It was only a couple of years ago that deflation fears featured prominently in the financial media. How quaint. Those days seem destined to go down in economic history as, “Remember when …”

As we toured the country meeting hundreds of clients last month, it became apparent that despite strong economic fundamentals, many people are intensely concerned about the current state of affairs. At the top of their list of worries are interest rate increases and inflation, a flattening yield curve, a ballooning deficit, and of course international trade (click here for our most recent update on tariffs and trade). When you add to that a special counsel investigation that shows no signs of wrapping up and midterm congressional elections that could flip party control, the list of “what ifs” seems almost paralyzing. The antidote to feeling overwhelmed is simply to address one concern at a time. Experience suggests there is always something to worry about, and perspective is warranted. Here are some highlights covering the top questions received on our trips.

When do higher interest rates and inflation become a problem?
The yield on the 10-year Treasury note began the year near 2.4%, but now is above 3% (Exhibit #1). Over these same few months, 12-month LIBOR and 30-year fixed mortgages are both up half a percent or so. As for inflation expectations, the 10-year TIPS breakeven inflation

Exhibit 1 » 10-Year U.S. Treasury Bond Yield Year-to-Date (%)

Executive Summary
When do higher interest rates and inflation become a problem?
Yes, interest rates have risen, and yes inflation expectations have firmed. After so many years of going in the other direction, these moves are uncomfortable. But, neither inflation nor interest rates have raced ahead of the path we expected early in the year, and both remain in a range that is well digestible given economic fundamentals.

Does a flattening yield curve suggest a slowdown ahead?
With the Fed set to raise short-term rates another two or possibly three times this year, our expectation is that the long end of the yield curve will experience roughly half of the increase that is seen on the short end. This would result in a modest amount of yield curve flattening, but not to a degree that would cause a considerable jump in recession probability.

Will the seemingly unsustainable U.S. debt and deficit limit long-term growth?
It’s hard not to be shocked by a hole that deepens by a trillion dollars per year. The numbers are large enough to lead to frequent worry by some, and complete head-in-the-sand avoidance by others. We advocate neither position. The U.S. debt and fiscal deficit, certainly to this scale, is undesirable, but very unlikely to lead to a crisis.
rate passed 2% in early January and hasn't looked back since (Exhibit #2). Oil prices have risen (Exhibit #3), base metals prices are trending higher, and both the producer price index (PPI) and consumer price index (CPI) have firmed in recent months. Before we get ahead of ourselves though, keep in mind that the Fed's preferred measure of inflation, the core personal consumption expenditures index (core PCE) is still not expected to consistently hit 2% or above until 2019, according to the most recent projections by Fed staff economists. Compared with CPI, the core PCE not only has a much smaller weight to housing, but also accounts for the "substitution" that takes place between goods when some become more expensive.

Yes, interest rates have risen, and yes inflation expectations have firmed. After so many years of going in the other direction, these moves are uncomfortable. But, neither inflation nor interest rates have raced ahead of the path we expected early in the year, and both remain in a range that is well digestible given economic fundamentals. Looking forward, what level of rates and inflation can the economy sustain? It’s difficult to know for certain, but another 50 basis points on the 10-year Treasury note yield in 2018 shouldn’t derail the expansion. The ongoing debate of three Fed rate hikes versus four this year is less meaningful than whether inflation remains range-bound and growth stays on track, both of which fit with our base case scenario.

Does the flattening yield curve suggest a slowdown ahead?

It seems that market participants are now more focused on the shape of the yield curve than ever before. Yield curve inversion has an enviable track record of predicting recessions, and once the yield on short-term (e.g., 3-month) Treasurys becomes equal to or below that on long-term Treasurys, the probability of recession over the next 12 months starts to become very meaningful. With the Fed set to raise short-term rates another two or possibly three times this year, our expectation is that the long end of the yield curve will experience roughly half of the increase that is seen on the short end. This would result in a modest amount of yield curve flattening, but not to a degree that would cause a considerable jump in recession probability. As short-term interest rates rise, we have to be aware that flat or declining 10-year Treasury yields could signal that challenging times are ahead. On the flip side, too large a run-up in longer-term interest rates might unduly restrain the economy. As the yield curve relates to the economic conditions we see this year, a spread (10-year yield minus 3-month yield) in the range of 50 to 100
basis points is probably the “sweet spot” as we work through 2018. For some historical context, it is worth noting that the spread stayed in exactly this 50-100 basis point range for much of the mid-to-late 1990s, a period of robust economic and market expansion.

Will the seemingly unsustainable U.S. Debt and deficit limit long-term growth?

It’s hard not to be shocked by a hole that deepens by a trillion dollars per year. The numbers are large enough to lead to frequent worry by some, and complete head-in-the-sand avoidance by others. We advocate neither position. The U.S. debt and fiscal deficit, certainly to this scale, is undesirable, but very unlikely to lead to a crisis.

Exhibit 4 » Debt Held by Public as a Percentage of GDP

Exhibit 5 » Interest as Percentage of Total Federal Outlays

The federal debt as a percent of GDP is expected to continue hitting fresh highs in the coming years (Exhibit #4). That said, the debt servicing burden as measured by interest payments on the debt as a percentage of federal outlays is expected to remain below the levels seen in the late 1980s and early 1990s (Exhibit #5). Rather than resulting in a crisis, bad outcomes would likely entail knocking off a few tenths of a percent of GDP growth for several years if something were to trigger investor confidence in the U.S.. That would certainly be meaningful from an economic standpoint, but still a far cry from a crisis. At what point would the size of the debt or deficit trigger such a reassessment of confidence in the U.S. economy? That’s extremely difficult to predict and may not happen at all. Regardless, the U.S. government looks on course to kick the can down the road as many years as possible.

What about the special counsel investigation and midterm elections?

Tax reform and the two-year spending bill have both passed. A big infrastructure bill looks unlikely. Trade frictions and tariffs remain a prominent concern, but if those negotiations move towards a resolution, then the outcomes of the special counsel investigation and midterm elections seem unlikely to have a strong influence on the overall economy in the near term. If Republicans maintain control of Congress, that could mean another go at Obamacare and other social programs. While this is deeply significant for many people who favor or oppose such directions, it is unlikely to be needle-moving either way for the economy in the near term.

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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 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 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 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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Yung lives in Portland, Oregon with his wife and two children. He is a basketball fan and enjoys cheering on his sons’ teams.

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