Outlook for Financial Markets

"There's no place like home. There's no place like home. There's no place like home."

– Dorothy, Wizard of Oz.

Beneath the headlines...

You might not realize it based on the concern reflected in daily headlines, but the U.S. economic data continues to come in positively. The June jobs report showed that 213,000 jobs were created for the month, and a jump in new entrants into the labor force put the 12-month average at over 160,000 new entrants per month. All those "Help Wanted" signs you see while driving around have a collective effect on the economy. Those new entrants have helped to contain wage pressures which, based on average hourly earnings, are up a modest 2.7% year over year. Average weekly earnings are up about 3% on the year, so the average person is also working longer hours. The "sweet spot" for the markets is probably right around a 3% average wage increase, which allows for real wage growth after inflation but does not cut into profit margins meaningfully. Inflation readings show that prices are firming, but not roaring ahead. The Core PCE (personal consumption expenditures) index, the Fed's preferred measure of inflation, is running about 2% year over year ***(Exhibit #1)***.

At the business level, recent Institute for Supply Management (ISM) readings also point toward positive U.S. economic trends. Manufacturing and non-manufacturing readings both showed some upside, surprise recently, coming in at 60.2% and 59.1%, respectively. In both cases, the "New Orders" component was a positive standout. Similarly, surveys of future capital expenditures by business continue to point upward ***(Exhibit #2)***. At the consumer level, the housing market looks healthy as evidenced by the National Association of Home Builders survey, which continues to post elevated readings. Consumer sentiment also remains high ***(Exhibit #3)***. And, last but certainly not least, according to FactSet, corporate earnings and revenue expectations for Q2 are expected to come in up 20% and 8.7% year over year, respectively. Further, the negative guidance that typically precedes the reporting season is well below its 5-year average.

Executive Summary

Labor markets in the U.S. remain strong and wage inflation pressure has stayed within range

Leading indicators and corporate earnings trends in the U.S. are positive

Tariffs and trade concerns may cause continued turbulence in the markets

The yield curve is an important indicator, but the 10-year minus 3-month Treasury spread is still a meaningful distance away from inverting

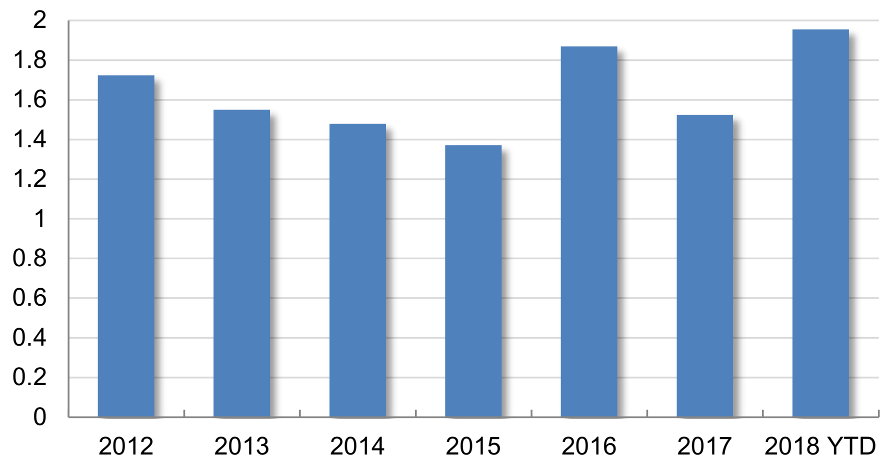
Of course, these economic developments are not happening in a vacuum. The U.S. is digging in on trade in a way that has surpassed most expectations. The China tariff tit-for-tat is in full swing (see our recent piece, Wartime president?), and even U.S. trade relations with allies such as Canada and the E.U. look to be pushed harder than originally anticipated. There's potential for pain and disruption to be spread across the globe, slowing economies and increasing prices. It's not clear skies and sunny. It's turbulence, seat belts fastened, but trying to barrel ahead nonetheless.

Our take on the yield curve

The shape of the yield curve, or the yield spread that subtracts a shorter-term Treasury rate from a longer-term Treasury rate, has become quite a hot topic in the financial media. It's important to note that different people reference different yield spreads. The 10-year minus the 2-year rate is common, as is the 10-year minus the 3-month rate. A recent study by the San Francisco Federal Reserve[1] showed that every recession since 1955 has been preceded by an inverted yield curve, and that the beginning of the recession has ranged from 6 to 24 months following an inversion. The downturn-predicting track record of the yield curve is, in a word, stellar.

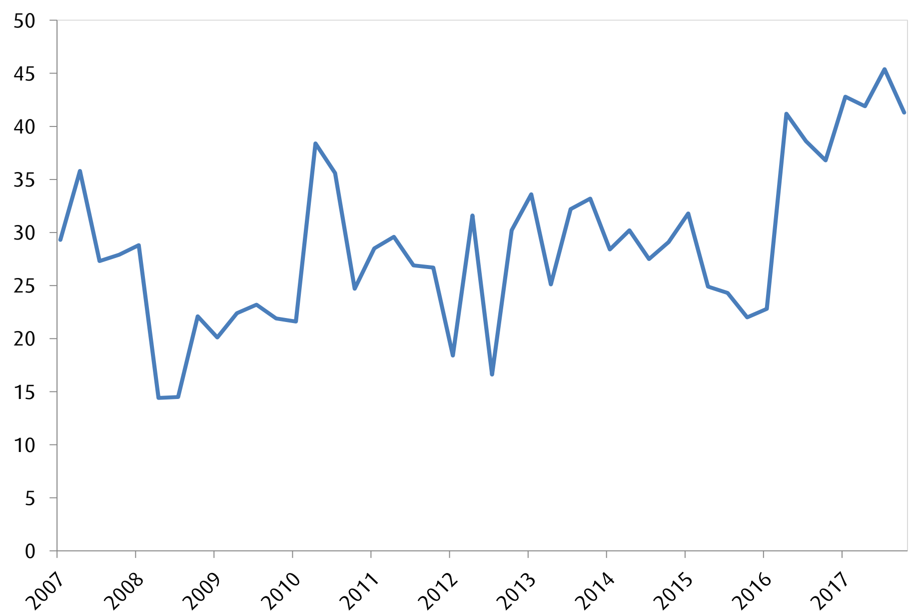
The San Francisco Fed's study, however, splits the difference between the two most common yield spread measures and instead uses the 10-year minus the 1-year rate. Given that the 10-year minus the 2-year yield spread is only 29 basis points as of late July, whereas the 10-year minus the 3-month yield spread is 94 basis points, the difference is significant ***(Exhibit #4)***. The New York Fed has also developed a recession prediction model based on the 10-year minus the 3-month rate, and it currently shows only a 12.5% probability of a recession by June of 2019.

