October Outlook for Financial Markets

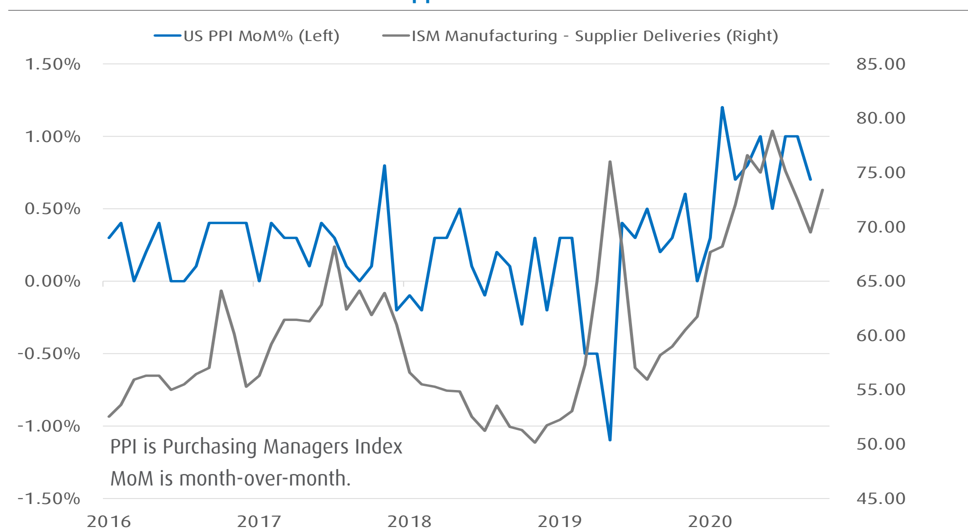
Stickier inflation, Fed tightening and slowing growth

"One of our worst traits in journalism is that when we have a narrative in our minds, we often plug in anecdotes that confirm it. Thus, we managed to portray President Gerald Ford, a first-rate athlete, as a klutz."

– Nicholas Kristof

A narrative on the U.S. economy is starting to take shape. It is one of stickier inflation, Fed tightening, slowing growth, and an equity market presumably priced for a type of perfection that has all but faded from view. The visual of stockpiled cargo containers reinforces the reality that supply chains are getting worse, not better, and producer prices increasing at almost 1% per month implies continued inflation "in the pipeline" ***(Exhibit #1)***. As with most narratives, the more it takes hold, the more it becomes the lens through which other developments are interpreted. We have been messaging an expectation of a balanced market for several months now, and equities have seen more ebb than flow of late. It is important to note, however, that just because a narrative is forming doesn't mean it has staying power.

Exhibit 1 » U.S. Producer Prices and Supplier Deliveries



Source: Bloomberg, Bureau of Labor Statistics, Institute of Supply Management, BMO Wealth Management

Executive Summary

The market narrative of stickier inflation, damaging Fed tightening, and slowing growth may loosen its grip in coming months

The equity market has historically performed well in the early and even middle phases of Fed tightening cycles

Supply chain issues remain severe, but healthy business spending and consumer spending should support growth while the supply knots gradually untie

Longer-term interest rates – an important factor in equity valuation – would have to rise sharply from current levels to result in extreme equity overvaluation

High levels of inflation are indeed likely to persist for a few more quarters, but what is more important is that inflation begins to show signs of peaking – which we expect to materialize in early 2022. This should give the Fed breathing room to stay reasonably patient on expectations for future interest rate increases. We will get updated readings on the Fed's leanings at both the November and December meetings, although only December will have a formal updated set of projections. Projections from prior quarters pulled forward the expected timeline for future interest rate increases, but not aggressively so. In general, it is important to note that the equity market has historically performed well in the early and even middle phases of Fed tightening cycles.

