Outlook for Financial Markets

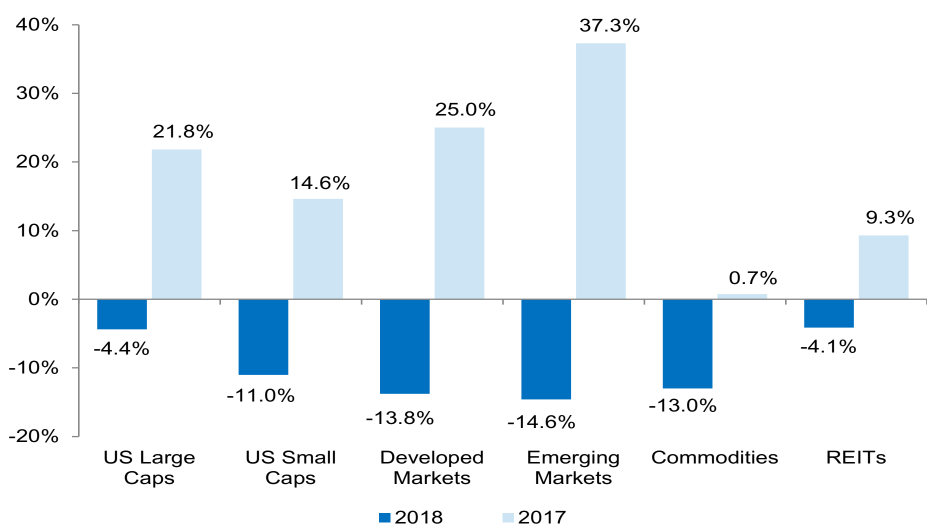
Market outlook: Resetting expectations

"When one's expectations are reduced to zero, one really appreciates everything one does have."
– Stephen Hawking

Volatility returns

A lot can happen in twelve months, and 2018 was certainly no exception. Fresh off the heels of the most sweeping changes to the tax code in decades, the year started with high expectations for the economy and for equity investors. In a world that now seems long forgotten, recall the S&P 500 rallied 5.6% last January alone on the back of rising growth prospects, robust business spending plans, and a strong consumer sentiment. This stands in stark contrast to a gloomier December that saw large cap equities fall 9.0%, bringing to a close one of the more challenging years in recent memory. As ***Exhibit #1*** demonstrates, there was little place to hide in 2018, with major equity markets registering across-the-board declines. Compare this with the exceptionally strong 2017 results, and the sharp reversal becomes even more dramatic.

Exhibit 1 » Equity and Commodity Performance Through December 2018



Source: BMO Wealth Management, BMO Private Bank. Indices = S&P 500® Index, Russell 2000® Index, MSCI EAFE, MSCI Emerging Markets Index, Bloomberg Commodity Total Return Index, FTSE NAREIT All Eq REITs Index.

Executive Summary

Harsh December caps difficult year for global equities

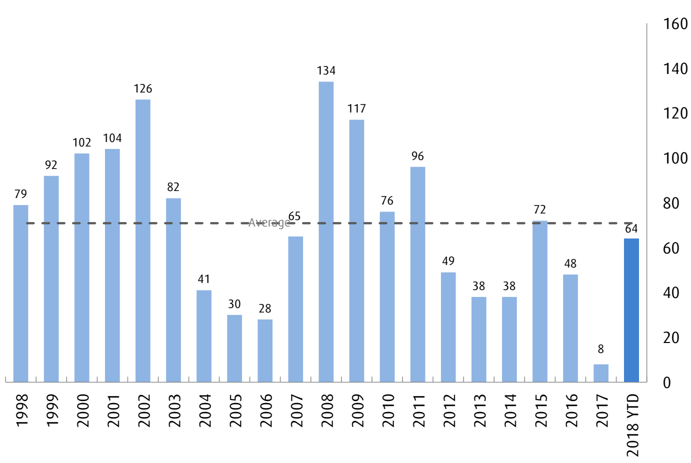
Volatility is a two-sided measure, and large positive days have a meaningful impact on long-term results

A transition to a slower growth regime is underway, but negative sentiment may have gone too far

The Federal Reserve stance has softened, though a larger pivot may be required

Volatility also came back with a vengeance in 2018, and those expecting a continuation of 2017's historic tranquility were surely caught by surprise. One simple measure of market fluctuation involves looking at the number of daily 1% moves over time. ***Exhibit #2*** details this for the S&P 500 back to 1998. Interestingly, while last year may have seemed excessively volatile (in particular during February and December), the number of overall days having a greater than 1% move was still below the 20-year average. However, as can also be seen from the graphic, the number of days was up sharply relative to 2017. We cautioned that the 2017 levels were unlikely to persist, and indeed believe that more "average" volatility should continue into 2019.

