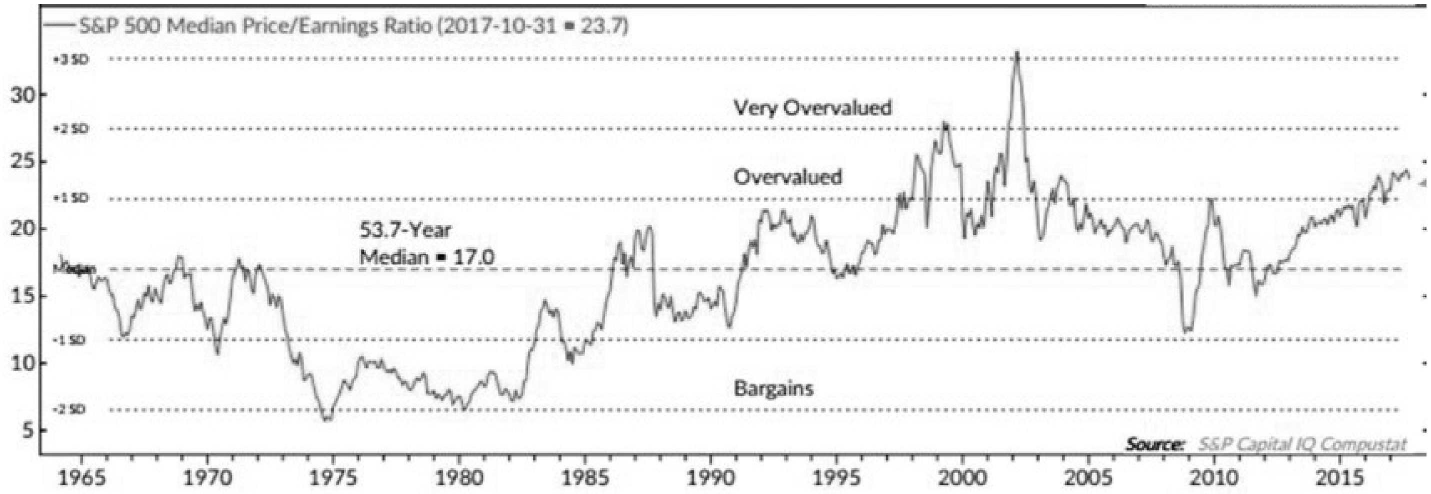
Notes From the North: Market Outlook

November, 2017

In the 10 years since the previous stock market peak in October 2007, highly stimulative monetary policies adopted by central banks throughout the world have probably helped boost stock prices more than earnings growth. Doug Ramsey of Leuthold Group calculates that based on generally accepted accounting principles, the S&P 500's trailing earnings per share has grown just 2% annually over those 10 years, a measure that *includes* the impact of stock buybacks on earnings. (Buybacks reduce the number of shares outstanding, thereby increasing the earnings per share whether or not total corporate earnings actually increase.) Chart 1, below, compiled by Ned Davis Research, shows graphically the volatile but steady increase in median P/E ratios since 1975. Over the trailing 10 years, the median P/E multiple on trailing earnings has increased from 18.4x to 23.7x.

