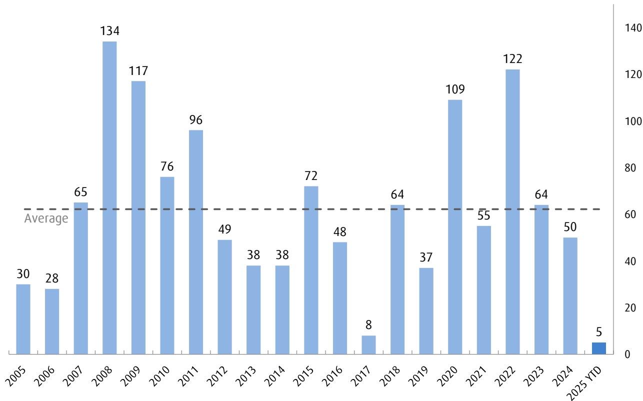


Chart 3

S&P 500 Market Capitalization

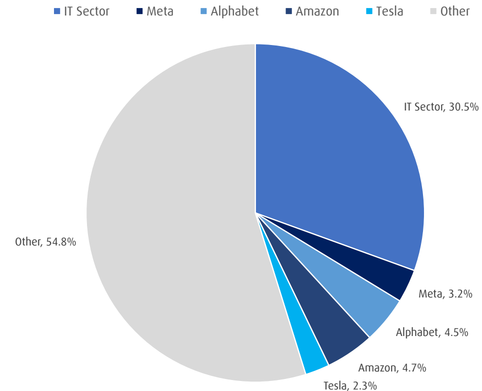


Chart 2

S&P 500 Returns & Intra-Year Pullbacks

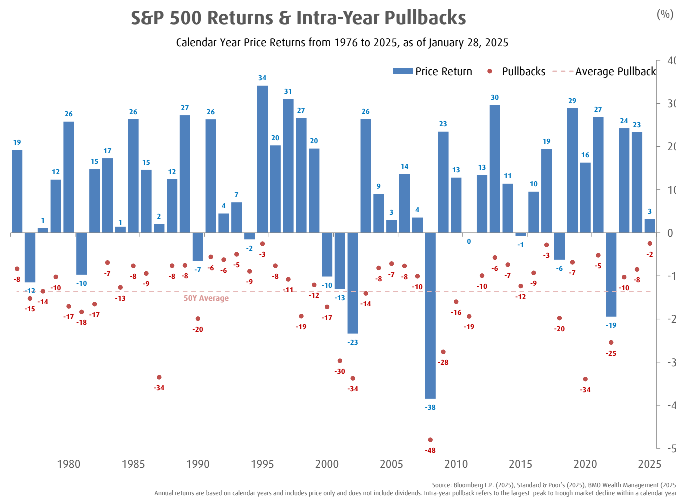


Chart 5

Percent of Time S&P 500 Was Positive, 1970 - 2024*

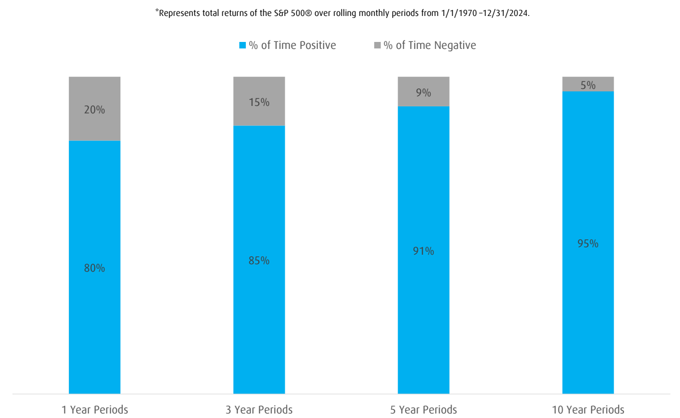
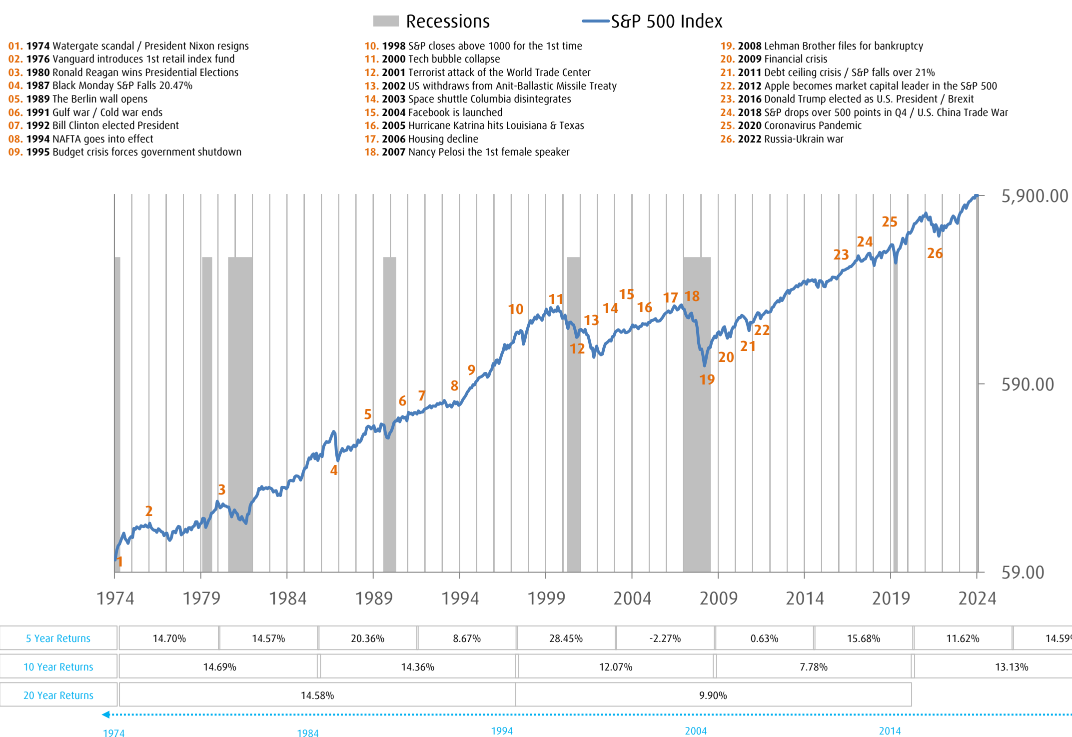


