Outlook for Financial Markets

"Until you make the unconscious conscious, it will direct your life and you will call it fate."
– Carl Jung

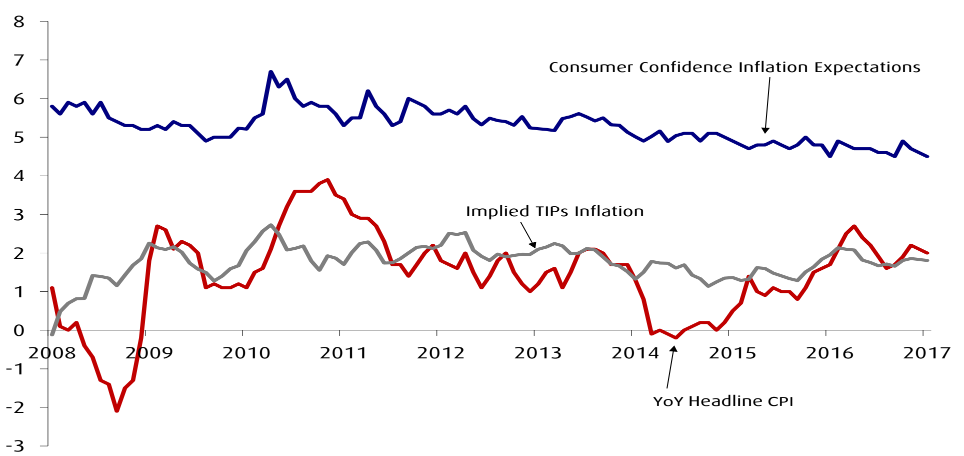
Economy 2018

As we enter the ninth year of economic expansion, fiscal policies in the form of tax incentives take center stage. The recovery, fueled entirely by monetary stimulus in the form of zero interest rates and $3.6 trillion of quantitative easing, is currently the third longest expansion on record. It also happens to be the shallowest recovery on record. Our current expansion makes the 1991 "jobless recovery" look like a whiplash-inducing snapback.

Fiscal policy was sorely needed in 2009 when the credit crisis dragged the economy into the worst modern-day tailspin, second only to the Great Depression. Corporate tax reform is coming at a time when our economy is 18% larger than it was before the crisis, when the unemployment rate, at 4.1%, is at its lowest level in 17 years. Adding fiscal fuel to a smoldering monetary fire could spark an inflationary flare up.

Bond traders are skeptical. Despite the monetary and fiscal conflagration, the five-year inflation rate implied by the Treasury market remains consistently below the Fed's 2% target, as it has since 2014. In fact, the bond markets' inflation expectations have overshot actual inflation since 2010 *(Exhibit #1)*. Consumers' inflation views have sagged as well. The downtrend in longer-term interest rates supports a "lower for longer" view on price growth, although a great deal of the gravitational pull on intermediate Treasury yields may have more to do with 0.31% German bund yields than the economic outlook. Eventually, spare capacity for production and labor evaporates, leading to a mismatch between ongoing demand and constrained supply, resulting in higher prices for finished goods, commodities or increased wages. This typically caps a traditional business cycle when interest rate increases, fueled by inflation or the Fed, outpace profit growth, pushing demand

Exhibit 1 » Inflation Expectations versus Reality



Source: Bureau of Labor Statistics; Conference Board; BMO Private Bank Strategy

Summary

Fiscal policy was sorely needed in 2009 when the credit crisis dragged the economy into the worst modern day tailspin, second only to the Great Depression. Corporate tax reform is coming at a time when our economy is 18% larger than it was before the crisis, when the unemployment rate, at 4.1%, is at its lowest level in 17 years.

The architects of the plan believe that a lower tax rate, combined with incentives to expand capital expenditures, will grow businesses, create jobs and spur domestic growth. We agree. The economy is coming off two consecutive quarters of three-plus growth and we expect the momentum can continue into the first half of next year.

Capricious trade treaty terms run the risk of turning our vital manufacturing industries upside down. Free trade is important. Interfering with it is an acute risk that could harm our synchronized global recovery.

Many Republicans see tax legislation as their salvation in the midterms. That's why many are willing to accept passage at any cost. Their near-term concern is somewhat misplaced, given their virtual lock on the Senate.

Should our forecast of improving growth on the back of business investment play out in 2018, value-oriented sectors, like telecom, financials and energy, could be surprising market leaders. 2018 could represent a healthy broadening of equity market participation.

downward. Rates go up, the Fed tightens too much and a slowdown ensues.

Inflation is not an immediate threat. Given the shallow recovery, it's possible that our expansion could continue well into 2018 and perhaps 2019 before we see the whites of inflation's eyes. Steady growth, combined with low bond yields and little inflation, will create a favorable risk-taking recipe in the year ahead. Inflation barometers, like wages and prices, will be critical to gauging risk in 2018.

