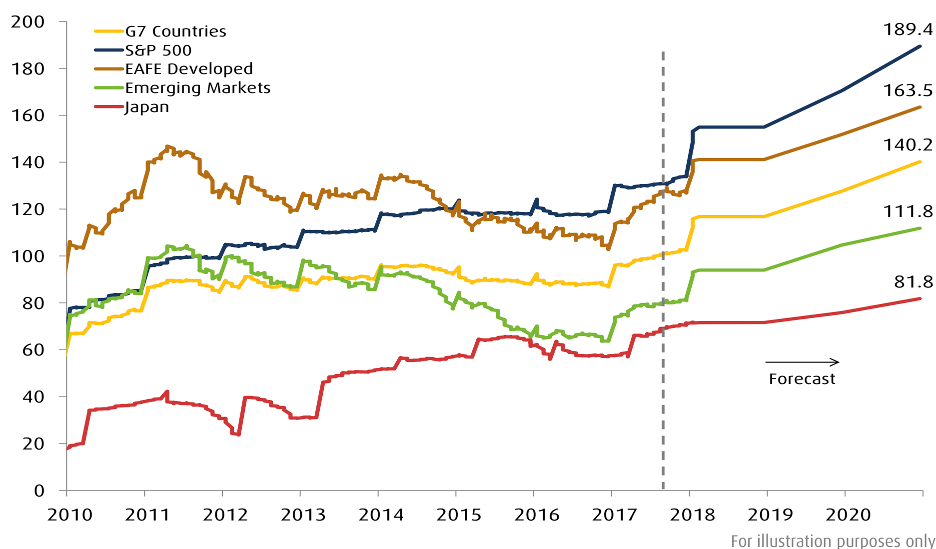
Outlook for Financial Markets

"The key to good decision making is not knowledge. It is understanding."
– Malcolm Gladwell

Economy

Tax cuts – old news. Global synchronized growth – we've been seeing that for a while; more old news. It would be a mistake, however, to treat the economy as we do the news cycle, especially given the market volatility that dominated headlines in early February. Economic forces tend to have long-lasting effects. Business spending already perked up in 2017 after a couple years of malaise. The tax package provides for immediate expensing of capital expenditures for the next five years and should lead to further acceleration of this existing trend. For consumers, the complexity of the tax law and uncertainty as to who gets what, depending on location and deduction elections, almost certainly curbs some of the enthusiasm for what will be on average a large benefit. Politically, perhaps nothing answers the question, "What have you done for me lately?" like a big one-time check signed by the U.S. Department of Treasury. But, a small bump in take-home pay of, say, $35 every two weeks is likely to be spent and recirculated in the economy. The Tax Policy Center estimates that the middle household income quintile will benefit by over $900 per year from the tax cuts. Given that the savings rate in the U.S.

Exhibit 1 » Global Earnings Estimates



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Source: Bloomberg, MSCI, BMO Wealth Management Strategy

Executive Summary

The Tax Policy Center estimates that the middle household income quintile will benefit by over $900 per year from the tax cuts. Given that the savings rate in the U.S. is now around 3%, that's a sizeable bump in extra spending money that consumers will have available starting in February.

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While the volatility seen in the first weeks of February was extraordinary, the difference between short-term corrections and more concerning developments is often gleaned from high-yield corporate bond spreads, which remain tight by broad historical standards and consistent with other periods of stable economic growth.

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Economists are largely in agreement that corporate tax cuts will pull forward growth in the U.S. and that the long-term 2% trend is essentially intact, notwithstanding a few years of stimulus-driven ramp up. If the new law does result in a more lasting domestic investment increase, we could see a more sustained benefit to growth. So rather than closing the book on the prospect of long-term benefits from the tax package, we prefer to leave this as an open question that may take a few years to resolve. Time will tell.

But why the early 2018 ramp in equity prices after the late 2016 "Trump bump," an unyielding 2017, and a telegraphed tax package? On the latter point, while there was general consensus that a tax change was likely in 2017, details proved elusive until the final hour. The U.S. tax code is also notoriously complex and, as a result, forward earnings estimates only recently spiked upwards as analysts digested the news ***(Exhibit #1)***. This reiterates that at times the market can be slow to process new information, which is the general principle behind the existence of momentum trading strategies.