Chart 4

S&P 500 Index



5 Year Returns	14.70%	14.57%	20.36%	8.67%	28.45%	-2.27%	0.63%	15.68%	11.62%	14.59%
10 Year Returns	14.69%		14.36%		12.07%		7.78%		13.13%	
20 Year Returns	14.58%				9.90%					

1974 — 1984 — 1994 — 2004 — 2014 — 2024

Market data through period ending 12/31/2024; Source: Bloomberg L.P. (2025), BMO Wealth Management (2025)

In focus in North America

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

This week

The AI theme: invincible until it wasn't – Skyrocketing data center construction and advancements in processing technology have been seen as the catalyst for a massive AI capex cycle, boosting demand for both capital equipment and electricity. However, the entire thesis was called into question when DeepSeek, a relatively unknown Chinese company, announced software innovations (vs increased processing intensity) that allowed the company to rapidly develop an AI model capable of producing results similar to OpenAI's ChatGPT – at a significantly lower cost. **If true, this suggests that demand estimates for graphic processing chips, data centers, and the associated picks and shovels may potentially be too high, but industry leaders including Mark Zuckerberg indicate that determination is too early to make.** Nvidia shares fell 17% on Monday, losing $589 billion in market cap. AI-leveraged utilities, renewable and industrial sector companies also took a beating. **While questions have arisen about the validity and uniqueness of DeepSeek's results, the increased perceived risk to the AI thesis may limit trading multiples investors are willing to assign.** On the flip side, large tech companies could be beneficiaries of software-driven efficiency gains. The transition to software predominance could imply current AI capex budget assumptions may be too high. President Trump called this a wake-up call for U.S. technology companies, emphasizing that they must compete to win. **From a broader economic perspective, lowering the cost of AI should only serve to induce faster and broader adoption that supports rising productivity.**

Canada/US tariffs – President Trump recently reiterated his views that Canada and Mexico may get hit with tariffs as early as this Saturday, February 1, without offering many specifics on magnitude and scope. The Canadian government has indicated it is ready to implement retaliatory tariffs on U.S. goods if necessary. Additionally, discussions are underway about instituting a massive stimulus package to support the Canadian economy. More broad measures may be limited as the Canadian Parliament is not due back in session until March 24 – when the government may fall and new elections could be called. Ontario Premier Doug Ford called a snap election for Feb 27, 2025, seeking a new mandate to deal with threatened tariffs. **Our House View has long held that tariffs are more likely to be used as negotiating tactics for extracting desired outcomes and cutting deals with trading partners than as blunt weapons.** This view is reinforced by both the selection of the individuals who will lead policy creation/implementation and by implication since tariff policy didn't appear in early executive orders from the President. **The Bank of Canada did lay out a detailed scenario of how broad, 25% tariffs would affect the economy: first, an expected 2.5% hit to real GDP in year one; second, net upside on inflation (reflecting full retaliation and a much weaker Canadian dollar).** The implications for monetary policy are muddied, but **the main message was "we can't lean against weaker output and higher inflation at the same time."** The BoC will intensely monitor the impact of tariffs (if and when they come). We shouldn't necessarily expect an immediate policy reaction or the start of a trade war.

