December Outlook for Financial Markets

2022 – A Year for Reasonable Expectations

The Fed, Inflation, and Interest Rates

The coming year is likely to see a nearly constant Federal Reserve ("Fed") watch as the Central Bank undertakes both an accelerated wind-down of its asset purchase program and also begins to lift short-term interest rates off the current zero-bound. Projections – both for the speed of "tapering" bond purchases and raising interest rates – have increased in recent months following persistent inflation and a strong labor market. While monetary policy accommodation is certainly preferable for the market, historically, the more challenging time for equities has come in the later stages of Fed rate hikes or more extreme Fed hawkishness. Each cycle, however, can have unique characteristics, but as a starting point we would suggest Fed tightening is cause for vigilance and not alarm.

Of course, the Fed's changing tune is being driven by bulging inflation, which hit 6.8% in November, and even excluding food and energy is still registering a hefty 4.9%. Inflation is also impacting confidence – both consumer and business. It is important to remember that confidence surveys, however, are not actual spending. Typically, if jobs are plentiful and profits are growing at a healthy clip, confidence and spending hold up well. But the current mix of high inflation along with ongoing – and possibly reigniting – COVID-19 health concerns could moderate spending plans, and is a risk factor for 2022.

Ironically, Fed concern over inflation is heating up just as the rate of inflation may be peaking and set to decline gradually in 2022. Will inflation fall back to the Fed's 2% target in 2022? Probably not. Actually, hopefully not, because such a decline would likely be driven by a precipitous growth slowdown. The good news is that the 2% target is a made-up number, and we consider the future trajectory of inflation to be considerably more important. The bad news is that the Fed is nonetheless likely to position interest rate policy around this 2% inflation target and still sees "equilibrium" short-term interest rates near 2.5%. We believe that eventual level of interest rates would not be easily digestible by either the markets or the economy, as the world has grown more reliant on extremely low rates. While the

Executive Summary

Monetary policy will tighten, but the path remains uncertain and back-loaded

Will earnings surprises continue? A moderate growth forecast suggests expectations can be exceeded

A slumping Chinese property market poses a downside risk to global growth

U.S. equities look to outperform, but potential headwinds moderate expectations ultimate short-term interest rate equilibrium level is not likely a 2022 story, uncertainty around interest rate policy will lead to plenty of headlines in the coming months ***(Exhibit 1)***.

Though the Fed effectively "controls" short-term interest rates, its influence on longer-term rates is less easily quantified. The Fed has telegraphed that its bond purchases will end around Q2 2022, but the ultimate effect on longer-term rates may only become clear as those purchases draw to a close and are considered in conjunction with the prevailing global rate environment. Recent bond market developments point toward the idea that even when the Fed exits the market, longer-term rates will not rise dramatically. In line with this thesis, we continue to expect a modest upward trajectory to long-term rates in 2022, but much will also depend on the global picture for growth, inflation, and interest rates. There are risks in both directions, but the outlook appears bell-curve shaped with the most likely environment being one where long-term rates drift moderately higher and have a benign impact on the economy and equity markets.

COVID-19 and Profit Margins

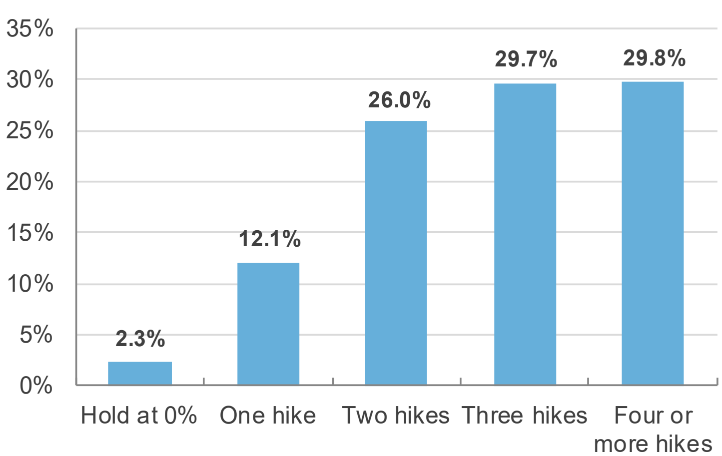
As of writing, the Omicron variant is causing concern across the globe at a time when areas in Europe are struggling with the Delta variant and U.S. cases are on an upswing. Early indications for the Omicron variant point to the potential for less severe outcomes which, if true, would be an extremely welcome development. However, early indications can often be unreliable and more information will soon emerge. From the market's standpoint, the impact of this variant could go in either direction depending on severity.