Interest Rates & Inflation

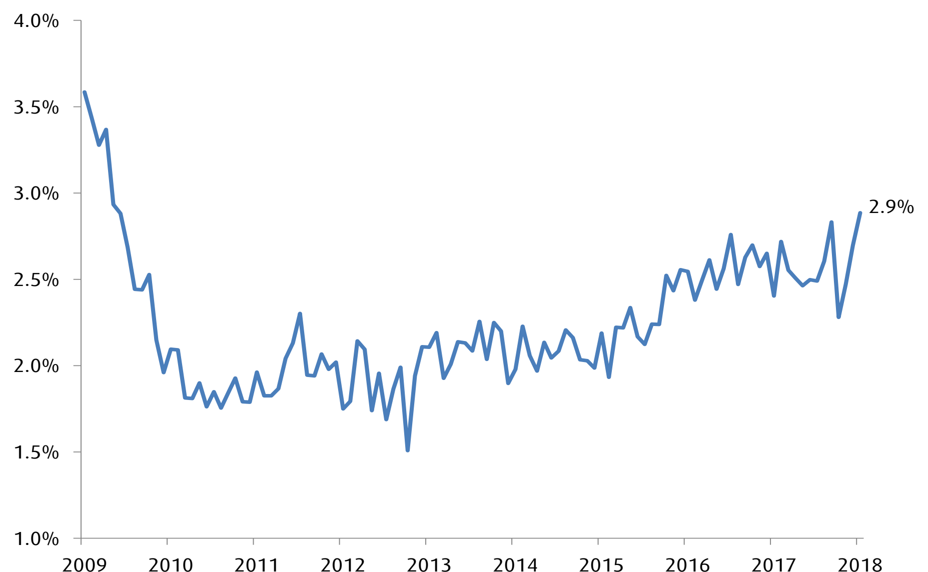
From early December 2017 through early February of this year, the yield on the 10-year Treasury note has jumped about 45 basis points. Over this same time, the Treasury Inflation-Protected Securities (TIPS) 10-year breakeven inflation rate has also climbed about 25 basis points to just over 2%. The equity market initially ignored this rise in interest rates, but concern that inflationary pressures might be gaining momentum took hold in early February following the January wage growth release that showed a 2.9% increase year over year ***(Exhibit #2)***. Going forward, we are watching this closely as the prospect of economic overheating and a more aggressive Fed could provide a sustained headwind for the equity markets. Indeed, this dynamic played a significant role in the recent equity selloff (for more on the topic see our note: *Reversal of Fortune?*). While the Fed is certainly rolling back its accommodative monetary stance, convincing signs of sustained inflation have yet to emerge – notwithstanding the recent one-month jump in wage growth. Overall, rising interest rates due to economic growth, both in the U.S. and globally, can likely be digested by the equity markets. The real concern is inflation and the Fed taking a more aggressive policy stance than anticipated.

While the volatility seen in the first weeks of February was extraordinary, the difference between short-term corrections and more concerning developments is often gleaned from high-yield corporate bond spreads, which remain tight by broad historical standards and consistent with other periods of stable economic growth. Prior to the 2001 and 2008 recessions, increases in the high-yield spread provided early warning signals for coming turbulence, and we expect this relationship to hold going forward. So far this year, high-yield corporate bond spreads are right about where they began 2018.

Given increasing interest rates, a valid question is how much of the equity market run-up in recent years may have been attributable to low yields? First, it's important to understand that when considering equity valuations, long-term expected interest rate levels matter much more than those in any given year. With that caveat in mind, we do believe equity prices are higher than they would be if markets believed a reversion to the long-term historical average interest rate environment was probable. But, before we become skittish, it is worth noting that while interest rates may rise in the short run, demographic and other structural factors are likely to keep rates below long-term norms.

