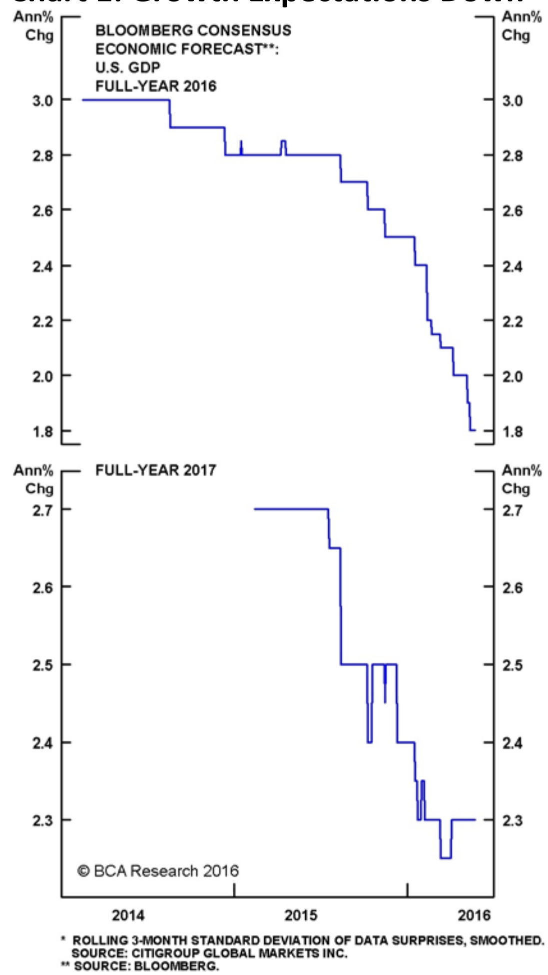
NOTES FROM THE NORTH: MARKET OUTLOOK

June, 2016

U.S. stocks have been surprisingly resilient this year, but an even bigger surprise is the 4%+ return to the broad bond market thus far in 2016. Part of the strength in bond prices is related to the continuing downgrades in growth expectations, demonstrated in Chart 1 (below).

In a recent Barron's "Roundtable" discussion, the stock market was widely expected to be relatively unchanged over the balance of this year. Expectations for long term returns from equities have been downgraded to perhaps 5% per year. A couple of the strategists interviewed were quite bearish, but most thought there is still good money to be made in selected stocks. Separately, Goldman Sachs expects the S&P 500 to close the year at 2100 (versus 2071 today) and to end 2017 at the 2200 level.

Chart 1: Growth Expectations Down



We see one recent development and one upcoming event that could cause financial markets to move more sharply than the consensus forecast mentioned above:

Recently, Janet Yellen changed expectations for upcoming interest rate hikes rather abruptly. Having raised the Fed Funds target range to 0.25%-0.50% in December, it had been expected that the Federal Reserve would increase this range two more times in 2016. The plan was to raise rates to a *neutral level,* i.e. one that would be compatible with full employment and stable inflation. Unfortunately, this level cannot be determined ahead of time nor can it be measured in real time. It's always a guess, at best. In the past, Yellen had said that the Federal Reserve was waiting for "temporary headwinds" to pass before raising rates. Yellen's June 15th comments shifted emphasis from "temporary headwinds" to "persistent problems" such as aging societies and a global slump in productivity.

Greg Ip, writing for The Wall Street Journal, notes that the neutral interest rate seems to be dropping. In 2013, it was thought to be 4%. Many now consider it to be about 3%. In her most recent statements, Ms. Yellen seems to be suggesting that it is now 2%. Speaking on June 17, St. Louis Fed chairman Jim Bullard doubled down on Yellen's remarks. Given his expectations for long term growth of only 2% in the U.S., Bullard thinks a Fed Funds rate of 0.63% will be high enough through 2018. In our view, it is not the rate forecast that is most important, but the growing realization that growth will be disappointing. Greg Ip thinks the U.S. is in danger of becoming like Japan where the economy has floundered for two decades, and does not seem to be responding to recent monetary resuscitation efforts. (The Japanese central bank has employed strong monetary stimulation and lowered interest rates below zero, so far without favorable results).

