# Outlook for Financial Markets

*"Strong convictions precede great actions."*
– James Freeman Clarke

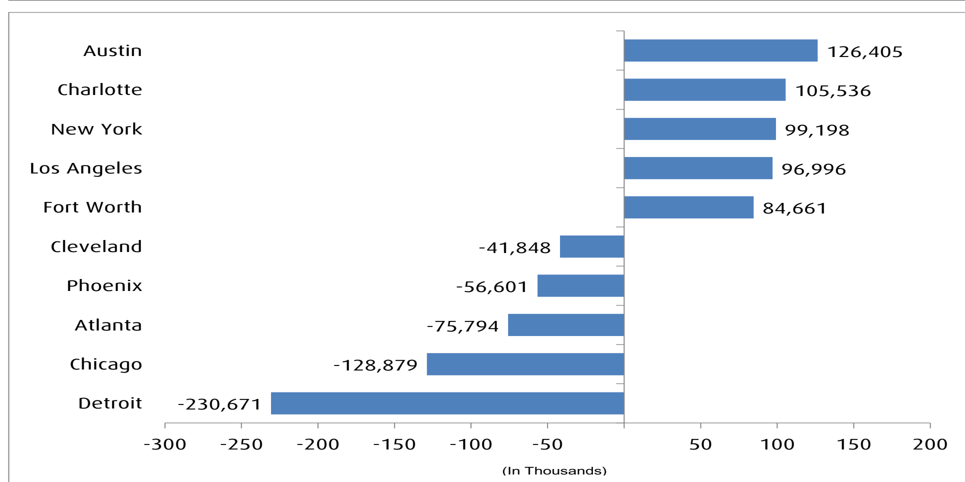
## Economy

U.S. growth is surprisingly resilient in the face of global strain. If inflation is defined as too much money chasing too few goods, it's hard to argue that the world isn't awash in money. Then again, it's also swimming in goods. The White House released its annual Economic Report of the President, a 400-page tome that offers insight on Washington lawmakers' thinking. While the report covers a wide variety of topics, there are a few points worth noting. At the risk of overstating the obvious, global growth is disappointing. International Monetary Fund (IMF) economists have had to routinely cut back their global economic estimates over the last several years, since growth has continually fallen short of previous prognostications. Economists were projecting 5% worldwide growth for 2016 as recently as five years ago. Thus far, the figure is clocking in at 3.5%. In 2010, the IMF tried to project five-year cumulative real GDP for 20 of the world's major economies. Eighteen fell short of expectations, with Italy, Brazil and Russia falling substantially behind.

Closer to home, Washington economists are troubled by rising income inequality and point to the disparity in fortunes between the holders of capital and the working class. The report notes the decline in unionization has undermined workers' bargaining power. In 1970, when union membership was brimming, employee compensation accounted for 59% of GDP while corporate profits' share accounted for about 7%. By 2015, employee compensation had shrunk to 54% while corporate profits accounted for 10% of GDP.

Rising housing costs are also a concern, particularly around city centers. Only 10% of San Francisco's housing stock is deemed "affordable" to median income residents; in New York the figure is 22%. Two-thirds of the housing stock is within reach in Chicago and Washington, DC, rendering them among the most affordable. The report blames restrictive zoning rules and other local regulations that limit housing stock as the chief cause of problems in San Francisco and elsewhere. The authors argue that an increase in construction costs only explains a small fraction of the increase in

**Exhibit 1 » Five-year Best and Worst City Population Change as of 2014**




Source: U.S. Census Bureau; BMO Private Bank Strategy

## Summary

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**Central banks, dazzled by bitcoin and its underlying technology,** are exploring digital currencies of their own. Like bitcoin, a "digital dollar" would be built on blockchain technology.

**In 1982, when easy monetary policy began in earnest, 10-year Treasurys were yielding 15.3%,** a double-digit percentage point gap over and above stock market yields. These days the dividend yield on the S&P 500 is actually 0.5% higher than the T-note. The narrowing yield differential between stocks and bonds has important implications for income investors.

home prices, suggesting that land use restrictions are the culprit.

