Outlook for Financial Markets

"Do not let what you cannot do interfere with what you can do."
– John Wooden

Economy

Good news: Household incomes are on the rise. Bad news: Americans still view the economy as terrible. According to a new report from the U.S. Census Bureau, household incomes surged last year, reversing a seven-year decline. Adjusted for inflation, median household income spiked 5.2% to $56,516, representing the largest annual gain since 1967, the year the survey began. Bureau officials credit higher wages, an increase in the average number of hours worked and tepid inflation. The lowest wage earners enjoyed the largest wage gains thanks to the 21 states that increased their minimum wage last year. Arkansas, for example, boosted its minimum pay by 20% *(Exhibit #1)*.

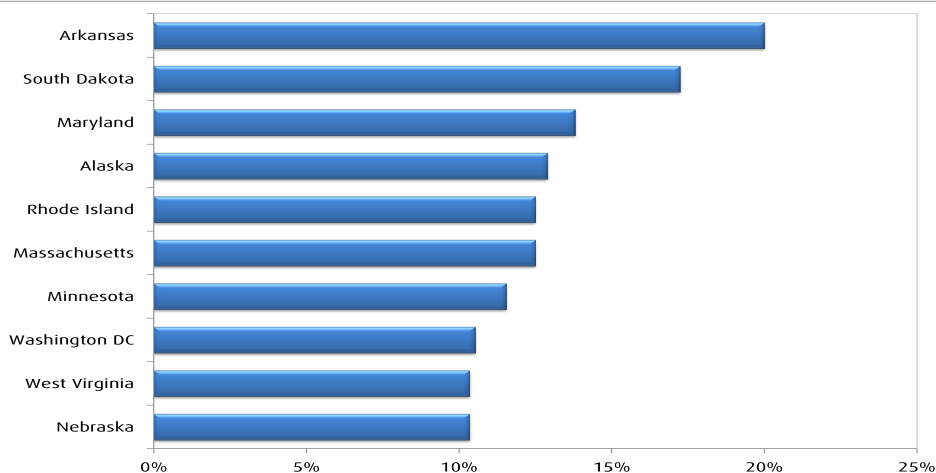
Longer term, incomes have been much slower to recover than stock portfolios and home values, and divergences between households have been wide. Growth differentials between rural and urban households have been particularly acute. Over the last 10 years, urban households enjoyed a 7.3% advance in their incomes while rural households saw theirs fall by 2%.

Despite the recent improvements, most Americans believe the economy is broken, largely because middle-class Americans make significantly less than they did 15 years ago, adjusted for inflation. Median household incomes stand 1.6% below the level reached in 2007 and 2.4% shy of the all-time high hit in 1999. Lackluster income growth goes a long way toward explaining our unusual election campaign season.

Bond Market

Money market rules are changing and the move is exerting its influence over a wide swath of the U.S. bond market. As of October 14th, "prime" money market funds, portfolios that invest in short-term

Exhibit 1 » Minimum Wage Percent Increase versus the Previous Year



Source: Department of Labor; BMO Private Bank Strategy

Summary

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Money market rules are changing and the move is exerting its influence over a wide swath of the U.S. bond market. As of October 14, "prime" money market funds, portfolios that invest in short-term corporate paper and other short-term debt, will be able to impose redemption fees and erect "gates," halting redemptions, should stressful market conditions require.

Restaurant stocks are in a funk. Increased competition from new entrants, combined with rising labor costs, means restaurant profit margins are falling faster than a soufflé.

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corporate paper and other short-term debt, will be able to impose redemption fees and erect “gates,” halting redemptions, should stressful market conditions require. The new regulations were imposed in response to the financial crisis when a money market fund, which had invested in Lehman Brothers debt, collapsed. The Federal Reserve swooped in and backstopped money market holdings up to$250,000, preventing further damage in the sector.

The move is designed to insulate money market funds from future liquidity crises, but they will become less attractive to those investors who believed their money market fund was a bank account. Already the market is responding to the change. Prime funds have shifted their holdings toward highly-liquid, cash and short-term Treasurys as investors have liquidated their holdings. As a result, demand for short-term corporate bonds has fallen, pushing rates higher. The LIBOR (London Interbank Offered Rate) spiked, increasing the cost of currency hedges for foreign investors hoping to latch onto incrementally higher U.S. yields. Since June, LIBOR has surged to 0.85%. That’s up from a .63% as recently as last June. Incrementally less demand has helped push other short-term yields higher too. From a low of 1.6% reached at the beginning of August, two-year triple-B corporate yields moved to 1.7%, while their Treasury counterparts were virtually unchanged. More expensive hedging costs could push longer-term Treasury yields higher as incremental “carry trade” demand diminishes.

Higher hedging costs means that fewer investors will be willing to sell dollars, so all other things being equal, dollar strength will ensue. A strong dollar pushes the value of gold lower and disadvantages U.S. multinationals at the expense of their foreign competitors. The greenback has trended higher over the last quarter, up nearly 3%. Gold, meanwhile, is off 7% since the beginning of August.

