NOTES FROM THE NORTH: MARKET OUTLOOK

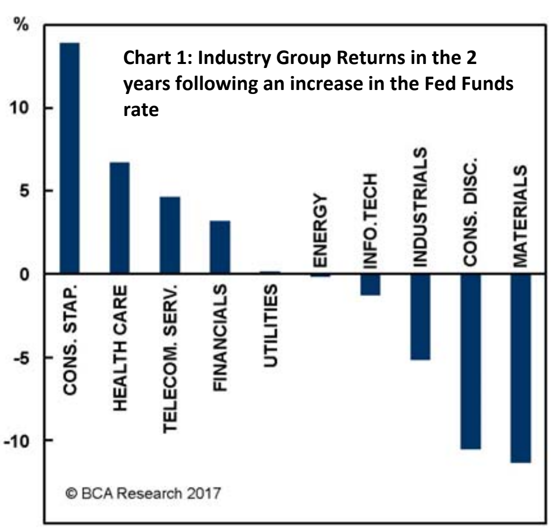
January, 2017

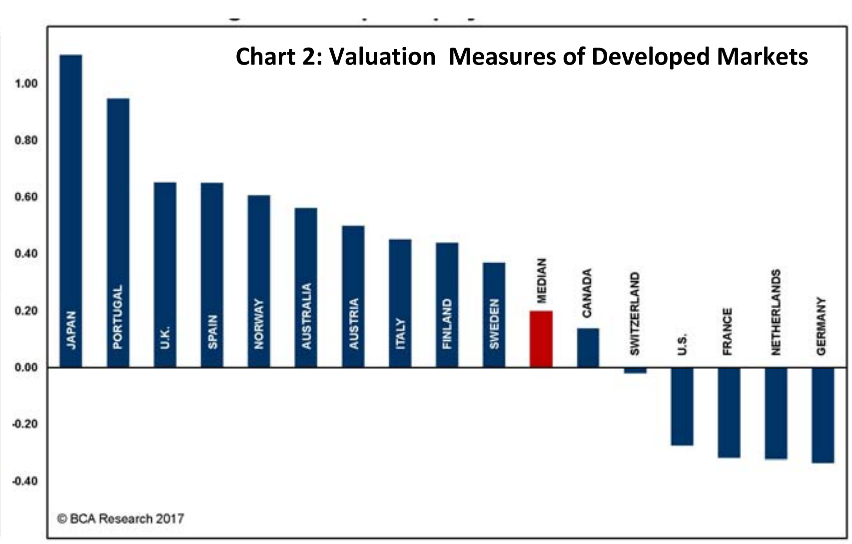
It is that amusing time of year when analysts and money managers flood the media with their predictions for the coming 12 months. Imagine the analyst who, in January 2016, went against the tide and *correctly* forecasted that earnings for the S&P 500 would show no significant progress, that U.K. voters would choose to leave the European Union and that Donald Trump would become President. Anyone who listened would have immediately reduced their stock holdings, as any one of those predictions would have been expected to be a significant negative. Each of those surprises came true, and yet stock prices (in the U.S., at least) proved resilient all year and ended with a strong and confounding upswing.

Although few predictors have enough time to generate a statistically-proven record of accurate forecasts, over the years we have found a small circle of analysts whose forecasts we feel it is worthwhile to consider. Not necessarily for major calls on market direction, but sometimes to help us determine which segments of the market offer better value than others. One such reliable source has been BCA Research (formerly known as the Bank Credit Analyst), headquartered in Montreal. Their take on the sharp rise in share prices for U.S. financial, cyclical and small-cap firms is that those stocks have for the moment discounted way too much good news. Yes, lower taxes, less regulation and more spending on infrastructure will help the economy, but how much of Trump's agenda will get through Congress and how long will it take to affect corporate profits? 2018, at least, for sure. How many hedge funds going "long the Trump Trade" will stick around until 2018?

Looking at industry groups within the U.S. market, BCA finds reasonable value in the U.S. healthcare, consumer staples, real estate and consumer discretionary sectors. They are cautious on materials, industrials and technology. With the Fed having raised interest rates in December, Chart 1 shows historical patterns of return amongst U.S. industry groups in the two years following the rate rise. Looking abroad, BCA's global strategist (Peter Berezin) thinks investors can safely over-weight global equities for the next two years while under-weighting bonds and cash. As shown in Chart 2, BCA finds better value in Japanese and some European markets than in the U.S. market.