Exhibit 2 » S&P 500: Number of Trading Days Closing
with a Move of +/- 1% or More



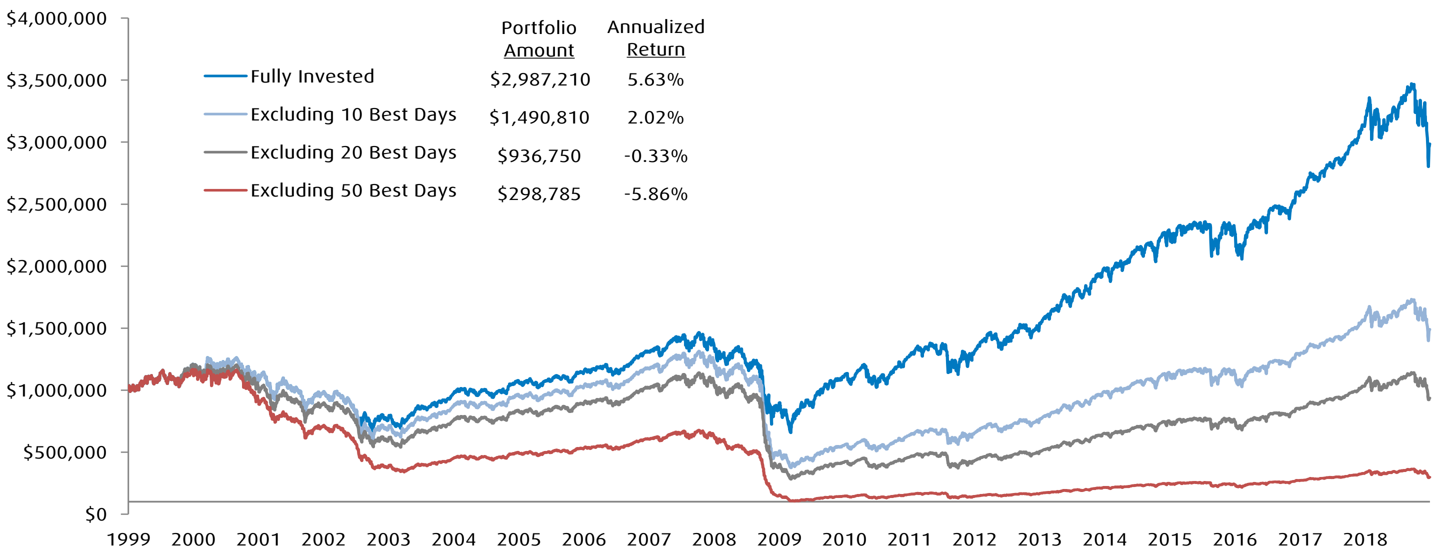
Source: Bloomberg; BMO Wealth Management Strategy

Of course, it is important to note that volatility is a two-way street. While we tend to feel it more on the downside, large positive days also have a meaningful impact on long-term results. In fact, as ***Exhibit #3*** demonstrates, missing the ten best S&P 500 days since 1999 would have cost over 3.6% in total annualized return (e.g. 5.63% - 2.02%), and missing the top 50 would have shaved a whopping 10%+ off the fully invested result. The moral of the story: create a prudent plan and stick to it during times of heighted uncertainty. Missing even a small number of days can have a significant impact on long-term objectives.

Economic backdrop

We started 2018 enthusiastic about global growth prospects and the backdrop for equities. We did, however, identify several risks including the prospect for rising interest rates, slowing Chinese growth, and a resurgence of trade tensions. While we felt none of the aforementioned issues alone seemed likely to cause a significant headwind for equities, it was acknowledged that the cumulative impact did have the potential to be disruptive, particularly outside the U.S. With this in mind, over the course of the year, we gradually reigned in our international overweight and marginally reduced overall portfolio risk. This proved beneficial, but U.S. equity and credit positions were hit hard in December as expectations for economic growth stumbled and the Federal Reserve stood firm on future interest rate hikes.

