BMO Private Bank JANUARY 2016

Outlook for Financial Markets

"We are what we repeatedly do. Excellence, then, is not an act, but a habit."
–Aristotle

Economy

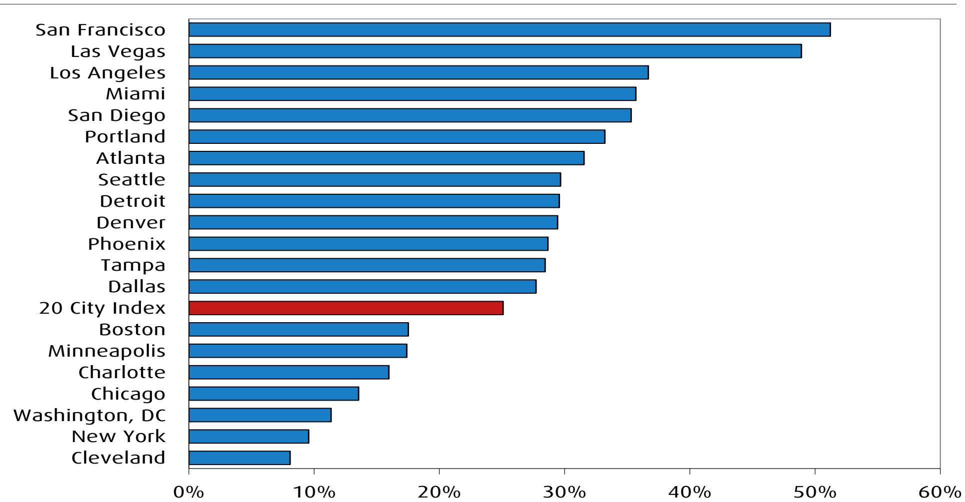
The U.S. housing market is recovering, although actual price appreciation really depends on where you live. Both coasts are in great shape, while the middle of the country struggles to keep pace. Thanks to the tech boom, constrained supply and the international appeal of its technology, San Francisco has seen home prices rocket 50% higher over the last three years while prices among the top 20 cities rose "only" 25% and the nationwide gain clocked in at 17% *(Exhibit #1)*. Meanwhile, despite a sharp rally, prices in overbuilt Las Vegas remain about 40% below the boomtime peak.

Back in San Francisco, not all is rosy. Social stress abounds now that home prices are 9 times the local household income and 20 times annual rents. The national average is just a fraction of those multiples. On the other end of the spectrum, the price-to-income ratio in beleaguered Detroit is 2, as is the ratio in Pittsburgh, despite its strides toward downtown revival.

San Francisco aside, homes in the U.S. cost 3.6 times the median income, which is cheap relative to the rest of the world. The U.S. compares favorably with the United Kingdom at 4.7 times income (and England itself is even higher). Also rich compared with the U.S. are Japan at 4.4 times income and Canada at 4.3. Hong Kong property prices are crazily being sold for 17 times local incomes. International buyers are making New York, Washington, Miami and San Francisco real estate prices appear stretched. With locals being priced out of those markets, frothy conditions can only persist as long as foreign fund flows remain intact.

Despite the relative attractiveness of residential real estate in most of the country, first-time homebuyers comprise just 32% of all purchasers, the lowest level in three decades. That's the smallest percentage since 1987, according to the National Association of Realtors. The historic norm is about 40%. With housing on track to post its strongest gains since the crisis, economists fear that Millennials could be missing out on critical wealth accumulation

Exhibit 1 » Case-Shiller House Price Index 3-Year Percent Change Through October



Source: S&P / Case-Shiller

Summary

Despite the relative attractiveness of residential real estate in most of the country, first-time homebuyers comprise just 32% of all purchasers, the lowest level in three decades.

The current emerging market debt burden represents another stage in the saga of capital misallocation that began in the U.S. mortgage market and shifted to the euro area.

Over the last 10 years, cumulative net income among the non-financial components of the Dow Industrials increased 38%, a 3.3% annualized growth rate. However, thanks to share buybacks, earnings per share rose 7.2% per year, a doubling.

Japan is a stark example of demographics undermining growth, particularly at a time when policymakers are doubling down on stimulus programs. By 2050, Japan's working-age population is expected to shrink by 28%.

A strong dollar is a mixed blessing for the various asset classes. The greenback has rallied by more than 1% in 13 of the last 50 weeks.

by sitting on the sidelines. Without their participation, young people will also make it difficult for current owners to trade up or for empty nesters to cash out and downsize. When asked, a quarter of first-time buyers said their biggest challenge in buying a home was accumulating a down payment. Many blamed student loan balances as their biggest obstacle. Meanwhile, rents are up 20% over the last five years. Needless to say, incomes are not.

