Outlook for Financial Markets

"Times and conditions change so rapidly that we must keep our aim constantly focused on the future."

- Walt Disney

Executive Summary

Positive vaccine news lifts sentiment in the closing days of 2020

Corporate earnings rebound is set to continue into next year

Traditional measures of equity market valuation may look high, but that is not the whole story

Accommodative policy and improving economic conditions support an equity market overweight

2021 Outlook: A rousing recovery

While the extraordinary developments of 2020 rendered many annual outlooks obsolete within only a couple of months, a number of our key calls proved accurate. We anticipated that continued accommodative monetary and fiscal policy would support markets, and that market destabilizing political developments would not come to pass. Though 2020 was a year of many challenges, we are optimistic for 2021 and expect improved economic conditions and better times ahead.

A shot in the arm

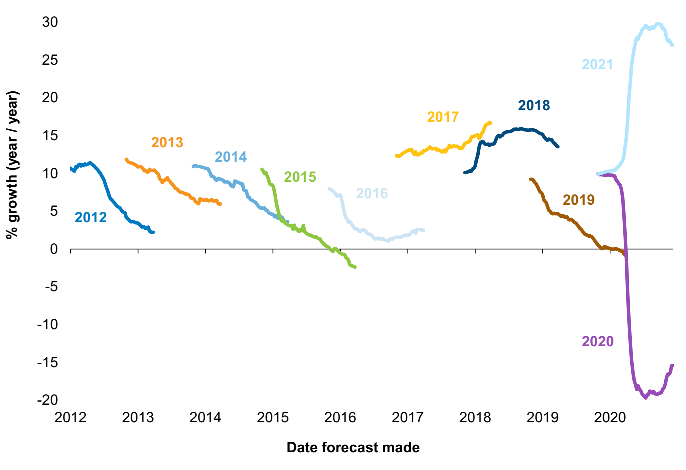
2020 is closing on an optimistic note as countries around the world begin to administer COVID-19 vaccines. The development timelines have been nothing short of extraordinary, as multiple companies were able to develop a vaccine, run trials, receive regulatory approval and begin distribution, all within a year. We expect ongoing vaccination in the first half of next year to set the stage for a vigorous growth recovery in 2021. The beaten-down services sector should be the principal beneficiary of this return to normal as the in-person economy roars back to life in the post-pandemic world.

By mid-year or late summer, we expect certain sectors such as travel and tourism, to bump against capacity constraints as long-delayed holidays and other spending finally materialize. The return to normalcy and shift in consumer spending will also lead to greater demand for labor. While the U.S. unemployment rate by the end of 2021 may not match the pre-pandemic level of 3.5%, we do expect it to be meaningfully lower than the current rate of 6.7%, with strong momentum. The explosion in debt, which helped economies endure lockdowns, will linger for years, but we believe strong growth and low interest rates should minimize its long-term effects.

The policy pipeline will keep flowing

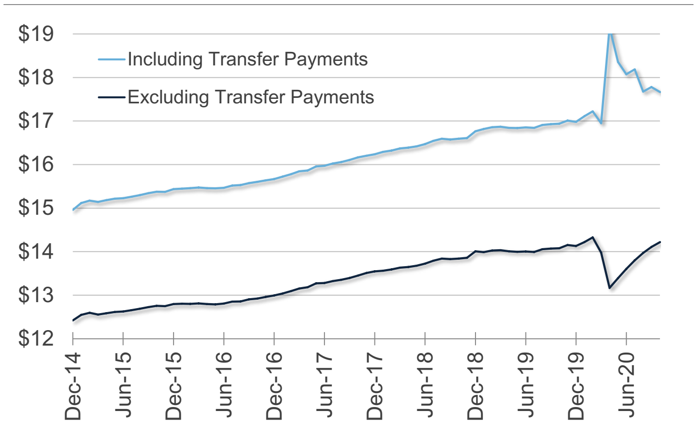
In response to the pandemic, 2020 saw unprecedented fiscal and monetary actions worldwide. Global central banks launched multiple initiatives, including significantly lowering interest rates and purchasing financial assets in massive quantities. In parallel, fiscal authorities loosened the purse strings, spending aggressively to support their domestic economies. The combined fiscal and monetary support proved crucial to global economies, and by extension, global asset markets.

Exhibit 1 » MSCI All Country EPS Growth



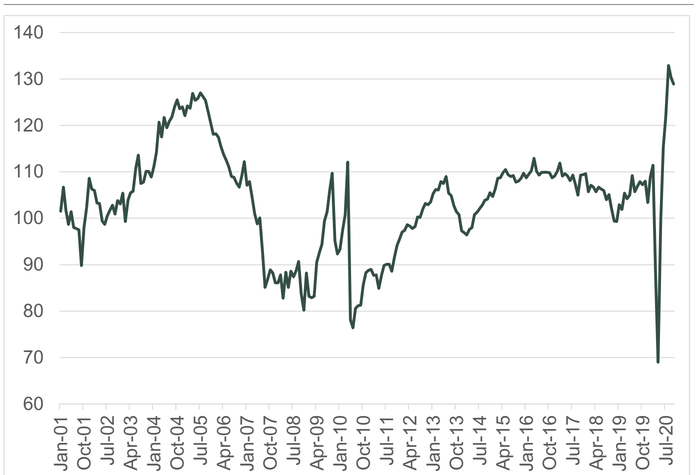
Source: BMO Global Asset Management and Datastream, as of December 2020

