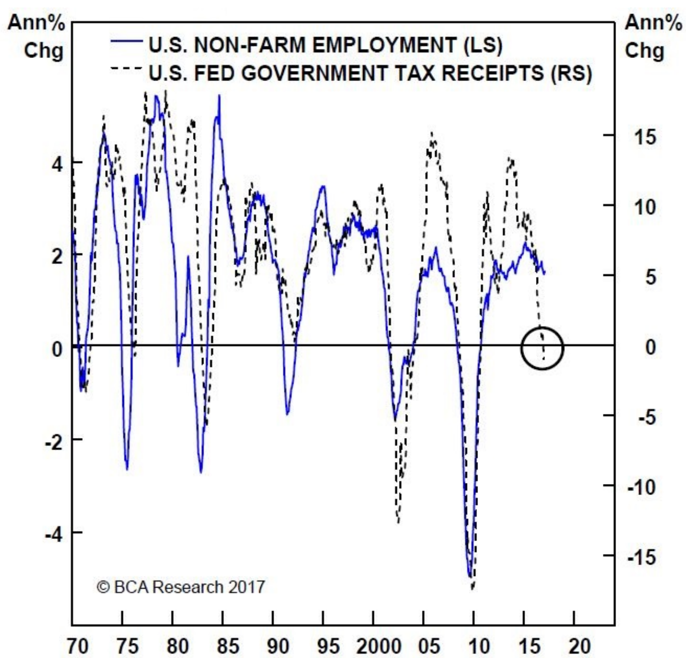
# NOTES FROM THE NORTH: MARKET OUTLOOK

***February, 2017***

Last year's stock market rally is continuing this year. The Dow Jones Industrial Index is up another 3%+ and the S&P 500 is up even more. Is it time to get excited and get in on the action?! Although hedge fund managers have lost some of their luster in recent years, a number of the very good ones are questioning the wisdom of chasing stocks at these prices. A recent Wall Street Journal article said Paul Singer of Elliott Management is worried about a deep underlying investor complacency. Seth Klarman of Baupost has 30% of his fund in cash. His position is that if things "go wrong", we could find ourselves at the beginning of a lengthy decline in the dollar hegemony, a rapid rise in interest rates and inflation, and global angst.

With equity valuations at or near all-time highs, it is important to realize the economy has not yet demonstrated it can break out of the rut it has been in. 2016 was the 11th consecutive year in which America failed to reach 3% real GDP growth, the longest period since the Bureau of Economic Analysis started reporting on GDP. This weak growth has persisted in spite of many years of zero interest rates and massive quantitative easing, without which the economy would have shrunk. Earnings for the S&P 500 showed virtually no growth in 2015 or 2016, although reported non-GAAP (GAAP = "Generally Accepted Accounting Principles") earnings are roughly 10% higher than are GAAP-calculated earnings. The most impressive economic improvement has been seen in the job market, but how then to explain Chart 1, (below) which shows that tax receipts are not rising? BCA reports there has never been a contraction in tax receipts without a corresponding slump in employment growth.

