Outlook for Financial Markets

Walk the Line

"I keep my eyes wide open all the time."
– Johnny Cash

The U.S. and global economies face an environment ripe with extreme conditions. Inflation is at the highest levels in decades, the Federal Reserve ("Fed") is signaling an aggressive path, the labor market faces historic tightness, China's COVID-19 lockdowns threaten supply chains, and the war in Ukraine along with sanctions on Russia – add to risk and commodity price pressures. The history of Fed rate hike cycles is particularly uninspiring, with most culminating in recession rather than soft landing. Despite these risks, we still see the U.S. economy walking a line of modest growth, easing inflation, and favorable labor market strength throughout the remainder of 2022.

Looking at the four most recent Fed rate hike cycles – 1994, 1999, 2004, and 2016 – the middle two ended in recession but the first and last did not. Distinguishing features of the 1999 and 2004 cycles were the considerable economic imbalances that needed to be unwound, which resulted in the slowdowns feeding on themselves and spiraling into recession. At present, the good news is that such economic imbalances, at either the corporate or consumer level, are not large. The caveat, and why recession risk looking out into 2023 remains elevated, is that the Fed is fighting strong inflationary pressures and there is greater-than-normal risk of over-tightening.

Executive Summary

The U.S. and global economies face a number of challenges, but fortunately consumer and corporate imbalances are not prominent, and the labor market is historically strong

Expected inflation moderation is being pushed against by China's COVID-19 lockdowns and commodity pressures

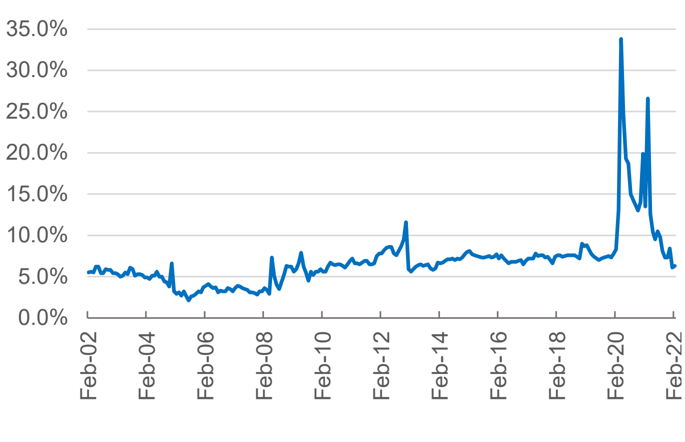
The path to a soft landing depends on inflation moderating in coming quarters; some early signs are encouraging but still a long, long way to go

Short-term interest rates look fairly priced, and longer-term interest rates will be in a tug-of-war between moderating growth putting downward pressure and Quantitative Tightening ("QT") putting upward pressure on rates

Positives

The biggest positives for the U.S. economy are the historically strong job market and expected stability in consumer spending. Currently there are approximately 1.7 job openings for every person seeking work, which is unprecedented. Similarly, the weekly initial claims for unemployment benefits have been hovering at a 50-year low despite the labor force having grown considerably over this time. Consumer spending is no doubt strained for some due to inflation, but at the aggregate level the pandemic-era rise in savings – coupled with rising home values and equity holdings – provides a healthy cushion for ongoing spending. Although the personal savings rate is slightly below pre-pandemic levels, it is considerably higher than the handful of years preceding the 2008-2009 Financial Crisis ***(Exhibit #1)***. Even with some moderation in the growth rate of the economy, the labor market should remain healthy and consumer spending should hold up.

Exhibit 1 » Personal Savings Rate



Source: Federal Reserve, BMO Wealth Management

Risks

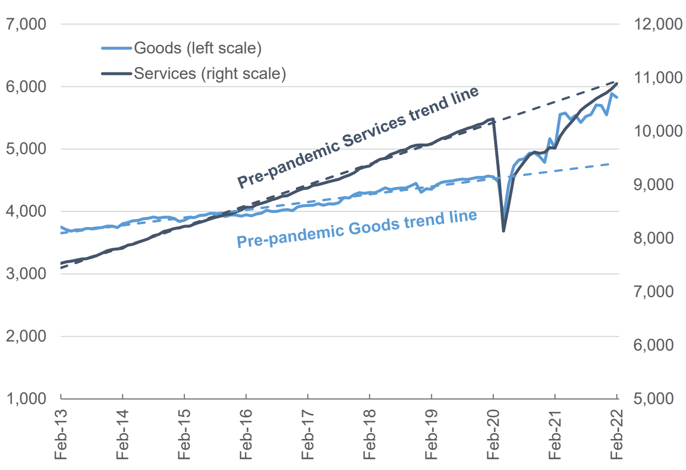
The biggest risk continues to be elevated inflation that pushes the Fed to raise interest rates and tighten financial conditions more than anticipated. While we believe the economy can withstand the current interest rate environment expectations for Fed tightening, should longer-term rates, including mortgage rates, shoot up dramatically – that could slow growth considerably. However, we do believe the housing market will remain stable even if mortgage rates rise another percent to about 6% on a 30-year fixed mortgage – much beyond that level, however, could present strains.

