Outlook for Financial Markets

"A mind that is stretched by a new experience can never go back to its old dimensions."

– Oliver Wendell Holmes

Housing: Balanced, not faltering

It goes without saying that the housing market is important for the U.S. economy. While residential fixed investment typically makes up only about 3% to 5% of total U.S. Gross Domestic Product (GDP)[1], once expenditures on rents and other housing services are taken into account, the total impact of housing is estimated to be 15% or more of GDP[1]. Additionally, the "wealth effect," whereby people tend to spend more money if their wealth increases, is estimated to generate about 5 to 10 cents of additional spending per dollar of wealth if that wealth increase comes from home price appreciation[2]. For comparison, wealth generated from financial market appreciation is generally estimated to have a much smaller effect on spending. Clearly, the impact of housing runs very deep. But, as we well know from the Great Financial Crisis, this effect cuts both ways.

Today, home prices are high. Affordability is falling. Housing starts and sales are slowing. Inventory is building. Does this seeming inflection point portend a downturn for the U.S. economy? We believe the answer is a resounding "no," and the contrast between the current state of the housing market and that in 2006 and 2007 is striking. First, while home prices have been rising, housing affordability, which takes into account income levels and interest rates, is far from the 2006 peak ***(Exhibit #1, left axis)***. Additionally, IMF (International Monetary Fund) research indicates that a real estate boom by itself is typically benign unless it is accompanied by an excessive buildup of debt[3]. Currently, mortgage debt-to-GDP remains near 2002 levels and is far below the 2006 to 2009 mortgage debt explosion ***(Exhibit #1, right axis)***. Mortgage delinquencies continue trending downward, and are at the lowest level in a decade. Anyone who has bought a home in the post-Crisis period likely knows that the pendulum of loan underwriting standards has swung far from the pre-Crisis "no-doc," interest - only, 105% loan-to-value go-go days. Inventories, for their part, now reflect a more balanced market, rather than one of low supply that has prevailed the past few years.

Perhaps nothing shows as sharp and important a contrast between today's housing market and that in 2007 as the National Association of Home Builders sentiment index ***(Exhibit #2)***. Back in mid-2007, the index stood at a mere 28 (below 50 is considered a negative reading). Even going back another year to mid-2006, when the U.S. economy was chugging along nicely, the sentiment survey came in at a downbeat reading of 42. Today the index clocks in at a healthy 67. Given this survey's track

Executive Summary

Home prices are high. Affordability is falling. Housing starts and sales are slowing.

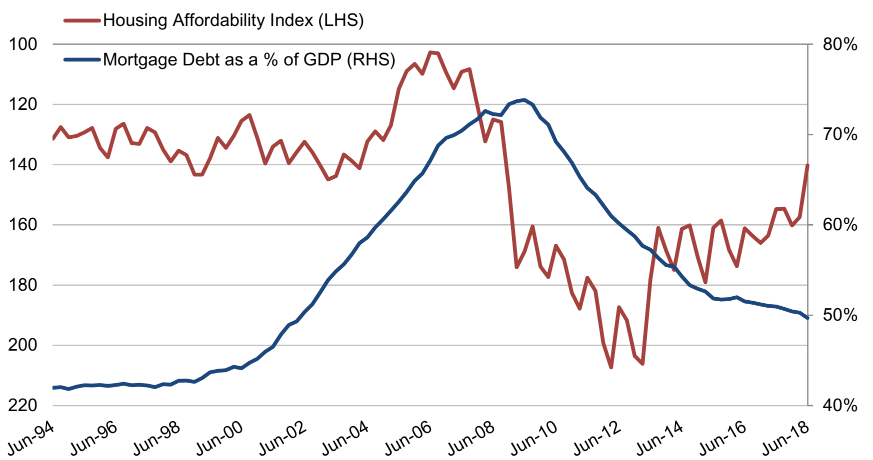
Mortgage delinquencies continue trending downward, and are at the lowest level in a decade.

Current 30-year fixed mortgage rates are in the 4.5% range – up about 1% since 2016, but below the 20-year average of about 5.4%.

We believe that the economy can digest wage growth of about 3.5% without meaningfully cutting into corporate profit margins.

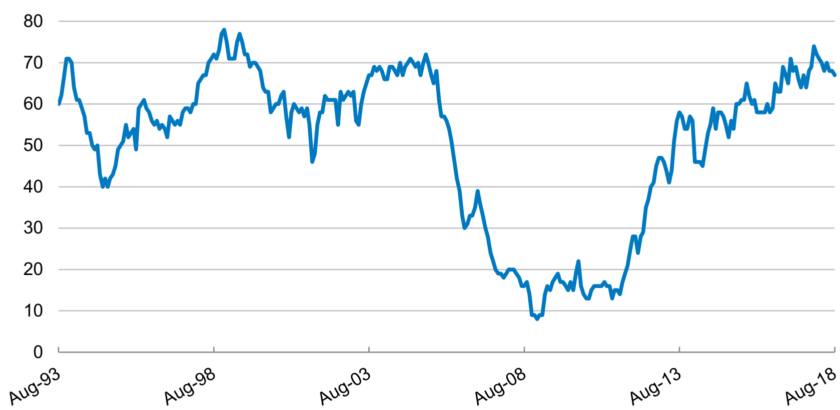
To the extent all of these tariffs actually go into place, we would expect the real economic effects to increase somewhat gradually but eventually become meaningful – dampen capital expenditure, dampen consumer sentiment, and raise prices.

