Outlook for Financial Markets

"If you find yourself in a hole, stop digging."

- Will Rogers

Executive Summary

The economic rebound is aided by a balanced economy and low debt service payments.

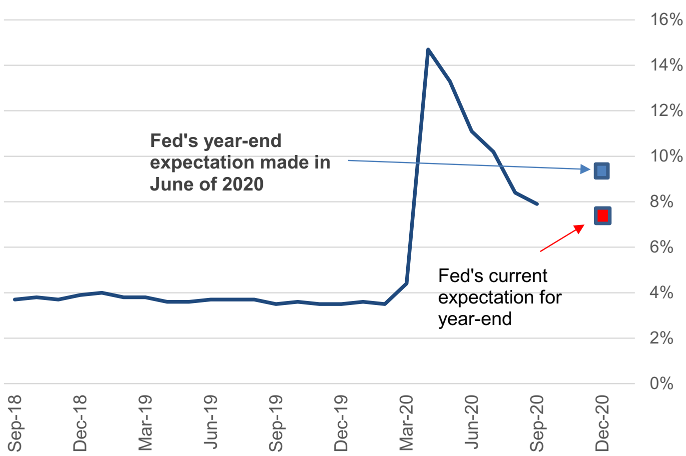
Current economic, political and COVID-19 uncertainty is real, but should not result in an economic "unwinding".

Presidential and Senate election outcomes remain uncertain, but cautious optimism is warranted for 2021.

Strained but balanced economy underpins the rebound

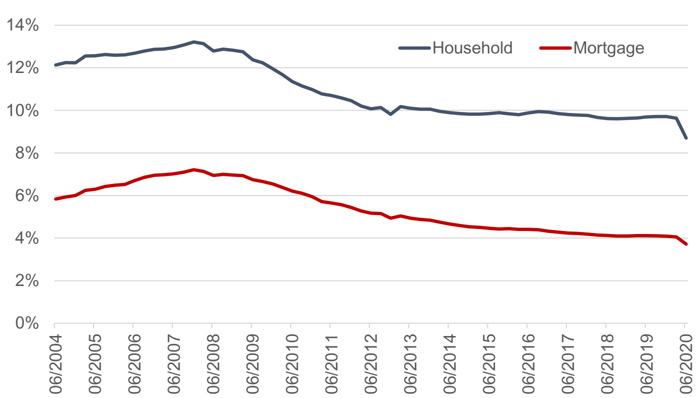
In the face of high unemployment, stalled stimulus negotiations, various election possibilities, and even the possibility of higher taxes, why has the U.S. equity market held up so well? The answer, like the question, is multifaceted but begins with a more vigorous economic rebound than many anticipated. While the labor market still has a great deal to overcome, the current unemployment rate of 7.9% is more than a full percentage point below the Fed's expectation back in June for the year-end unemployment rate ***(Exhibit 1)***. The Fed's unemployment forecast has since been revised downward. But referencing their belief of just a few short months ago shows that the rebound has been much more vigorous than initially expected. Another factor supporting the markets was the lack of economic imbalances in the household and corporate sectors heading into 2020. Compared with 2008, for example, debt service payments as a percent of disposable income – both at the mortgage and total household levels – was at historic highs, but today is at 40-year lows ***(Exhibit 2)***. Economic "unwinding" in the form of behavior changes in debt, spending, and labor and capital allocation – which occurred post the 2001-2002 and in 2008-2009 downturns – is a more precarious and uncertain process because of the economic restructuring that takes place. Today, filling in the massive economic crater that exists takes time and resources. But the process for confronting an exogenous shock is clear, at least in relative terms.

