NOTES FROM THE NORTH: MARKET OUTLOOK

July, 2016

Many investors were anticipating a difficult summer. Equity valuations are unusually high. The Bank Credit Analyst reports that at 27, the cyclically-adjusted price-earnings multiple on U.S. stocks is 25% above the average of the past 60 years. Second quarter earnings are expected to fall, marking the fifth consecutive decline in quarterly results. Finally, British citizens voted to leave the European Union [EU], adding to both economic and political woes for Europe. Individual investors pulled $52 billion out of U.S. stock mutual funds and exchange-traded funds in the first half of the year. Perhaps we should not be surprised when the market does just the opposite of what most investors are expecting. After a two-day, 5% swoon triggered by the Brexit vote, the S&P 500 has fully recovered and is making new highs.

Here are some moderating factors that could explain the enthusiasm: While the British vote is still seen as bad news, the split from the EU will not happen for two years. In the interim, the EU is expected to become more flexible in its dealings with individual countries and pay more attention to problems such as huge loan losses at Italian banks. There is still a fear that the citizenry of some countries will seek their own referendums on EU memberships, but it seems unlikely that they will be given an opportunity to vote on the matter. In Japan, the Abe government got a vote of confidence that is likely to bring more quantitative easing. In the U.S., the latest jobs report was surprisingly strong, although David Stockman warns that low paying jobs are replacing higher paid jobs. If wages were rising, we would be seeing stronger gains in withholding taxes (see Chart 1, below) Furthermore, the Citigroup U.S. Economic Surprise Index has risen into positive territory for the first time in 2016, giving some hope that earnings will start to rebound in the second half of the year.

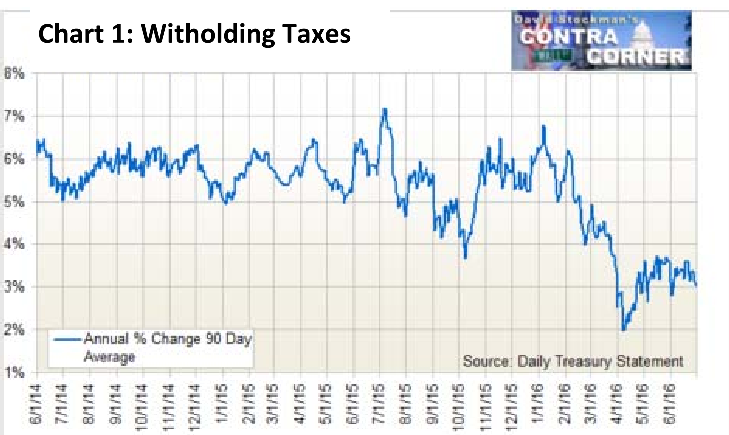
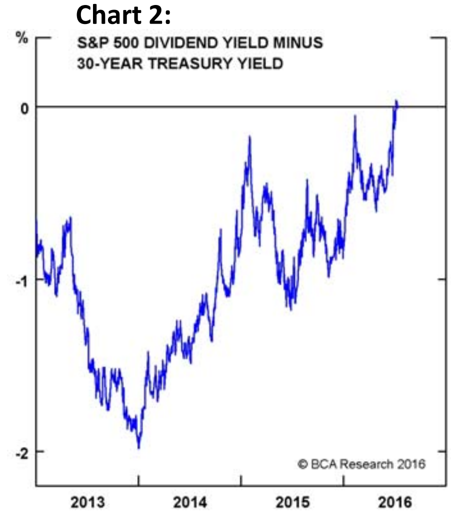


Chart 2:



One continued support for U.S. stocks has been the continued use of companies' free cash flow to buy back their own shares. Some have increased balance sheet leverage and raised money with bond sales to fund equity share repurchases. The number of shares outstanding is likely to decline for the first time since 2011 as companies in the S&P 500 bought back $161.39 billion worth of shares during the first three months of 2016. Companies have authorized $357 billion in buybacks in 2016, more than offsetting the net equity sales being made by individual investors.

Some analysts feel the rise in stock prices is irrational. David Kelly of J.P. Morgan Asset Management claims it is not *stocks* that are behaving illogically, it is the central banks that keep pouring liquidity into worldwide economies. Those actions may not be having the desired effect on worldwide economic growth, but Chart 3 (over, top) illustrates a high correlation between Fed actions and the stock market. BCA concludes that by promoting exceptionally low bond yields around the world, central banks have made stocks cheap relative to bonds. The U.S. equity dividend yield is now similar to the yield on the 30 year Treasury bond (Chart 2, above), compared with an average negative gap of 380 basis points

Chart 3: S&P 500 versus Federal Reserve Bank Total Assets

during the last 50 years. Why not buy stocks with rising dividend yields rather than bonds with low fixed returns? BCA believes that low bond yields will continue to support equities as the search for yield remains a powerful driving force for investors.

At current yields, the bond market cannot be considered an attractive investment. However, bonds still have a place in many portfolios. First, we advise clients who depend on principal withdrawals to maintain their lifestyle that they should have at least two years worth of necessary funds in cash or fixed income investments. We wish to avoid the possibility that in the event of a sharp market decline, they would be forced to sell stocks at lower prices to meet anticipated withdrawals. Second, bonds give us dry powder to use should stocks provide such a buying opportunity.

With stocks bouncing around in sometimes inexplicable ways, some investors may be frozen into inaction. We hope to take advantage of whatever opportunities the market gives us. If foreign stocks become too cheap versus U.S. stocks, we may do some buying abroad. If utility stocks become overpriced versus auto parts companies or supermarket chains, we will move money accordingly. Regardless of the industry, we intend to stick with good quality choices that we know will survive any downturns and come back stronger on the next upswing.

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