Outlook for Financial Markets

While this Outlook focuses on economic and market considerations, we first wish to thank all essential workers and acknowledge this time of extraordinary difficulties for so many people in our communities.

Market Update: Where do we stand?

The $2 trillion+ in fiscal stimulus of late March has been recently followed by an additional $484 billion of forgivable loans to small business and funding for health care, which combined represents well over 10% of U.S. GDP. Recent indications point toward another large round of measures in the coming months focused on jobs and infrastructure. Other countries are also planning or enacting fiscal packages on a massive scale, including China, U.K., Germany, France, Malaysia, Australia, and the list goes on. To fund these packages, the world will soon be awash in government debt. It is hoped that this fiscal firepower will help the world emerge invigorated from an economic "hibernation."

With trillions and trillions in stimulus, borrowed at a very low cost, can a virus truly stand in the way of a swift economic revival? The reality is that while we have an unprecedented global health crisis, we now have an equally unprecedented fiscal and monetary response. The global economy is not just "hibernating" but rather suffering damage. Many retail stores may not reopen, global wealth has declined significantly, and adjusted spending patterns likely mean that otherwise gradual economic trends could turn into abrupt shifts. And, much remains unknown about the virus. Will the summer weather effects be strong? Will virus resurgence in the fall and winter take the legs out of a budding economic recovery? Will prophylactic treatments develop in time to soften the severity until a vaccine is ready? Of course, in all of these various scenarios, the question is how will we adapt?

Some comfort can be found in overseas developments where the outbreak preceded our own. New virus cases in many parts

Executive Summary

Fiscal stimulus has been massive and another large round is expected in the coming months

Overseas developments are mildly encouraging, but also uneven and slow moving

Much remains unknown about the future path of the outbreak and treatments/vaccines. This broad range of outcomes calls for a balanced approach

Our Q&A section provides detailed responses to questions from our recent webinars

of Europe are falling, South Korea has been showing only tens of new cases per day, and almost all large companies in China are back to work. Yet, even in some countries that seemingly, achieved containment, new outbreak clusters have appeared. Longer term, a vaccine makes all of this go away, but some experts are saying that the 12- to 18-month timeframe is optimistic, and scaled-up manufacturing and widespread vaccination could be beyond 18 months away.[1]

Where does this leave us? To be very aggressive owners of risk assets at these equity market levels requires a favorable resolution to some of the uncertainties listed above. Deep pessimism, however, would be too dismissive of the unparalleled scale of fiscal and monetary support taking place. We cannot, nor can anyone in our belief, rule out ongoing economic challenges whose resolution is gradual in nature. In response to both the broad range of potential outcomes and the strong market rebound seen in April, we recently recommended reducing portfolio risk via the sale of a below investment- grade fixed-income. This was accompanied by a buildup in cash positions. Yet, we still remain moderately overweight equities in our model portfolios, with a focus on the U.S., thus taking an overall balanced approach to navigating the myriad of potential outcomes ahead.

Some unanswered questions...

During our market webinars, we strive to answer as many questions from clients as possible. Due to the large volume of inquiries recently, that has proved more difficult than normal. So, in this instance of our monthly *Outlook*, we are reviewing several common themes that arose during our recent Q&A sessions but did not receive significant attention during the live events. Before beginning, a quick note of thanks to those who take the time to submit questions for our review. We greatly appreciate it!

What is the outlook for the Chinese economy?

China definitely faces considerable challenges, but the country also has large fiscal resources. Smaller businesses in China are likely to be most affected. We do not believe that China's economy will collapse, as most of the corporate debt is owned by state-owned enterprises and owed to state-owned banks. It's largely a state-to-state problem, and we believe the federal government has sufficient resources to address the problem. We would grow more concerned with China if real estate prices began to fall meaningfully (more than 10%). If sustained, such a development could trigger a downward spiral in the economy, but we do not see this as imminent.

Why do lower oil prices hurt the U.S. economy?

The U.S. is now the world's largest producer of oil, and the oil and gas industry in the U.S. employs millions of people – as many as 10 million jobs according to some estimates counting both direct and indirect ones supported by the industry (API estimate). Also, while the energy sector is small in terms of market capitalization, it has an outsized proportion of capital expenditures. Higher oil prices affect consumers negatively, but that effect tends to be small in most cases. It would be negative for the U.S. economy if lower oil prices caused lasting damage to the domestic industry, and then higher oil prices in future years resulted in greater imports rather than most of the demand being fulfilled by domestic production.

The federal debt is exploding. Will this cause inflation and higher interest rates?

In the near term, we do not expect either significant inflation pressures or meaningfully higher interest rates. The current collapse of global growth will put a lid on inflation pressures for most items (although the cost of food and other necessities is rising). The U.S. is in an enviable position of having the world's reserve currency and being the place investors look to for safety during times of economic stress. And even though interest rates are extremely low in the U.S., they are still higher than in other countries such as Germany that are also considered among the safest. These factors allow the U.S. to borrow in vast quantities.

Looking further ahead, as the global economy rebounds in 2021, the eventual path of interest rates, and inflation is more likely to drift higher. We do not expect run-away inflation or

[1] https://www.cnn.com/2020/03/31/us/coronavirus-vaccine-timetable-concerns-experts-invs/index.html

interest rates as there are still certain deflationary forces in the economy such as technology developments and demographics.

What will happen in the stock market over the next year?

There remains a wider-than-usual range of possible market outcomes that are largely driven by outbreak developments, and both economic re-opening and stimulus in the U.S. and worldwide. We continue to have a "quality" bias, which for equities is focused on large-cap U.S. companies, both because of the resources available to large and stable companies, and because the U.S. has tremendous capacity for fiscal stimulus.

Why buy bonds in this low rate environment?

We currently recommend a tactical underweight allocation both to investment grade bonds and to the "Extended Fixed Income" bucket that includes high-yield bonds and bank loans. Historically, both asset classes have provided valuable portfolio diversification and a favorable return given their risk profiles. Although we have an underweight recommendation, the Fed is providing some degree of backing, and the additional yield over Treasury securities has increased for both investment-grade and high-yield bonds.

Is it a big risk to re-open the economy? What has happened in other countries?

When China opened its economy back up in late March, it was reporting around 100 or so new COVID-19 cases per day (in a population of more than four times that of the United States). In contrast, the U.S. is preparing to open the economy back up with well over 20,000 new cases still being reported each day. It is unclear whether precautions and social distancing are enough to prevent the return of exponential growth in COVID-19 cases given such a high base that remains. Even with China's relative success in re-opening, measures such as metro trips in Shanghai are down by about 40% in mid-April relative to year ago levels (China, Ministry of Transport). We are likely to be in an extended period where we learn to live with a virus that continues to spread, albeit hopefully in a more manageable trajectory.

Sweden is an interesting case because it has not instituted aggressive "lock-down" measures. Sweden's outbreak began at approximately the same time as that of the U.S., and on a population-adjusted basis, Sweden currently has about 35% more COVID-19 deaths than in the U.S. It is difficult to adjust for all risk factors, however, as Sweden has a slightly older population but also has much lower rates for certain other risk factors such as obesity and diabetes.

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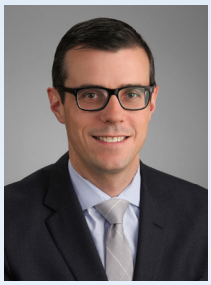

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As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth 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.

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 children's teams.

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C-11# 10127421
Written: April 28, 2020