Outlook for Financial Markets

"Many receive advice, only the wise profit from it."
– Harper Lee

Economy

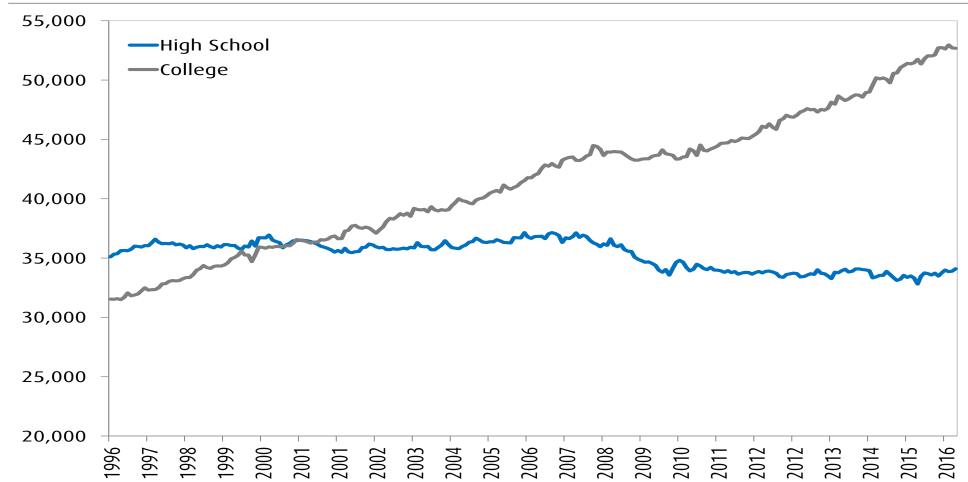
President Trump was swept into office on a wave of anger and frustration. A lack of income opportunities and labor market challenges made attacking unpopular trade deals with China and Mexico a political winner. There are roughly seven million fewer American manufacturing jobs than there were at the 1979 peak, but a recent *New York Times* report concluded that China and Mexico were responsible for only a small fraction of job losses. The biggest factor behind the evaporation of manufacturing jobs was automation. The steel industry is a case in point. Between 1962 and 2005, the industry shed 400,000 people, or about 75% of its workforce, according to that report. Shipment volumes did not fall.

While globalization and trade permeated the campaign, scant attention has been paid to the impact of innovation on jobs and job creation. For decades it was thought that while technology and innovation destroyed old industry jobs, they tended to create more opportunities in new industries and sectors. For example, television destroyed radio jobs but created a much bigger industry. Old trends may be giving way to a system in which technological advancement is leaving people without jobs and without transferrable skills.

The automation trend has shifted the bulk of new jobs into the service sector. In 1990, there were nearly three U.S. manufacturing jobs for every food service job. In December, the figures were equal. 86% of American jobs are now service jobs, according to the Bureau of Labor Statistics. Middle class service jobs are "knowledge" jobs, requiring an educational degree, certificate or specific skill. That's why the number of jobs requiring a college degree continues to expand while the amount requiring only a high school diploma continues to flatline *(Exhibit #1)*. While the jobs market has improved in recent years for a large segment of the workforce, workers, particularly those engaged in unskilled manual labor, have not seen expanding opportunities.

Innovation continues apace, casting a shadow on a large swath of the workforce. Artificial Intelligence

Exhibit 1 » Number of Americans Employed by Educational Attainment (000s)



Source: Bureau of Labor Statistics; BMO Private Bank Strategy

Summary

There are roughly seven million fewer American manufacturing jobs than there were at the 1979 peak, but a recent *New York Times* report concluded that China and Mexico were responsible for only a small fraction of job losses. The biggest factor behind the evaporation of manufacturing jobs was automation.

The International Monetary Fund estimates that as much as 15% of loans made by banks to Chinese companies could default. That doesn't consider the $8.5 billion in loans made by the "shadow" banking system.

Investor expectations are high, anticipating that the Trump administration's business-friendly policies will become law. Large cap equity markets are nearly 10% higher since the election on those hopes, leaving the market expensively priced and vulnerable to disappointment.

Trump has promised tax cuts, regulatory reforms and infrastructure spending. Turning a 2% economy into a 4% economy runs the risk of major consequences if things don't go right.

Sanguine lenders have offset monetary policymakers' restraint, as credit spreads, the yield premium lenders require to extend loans to lower-quality borrowers, remain low. Even as the Federal Reserve tightens monetary policy, foreign central banks remain easy.

