

Outlook for Financial Markets

2022 Second Half Outlook – looking to narrow the range of possible outcomes

“All economic forecasts are subject to considerable uncertainty. There is always a wide range of plausible outcomes for important economic variables, including the federal funds rate.”

– Federal Reserve Chairman Jerome Powell

Rapidly shifting narratives

The first half of 2022 was marked by abrupt increases in inflation and Fed interest rate hike expectations, geopolitical shocks, soaring gasoline prices, and rapidly shifting market narratives. Both the markets and the Fed struggled to adjust to rising inflation that – while already on the upturn – spiked even higher from the impacts of the war in Ukraine. In the late spring, conventional wisdom coalesced around the economy falling into recession as a foregone conclusion. That narrative lasted a handful of weeks until both resilient consumer spending and a persistently strong labor market shifted the narrative to incorporate the possibility of a “soft landing.” More recently, market-based expectations of future inflation have moderated, commodity prices have softened, and the beginning of Q2 earnings season has seen mixed – not terrible – results. Nonetheless, there remain several major risks whose range of possible outcomes remains quite broad.

The Fed, inflation, interest rates, and fixed income markets

Inflation expectations have come down considerably from just a couple of months ago. The TIPS¹ “breakeven inflation rate” is a market-based

measure that proxies for future inflation expectations and has come down a full percentage point from its peak (*Exhibit 1*). The Fed is still expected to raise interest rates through year end with the short-term Fed Funds rate likely settling between 3.25% and 3.75%. Further upside inflation surprises – or even persistent inflation stickiness – would increase the possibility of excessive tightening by the Fed.

The sharp rise in interest rates earlier this year resulted in fixed income returns turning negative at the same time equities were falling. After pricing-in Fed interest rate expectations, the high quality areas of short-term fixed income now provide much more safety in the portfolio, and the high-quality areas of longer duration fixed income can better serve as a portfolio hedge in the event of further equity market selloffs.

Going forward, our focus is equally – or even more so – on the expected degree of Fed tightening as it is on inflation itself. Equities can still perform reasonably well in an inflationary environment as was seen in the late 1970s and early 1980s (*Exhibit 2*). In many instances, companies have sufficient pricing power to raise prices and offset their own rising costs. The ongoing growth concerns, however, present the risk of drawn-out stagflation, which would clearly

Executive Summary

Rapidly shifting market narratives are a by-product of the heightened economic and geopolitical uncertainty

Inflation readings and the Fed’s actions will continue to take center stage

A “soft landing” still looks probable given the strength of the labor market

International markets continue to have greater risk than domestic ones

High-quality fixed income is now fairly valued and we continue to lean toward greater stability and diversification in portfolios rather than greater risk taking

¹ Treasury Inflation Protected Securities (TIPS), whose par value adjusts based on the inflation rate

Exhibit 1 » TIPS 5 Year Breakeven Inflation Rate



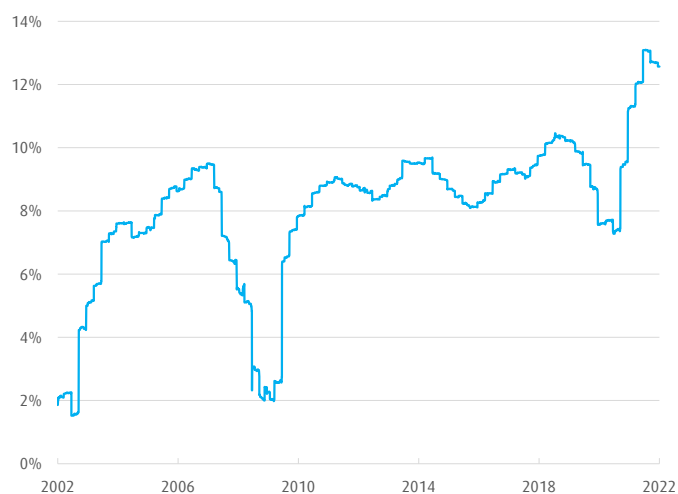
Source: Source: Bloomberg, BMO Wealth Management

Exhibit 2 » Inflation and Equity Returns (1977 to 1984)

Year	Annual CPI	S&P 500 total Return
1977	6.7%	-7.0%
1978	9.0%	6.5%
1979	13.3%	18.5%
1980	12.5%	31.7%
1981	8.9%	-4.7%
1982	3.8%	20.4%
1983	3.8%	22.3%
1984	3.9%	6.2%

Source: Bureau of Labor Statistics, pages.stern.nyu.edu/~adamodar

Exhibit 3 » S&P 500 Profit Margins



Source: Source: Bloomberg, BMO Wealth Management

be negative for equity markets. On top of growth concerns, corporate profit margins are extraordinarily high on a historical basis (*Exhibit 3*). There are multiple reasons why profit margins have risen so much (e.g., the rise of technology megacaps and lower effective corporate taxes), but the current environment of slowing growth, high input costs, and a tight labor market increases the risk of profit margin pullback.

