Outlook for Financial Markets

"Courage is the most important of all the virtues because without courage, you can't practice any other virtue consistently."

– Maya Angelou

Economy

Evidence of strong U.S. economic momentum continued last month, with real GDP growth for the second quarter coming in at 4.2%, the fastest pace in nearly four years. Consumer spending was up 4%, as individuals continued to benefit from a strong labor market and lower tax withholdings. Exports also soared 9.3%, with advanced soybean shipments leading the way as companies worked hard to get ahead of new tariffs. While the export surge will likely prove short-lived, inventory trends present a brighter picture for future quarters. A plunge in overall inventories reduced growth by a full percentage point in Q2, which will likely provide a tailwind going forward as firms restock.

At a company level, the second quarter earnings season has proven to be similarly robust. Of the S&P 500 firms that had reported results as of the time of this writing, over 85% had beaten earnings estimates while 72% had exceeded revenue expectations. Perhaps more impressively, aggregate year over year earnings and revenue growth were running at close to 25% and 10%, respectively.

Economic indicators have been stabilizing in several international markets after an early 2018 slump. As can be seen from *Exhibit #1*, economic surprises for Japan and Eurozone rebounded from the depths seen in the first half of the year. China also joined the party, though to a lesser extent. The world's second-biggest economy continues to balance the need to manage excesses related to debt and shadow banking with the desire to deliver strong growth in the face of additional trade headwinds. This will likely prove to be the pivotal story of late 2018 and 2019.

Executive Summary

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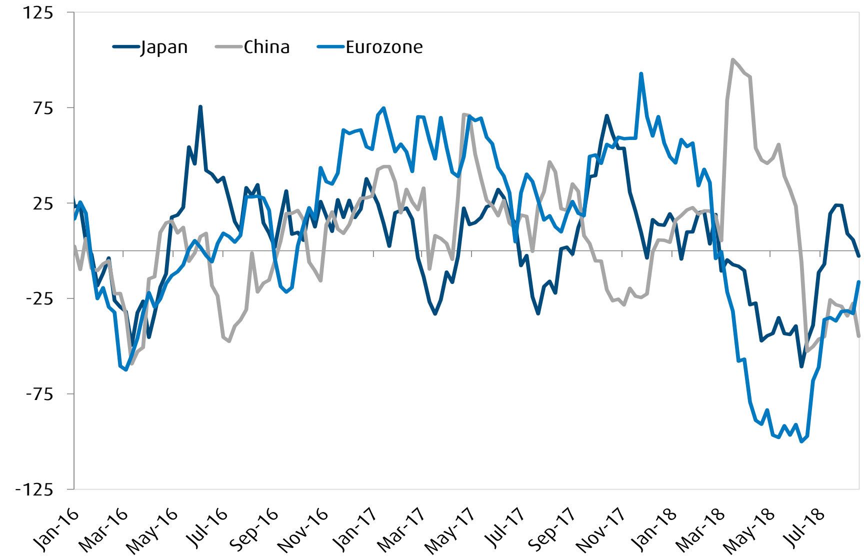
Reinsurance and catastrophe risk

For the past few years, we have been recommending reinsurance investments to clients when appropriate, as potential exists for this asset class to deliver attractive returns with low correlation to public markets. With the 2018 Atlantic hurricane season now upon us, memories of 2017 are still painful – particularly for those in Texas, Florida and Puerto Rico. After a decade of relative calm *(Exhibit #2)*, 2017 was one of the most active hurricane seasons on record. The storms resulted in hundreds of deaths, thousands of displacements, and over $200 billion in damages. The season was truly a tragedy.

From purely an investment perspective, 2017 was a difficult year for reinsurance strategies as well. Given these negative results and the preponderance of hurricane-related events, we felt it prudent to revisit our baseline investment assumptions for the asset class. To do so, it is first important to note that the insurance and reinsurance markets exist because it is not perfectly predictable when insured events will happen, how large the damages will be, or where the damages will occur. In the case of hurricanes and other large-scale natural disasters, the phrase "not perfectly predictable" is an understatement.