Despite the recovery, state-level finances remain under stress. The report points to a decline in education employment that has exceeded the falloff in the school-age population, causing a rise in student-to-teacher ratios. In a related issue, unfunded pension liabilities are rising relative to state and local revenues. According to Federal Reserve data, unfunded pension liabilities total nearly 80% of annual state and local tax receipts, up from less than 20% before the financial crisis. Closing the gap with higher taxes isn't that simple. Frustrated state voters have the ability to vote with their feet, and many have. Chicago's Cook County, home to one of the nation's worst fiscal situations, has lost about 129,000 residents over the last five years. BBB-rated Illinois shed more residents in 2014 than all of the other nine Midwestern states combined. Where are they going? Austin, Charlotte and New York City collectively picked up more than 331,000 new taxpayers *(Exhibit #1)*.

Washington economists are puzzled by the lack of productivity gains over the last several years and are looking into ways new technologies could spur growth by leveraging human input, not simply replacing it. While the Internet unleashed a wave of productivity in the late nineties and early 2000s, recent technological innovations like Twitter and Uber have failed to measure up productivity-wise. Their software benefits users, but it's simply difficult to gauge how much more Americans are producing as a result of these offerings. Industrial robot usage has doubled since the start of the decade, mostly at the expense of human input. Yet productivity has trailed historical trends. Over the last 10 years, productivity has grown less than 1.5% annually, substantially below its longer-term 2% trend and, more importantly, trailing the 2.1% wage growth rate. The ability to produce more goods and services with the same amount of effort fuels higher living standards. Corporate profits are crimped when employment costs outstrip productivity gains for an extended period. Like breakthrough innovations, advances in productivity are hard to predict. Nevertheless, continued investments in education combined with real efforts at red tape reduction will help.

## Bond Market

Crude oil dipped into the mid-$20 range earlier this year but has staged a stunning rebound, climbing above $40 before recently settling just below that mark. Traders certainly exhaled, as plunging oil prices caused many to believe a global recession was imminent. Even with the recent price bounce, the energy sector's problems have not gone away. Given the degree of energy-related borrowing over the last several years, oil represented the connective tissue between the global economy and the world's credit markets. The size of global oil and gas debt is nothing to sneeze at; the total surpassed $3 trillion in 2014, three times the 2006 amount.

Oil prices are still about 35% below the 2015 peak, even after the recent surge. Now the number of bad energy loans outnumbers good loans, according to a recent *Wall Street Journal* report. Meanwhile, industry liquidity is contracting. Several banks have reduced their exposure to the energy sector by selling off loans or crimping credit limits. Hedge funds and private equity firms have stepped in by purchasing outstanding debt at sizable discounts. According to the report, 51 North American oil and gas companies have filed for bankruptcy since the beginning of 2015, representing more than $17 billion in cumulative debt. About 175 companies are at risk of not meeting loan covenants.

While many of the nation's largest banks will be forced to write down their loan exposure, it should be noted that the energy sector represents less than 5% of bank balance sheets. Many of the troubled loans are revolving credit facilities backed by future production. The industry's response has been a pursuit of "rabbit starvation," the phenomenon by which hikers lost in the wilderness expend more calories hunting for food than the amount they consume from foraged food. In oil and gas the response has been to pump and then pump more.

While oil and gas companies have in fact cut back on drilling and exploration, they continue to pump aggressively despite the supply glut. Natural gas output has expanded 2% since January, while prices have continued to decline even as oil prices rallied. Unseasonably warm temperatures last winter only exacerbated the imbalance. The problem is that they are forced to keep pumping because the losses are smaller than they would be if operations were completely shuttered.

Eventually the price gap between oil and gas could weigh on oil producers as opportunistic consumers shift to the cheaper energy source. Purchasing enough natural gas to mirror the energy in a barrel of oil costs only $12.50. While oil prices will be hard pressed to head that low, cheap natural gas will likely cap oil's upside.

