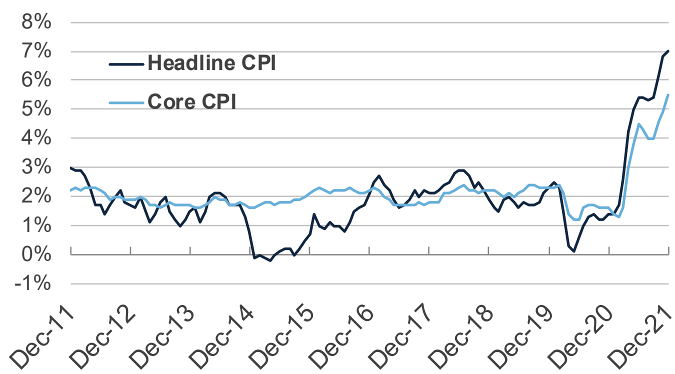
Inflation pressures accelerate Fed timeline

Brandon Huddleston, Director | Senior Investment Strategist, BMO Wealth Management - U.S.

Thursday, January 13, 2022

U.S. CPI soared 7.0% (year-over-year) in December, outpacing prior-month readings and closing out 2021 at a 40-year high *[Exhibit 1]*. Core prices, which exclude food and energy, hit 5.5% — their largest gain since 1991. Market reaction to the news was tame, as the results were largely in line with forecasts and did little to alter expectations around Fed policy.

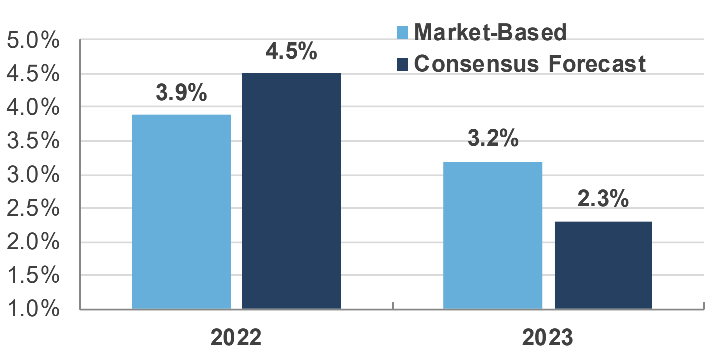
Exhibit 1: U.S. Inflation (Year-over-Year)



Source: U.S. BLS

Elevated price-pressures are likely to persist throughout 2022, but we don't believe they will by themselves derail the economy. That said, it is important that inflation begins to show signs of peaking — a development we expect to materialize in coming months as supply-chain problems ease and consumer demand rebalances between goods and services. Once inflation has peaked, we anticipate its path downward will be gradual rather than a sharp drop. Currently, financial markets and economists project falling, if still elevated, inflation over the next two years *[Exhibit 2]*.

Exhibit 2: Inflation Expectations: Calendar-Years 2022 and 2023



Source: Bloomberg; BMO Wealth Management

The arrival of Omicron does represent something of a wild card and has the potential to postpone supply-chain normalization and the return to more traditional consumption patterns. Beyond those nearer-term challenges, though, the transformation of current inflationary pressure into a long-lasting, endemic problem remains unlikely. For a full-blown, high-inflation process of that strength to take hold, inflation expectations would have to become untethered and/or wages would need to spiral upwards. At present, neither of those issues is visible on the horizon, although we are tracking developments in that area closely.

A related risk we're monitoring closely is the Fed's emerging response to current inflation dynamics. Markets now expect the Fed to raise interest rates three or four times in 2022; a forecast that is up sharply from just a few months ago. Furthermore, the Fed's December meeting minutes, released on January 5, revealed an in-depth discussion of the Fed's intention to reduce the size of its massive balance sheet sooner than markets had been anticipating. The big question is not whether the economy and markets can withstand a few interest rate increases this year, but rather as we move toward year end what does the interest rate trajectory look like then? Ongoing tightening would eventually become challenging for equity markets. Such a scenario playing out is not our central view at this time because we do expect inflation to moderate and Fed hawkishness to moderate. Persistent Fed tightening, however, is the greatest risk to U.S. equity markets over the tactical horizon and, therefore, a factor that merits close, ongoing scrutiny.

In the meantime, our recommended portfolio positioning of overweight U.S. Equities and Real Estate and underweight Core Fixed Income is intended to be more inflation resistant. U.S. Equities and Real Estate typically provide a natural inflation hedge through price increases, and Core Bonds are likely to see ongoing pressure as the Fed takes action in 2022. Clients are encouraged to discuss their individual circumstances with their advisor.

Disclosure

This report contains our opinion as of the date of the report. It is for general information purposes only and is not intended to predict or guarantee the future performance of any investment, investment manager, market sector, or the markets generally. We will not update this report or advise you if there is any change in this report or our opinion. The information, ratings, and opinions in this report are based on numerous sources believed to be reliable, such as investment managers, custodians, mutual fund companies, and third-party data and service providers. We do not represent or warrant that the report is accurate or complete.

