Outlook for Financial Markets

March 2015

Summary

- **Zero-percent interest rates and trillions of dollars injected into the financial system have gone a long way to boost real estate and stock prices**, and in turn the confidence of the well-to-do. While spending has picked up, it's been concentrated among the high-end earners, creating a two-tier market for goods and services.
- **Why would any profit-minded investor purchase bonds** with the promise of receiving less than their original investment? One reason is fear.
- **Investors have favored smaller companies this year, mostly because the 40% of S&P 500 revenue** that is generated abroad tends to be the work of the largest 100 companies. The smallest 100 companies in the S&P have rallied 1.2%, edging out the 0.4% decline of the top 100.
- **The U.S. energy revolution drew in over $100 billion of capital investment.** At the same time, it boosted U.S. competitiveness while mitigating a strategic vulnerability. Not since the early 1980s, when new supplies were tapped in Mexico, the North Sea and Alaska, did the industry see such a supply spike and price crash.
- **Should bailout negotiations fail, Greece would be forced to default on its debts,** leave the eurozone and adopt its former currency, the drachma.

"The whole of science is nothing more than a refinement of everyday thinking."
– ALBERT EINSTEIN

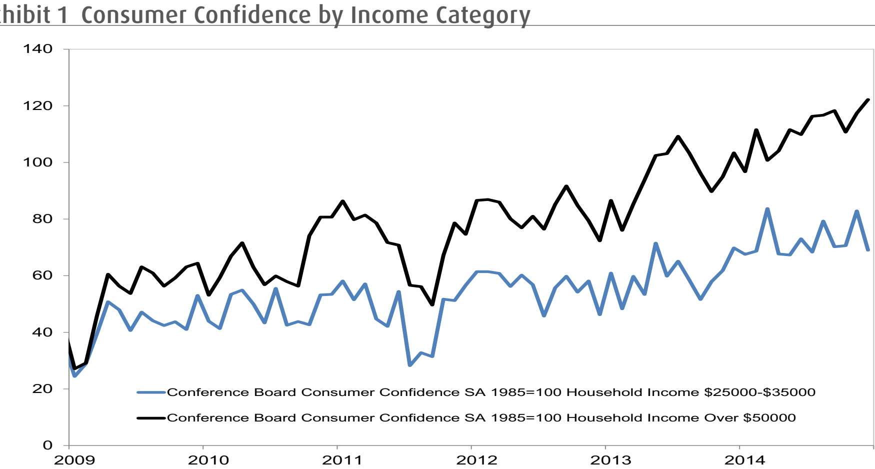
Economy

The U.S. economy closed 2014 on a disappointing note as 2.6% annualized growth in the fourth quarter fell short of expectations, especially after having posted blockbuster 5% growth in the previous quarter. However, thanks to cheap gasoline and a favorable labor market, consumer spending surged 4.3% in the last three months of the year. A bulk of the incremental growth came from middle- and lower-income households where energy bills account for as much as 20% of spending. Consumer spending is at its strongest in nine years, even though the pre-recession era was known for debt accumulation, cash-out refinancing and zero-down mortgages. Meanwhile, business investment grew at a meager 2.3% annualized rate in the fourth quarter, while corporate spending on equipment declined 1.9% as oil companies mothballed uneconomic projects. Government spending decreased at a 2.2% annualized pace as defense spending sagged the most in 2 years. A stronger dollar weighed on trade, making U.S. exports that much less competitive and capping the GDP data.

Zero-percent interest rates and trillions of dollars injected into the financial system have gone a long way to boost real estate and stock prices, and in turn the confidence of the well-to-do *(Exhibit #1)*. While spending has picked up, it's been concentrated among the high-end earners, creating a two-tier market for goods and services. The diverging trend is redefining the United States, with many in the middle saying they are being squeezed. According to the Federal Reserve, incomes have been flat or falling for all but the top 10% of wage earners. Since the depths of the financial crisis, spending among the top 5% has climbed an inflation-adjusted 12%, while overall spending has slightly declined, according to a recent *Wall Street Journal* report. Those top households now account for 30% of consumer spending, up from 23% two decades ago. Although it's anecdotal and company-specific, Tiffany has seen its shares rise more than 130% in the last five years while Sears has seen its stock cut in half.