Notwithstanding the real estate rally in many communities, housing wealth is playing a smaller role in the economy than it had in previous cycles. Home equity has roughly doubled to $12.1 trillion since housing bottomed in 2011, according to the Federal Reserve. Even so, newfound wealth has had little impact on buying behavior. Homeowners borrowed $43.5 billion against their homes in the first half of the year but that was only a quarter of what was drawn against home equity in 2007. Research by Moody's estimates that for every dollar that home equity amounts increased in late 2014, only about two cents of additional spending followed in the months thereafter. Before the housing bust, the effect was triple that. For good reason, tapping home equity isn't as easy as it used to be now that many lenders and regulators have learned their lesson. Home equity is up to 56% of real estate values, almost back to the 60% seen before the boom fell apart. Household balance sheets have come a long way.

Bond Market

Monetary stimulus, unleashed after the financial crisis, reinvigorated risk-taking worldwide. The Fed's $3.5 trillion quantitative easing (QE) program of money creation was leveraged several times over and a chunk of it got funneled into emerging market debt. In other words, the Federal Reserve's balance sheet helped finance production in China, Russia, Brazil and elsewhere. There were two primary pipelines between QE money and emerging market debt. One was the traditional investors who have been "hunting for yield" ever since the central bank cut short-term interest rates to zero. Beneficiaries included high-yield and emerging market bonds. The tsunami of willing lenders prompted many to borrow even for projects that would have been uneconomic in another environment.

"Carry traders" populated the other pathway by borrowing euros or dollars at excessively low short-term rates and using the proceeds to invest in the Singapore dollar, Brazilian real and other currencies offering incrementally higher yields. Such carry trades are effective only if yield differentials remain positive and purchased currencies maintain their value. Carry trade reversals were largely to blame for the swift selloff in risky assets last August after China suddenly devalued the yuan.

The current emerging market debt burden represents another stage in the saga of capital misallocation that began in the U.S. mortgage market and shifted to the euro area. Fortunately, Europe is poised to enjoy its best economic growth since 2011 and U.S. consumers are thriving.

The run-up in emerging market debt levels is cause for concern. Private sector debt in emerging countries rose to 107% of GDP, up from 73% as recently as 2007. Including non-bank financial institutions, private debt has exploded to 127% of GDP. Three-quarters of private borrowing is concentrated among businesses. Corporate debt as a percentage of GDP ballooned from less than 50% in 2008 to nearly 75% in 2014, according to a recent *Economist* report. While China accounted for a bulk of the borrowing, Turkey, Brazil and Chile saw a substantial rise in corporate debt balances too. Despite their debt expansion, countries like India have been somewhat insulated. The IMF is predicting Indian GDP will rise 7.3% in 2016, making it the world's fastest-growing economy. The country has the tailwind of the oil price collapse, although that can prove fleeting if global economic recovery brings a surprise rally in fossil fuels.

Emerging market companies face the possibility of a cash crunch as the Fed calls an end to easy money. It is estimated that $7 trillion flowed into the emerging world since the Fed started buying Treasury bonds in 2008.

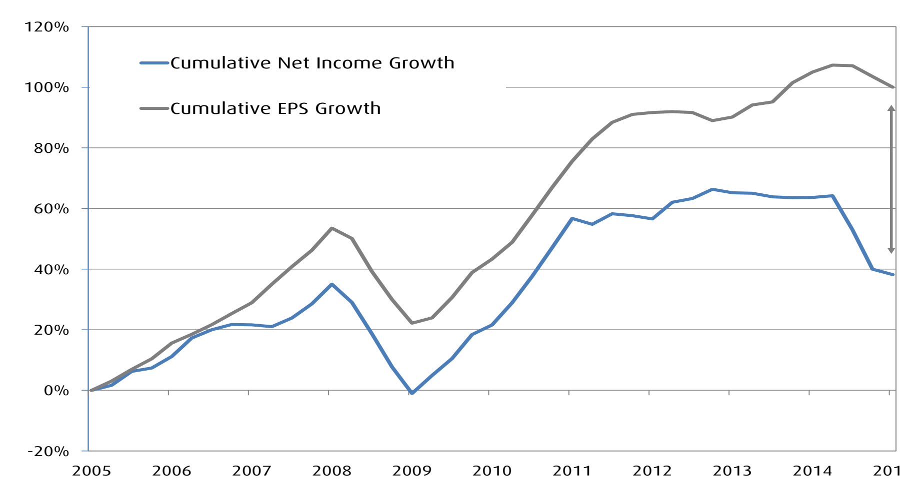
Emerging market credit conditions are at their lowest level since 2009 as credit demand and availability faded in recent weeks while non-performing loans headed higher, according to the Institute of International Finance. Difficult credit conditions will undoubtedly result in rising defaults. However, rather than ushering in another crisis, the credit withdrawal will probably be an economic impediment rather than some reincarnation of the Lehman era. Don't expect an investment-led recovery coming from the emerging world though. It will have to be the U.S. and Europe that lead the way in 2016 and 2017. Nevertheless, it is heartening that markets have spent several years growing to understand these problems, so much of the headwinds facing the emerging world have been "priced in," especially in stocks.