Exhibit 1 » Unemployment rate and Fed's year-end projection



Source: U.S. Bureau of Labor Statistics; Federal Reserve

Exhibit 2 » Debt service payments as a percent of disposable income



Source: Federal Reserve

The first rule of being in a hole, of course, is to stop digging. That's easier said than done when an autumn COVID resurgence has slammed Europe. Germany, France, Spain and several other countries are regularly reporting more than 10 times the number of daily COVID cases than prevailed in the late spring when the virus looked better contained.[1] The U.S. is also bracing for a virus resurgence, just as the general election nears. Yet, while risk is building, so too are vaccine developments continuing apace. Moncef Slaoui, head of "Operation Warp Speed" and a former professor of immunology and head of GlaxoSmithKline's vaccine department , recently expressed hope that a vaccine could be available by year end for high-risk populations and that the vaccine would have a favorable profile at 80% to 90% efficacy.[2]

Adjusting to election and stimulus uncertainty

Uncertainty is known to be unpalatable to financial markets. Yet, uncertainty has the greatest impact when the economic implications are longer term in nature, or the potential outcomes include scenarios whose scope seems expansive. For example, the dot-com bust of 2000 - 2002 did more than just erase a vast amount of wealth. It called into question the foundation of productivity increases and business models that were believed to be at the core of the "New Economy" – a designation that was formalized with capital letters in print media. The financial crisis of 2008-2009 presented the potential abyss of a financial system meltdown, the implications of which seemed almost limitless in the moment.

[1] Johns Hopkins University, https://coronavirus.jhu.edu/map.html
[2] Marketwatch, https://www.marketwatch.com/story/trumps-vaccine-czar-says-the-first-vaccine-should-be-submitted-for-emergency-authorization-around-thanksgiving-2020-10-08

Today's uncertainty is quite different. Yes, there are tail risk scenarios where the presidential election outcome is contested and potentially controversial, but even results in which court decisions play a role should generally be seen as valid. As for an additional round of fiscal stimulus, a pre-election breakthrough now seems unlikely, but the economic imperative will ultimately result in at least targeted stimulus and possibly much more activity post election. That may be ice cold comfort to the currently unemployed. But in broad macroeconomic terms, the expectation of a late 2020 stimulus + vaccine should be sufficient to ward off downward economic momentum, as long as consumer confidence does not turn sharply lower. Along those lines, the University of Michigan's Consumer Confidence Survey remains off the crisis lows, but has not registered much overall improvement in the past few months. We will be keeping a close eye on it, and other confidence figures, in the near future.

In sum, yes there is uncertainty around major issues. And the economic hole is large. Nonetheless, we are not faced with a precarious "unwinding", and the core tenants of our economy have not broken down. We are looking toward a brighter future – not staring into an abyss.

Taxes, spending, and the market narrative

A change in corporate taxes directly hits the bottom line and therefore affects the profits to which equity investors have a claim. Election outcomes for both the White House and Senate remain uncertain, but it is nonetheless important to consider potential scenarios. Joe Biden, should he win the election, wants to increase both corporate and personal taxes as well as government spending. On net, we would view these counterbalancing effects as something less than a wash for markets should they come to pass given that corporate taxes directly affect the bottom line. Even under a Democratic White House, however, Senate control will largely determine what does or does not get passed as legislation. Should Democrats manage to pick up three Senate seats, a 50/50 split means that a single dissenting vote across party lines would be enough to bring aggressive tax hikes to a standstill. These hypothetical scenarios just highlight the range of possible outcomes involved.

It is also important to keep in mind that the market narrative can sometimes shift abruptly. In the run-up to the 2016 presidential election, talk of global trade frictions dominated the discussion around President Trump's then candidacy. But once the markets opened the morning after the election, the prospect of tax cuts – both corporate and personal – overwhelmed those trade concerns and sent equities soaring. We are not necessarily expecting such a shift in narrative after the coming election, but that experience highlights the sometimes fickle nature of prevailing market wisdom. We do feel confident, however, that six months from now the U.S. economy will be on the mend, and even more so another six months after that. Such an expectation warrants a cautiously optimistic tilt in portfolios.

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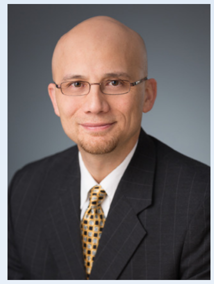
As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments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