Outlook for Financial Markets

The usual suspects – COVID-19, inflation, stimulus, and speculation

"I have often thought that perhaps the strongest force that starts an economy upward after it has hit bottom is the simple fact that all of us must somehow find a way to live."

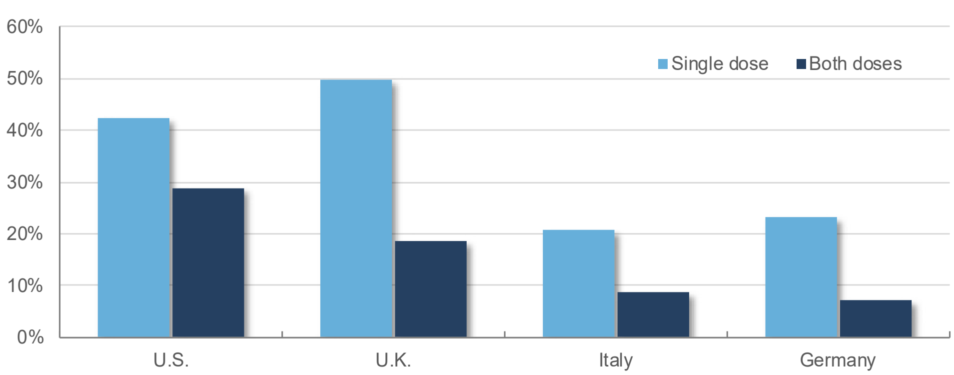
\- Bernard Baruch, *My Own Story*

Vaccine availability and COVID-19 divergences

While a small number of countries – including the U.S. – have achieved an impressive COVID-19 vaccine rollout, vaccine prevalence remains very uneven across the world ***(Exhibit 1)***. In India, where the BBC indicates that only about 8% of the population has received at least one dose, they have seen a parabolic rise in COVID-19 cases over the past month, which has been accompanied by new lockdowns and reduced growth expectations.

The U.S., in contrast, has seen both COVID-19 cases and deaths fall to about one-fourth of their January peaks. The current dispersion in vaccine availability across the globe will almost certainly narrow as production and availability continue to ramp up throughout the year. And despite the very real challenges that remain, we believe that by year end, even countries now in the throes of the pandemic will have clearly turned the corner, and the synchronized nature of the global economic upturn we believe it will become increasingly apparent.

Exhibit 1 » Percentage of Population Vaccinated (as of April 25)



Source: Our World in Data

Executive Summary

The global economic upturn should become more apparent by the end of the year as vaccine availability broadens

Inflation is coming and, along with rising long-term interest rates, could lead to periods of market digestion of new information

Robust growth expectations through 2022 favor small-caps

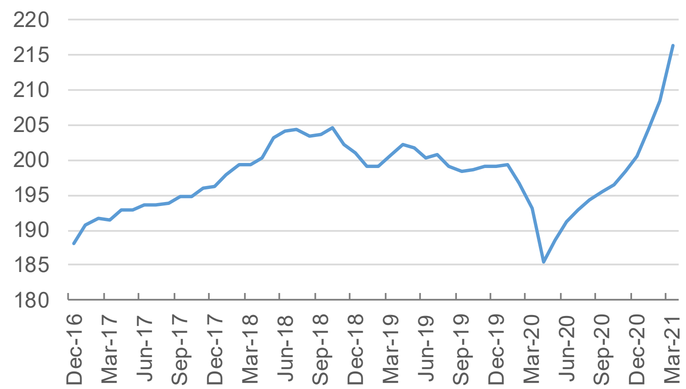
Certain areas of the market are showing signs of froth, but our proprietary measure of market sentiment does not indicate excessive exuberance.

Inflation and the irony of a labor shortage

The Producer Price Index ("PPI," an index of prices received by domestic suppliers throughout the supply chain) for all commodities initially fell during the pandemic but is now up over 7% from pre-pandemic levels, and up over 30% from the April 2020 nadir ***(Exhibit 2)***. Companies are facing higher costs, and those with pricing power are looking to pass them on to consumers. Amazingly, reports of labor shortages are becoming more commonplace, as many potential workers remain either unemployed or out of the labor force due to some combination of ongoing expanded unemployment benefits (through September 2021), COVID-19 concerns, school shutdowns or lack of childcare, and other re-prioritizations. Business can take some comfort that wage growth is not spiking upward, but it has also not fallen the way it did during and after the prior two recessions ***(Exhibit 3)***.

