Outlook for Financial Markets

The great inflation debate ... and investing implications

"A problem well stated is a problem half solved."

\- Charles Kettering

Inflation in the U.S. has been on a downward trajectory for 40 years; a trend now being broken in dramatic fashion ***(Exhibit #1)***. It's a challenge to even cobble together a historical "inflation playbook" because of the fundamental economic shifts that have occurred since the late 1970s and the unique nature of the post-pandemic economic reopening driving inflation today. To add another twist, while inflation has only recently begun to show up in monthly government data, the bond market seems eager to look past current price pressures and pass a verdict that the price jumps will be transitory. While the year began with a sharp rise in 10-year Treasury note yields, that has petered out and those yields have fallen about one-quarter of a percent from the spring highs.

At a high level, we agree with Federal Reserve Chairman Powell that most of the inflation pressures the economy experiences in the coming months will ultimately prove temporary. That said, "temporary" might be more drawn out than many posit, and certain price pressures could have a long tail. For example, the cost of "shelter," as captured by standard inflation measures, tends to lag home price increases by a year and are likely to push higher well into 2022. Additionally, shipping bottlenecks are likely to persist for many more months, and the Producer Price Index shows considerable cost pressures in the supply chain. Even oil has meaningful upside risk from current levels. Looking out to mid-2022, however, the current modest rate of wage growth is not consistent with persistent longer-term inflation, and the strongest wage

Executive Summary

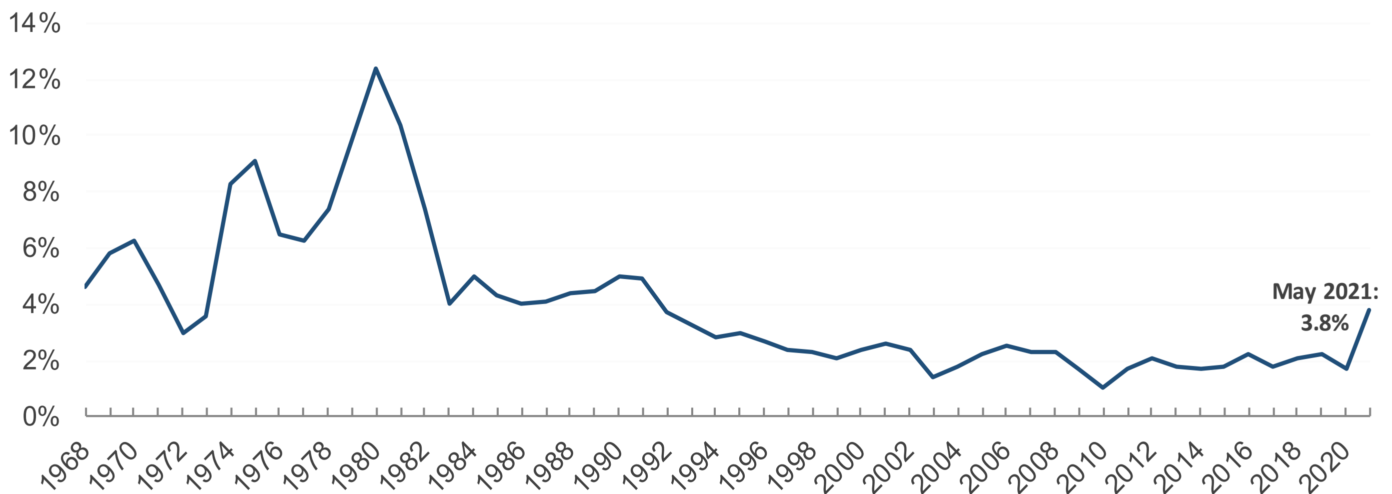
The breaking of a 40-year trend of declining or low inflation ushers in a highly unfamiliar environment for market participants.

Some inflation pressures will persist well into 2022, but current wage growth levels are not consistent with longer-term inflation.

Federal Reserve projections for interest rate levels in 2023 increased, but remain well within bounds that are digestible by the economy and market.

Equities provide a medium-term inflation hedge, and we expect that investors will gradually become more comfortable amid inflationary pressures.

Exhibit 1 » U.S. Core Consumer Price Index (CPI) (less food and energy)



Source: U.S. Bureau of Labor Statistics

pressure is concentrated in the lowest wage quartile ***(Exhibit #2)***. Overall, wages are increasing at a slower rate than that seen in growth periods of prior decades.

Will the Fed's response derail the equity market?

The Fed's updated projections released on June 16, and Chairman Powell's accompanying press conference, provided a flavor of what is likely to come. Nothing in the new projections or the press conference conflicted with an overall dovish approach, but marginal new information nonetheless led to short-term market digestion and selloff. Projections for interest rate levels in 2023 were increased, but Chairman Powell's press conference partially calmed markets when he stressed that most inflation pressures appear temporary, are reasonably "anchored," and that an interest rate liftoff is "well into the future."

