August 2014

Outlook for Financial Markets

Summary

- **It is possible that inflation will remain low for some time.** Global growth has slowed and many countries are confronting an aging crisis. While governments accumulate debt, households are reducing it.
- **There's a tug-of-war going on between the stock and bond markets**. Equities continue to advance while bonds, a harbinger of lower growth, reversed their downward slide and rebounded for the first two quarters of the year.
- **Stocks, bonds and commodities advanced in unison**, a rare occurrence not seen in more than 20 years.
- **Looking at college costs analytically, the thousands of dollars spent on a sheepskin is worth it,** but student loan burdens are the new financial cancer. Like home prices, college costs have surged over the last three decades, while household incomes have barely budged, shrinking the number of financially qualified borrowers.
- **Over the last several years, smaller mid-cap stocks have outpaced their larger brethren** as investors worldwide clamored for U.S. market exposure. Mid-cap stocks have outpaced mega-caps by 40 percentage points since 2009.

"Action is the foundational key to all success."

– PABLO PICASSO

Economy

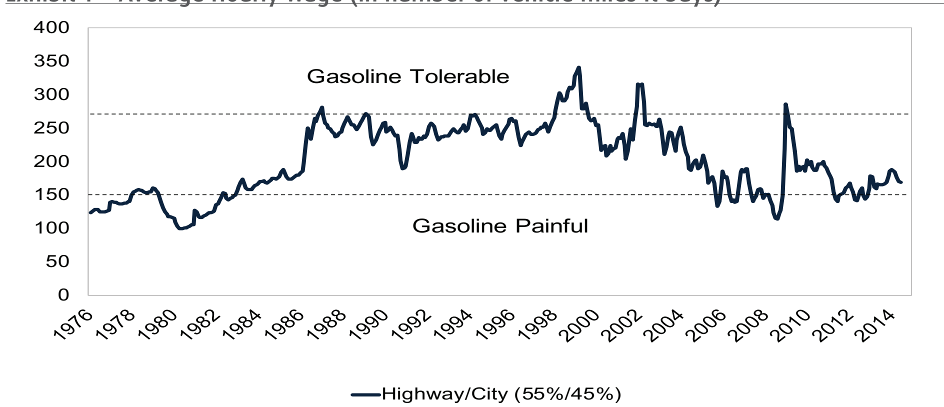
The U.S. economy has fallen victim to the paradox of thrift. Retail sales edged 0.3% higher in June month and consumption accounts for nearly 70% of the economy. Some forecasters have been disappointed by the mass shoring up of household balance sheets in recent years. The financial crisis has left Americans scarred. Many young people watched their parents or their friends' parents enter foreclosure, leading to the view by some that home ownership is a burden, not a dream. At the peak, more than 25% of mortgages had balances that exceeded the market value of the home. All the while labor mobility plunged because people couldn't afford to sell their homes and relocate.

Interestingly, consumer price inflation has inched up to 2.1%, right around the Federal Reserve's 2% target rate for the "personal consumption expenditures deflator," another measure of inflation. Current inflation is the hottest since October 2012 – and it's providing an open invitation for risk-taking. Unlike the "stagflation" of the 1970s, we think the trend is signaling a stronger economy and improving corporate revenue growth. Higher inflation readings could propel interest rates higher too, ending the 30+ year bond rally that commenced when the 10-year Treasury yield was 15.8%. Nevertheless, rising rates would create a headache for home buyers and others seeking to take on debt. A secular interest rate reversal would end Washington's status quo growth-by-debt policy that is as old as the hills.

It is possible that inflation will remain low for some time. Global growth has slowed and many countries are confronting an aging crisis. While governments accumulate debt, households are reducing it. In contrast to years past when leverage enabled the economy to expand beyond its natural growth rate, deleveraging acts as the payback.

Investors have done a great job compartmentalizing geopolitical events lately. U.S. equities have rallied right on through the Russian annexation of Crimea and now the advent of an Iraqi civil war. Investors have been keen to delineate between political crises and financial crises. The crisis in Ukraine, one of the world's largest corn exporters, pushed prices of that commodity 20% higher

Exhibit 1 Average Hourly Wage (in number of vehicle miles it buys)



Source: Bureau of Labor Statistics, EPA, BMO Global Asset Management Strategy. Calculation Example: Jun. 2014 avg. wage = \$20.54/hour, regular unleaded gasoline = \$3.69/gal, average fuel economy = 30.3 mpg. Math = (\$20.54/\$3.69) x 30.3 = 168 miles of travel for one hour of labor.

