

NOTES FROM THE NORTH: MARKET OUTLOOK

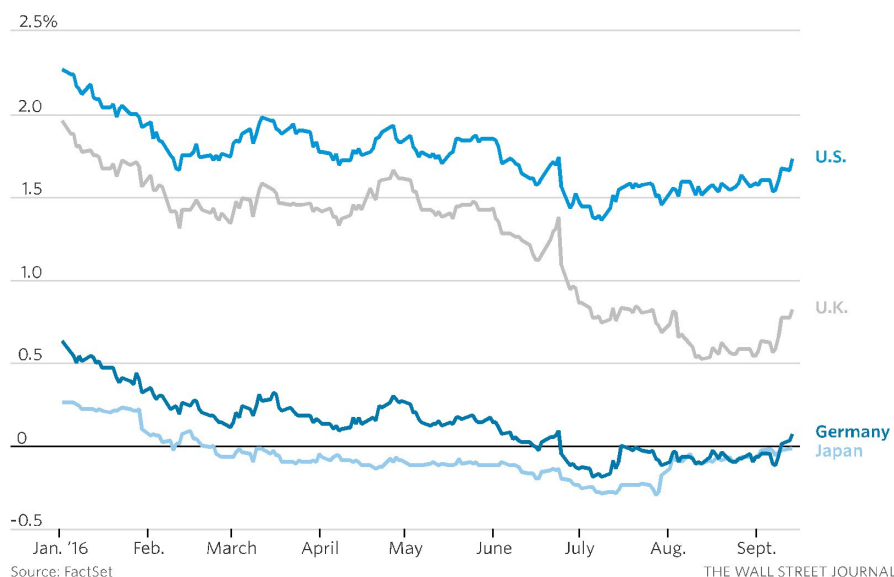
September, 2016

After an extended bull market in stocks and bonds, some successful investors are expecting the situation to change. For instance, Jeff Gundlach of the DoubleLine funds (a respected bond manager) just did a webcast in which he stated that “interest rates have just bottomed.” Gundlach thinks investors are losing faith in the efficacy of monetary stimulus and it appears that central bankers may be also. This sentiment was echoed by Richard Barley recently. Writing in the Wall Street Journal, he said that both the European Central Bank and the Bank of Japan are working on potential changes to their policy mix. In both cases, the general concern is that the new policies will be less supportive of long-dated bonds. As shown in Chart 1 (below), we have seen a modest move up in 10-year government bond yields in all developed nations.

Rising rates would obviously hurt bond prices, but investors need not liquidate all bond positions even if Gundlach is correct. Owning short and intermediate term bonds for modest income and holding them to maturity still makes sense, especially if you are not bullish on the stock market. Long term bonds could be more problematic since their prices will fall the most in an environment of rising rates. It is important to understand that bond funds, as opposed to individual bonds, could be particularly vulnerable. A bond fund reinvests the proceeds from maturing bonds, giving it an unlimited maturity for all practical purposes. Granted, funds holding long term bonds will be more vulnerable than funds with shorter term bonds, but even the shorter term bond funds may struggle to get back to today's prices.

If interest rates are getting set to rise, you might think this would then be the time to rotate more money into stocks. Think again says Peter Berezin, managing editor of Global Investment Strategy for the Bank Credit Analyst. He agrees that higher interest rates are likely and higher interest rates will cause the U.S. dollar to rise in value versus other major currencies. BCA projects a 10% increase in the dollar over the next 12

Chart 1: Modest Rebound in government bond yields



NOTES FROM THE NORTH: MARKET OUTLOOK, CONT'D

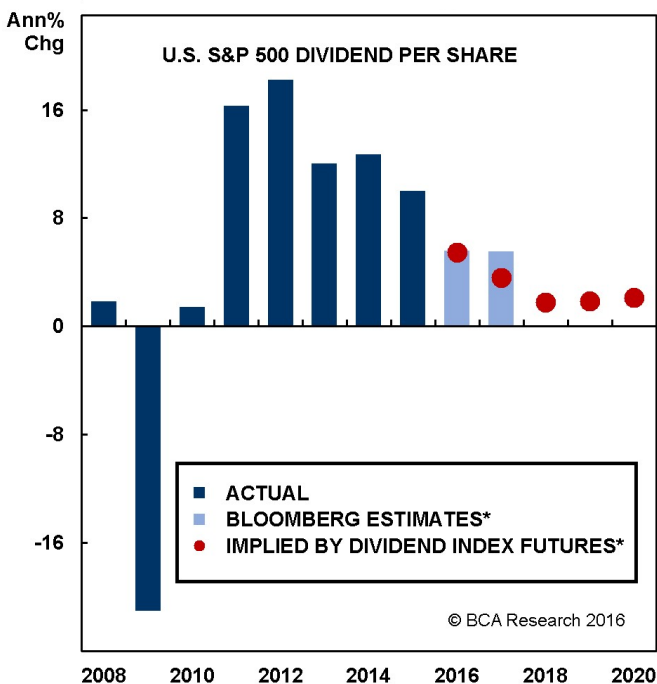
months. This will put further pressure on profits for the S&P 500 companies. A stronger dollar makes their products more expensive for foreigners to buy, and the profits they earn overseas in foreign currencies will translate into fewer dollars. Mr. Berezin thinks today's high equity valuations could be tolerated if earnings were going to accelerate sharply. Unfortunately, that is not going to happen. In the quarter just ended, operating earnings per share shrank for the seventh consecutive quarter. Profit margins are falling in more than half of the S&P sectors and accelerating wages are likely to cause further compression.

Of course this is not the first time we have heard this line of thought, and stocks have held up well anyway. BCA attributes part of the market's strength to the stock buybacks being made by large corporations and to the dividend increases that have attracted investor attention in a yield-starved world. Unfortunately, both stock buybacks and dividend increases are slowing. Rising equity prices require firms to pay more money to repurchase the same number of shares. With profit margins shrinking and debt levels rising, Goldman Sachs tells us that stock buybacks fell 30% in the first half of 2016. Bloomberg estimates that dividend-per-share growth is set to slow from 9.3% in 2015 to 5.5% this year. The S&P 500 dividend yield is at 2.1%, well below the historic average of 3% despite a rising payout ratio. Chart 2 illustrates the trend in dividend payouts.

Granted, the dividend yield on the typical large cap stock is reasonable vs. current bond yields, but Mr. Berezin warns that this relationship will become unfavorable if interest rates rise as expected. The markets are forecasting a 60% chance that the Fed will raise short term interest rates by year end. BCA expects one rate rise in December and another two in 2017.

No one can successfully "time" the market, but it makes sense to reduce positions that are overvalued and look to replace them with good investments that are undervalued. We plan to maintain core positions, but you may see us take some profits in stocks that have gotten too far ahead of fundamentals. Given the above thoughts, we would hope to either have an opportunity to rebuild those positions at lower prices somewhere in the next two years, or find better values elsewhere. The market has held up well, but some stocks have been sold off rather aggressively when they announce bad or disappointing news.

Chart 2: Dividend Growth is Slowing



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