NOTES FROM THE NORTH: MARKET OUTLOOK

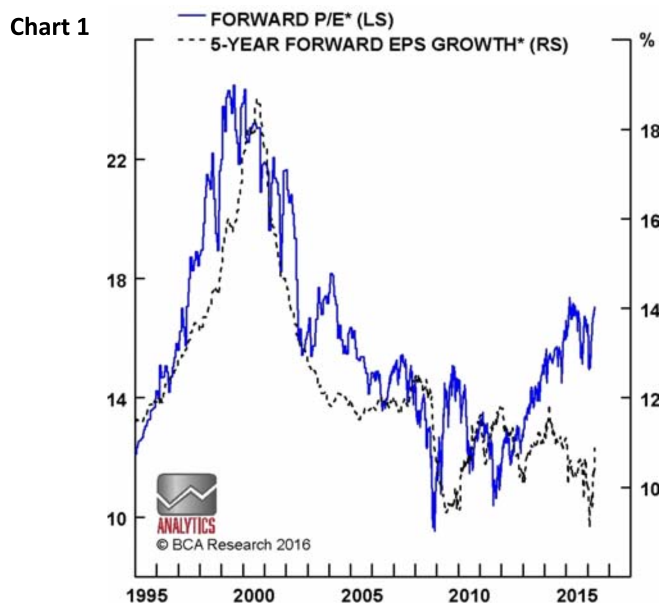
May, 2016

Given high equity valuations, falling earnings and profit margin headwinds, we feel fortunate that the S&P 500 is essentially unchanged for the first 5 1/2 months of 2016. We have been cautious about adding new names to our holdings, but have been comfortable with the high quality stocks we already own. Should we lighten up on those holdings? Extraordinarily successful investors such as Warren Buffett and David Tepper remain optimistic, but others with equally remarkable histories, such as Stanley Druckenmiller and Jeff Gundlach, think stocks are vulnerable.

This seemed like a good time to talk privately with Joe Abramson, who is a managing editor at the Bank Credit Analyst. BCA has been saying that they do not see the conditions for a sustained bull market, but it is possible that Chinese reflation, dollar weakness and Fed inaction could support prices for the next few quarters. We asked Mr. Abramson what would cause him to become more bearish.

Abramson believes that the massive liquidity provided by central banks has allowed stocks to become detached from fundamentals. Chart 1 (below) shows how forward price/earnings multiples have risen sharply over the last four years while projected earnings growth has been stagnant. He favors a neutral weighting in stocks. In other words, if your normal asset allocation is 60%-80% stocks, he would be at 70%.

Chart 1



These are some of the events that could make BCA more bearish:

1. Renewed Fed hawkishness that causes the dollar to rise sharply, with the relationship of the dollar and the Euro being especially important. A stronger dollar depresses U.S. exports and hurts earnings of U.S. multi-nationals.
2. Renewed corporate bond stress. When the yield of junk bonds rises versus the yield on Treasuries, the stock market often suffers. Joe noted that half of all leveraged loans were underwritten during the "covenant-light" 2013 period and have now had time to "season," i.e. if the loans were too optimistic, stresses would typically begin to show after about three years.
3. A sharp slowdown in China would affect many markets. Chinese demand affects commodity prices, including oil.

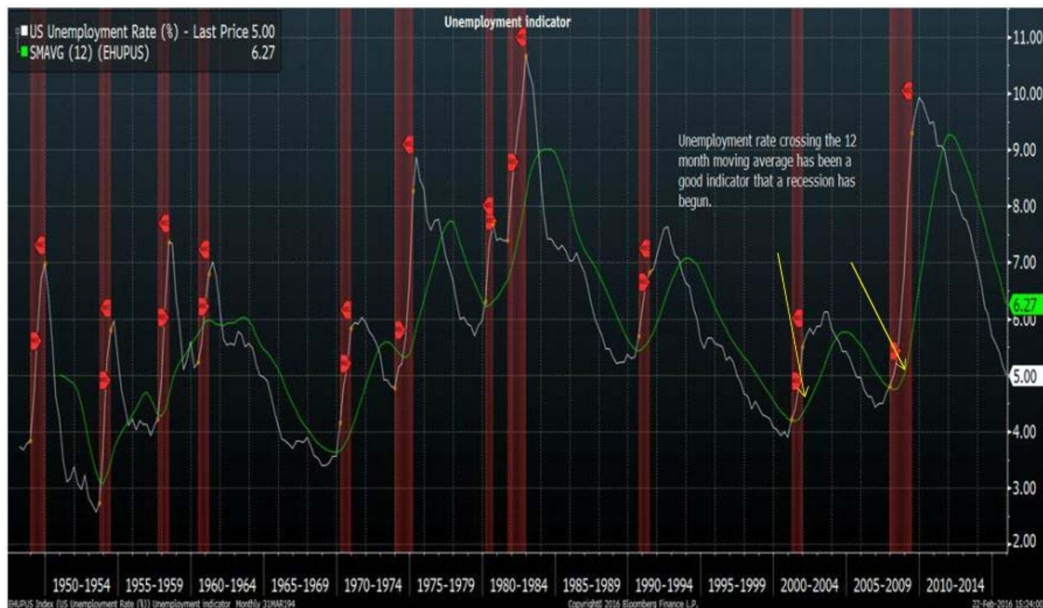
Had China not grown as rapidly as it did in the last 10 years, worldwide GDP figures would look a lot worse.

4. Poor relative performance of investment banking stocks, which often lead the market. This red flag is already waving; look at Goldman Sachs (ticker symbol "GS").
5. Watch for an inversion of the yield curve. An inversion of the yield curve (short rates higher than long rates) is one of the cleanest signals of impending recession. Because the Federal Reserve is so concentrated on managing the short end of the rate curve, however, the shape of the curve between the 10-year Treasury and the 30-year Treasury may be more prophetic than the standard tool, the curve between the Treasury bill and the 10-year.

Also on the subject of recession, Jeff Gundlach watches the data below for his recession signals. (Gundlach, remember, is one of our pessimists.) Chart Two shows the U.S. unemployment rate (white) versus its 12 month moving average (green). Gundlach notes that when the current unemployment rate exceeds the moving average, a recession often occurs. The latest jobs data were disappointing, but like the yield curve, this signal is not flashing caution yet.

Returning to our conversation with Mr. Abramson, he acknowledges that unusual circumstances, especially negative interest rates, have unsettled investors, but assets must be invested somewhere and U.S. equities are still a good choice for the long run. We like that within U.S. equities, one of Abramson's strongest tactical equity convictions is a preference for large companies over smaller ones. We came away from our conversation continuing to think that we will watch the market closely for signs of deterioration, but we continue to hold the high quality stocks we now own.

Chart 2



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