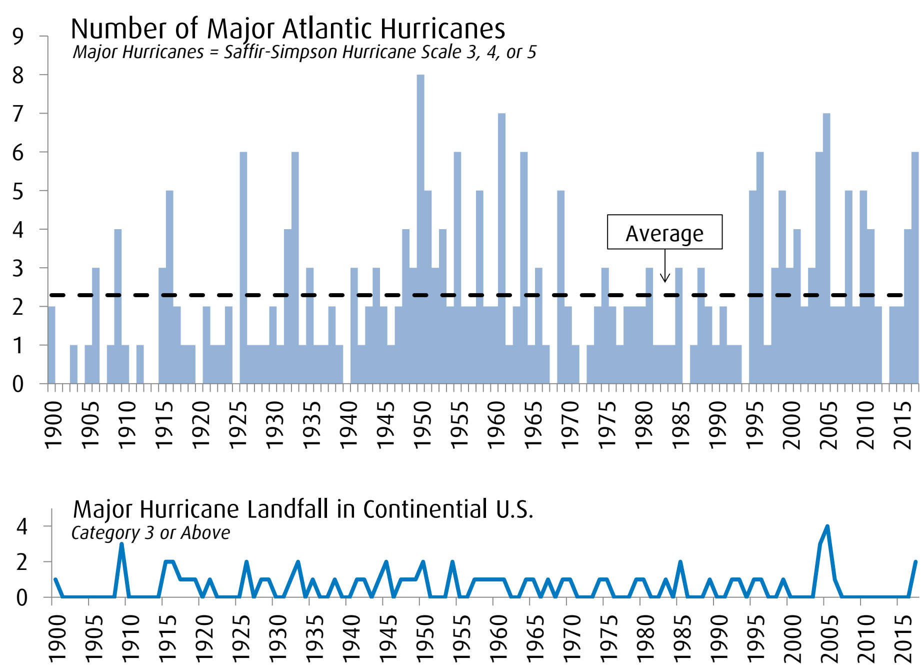
In the near term, we have some good news. Or, mathematically speaking, "good news in expectation." One of the nation's preeminent forecasters of hurricane activity, Colorado State University's (CSU) Department of Atmospheric Science, recently revised its earlier Atlantic hurricane activity forecast

Exhibit 1 » Citibank Economic Surprise Index



Source: Citibank, BMO Wealth Management Strategy

Exhibit 2 » Number of Major Hurricanes



Source: BMO Wealth Management , NOAA National Center for Environmental Information for 2018, adjusting it sharply lower. The probability of a direct hit on the U.S. coast from a category 3 to 5 hurricane this season has been reduced from 63% to 39% (last-century average probability was 52%), according to CSU. Further, the expectation for major hurricanes has decreased from the 3 forecasted a few months ago to just 1, and the 1-standard-deviation range decreased from 2–4 to 0–2. Think of it this way, the probability of 3 major Atlantic hurricanes in 2018 just went from about 50% down to about 2.5% based on CSU's published statistics. Thank goodness.

Of course, these are only probabilities. And a 39% chance of the U.S. coast being hit by a hurricane of category 3 or above is still meaningful. For example, in 1992, hurricane activity was expected to be low overall, and it was, but with one big exception. As un-luck would have it, that big exception, named Hurricane Andrew, went barreling straight into Miami-Dade County. So, you can still get bad outcomes from an attractive distribution, but, on average, the estimates look promising for 2018. Add to that a modest increase in reinsurance rates due to last year's heavy losses, and the risk-return relationship for this year looks more favorable than usual.

Thinking more broadly, the question of how climate change might affect catastrophe risk is a prominent topic. While there are theories that a warmer climate will lead to more intense hurricanes, there is no scientific consensus issue. According to a prominent expert, Kerry Emanuel - MIT Professor of Atmospheric Science, "It is not possible to discern any change that might have occurred owing to warming that has already taken place," because rising temperatures are a relatively recent phenomenon and the time series of data is not yet sufficient to draw data-driven conclusions. Based on the underlying physics of hurricanes, however, Professor Emanuel expects that storms of greater intensity will be a trend in the years and decades to come.