**Chart 1**



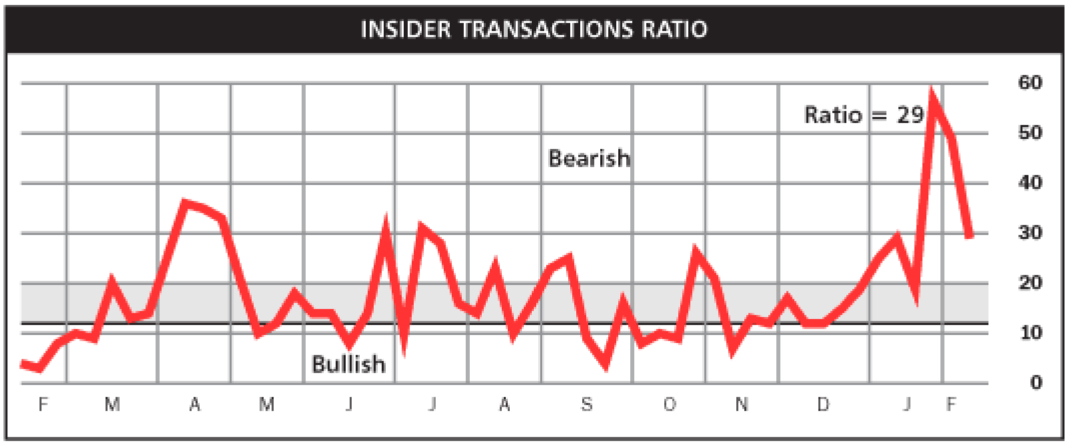

Clearly some investors expect President Trump's pro-business policies to stimulate growth. Writing in <u>Barron's Magazine</u>, Michael Lewitt estimated the possible effects of expected legislation. If the maximum corporate tax rate is lowered to 20% from 35%, Lewitt estimated 2018 S&P 500 earnings would be 12% higher than otherwise. However, a 20% border tax on imported goods would reduce earnings by 6% (and raise the risk of a trade war). Congress is also discussing the elimination of interest deductibility, which would eliminate a major tax break for any indebted companies. Merrill Lynch estimates that the loss of interest deductibility would shave 4% from 2018 earnings. The combined impact of all three policies above? No change. Keep in mind, as well, that we're talking about a one-time adjustment to earnings levels, not an increase or decrease in earnings growth rates.

One might reasonably believe that corporate CEO's and other business insiders would be in an excellent position to determine the effect of Trump's proposals. Chart 2 (over) shows that insider selling has spiked to extraordinarily high levels. In addition, corporate treasurers are now buying back fewer shares. (Corporate buybacks provided a strong support to earnings in 2016, and were a source of demand, for shares, as well.) Who, then, is buying this market?

The same question was asked in 1987 when huge buy orders halted a six-day, 30% decline in stocks. Sebastian Mallaby's recent biography of Alan Greenspan details the Fed's 1987 bullying of banks to make them lend to what otherwise would have been failing brokers. The critical buying was the result of pressure by the New York Fed on Stanley

Shopkorn, the head trader at Salomon Brothers and Bob Mnuchin, the head trader at Goldman Sachs. (Yes, the Mnuchin name has been in the news recently. Bob Mnuchin's son, Steve Mnuchin, was just named the new U.S. Secretary of the Treasury.) In 1987, each of these Wall Street captains agreed to buy up to $500 million worth of shares the floor specialists could not absorb.

**Chart 2**




Ratio of Insiders Sales to Buys. Readings under 12:1 are Bullish. Those over 20:1 are Bearish.
The total top 20 sales and buys are 365,614,334 and 12,767,249 respectively; Source: Thomson Reuters

Although the Federal Reserve has bought huge quantities of bonds in recent years, it has never been authorized to buy stocks. In other countries, however, *it is legal* for the central bank to buy stocks. Could this be a source of money flows? Japan, China and Switzerland regularly buy stocks with printed money without any worry about making a profit. The buying is related to currency manipulation and desires to stimulate growth, and the size of these programs is astounding. The Swiss National Bank now owns $1.7 billion of Apple, $1.1 billion of Exxon and $1.2 billion of Microsoft. The Bank of Japan owns two-thirds of all Japanese ETFs! Zero Hedge (an online, anonymous, and intentionally-disruptive source for financial news) claims that if current buying programs remain in place, within a few years the world's monetary authorities who are tasked with "financial stability" will have acquired a majority of the world's equity, nationalizing it for all practical purposes.

Given high valuations and all the unpredictable forces affecting stock prices, we're not chasing market euphoria. In fact, at the margin we're shifting modestly towards a capital preservation mindset. This has led us to reduce equities where we're above our targets, and with individual stocks, we favor high quality companies in groups such as healthcare and consumer staples, since these remain reasonably priced. We agree with BCA, who finds that the energy, materials and industrial stocks are over-extended, at least in the short run. Over the long run, BCA continues to expect stocks to outperform bonds (as do we), but this is probably a good time to start getting comfortable with leaving some money on the table even if the market continues to run up to new highs.

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