Related risks are that commodity price pressures once again jump higher due to more forceful sanctions on Russia in the coming months, and the potential for price spikes due to supply chain disruptions that could result if China's COVID-19 lockdowns continue unabated. And, finally, while the U.S. is a relatively insular economy, it is not immune to international developments, and there is potential that a more pronounced slowdown in both Europe and China could drag down U.S. growth as well.

Walking the Line

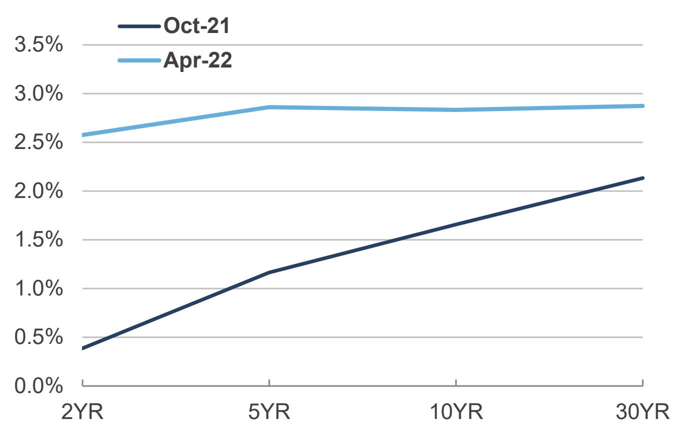
Part of our thesis for stable, albeit modest, economic growth rests on the belief that inflation will moderate in coming quarters. Prices will still rise, on average, but the rate of increase should slow as consumers shift spending from goods to services during the summer months and beyond. Spending on services is just barely approaching its pre-pandemic trendline, whereas spending on goods remains elevated ***(Exhibit #2)***. We believe the shift toward spending on services will allow for inflation in goods to moderate, and the March Consumer Price Index report exhibited some signs of this with prices for used cars falling 3.8% on the month. Since that March report, oil prices have fallen as well.

Exhibit 2 » U.S. Consumption: Goods vs. Services (billions of dollars)



Source: Federal Reserve, BMO Wealth Management

Exhibit 3 » Treasury Yield Curve



Source: Bloomberg

The path to a soft-landing lies with moderating inflation, a Fed that does not slam the brakes on the economy, and international risks that do not result in significantly more damaging outcomes than already anticipated. It is a feasible path, but one that requires wide-open eyes and heightened vigilance.

Interest Rates and the Bond Market

Compared with six months ago, the yields on Treasuries have shot up across the curve ***(Exhibit #3)***. This increase is most pronounced around the 2-year Treasury mark where interest rates have risen over 2% during this time. The sharp rise in yields have resulted in a fall in bond prices, and bonds have struggled in line with the U.S. equity market to begin the year. The worst of the decline in bonds is very likely behind us, and we believe that the "short end" of the yield curve (3 years or less) is the most fairly priced as it incorporates relatively aggressive Fed tightening by year end.

Longer-term interest rates will be driven mainly by two competing forces. Exerting upward pressure on rates, the Fed's imminent balance sheet reduction (known as Quantitative Tightening, or "QT") will play out over several quarters. On the opposite side, moderating growth both in the U.S. and globally could exert downward pressure. It is unclear exactly how these competing forces will balance out, but on net we expect only modestly higher longer-term interest rates by year end that would be unlikely to far exceed 3.5% on the 10-year Treasury. Our best case scenario expects sufficient economic growth to prevent longer-term interest rates from declining from current levels but, as we laid out, the current set of risks – like most extreme or unprecedented events – has heightened the uncertainty.

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

Yung-Yu Ma, Ph.D.

Chief Investment Officer

BMO Wealth Management – U.S.

Yung-Yu Ma is the Chief Investment Officer for BMO Wealth Management in the U.S. and joined the organization in 2016. He brings a dynamic combination of academic achievements and industry experience to the Investment Strategy team. As Chief Investment Officer, he is responsible for guiding strategic and tactical asset allocations for client portfolios and leads a team that conducts macroeconomic and market analysis, and also modeling across asset classes. He is frequently cited in print media including the Wall Street Journal, NY Times, Barron's, etc., and has appeared on NPR, CNBC, and Yahoo Finance television.

Prior to joining BMO, Yung-Yu was a finance professor at Lehigh University, where he taught courses in equities, fixed income, and derivatives. His academic studies have been cited in leading finance journals (including the Journal of Finance), top law journals, the Wall Street Journal, the Handbook of High Frequency Trading, and in the 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 with operations in Hong Kong, Taiwan and Mainland China where he performed financial, macroeconomic, and market analysis for global companies. Later, he served as a regional manager 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 in Massachusetts.

To view this piece, and other articles online, please visit us at uswealth.bmo.com/insights/

BMO | Wealth Management

Corporate Office: 320 S. Canal Street, Floor 12, Chicago, IL 60606

C-11# 14890524

Written: April 26, 2022