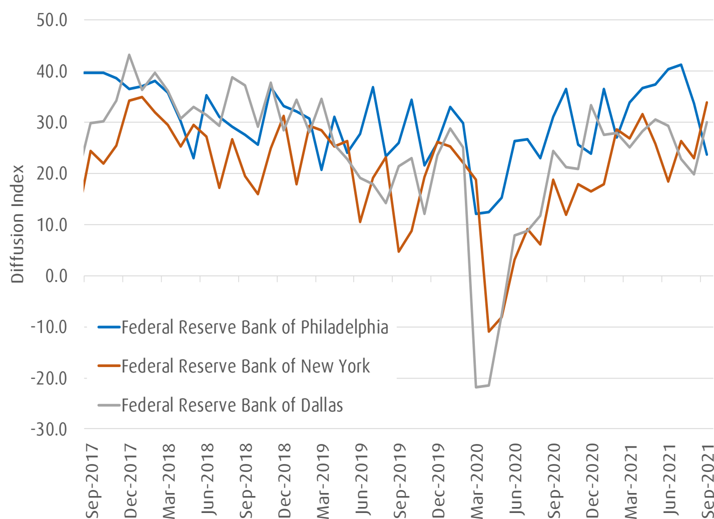
That positive equity market performance – despite interest rate headwinds – has usually come from continued economic and earnings growth. While today's supply chain issues could lower earnings estimates by a few percentage points, if this effect is limited to 2022 then the impact on equity valuations should be quite minor. Early indications from Q3 earnings season indicate the impact, in aggregate, may not be large even if certain individual companies experience bigger hits (see Q3 Earnings Preview special section). As 2022 gradually unties these supply chain knots, the fundamentals of a healthy job market and favorable wage growth should support consumer spending. Additionally, expectations for business spending continue to look robust ***(Exhibit #2)***.

It is also important to recognize that slowing growth caused by supply constraints is much better than having a period of demand softness. At a macro level, U.S. GDP is now above pre-pandemic levels. The total number of people employed compared to the pre-pandemic period, however, is still running at a deficit of five million. It's a staggering number that pushes total employment levels all the way back to 2017. But the current GDP-to-total employment relationship speaks to earnings and profit margins remaining elevated.

While we do not dismiss a more malignant market narrative, we do believe it lacks staying power. For one, downside follow-through in equity markets is typically preceded by high-yield debt spreads increasing markedly (that spread being the interest rate on junk bonds in excess of that on high-quality bonds). While no indicator is perfect, the current environment shows nothing of the sort ***(Exhibit #3)***. Additionally, it is unclear that the Fed will become increasingly hawkish or that earnings will surprise to the downside in coming quarters. Growth is slowing; that is well established. It is not, however, grinding to a halt as images of anchored cargo ships might lead one to believe.

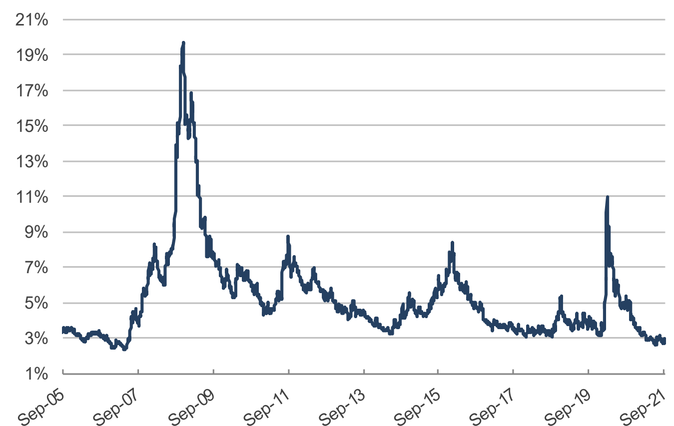
In recognition of the ongoing uncertainty, however, we have recently made a shift in tactical positioning to bring emerging market equities to neutral (from overweight) in favor of an allocation to U.S. REITs ("Real Estate Investment Trusts"). Historically, REITs have performed well in periods of above

Exhibit 2 » Future Capital Expenditures



Source: Federal Reserve Bank of Philadelphia, Federal Reserve Bank of New York, Federal Reserve Bank of Dallas ; BMO Wealth Management Strategy

Exhibit 3 » High Yield Spread (Option-adjusted)



Source: Bloomberg

average inflation, and several large REIT industries such as the Industrial, Infrastructure, Data Center, and Residential areas have considerable pricing power and growth prospects. At the margin, this change is risk-reducing for portfolios. While emerging market risks are similar to those in the U.S. – global growth trends, inflation, higher interest rates, and a Chinese growth slowdown – emerging markets are likely to have greater sensitivity in downside scenarios.