Recession or no recession?

We can propose a recession probability, but we believe the more appropriate question is “soft landing” or “hard landing”? Growth has slowed; that is already baked in. Whether growth has slowed just enough to stay out of what the official National Bureau of Economic Research recession dating committee decides (retroactively) is a recession is not a primary consideration. A “hard landing” would be an entirely different story altogether – that would be marked by an even steeper slowdown and sharply declining corporate profits. We continue to believe the prospects for a hard landing are lower than those of a soft landing, and the greatest risk for a hard landing is Fed over-tightening.

On the positive side, in aggregate, both households and corporations have low leverage, high savings, and low debt servicing requirements. In the 2001 and 2008 recessions, there were substantial amounts of misallocated capital and leverage that resulted in a negative feedback loop when the economy slowed. The current economic environment may still have areas of froth – cryptocurrency, SPACs, and pre-IPO tech “unicorns” come to mind – but these do not appear to have the far-reaching economic implications of prior economic distortions. The current relatively stable economic underpinnings are supported by a labor market that remains healthy and steadies consumer spending. Strains are emerging, but the lack of major imbalances should allow for “bend but don’t break.”

The U.S. housing market

The housing market is clearly pulling back due to the combined effects of high prices and rising mortgage rates that have strained affordability. Homebuilders are reporting falling demand and housing starts have fallen to a 2-year low (*Exhibit 4*). This housing downturn, however, is likely to be short lived. From 2012 through 2021, over 12 million households were formed in the U.S. but only 7 million new single-family homes were built during that time². The accompanying graph indicates the decade-plus dearth of home construction that has finally caught up with us. Given this medium-term supply-demand dynamic, we expect home sales to slow sharply for a few quarters and prices could fall modestly, but we expect stability and balance should emerge in the housing market again by the spring of 2023.

Midterm U.S. elections

Pundits and prediction markets are giving high odds to Republicans regaining control of the House. Control of the Senate, however, is a closer call. Any outcome other than one-party control of the White House and both houses of Congress implies gridlock on major issues such as taxes and fiscal spending which

² www.cnn.com/2021/09/14/america-is-short-more-than-5-million-homes-study-says.html

Exhibit 4 » Single Family Housing Starts (thousands of units)



Source: Federal Reserve, BMO Wealth Management

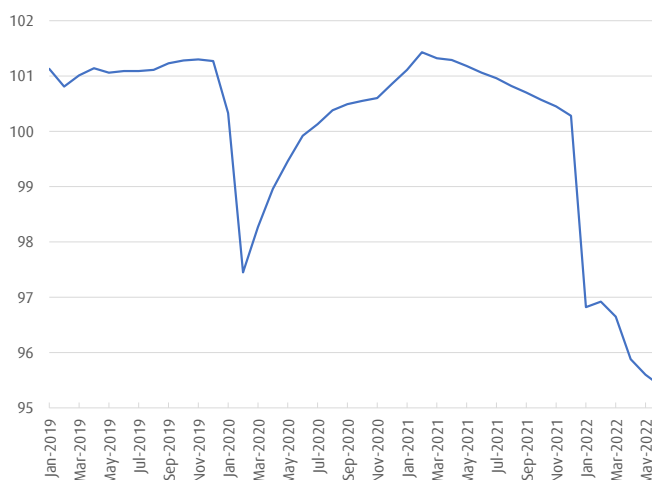
have more market-moving implications. The near-term market impact of the midterm elections is therefore likely to be modest. The midterms may raise the stakes for the 2024 Presidential election, but there are far too many considerations presently in play for the markets to worry about an even more uncertain division of power that is two years away.