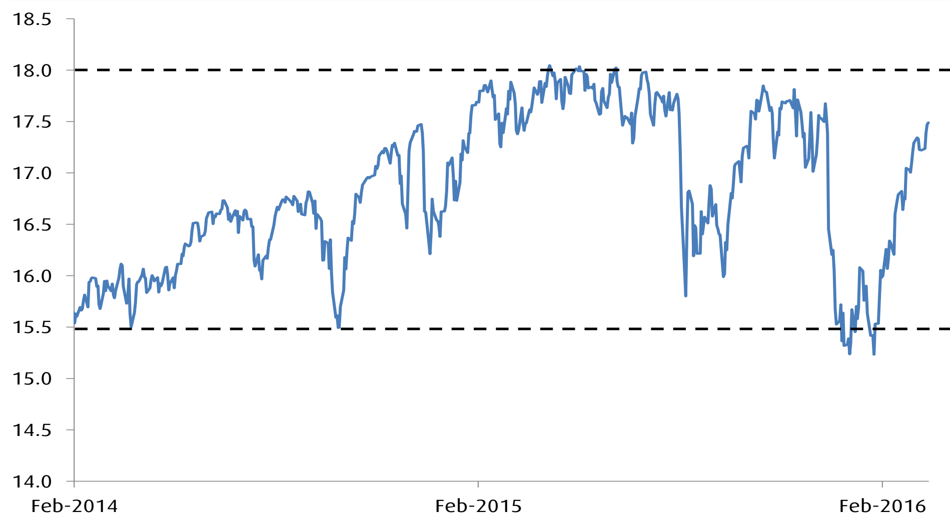
## Equity Markets

What a turn of events. January kicked off the worst 10-day start in stock market history, yet the rally since mid-February has been so strong that those losses have been erased. A distant observer could be forgiven for thinking nothing happened in the first quarter. The S&P 500 actually finished the quarter up more than 1%. January was a perfect storm of negativism. The Federal Reserve had kicked off its tightening program just one month before, prompting investors to worry about comparably attractive U.S. interest rates sucking capital away from parts of the world that could least afford to witness capital flight. Weak economic reports from China, accompanied by devaluation of the yuan, only fanned investors' fears.

At the same time, crude oil got caught in a tailspin. The commodity plunged 25% in the first six weeks of the year, fostering widespread uncertainty. Oil has been representing the link between the economy and the credit markets, so it comes as no surprise that high-yield bonds shed 6.6% of their value during the comeuppance.

Crude oil had suffered a barrage of bad news in January and early February, the worst of which was probably the Saudi oil minister's affirmation that the world's largest oil producer would not cut production, signaling that he did not trust other OPEC members to follow suit. The news was about as bad as it could get, sending

**Exhibit 2 » Range Bound: S&P 500's Forward P/E Ratio**




Source: Bloomberg; BMO Private Bank Strategy

oil as low as $27. When a handful of central banks began making conciliatory statements and taking easing action, investor confidence suddenly bloomed. The upward snapback in equities, commodities and junk bonds was just as bold as the fall that preceded it.

High-yield bonds rallied nearly 8% off the lows, closing out the quarter a little more than 2% in the black. Emerging market equities, the focal point of fear, were down more than 12% before battling back and ending the quarter more than 6% to the good. Brazil, notwithstanding the uncertainties related to the corruption scandal involving President Dilma Rousseff, led the group higher and gained nearly 30% for the first three months of the year. Russia, a troubled energy exporter, added more than 15%.

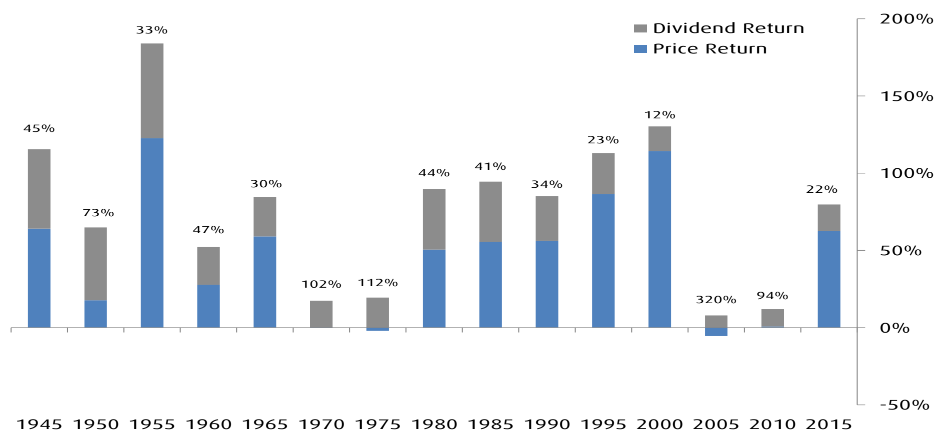
Gold posted its best quarterly result in decades as the world's central banks pursued competing strategies to weaken their respective currencies. The store of value surged more than 16% through March, its best quarterly showing since 1986. Continued gains for gold are predicated on increasingly aggressive monetary policy moves among the largest central banks and continued deterioration in "real yields," or yields after accounting for inflation. An increase in the level of inflation or a decrease in short-term rates will continue to present a favorable backdrop for gold investors.