As for the final element of the current market narrative – extreme equity valuations – our models point to modest, not extreme, overvaluation. It is worth noting that these models are sensitive to the level and path of longer-term interest rates, and we have already considered increases in coming years. Interest rates would have to rise sharply from their current range before equity valuation levels would warrant a position change. In sum, it's not that the current market narrative has no possibility of becoming an economic reality in 2021; it's just premature to assume those pieces are all going to fall into place.

SPECIAL SECTION

Q3 2021 Earnings Preview: Supply chain kink in the outlook October 2021

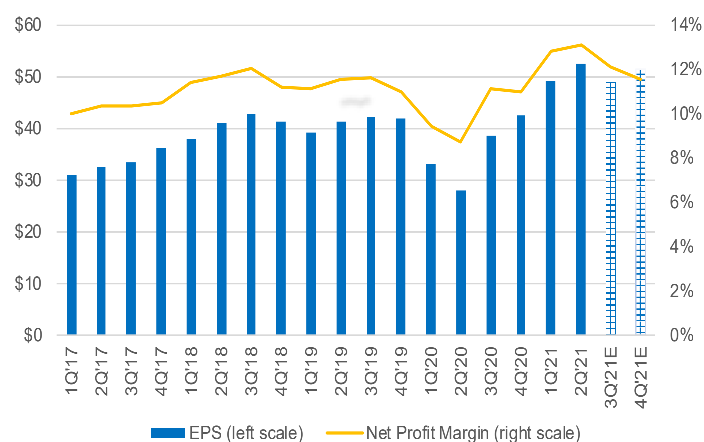
With the Q3 earnings season kicking off, investors will be paying close attention to how companies are navigating the myriad of supply chain issues and other cost pressures. While investor expectations are lower than they were three months ago, stocks may struggle to move higher in the near term as investors readjust to less extreme earnings relative to previous quarters.

For Q3, S&P 500 earnings per share are expected to grow 27% (per Refinitiv) – a far cry from the 88% increase last quarter. This quarter, we have tougher year-over-year comparisons combined with unrelenting cost pressures. Of the roughly two dozen S&P 500 companies that have reported at the time of this writing, 76% have beaten on earnings, which is favorable relative to the historical average of ~70%, but well below the beat rate for the last few quarters.

On recent earnings calls, company managements have been almost universally positive regarding the demand environment. That enthusiasm, however, has been offset by cautious commentary around supply chain challenges and other cost pressures. Some sectors, such as Consumer Discretionary, have seen estimates decline recently as they are more susceptible to rising energy and raw material costs, component shortages, clogged logistics networks, and wage inflation. On the other hand, sectors such as Energy and Materials have seen estimates increase as they benefit from rising commodity prices. Additionally, some areas such as Semiconductors have been able to pass along higher costs to their customers, but a higher level of earnings misses are possible for companies with less pricing power.

Currently, Wall Street analysts forecast that cost pressures will cause S&P 500 net profit margins to decline from a record 13.1% in the last quarter to around 12.1% in the third quarter, and a bit below that by yearend ***(Exhibit #4)***. For 2022, analysts are now calling for 10% earnings growth, but that is down from 12% three months ago. Such declines are typical as the new year approaches, but acceleration to the downside in these estimates – should it occur – might indicate more lasting challenges.