Equity Markets

Stock market indexes are rising, but the average stock is falling behind. While the S&P 500 has gained about 3.5% so far in 2015, the typical U.S. stock is down 1.4%. Nowhere is that divergence more on display than in the retail sector where nearly one-third of the companies look like they will post their worst performance since 2008. A glance at the S&P 500 Retail Index's 26% gain certainly doesn't let on. That's because Netflix and Amazon have more than doubled. Almost all of the gains can be attributed to those two plus Home Depot. In fact, out of the 30 stocks in the retailer index, 24 are behind the industry benchmark in 2015.

Many companies in the industry have suffered from having waited in vain for gas pump savings to filter into shopping malls. Instead, households have held on tightly to their purse strings. The National Retail Federation is forecasting that Christmas sales will fall this year.

Exhibit 2 » Dow Industrials (ex Financials): EPS Growth vs. Net Income Growth



Source: Bloomberg; BMO Private Bank Strategy

Facing slowing revenue and net income growth, retailers are doing what their counterparts in other industries have also done, which is resort to stock buybacks as a way to bolster earnings per share. Stock repurchases have reached record levels, even though doing so may endanger long-term competitiveness. Critics contend that such financial maneuvers tend to choke off research and development, slow growth and widen income inequality.

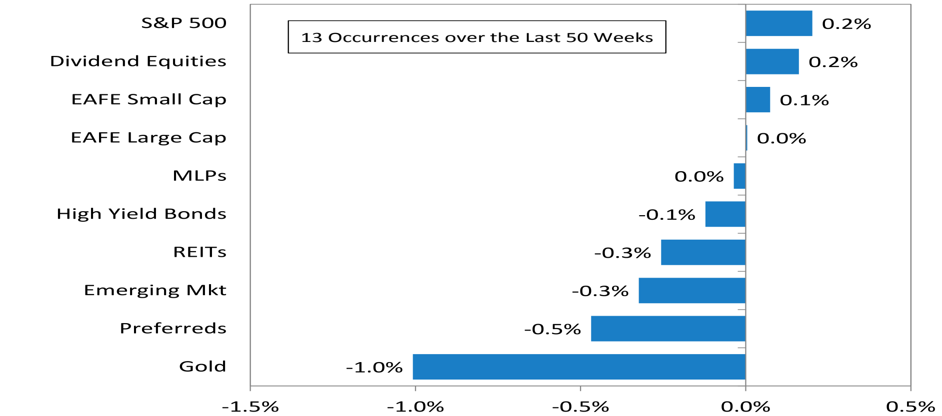
Research by Reuters confirms that spending on share repurchases is rising at a far faster pace than R&D investments and other capital expenditures. In fiscal 2014, according to the study, spending on buybacks and dividends outstripped companies' combined net income for the first time outside of recessions. That figure continues to climb. A record $520 billion of share repurchases was accompanied by $365 billion in dividend payments. Among the 1,900 companies Reuters tracked since 2010, buybacks and dividends amounted to 113% of capital spending, up from 60% in 2000 and 38% in 1990.

Executive compensation, often tied to earnings per share growth and stock performance, is feeding the trend. At the same time, corporate decision makers are reluctant to risk long-term bets on products and services. Over the last 10 years, cumulative net income among the non-financial components of the Dow Industrials increased 38%, a 3.3% annualized growth rate. However, thanks to share buybacks, earnings per share rose 7.2% per year, a doubling *(Exhibit #2)*. Expect this trend to continue until corporate balance sheets are exhausted.

