NOTES FROM THE NORTH: MARKET OUTLOOK

July, 2017

The European Central Bank announced that it is nearing the end of its stimulative efforts, and Janet Yellen reiterated that the Fed will be raising short term interest rates. This headline news from the last month has had more significance for the bond market than for the stock market. European bonds fell sharply in price as yields rose (although admittedly from extraordinarily low levels). The U.S. bond market reacted similarly, though in a more subdued manner. In the U.S., investors were heartened by Yellen's comments that the "neutral," or target rate, is lower than it had been because inflation remains under control. Last week, BCA, a trusted source for economic projections, wrote that they expect inflation to pick up in the second half of 2017. They anticipate the Federal Reserve will raise rates in December, and several times more in 2018. We agree with BCA that the outlook for bonds is not as rosy as the outlook for stocks.

Ray Dalio, a successful hedge fund manager, quips that investors need to keep dancing but be nearer the exit. Indeed, the primary direction for U.S. stocks over the last four weeks has been sideways. BCA is more optimistic. Keeping in mind that corrections of 5-10% are always a distinct possibility, BCA's view is that if inflation does not spike too much and the Fed raises rates gradually, rising earnings will allow large-cap U.S. stocks to rise about 20% before the end of this decade (about 7.5% annualized). They continue to monitor the pre-conditions for a recession; at the moment these are absent. If BCA is correct, the many investors who are holding stock index funds will continue to do well over the foreseeable future. However, there may be better ways to participate in the stock market. It seems to us that some trends have been carried too far, creating opportunities.

Consider Chart 1, for instance, which shows the price action of growth stocks against that of value stocks. There are different definitions of "growth" and "value," but we show here the Vanguard Growth ETF (VUG) and the Vanguard Value ETF (VTV), which use the CRSP (Center for Research in Security Prices) definitions. Briefly, CRSP identifies growth stocks using primarily historical and future earnings growth rates, while value stocks are identified by multiples of book value, current and next year's earnings, and dividends. Growth stocks tend to have higher expectations and higher multiples of earnings and book value than value stocks. In the past, growth stocks generally did well when interest rates were falling, but they may decline sharply when the economy is cooling. Value stocks, often stocks in cyclical industries, tend to do well *early* in an economic recovery, but they typically lag in a sustained bull market. The current economic recovery has been muted, but it has lasted a very long time, thus

Chart 1: Growth versus Value since 2007

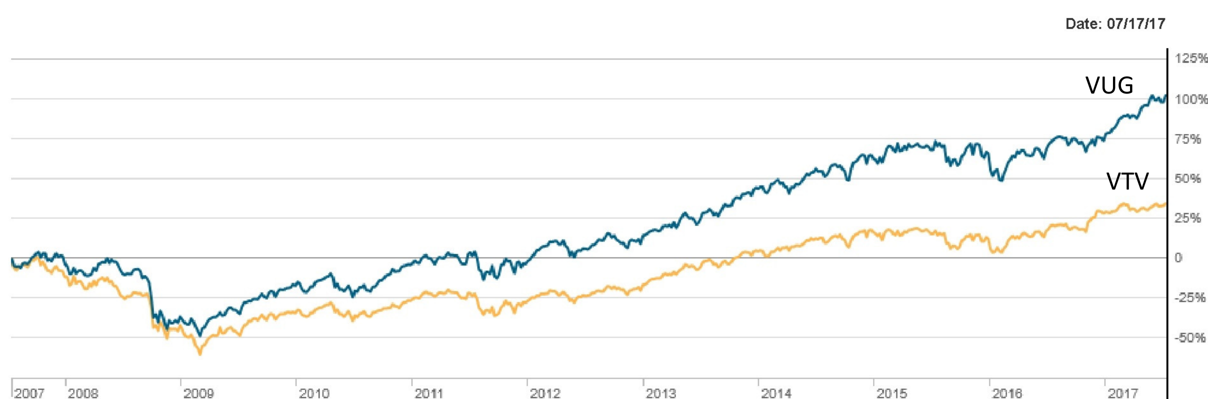

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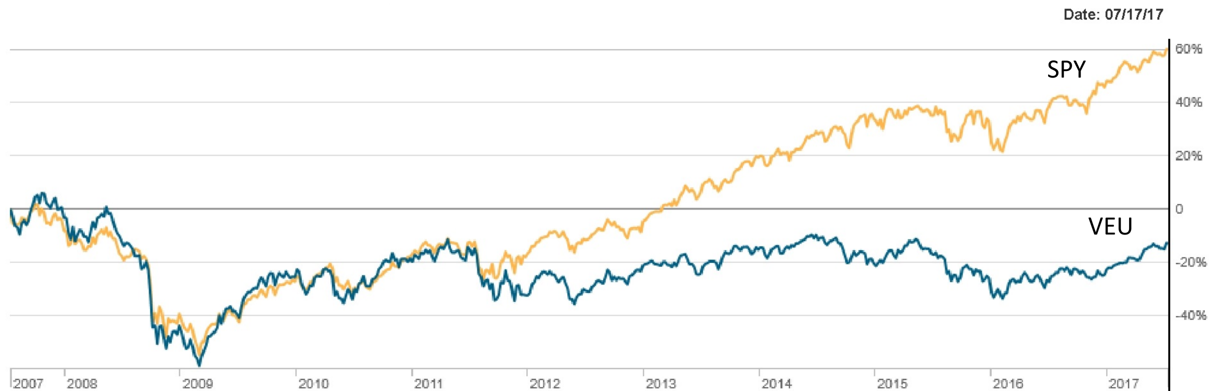
Chart 2: US stocks versus Foreign Stocks since 2007



favoring growth stocks. Most studies show that over the long run, value stocks as a group outperform growth stocks as a group by at least a small margin. Over the last 10 years, however, growth (VUG) has risen 108% while value (VTV) is up only 40%. History suggests that a differential such as this will even out or "revert to the mean."

The same thought process can be applied to the relationship between U.S. stocks and foreign stocks. Chart 2 above shows the price action for the last 10 years of the S&P 500 stocks (SPY) versus that of foreign stocks (VEU, the Vanguard ETF for foreign stocks). U.S. stocks are up 66% while foreign stocks are still below the levels reached in 2007. Aside from offering better value, economic trends both in Europe and Japan are encouraging. U.S. interest rates are likely to rise faster, as well, which ought to give the stock and bond markets in Europe and Japan an edge over ours.

For investors willing to own individual stocks, a variety of interesting and tempting value gaps are appearing. For instance, U.S. drug stocks have vastly outperformed foreign companies such as Roche, Novartis and Novo Nordisk, yet these firms all face the same end markets. Amazon sells at a forward price/earnings ratio of 90x and a price/sales ratio of 3.4x. A share in WalMart sells at a forward P/E ratio of 16.6x and a price/sales of 0.5. Other, smaller retailers offer even better valuations. Is Amazon going to put all retailers out of business, or are stocks like Williams-Sonoma and Kroger perhaps oversold? Nordstrom stock price has declined so much that the family, who owns 30% of the company, is considering a bid to take the firm private. Energy stocks remain extraordinarily depressed in the face of depressed oil and gas prices. If energy prices rebound (as BCA expects), what might happen to energy stocks? For someone willing to do the work and hold an unpopular company, there appear to be multiple opportunities to tilt the odds in one's favor.

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