Irrespective of Omicron, COVID-19 has already led to many well-known shifts in the economy – from increased spending on goods, supply chain disruptions, inflation pressures, and, of course, the public health-related implications. Quite impressively, corporate profit margins have held up well during this time ***(Exhibit 2)***. We do believe that 2022 should prove more challenging in this regard as companies continue to face cost pressures but may have increased difficulty raising prices. This is not a reason to avoid U.S. equities, though it does suggest more tempered expectations are warranted going forward.

China

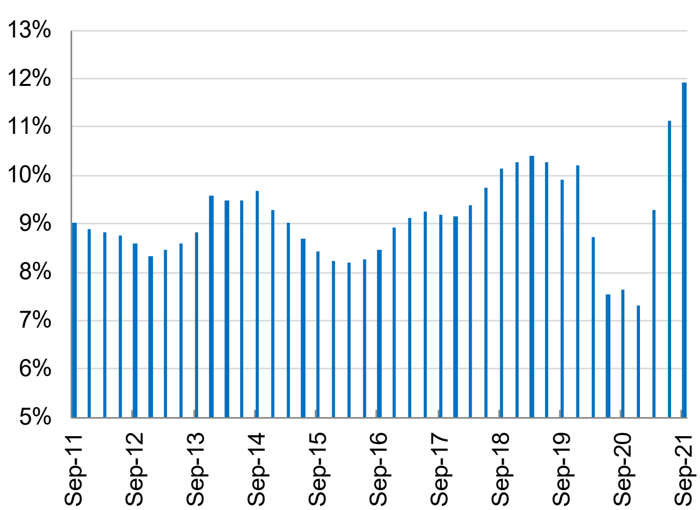
One surprise during 2021 was the extent to which China pivoted from targeted restrictions on specific companies to an expansive "Common Prosperity" initiative that cut across many areas and, on net, is market unfriendly. In addition, the property sector in China, which is estimated to represent

Exhibit 1 » Fed Rate-Action for 2022: Market-Implied Probabilities (as of December 2021)