Bank of Canada cuts rates - The BoC trimmed its overnight rate 25 basis points to 3.0%, the sixth consecutive cut for a cumulative reduction of 200 basis points since last summer. A rate drop was expected and cements the central bank's title as the world's most aggressive cutter. In a bit of a surprise, the bank also abruptly ended quantitative tightening, and will begin term repos in early March. Inflation is expected to stay close to target, the bank said, and domestic demand is turning the corner. Much slower projected population growth is behind the modest downward revision in GDP growth for both this year and next. Cumulative rate cuts of 200 basis points are setting a much more positive backdrop for the Canadian economy – arguably one of the most rate-sensitive economies in the world. Next steps clearly are dependent on what unfolds on the trade front. **BMO Economics suspects that while the BoC may initially respond cautiously to a trade war, eventually it would be compelled to cut much more than the market currently expects.**

U.S. Federal Reserve kept rates steady – as expected, but what was initially thought to be a hawkish tweak in its policy statement pushed stocks and bonds lower. During the press conference, however, Chair Powell clarified that the wording adjustments were merely a "language cleanup" and not meant to signal a shift in policy. **FOMC members view rates as meaningfully restrictive but believe the current policy stance is appropriately calibrated to balance the Fed's dual mandate of price stability and full employment.**

U.S. Consumer sentiment increasingly pessimistic – relative to both the current state of the job market and the broader U.S. economy. The Conference Board's Consumer Confidence Index fell in January, although it is still above levels seen in mid-2024. Survey respondents indicated that jobs were harder to find, business expectations declined and inflation and interest rate expectations edged higher. Interestingly, lower-income consumers saw the largest increase in upbeat sentiment, while

those earning over $125,000 per year experienced the sharpest decline. Survey respondents maintained a constructive outlook on stock prices, reported an improved perception of personal finances and expressed limited recession fears. **Inflation expectations and job market strength remain key watch points for the Federal Reserve.**

Earnings reports from four of the Mag 7 – share price whipsaws between earnings release and subsequent investor calls underscored market nervousness over AI spend and progress. Managements remain committed to their long-term goals for dominance, however, recommitting to plans for continued investment.

Next Week

A number of data points to ponder both in Canada and the U.S. relative to the health of business, services and payrolls. All eyes will be tuned to employment cost and hiring trends for hints at the Fed's next move. Earnings season gains momentum with a large chunk of the S&P 500 slated to release results.

- **Monday 2/3** – U.S. manufacturing PMI and ISM surveys | Canada manufacturing PMI
- **Wednesday 2/5** – U.S. services PMI and ISM surveys, trade deficit, ADP employment | Canada services PMI and balance of trade
- **Thursday 2/6** – U.S. Initial Jobless Claims and Q4 productivity
- **Friday 2/7** – U.S. payrolls report, consumer sentiment | Canada employment

Data scorecard as of January 29, 2025

Equity Market Total Returns						
	1/29/2025 Level	WTD	YTD	2024	2023	2022
S&P 500	6,039	-1.0%	2.8%	25.0%	26.3%	-18.1%
NASDAQ	19,632	-1.6%	1.7%	29.6%	44.7%	-32.5%
DOW	44,714	0.7%	5.2%	15.0%	16.2%	-6.9%
Russell 2000	2,283	-1.1%	2.4%	11.5%	16.9%	-20.5%
S&P/TSX	25,473	0.1%	3.2%	21.7%	11.8%	-5.8%
MSCI EAFE	8,447	0.1%	4.5%	3.8%	18.2%	-14.5%
MSCI EM	584	0.2%	1.7%	7.5%	9.8%	-20.1%
Bond Market Total Returns						
		WTD	YTD	2024	2023	2022
Bloomberg U.S. Treasury		0.4%	0.5%	0.6%	4.1%	-12.5%
Bloomberg U.S. Aggregate		0.5%	0.5%	1.3%	5.5%	-13.0%
Bloomberg Canada Aggregate		0.6%	0.3%	-4.6%	9.5%	-17.3%
Bloomberg U.S. Corporate		0.4%	0.6%	2.1%	8.5%	-15.8%
Bloomberg U.S. High Yield		0.1%	1.3%	8.2%	13.4%	-11.2%
Bloomberg 1-10 Year Munis		0.3%	0.6%	0.9%	4.5%	-4.7%
Government Bond Yields						
	1/29/2025	Last Month End	Last Quarter End	2024	2023	2022
U.S. 10-Year Treasury	4.53%	4.57%	4.57%	4.57%	3.88%	3.88%
Canada 10-Year Government	3.17%	3.23%	3.23%	3.23%	3.11%	3.30%
U.K. 10-Year Gilt	4.62%	4.56%	4.56%	4.56%	3.53%	3.66%
German 10-Year Bund	2.58%	2.36%	2.36%	2.36%	2.02%	2.57%
Japan 10-Year Government	1.19%	1.09%	1.09%	1.09%	0.61%	0.41%
Currencies & Real Assets						
	1/29/2025 Level	WTD	YTD	2024	2023	2022
USD Index	108.00	0.5%	-0.4%	7.1%	-2.1%	8.2%
CAD:USD	$0.69	-0.5%	-0.2%	-7.9%	2.3%	-6.7%
Bitcoin	$103,751.41	-1.3%	10.7%	120.5%	157.0%	-64.3%
Gold	$2,759.36	-0.4%	5.1%	27.2%	13.1%	-0.3%
Oil (WTI)	$72.62	-2.7%	1.3%	0.1%	-10.7%	6.7%

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