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between January and April. Corn prices have since retreated, but commodity investors have to focus on oil now that ISIS is showing itself to be more ruthless than Al Qaeda. West Texas Intermediate crude oil has run to $105 from $91 in January.

It is remarkable that equity markets have been able to shrug off some of these developments; the S&P 500 returned 7% to the strong hands that held it the entirety of this year's first half. Part of the rationale for holding onto stocks, at least as far as a rising crude oil price is concerned, is that the public has some wiggle room left before gasoline prices start to really hurt.

There is some threshold for crude oil prices above which economic activity would slow. The problem is that the tipping point is a moving target because incomes, fuel efficiency, commuting distances and many other factors are ever changing. So we calculated how many miles a typical American could drive their car using the money earned from an hour's worth of labor, factoring in the prevailing fuel economy of typical automobiles at any given point in time. Right now on average Americans earn wages of $20.54/hour, spend $3.69 per gallon on gas and drive cars that get 30 miles to the gallon, so one hour of work "earns" 168 miles of driving.

It appears that the pain threshold occurs when an hour of labor will only buy perhaps 150 miles of vehicle travel *(Exhibit #1)*. Levels below that coincided with the back-to-back recessions of the early 1980s and the years directly preceding the stock market waterfall that commenced in 2007. At current prices, gasoline can head ever so slightly higher, but the pain threshold is in danger of being triggered.

Bond Market

There's a tug-of-war going on between the stock and bond markets. Equities continue to advance while bonds, a harbinger of lower growth, reversed their downward slide and rebounded for the first two quarters of the year. The Bank for International Settlements (BIS), a consortium of the world's central banks, appears to be siding with the bond market's pessimism. Their recently released annual report pointed to a "puzzling disconnect between the (stock) markets' buoyancy and underlying economic developments globally." At 3%, they assert that global growth will be stuck below the 3.9% average enjoyed between 1996 and 2006. In several economies, output, productivity and employment trends remain below pre-crisis levels.

Last decade's debt binge is largely to blame. While governments have done a good job reducing their fiscal deficits, public debt is rising faster than economic growth across most of the developed world. The BIS report discusses debt-to-GDP ratios in excess of 100% among the nations that at one point in modern times or in antiquity found themselves managing the world's largest economy: Italy, Spain, France, the U.S. and the U.K.

The BIS is confessing that "quantitative easing," the tool that central banks have selected since overnight interest rates hit zero several years ago, isn't working. Monetary expansion has boosted asset values but it hasn't effectively addressed growth. While the stock market suggests an economic resurgence is around the corner, the bond market doesn't believe it.

Credit spreads, the yield premium lenders require for lower-quality borrowers, remain low. At 3.8%, the yield of the lowest-rated "investment grade" 10-year corporate bonds is currently set about 1.2% above Treasury note yields. That's about one-half percentage point less than the historic premium, a 15th percentile reading over the last 12 years. Meanwhile the trend continues lower. As recently as April, the yield premium was 1.5 percentage points. Credit spreads represent a good real-time barometer of investors' risk appetite and we remain comfortable as long as they remain low.

Equity Markets

Investors were emboldened by easy liquidity in the year's first half, as risk-taking of all kinds was rewarded and stock market variability fell. The CBOE Volatility Index, or "VIX," posted its lowest first-half-of-the-year average since 2007 and is currently 31% below its long-term norm, according to a recent *Wall Street Journal* report.