Central banks are under intense pressure from legislators and politicians who want to rein in their independence. Donald Trump recently derided Janet Yellen, asserting the Fed Chair should be “ashamed of herself” for what he described as financial bubbles the Fed and other central banks have created. Since their inception, central banks worldwide have enjoyed political independence. Lawmakers both here and abroad increasingly believe central banks should report to their respective legislative governing bodies, be it Congress, Parliament or the Diet. They may be right. Having employed traditional strategies like slashing borrowing costs, and non-traditional quantitative easing and negative rates, central banks are quickly running through their collective toolkits to spur the inflation rate. Their very independence may be impeding their ability to deploy one of the most effective, yet controversial tools in rising prices: “helicopter money.”

Public spending financed by central banks would draw monetary policymakers away from indirectly influencing economic activity to helping determine how money is spent — a role historically left to lawmakers. Leaders in both Japan and Europe have disavowed intermingling fiscal and monetary policies. Should monetary policy tip into the fiscal realm, the side effects may be worse than the cure. Helicopter money may indeed stimulate economic activity and inflation, but the potential loss of confidence could be devastating.

Equity Markets

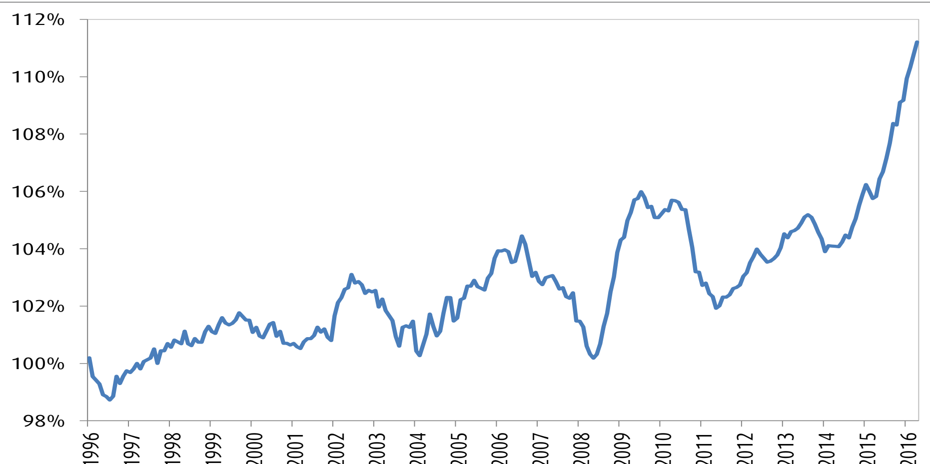
The third quarter ushered in the best quarterly performance of equities so far this year as the S&P 500 gained 3.3% for the three months ended September 30. Investors were comforted by a broadening of sector performance. No longer was the market driven solely by a quest for dividend income. The beleaguered financial sector, a group most closely aligned with the underlying health of the financial markets, participated in recent gains. While the first and second quarter performance was influenced by fears of Fed tightening and higher interest rates, investors exhaled in the third quarter as aggressive Fed rhetoric never translated into action. To date, Yellen & Company have failed to raise rates once this year, even after threatening four such moves in early 2016.

Despite advancing stock markets, earnings remain a concern. Analysts anticipate the earnings recession to leach into its fifth consecutive quarter, although revenues are expected to advance incrementally. The tech-oriented Nasdaq surged nearly 10% for the quarter, its best showing since 2013. Big banks are struggling under the weight of near-zero interest rates and negative rates abroad. Deutsche Bank AG, Germany’s largest bank, is suffering a lack of capital thanks to a portfolio of troubled loans, negative overnight interest rates and a $14 billion fine levied by U.S. regulators. U.S. banks could get a little more breathing room should the Fed decide to raise rates in December as they’ve intimated.

Volatility has picked up as the market has advanced, however. The S&P 500 enjoyed a two-month stretch, July and August, without a 1% daily move. September ended the tranquility as investors sold stocks in anticipation of a September rate hike. The combination of the Fed holding off and Japan’s stepped-up stimulus helped bolster risk-taking through the end of the quarter.

Restaurant stocks are in a funk. Increased competition from new entrants, combined with rising labor costs, means restaurant profit margins are falling faster than a soufflé. Recent price increases certainly haven’t helped traffic. Since the recovery began, the price of dining out has outpaced the cost of buying food at the grocery