(AI), or neural networks, represent an entirely new computational platform. Companies like Google, Facebook, Apple and Amazon have entered the field and some of their efforts are already bearing fruit. Google Translate was introduced 10 years ago for simple language conversion. Now the company is incorporating AI into it, making the application more intuitive and able to translate concepts between English, Spanish, Portuguese, German, Chinese, Japanese, Korean and Turkish. The new wave of AI-enhanced assistants, such as Apple's Siri, Facebook's M and Amazon's Echo, are built around machine learning, allowing them to get smarter as interactions accumulate.

The commercialization of artificially–intelligent devices has raised the ante on the skilled jobs market. Not only are 3.5 million commercial drivers' livelihoods threatened by the introduction of self-driving vehicles, but skilled professionals may also be at risk. Consider radiologists. Researchers have found that neural networks can find tumors in medical images faster than humans can. Similarly, a neural network designed to translate could work through millions of pages of legal discovery in a fraction of the time it would take a lawyer.

No longer will computers replace humans only in jobs involving repetitive tasks often associated with a relative lack of skills. Now, thanks to machine learning and neural networks, white collar professionals such as travel agents and realtors are at risk. We are approaching the point where machines will learn from human speech and program themselves. President Trump's mission to open a spigot of jobs that were outsourced through globalization is a noble one, but technology and innovation are creating a drain that dwarfs that spigot.

Bond Market

Low interest rates and easy credit have helped fuel China's stellar growth since the financial crisis, but now the global increase in debt servicing costs are upsetting the system. The country's bond market has blossomed in recent years as easy credit and low interest rates have encouraged borrowing. Credit balances have outpaced economic growth since 2009, reaching $27 trillion this year, growing twice as fast as economic activity. Easy credit has funneled capital into non-productive areas, keeping struggling companies alive and feeding speculative investments.

China's central banks raised interest rates about a year ago to weaken the enthusiasm. The problem is that an estimated 40% of "wealth management products," off balance sheet investment vehicles used to get around lending limits, are invested in bonds. The game works when bonds behave, but now we have a spike in 10-year Chinese government bond yields that has wiped out billions. Money is flowing out despite strict capital controls, leading to a fall in the country's once formidable foreign reserves by 21% over the last 24 months.

The International Monetary Fund estimates that as much as 15% of loans made by banks to Chinese companies could default. That doesn't consider the $8.5 billion in loans made by the "shadow" banking system. China's central bank has the wherewithal to inject enough liquidity to keep debt markets afloat. Fortunately, Beijing learned from the rolling debt crises of the late 1990s, so the bulk of the debt obligations are denominated in yuan, not dollars. Nevertheless, the risk is that liquidity injections will undermine the yuan, causing it to continue to weaken against foreign currencies. Then again, if China wishes to remain a trade dynamo, maybe a weaker yuan is what it needs.

China's not alone in its fledgling battle against higher rates. We're starting to see early problems in U.S. housing. First and foremost, there doesn't seem to be anyone left that hasn't refinanced their mortgage. Volumes on that front are back to 2008 levels, the year higher mortgage rates threw cold water on the steady "stimulus package" of episodic refinancing. The rate of a conventional 30-year fixed rate mortgage is back up to 4.2%, rising swiftly from 3.42% as recently as July. Mortgage lenders expect 2017 refinancing activity to be roughly half of what it was last year, but it seems to us that it could be even softer.

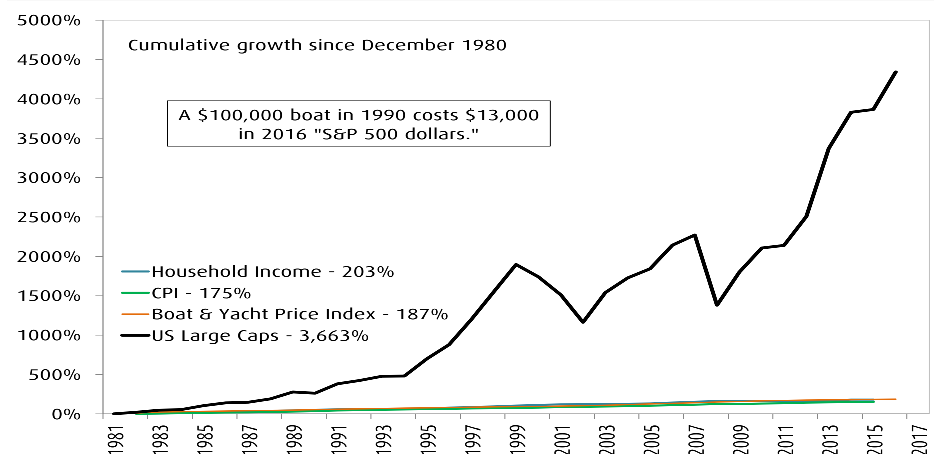
Then there are the millions that have outstanding home equity lines of credit (HELOCs) and adjustable-rate mortgages (ARMs). While only 7% of mortgages are ARMs, higher mortgage rates in general make the math of homeownership an obstacle for Americans that are hoping their home's value appreciates. Take a $250,000 house and a 20% down payment. Assuming that we can actually find many families in the market for this house that have $50,000 lying around, they would have a $1,208 monthly mortgage payment if they had locked in the 3.42% rate in July 2016. At today's 4.20%, their monthly nut would be $89 higher, at $1,297. If rates were to hit 5%, they would be looking at $1,392 per month. Putting it another way, if they want to pay today the same $1,208 that they could have locked in July, they'd bid $232,000 for the house now. At 5%, their bid would be $215,000, assuming 20% down.