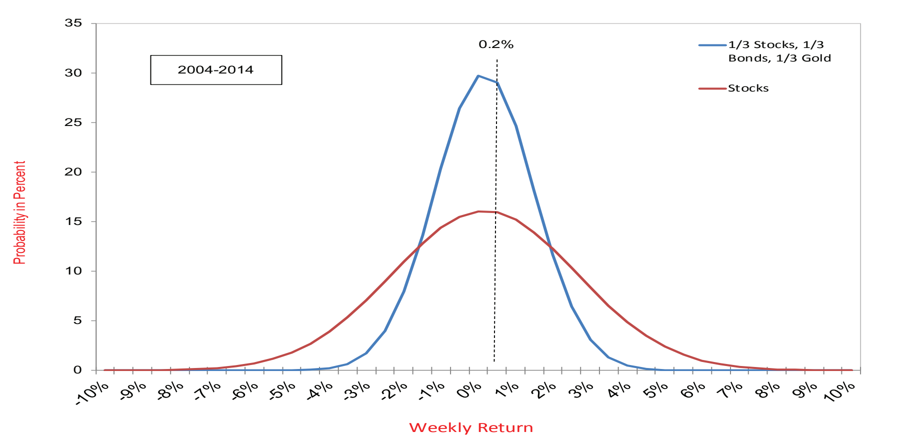
Stocks, bonds and commodities advanced in unison, a rare occurrence not seen in more than 20 years. Equities and commodities tend to do well as economies expand, while bond prices often do the opposite. So far this year, the S&P 500 and the Dow Jones UBS Commodity index both rose 7.2%, while the Barclays Aggregate Bond index gained 3.8%. Over the last 10 years, an equally weighted portfolio of stocks, bonds and gold returned about the same as a stock-only portfolio, but with just over half the risk *(Exhibit #2)*.

The lowest-quality stocks within the S&P 500 are doing the best this year. There are only five companies in the S&P that carry the lowly "C" rating. According to Standard & Poor's, they have "significant speculative characteristics," yet that motley crew has rallied more than 24% thus far, more than three times the return of the market overall. Meanwhile, "A-plus" stocks are up just 4.9%. Clearly the low rate environment has hurt those taking the safer approaches. We expect more of the same, possibly for as long as short-term interest rates remain significantly below the prevailing inflation rate.

Outlook

It's been eight years since housing peaked in summer 2006, leaving millions drowning

Exhibit 2 The Benefit of Diversification: Stocks/Bonds/Gold vs. Stocks Only



Source: Bloomberg; BMO Private Bank Strategy in debt. The fiasco was years in the making. Ever-increasing home prices made it more and more difficult for those who were born too late. For many, it felt like the American Dream of homeownership needed to happen as soon as possible, as the bubble mentality led many to believe that homes were only going to become more inaccessible. Fast forward a few years and we are seeing a replay, only this time the American Dream is in the halls of academia.

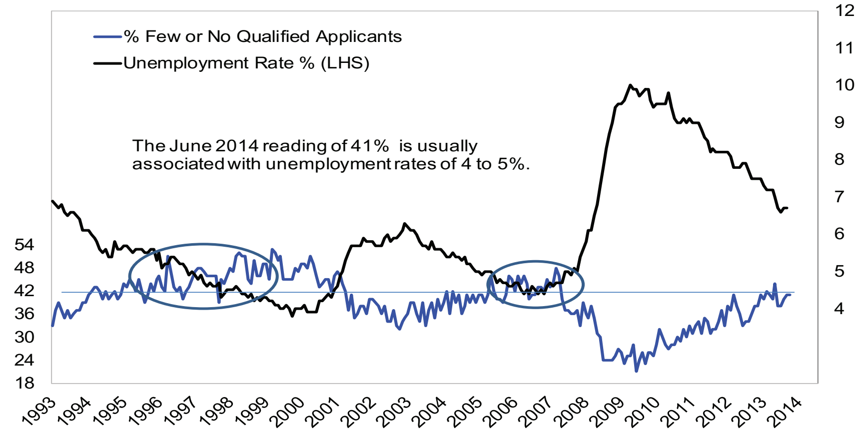
Looking at college costs analytically, the thousands of dollars spent on a sheepskin is worth it, but student loan burdens are the new financial cancer. Like home prices, college costs have surged over the last three decades, while household incomes have barely budged, shrinking the number of financially-qualified borrowers. In an effort to address the imbalances, lending standards for school loans slipped. Student loan debt has mushroomed to over $1.2 trillion and Washington's interventions to ease the burden on borrowers may end up doing the opposite. President Obama issued a directive capping student loan payments at 10% of incomes, but that may cause even more people to pursue a degree. The trouble is that eventually supply meets demand.

Taxpayers, through the government's school loan subsidy, ultimately bear the burden. Society is not making education more affordable by signing up more people. As was the case with medicine, eventually the doors will come bursting open when incessant subsidy bends the cost curve parabolic, leading to another sector of the economy being socialized for political expediency.