Exhibit 2 » Cost of Dining Out versus Food at Home

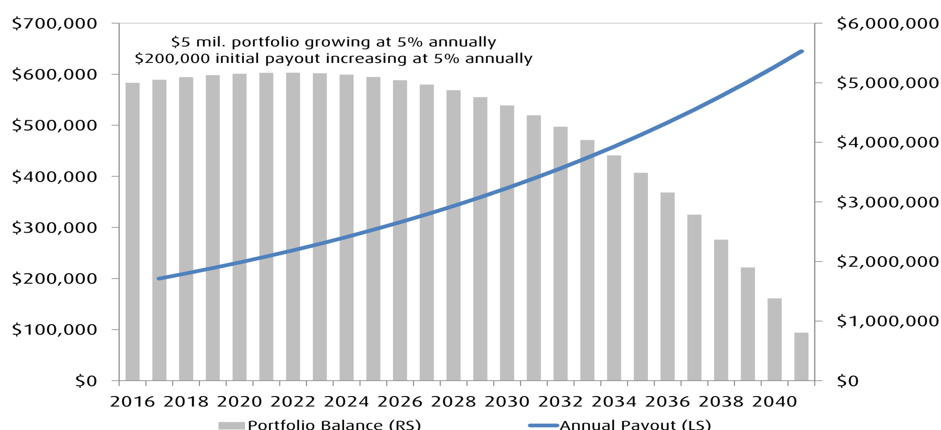


Source: Bureau of Labor Statistics; BMO Private Bank Strategy

store and eating at home *(Exhibit #2)*. Some industry analysts expect the restaurant recession to continue as consumers curtail dining excursions.

Fast food and casual dining chains are also feeling the pinch. Consumer traffic at leading chains has slipped for three consecutive quarters. Sales at food and drinking establishments have fallen in five of the last seven months, according to the Census Bureau. Before we lay Ronald McDonald to rest, however it should be noted that industry revenue year-over-year through August advanced 5.7%. While restaurant revenue has been growing faster than the economy, its most recent reading is the slowest since 2014.

Exhibit 3 » Maximizing Happiness: Increasing Payouts through Retirement



Source: BMO Private Bank Strategy

Outlook

Money is great, but happiness is key. The relationship between money and happiness is not as strong as many would assume. While financial independence affords certain flexibility and freedoms, studies have shown that people become inured with their income and wealth to a large degree. Happiness is often the result of changes in incremental circumstances, once a base level of circumstances is attained. The birth of a grandchild brings joy to an entire family regardless of their net worth. Having to give up a NetJets subscription is deflating. Improving circumstances, or trending toward continual improvement, could offer a fresh perspective on maximizing happiness in retirement.

Research indicates that people feel happier when the rewards they receive increase over time, like eating the bottom of the cupcake first and saving the frosting for last. Yet when planning for retirement, most financial professionals chart out a level payout stream, even though building a timeline where cash flows start small and increase over time would in theory result in happier clients. By offering alternative payout structures, financial planners have the potential to help clients maximize their pleasure in their golden years.

Hedonomics, the study of the relationship between economic principals and happiness, is an emerging field that seems to be designed for today's economy. While Baby Boomers, the "have it now" generation, thrived on stuff, Millennials, saddled with school loan debt and fewer job prospects, savor experiences instead. Happiness is relative. A recent *Wall Street Journal* report concluded that people feel best when they feel their lives are improving, not necessarily when they achieve the most at once. This suggests that alternative drawdown methods may be most effective in retirement satisfaction.

One of the most popular alternative drawdown methods, according to the report, is called the "upward slope", where income increases over time. Under the upward slope method, payouts start small and increase over time, helping not only to optimize happiness theoretically, but also addressing concerns about running out of money *(Exhibit #3)*. Instead of worrying about not having enough down the line, retirees can expect better times ahead. Critics of the upward slope method argue that the best time to enjoy retirement is in the early years when health concerns and lack of mobility are less of an issue. Another alternative is the "spike" method, where retirees receive large, one-time bonuses periodically, say every three to five years. That way recipients can look forward to a special vacation or anniversary celebrations and have time to plan the big event. According to a recent Harvard Business School study, most people surveyed would prefer a "bonus month" payment every year. Wealth is great, but we all know it's merely a means to an end. While everyone wants more money, friends and time, we'll never have enough of any of them. The best thing we can do is try to maximize our happiness with the money, friends and time we do have.

Financial Market Strategy

Investing in the market these days is difficult. Equities appear expensive relative to their earnings and revenues and the 10-year Treasury note offers a yield below 2%. CDs yielded 5% as recently as 2007. Bond yields are so low that they're the only lens through which today's stock market appears cheap. Central banks have made safety unattractive in an effort to spur risk-taking.

There are few investments that offer investors relatively low volatility with the potential to score moderate investment returns. Consider structured notes. Issued primarily by financial institutions, structured notes are debt instruments whose returns are derived from another investment vehicle, like an equity index or another market benchmark. Since structured notes are built with options, they often allow holders to participate in the upside of the investment index while limiting downside exposure.

Downside protection, however, comes at a cost. Generally, the cost is upside opportunity. A typical note would offer a one- to five-year maturity and participation with the S&P 500 with an upside cap, the maximum amount the holder can participate. In exchange for limited upside, holders often enjoy a downside buffer where they don't suffer losses until the S&P 500 falls below a particular threshold, say 10%. From that point investor losses fall one-to-one with the index. A 12% decline over the holding period would result in a 2% loss in this example. Structured notes work well when markets are expected to trade within a narrow range. In an environment where equity values are full and swinging for the fences probably doesn't make sense, structured notes could offer investors the ability to hit singles and get on base. ■

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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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