Exhibit 2 » U.S. Real Personal Income (trillions USD)



Source: Federal Reserve

Exhibit 3 » U.S. Pending Home Sales Index



Source: National Association of Realtors

As we move into 2021, these levers of support will remain in place, and in some instances, expanded upon. In the U.S., for example, we expect further fiscal support from the federal government, with additional stimulus of nearly $1 trillion, or approximately 5% of the economy. We anticipate similar increases in fiscal support from major developed economies and select emerging economies as they look to bridge the gap to a full recovery. ***(Exhibit #1)*** Central banks should remain accommodative in 2021 and beyond as well. The European Central Bank, for example, may increase asset purchases in the near future.

With continued fiscal and monetary accommodation, we expect a modest increase in longer global rates, as global growth accelerates and inflation ticks upward. At the same time, shorter interest rates should remain anchored at their current levels with central banks on pause for the coming year. Global yield curves should thus steepen modestly throughout the year. However, with absolute rates remaining historically low, this environment should be supportive for equities and broader risk markets globally.

Equities: Macro risks ease and earnings improve

We continue to have a favorable view on equities for 2021 due to our expectations for a vaccine-driven economic recovery and revitalized global corporate earnings. While earnings in the U.S. were negative throughout 2020, momentum turned sharply positive in the third quarter as a record-high percentage of S&P 500 companies reported earnings above expectations.

The fourth quarter of 2020 saw a recovery in value stocks and small-caps, which had lagged their growth and large-cap counterparts significantly over the past few years. Despite this short-term reversal, we recognize that long-term secular trends are at work here and we remain relatively neutral on both value versus growth and small versus large.

U.S.

We expect the U.S. economy and financial markets to perform well on the fiscal, monetary and vaccine developments discussed above. Elevated levels of personal income and savings that accrued from fiscal stimulus and reduced economic activity in 2020 should result in a burst of pent-up demand in the second half of 2021. ***(Exhibit #2)*** Adding to spending power is a healthy housing market and mortgage refinances that in 2020 have run at almost twice the 2019 rate. ***(Exhibit #3)***

In past expansions, headwinds often built up as the Federal Reserve (Fed) lifted interest rates to head off inflation pressures. In August 2020, however, the Fed announced a new "average inflation targeting" approach that not only backs away from pre-emptive measures to contain inflation pressures but actually permits inflation to be above target "for some time." This policy could play a prominent role in 2021 and beyond as an accommodative Fed provides support to risk assets.

At present, equity market valuations are front and center, with some investors fearing they have gone too high. It's important to understand that comparing P/E ratios across time excludes many important variables: growth, interest rates, inflation, risk appetite and structural shifts in the market. Our long-term valuation modeling, which includes these considerations, indicates that equities are reasonably priced at current levels. There may be pockets in the market where exuberance has taken hold, but overall valuations would have to march considerably higher before action is warranted based on that consideration alone.

Europe

In line with our expectation that the world will get back to something approaching normal in 2021, those regions and sectors that have suffered the most from the pandemic logically have the most to gain. On this basis, Europe should have a strong upside: it has suffered a much greater loss in terms of GDP and corporate earnings than either China or the U.S. The challenge to this argument is that Europe has repeatedly disappointed growth expectations in the past. Buying Europe also involves a significant sectoral bet, in that it has few technology companies and significant exposure to financials. Therefore, our strategy is to be ready to overweight Europe but only after we see clear evidence of outperformance on the economy and earnings. The purchasing managers' indexes will be important in this regard. The U.K. faces its own challenges post-Brexit as it reconfigures its economy to the new world.

Emerging markets

Emerging markets also look poised to benefit from a global economic recovery in 2021, with rates of growth again superior to those of developed markets. Debt-fueled fiscal expenditure and accommodative monetary policy should help to achieve this growth, albeit indirectly, as developed countries have more flexibility in both forms of stimulus. The burden of COVID-19 and the associated restrictions, heavier in Latin America, emerging Europe and South Asia versus East or Southeast Asia, should be lifted thanks to the growing number of vaccines. This is likely to contribute to the unleashing of employment and pent-up consumption.

Improvements already seen in trade and manufacturing — especially in East Asia where COVID-19 was better contained — could well continue. Upward pressure on commodity prices, consistent with a recovery in manufacturing, is expected to have a greater impact in emerging markets as well. And, finally, the Fed's policy shift to "average inflation targeting" means that the external risk to emerging markets of a strong dollar and tightened liquidity as growth accelerates has reduced considerably.

Positioning

After the challenges of 2020, we expect many to appreciate the coming of a new year like never before. Though it may take a few months to get the pieces in place for a pronounced recovery, we are optimistic that this can happen in 2021. In terms of positioning, we expect accommodative policy and a vaccine-driven recovery to support risk assets. As a result, we are currently overweight U.S. and emerging-market equities and underweight fixed income.

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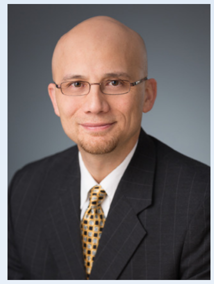
As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments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