International Markets

Exhibit 2 » Year-Over-Year Wage Growth



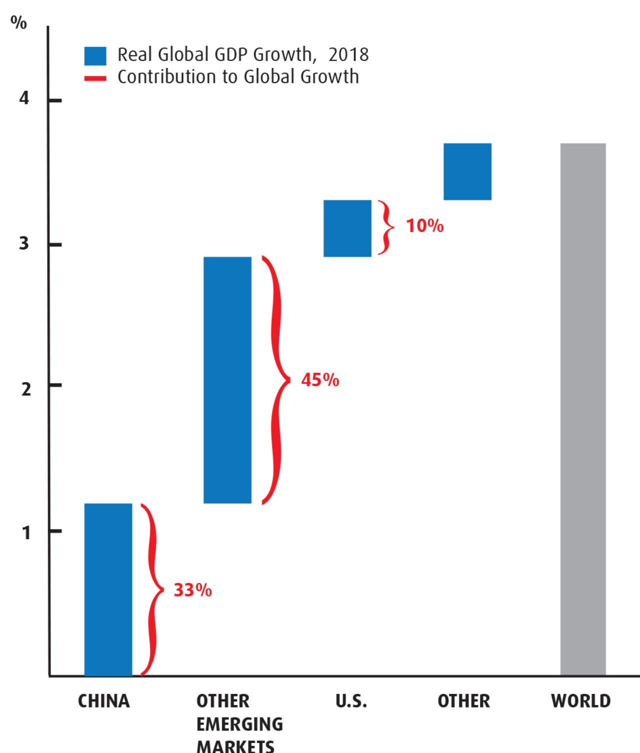
Source: Bureau of Labor Statistics; BMO Wealth Management Strategy

As mentioned in our *"2018 Outlook: An object in motion…"*, Europe and Japan, both equity market winners in 2017, look economically well-positioned into 2018. In Europe, growth is accelerating, deflation risk is gone, political risks have largely abated, and the ECB is still in accommodation mode. It's hard to argue with that list. German manufacturing PMIs, data points shown to have predictability for the future economic activity, recently recorded the strongest readings since the data was first tracked in 1995. In Spain, exports and growth have had a strong ramp in the past few years and the unemployment rate is down about 10% from its 2013 peak. Recent labor reforms in both Spain and France should have a positive effect on these economies. These developments may not have the flair of a trillion dollar tax cut, but change is at the margin and should be given its due. Reasonable valuations, continued earnings growth, and expanding profit margins should provide a tailwind for European equities in 2018.

Japan's manufacturing PMIs, while not quite as stellar as Germany's, are themselves hitting multi-year highs. The Bank of Japan remains accommodative, valuations are attractive, and shareholder reforms are slowly taking hold. We expect that Japanese equities should continue to perform well in 2018. Overall, the synchronized and relatively stable world growth reinforces the positive trends in these regions.

Emerging markets are a very diverse group, but China has an outsized weight both because of the sheer size of its economy, and because several other emerging market countries list China as a major trading partner. Indeed, IMF forecasts suggest China is poised to account for close to 33% of real GDP growth for 2018 ***(Exhibit #3)***, but corporate debt accumulation remains a risk and a "policy error" of excessive tightening could indeed lead to market turmoil.

Exhibit 3 » Real Global GDP Growth, 2018



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Source: BCA Research, IMF, Haver Analytics, BMO Wealth Management Strategy

That said, the state has vast financial resources and much of the bad debt is owed by state-owned enterprises (SOEs) to state-owned banks. As long as the debt accumulation problem does not continue to grow unchecked, we expect China's long-game approach for dealing with the bad debt to gradually work out. This remains one of our top areas to watch for 2018.

Financial Markets

We continue to find the reward-to-risk ratio most attractive in international equity markets, both non-U.S. developed and emerging markets. That's not to say that the U.S. equity market cannot put in a solid showing in 2018 in spite of the recent retreat. Absent stronger inflationary pressures or other risks developing (as outlined in our *"2018 Outlook: An object in motion . . ."*), economic momentum looks strong enough to lead U.S. equities higher. Corporate tax cuts have led to eye-popping increases in expected earnings in the U.S. According to Factset, as of late January, S&P 500 companies to date have registered almost 12% annual earnings growth with 81% of companies beating sales estimates, which is the highest level on record since data tracking began in 2008. The U.S. economic momentum is palpable. Not throbbing as in 1999, but a strong and quickening beat as in 1997 or early 1998. Yet, taking a step back, we consider where the trends look more durable, longer-lasting, and under-appreciated, which has us leaning overseas. ■

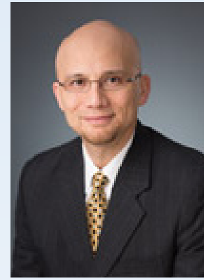
Michael Stritch, CFA
Chief Investment Officer &
National Head of Investment
BMO Wealth Management - U.S.

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

Michael Stritch, CFA
Chief Investment Officer & 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 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 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 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 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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