

April 2015

Outlook for Financial Markets

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Jack A. Ablin, CFA

Chief Investment Officer

BMO Private Bank

(312) 461-7756

jack.ablin@BMO.com

"I'd rather regret the things I've done than regret the things I haven't done."

~ Lucille Ball

Economy

Is inflation making a comeback? After seven years of attempting to spur price growth, the Federal Reserve may be finally getting its wish. Inflation is a late stage economic phenomenon. Consistent economic growth tends to erode excess capacity in both fixed investments and labor until supply constraints eventually push costs and wages higher.

The most recent jobs report revealed a monthly pickup in average hourly earnings of 0.5% in January, the highest monthly reading since the Fed opened the monetary spigot in 2008. Labor tightness is showing up in several high-profile labor disputes. The largest U.S. strike covering 35 refineries has entered its fifth week as workers representing one-fifth of national production capacity were walking picket lines. We estimate that regular unleaded gasoline is selling more than 20 cents higher than what crude oil prices would suggest due to constrained refinery output.

The labor unrest affecting 29 West Coast ports has caused up to a two-month backlog in cargo activity, according to a recent CNBC report. 20,000 dockworkers are expected to approve a new five-year contract including the maintenance of nearly no-cost health coverage, an \$11,000 increase in the maximum pension benefit and a dollar per hour wage increase over each of the next five years.

Bowing to political pressure and a tight job market, Walmart agreed to offer its associates starting wages well in excess of the minimum wage. With more than one million employees, Walmart is the nation's largest employer. The move will boost the incomes of roughly half of its workforce within weeks. And in response to long lines at the "It's a Small World" ride at the Magic Kingdom, Disney will be raising the price to enter their theme parks to over \$100 for the first time.

Like the Fed, we are data dependent and we haven't yet seen higher costs and wages filter into the Consumer Price Index. Given where we are in the economic cycle, we wouldn't be surprised if the Fed's dream will soon come true.

Summary

- Is inflation making a comeback? After seven years of attempting to spur price growth, the Federal Reserve may be finally getting its wish.
- Lenders are at it again. Loans to consumers with low credit scores have reached levels not seen since before the financial crisis, a crisis that was caused by loans to people with weak credit.
- Currency valuation is a key ingredient in global competitiveness. As the growth of the global pie slows, countries and regions are scrambling to increase their slice through a more competitive exchange rate.
- Solar energy, once the domain of academics, environmentalists and left-leaning politicians, is approaching a point of economic viability.
- Now the REIT market has become a victim of its own success. At just 3.6 percent, REIT dividend yields are lower than ever.

Please refer to last page for Disclosure Statements.

Bond Market

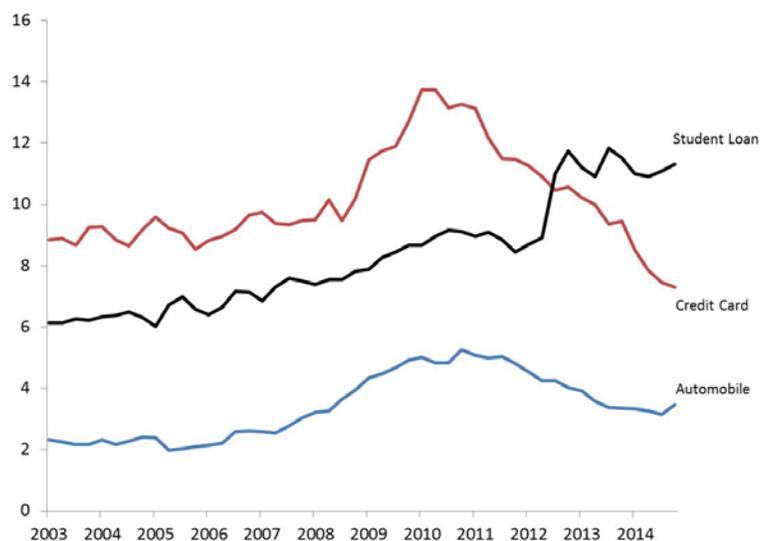
Lenders are at it again. Loans to consumers with low credit scores have reached levels not seen since before the financial crisis, a crisis that was caused by loans to people with weak credit. This time around credit expansion is fueled by autos, not housing. According to credit reporting company Equifax, nearly four out of 10 personal loans made in 2014 were issued to subprime borrowers. That amounted to 50 million consumer loans totaling nearly \$200 billion.