Source: CME Group

Exhibit 2 » S&P 500 Profit Margin



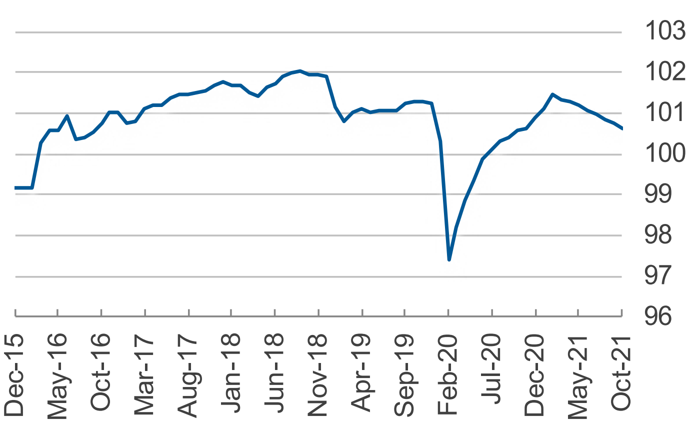
Source: Bloomberg

a nearly 30% of GDP,[1] faces a long-term headwind that the government is now seeking to mitigate via targeted easing measures. Even so, the Chinese government has begun rolling out property taxes in select cities – which supports China's long-term goals but could drag out the property correction *(Exhibit 3)*. China's role as the world's dominant growth engine now seems a story of bygone days. The difficulty with this development is that many international economies have relied on China's high growth for their export markets and could similarly face headwinds going forward. Relative to many countries, the U.S. is more insular with exports accounting for only about 12% of GDP, and exports to China representing only about 9% of that total.[2] Export-driven economies such as Germany have exposure to China many times that of the U.S. As we begin 2022, our preference towards U.S. equities over international markets has much to do with the uncertainty emanating out of China.

U.S. – Risk, Return, and Expectations

A primary tenet of finance is that investors should receive a return premium, on average, for accepting risk. How the return plays out in actuality depends partially on expectations – or what is "priced in" – versus what comes to pass. Expectations can surround monetary and fiscal policy, interest rates, geopolitics, inflation, COVID-19, and of course earnings growth. Clearly, surprises can come from many directions. We do take comfort that current earnings growth expectations are not excessive aggressive *(Exhibit 4)* and look more like steady-state growth rather than a vigorous economic rebound. This suggests the prospect for positive earnings surprises in 2022 could provide an equity market tailwind next year. Meanwhile the risks for 2022, as they appear now, look to play out in a staggered fashion across the year. Inflation may feature prominently in the near term, while in the second half the potential for excessive Fed tightening along with Chinese economic growth uncertainty will be in focus.

Exhibit 3 » China Real Estate Climate Index

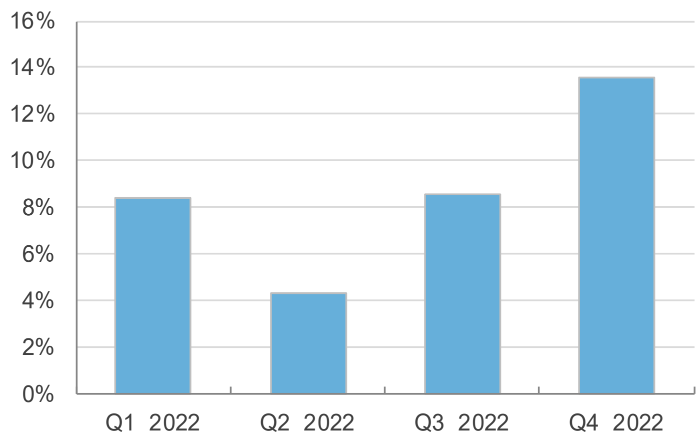


Source: China National Bureau of Statistics

[1] www.theguardian.com/world/2021/oct/15/chinas-booming-real-estate-market-could-spell-trouble-for-the-economy

[2] https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china

Exhibit 4 » S&P 500 - Projected Earnings Growth (Y.o.Y.)



Source: : Standard & Poor's

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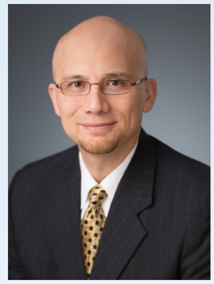
As head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy throughout the United States. He joined the organization in 2013 as a Managing Director of Investments for our Ultra High Net Worth group, and remains a board member of BMO Family Office, LLC. Michael became U.S. Head of Investments in 2015, and in January 2018 took over the role of Chief Investment Officer. With over 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. He holds a Chartered Financial Analyst designation, and is a member of the Economic Club of Chicago, Beta Gamma Sigma International Honor Society, CFA Institute, CFA Society of Chicago, and Chicago Quantitative Alliance. He is also a board member of WITS, an institution focused on early childhood literacy.

Michael is frequently quoted in the financial press and media outlets, including Bloomberg, The Wall Street Journal, Marketwatch and U.S. News. He resides in LaGrange, IL with his wife and children.



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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.

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