Equity Markets

The prospect of tax cuts and regulatory rollbacks have investors licking their chops, sending large cap stocks surging nearly 10% since the election. Analysts have latched onto investors' enthusiasm and anticipate the profit recovery to continue. Earnings among S&P 500 companies are expected to rise 3.2% year-over-year through the fourth quarter. That's about equivalent to the 3.1% advance last quarter, which was the first in five, that earnings growth was positive.

Investor expectations are high, anticipating that the Trump administration's business-friendly policies will become law. Large cap equity markets are nearly 10% higher since the election on those hopes, leaving the market expensively priced and vulnerable to disappointment. Nevertheless, the proof will be in the pudding of revenues and profits. The S&P 500 is trading at about two times trailing revenue, about 30% above its median ratio of 1.2 and the highest level since the tech bubble. Equity markets are forward looking and investors anticipate strong growth in both profits and revenues. The Street anticipates 2017 earnings growth of 13.5% on revenue increases of 6.4%. That type of growth would soothe our concerns, but it has to actually happen first. The price-to-earnings ratio for the S&P 500 based on next year's prognostications is 17.5, making for an earnings yield of 5.7%. Historically, the S&P's earnings yield more closely approximated that of investment–grade 10-year bonds. Fortunately for stocks, today's earnings

Exhibit 2 » Income versus Capital: Saving versus Spending



Source: Pew Research Center; *The Wall Street Journal*

yield is 1.8% higher than corporate bond yields. Strong earnings results could help bridge the gap between high expectations and future results, giving companies and legislators the benefit of the doubt about future results.

Outlook

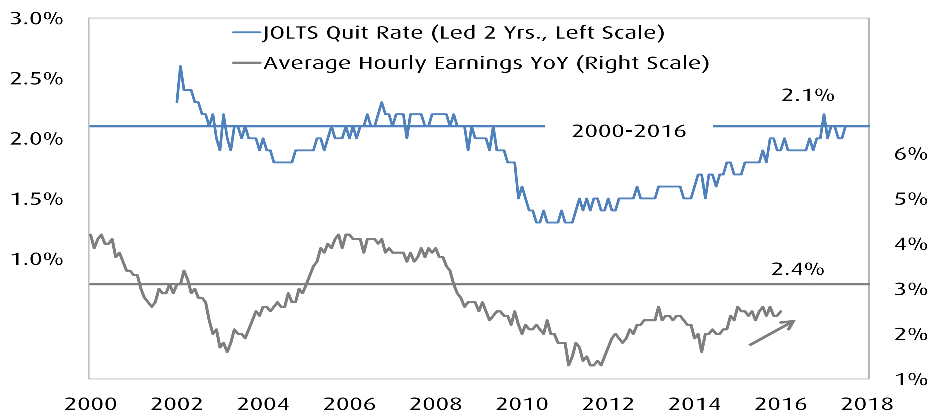
"Make America Great Again." Donald Trump's campaign resonated in a country in which middle and lower income households have seen their incomes shrink relative to inflation over the last 15 years. Investors have fared much better. Between 1980 and 2016, inflation rose 175% while wages were up 203%, but buying and holding the S&P multiplied the original investment 37-fold *(Exhibit #2)*. Voters are angry.

Trump has made big promises of lofty growth goals. The newly elected president has vowed to double the GDP growth rate from 2+% to 4%. How he plans to beat the donkey into a racehorse is laid out in his tax reform and regulatory rollback platform. At the same time, Trump has pledged to strengthen entitlement programs. Many of his supporters rely on Social Security as their primary source of retirement income, while Medicare and Medicaid provide their health care.