Income trends have influenced housing too. For the first time in history, homebuilders are selling more homes priced over $400,000 than under $200,000, and the median home price has crept to just under $300,000, according to Fannie Mae. At the same time, the homeownership rate has slid six percentage

Exhibit 1 Consumer Confidence by Income Category



Source: Conference Board; BMO Private Bank Strategy points from its peak, to 64%. The rental vacancy rate is down to just 7% from its recent 11% peak, suggesting there is no shortage of people looking to rent. Existing home sales declined 3.1% in 2014, the first annual drop in 4 years. Before we worry that too few Americans are purchasing homes, it was just the opposite problem that fueled the housing bubble in the first place. Our primary concern should be income, not ownership.

Bond Market

Slowing growth and disinflation have pushed global bond yields to record lows. Oil prices have been cut in half and massive quantitative easing programs by many of the world's central banks are bolstering bond demand. The benchmark 10-year Treasury offers investors a scant 1.6%, the stingiest payout in the nation's history. Benchmark yields in all 25 developed market nations have fallen this year. For an idea of the intensity of the situation, look no further than the negative 0.11% yield on 10-year Swiss government bonds. In fact, there are nearly a dozen countries where bonds carry negative interest rates.

Why would any profit-minded investor purchase bonds with the promise of receiving less than their original investment? One reason is fear. The depth of the financial crisis pushed venerable banks and financial institutions to the brink of insolvency after Lehman Brothers closed its doors. In 2008, short-dated U.S. Treasury bills slipped into negative territory for a brief spell as investors clamored for safety. While hoarding cash would have at least assured a 0% return, holding massive amounts of physical cash would be impractical. While negative yields on short-term securities are almost understandable, on long-term debt, it's quixotic.

Besides irrational panic, investors might be saying that they'll take a negative yield for 10 years because of anticipated structural deflation. After all, Europe is struggling to regain a stable growth trajectory as it faces a poor demographic outlook and a shrinking workforce. Diminished demand and deleveraging could conspire to push price growth into persistently negative territory. Japan endured several years of persistent deflation, yet its bond yields remained slightly positive. Another possibility is that investors expect currency gains to offset and potentially outweigh any yield disadvantage. In a world where central banks hope to weaken their currency to gain a competitive advantage, this angle makes sense. Anyone in Europe who held 10-year Swiss notes enjoyed a 30% windfall when the Swiss National Bank suddenly lifted the franc's artificial peg to the euro on January 15. While short-term investors tend to favor higher-yielding currencies, high-inflation countries will tend to see their currencies lose value to more stable regimes. That explains why investors who expect the European Central Bank's (ECB) new money printing program to erode the euro's value may be inclined to buy a negative yielding franc-denominated bond. If the global bond market returns to normal, or if inflation heats back up, the losses on government bonds could be substantial.

Equity Markets

Stocks are off to a rocky start this year. Oil prices plunged early and bounced in response to the ECB's quantitative easing announcement. Greece's rejection of fiscal austerity sparked some concern as well. The S&P 500 is flat for the year, although there is a 7% return differential between the best and worst sectors. Utilities are leading the market, advancing more than 3% in response to collapsing bond yields. Defensively positioned health care and dividend-heavy telecom shares are not far behind. Financials are nearly 4% lower on slowing growth and the worry that the capital-intensive energy sector will weigh on credit conditions. Energy comprises roughly 15% of the corporate bond market and a slightly higher weighting on bank balance sheets.

Investors have favored smaller companies this year, mostly because the 40% of S&P 500 revenue that is generated abroad tends to be the work of the largest 100 companies. The smallest 100 companies in the S&P have rallied 1.2%, edging out the 0.4% decline of the top 100. The most dominant theme so far this year is the same as last year: the hunt for income. The 100 stocks with the highest dividend yields are 2.4% higher thus far; the remaining 400 are off fractionally.