Tax Reform and Investment

As of this writing, it looks like the Republican tax plan will be putative legislation by year-end 2017. That's welcome news to businesses, particularly small, domestically focused companies, which have been forced to pay a 35% corporate tax rate. The architects of the plan believe that a lower tax rate, combined with incentives to expand capital expenditures, will grow businesses, create jobs and spur domestic growth. We agree. The economy is coming off two consecutive quarters of three-plus growth and we expect the momentum can continue into the first half of next year. Since peaking in 2015, business expenditures, excluding residential housing investment, slipped in 2016 due to plunging oil prices, but have steadily improved since then. Corporate tax reform could trim our economy's reliance on consumer spending, which currently accounts for 69% of U.S. economic activity. Capital investments drive only 17%.

Reengaging businesses with a lower tax rate and capex incentives will work. Multinational companies collectively are sitting on more than $2 trillion of cash in lower tax territories like Ireland, Singapore and Hong Kong. Apple alone holds over $252 billion overseas, according to company filings. The government can't create productivity, but it can create an environment conducive for business investments to flourish. Capital expenditure growth has declined and capital assets of American companies need a refresh. The average age of industrial equipment is 10 years, among the oldest in over a generation. The tax plan could be the right incentive to spur a business investment boom, creating a longer-term productivity-led economic growth path, not simply short-term stimulus that draws future demand forward.

While businesses are poised to spend, it's up to management whether or not their anticipated expenditures will create good-paying jobs as the President has pledged. Financial markets remain skeptical of the ballyhooed jobs boom. The employment-to-population ratio among 25-to 54-year olds is perched well below its 2007 high of 80%. According to a recent report in *The Economist*, it would take 2.5 million more jobs to get back to pre-crisis participation levels, not taking into account population growth.

Trade Policy

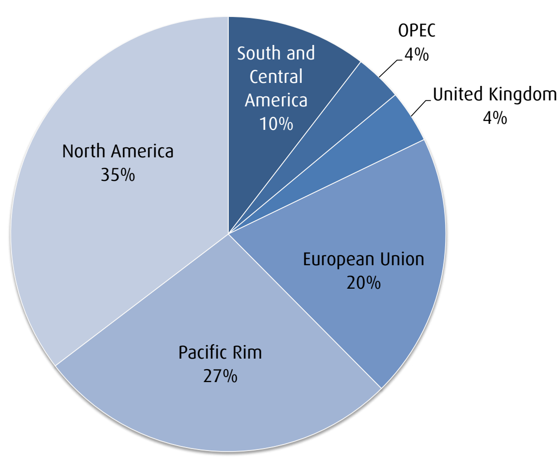
Trade policy, which is on President Trump's legislative list for 2018, represents the biggest financial risk to the economy and markets. The President has been an outspoken critic of America's current trade arrangements. Top of the list is the North American Free Trade Agreement (NAFTA), which has been in place since the early 1990s. Mexico and Canada are important trading partners, accounting for 35% of our nation's exports *(Exhibit #2)*. Sensing a policy shift, our neighbors to the north and south are diversifying their trade options. Canada feels particularly vulnerable. The United States is far and away its largest export market, dwarfing China, its next largest market, by a factor of 15.

Ripping up NAFTA or rolling back trade agreements runs the risk of setting back growth globally. While trade treaties are designed to facilitate efficiencies, they're also in place to ensure fair trade practices, like intellectual property protection. Imposing artificial barriers, like sanctions or trade restraints, forces businesses to pursue less efficient practices, resulting in unnecessary inflation and reduced productivity. We know of no economist who believes that trade barriers would burnish our economy.

Complicating matters, global trade trends are slowing naturally. Aging consumers in the developed world and in China are channeling more of their incomes toward services, like health care, which are delivered locally. At the same time, other Asian economies, grappling with demographic challenges of their own, lack low-cost manufacturing labor. After years of bolstering their economies with export-led growth, many Asian markets are shifting inwards, toward domestic demand, thanks to an expanding middle class. South Korea's gross domestic product grew 3% last year, its fastest pace in seven years. Singapore's economy is on the rise too, posting its best results since 2014. While the expansions are a fraction of the 10% growth fueled by exports in the 1990s, their domestic growth is more sustainable. The World Trade Organization estimates that global trade will have grown by 3.6% in 2017, roughly half the growth rate prior to the financial crisis. While Asian economies have become less reliant on trade, it remains an important growth lever.

Meanwhile, Washington is challenging existing trade pacts with Korea and China.