Inflation is coming, but we continue to agree with Chairman Powell and the Fed's messaging that much of these price pressures will be temporary. If we were to choose a single indicator to monitor whether inflation will prove temporary or lasting, it would be wage growth over the coming quarters. As we move toward the second half of 2021, however, investors may have to recalibrate to the notion of "temporary" lasting a year or longer; which could lead to a period of market indigestion. Interest rates could also rise from either inflation expectations pricing in more lasting inflation or an increase in the real rate of interest (i.e., after stripping out the inflation component). Either way, low interest rates have become intertwined with many aspects of the world economy such that a significant rise – even back to historical norms – could lead to a prolonged headwind for the markets. 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. Nonetheless, the possibility of spiking longer-term interest rates remains a prominent risk to the outlook.

Exhibit 2 » U.S. Producer Price Index (PPI) – All Commodities

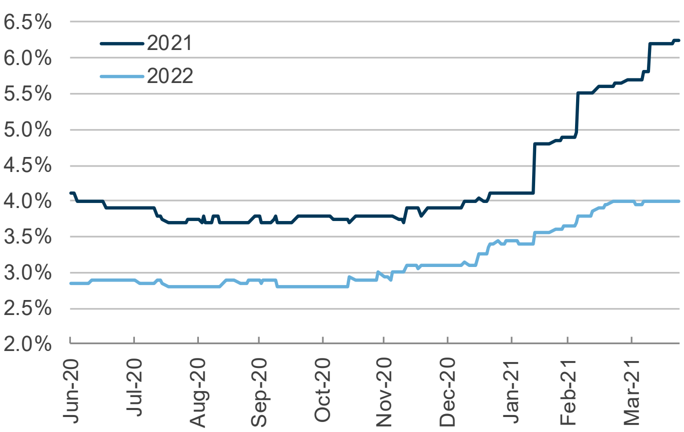


Source: FRED Economic Data

Exhibit 3 » Wage Growth Tracker (3-month moving average)

Source: Federal Reserve

Exhibit 4 » Bloomberg Consensus GDP Forecast United States



Source: Bloomberg Financial

Peak growth, but still favoring small-caps

GDP growth, both in the U.S. and worldwide, is set to skyrocket in 2021 and slow into 2022 and beyond. Such peaks inevitably lead to the question of whether the forward-looking equity market is similarly set to shift directions or level off. Historically, there are multiple instances when peak growth in one year led to a struggling stock market the next. That dynamic, however, is typically associated with a corresponding period of below-trend growth. Current projections for 2022 GDP growth remain firmly above trend and have been increasing in recent months ***(Exhibit 4)***. This typically indicates a favorable environment for risk taking. Indeed, as more people return to work, there is ample room for continued economic momentum both in the U.S. and worldwide.

We recently adjusted our tactical asset allocation recommendation with an increase to U.S. small-cap and mid-cap equities, while reducing large-caps and maintaining the same overall equity overweight position. Small- and mid-caps have a greater sensitivity to economic growth prospects, and we expect a vigorous economic rebound, along with a coming infrastructure package, to provide a sustained tailwind in the space. For international developed equities, we remain neutral overall, but note the favorable economic developments in the U.K. and Japan, and expectation for growth in continental Europe to accelerate in the second half of the year. In this category as well, small-caps are favorably positioned.

In closing – Another risk

Despite a positive backdrop, we continue to contemplate risks such as those discussed above regarding inflation and interest rates. Another developing danger, we believe, is the speculative nature of investment flows driving certain areas of the market. This trend can be observed with SPACs (“special purpose acquisition companies”), IPO listings, NFTs (“non-fungible tokens”), and penny stocks. Similar implications can be seen in broader surveys of investor sentiment. Our proprietary BMO Sentiment Metric is a contrarian indicator that for much of 2020 implied too much negativity on market prospects. The metric has now turned neutral and could signal a headwind in the coming months if our proxies for investor sentiment show abnormally high readings.

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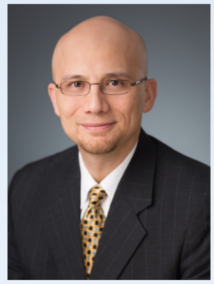
As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments 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.
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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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