Outlook

Demographics are a slow-moving yet powerful force influencing the global economy. Aging populations in the developed world represent one of the stiffest headwinds buffeting global growth. For the first time since 1950, the combined working-age populations of the world's advanced economies will decline. Among emerging economies, Russia and China will suffer from workforce contractions. It took 80 years for the median U.S. age to rise from 23 to 30, and then it only took a third of a century for the median to rise to 38. The U.S. labor force has grown 0.2% per year since 2008, compared with 1.2% in the previous decade. An aging population is largely to blame for America's weak recovery at a time when the unemployment rate is historically low. Baby Boomers, the largest demographic cohort, are moving into the high savings period of their lives as they prepare for retirement. That's impeding the Federal Reserve's ability to employ historically low interest rates to spur a recovery.

Exhibit 3 » Asset Class Performance in a Rising Dollar Environment



Source: Bloomberg; BMO Private Bank Strategy

Japan is a stark example of demographics undermining growth, particularly at a time when policymakers are doubling down on stimulus programs. By 2050, Japan's working-age population is expected to shrink by 28%. The land of the setting sun's aging population has created a labor shortage. Even though Japan's unemployment rate is an enviable 3.4%, the country may have slipped into its second recession in two years because of its graying problem.

The country's biggest impediments are an aging population and a skills mismatch between the needs of the private sector and what the workforce has to offer. An expected deficit of about one million workers in 2015 and 2016 is estimated to cost the Japanese economy about 2% of GDP, or about $86 billion, according to a recent *Wall Street Journal* report. The labor shortage is attenuating the impact of extensive monetary and fiscal measures implemented under Mr. Abe, according to an IMF study.

Despite a low unemployment rate, wages are only rising modestly because of the awkward labor market structure. Nearly 40% of Japan's workforce holds temporary, often part-time positions that pay far less than permanent jobs. This percentage has doubled in two decades. Part-time positions are on the rise because it is extremely difficult to lay off full-time employees. The dual labor market is exacerbating the skills mismatch since companies spend far less on training part-time workers. This is limiting Japan's productivity and its potential growth. Given that the world's third-largest economy possesses few natural resources, it must rely on human capital to drive growth and prosperity. Without skills, however, Japan's future will suffer.

Nevertheless, right now Japan looks like a bastion of stability compared with the seemingly daily reminder of terror in the U.S., Europe and elsewhere. We have already been biasing our clients' portfolios in the direction of developed market equities. In 2016, we may shift some more of that capital toward Japan, which has one of the most competitive currencies in the world.

Financial Market Strategy

After nearly seven years of pedal-to-the-metal monetary policy, the Federal Reserve is set to embark on its first tightening program since 2006. This is a hindrance to the global liquidity tide that will only be ameliorated if we continue to see pedal-to-the-metal QE from Europe and Japan.

The prospect of comparatively higher interest rates in the U.S. has created demand for dollars that pushed the greenback higher against its trading counterparts in recent years. A strong dollar is a mixed blessing for the various asset classes. The greenback has rallied by more than 1% in 13 of the last 50 weeks. Not surprisingly, commodities were the biggest victims during those periods. Gold typically sold off by 1% during those episodes ***(Exhibit #3)***. Preferred stocks, off 0.5% on average during the dollar spikes, slipped as a result of the rises in interest rates that often come with greenback strength. Emerging market equities, beneficiaries of easy money, fell by 0.3% on average. There were three beneficiaries of an emboldened dollar. The S&P 500 gained 0.2% on average, as did dividend stocks. Surprisingly, developed market small caps gained incrementally as well. If the U.S. dollar bull market continues, U.S. equities will probably lead the world. If not, our overseas portfolio positioning should prove fruitful. ■

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As Head of Macro Strategy, Jack chairs the Asset Allocation, Mutual Fund Re-Optimization and Harriscreen Stock Selection Committees and is responsible for establishing investment policy and strategy within BMO Private Bank throughout the U.S. He joined the organization in 2001 and has three decades of experience in money management.

Jack earned a bachelor's degree from Vassar College in New York, where he graduated with honors with an A.B. in Mathematics and Computer Science. A member of the Beta Gamma Sigma International Honor Society, Jack received an M.B.A. with honors and graduated *cum laude* from Boston University in Massachusetts. He holds the Chartered Financial Analyst designation and is a member of the CFA Society of Chicago.

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- Frequent contributor to CNBC, Bloomberg, *The Wall Street Journal* and *Barron's*
- Served as a Professor of Finance at Boston University, Graduate School of Management
- Spent five years as a Money and Markets correspondent for WTLV, the NBC affiliate in Jacksonville, Florida
- Named one of the Top 100 Wealth Advisors in North America by *Citywealth* magazine, in 2006, 2010 — 2015

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