Fortunately, efforts have been made, particularly within the private sector, to take a second look at education and training. The first iteration was massive open online courses, or MOOCs. The early results are mixed. Studies have shown that many students sign up for MOOCs, but drop out almost immediately, with fewer than 10% completing the coursework. And in contrast to the perception that MOOC students are pursuing a bachelor's degree, most students availing themselves of them already have that degree.

Now, online education has taken a slightly different tack thanks to corporate involvement. Rather than trying to become an online university, newer MOOCs are instead focusing on skills. Called "nanodegrees," these programs focus on specific job skills rather than broader education. Google is working with online education company Udacity to create a nanodegree for programmers who work on Google operating systems like Android. Similarly, AT&T will accept the successful completion of a NanoDegree as a credential for entry-level jobs, reserving 100 intern slots for its graduates, according to a recent *New York Times* report. Whether or not nanodegrees will supplant bachelor's degrees remains to be seen, but trends are moving in a positive direction.

Exhibit 3 Businesses Reporting Few or No Qualified Applicants for Open Positions



Source: Bloomberg, OECD, BMO Global Asset Management Strategy

Young people want good careers and employers want qualified candidates. Currently, 41% of business owners surveyed claim they're having a hard time finding candidates who meet their job requirements *(Exhibit #3)*. At the same time the unemployment rate among 25- to 34-year-olds is 6.7%, or 0.4 percentage points higher than the national rate. Labor participation in this age group is 80.8%, the lowest since 1983. Computer technology has for decades been used to streamline work and eliminate jobs, so it's about time computer technology was harnessed to retrain Americans for the job market of the future.

Financial Market Strategy

The S&P 500 is a capitalization-weighted index, meaning that the largest companies have the biggest representation. Apple is the largest company in the S&P 500 thanks to its $564-billion market value, making it 3.2% of the index despite the presence of 499 other companies. Investing in the S&P 500 is tantamount to investing in the truly mega-cap household names like McDonald's and Coca-Cola. After all, the 100 largest stocks comprise 60% of the S&P.

Equal-weighted strategies, particularly on the S&P 500, have gained popularity in recent years. Instead of weighting stocks by their size, each stock gets only 1/500th of your money. That means that a stock like Dr. Pepper Snapple, worth $11 billion, gets the same attention as Apple, Exxon Mobil and Microsoft. Over the last several years, smaller mid-cap stocks have outpaced their larger brethren as investors worldwide clamored for U.S. market exposure. Mid-cap stocks have outpaced mega-caps by 40 percentage points since 2009. Following along with the favorability of smaller companies, the equally weighted S&P 500 beat the "normal" S&P 500 by 14%.

Mid-caps carry a forward price-to-sales ratio over 20, while the S&P 500's ratio is 17. Price-to-book value is even worse. Mid-caps trade at a 66% premium to its historical position when gauged against large-caps on that measure. We suspect that a switch is in the offing, with the big everyday companies that everyone has heard of taking over leadership in the next half decade. ■

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July 2, 2014

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Executive Vice President and Chief Investment Officer,
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Jack Ablin is Executive Vice President and Chief Investment Officer with BMO Private Bank. He is responsible for establishing investment policy and strategy within the Personal Investment Management Group of BMO Private Bank. Mr. Ablin also chairs the BMO Private Bank Asset Allocation Committee, which determines the strategy for investment portfolios for BMO Harris Private Bank. Mr. Ablin joined BMO in 2001 and has more than 25 years of experience in money management.

Mr. Ablin earned a bachelor's degree from Vassar College, New York, where he graduated with honors with an AB in Mathematics and Computer Science. Mr. Ablin received an MBA with honors and graduated *cum laude* from Boston University, Massachusetts, and is a member of the Beta Kappa Sigma Honors Society. He holds the Chartered Financial Analyst designation. He is a member of the CFA Society of Chicago and a CFA Institute Charter holder.

Accomplishments include:

- Author of *Reading Minds and Markets: Minimizing Risk and Maximizing Returns in a Volatile Global Marketplace,* published in July 2009 by F.T. Press; *Wall Street Journal's* best-seller list, 2009
- Written on a variety of topics, including investor psychology and financial markets outlook
- Frequent contributor to CNBC, Bloomberg, *The Wall Street Journal* and *Barron's*
- Served as a Professor of Finance at Boston University, Graduate School of Management
- Spent five years as a Money and Markets correspondent for WTLV, the NBC affiliate in Jacksonville, Florida
- Named one of the Top 100 Wealth Advisors in North America by *Citywealth* magazine, (2010)

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