Exhibit 1 » Housing Affordability Index



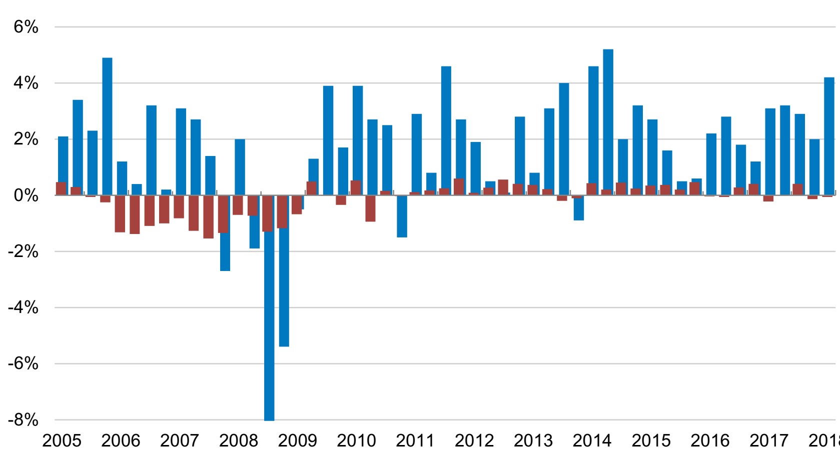
Source: Bloomberg Financial, Bureau of Economic Analysis, BMO Wealth Management Strategy

Exhibit 2 » National Association of Home Builders Market Index



Source: Bloomberg Financial, National Association of Home Builders, BMO Wealth Management Strategy

Exhibit 3 » Residential Investment Contribution to GDP



Source: Bloomberg Financial, BEA, BMO Wealth Management Strategy

record of providing advanced warning for turns in the housing market, it's an economic indicator we follow closely. Finally, while housing's contribution to GDP growth is likely to hover around zero in the quarters to come ***(Exhibit #3)***, other drivers of the U.S. economy, including consumer spending and business capital expenditures, are picking up the slack. A more neutral impact of housing on the economy may even be a welcome development, as it may soften inflation readings and avoid contributing to overheating or labor market tightness. A balanced market is just fine.

As for mortgage financing, current 30-year fixed mortgage rates are in the 4.5% range – up about 1% since 2016, but below the 20-year average of about 5.4%. Earlier this year, Home Depot stated that mortgage rates could increase to 7% before housing affordability becomes an issue! That strikes us as an excessively benign assessment, but another 50 or 75 basis points increase in mortgage rates is unlikely to change the equation much.

Domestic

Beyond a neutral housing environment, the U.S. economy continues to exhibit signs of strength. Recent Institute of Supply Management (ISM) surveys, both manufacturing and non-manufacturing, posted strong results ***(Exhibit #4)***. Consensus GDP forecasts for the third quarter continue to sit above 3%, and capital expenditures in the U.S., a positive theme of ours coming into 2018, remain firm ***(Exhibit #5)***. The labor market also continues to be a bright spot and job creation has continued apace in recent months.

One area of nascent concern is increasing wage pressures. In the August jobs report, annual wage growth came in at 2.9%, which at the time of release sent the yield on the 10-year treasury up close to 3%. To put this wage growth number in context, we believe that the economy can digest wage growth of about 3.5% without meaningfully cutting into corporate profit margins. How do we arrive at this estimate? With inflation expected to track around 2%, corporations should realize similar price increases, albeit spread unevenly across different sectors and companies. If productivity growth can add another 1.5%, then we get to a comfortable 3.5% range where profit margins are not impacted significantly by wage growth. Productivity has accelerated recently, and while the year-over-year reading is 1.3%, the recent acceleration, if maintained and annualized, would lead to labor productivity growth well over 2%. Given these trends, we believe that 1.5% labor productivity growth is an achievable and sustainable number, which will enable companies to digest these wage increases more easily.

Armed to the teeth for a trade war … or so it would seem

These positive U.S. economic trends, however, have an additional implication. It is likely that President Trump feels armed to the teeth when pushing his trade agenda and exerting pressure on our trading partners in the form of tariffs or threatened tariffs. The trade situation with China is about to enter a new, more serious, phase as 25% tariffs on $200 billion of imports gets implemented. Beyond that, President Trump recently added, "… there is another $267 billion ready to go on short notice if I want." It is definitely a high-pressure strategy. President Trump also continues to call for 25% tariffs on imported autos, which would hit the pocketbooks of German and Japanese companies … and of U.S. consumers who happen to need to buy a car.