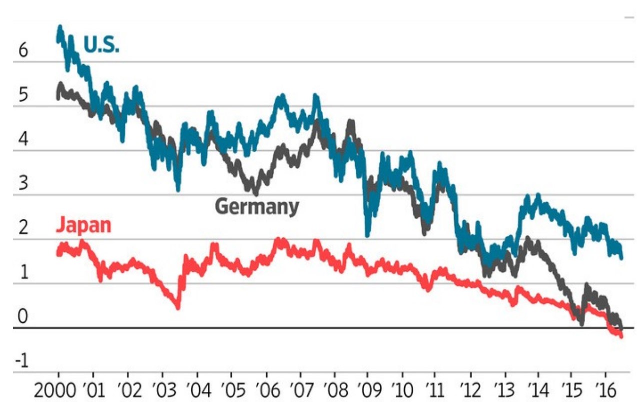
The Fed's comments were greeted favorably by Wall Street since low interest rates are seen as being positive for both stocks and bonds. However, if Mr. Ip is correct as to the reason that rates will stay low, investors may need to reassess their valuation framework for stocks (higher) as well as potential earnings growth for stocks (lower). Income-oriented investors such as pension funds will continue to be hard-pressed to find suitable fixed-income investments to meet their return requirements.

The upcoming item that deserves careful attention is the June 23 "Brexit" vote in Britain, a general referendum on whether the United Kingdom should remain a member of the European Union (EU). The polls show a close race. The EU is an economic and political union of 28 European nations, nineteen of which have adopted the Euro as their common currency. The original goal of the union was to foster trade and prevent war. Those who favor the UK leaving say the rules on businesses have become too onerous and the billions of dollars that Britain must pay in fees buy few benefits. They also want the UK to have control of its own borders. Those who favor the UK staying say that the EU structure allows a freer movement of goods, money and employees.

The bureaucratic power of the EU has grown to the point where it issues rules on transportation, consumer rights and even mobile phone charges. The central administration has also sought to tell countries how to handle immigrants from Syria and other Middle Eastern countries. The fact that newly arrived migrants can be eligible for welfare, health care and education has made some middle class voters grumble that after taking care of tens of thousands of immigrants, there may not be enough money left over to pay their own benefits down the road. While Germany may be able to put this many new arrivals to work, employees in other countries also see their jobs as being at risk. If the vote goes in favor of leaving, there will be a two year process to work out the details but financial markets will not wait that long to react. European stocks have been falling when the "leave group" rises in the polls and vice versa but the primary action should be in the currency markets.

Swiss money manager and Roundtable participant, Felix Zulauf, thinks a Brexit would be more damaging for the EU broadly than for the UK specifically, because the project of a "greater Europe" will have failed. Writing for The Telegraph, Ambrose Evans-Pritchard suspects that "contagion" would be visited on other EU nations. 90% of Dutch voters want an opportunity to vote on their own exit. Austria recently came within 1% of electing a far-right anti-EU president. Marie Le Pen, the National Front candidate for the French presidency is tied for the lead in recent polls. Even many German workers are re-thinking the advantages of the EU.

Chart 2: 10-year government bond yields



Source: FactSet (U.S. Treasurys); Thomson Reuters (foreign bonds)
THE WALL STREET JOURNAL.

While a Brexit would seem to be bad news for European stocks, the effect on U.S. stocks is less clear. Multinational firms would be inconvenienced, but a possible outcome would be an increased perception of the U.S. as a safe haven and even more demand from foreign investors. This has already happened in the bond markets where in addition to slowing growth expectations and supportive monetary policy, overseas demand for U.S. bonds has pushed prices higher as well. Chart 2 (above, right) is self-explanatory. A saver in Japan and Germany must *pay* to invest in a 10-year bond in those countries. Global conditions such as this put the 1.75% yield on a U.S. Treasury and the 2.0% dividend yield on the S&P 500 in a very different light.

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