

NOTES FROM THE NORTH: MARKET OUTLOOK

August, 2017

Putting aside the concerns about North Korea, a number of well-respected professionals in the investment world have been sounding notes of caution over the last month:

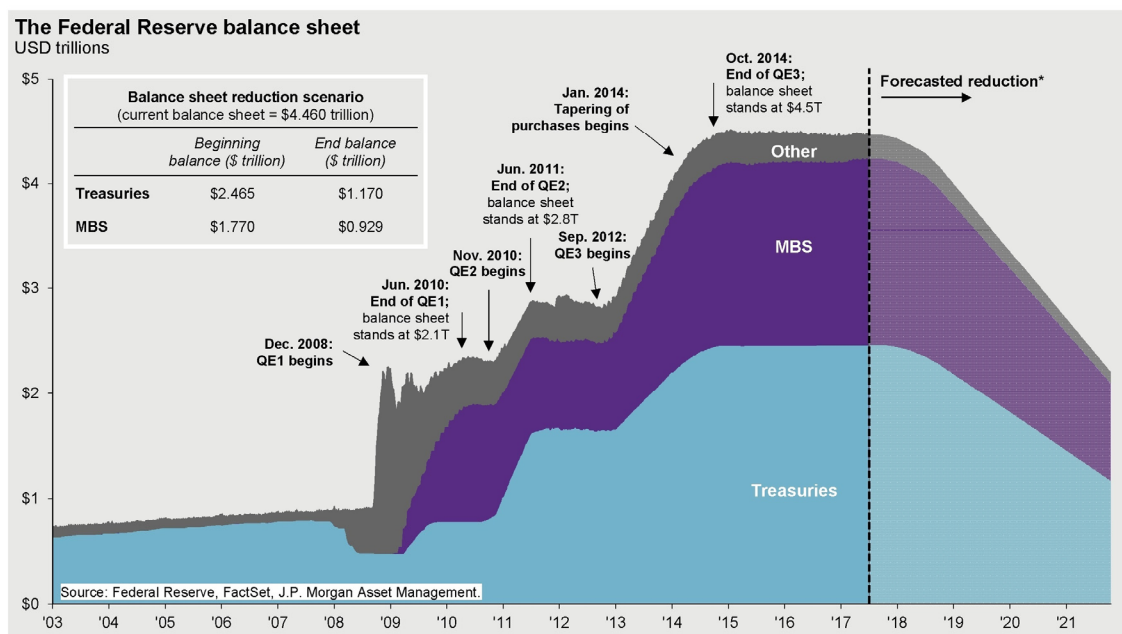
Jamie Dimon, head of JP Morgan, said (and we quote only *some* of the reported comments) "We have become one of the most bureaucratic, confusing, litigious societies on the planet...We are unable to build bridges, we're unable to build airports, our inner city kids are not graduating." He claims the US would be growing faster than 2% if it was not for our stupidity and political gridlock and that we need to make our tax system more competitive and allow firms to bring money earned overseas back to the U.S. where it can fund growth and jobs. And, now famously, "It's almost an embarrassment being an American citizen traveling around the world..." Well, we know where he stands!

Howard Marks of Oaktree Capital speaks more softly, but also carries a big stick. In a 20 page memo dated July 26, he reminds investors that they make the most and safest money when they do things other people don't want to do. What many investors have been doing is buying index funds. If you refuse to join the crowd, it is quite possible that you will lag the market for a while. Eventually, however, it is also quite possible that you will keep your capital when others lose theirs. Times of complacency have always been followed eventually by corrections in which penalties are imposed. It has been too long since the last 10% correction. Risks are now high and potential returns are too low to justify an aggressive market stance.

Ray Dalio is the founder of Bridgewater Associates, one of the world's most successful hedge funds. He just warned that prospective risks are now rising and they do not appear to be appropriately priced into the market. The emerging risks are more political than economic, which makes them especially challenging to discount. He recommends that investors allocate 5%-10% of their portfolios to gold which he feels would benefit more from an upheaval than other safe havens such as Treasuries.

And then there is Jeff Gundlach, head of DoubleLine Capital. In recent years he has been recognized as the new "king" of bond investors. He has gained a reputation for making unconventional calls that often prove correct. Just before the news from North Korea hit the headlines, he predicted that stocks would fall at least 3% by the end of November. He thinks European bond yields are too low. He predicts that when they rise, U.S. bond yields will also rise, causing bond

Chart 1



NOTES FROM THE NORTH: MARKET OUTLOOK, CONT'D

and stock prices to fall.

In light of the above, this might be a good time to recall why stock and bond prices are at such elevated levels. A recent Wall Street Journal article offered five theories for the market's strength.

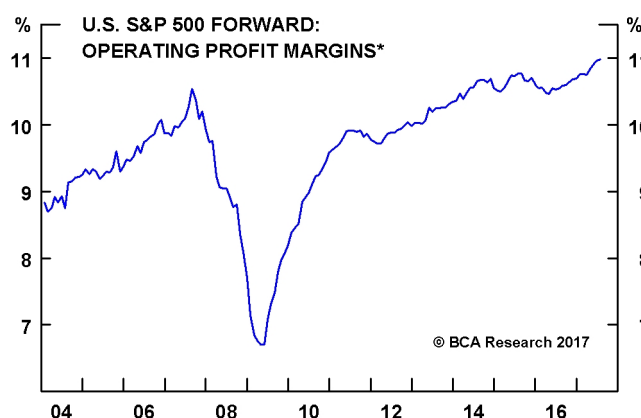
- Stocks reflect corporations' resurgent health
- The global outlook is brightening
- We are in a "Goldilocks" environment where everything is "just right" for investors
- Money pouring into index funds and passively managed exchange-traded funds is propping up prices
- Finally, there is no better alternative to stocks.

Mike O'Rourke, Jones Trading's chief market strategist, adds a sixth reason: "Failing to recognize the structural shift in the U.S. economy at the turn of the century, the Fed has been mistakenly chasing 20th century 3.5% GDP growth in a 2% GDP growth U.S. economy. The excess has wound up in asset prices." The extent of the asset buildup, amounting to trillions of dollars, is shown in Chart 1 (page 1). As the Fed was buying bonds, it was pushing money into the economy. That was money that was *not* needed to build new plants or equipment or to hire new employees. The Fed has announced that it is about to start reducing its \$4.5 trillion balance sheet. What will be the effect, if any, on bond and stock prices?

BCA, which has been correctly bullish on stocks for several years, believes the market can continue to do well for another 12 months. They expect the Fed to act slowly and predictably, thereby not ruffling the market's feathers. Strong corporate earnings growth will drown out worries about North Korea. (Despite its bluster, North Korea has a history of acting rationally.) Nearly 80% of S&P 500 companies have reported second quarter earnings that exceeded expectations. As shown in Chart 2, operating margins are at their highest level of the last decade. Earnings per share are up about 11% over the previous year. Foreign firms are growing even faster: 12.6% in Europe and 14.8% in Japan. All eleven industry sectors have reported positive growth. Looking ahead, the weakness in the dollar will further aid results for U.S. multinationals.

How investors react to all of the above should perhaps be governed by their risk tolerance and time horizon. One of our clients wisely stated that he wanted his children's accounts to remain fully invested, but given his age, he wanted to adopt a more conservative asset allocation with his funds. At the least, we are advising clients who know they will need to withdraw funds in the foreseeable future to keep those funds in shorter-term, non-equity investments.

Chart 2



Martha Cottrill, CFA
President

Carl Erickson
Principal

Edmund R. Taylor, CFA
Chief Investment Officer

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