The whiplash-like market move has left U.S. large caps relatively expensive when gauged against underlying revenues and profits. The S&P 500's forward price-earnings ratio has been bound between 15.5 and 18 recently *(Exhibit #2)*. Now that the forward P/E for blue chips is 17.5, it would suggest that the upside on the market is capped at 2,126, just 3% from current levels, assuming no increase in earnings estimates. The problem is that analysts are forecasting S&P 500 profits to rise more than 10% over the next four quarters, yet earnings are anticipated to be more than 9% lower in the first quarter. Excluding energy, S&P 500 earnings are expected to come in 4.5% lower, a far cry from the 8% rise that the market was penciling in last summer. It just goes to show that optimism tends to fade as earnings season approaches.

## Outlook

What the Internet did for commerce, "blockchain" could do for financial markets. The difference between the infrastructure underpinning bitcoin and traditional clearing house databases is that ledgers are not kept by a single entity such as a bank. Instead, a number of participants have exact copies of the same data. What emerges is a way for participants to create and verify transactions on a network instantaneously without a central authority. Instead of keeping track of assets in separate places, as financial firms currently do, they can share one common ledger. Transactions could be settled instantly,

**Exhibit 3 » S&P 500 Trailing Five-Year Total Return Components: Price and Yield**




Source: Standard & Poor's; BMO Private Bank Strategy

without the need of intermediaries like clearing houses or trust companies. That's a sharp contrast to the three days it takes to settle common equity transactions today. More than 40 of the top financial institutions are exploring distributed ledger technology as a secure and transparent way to digitally track asset holdings and transactions in a way that lowers costs and reduces the risk of fraud.

Depository Trust Company, or DTC, was established in 1973 to reduce costs and provide clearing and settlement efficiencies by immobilizing securities and making "book-entry" changes to ownership of the securities. Prior to DTC, stocks and bonds were held in physical form, meaning that transactions required the movement of certificates between vaults. Depository Trust Company retains custody of more than 3.5 million securities valued at $37.2 trillion, according to the company's website. DTC reported revenue of nearly $1.5 billion in 2014 from transaction and clearing charges. Shifting to blockchain technology has the potential to save billions annually. There's a lot at stake.

The implications are both promising and ominous. Central banks, dazzled by bitcoin and its underlying technology, are exploring digital currencies of their own. Like bitcoin, a "digital dollar" would be built on blockchain technology. However, unlike blockchain's distributed ledgers, the database would be tightly controlled by the Treasury. Digital currencies would save on the costs of printing and managing paper money and would be more difficult to forge, although a successful cyber attack could be catastrophic. To the extent digital money replaces cash, central bankers would have freer authority to drive interest rates well into negative territory without the threat of a "cash under the mattress" bank run. On the plus side, digital currencies would curtail money laundering and tax dodging. The underground economy, estimated to be nearly $1 trillion in the U.S., would be forced out of the shadows. On the other side, government control of all currency transactions carries with it obvious privacy concerns.

## Financial Market Strategy

In a market steeped in uncertainty, investors have been clamoring for dividends. The Dow Jones Dividend Select index is up nearly 10% in 2016 against a backdrop of modest gains dotting most equity markets. Within the S&P 500, the top 100 highest-yielding stocks have returned 7% this year, while those with no dividend are flat.

In the modern era, dividends have played a dwindling role in total shareholder returns, but that could change. From 1940 to 1990, dividends accounted for no less than 30% of investors' total return in any given five year period. In 1982, the S&P 500 yielded as much as 5.6%. Since then, benevolence toward shareholders has plunged along with interest rates. Of the 80% total return for investors in the five years through 2015, only 22% was attributable to shareholder payouts *(Exhibit #3)*. Should the market embark on a period characterized by lower capital appreciation, dividends may present a valuable bird-in-the-hand.

In 1982, when easy monetary policy began in earnest, 10-year Treasurys were yielding 15.3%, a double-digit percentage point gap over and above stock market yields. These days the dividend yield on the S&P 500 is actually 0.5% higher than the T-note. The narrowing yield differential between stocks and bonds has important implications for income investors. Equities and dividends must play a larger role in retiree portfolios, especially when bond yields struggle against inflation. Unlike with fixed income, dividends have a better opportunity to keep pace should inflation pick up. Expect income from equities to take a bigger role in investor portfolios in the coming years. ■

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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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