The increase in loan volume was a result of both supply and demand. Faced with historically low interest rates, non-bank firms have stepped in to fill the void left by traditional banks that have been reluctant to extend credit to marginal borrowers. Backed by private investors and hedge funds, online lenders don't face the same regulatory scrutiny that their banking brethren do. At the same time consumers are increasingly willing to take on debt as their financial circumstances have stabilized. Fortunately, subprime borrowers owe on average "only" \$48,000 across all debt obligations including mortgages, according to the FICO score company Fair-Isaac. That figure is down from \$55,000 in 2012 and \$61,000 in 2008.

However, easy financing has helped fuel another auto boom, with 16.5 million cars and trucks sold last year, the best annual showing since 2007. Car loans accounted for the largest increase in subprime lending last year, totaling \$129 billion through November 2014. Between auto loans and student debt, it's beginning to appear that Americans are getting in over their heads (again).

All told, household debt increased \$117 billion in the last quarter of 2014 to a total of \$11.8 trillion, according to the Federal Reserve. The surge in auto loans, especially to Americans with low credit scores and significant student loan debts, is fueling concern that credit conditions are deteriorating. The share of auto and student loans that are 90 days past due are up to 3.5% and 11.3%, respectively, according to Federal Reserve data ([Exhibit #1](#)). Given the recent rise in loan volume, it's reasonable to assume that delinquencies could rise. There were \$102 billion of new household loans originated last quarter and nearly \$20 billion of newly delinquent auto loans hit over that timeframe. While mortgage debt is under control this time, the quality of household debt is a concern.

Exhibit 1: Percent of Personal Debt more than 90-days Past Due



Source: Federal Reserve; BMO Private Bank Strategy

Equity Markets

The threatened departure of Greece was the most recent cloud hanging over the eurozone as the region has bounced from crisis to crisis over the last seven years. All the while, daunting headlines, economic stagnation and a recent go at quantitative easing have weighed on the region's common currency. Since its peak of \$1.48 in April 2011, the euro has plunged nearly 25% against the dollar. The slide has been more pronounced of late, shedding nearly 20% over the last 12 months.

Currency valuation is a key ingredient in global competitiveness. As the growth of the global pie slows, countries and regions are scrambling to increase their slice through a more competitive exchange rate. The U.S. dollar's 40% slide between 2002 and 2008 sparked a manufacturing renaissance. Now it's the euro's turn.

Recent dollar strength and euro weakness are beginning to show up in the numbers. Europe's economic results lately are beating economists' expectations. Over the last three weeks, European retail sales growth, purchasing managers' indexes and GDP growth have all outpaced consensus forecasts. At the same time, U.S. dollar-reliant data like durable goods orders, manufacturing activity and GDP growth fell short of expectations, although the readings themselves were strong. The Citibank Economic Surprise index, which measures economic results versus consensus expectations, has moved into positive territory in Europe while falling into negative terrain in the United States.

Equity market performance comes at the intersection of reality and expectations, so it's interesting to note this shift. Investors have taken notice. So far this year the Euro Stoxx 50 index, representing the largest companies in the eurozone, has advanced 4.7%, more than double the S&P 500's 2.2% gain. That's measured in dollar terms; in euros it's up more than 15% since the beginning of the year. This trend will likely continue.

Outlook

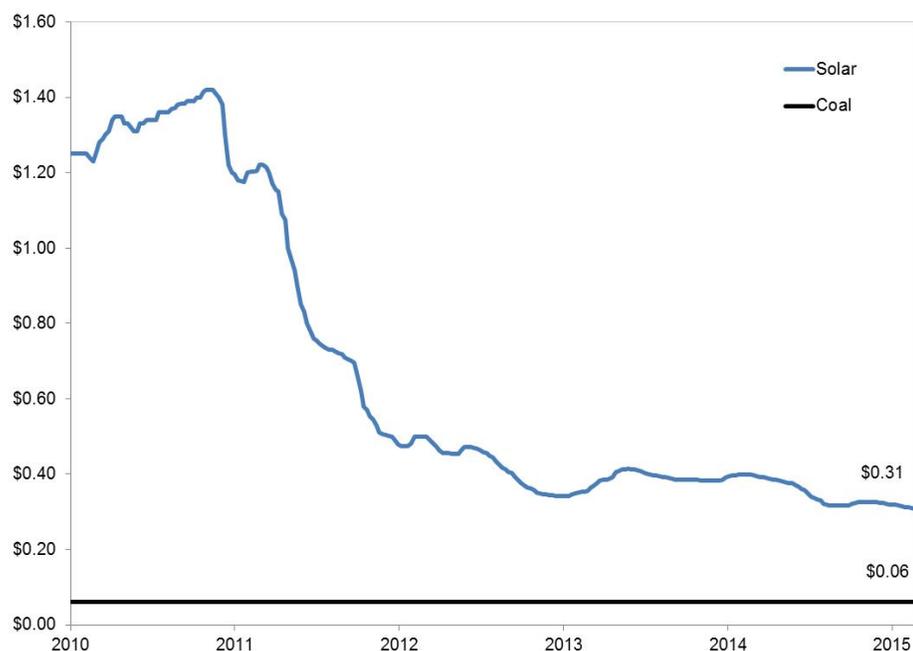
Thanks to years of research, ingenuity and investment, there's a revolution about to get underway that could turn the energy sector upside down. It has the potential to push fossil fuel prices dramatically lower. The revolution I'm describing doesn't involve horizontal drilling and hydraulic fracking. In fact, it doesn't involve fossil fuel at all. It's solar power.