There is more scientific consensus that climate change will result in greater flood and fire risk due to droughts and higher temperatures. Flood risk has the unfortunate attribute of being correlated with storm risk. Recent wildfires in the western U.S. have highlighted that fire season in some places is now year-round. According to the deputy chief of California Fire, "The new normal is already here. We don't even use 'new' anymore . . . In Southern California especially, it's year-round."

How will the catastrophe insurance market respond to these risks, and will it remain a good area for investment? There are three issues to consider. The first is model risk – risk-pricing models currently used do not capture structural changes well in real time as they develop. The second is that historically, reinsurance companies have responded to environments of perceived greater risk by increasing premiums by more than enough to compensate for the risk. For example, according to the Wharton School's study, "Managing Large-Scale Risks in a New Era of Catastrophes," the cost of reinsurance went up 76% in the year following Hurricane Katrina. The third and counterbalancing consideration is that as more investment capital comes into the reinsurance markets, which is a great development for the economy as a whole, premiums will be driven lower than would have been expected had the reinsurance companies maintained their oligopoly. Warren Buffet mentioned this trend in his 2014 annual shareholder meeting, as leading to Berkshire Hathaway's "constrained volume of [reinsurance] business" due to "management's assessment of the adequacy of premium rates."

Taking those three issues in aggregate, we continue to expect that reinsurance will provide returns over the longer term that are attractive, given the generally uncorrelated nature of the return stream. As diversified investors, we have the benefit of considering reinsurance in the context of our overall investment portfolio. The model-risk consideration does, however, potentially inject an element of additional volatility as the industry assesses and reprices risk, but there is no doubt that considerable resources will be spent addressing the issue.

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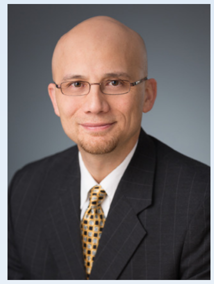
As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments for our Ultra High Net Worth group, and became National Head of Investments in 2015. In January 2018, Michael took over the role of Chief Investment Officer. With close to two decades of experience in money management, Michael has a deep background in economic analysis, portfolio construction and risk management.

Michael earned a BA in economics from Northwestern University and an MBA with distinction in finance and decision sciences from the J.L. Kellogg Graduate School of Management at Northwestern University in Evanston, Illinois. He is a member of the Beta Gamma Sigma International Honor Society, holds a Chartered Financial Analyst designation, and is a member of the CFA Institute, CFA Society of Chicago, and the Chicago Quantitative Alliance. He is also a graduate of the American Bankers Association – National Trust School.



Yung-Yu Ma, Ph.D.
Chief Investment Strategist BMO Wealth Management - U.S.

As Chief Investment Strategist, Yung-Yu is responsible for performing macroeconomic analysis, valuation modeling and market analysis across asset classes to guide strategic and tactical asset allocations for client portfolios.

Prior to joining BMO Wealth Management, Yung-Yu was a finance professor at Lehigh University, where he taught courses in fixed income, equities and derivatives. His academic studies have been cited in the *Wall Street Journal*, in leading finance journals, top law journals, the *Handbook of High Frequency Trading*, and in *Oxford Handbook of Corporate Governance*. During his tenure at Lehigh, he was awarded the Staub Outstanding Teacher Award, awarded to one faculty member by a vote of faculty and students. Prior to his academic career, Yung-Yu worked for a global consulting firm performing financial and market analysis for global companies with operations in Hong Kong, Taiwan and Mainland China. Later, he oversaw the operations at a Fortune 500 subsidiary in Taipei and Mainland China.

Dr. Ma earned his Ph.D. in Finance at the University of Utah and his B.A. in Economics and Political Science, *magna cum laude*, at Williams College.

Yung-Yu lives in Portland, Oregon with his wife and two children. He is a basketball fan and enjoys cheering on his sons' teams.

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Written: August 10, 2018