Outlook for Financial Markets

Shaky but not fragile

"Every business and every product has risks. You can't get around it."

\- Lee Iacocca

While U.S. large-cap stocks continue to trade near record levels, several risks have emerged on the horizon. It is important to break down the individual pieces one-by-one because in aggregate the Delta variant spread, decelerating service sector, Fed tapering, inflation pressures, delayed infrastructure bills, and Afghanistan heartbreak can feel daunting. The well-publicized spread of the Delta variant has led to renewed caution and curtailment of certain reopening activities. From a comparative perspective, some countries, including India, contended with a surge in the Delta variant for approximately two months before seeing cases taper off considerably. Early indicators suggest the U.S. may be following a similar path. So, while the current service sector deceleration is clear ***(Exhibit 1)***, we expect activity to level off towards a steady state trajectory in the coming weeks and months rather than continue a downward descent.

Amid this backdrop, the Fed is also evaluating the timeline for "tapering" its bond purchases that continue at a massive rate of $120 billion per month. We expect the Fed to start reducing this purchase amount by the end of the year, but the exact timing is of little import. They will continue to evaluate the health of the economy amid the Delta variant spread, ongoing improvements in the labor market, and inflation pressures. At this point any tapering should be thought of as reducing the unprecedented looseness of recent monetary policy rather than outright tightening. The Fed is also likely to reiterate the transitory nature of most inflation pressures. Despite

Executive Summary

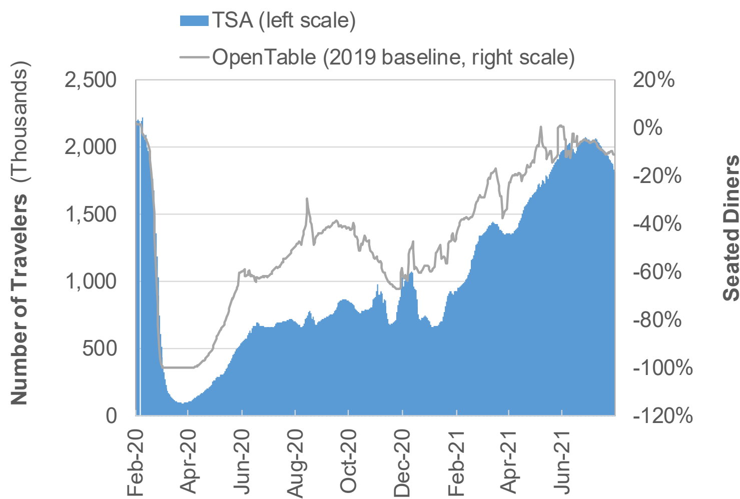
Multiple risks have emerged, but it is important first to analyze them one-by-one.

Fed tapering should not be unsettling to markets, but it remains important to monitor inflation pressures that could lead to Fed hawkishness.

Healthy earnings growth should continue, but P/E multiples are likely to gradually compress.

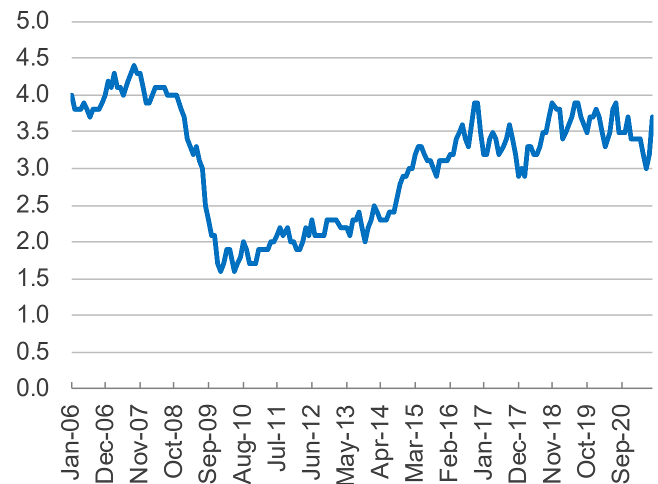
See our Special Section on accelerating productivity and automation.

Exhibit 1 » TSA Total Travelers Throughput and OpenTable Seated Diners in U.S. (7-days MA)



Source: TSA, OpenTable, Bloomberg

Exhibit 2 » Atlanta Fed Wage Growth Tracker



Source: Federal Reserve Bank of Atlanta

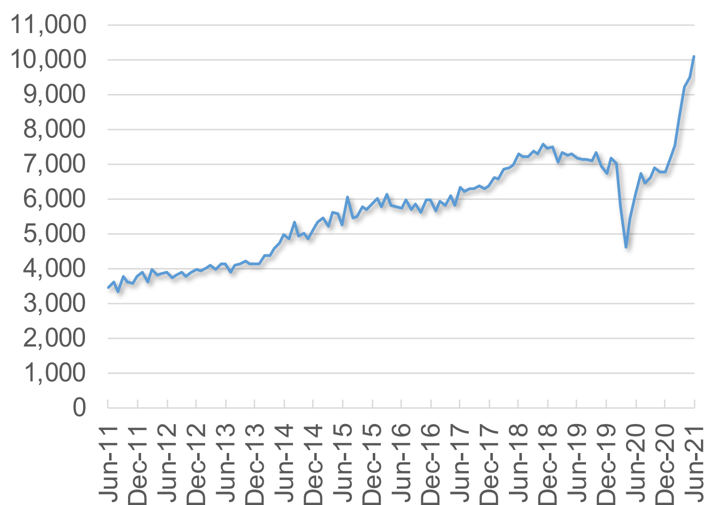
this refrain, the longer that pricing pressures persist – which we expect to be for multiple quarters still – the more the Fed will worry that inflation expectations are getting reset to a higher level. A key variable to consider here is wage growth, with readings at or below 4% being quite healthy ***(Exhibit 2)***, but much above that may call the transitory inflation argument into question.