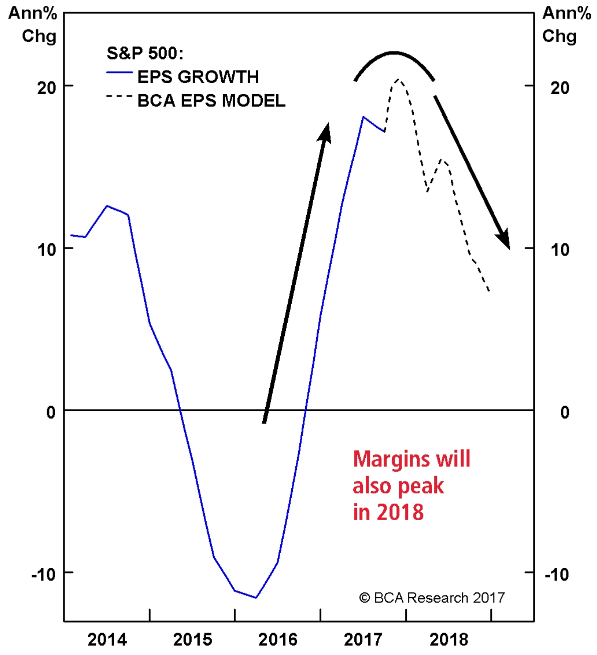
Chart 1



Source: S&P Capital IQ Compustat

It looks like we are now at a point where earnings growth will be needed to justify today's stock valuations, especially since most central banks are expected to be reversing their stimulative policies. Fortunately, the worldwide economy is strengthening and corporate earnings are responding. Earnings growth for the S&P 500 in the third quarter should come in near 8% with revenues up 5%. With 43% of the S&P 500's sales coming from outside the U.S., strong foreign economies have helped significantly. BCA analysts expect good earnings growth to be a tailwind for stock prices in 2018, but warn that the rate of growth will slow as we get closer to 2019 (See Chart 2, right). BCA also expects oil prices, wages and inflation to increase next year. If inflation rises too quickly, the Federal Reserve might raise rates faster in response, increasing the risk of a recession-causing overshoot in policy. The timing for recession in this scenario would most likely be in 2019.

Chart 2



One of the factors in this year's strong stock market is the prospect of lower corporate taxes. Although the two versions differ and will need to be reconciled before any changes take effect, both the U.S Senate and the House have passed a tax bill. The media has been focusing on the minor changes proposed for individual tax brackets, but the changes in corporate rates are more important to the stock market. The general consensus is that the market has now discounted tax reform, and would likely correct by 5-10% if a bill that lowers corporate rates and allows companies to repatriate money earned overseas does *not* pass.

BCA, whose forecasts have been remarkably accurate over the last several years, thinks that regardless of tax policy, stocks can continue to rally over the next twelve months. However, they see some danger in the market's historically high valuations. Their advice to market participants with a *short* time horizon (nimble traders) is to remain overweight global stocks now and plan to turn more defensive late next year. Their advice to long-term investors; consider paring back exposure now. Normally, risk reduction would entail selling stocks and putting money into bonds. Unfortunately, the bond market may be vulnerable now as well.

The yield on the one-year Treasury Bill (which closely follows changes in the Fed Funds rate) has risen from 0.1% in 2014 to 1.6% today. The Federal Reserve appears set to raise short term rates once more before year end, and is prepared for three more increases in 2018. The percentage move in long term rates has been more muted, and as a result, the yield curve has flattened. Central bank bond purchases may partially explain the limited response in long rates, but central banks are expected to soon follow the Fed's lead and reduce bond purchases. If long-term rates (and by long-term we mean bonds with maturities of 10 to 30 years) were to rise sharply, long-term bond prices would decline sharply. Global bond prices are particularly vulnerable since central bank buying has caused yields in many countries to be negative. (That is, bond buyers are *paying* rather than *receiving* interest for the privilege of owning bonds!)

Shorter term price action is highly unpredictable, but Boston-based investment management firm GMO has earned a reputation for being an accurate forecaster of long term asset class returns (their preferred “long term” is 7 years). Currently for U.S. bonds, GMO is forecasting an inflation-adjusted return of -1.0% annually over the next 7 years. Their projected return for foreign bonds, -2.6%, is even worse. BCA’s advice to bonds investors is to shorten their maturities and not own any bond with a maturity in excess of 10 years.

Although every bond portfolio is a little different, the average maturity of all our clients’ bonds taken together is just 3 years and change, and we have been gradually reducing stocks towards each client’s equity target all year. More recently, within the equity allocation we have been looking to cut back on the riskiest stocks and replace those with better values. Front of mind, however, is that the last portion of a bull market is often the most profitable, and the stocks that have fallen in price now may not be the ones we would want clients to own going into the next downturn. Finding the right blend is easier said than done, but it’s a worthwhile goal.

Martha Cottrill, CFA	Carl Erickson	Edmund R. Taylor, CFA
President	*Principal*	*Chief Investment Officer*

All equity investments entail the risk of loss and the stocks mentioned here may not be suitable for your portfolio. The securities mentioned do not represent all the securities bought, sold, or recommended for clients and you should not assume that investments discussed above are or will be profitable. The information provided should not be considered as a recommendation to buy the securities mentioned.