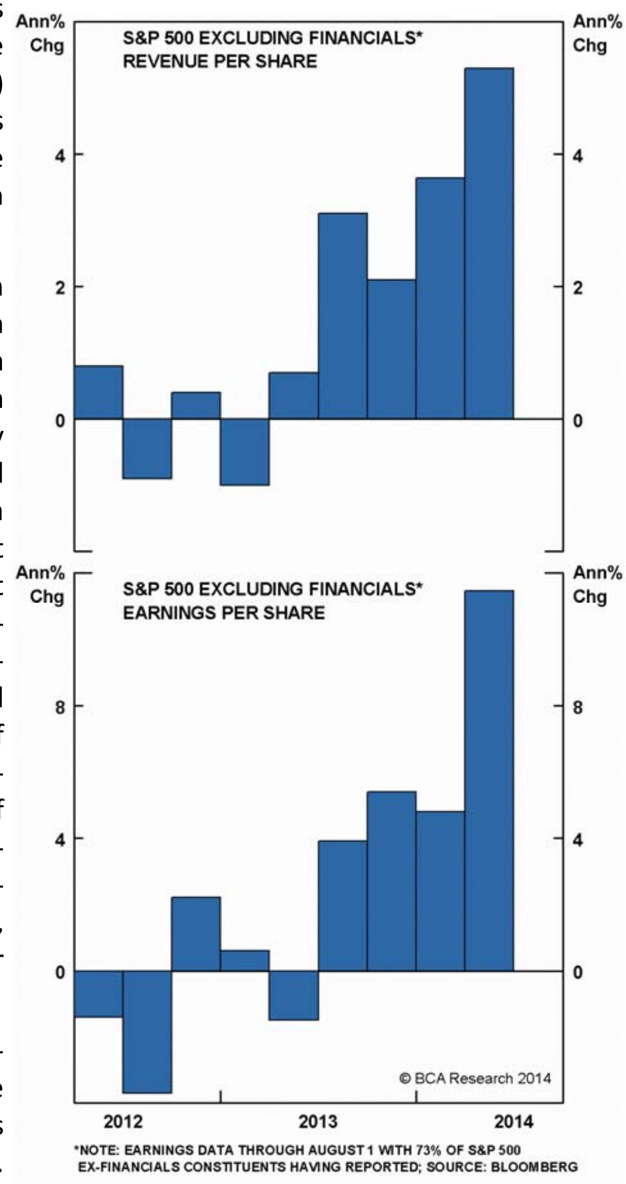
NOTES FROM THE NORTH: MARKET OUTLOOK

August, 2014

The stock market is down modestly since we cautioned in last month's newsletter that stocks were becoming vulnerable due to overvaluation. Early last year, we noted that most of the market's remarkable increase had come solely on the back of earnings recovery; there had been *no* price/earnings multiple expansion to speak of. Be careful what you wish for! Today, we note with increasing concern that since 2012, only 12% of the advance in world stock prices can be explained by rising profit expectations: *88%* is due to an expansion in price/earnings multiples. Although the returns generated by multiple expansion may be pleasant, we find the speculative element entering into market valuation to be increasingly unsettling.

Given the higher valuation of the broad market, it is fortunate that second quarter corporate earnings results cheered investors (see Chart 1, right). S&P 500 revenues rose roughly 5% while earnings per share rose 10%. Half of the earnings increase (5%) can be attributed to the revenue growth, while the other 5% was due to share buybacks (a financial management technique we highlighted last month). Margin expansion was not a factor in earnings growth.

Chart 1



It would not be realistic to expect margin expansion. Between 1980 and 2000, corporate profit margins cycled up and down through a narrow band with a fairly predictable average. From a cyclical low in 2000, however, corporate profit margins began marching steadily higher, and they have been in record territory for almost 10 years. The Bank Credit Analyst recently concluded that the current extremely high level of profit margins is not a reflection of miraculous efficiency gains (which would warrant continued optimism about the sustainability of strong profit growth even if revenue growth remains soft). While lower interest rates have helped significantly in the last five years, BCA research highlights the divergence between labor productivity and real compensation over the last ten years and calculates that if this relationship returned to "normal," then real worker compensation would be about 10% higher. This higher level of worker compensation would bring corporate profit margins almost immediately back to their long-term average. This prospect, combined with anemic worldwide economic growth, causes BCA to forecast overall earnings growth of 5% or less over the next several years.

One important question for long term investors is whether historical asset class returns are likely to be a good guide for the future. According to a report from Vanguard, since 1926, bonds have provided an average annual total return of 5.5% while U.S. stocks have gained 10.2% per year.

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Market Outlook, continued

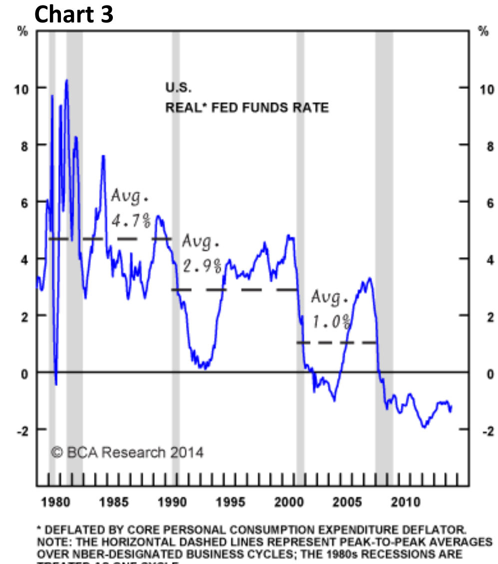
While this sounds promising, in our opinion it would be a mistake to "bank" on returns of this level in the next 10 years. The much-needed deleveraging that began with the financial crisis in 2008 has progressed, but still has a long way to go. Chart 2 (right) shows the dramatic rise in U.S. private non-financial debt as a percent of potential GDP and highlights the distance we still need to go.

Although *private* U.S. debt has been reduced (and may, indeed, be stabilizing), Federal debt has continued to increase and now is roughly $140,000 per household (a figure that does *not* include unfunded social obligations such as Medicare and Medicaid!). Unfortunately, most of Europe and parts of Asia followed our lead and also become over-indebted during the binge years. Deleveraging, while needed, will continue to keep demand, and thus growth, constrained. This is confirmed by the U.S. "output gap" (the difference between what the economy *is* producing and what it *could* produce), which typically closes during an economic recovery. Since 2008, it has remained stubbornly in negative territory.

Chart 2

In this world of reduced overall demand, it's quite conceivable that the price of money, real interest rates, will remain low for longer than anyone (including us) had expected. As Chart 3 clearly shows, the trend for U.S. Fed Funds rates has been definitively *down* since 1985. Lower interest rates imply a higher premium for growth, so it would not be surprising to experience the continued uncomfortable experience of low returns on conservative investments and a higher than normal multiple on riskier, equity investments, even if their profits continue to grow only slowly.

Chart 3



The bottom line is that we agree with BCA and several other organizations that have recently warned that returns over the next 10 years are unlikely to match historic averages. With 10-year Treasuries now yielding a historically low 2.4%, we would expect bonds to return no more than 2%-3% over the next 10 years. It would not surprise us, either, if U.S. stocks returned 5%-7% per year rather than 10%. Realistically, however, these returns may look quite attractive compared to other potential liquid investments, especially cash.

Barring a recession, which does not appear likely over the foreseeable future, the conservative stocks we currently own for clients should prove to be worthwhile holdings over the next decade.

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