Turning to politics, the social infrastructure bill is likely to be much smaller than the $3.5 trillion proposed by Democrats, but still sizable. In the Senate, Democrats cannot lose a single vote and still pass the spending package through the reconciliation process. West Virginia Democratic Senator Joe Manchin's centrist views are well established, but also Arizona Democratic Senator Kyrsten Sinema has said very explicitly that she will not support a bill that costs $3.5 trillion. So, compromise will be the order of the day, accompanied by tax increases more modest than initial proposals.

The multiple elements of uncertainty that the economy and markets face are not small and may take some time to play out. Taken individually, none appears insurmountable with the continued backing of strong pent-up demand, healthy business spending, and a very favorable labor market ***(Exhibit 3)***. In particular, we believe inflation pressures will persist for a few more quarters before easing. At present, it is hard for the Fed to turn hawkish at the same time it cancels the in-person Jackson Hole meetings, but the economic case for tapering bond purchases sooner rather than later is strong. The trajectory ahead looks like good earnings growth that flows partially (but not fully) into equity market gains as price-to-earnings multiples continue to gradually compress. The economy has been lacking balance ever since the pandemic began, so convergence in that direction – while less spectacular – should be a welcome and healthy environment for investors.

While a steadying backdrop may be the base case for now, accelerating productivity trends point toward greater U.S. economic potential over the next several years. This view is grounded in a rapidly developing trend in the manufacturing industry. Details are outlined in a special section below.

Exhibit 3 » U.S. Job Openings (In Thousands)



Source: FRED, Bureau of Labor Statistics

SPECIAL SECTION

Welcome Back – Enhanced Productivity & Industry 4.0

Issues surrounding the U.S.-China trade war, COVID-19, semiconductor shortages, and supply chain bottlenecks have renewed the push for a strong domestic manufacturing sector from both sides of the political aisle. While labor availability and wage pressures are seeming barriers to a U.S. revival, automation may provide a solution. A collection of technologies is ushering in "Industry 4.0," or what has been dubbed a "Fourth Industrial Revolution." Professor David Hardt of MIT has described Industry 4.0 as a period of digitalization that combines technologies to capture data everywhere, provide fast access to that data anywhere, and then utilize tools to improve outcomes. These technologies include smart sensors, 5G connectivity, artificial intelligence (AI), flexible/autonomous robots, 3D printing, and augmented reality (AR). Improving technological capability, cost, and speed have led to an adoption inflection point and greatly expanded the markets for automation equipment and industrial software.

Companies that have successfully implemented these technologies have witnessed significant improvements in key performance indicators including product quality, cost, lead times, inventory levels, flexibility, energy efficiency, and labor productivity. For example, the President and CEO of I.D. Images, Brian Gale, is investing heavily in automation, such as replacing forklifts with autonomous robots. This allows for closer spacing between racks, increases warehouse capacity by 25%, reduces employee headcount, and has a payback period of under three years. Similarly, GXO Logistics (GXO), the world's largest pure play warehouse logistics company and industry leader in implementing Industry 4.0 technologies, sees its fully automated warehouse facilities requiring only 250 employees rather than 1,500. Another of the numerous potential examples is Canadian oil company Suncor which has installed sensors throughout its processing plant. The collected trove of operating data runs through IBM's Watson to predict potential failure points and recommend solutions.

While early adopters of Industry 4.0 technologies may see the greatest benefits, a drop in cost is set to democratize the proliferation of these technologies and open a window of opportunity for small-to-medium sized businesses to compete more effectively. In its fourth quarter 2020 CEO survey, the Federal Reserve Bank of Richmond found that 56% of large firms and 31% of small-to-medium businesses are looking to implement automation as a means of offsetting labor challenges. Given the step change in quality, rate, cost, and flexibility associated with Industry 4.0 technologies, these estimates may quickly prove to be too low. Industrial technology is at an inflection point and should drive productivity gains in the U.S. for years to come. For small-to-medium sized businesses, adoption of these technologies is becoming increasingly important to remaining competitive.

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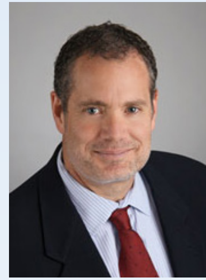
As Chief Investment Strategist, Yung-Yu is responsible for performing macroeconomic analysis, valuation modeling and market analysis across asset classes to guide strategic and tactical asset allocations for client portfolios.

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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Jon provides top-down and bottom-up analyses of the energy, materials, and industrial sectors for BMO Private Bank and serves as an analytical resource for BMO's Disciplined Institutional Equity team. He has over 25 years of experience in the financial services industry.

Jon joined our organization in 2011, working with the BMO Asset Management team with a focus on Oil and Gas for BMO Small-Cap Growth and BMO Mid-Cap Growth Funds and related portfolios.

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C-11# 13413839
Written: August 27,2021