To the extent this report contains information about specific companies or securities, including whether they are profitable or not, it is being provided as a means of illustrating the investment manager's investment thesis. The investment manager may or may not have invested in these securities at the time this report was prepared or is accessed by the reader. References to specific companies or securities are not a complete list of securities selected and not all securities selected in the referenced timeframe were profitable.

Other Bank of Montreal affiliates, and their agents and employees, may provide oral or written market commentary or trading strategies to clients that reflect opinions that are contrary to the opinions expressed in this report. These same persons and affiliates may make investment decisions that are inconsistent with the recommendations or views expressed in this report. We and our affiliates, directors, officers, employees and members of their households, will from time to time have long or short positions in, act as principal in, and buy or sell, the securities referred to in this report. We and our affiliates, directors, officers, employees and members of their households, may have positions in the securities mentioned that are inconsistent with the views expressed by this report.

This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, a recommendation to buy, hold or sell securities, or a recommendation of any investment manager or investment strategy. Do not use this report as the sole basis for your investment decisions. Do not select an asset class, investment product, or investment manager based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Any forward-looking statements in this report involve known and unknown risks, uncertainties and other factors that may cause the actual performance of future markets to differ materially from the projections depicted in the report. Past performance is not indicative of future results and current performance may be higher or lower than that shown in the report. There can be no certainty as to the extent or depth of any market downturn, nor any assurance regarding the nature, extent or timing of markets rebounding. When evaluating the report, you are cautioned not to place undue reliance on these forward-looking statements, which reflect judgments only as of the date of the report. Investment returns fluctuate, and investments when redeemed, may be worth more or less than the original investment.

Standardized performance returns include reinvestment of dividends, other income and capital gains, which depict performance without adjusting for the effects of taxation or the timing of purchases and sales. Performance data is presented without deducting the investment advisory fees and other charges that may be applicable. The deduction of such fees and other charges (and the compounding effect thereof over time) will reduce portfolio return. Unless otherwise indicated, traditional investment performance data generally represents a composite or representative portfolio return and is shown gross of the investment manager's advisory fees. Unless otherwise indicated, alternative investment performance data is shown as net of fund expenses, management fees, and incentive fees. Index performance data is shown as total return. You cannot invest directly in an index. Due to a system conversion, the ability to manipulate or restate client specific performance data prior to December 31, 2007, may be limited.

Any discussions of specific securities, investment managers, or strategies are for informational purposes only and should not be considered investment advice. The report does not constitute an offer to sell or a solicitation to buy any security or investment product. Any offer to sell or solicitation to buy an interest in any private security, investment product or fund may only be made by receiving a confidential private offering memorandum, prospectus, investment advisory agreement or similar documents from the investment manager, which describes the material terms and various considerations and risks relating to such security, investment product or fund.

Alternative investments, such as private equity and hedge funds, contain risks that are amplified when compared with other asset classes, such as illiquidity, stock or sector concentration, financial leverage, difficulties in valuation, and short selling. Alternative investment vehicles have minimal regulatory oversight and alternative managers have the latitude to employ numerous investment strategies with varying degrees of risk.

We are not licensed or registered with any financial services regulatory authority outside of the United States. Non-U.S. residents who maintain U.S.-based financial services accounts with us may not be afforded certain protections conferred by legislation and regulations in their country of residence with respect to any investments, investment solicitations, investment transactions or communications made with us.

You may not copy this report or distribute or disclose the information contained in the report to any third party, except with our express written consent or as required by law or any regulatory authority.

"BMO Wealth Management" is a brand name that refers to BMO Harris Bank N.A. and certain affiliates that provide certain investment, investment advisory, trust, banking and securities products and services. Investment Products are: **Not Insured by FDIC or Any Other Government Agency | Not BMO Harris Bank Guaranteed | Not BMO Harris Bank Deposits or Obligations | May Lose Value**

BMO Private Bank is a brand name used in the United States by BMO Harris Bank N.A. Member FDIC. Not all products and services are available in every state and/or location.

BMO Family Office is a brand delivering family office services and investment advisory services through BMO Family Office, LLC, an investment adviser registered with the U.S. Securities and Exchange Commission; investment management services, trust, deposit and loan products and services through BMO Harris Bank N.A., a national bank with trust powers; and trust services through BMO Delaware Trust Company, a Delaware limited purpose trust company. BMO Delaware Trust Company does not offer depository, financing or other banking products, and is not FDIC insured. Not all products and services are available in every location. Family Office Services are not fiduciary services and are not subject to the Investment Advisors Act of 1940 or the rules promulgated thereunder. Investment products and services: **ARE NOT A DEPOSIT – NOT INSURED BY THE FDIC OR ANY FEDERAL GOVERNMENT AGENCY – NOT GUARANTEED BY ANY BANK – MAY LOSE VALUE.**

Capital Advisory Services are offered by a division of BMO Harris Bank N.A.

NMLS #401052

EQUAL HOUSING LENDER

Corporate Office: 111 W. Monroe Street, Chicago, IL 60603

BMO Wealth Management