NOTES FROM THE NORTH: MARKET OUTLOOK

October, 2016

Over the last three months, the stock market has moved largely sideways. Investors appear to be weighing the negatives of high valuations (Chart 1, below left) and six consecutive declines in quarterly earnings for the S&P 500 against the expectation that central banks throughout the world will continue to print money that finds its way into stocks. There is also the hope that earnings will rise sharply in 2017. While the 59 economists polled this month by the Wall Street Journal now think there is a 60% chance of a recession during the next four years, only 20% see a chance of it starting in the next year. The current expansion has lasted for 88 months, making it the fourth longest expansion since 1854. However, the modest 2.1% growth rate of GDP since 2009 makes this recovery the weakest since World War II, a condition that is frustrating but also conducive to an extended expansion.

Chart 2 shows that the consensus of economists expects real GDP growth for the third quarter of 2016 to come in somewhere between 2.5% and 3.0%. The Atlanta Fed does a good job of predicting GDP and they have substantially reduced their expectations to only 1.9% for the third quarter. Even that should be a reasonably good environment for corporations. How is it that corporate earnings are expected to fall once again? The Bank Credit Analyst (BCA) explains that worldwide over-capacity in most industries is making it difficult to raise selling prices. At the same time, labor costs in the U.S. are rising, negatively impacting profit margins. The strong dollar doesn't help. The strong dollar makes our exports relatively more expensive. Exports (surprisingly) account for only 12% of U.S. GDP, however, so the large impact of the dollar comes from the translation of overseas (non-dollar) earnings into dollars. One-third of pre-tax profits for U.S. firms are derived overseas, where demand remains sluggish overall. Finally, profits in the energy sector have been hurt by the decline in oil prices. The worst of that may be in the rearview mirror, however.

Chart 1: High Equity Valuations

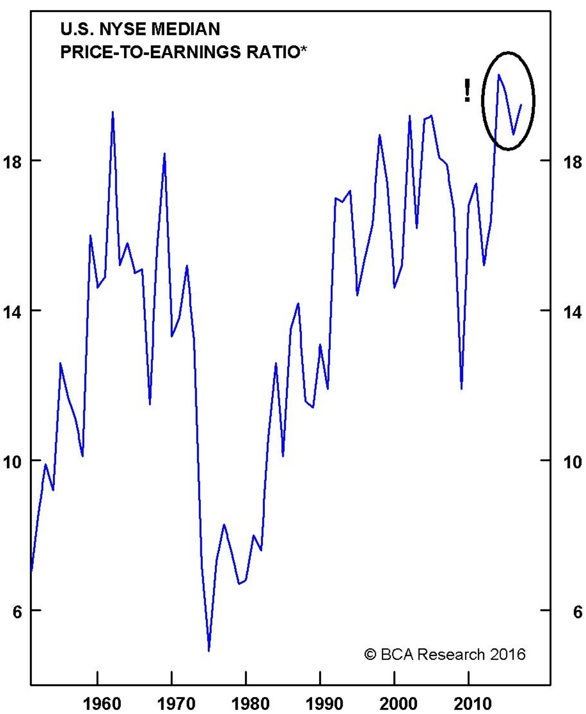
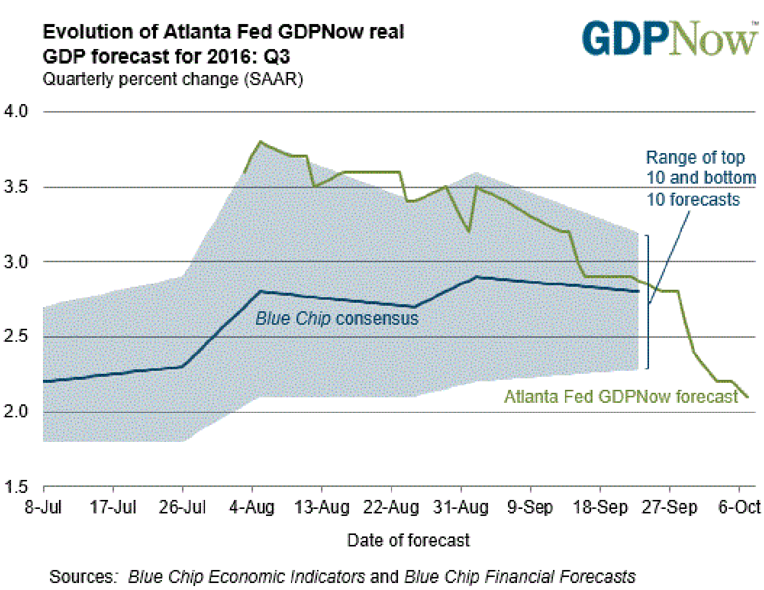