To the extent these tariffs actually go into place, we would expect the real economic effects to increase somewhat gradually but eventually become meaningful – dampen capital expenditure, dampen consumer sentiment, and raise prices. To be sure, we expect that these effects would be more pronounced internationally than in the U.S., which our current positioning reflects. It's a dangerous gambit in this interconnected world economy. While President Trump may feel armed to the teeth, the Northern Front (Canada), Atlantic Front (Europe), and Far Eastern Front (China) are all open. Our expectation is that an agreement on those first two fronts will take place well before the third one.

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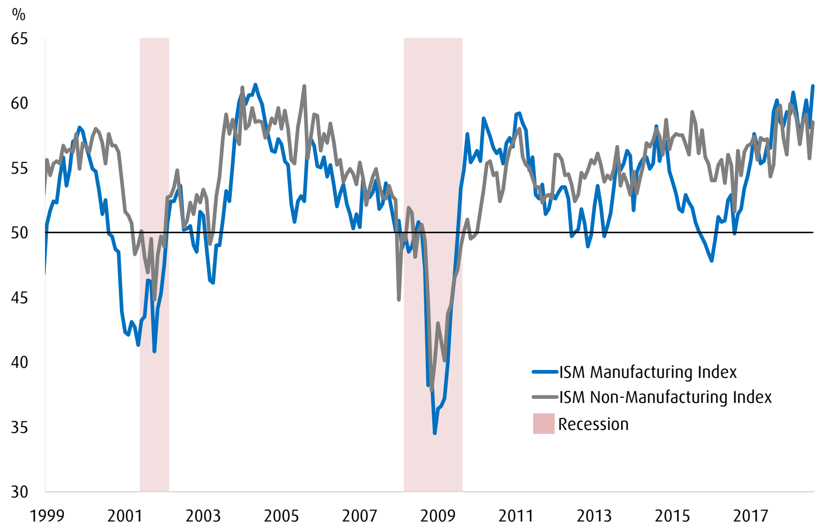
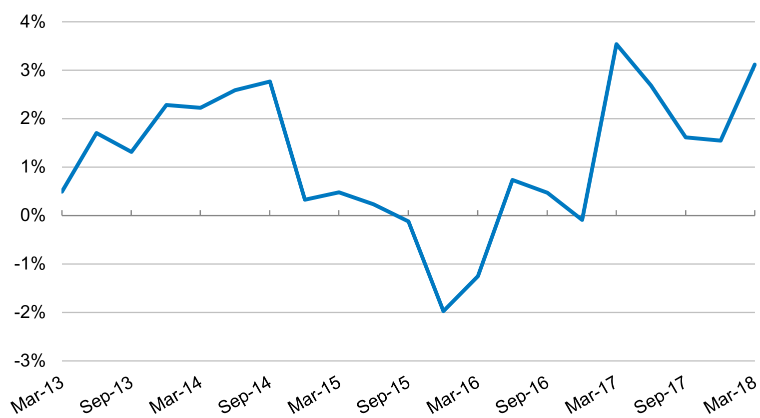
Exhibit 4 » Services vs. "Things" Domestic U.S. Economy



Source: Bloomberg L.P., Institute for Supply Management, BMO Wealth Management Strategy

Exhibit 5 » Quarterly Change in Gross Fixed Asset Capital Formation



Source: Bloomberg Financial, Bureau of Economic Analysis, BMO Wealth Management Strategy

[1] https://www.nahb.org/en/research/housing-economics/housings-economic-impact/housings-contribution-to-gross-domestic-product-gdp.aspx

[2] See Benjamin, Chinloy, and Jud, 2004, "Real Estate Versus Financial Wealth in Consumption," Journal of Real Estate Finance and Economics, and also Carroll, Otsuka, and Slacalek, 2011, "How Large are Housing and Financial Wealth Effects?", Journal of Money, Credit, and Banking

[3] Min Zhu, IMF Deputy Managing Director, 2014, "Housing Markets, Financial Stability and the Economy"

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Chief Investment Officer & National Head of Investments
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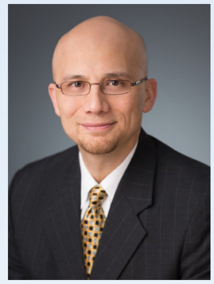
As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments 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.



Yung-Yu Ma, Ph.D.
Chief Investment Strategist
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As Chief Investment Strategist, Yung-Yu 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-Yu 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-Yu 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.

Dr. Ma earned his Ph.D. in Finance at the University of Utah and his B.A. in Economics and Political Science, *magna cum laude*, at Williams College.

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

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