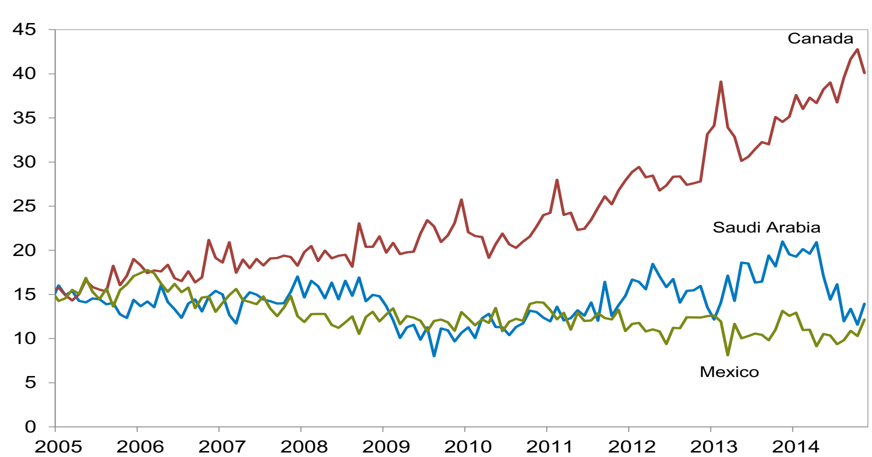
Could this be the year for international stocks? International large caps are up about 2% in dollars and 5% in local currency terms, while emerging markets are up more than 2% in dollars. International developed market equities are trading at a 25% valuation discount to the U.S. on a price-to-sales basis, while the discount for emerging markets is nearly 50%. Emerging markets have not been this cheap relative to the S&P 500 since 2002, a year that kicked off an incredible 10-year emerging markets run of 277%, leaving the S&P 500's 34% gain in the dust.

Outlook

Saudi Arabia's decision to keep its oil production levels intact may have been the catalyst to throw the oil market into a tailspin, but the truth is that OPEC's anchor country didn't cause the recent supply glut. The strategy, one that will likely remain in place despite the accession of a new Saudi king, has the potential to change the energy industry. The supply/demand imbalance is the widest on record, as stockpiles are increasing at a rate not seen in 30 years.

Thanks to innovation, energy production in the United States has expanded 80% since 2008. Last year, the U.S. displaced Russia as the world's top gas producer and is one of the

Exhibit 2 Percent Share of U.S. Crude Imports



Source: U.S. Department of Energy; BMO Private Bank Strategy top oil producers now that daily production is north of 9 billion barrels. Oil and gas production have nearly doubled since 2008.

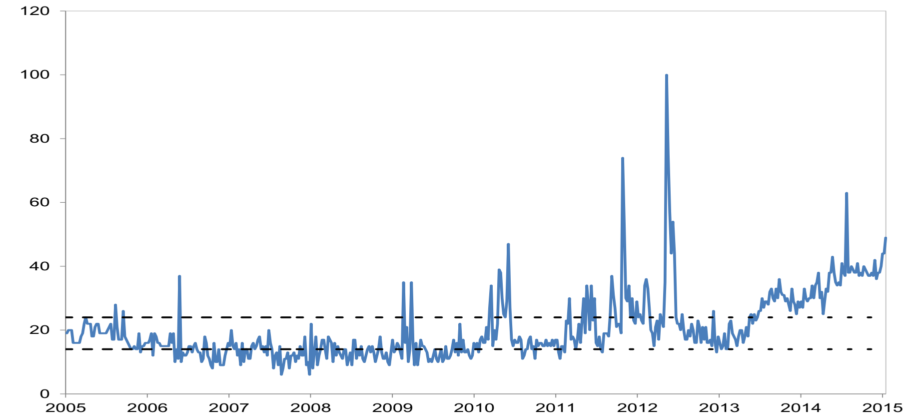
The U.S. energy revolution drew in over $100 billion of capital investment. At the same time, it boosted U.S. competitiveness while mitigating a strategic vulnerability. Not since the early 1980s, when new supplies were tapped in Mexico, the North Sea and Alaska, did the industry see such a supply spike and price crash. This time, the oil crash was forestalled by China's growth and Mid East turmoil. Sanctions against Iran took roughly a million barrels per day out of circulation, but it wasn't enough.

