# NOTES FROM THE NORTH: MARKET OUTLOOK

***September, 2015***

Last week, the Federal Reserve decided, once again, to leave interest rates unchanged, extending even further the six-year-old policy of zero interest rates (“ZIRP”). While the Fed’s written commentary on the U.S. economy rarely changes significantly, one new and notable addition included the statement that "*recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term.*" As Peter Boockvar of the Lindsay Group points out, China has been slowing for 5 years and commodity prices have been falling for 4 years; if the Federal Reserve is now going to consider overseas economic conditions as well as domestic, their next major move may not be higher interest rates, but rather a fourth edition of quantitative easing.

Equity investors, or at least the computers that now account for 70% of trading on the New York Stock Exchange, initially reacted favorably to Janet Yellen's dovish comments regarding the Fed's decision. Positive trading persisted for about an hour, then selling took the market lower into Thursday's close and throughout Friday. Those declines brought the year to date loss on the S&P 500 index to roughly 5% and to roughly 8% for the Dow Jones Industrials index.

Long term investors should probably ignore most swings in the market, but those with cash to invest are asking if this isn't a good time to add to positions. It is true that the U.S. economy is holding steady despite the troubles overseas. Employment numbers are good; core consumer price inflation is holding steady just below 2%; industrial production has stabilized with the ISM manufacturing survey above 50%; and single-family building permits are the highest since January 2008. The Atlanta Fed estimates that real GDP in the third quarter will grow by 1.5%. However, corporate earnings are now expected to decline about 4% this quarter. Profits are being hurt by the strong dollar (see Chart 1, below) which makes exports more expensive and reduces the value of overseas earnings. Also important is the devastating effect of the decline in oil prices (over 50%) on earnings for U.S. energy firms.

We have seen profit margins for S&P 500 companies begin to decline, and many companies complain that they lack pricing power. Recent earnings reports from FedEx, Verizon and Oracle, three very different companies, were roughly in line with expectations. However, all three stocks fell in price when their managements lowered earnings expectations for coming

**Chart 1**

quarters. This type of reaction is not surprising when stocks are relatively expensive. Chart 2 (below) highlights how stock prices (the blue line) have grown more than earnings (the dotted black line) over the last three years.

The Bank Credit Analyst urges patience in committing new funds to the equity market. They believe the U.S. market could be more vulnerable to deteriorating conditions in emerging markets than many are anticipating. This may seem counterintuitive when U.S. exports to emerging markets only account for 4% of U.S. GDP. Moreover, the U.S. banking system has strong balance sheets and does not have sizable direct exposure to emerging markets, including China.

However, many U.S. multi-nationals such as Apple, General Motors, Caterpillar Tractor and Yum! Brands (the Taco Bell, Pizza Hut and Kentucky Fried Chicken chain) generate significant sales revenues in emerging markets. Also U.S. investors have significant exposure to emerging market debt and equity markets. Losses sustained in a weak asset class (such as emerging market equities) sometimes trigger profit-taking in a stronger one (such as U.S. equities) simply to rebalance portfolios towards asset allocation targets.

Emerging markets are also much larger now than they were in 1998, when they last caused havoc in world markets. The emerging market now accounts for 57% of the world's GDP when measured on the basis of purchasing power parity (see Chart 3, below). Measured this way, China alone has a bigger share of world GDP than the U.S., Europe or Japan. In the short

**Chart 2**

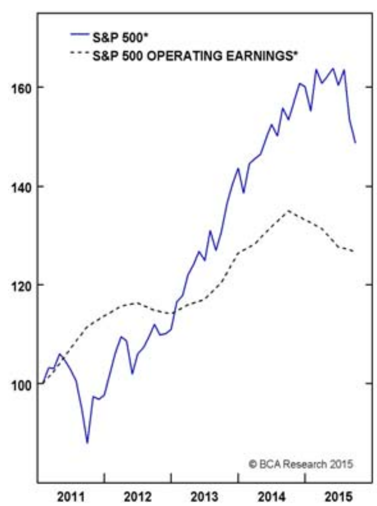
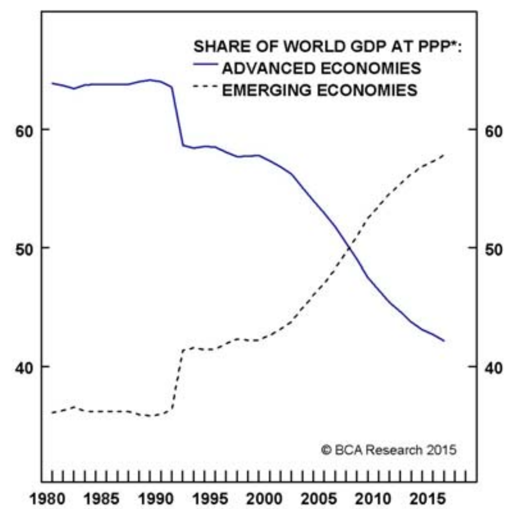



**Chart 3**




run, the Bank Credit Analyst sees better risk/reward in low-yielding U.S. Treasuries than in U.S. stocks. For our part, we remain constructive on the long term outlook for the stocks we own, but are content to wait for better buying opportunities before putting new money to work. This would not preclude us, of course, from swapping one stock for another if the spread in their relative valuations became unusually wide. We continue to favor firms with primarily domestic operations, but note that if the dollar stops rising, earnings comparisons for multi-nationals would become more favorable in 2016.

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