Jeff Gundlach, the chief investment officer of DoubleLine Capital, has earned a reputation as an outstanding bond manager. His predictions are interesting partly because they are often contrarian, and many have proved to be accurate. In the equity markets, he agrees with BCA on Japanese stocks, but not on European stocks. He likes emerging market stocks, especially India. His views on interest rates, however, are probably more noteworthy. Gundlach expects the Federal Reserve to raise rates two or three times in 2017. At one point in 2016, the yield on the 10 year Treasury bond





was less than 1.4%. It is now 2.48%. With a granularity reserved for those who are more comfortable forecasting than we are, Gundlach thinks that this rate could fall to 2.25% before beginning to rise again. Any breakout over 3% would be bearish for both bond and stock markets (we tend to agree). Gundlach reminds us that inflation and economic growth are already at levels similar to 2006 when interest rates were at 6%, and he believes the 10-year Treasury yield could hit 6% in four years. BCA is expecting interest rates to rise only modestly over the next two years, but is then preparing for a major bond bear market beginning toward the end of the decade as stagflation reappears.

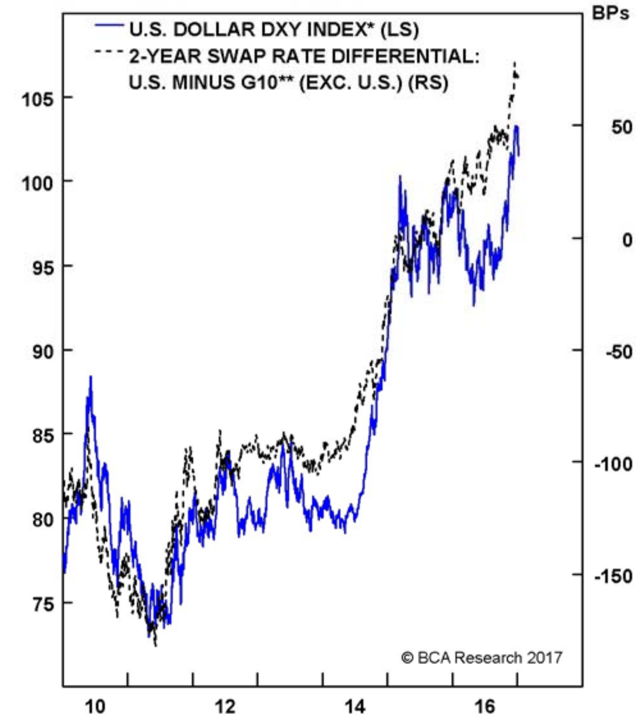
To muddy the water further, some of the best interest rate forecasts of the last ten years have been made by Dr. Lacy Hunt of Hoisington Management. Hunt expects the secular downward trend in bond yields to remain intact. Time will tell.

The value of the dollar is likely to be an important factor in 2017. As shown in Chart 3, the dollar is near a 13-year high. While the dollar has been rising, the Chinese yuan has slumped to a seven year low. A strong dollar will reduce the cost of imported goods and make it more difficult for U.S. firms to raise prices even as domestic labor costs increase. International market share will be harder to come by, and profits earned overseas will be diminished upon currency conversion. The forecasters? Mr. Berezin (BCA) thinks the dollar will appreciate another 6% from current levels while the Euro, yen and yuan slip vs. the dollar. Mr Gundlach (DoubleLine) is neither bullish nor bearish on the dollar, but he would not be surprised if, based on the DXY index, it got as high as $120 (versus the current level of $102). Hoisington Management hasn't weighed in here.

The above information does not alter our long term confidence in the carefully chosen equities we own. Yes, they will decline if the market violently retraces the Trump rally, but they did not participate in the upside that much so they could be expected to not participate in a selling frenzy. On a risk-reward basis, we are quite confident they will be worthwhile holdings over the next five years.

If clients add money to their accounts, we may space out purchases rather than invest it all immediately. Given the valuation disparities illustrated in Chart 1, we may add to overseas equity positions in our fully-diversified portfolios. We will continue to buy bonds for those clients who do not want their entire portfolio fluctuating with stock prices. However, we will continue to keep average maturities on the shorter end of the scale and plan on reinvesting maturing bonds at higher yields as rates rise. We do not see 2017 as a good time to embrace more risk.

Chart 3



Martha Cottrill, CFA	Carl Erickson	Edmund R .Taylor, CFA	Fletcher S. Cole, CFA
President	*Principal*	*Chief Investment Officer*	*Portfolio Manager*