

NOTES FROM THE NORTH: MARKET OUTLOOK

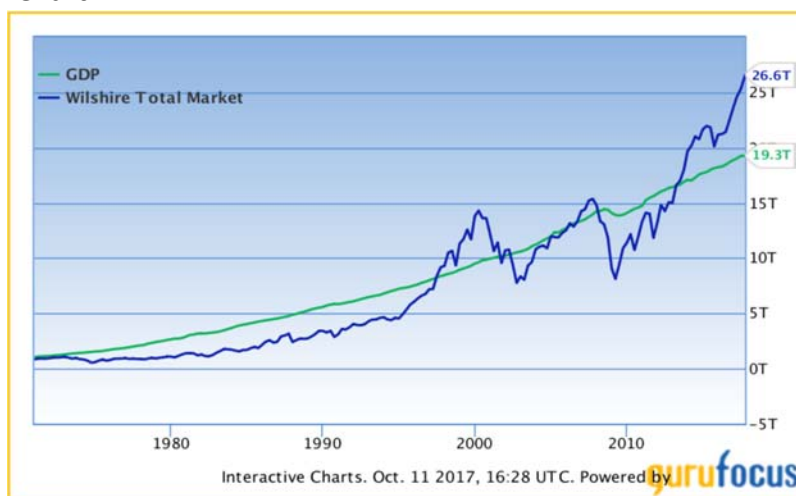
October, 2017

Stock markets throughout the world continue to rise. Perhaps one reason for higher prices is that central banks have purchased roughly two trillion dollars worth of stocks and bonds this year. The U.S. Federal Reserve has said it will begin unwinding its portfolio of bonds purchased since 2008, but central banks in Europe, Japan and China are not yet following the Fed's lead. Aside from direct buying by central banks, monetary policy has pushed interest rates so low that it is widely suspected that at least some investors who might normally purchase bonds or keep money in money markets funds have been pushed into equities.

Another reason that stocks are doing well is that global growth is firing on all cylinders. The OECD estimates that all 46 of the economies it tracks will see positive growth this year. Leading economic indicators remain upbeat. Growth overseas is currently faster than that seen in the U.S., and that will benefit multinational U.S. firms. Third quarter earnings which are about to be reported are expected to rise 4.9%. That number might have been higher if we had not had major hurricanes in Texas and Florida. Fourth quarter estimates now call for a gain of 12.3% while results in 2018 are expected to increase 10.7%.

Institutional investors are aware that the stock market is highly valued, but they are reluctant to raise cash since the market often does exceptionally well at the end of a bull market. One way to measure valuations is shown in Chart 1. It shows the relationship between U.S. GDP and the total market value of U.S. stocks. Warren Buffett has said that this is "probably the best single measure of where valuations stand at any moment." Of course today's high valuations could be even higher by year end.

Chart 1



Long-term investors shouldn't worry too much about typical market fluctuations of less than 10%, or even about a market "correction" (a decline of 10% but less than 20%). These can happen at any time, and it's counter-productive to try to anticipate or react to these moves. Of course it would be worthwhile to avoid a bear market decline (20% or more) but unfortunately they don't announce themselves when they begin. There are some conditions and indicators to watch for, however. For instance, economic recession consistently overlaps with bear markets (Chart 2, over). The challenge with this correlation is that a recession is usually not identified until it is well begun, and the stock market typically peaks six months before recession begins.

What might help forecast a recession? Historically, the shape of the yield curve has been a signal. When short-term

NOTES FROM THE NORTH: MARKET OUTLOOK, CONT'D

Chart 2

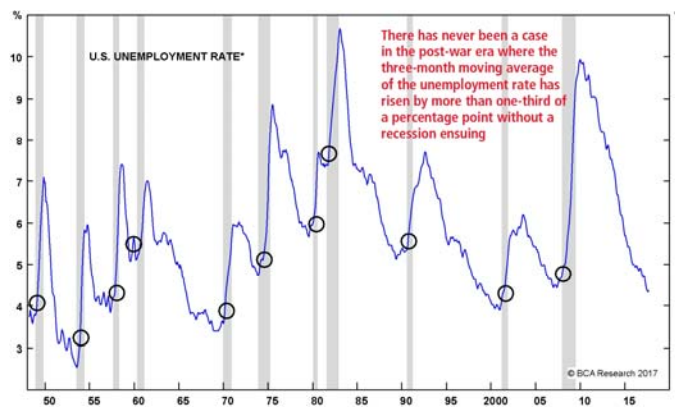


rates rise *above* long-term rates, a recession typically follows. Although rates are low, the yield curve itself is not flashing a warning indicator: Rates on 3 month Treasury bills, 2-year notes, 10-year notes and 30-year bonds are 1.1%, 1.6%, 2.4% and 2.9% respectively.

Another possible leading warning sign is the unemployment rate. Chart 3 (below) shows that even a small uptick in the unemployment rate has historically been bad news for the business cycle. Fortunately, BCA is positive on this metric as well, and thinks the unemployment rate is headed lower, perhaps to 3.5% by the end of 2018 and even further if taxes are cut as the President is proposing. (To frame this figure, U.S. unemployment was 3.8% in 2008 just prior to the Financial Crisis.) BCA's research leads to the conclusion that we will not see a recession in 2018, and in fact U.S. growth might even surprise on the upside.

Those who agree with the arguments made above should remain invested in stocks, both domestic and foreign. Interest rate sensitive stocks such as utilities and REITS may underperform more cyclical stocks. A strong economy with a growing threat of inflation could cause the yield on 10-year Treasuries to rise to 3%. That would push bond prices lower. When we get the next recession, 10-year yields could fall to 2%, but BCA thinks rates will then rise, perhaps as high as 5% by 2023 and beyond. This is not a reason not to own bonds, but rather one for keeping maturities shorter than normal.

Chart 3



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