Solar energy, once the domain of academics, environmentalists and left-leaning politicians, is approaching a point of economic viability. Solar power currently accounts for less than 1% of global energy, but it's been expanding at a 50% annualized rate over the last six years, according to a *Foreign Affairs* report by Dickon Pinner and Matt Rogers. The annual capacity of photovoltaic panels installed in 2014 hit 45 gigawatts, enough to power more than seven million homes. Suddenly the numbers are starting to be "real."

How solar energy evolved from a miniature pinwheel inside a glass bulb to a full blown energy sector was the result of public and private sector forces. Solar power would not have blossomed without regulatory support and subsidies, both here and abroad. Government mandates and pro-solar policies which included industry incentives cleared the way for research and development.

Latching onto the increased global demand for photovoltaic panels, China got into the act, industrializing solar panels in 2005. Through competition, cost cutting and innovation, the cost of producing panels has plunged by more than 80% in a half decade ([Exhibit #2](#)). Prices are expected to fall an additional 10% in the first half of 2015. The *Foreign Affairs* piece goes on to say that photovoltaic cells have gotten more efficient too, generating two watts of electricity for every 10 watts of sunlight hitting them, or a 20% efficiency rate. The stakes are high and that figure will grow. According to industry experts, every 1% increase in efficiency translates into a 5% cost reduction on an entire system.

Exhibit 2: The Cost of Generating a Watt of Electricity



Source: PVinsights; BMO Private Bank Strategy

New financing arrangements enable homeowners to install solar panels owned by a third party and either pay a fixed monthly rate or a fixed price per unit of power, enjoying energy savings with no upfront expense. Nearly two-thirds of household rooftop installations employ this type of third party ownership arrangement. The *Foreign Affairs* investigation notes that while costs are expected to decrease 8- 12% annually, the biggest impediment for solar and wind power is consistency. After all, solar panels are at the whim of the sun and clouds, or nightfall. Once the sun goes down, that's the end of it. That's where battery innovation comes in.

The key to unlocking renewable power is energy storage. Current lithium ion batteries are capable of storing large amounts of power, but they're still expensive. For example, batteries account for roughly one-third of the price of an electric automobile. While lithium ion battery prices will fall, right now they represent a significant bottleneck for both renewable energy and electric vehicles. Five years ago the United States and China promoted the development of battery powered automobiles. The U.S. set a goal of one million vehicles on the road by 2015, yet fewer than 350,000 electric cars were in the two countries combined by the end of 2014. Tesla has sold fewer than 50,000 luxury electrics so far. Part of the explanation is that gasoline contains 50 times as much energy per pound compared to a lithium-ion battery.

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Tesla chief Elon Musk is setting out to create a cheaper, more efficient battery. Tesla is building a \$5 billion battery “gigafactory” near Reno, Nevada. Progress has been made and will continue. In 1995, a battery with a one kilowatt-hour of capacity was \$3,000. That’s now shrunk to about \$200. It is expected that the cost of large-scale batteries could drop by more than half by 2020, to about \$0.23 per watt. That would enable renewables to effectively compete with coal in powering the grid. There are enormous economic, geopolitical and environmental advantages to be gained by the countries that could effectively harness renewable energy. The race is on.

Financial Market Strategy

Last year the Dow Jones REIT index of real estate investment trusts surged more than 28%, capping a 115% five year performance. REITs avoid double-taxation by paying out 90% of their operating income, making them an interesting income vehicle. Historically, low Treasury yields have pushed investors into the asset class, driving returns. Now the REIT market has become a victim of its own success. At just 3.6%, REIT dividend yields are lower than ever. Relative to cash flow or funds from operations, REIT prices are at an all-time high, suggesting further gains will be difficult (Exhibit #3). Since 1993, dividend income comprised 53% of the group’s total returns. Historically low dividends and record high valuations will ultimately conspire to crimp the prospects of the asset class.

Exhibit 3: REIT Market Valuation: Price-to-Funds from Operations (FFO) History



Source: Bloomberg; BMO Private Bank Strategy

J.A.A.
March 3, 2015

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