Exhibit 3 » Performance of $1,000,000 Invested in the S&P 500 - 20-Year Trailing Data Ending on December 31, 2018

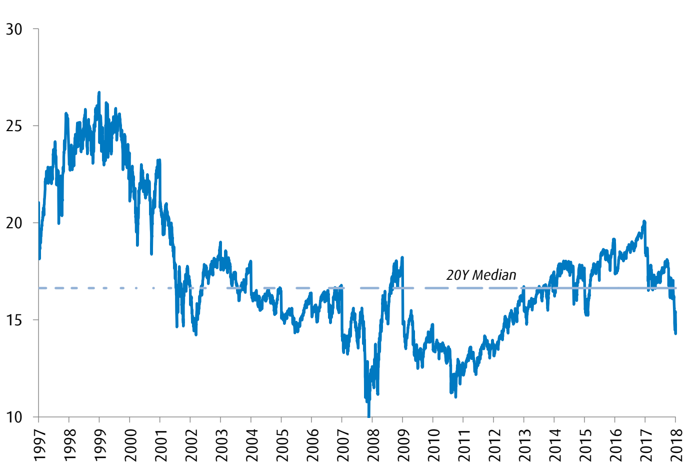


Source: Bloomberg; BMO Wealth Management Strategy

Have expectations come down too far? There is a strong case to be made that they started too high in early 2018, and now may have swung too far in the other direction. Real GDP will slow in 2019, but a robust labor market suggests that consumption should remain strong, and the fiscal tailwind from last year's budget deal will continue. There is even the possibility of additional government spending via an infrastructure bill, though we put the odds at still slightly below 50%. True, consumer confidence did show a decline in December, but the Current Conditions Index (our preferred measure) registered little slippage. In addition, Mastercard reported that holiday sales increased a robust 5.1% through December 24th. While this figure could prove the high watermark for spending growth, it does not suggest that stock market wobbles have yet curtailed consumer spending. And let's not forget the continued tax law tailwind expected in 2019. To date we have seen estimates indicating anywhere from an additional \$70-\$85 billion in federal income tax refunds to be paid this year above those distributed in 2018. This, along with solid wage growth, should buffer consumers.

On the corporate side, S&P 500 earnings are currently projected to grow between 5% and 7% in 2019, implying an approximate 14.7x forward price-to-earnings ratio ***(Exhibit #4)***, which is below the 20-year median of 16.6[1]. Our more comprehensive valuation metric is also now signaling an attractive position for domestic large-cap equities for the first time in over two years. Of course, forward valuation indicators are based on future growth expectations, and thus subject to revision. Even if estimates are lowered to flat year-over-year growth, valuation would still be below long-term averages.

Exhibit 4 » S&P 500 Forward Price / Earnings History
Trailing 20-year daily data as of January 4, 2019

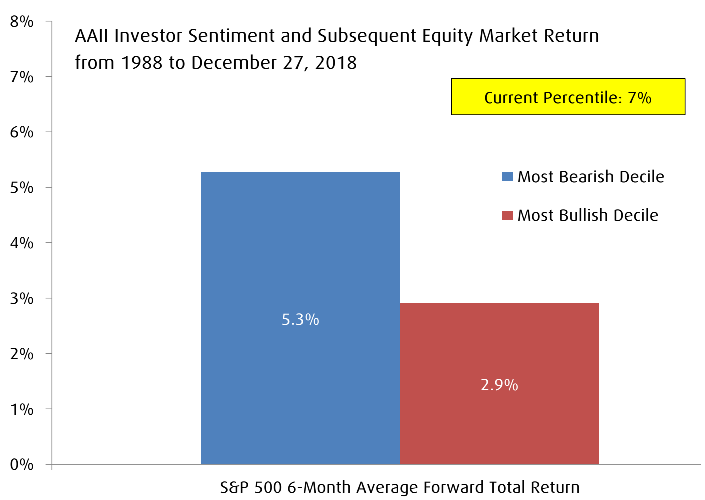


Source: Bloomberg; BMO Wealth Management Strategy

[1] Bloomberg, data as of January 4

From a market sentiment perspective, investor expectations have also fallen dramatically these past few weeks, and by some measures now stand close to all-time lows. The American Association of Individual Investors poll registered one of the most bearish readings on record, with the percentage of bulls relative to total respondents in the bottom decile of historical results. As followers of our metrics know, investor psychology is a contrarian indicator when it comes to future performance. History suggests higher returns on average over the next six months when expectations have previously fallen so low ***(Exhibit #5)***.

Exhibit 5 » Current Sentiment in Most Bearish Decile



Source: AAII; S&P; BMO Wealth Management Strategy

Going Forward

Our view remains that this selloff represents a normal correction within the context of a later-stage economic expansion; though we caution that more choppiness likely lies in front of us as several key issues come to a head in early 2019. We will continue to watch closely for signs that our "slow and steady" 2019 growth story could be faltering, and will also be intently observing the Federal Reserve. Since 1984, there have been six market corrections without recessions. All six ended with central bank easing, and we expect a further softening of the Fed's stance will be required in this instance as well.

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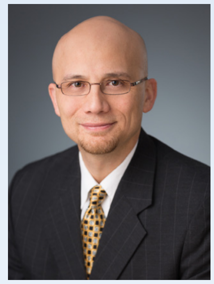
As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments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

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