Exhibit 1 » U.S. Core PCE (YoY %)



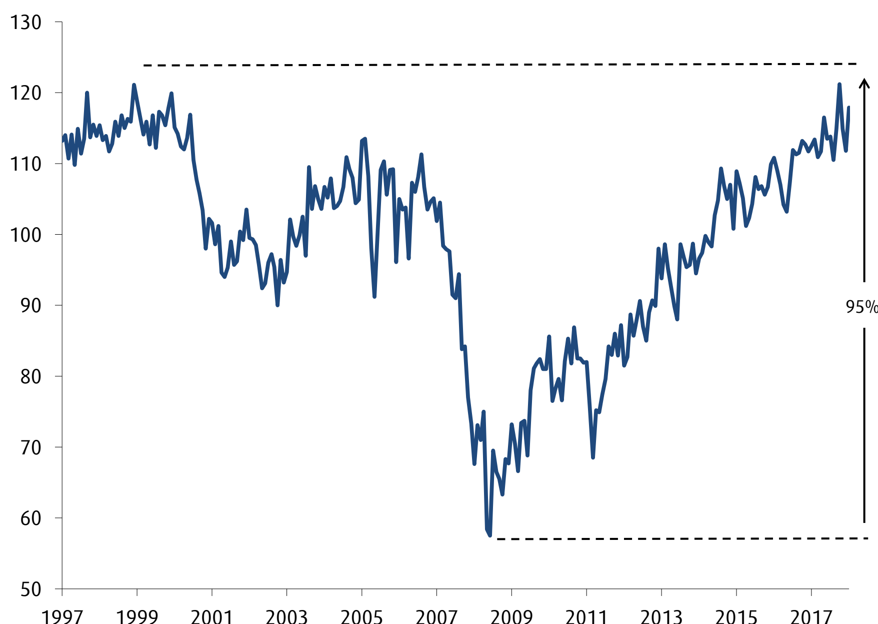
Source: : Bloomberg Financial

Exhibit 2 » Philadelphia Fed Survey CapEx Plans



Source: Philadelphia Federal Reserve; BMO Wealth Management Strategy

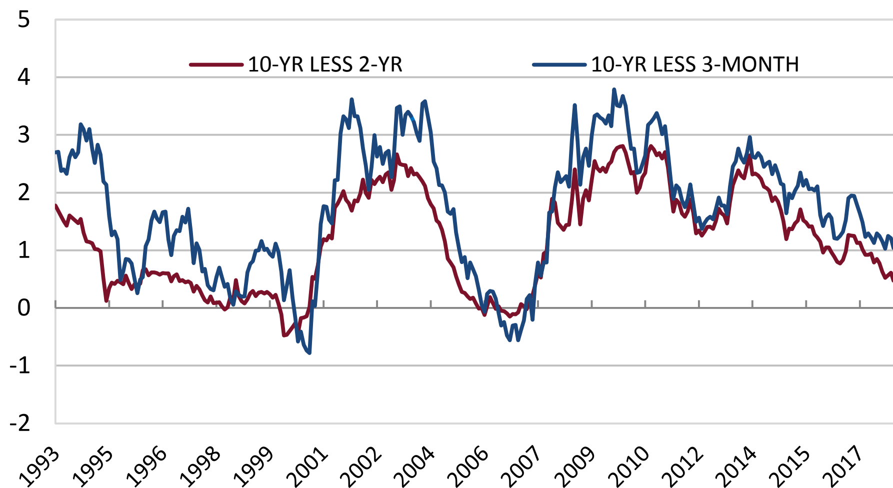
Exhibit 3 » Current Economic Conditions Index



Source: University of Michigan, BMO Wealth Management Strategy

We also favor the use of the 10-year minus the 3-month rate (rather than the 10-year minus the 2-year rate) for multiple reasons. First, that difference between the 3-month rate and the 2-year rate will incorporate a signal of coming economic activity that will be lost if the first two years of the yield curve are excluded. Second, to the extent that a flat or inverted yield curve decreases banks' incentive to lend, this effect should be more directly related to the short-term return that banks are able to receive. At present, this 10-year minus the 3-month yield spread has quite a ways to go before becoming negative. Should that happen in 2019 or beyond, we would not consider it deterministic for the economy or markets and, as usual, would draw on a range of economic and market indicators. That said, as far as individual predictors go, the yield curve is as important a consideration as any.

Exhibit 4 » 10-year spreads



Source: : Bloomberg Financial

[1] https://www.frbsf.org/economic-research/publications/economic-letter/2018/march/economic-forecasts-with-yield-curve/?utm_campaign=JM-305&utm_medium=ED&utm_source=for

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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.

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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 sons' teams.

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