Exhibit 4 » S&P 500 Quarterly EPS and Net Profit Margins



EPS is Earnings Per Share

Source: I/B/E/S data from Refinitiv (as of 10/8/21)

Michael Stritch, CFA®
Chief Investment Officer and
National Head of Investments
BMO Wealth Management - U.S.

Yung-Yu Ma, Ph.D.
Chief Investment Strategist
BMO Wealth Management - U.S.

Michael Stritch, CFA®
Chief Investment Officer and National Head of Investments BMO Wealth Management – U.S.

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 BMO Wealth Management – U.S.

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 children's teams.

To view this piece, and other articles online, please visit us at **wealth.bmoharris.com/insights/**

Corporate Office: 111 W. Monroe Street, Chicago, IL 60603

CFA® and Chartered Financial Analyst® are registered trademarks owned by CFA Institute.

"BMO Wealth Management" is a brand name that refers to BMO Harris Bank N.A. and certain affiliates that provide certain investment, investment advisory, trust, banking and securities products and services. Investment Products are:

Not Insured by FDIC or Any Other Government Agency | Not BMO Harris Bank Guaranteed | Not BMO Harris Bank Deposits or Obligations | May Lose Value

BMO Bank is a brand name used in the United States by BMO Harris Bank N.A. Member FDIC. Not all products and services are available in every state and/or location.

BMO Private Bank may have a material fiduciary, lending, or other banking relationship with any Company mentioned above or any of their affiliates, however, applicable laws, regulations and policies prohibit the disclosure of such relationship to employees who are not directly involved, as well as external disclosure without client consent.

The research analysts who contributed to this report do not know if BMO Harris Bank N.A. or its affiliates have any significant relationship with any Company mentioned above. BMO Capital Markets, an affiliate of BMO Harris Bank N.A., may from time-to-time engage in underwriting, making a market, distributing or dealing in securities mentioned herein.

Please consult with your advisor for your own personal situation. The research analysts contributing to the report have certified that:

- All the views expressed in the research report accurately reflect his/her personal views about any and all of the subject securities or issues; and
- No part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by him/her in this research report.

The information and opinions expressed herein are obtained from sources believed to be reliable and up-to-date; however, their accuracy and completeness cannot be guaranteed. Opinions expressed reflect judgment current as of publication and are subject to change.

Past performance is not indicative of future results. International investing, especially in emerging markets, involves special risks, such as currency exchange and price fluctuations, as well as political and economic risks. There are risks involved with investing in small cap companies, including price fluctuations and lower liquidity. Commodities may be subject to greater volatility than investments in traditional securities and pose special risks. Investments in commodities may be affected by overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes, and international economic and political developments.

BMO Family Office is a brand delivering family office services and investment advisory services through BMO Family Office, LLC, an investment adviser registered with the U.S. Securities and Exchange Commission; investment management services, trust, deposit and loan products and services through BMO Harris Bank N.A., a national bank with trust powers; and trust services through BMO Delaware Trust Company, a Delaware limited purpose trust company. BMO Delaware Trust Company does not offer depository, financing or other banking products, and is not FDIC insured. Not all products and services are available in every location. Family Office Services are not fiduciary services and are not subject to the Investment Advisors Act of 1940 or the rules promulgated thereunder. Investment products and services: **ARE NOT A DEPOSIT – NOT INSURED BY THE FDIC OR ANY FEDERAL GOVERNMENT AGENCY – NOT GUARANTEED BY ANY BANK – MAY LOSE VALUE.**

Capital Advisory Services are offered by a division of BMO Harris Bank N.A. NMLS #401052

If you no longer wish to receive email messages promoting or advertising our products or services, please reply to the email with the words 'Opt Out' in the subject line, and we will process your request. Please allow ten business days to process your request. Please note that even if you choose not to receive email messages promoting or advertising our products or services, you may continue to receive information specifically related to your BMO Harris Bank N.A. accounts.

BMO and BMO Financial Group are trade names used by Bank of Montreal.

© 2021 BMO Financial Group. All rights reserved

C-11# 13694786
Written: October 14, 2021