

NOTES FROM THE NORTH: MARKET OUTLOOK

March, 2017

The stock market's continuing upward momentum has been fueled by rising investor sentiment and buying by retail investors, in particular. According to JP Morgan, institutions have kept equity exposures unchanged this year. If anything, they have moved toward more defensive stocks. Individuals, in contrast, have been big buyers of ETFs. Surprisingly, the indices have been powered to record highs by just 15% of equities. SocGen reports that even though the S&P 500 and MSCI world indices are at new highs, the average MSCI stock is still 26% below its all-time high. The following list of stocks still below their 2007 highs illustrates this point:

Bank of America	-53%	MetLife	-24%
British Petroleum	-47%	Newmont Mining	-41%
General Electric	-30%	New York Times	-47%
Harley Davidson	-18%	Ralph Lauren	-22%
Macys	-32%	Toyota Motor	-18%

We've had several 9-12% corrections in recent years, but it has been over six years since market participants were challenged by a major, gut-wrenching correction of more than 15%. (In 2011, the market pulled back about 17% between April and September.) Since 1980, the S&P 500 has regularly posted major intra-year declines while still finishing the year higher in 27 of the 36 years. While they range from -3% (1995) to -49% (2008), the "average" worst intra-year drawdown has been about 14%. Short term market volatility is to be expected but unfortunately it cannot be predicted.

Much energy is spent watching GDP trends because recessions have always caused sharp price declines in stocks. Unfortunately, recessions are not really predictable, either. While imperfect, one of the few useful leading indicators of recession is the yield curve, i.e. the shape of the chart graphing interest rates through maturities varying from 30-day Treasury bills all the way out to 30-year Treasury bonds. When this chart starts high on the short end and slopes downward towards the longer end, it is said to be "inverted" and recession typically follows. The yield curve so far remains solidly upwardly sloped and there are no other recession clouds visible on the horizon.

Nevertheless, some high profile investors are growing skeptical of the rally. Others remain sanguine. Bill Gross, now of Janus Capital, just advised investors not to place too much faith in President Trump's efforts to double the growth rate of GDP from the 2% rate. Gross is concerned that the fiscal spending that will be required to do this will increase financial leverage at a time when the Federal Reserve will be raising interest rates. He suggests that now is a time to be more concerned with the return *of* your money than the return *on* your money. David Rosenberg of Gluskin Sheff is of the opinion that deteriorating demographics and productivity will make it very difficult to *permanently* raise the growth rate in the U.S. If many more high-paying jobs are created, for example, we will probably not have enough qualified workers to fill those jobs. Rosenberg believes the market is fully priced and better buying opportunities will present themselves. When asked what to buy, Japanese stocks are his answer. David Tepper, of Appaloosa Management hedge funds, is more optimistic. He thinks fewer regulations and lower taxes can have a positive impact on the U.S. economy. The stock market overall may be adequately priced, but he can find stocks worth owning. He currently favors European stocks over U.S. stocks and he is not a fan of bonds at these prices.

As usual, BCA Research has provided us with the most comprehensive and balanced analysis of current economic and market conditions. They see worldwide economic momentum intact and possibly building, offering Chart 1 (over) as evidence. With the Federal Reserve set to raise interest rates again this week, however, it is not too soon to begin

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Chart 1:

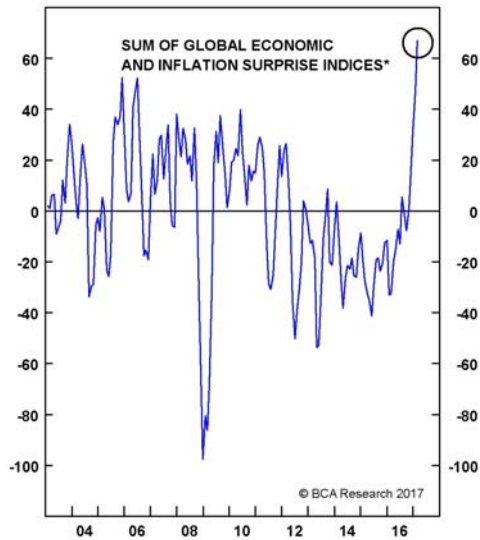
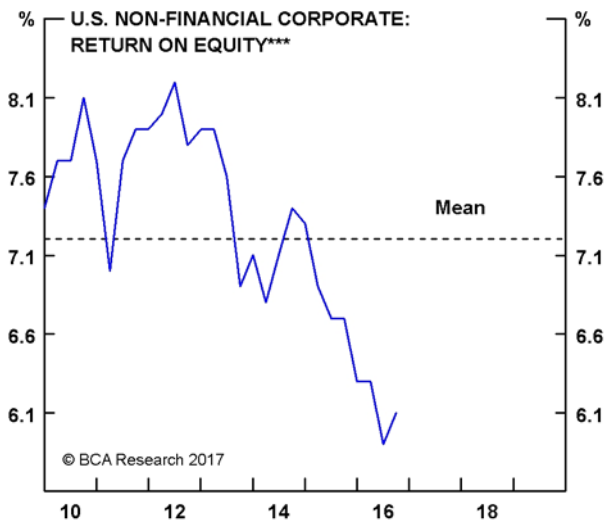


Chart 2:



watching for hints of the next recession. With this in mind, Martin Barnes, BCA's chief economist, just released a special report discussing the possible timing of the next recession. He makes a strong argument that in 2017, growth is more likely to accelerate than decelerate. The question is when full employment and rising inflation will cause the Fed to raise interest rates to the point where they choke off growth (remember the inverted yield curve from page 1).

President Trump will have the chance to appoint five or six Fed Board members over the next two years. It is generally expected that his appointees will be more hawkish (that is, more likely to raise rates) and possibly less well-versed on macroeconomics than the members they replace. Barnes thinks it is reasonable to expect the Fed Funds rate to get to 3% by the end of 2018. This could well be the figure at which short rates move level with or higher than the yield on long term Treasuries, giving the classic warning signal of a recession. Given that stock prices lead the economy by about 6 months, one might reasonably expect that U.S. stock prices would peak around the middle of 2018. (If the Fed allows the economy to run hot, a recession could be delayed for several more years, but that would also heighten the risks of an even deeper downturn.) The irony is that it could well be the new administration's successful effort to increase our economy's growth rate and its own Federal Reserve appointees that prove to be the downfall of this expansion.

For now, we remain cautiously optimistic about the market as a whole and, like Tepper, we find pockets of good opportunity. The surprising weakness in corporate return on equity (Chart 2) gives us more pause than the many reports of stocks being overvalued. We are more interested in return on total capital than return on equity, however, and do not see alarming declines in that measure except in energy and basic materials, where it is to be expected given challenging business conditions. Nevertheless, we are aware that rising wages and a stronger dollar, both likely outcomes of current policy efforts, will have a negative impact on profit margins and therefore profitability. We continue to move incrementally towards less risk and as always, towards better value.

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