Chart 2: Economists' Forecasts



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Analysts are currently predicting that earnings in 2017 will rise by double digits. BCA cautions that those bottom-up numbers are too optimistic. BCA expects earnings gains of only 5-6% in 2017. If BCA is pessimistic on the overall environment, does it make sense to raise cash? Keeping in mind that it's virtually impossible to predict near-term market action, BCA's recommendation is staying invested in good quality companies that can continue to increase their dividends at an above-average rate.

One group where dividend growth is expected to continue is healthcare. The stocks have done poorly versus the market (see Chart 3) despite the superior earnings growth (Chart 4). Politicians have been criticizing drug firms such as Mylan Labs for raising prices too rapidly and Hillary Clinton has threatened to limit future increases if she is elected. Of course the amount of power she will have to enact those promises could depend on whether the House of Representatives remains under Republican control. Once the campaign rhetoric dies down, the healthcare sector could begin to outperform the market. Data shows that retail sales at pharmacies and drug stores are booming. Employment at hospitals is still growing rapidly, suggesting more medical procedures and increased demand for drugs. Indeed, pharmaceutical companies are optimistic about their profit outlook.

For many years following the financial crisis, macroeconomics dominated the stock market. Is this changing? While still very significant to the general environment, the "macro" seems to be relinquishing at least some of its dominating effect in the market to the successes and failures of individual companies. Inflection points (the process of a shift or reversal in trend) are often very confusing, but they can also provide excellent investment opportunities. We'll continue to work hard to be on the right side of them!

Chart 3:
Relative Forward P/E of U.S. Pharmaceutical Industry

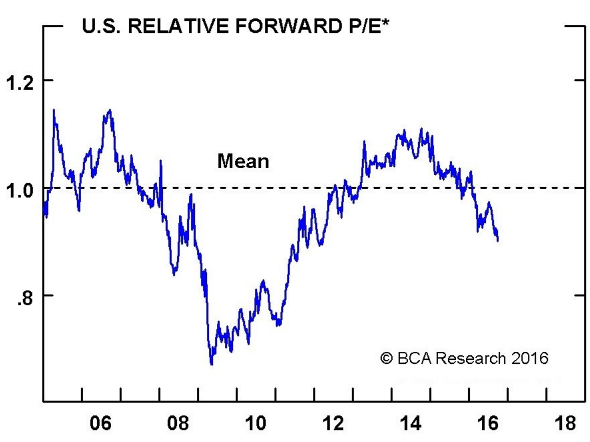
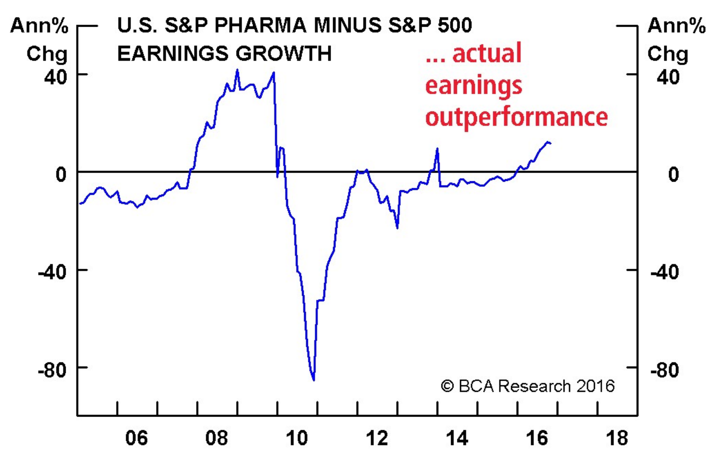


Chart 4:
Relative Earnings Growth of U.S. Pharmaceutical Industry



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