NOTES FROM THE NORTH: MARKET OUTLOOK

June,2015

Although still positive for the year, the stock market has trended largely sideways for the last four months. Overhanging concerns have included U.S. economic weakness during the first quarter and the continuing possibility that Greece will leave the eurozone. The Federal Reserve's first interest rate hike is somewhere on the horizon and revenue growth remains hard to find. On a more positive note, central banks around the world continue to push more liquidity into the hands of investors, U.S. corporations remain heavy buyers of their own shares, and M&A (mergers and acquisitions) activity has continued to bolster investor enthusiasm.

Media coverage of recent economic reports has been encouraging to the retail investor. For instance, Neil Shah, reporting for *The Wall Street Journal,* says that growing wealth and strong jobs growth should give consumers the ability to boost their spending. This would be welcome, since consumer spending accounts for about two-thirds of GDP. Shah reports that total U.S. household debt as a share of disposable income was 106.5% in the first quarter, the lowest level in more than a decade. While true, a longer perspective (Chart A, below) shows that the debt increases in the run-up to 2007 were unprecedented, and while down as reported, consumer debt levels remain considerably higher than anytime from 1960-2000. The personal savings rate (Chart B, below right) also remains relatively low, despite lower gasoline prices.

U.S. job creation and unemployment levels look good, especially versus those of most foreign economies. The U.S. economy is expected to continue to grow moderately while avoiding a recession. However, the well-regarded Bank Credit Analyst believes our economy is too weak to support a significant rise in interest rates. They are even more pessimistic on growth in Europe, and suggest that Europe may not be able to raise rates until the end of this decade.

Although the U.S. economic outlook is mostly positive, if not exciting, stock valuations are stretched by many traditional measures and profit margins, which have historically been "mean-reverting" (i.e. they cycle up *and down* around a long-term mean), have been at record levels for a very long time. On margins, BCA highlights that the strong dollar has been and will continue to be a headwind for U.S. corporate earnings. One-third of U.S. profits are generated overseas, and the mathematics of converting from a weak foreign currency to a strong U.S. dollar do not favor profit reports. Even if the dollar trades sideways from current levels, this pressure is likely to continue since earnings comparisons will be made with the year-earlier periods when dollar hedges were in place. BCA also expect wage expenses to rise and the impact of low borrowing rates to shift at the margin from a tailwind to a headwind.

Chart A

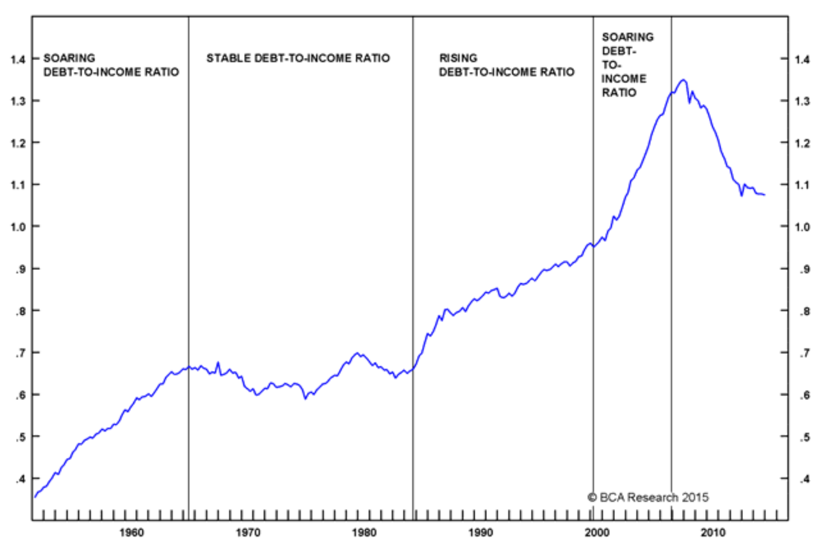
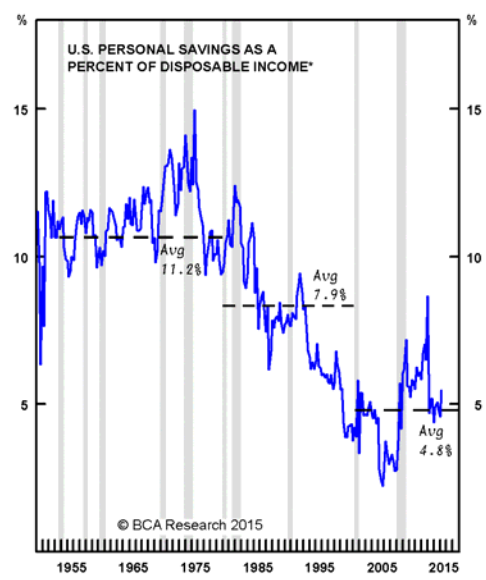


Chart B



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Market Outlook, continued

The negative trends that BCA foresees for U.S. corporate profit margins are worrisome, as a reversion to the mean would come at a time when stocks are fully valued by many measures (see Charts C, D and E below). Although future earnings and future valuations are what will ultimately matter, full valuations of current earnings are a good indicator that it would be unreasonable to expect above-average returns from these levels. This is a complicated way of saying we're beginning to feel we should be more cautious with our portfolios.

High valuations on stocks can be fully rationalized if interest rates remain low. Low interest rates have certainly made stocks more attractive than their standard alternatives (bonds and cash). However, it's time to begin to consider not just when, but *how* interest rates are going to rise. Using the iShares exchange-traded funds TLT, TLH, IEI, and SHY as proxies for the government bond market, the longest of these, TLT (20+ years), posted a low rate of 2.3% on January 30. Since then, the price dropped as much as 16% while the yield rose to 2.7% in increasingly volatile trading. (If the Dow Jones Industrial Average suffered a similar fate, it would fall 2,500 points). The TLH (10+years) fell by 6.6% as its rate rose from 1.99% to 2.12%. IEI (3-5 years) gave back just 2% as its rate increased by just 3 basis points (0.03%) and the SHY (1-3 years) remains virtually unchanged.

When rates rise more at the long end than at the short end of the yield curve, the curve is said to have "steepened." This is good for stocks, as it generally forecasts stronger growth. When the Federal Reserve raises short rates enough that money market funds and bank accounts offer a better return than a 10– or 30-year Treasury, the yield curve is described as "inverted," and this is almost always bad news for stocks. Inverted yield curves suggest the Federal Reserve is "taking away the punch bowl" and they almost always precede an economic recession.

While a speculator might now place a bet on the 30-year Treasury, thinking it had overreacted, or on European or Japanese stocks, where valuations are substantially lower than in the U.S., those would be portfolio shifts designed to increase returns and would require additional risk. Our inclination, at this point, is to begin to reduce risk. In our view, long-term investors should begin to consider the possibility that the best course over the next several years might be prudence, and positive returns might best be achieved by avoiding unnecessary risk.

Chart C

Chart D

Chart E: "The Buffet Indicator"
Market Capitalization to GDP

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