Geopolitics and international markets

We continue to recommend an underweight to both international developed equities and emerging market equities. The trajectory of the war in Ukraine, Europe’s and America’s response, and the economic warfare have continued to surprise geopolitical prognosticators and the markets in general. What was expected to be a quick Russian victory with little economic response from Europe has turned into a drawn-out war with sophisticated weapons being supplied by the West. Economic sanctions, initially off the table, soon came forcefully from the U.S. and Europe. Not to be outdone, Russia raised the stakes by reducing – and potentially cutting off – the flow of natural gas to Europe, which could lead to crippling effects on European industry. In short, risk in Europe remains elevated. Europe faces slowing growth and high inflation, but also greater geopolitical risks. The endgame for the war and its economic impacts are still very uncertain.

Our recommended underweight to emerging market equities remains in effect and was initiated based on the belief that China’s property model is broken. Those property sector risks continue to play out (*Exhibit 5*) and we do not see a quick path to stabilization. The outsized contribution to GDP and composition of household wealth that housing constitutes in China point to significant risk. Aggressive Covid lockdowns in China add to the country’s economic challenges, although we expect those lockdowns to begin easing by year end. Overall, while equity prices have come down in international markets, risk remains elevated and not adequately compensated by the range of likely outcomes.

Exhibit 5 » China Real Estate Climate Index



Source: National Bureau of Statistics of China, Bloomberg, BMO Wealth Management

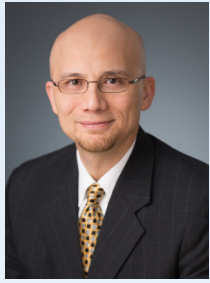
Portfolio approach amid heightened uncertainty

Our recent portfolio recommendations have focused on reducing equity risk – both international and U.S. – and increasing portfolio stability through high-quality, short-duration fixed income. Earlier recommendations also included reducing certain areas of international risk and adding small diversifying positions in publicly traded real estate and commodities. Such positions don’t always provide the desired diversification as the recent few months have shown, but they do increase the likelihood that portfolios will be better positioned overall to withstand various environments.

Both equity market and fixed income market valuations are best described as “neutral,” which points toward a balanced approach across those asset classes. Additionally, our proprietary BMO Sentiment Metric shows a very high level of investor pessimism. As a contrarian indicator, this tends to play out favorably for equity investors over the ensuing 12 months. A statistical regularity, however, is still not an assurance and each cycle can have its own dynamics.

The multiple risks we have outlined do not need “resolution,” per se, for the equity markets to regain their footing. In what remains of 2022, we are on the lookout for the path of these major risk factors – inflation, Fed intentions, profit margins, economic conditions, and multiple international risks – to narrow in the direction of market-digestible trajectories. At present, risk and uncertainty remain elevated and there is a wide dispersion of possible outcomes and combinations. Until those trajectories come better into focus, we expect that ongoing portfolio shifts would continue to lean toward greater diversification and stability rather than greater risk taking.

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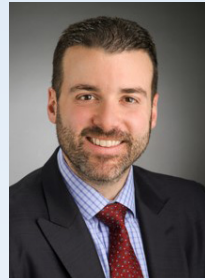
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As Chief Investment Strategist, Yung-Yu is responsible for performing macroeconomic analysis, valuation modeling and market analysis across asset classes to guide strategic and tactical asset allocations for client portfolios.

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.

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 Dallas, Texas and enjoys cheering on his son's basketball team.



Michael Miranda, CFA®
National Head of Research and Investments
BMO Wealth Management – U.S.

Michael is responsible for all aspects of the investment management business in alignment with the strategy for BMO Wealth Management – U.S. As head of the Investment team, Michael chairs the

Personal Asset Management Committee, is a member of our Asset Allocation Committee, and is responsible for setting investment policy and strategy throughout the United States. Michael is also a member of the Wealth Management Executive Committee.

Michael joined BMO in 2018 and brings over 20 years of experience running investment businesses, teams and portfolios to our organization. Prior to joining our firm, Michael served as Senior Managing Director and Chief Investment Officer at a large Chicago-based asset management firm, where he oversaw a team of portfolio managers, traders and research professionals in the Currency Management group. Previously, he had served as Senior Portfolio Manager overseeing multi-billion dollar fixed income portfolios for two established global asset managers.

Michael graduated from Northwestern University with degrees in both economics and music performance. He earned his MBA with honors from the University of Chicago Booth School of Business.

Michael serves on the board of the CFA Society of Chicago. He is on the Senior Leadership Council of the Association of Latino Professionals for America (ALPFA), Chicago Chapter.

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