From an economic perspective, U.S. growth is constrained by two primary factors: labor force expansion and productivity, the latter being how much workers can produce in a given amount of time. Despite government intervention, both factors have been in secular decline. Since 2010, the labor force has been expanding at a 0.7% annual rate, productivity by 1.2%. Added together, they suggest America's potential growth rate is about 2%. Of course neither labor force growth nor productivity is a given. Demographics drive the growth of the labor pool. Back in the 1970s, the labor force grew at a 2.4% annualized rate as Baby Boomers hit adulthood. Now the population is growing at its lowest rate since the Great Depression. An uptick in deaths, a slowdown in births and a slight drop in immigration has pushed population growth to 0.7%. While some economists conclude that an increase of 1.5 million new immigrants into the workforce each year would raise growth by 1%, a Trump administration will be working to stem the flow across the borders, not increase it.

Productivity, the other growth lever, can't be controlled by the government. Its fuel is corporate investment, research and development and innovation. In the 1990s, productivity expanded at a 2.2% annualized rate as the personal computer was put to commercial use. Productivity growth ramped up to 2.7% throughout the 2000s as the Internet came of age. Since 2010, however, productivity gains have been muted because companies have opted to repurchase their stock and increase dividends instead of making capital expenditures.

Exhibit 3 » Quit Rate versus Wages



Source: Bureau of Economic Analysis; Bureau of Labor Statistics; BMO Private Bank Strategy

Trump has promised tax cuts, regulatory reforms and infrastructure spending. Turning a 2% economy into a 4% economy runs the risk of major consequences if things don't go right. Government deficits can boost growth in the short run, but it gets paid for over the long haul. The Tax Foundation estimates that Trump's across-the-board tax cuts will reduce government collections by nearly $10 trillion over 10 years, raising the prospect of deep budget deficits. It also estimates that GDP growth would be 1% higher ,while capital investment, a key ingredient driving productivity, would increase almost 3% annually.

Running an economy above its natural growth rate is inflationary. Trump's $1 trillion infrastructure investment plan, combined with a tight labor market, would pressure wages and prices higher. The number of workers willingly quitting their job has already increased to 2%, the highest level since the financial crisis, suggesting labor market confidence. Historically, a high quit rate corresponds to stronger wage growth *(Exhibit #3)*.

There's no doubt that U.S. infrastructure is in need of an upgrade. More than two-thirds of U.S. roads are in less than good condition, and 143,000 bridges are in need of repair or improvement, according to data compiled by the Transportation Department. Infrastructure spending will increase the demand for construction workers – and that sector is already reporting tight labor conditions.

Employers shed more than 2.2 million construction jobs during the housing crisis, with 1.2 million hired back during the recovery. Many displaced workers went back to school, joined the military, moved onto other careers or simply got too old, creating a potential shortage of supply. Even if Trump's spending plans aren't fully realized, and it's likely they won't be, the incremental demand will create worker shortages, wage gains and inflation pressure.

Financial Market Strategy

Liquidity is beginning to recede. For years, pedal-to-the-metal monetary policy helped fuel risk–taking as central banks made risk aversion (holding cash) expensive. For almost a full economic cycle we have seen overnight interest rates held below the inflation rate, with negative rates in numerous countries. Low interest rates boosted the appeal of many asset classes, prompting investors to stick their necks out risk-wise. Corporate treasurers exploited low interest rates by issuing debt, using the proceeds to do share buybacks. Corporate issuance and stock buybacks hit an all-time high last year.

The easy money environment is changing and interest rates, both short and long, have been rising. Between September 30th and December 15, the 10-year Treasury yield rose one percentage point, while 10-year BBB-rated corporate bonds rose nearly 0.7% in six months. Similarly, two-year Treasury note yields spiked 0.5% in just a few months. Meanwhile, the Federal Reserve raised the Fed Funds rate by a quarter point in December, telling the market that it expects to raise it three more times this year.

Sanguine lenders have offset monetary policymakers' restraint, as credit spreads (the yield premium lenders require to extend loans to lower-quality borrowers) remain low. Even as the Federal Reserve tightens monetary policy, foreign central banks remain easy. The yield differential between foreign markets and those in the U.S. will likely keep U.S. interest rates lower than economic conditions would suggest. We will continue to monitor liquidity levels as a key indicator of future equity market performance. ■

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As Head of Macro Strategy, Jack chairs the Asset Allocation, Mutual Fund Re-Optimization and Harriscreen Stock Selection Committees and is responsible for establishing investment policy and strategy within BMO Private Bank throughout the U.S. He joined the organization in 2001 and has three decades of experience in money management.

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