Exhibit 2 » U.S. Exports by Region



Source: U.S. Census Bureau, BMO Private Bank Strategy

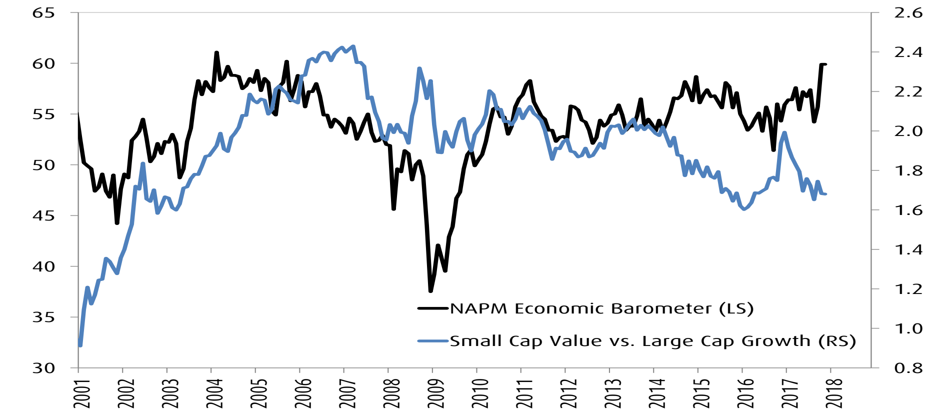
We support bilateral trade agreements. Although simpler, they do take longer to negotiate. But industry- or product-specific tariffs are unproductive and costly. The U.S. automobile industry, for example, has built its supply chains and production plans around trade policies that have been in place for nearly 30 years. Capricious trade treaty terms run the risk of turning our vital manufacturing industries upside down. Free trade is important. Interfering with it is an acute risk that could harm our synchronized global recovery.

Midterm Elections

Republicans hold all three elected houses of government and they are bracing themselves for voters' anger. Nearly two-thirds of Americans disapprove of the President's job performance. Many Republicans see tax legislation as their salvation in the midterms. That's why many are willing to accept passage at any cost. Their near-term concern is somewhat misplaced, given their virtual lock on the Senate. Democrats face an enormous challenge to claim a majority in the upper chamber. Of the 33 senate seats up for reelection, 25 are held by Democrats or independents. While Republican Senators Corker of Tennessee and Flake in Arizona will not be seeking re-election, it's unlikely that Democrats will steal their seats. Political futures markets currently give the Republicans an 80% chance of holding the Senate.

In the House, all 435 seats are up for reelection and Democrats would have to win over 24 seats to wrest control, overcoming gerrymandering and a tendency for Democratic voters to cluster in a handful of urban districts. A recent *Economist* report estimates that Democrats would have to win the national vote by seven percentage points, a landslide of historic proportions, to win a one-seat majority. While the odds of a Democrat-controlled House are somewhat higher than that of the Senate, the political futures market gives them a coin flip's chance of prevailing. The November elections are nearly a year away and political foundations are built on sand. There's still plenty of time for political missteps, tweets, poor policy decisions and new licentious behavior claims. Nonetheless, we believe that Washington's legislative advantage will remain the Republicans' to lose.

Exhibit 3 » Investment Style and the Business Cycle



Source: Bloomberg; BMO Private Bank Strategy

Conservatives would be best served spending 2018 peeling back the regulatory regime. Red tape has held back business startups and job growth for decades. Business startup formations have been in secular decline. Only 8% of private businesses are less than one year old; that's down from 16% 40 years ago. One quarter of American workers are employed by companies with 25 or fewer employees, according to ADP data.

After many years of wage stagnation, household income is on the rise. Adjusted for inflation, median household income rose 5.2% in 2017 on top of a 3.2% expansion in 2016. According to the Bureau of Labor Statistics, wage and salaries for factory work, construction and commercial driving rose 4% through the third quarter of 2017, outstripping pay gains for white collar professionals and managers. Blue collar job growth is a metric Republicans must stay focused on in 2018. Ironically, job prospects for Congressional Republicans and factory workers will be closely aligned this reelection season.

Equity Market Outlook

U.S. large caps posted a remarkable 2017, fueled by a business-friendly political environment. Yet most of the action occurred among the largest companies within growth sectors, like technology. As of this writing, there's a 43% performance differential between the best-performing sector, technology, at 36% and telecom, the worst performer, at -7%. FAANG stocks — Facebook, Apple, Amazon, Netflix and Google — led the charge higher this year.

Investors tend to gravitate to expensive large cap growth stocks when the profit environment is uncertain *(Exhibit #3)*. Investors are willing to pay vertiginous valuations for predictable profit growth when profits are elusive, since companies like Netflix could eke out profits in virtually any economic environment. Growth's leadership in many respects runs counter to a suffusive expansion. Perhaps it's a result of investor uncertainty.

Recently, however, smaller cap value stocks have moved higher in anticipation of the Republican tax package. Over the last four weeks, telecom shares have led the market higher, rising 9%, while technology shares have retreated. Financials, another value sector, surged more than 5% as odds of the tax package getting signed into law improved.

Should our forecast of improving growth on the back of business investment play out in 2018, value-oriented sectors, like telecom, financials and energy, could be surprising market leaders. 2018 could represent a healthy broadening of equity market participation. ■

Jack A. Ablin, CFA
Chief Investment Officer, BMO Private Bank

Jack A. Ablin, CFA
Executive Vice President and Chief Investment Officer, BMO Private Bank

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.

Jack earned a bachelor's degree from Vassar College in New York, where he graduated with honors with an A.B. in Mathematics and Computer Science. A member of the Beta Gamma Sigma International Honor Society, Jack received an M.B.A. with honors and graduated *cum laude* from Boston University in Massachusetts. He holds the Chartered Financial Analyst designation and is a member of the CFA Society of Chicago.

- 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
- 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, in 2006, 2010 — 2017

To view an online copy of the Outlook for Financial Markets please visit us at **wealth.bmoharris.com/insights/**

BMO Wealth Management

Written: December 12, 2017