Outlook for Financial Markets
Accelerating into the turn

"In particular, we expect that it will be appropriate to maintain the current accommodative target range of the federal funds rate until labor market conditions have reached levels consistent with maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time."

- Fed Chair Jerome Powell, 2/10/2021

February has seen a steady climb in longer-term Treasury rates with the 10-year T-Note at 1.35%, which is well above the sub-1% level where they began 2021 ***(Exhibit #1).*** Given President Biden's aggressive push for a $1.9 trillion stimulus package (nearly 10% of GDP) plus plans for a similarly expansive infrastructure and green energy package to follow, this rise in yields certainly makes sense and likely has more runway. It's important to note that the current level on the 10-year T-Note still sits well below where forecasters expect inflation to remain over this time period, making the "real yield" after subtracting inflation from Treasury yields negative at present.

In addition to massive fiscal injections, the ongoing vaccine rollout, sharply declining COVID-19 cases and deaths have begun to shift the focus from "will we turn the corner?" to "what is actually around that corner?" We do expect the Fed's actions to follow Chairman Powell's recent dovish statement, but the markets will no doubt wonder what is meant by "moderately" and "for some time." Markets are now contending with what is considered by some to be IPO froth, cheap-money fueled speculation, rising margin balances, and perceived equity market overvaluation. In this context, massive stimulus that drives up inflation expectations and longer-term interest rates creates certainty for the economic trajectory but uncertainty for the equity markets.

It is, however, important to remember that equities generally provide an inflation hedge as rising prices lead

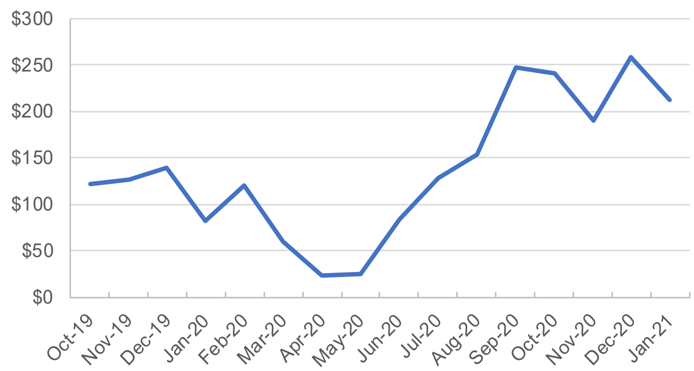
Executive Summary

- Treasury yields and inflation expectations have risen as the economy turns the corner and large injections of fiscal stimulus come into focus
- Equities provide a long-term inflation hedge and earnings growth has turned positive
- Robust M&A activity in 2021 should help underpin the equity market
- The big picture is about vaccine efficacy, earnings, and the level of interest rates which we expect will level off well below historical norms

Exhibit 1 » U.S. 10-year Treasury Yield

Source: Bloomberg Financial

Exhibit 2 » U.S. Mergers & Acquisitions: Aggregate Deal Value (Billions)



Source: Federal Reserve

to rising revenue for companies. This hedge may not be apparent on a daily or even monthly basis but does play out over time. That said, inflation is not uniform across the economy and some companies will have pricing power that exceeds their cost increases while others will have margins squeezed. Ultimately, both the markets and the Fed will focus not on the short-term rise in inflation and yields, but on the longer-term trends. Looking past the short-term, we believe it is unlikely that inflation and rising yields will derail the equity markets and the economy. Fed messaging over the coming quarters should soften the market's concerns.

Amid the big macro headlines, the bottoms-up earnings trends have already sprung to life. As of February 19, Factset reported an exceptionally high 79% of S&P 500 companies reporting positive EPS surprises in Q4. Year-over-year earnings in Q4 have been positive by about 3%, which is extraordinary considering the expectation at year end 2020 was for Q4 earnings to be down about 9%. Looking forward to Q1, analysts have been raising bottoms-up EPS estimates by a few percent which contrasts with typical quarters in which the first month usually sees EPS estimates decline by a couple percent. There is no guarantee this trend will continue, but it is consistent with a more vigorous rebound than initially forecast and such momentum tends to build on itself.

Adding to the market underpinning, mergers and acquisition activity is also off to a robust start to 2021 ***(Exhibit #2)***. Our expectation is for continuation of this trend. It's noteworthy that two sizable acquisitions announced on February 22 (Goodyear buying Cooper Tire for $2.5 billion and M&T Bank buying People's Bank for $7.6 billion) both resulted in the acquirer's stock price also rising on the news despite the premiums being paid for the acquisitions. In a rising cost environment, scale matters. Other corporations along with private equity will also be sizable "buyers" in the market this year.

At present, we see neither dangerous financial imbalances nor, perhaps controversially, concerning levels of equity overvaluation that would indicate a late-stage bubble environment. Yes, P/E ratios are well above historical averages, but the combined impact of low interest rates, growth, and stimulus are likely to mean elevated P/E ratios will abide. While it may be quite some time before everyone's activities return to pre-pandemic patterns and routines, for the markets that may be missing the point. The big picture is about vaccine efficacy, earnings, and the level and trajectory of interest rates. Those are the inputs into the navigation system as we head into the turn.

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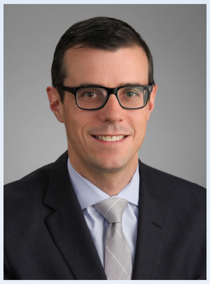

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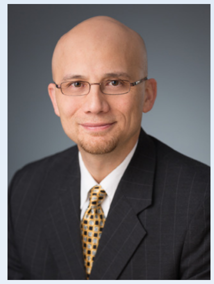
As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments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