June, 2014

NOTES FROM THE NORTH: MARKET OUTLOOK

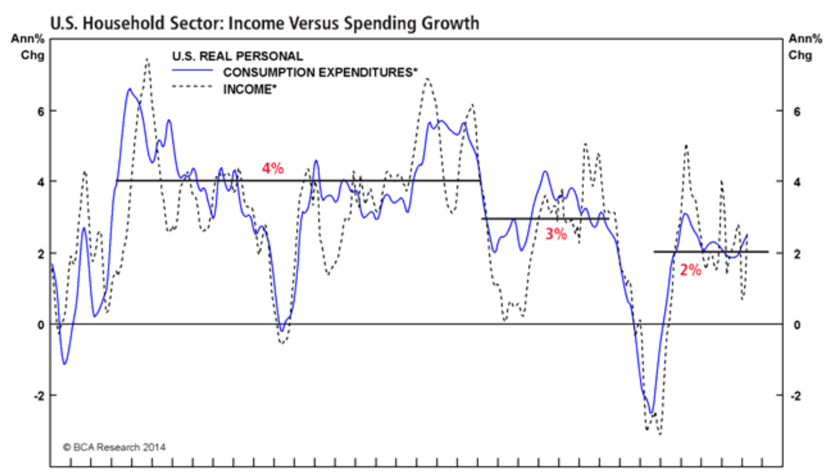
Administrative Alert!

Times being what they are, please be vigilant in protecting your personal information. We are! One of the new threats we're hearing about is the *increasingly sophisticated personalization of fraudulent email requests* for fund transfers. While we haven't experienced it first hand, our internal policy states "All personnel must remain alert to the possibility that virtually any "client" request could potentially be generated by an identify thief." We've decided to up our vigilance to protect against this potential fraud, which may throw up some speed bumps in processing even a normal request. It's unfortunate, but necessary, and we apologize in advance for any inconvenience this may cause you. If you have any questions or concerns, please give us a call.

As we write this piece, we find that year to date the S&P 500 Index is up 4.9% while the Dow Jones Industrials Index is up 1.4%. The surprise thus far in 2014 is that the yield on the 10-year Treasury bond has dropped from 3.0% at year end to 2.6%. Pundits had been sure bond yields would rise in 2014 as the Federal Reserve bought fewer bonds and the economy strengthened. The U.S. government needs to finance a deficit of roughly $40 billion per month. Foreign governments, who had been financing the bulk of this deficit, have reduced their buying to about $10 billion per month. While the Federal Reserve had been buying the balance, thereby supporting bond prices (and keeping rates low), Janet Yellen had announced that "tapering" from quantitative easing would begin and the Federal Reserve would be reducing its buying by roughly $5 billion per month. This was anticipated, and it was widely expected to result in upward pressure on U.S. interest rates.

At the end of last year, economic momentum was gaining steam and growth was widely expected to continue in 2014, another reason to think interest rates would move higher. In fact, the U.S. economy was far weaker in the first quarter than was expected, with low initial estimates of GDP growth being revised to –1.0% and revisions down to a possible –2.0% still on the table. While this was likely weather-related and completely explainable, it caught the bond market by surprise. At the same time, yields on European government bonds plummeted in 2014. Partly due to institutional speculation and partly due to European central bank intervention, German and even *Spanish* bonds now yield less than U.S. bonds. Based on quality, rational bond buyers should favor U.S. Treasuries at current rates and this has likely put additional, unexpected support under U.S. Treasury prices.

Chart 1



Last month we explained our reasoning for staying relatively fully invested in good quality, dividend-paying stocks. This month we will give voice to a persuasive pessimist. On May 26th, Barron's magazine featured an article about Stephanie Pomboy, President of MacroMavens. Pomboy, a well-regarded economist, has generally been correct in her views of the economy, if not in her predictions for the stock market. Her current view of the U.S. economy is that the extraordinary efforts of the Federal Reserve have helped raise prices of stocks and real estate, but she does not see that they have achieved any self-sustaining momentum in the economy. She cites the following data:

(Continued on page 2)

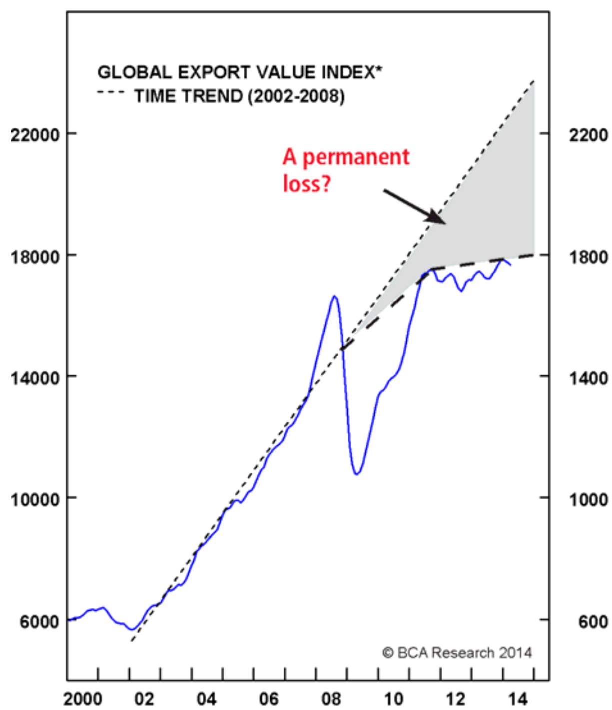
Market Outlook, continued

- The U.S. has had a steady slowing in nominal growth rates *since 2000*,
- The number of jobs has increased, but not the number of hours worked, suggesting that the current job market "improvement" is distorted by the fact that many workers are holding down more than one job, and
- Fully 90% of the increase in discretionary spending since 2007 is explained by inflation.

The Bank Credit Analyst research confirms that the labor participation rate remains low and the median wage is lower than it was in 2007. Lacking buying power, consumers are not buying more goods (Chart 1, page 1). Lacking demand for goods, corporations are not expanding their spending or their employment. This feedback loop describes the vicious cycle of decline that every monetary and fiscal authority wishes to avoid at all costs. Pomboy believes the economy will *not* accelerate if the Fed takes it foot off the gas pedal. In fact, she expects that they will soon realize their error, and will resort to more stimulus even though it has achieved little.

Looking beyond the U.S., BCA believes it is unrealistic to expect a significant spurt in the world's growth rate when almost everyone is under pressure to reduce debt. The slowdown in global trade, shown in Chart 2 (below), is compounding the problem. Muted growth and weak pricing will restrain earnings expansion while keeping interest rates lower longer than expected. The net result may be that GDP growth remains muted, but the "recovery," such as it is, could continue for an unusually long time.

Chart 2



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