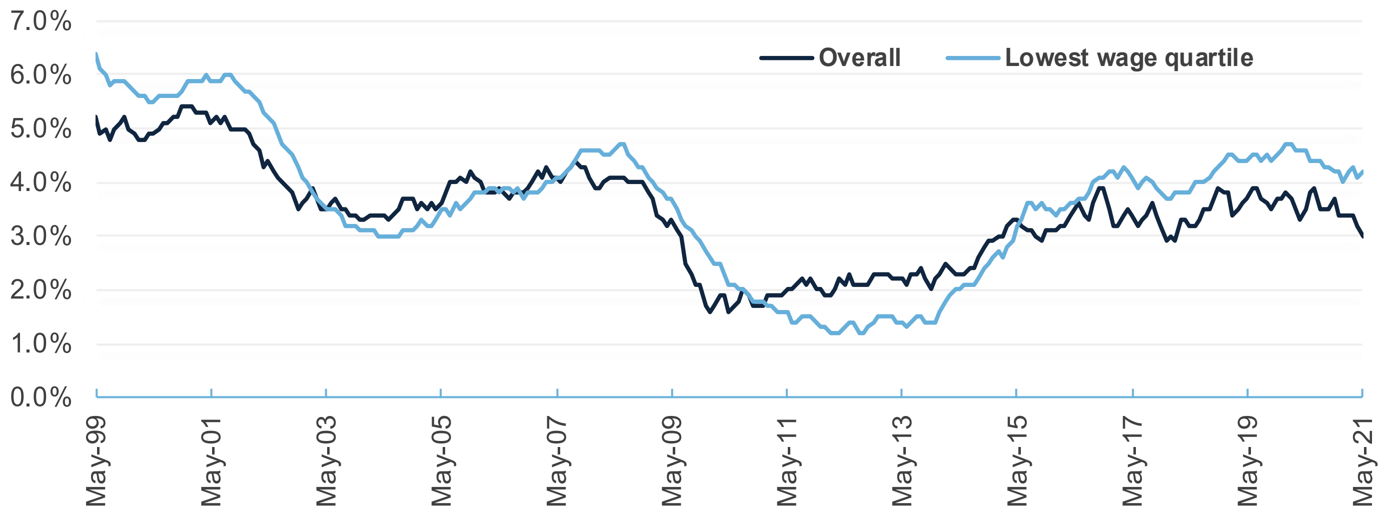
It is worth reiterating our thoughts from last month's Outlook … "Our base case, however, continues to be that longer-term interest rates will rise in a measured way throughout 2021, and are more likely to cause intermittent equity market volatility rather than a change in overall direction. From a broader perspective, equities tend to provide a degree of inflation hedge, at least for the industries with pricing power."

This statement remains valid, but inflation concerns could put a dent in investor confidence and depress the multiples investors are willing to pay for earnings until such fears abate. While such a shift in psychology could pose a headwind, we expect these concerns will diminish over the coming quarters. We may not yet have reached peak inflation concern, but we expect that investors will gradually become more comfortable amid inflationary pressures and gravitate toward equities as many companies find an adequate mix of managing and passing on cost increases.

Current positioning and inflation considerations

Within equities – an asset class, as mentioned, that serves as a medium-term inflation hedge – our recommended overweight to both small-cap and mid-cap U.S. equities aligns with economic acceleration and leans into more cyclical areas of the economy that should continue to benefit from reopening.

Exhibit 2 » Federal Reserve Bank of Atlanta Wage Growth Tracker



Source: Federal Reserve Bank of Atlanta

What about gold? While frequently cited as a good inflation hedge, that notion fails to hold up once the extreme inflationary period of the late 1970s is excluded. Gold could also struggle against a backdrop of strong economic growth this year and next. Indeed, immediately following the Fed's June 16 announcement, the dollar strengthened, bond yields rose, and gold prices tumbled more than two percent.

Other commodities might seem a no-brainer in an inflationary environment, but almost all investments in the space involve futures contracts, and those returns can deviate materially from spot prices. Even the headline-grabbing experience of soaring lumber prices has seen a comeuppance, and prices have fallen over 40% in recent weeks, although still trading well above historical norms. China also recently announced plans to release metal reserves to rein in commodity prices. Similarly, Treasury Inflation Protected Securities (TIPS) have also come down and failed to surpass the highs set in their January spike. The expectations for many of these assets pose a similar challenge -- that is, fine-tuning positions around inflation that is expected to ease in coming quarters can turn speculative and volatile.

Overall, we continue to favor accepting equity risk and remaining underweight core fixed income. The uncertainty associated with inflation persistence will likely lead to periods of pauses and pullbacks to digest new information, but unless the Fed shifts its dovish stance materially, equity markets should maintain a positive bias amid strong earnings growth. *It's hard to overstate the importance of the Fed's interpretation of data at this juncture of high uncertainty and unprecedented economic reopening.* In his June 16 press conference, Chairman Powell stressed that long-term inflation expectations are what matter for monetary policy, and that those come from a mix of economists, the public, and market-based measures. We are tracking these measures closely for early indications that the Fed may turn more or less supportive in coming months.

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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.

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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.

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

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