Notes From the North: Market Outlook

October, 2015

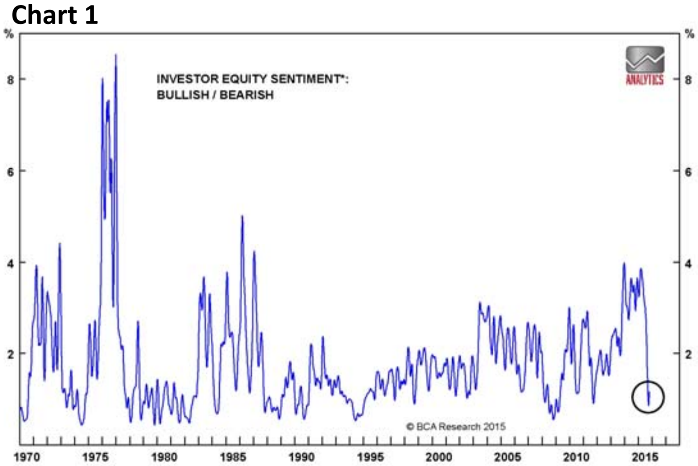
After a difficult third quarter, stocks rebounded strongly early in October. We attribute the strength to the growing likelihood that the Fed will not raise rates soon. The Bank Credit Analyst believes the probability of getting at least one rate hike by December 2015 has fallen to 34%. Perhaps equally important, Chart 1 (below, left) shows the extent to which market participants had become quite bearish. Historically, when sentiment deteriorates this sharply, investors have already sold stocks in anticipation of lower prices, so any buying that materializes pushes up prices.

In our work, we have noticed that some stock prices have fallen too sharply and therefore expect to do more buying in the fourth quarter. However, there is no reason to be particularly optimistic or pessimistic about the medium term outlook for the stock market as a whole. We would not be surprised if, in five or six years, we look back and calculate annualized stock returns of 5-6%, rather than the historical level of 9-10%. With bond yields still artificially depressed, we expect stocks to outperform bonds over the long run even if they do not provide as high a return as they have historically.

Why would "normal" returns in the next market cycle be lower than usual? To start, while 40% of the market increase since the beginning of 2012 can be attributed to higher earnings, an even larger share (60%) is due to a widening of the market's price/earnings multiple. The market is now at a valuation level where higher multiples are possible, but unlikely. Future stock price increases need to be supported by higher earnings. For the balance of 2015, unfortunately, earnings are now expected to fall. Indeed, there have already been a number of earnings disappointments among the few third quarter results that have been reported.

For the next calendar year, BCA expects earnings to rise by 4%-6%. This level of growth would be below current Street expectations (+10%), but still sufficiently positive to bolster the prices of *some* companies, if not the market as a whole. The table of earnings expectations by industry group (right) delineates the stark contrast in sales and earnings progress between sectors that is anticipated for the third quarter. U.S. domestic

Chart 1



Revenue and earnings per share estimates; Q3, 2015

SECTOR	REVENUE %	EPS %
CONSUMER DISCRETIONARY	4.1	10.9
CONSUMER STAPLES	1.6	-2.0
ENERGY	-36.8	-64.9
FINANCIALS	1.6	11.0
HEALTH CARE	7.6	3.3
INDUSTRIALS	-5.0	-2.7
MATERIALS	-9.0	-19.3
TECHNOLOGY	1.6	2.8
TELECOM	14.2	11.2
UTILITIES	2.9	-2.2
S&P 500	-3.6	-4.0

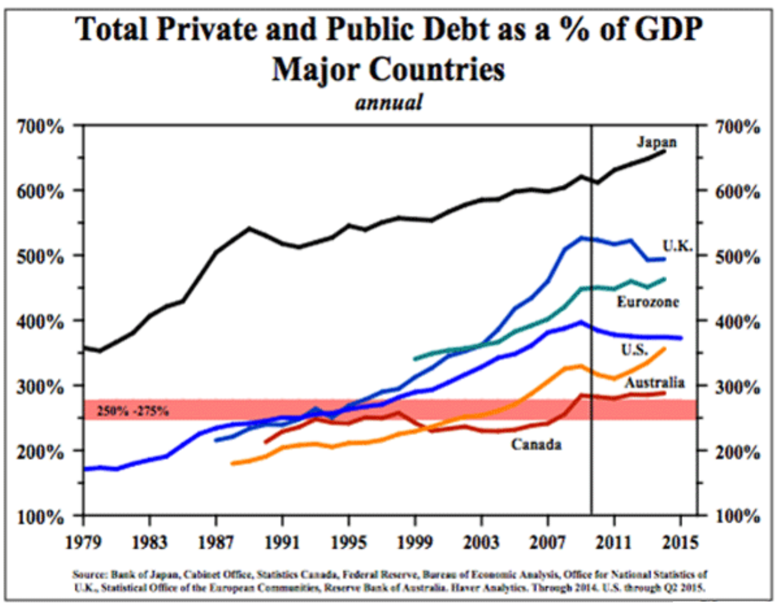
Source: BCA Research

companies, especially those tied to consumer spending, should benefit from a decent employment environment and a strong housing market. Companies with large overseas operations or a significant export business will be more at risk, due to a strong dollar and a continuing slowdown in foreign economies.

High debt levels as a percentage of GDP are likely to provide another drag on future growth. Growth in borrowing over the last fifty years has facilitated earnings growth, but debt worldwide has reached levels where further growth through leverage is quite unlikely. Chart 2 (below) highlights the growth of worldwide debt as a percent of Gross Domestic Product, or GDP. Studies show that real per capita GDP growth should slow by about one-quarter to one-third from the long-run trend when the total debt-to-GDP ratio rises into the red bar in the chart below (250% and 275%). According to Lacy Hunt of Hoisington Management, U.S. government debt has grown dramatically in the last 6 years and now amounts to 103% of GDP. While private debt fell during this period (partly because consumers reneged on mortgage contracts), the two added together comprise a total debt to GDP ratio of 370%. Since surpassing the critical 275% level in the late 1990s, real per capita GDP has grown just 1% per annum, much less than the 1.9% historical pace from 1790 to 1999.

Is it worth participating in the stock market if economic growth will be low and returns will only be in mid-single digits? Absolutely. 5% compounded over ten years grows to a gain of over 60%, while 2% (the 10-year Treasury rate) compounds to a gain of just 22%. After accounting for inflation of just 1%, the buying power would be $50 versus $10. Is it worth investing in speculative issues to chase double-digit returns? In our opinion, the risks are too high. Quality companies that can weather a variety of storms we can't even anticipate right now are more to our liking, and if we can buy them when expectations are low, chances are the return will be satisfactory.

Chart 2



Edmund R. Taylor, CFA	*Martha E. Cottrill, CFA*	*William B. Hamilton, Jr.*
Principal	*Principal*	*Sr. Financial Strategist*

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