Over the last five years, China's growth slowed and Libya's crude production nearly quadrupled. By mid-2014 the price of oil began to slip. Oil insiders assumed that OPEC would step in and cut production to bolster the price, yet Saudi Arabia refused. The Saudis were looking at higher-cost competition from North American shale oil and new supplies from Russia, the Arctic, Brazil and Africa. Saudi market share in the U.S. had spent 10 years sliding, while the U.S. grew spending on Canadian oil to 40% of all purchases, up from 15% in 2004 *(Exhibit #2)*.

The Saudis may not appreciate how low prices could fall, although they're motivated by both greed and fear. The Kingdom is leveraging their $10-20 per barrel production cost. At the same time, oil revenue accounts for about 80% of its government financing, making the monarchy vulnerable to paradigm changes. Even though it needs $86 oil to balance the budget, Saudi Arabia can withstand lower prices for a couple of years. Other producers are not as fortunate. Oil revenue accounts for 40% of Russia's government inflows; the country's bonds defaulted in 1998 when oil prices plunged from $26 to $10. In Nigeria, Africa's largest economy, oil represents 95% of export earnings and 75% of government revenues, according to a *New York Times* report.

Now that oil prices are in the upper 40s, we expect high-cost producers like Canada and the United States to curtail production. January's numbers for the 1,500 rigs in operation are 20% lower than in September, according to oil service company Baker Hughes. We expect that trend to continue, although production could remain elevated because energy is a capital-intensive business and producers may be forced to generate cash to service debt. Also, producers that hedged in the futures market are buffered from lower prices, so they could still pump. Also, most producers lease their property, prompting them to produce at least a minimal amount of oil to pay that bill.

Exhibit 3 Google Search Trends: "Drachma"



Source: Google; BMO Private Bank Strategy

The fall in prices represents a $1.5—2.0 trillion transfer from oil exporting countries to oil importers. The beneficiaries are diverse economies where the multiplier effect of the windfall is significant, whereas the largest producers rely almost exclusively on oil revenue to fuel their economies. This could be devastating to monarchies that are more inclined to open their spigots than cede power. Oil prices will likely stay lower for longer, providing the economic boost that has so far been elusive to monetary stimulus.

Financial Market Strategy

Economics is a social science, the study of resource allocation and human nature. Last January, economic theory and reality clashed as Greek voters rejected austerity, budget cutting and belt tightening by electing Alexis Tsipras, leader of the radical Syriza party. His platform was a Marxist agenda of resistance to German-imposed bailout conditions, including budget cuts and tax increases in return for €240 billion. Tsipras promised to roll out a spending package to ease the burden on the poorest quarter of the country's households. In order to deliver on his promises, Tsipras must win debt forgiveness or substantial concessions from his eurozone creditors. Factions of Syriza favor leaving the eurozone altogether.

Should bailout negotiations fail, Greece would be forced to default on its debts, leave the eurozone and adopt its former currency, the drachma. ECB-held bonds totaling €7 billion mature in July. Greece doesn't have the cash to repay them, according to a recent *Wall Street Journal* report. Failure to meet its financial obligations would prompt Greece's exit from the European Project.

Germany is loath to negotiate further concessions with Greece, recognizing that Spain, Italy and potentially France stand in line behind the Hellenic country. A Greek exit is certainly a possibility. Estimating the probability is difficult, although the number of Google searches for "drachma" has trended steadily higher since March 2013 and the search index has remained in the top quartile of its history *(Exhibit #3)*. There was a spike in searches last summer when investors had to hold their breath as Greece bought about €4.5 billion in 5 year debt. There was also an enormous surge in May 2012, the last time Greeks went to the polls.

While a Greek exit from the eurozone would undoubtedly cause a kerfuffle, it's entirely possible the euro would rally in response. Given that the euro is an average of its constituents, the resultant currency would look more like the deutschmark than the drachma. Stay tuned. ■

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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, 2011, 2012, 2013 and 2014.

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