Notes From the North: Market Outlook

January, 2018

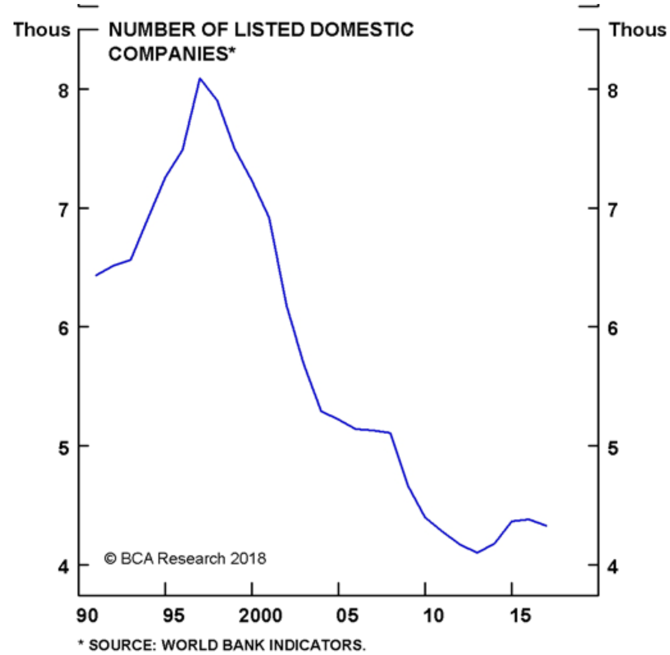
Equities were the hands-down winners in 2017. The total return to the S&P 500 was positive in every single month of the year, a feat last accomplished in 1970 and one that in 2017 resulted in a total return of over 20% for that index. Building strength upon strength, 2018 begins with the best outlook for economic growth we have had in ten years. Tax cuts will indeed help many U.S. firms; Credit Suisse recently raised their 2018 earnings growth expectations for the S&P 500 to +17%, adding that tax changes will account for about half of the earnings gains. Additionally, both business and consumer confidence are high. Most recent economic reports have exceeded estimates. Capital spending and wage growth are expected to accelerate. At long last, it appears that monetary stimulus has translated into economic activity and growth.

How much of this good news is already priced into the market? We think the chances are good that much of it is. On the other hand, while valuations are clearly at historic highs, both David Tepper and Warren Buffett have just said that valuations are not too high *given the low level of interest rates*. Perhaps then, the trend and level of interest rates will turn out to be a key determinant of stock price trends in 2018. In 2017, short-term interest rates rose from virtually zero to just over 1%. The Fed is expected to raise rates two to four times in 2018, probably in increments of a quarter of a point. The ten-year U.S. Treasury yield ranged between 2.1% and 2.6% in 2017 and ended the year close to where it started.

Who better to ask about future interest rates than bond "guru," Jeffrey Gundlach of Doubleline Capital? Gundlach thinks inflation expectations will increase while spreads between the 10-year Treasury and the Consumer Price Inflation (CPI) index will widen from the current level of 0.15% back towards the long-term average (2.4% since 1960). Rates on the 10-year Treasury could hit 6% by 2020. In a nutshell, he thinks the secular bull market in bonds is over.

One trend that has supported low rates is due to reverse in 2018. For the last three years, the G3 central banks were buyers of more bonds than their governments were selling in order to finance budget deficits. That will change in 2018. Today, the U.S. Federal Reserve is selling bonds from its balance sheet to the tune of $30 billion per month. The European Central Bank is not yet a net seller, but they are scaling bond purchases back by $20 billion per month. In all there will likely be a shift from a *$250 billion net demand* for bonds in 2017 to a *$550 billion net supply* in 2018. Gundlach points out that low interest rates have enabled the Federal Government to increase total debt by 113% since 2008, yet interest payments have risen only 5%. Corporate debt, much of which has been used for financial engineering rather than investment, is 79% higher than it was in 2008.

Chart 1



Price/earnings multiples tend to move in the opposite direction of interest rates so it will be difficult for multiples to rise if interest rates rise. Stocks could, however, maintain current price/earnings multiples and rise in line with projected earnings gains. Gundlach thinks stocks could continue rising over the nearer term, but he expects them to end the year lower than where they started. BCA strategists agree that interest rates will rise and the rise could trigger a recession late in 2019. However, unlike the bond market, the supply/demand balance in the stock market will continue to be favorable for stock prices. Chart 1 (page 1) shows how the supply of stock has been drying up due to buybacks, mergers and delistings. For BCA, the combination of rising earnings and favorable supply conditions will allow investors to earn a worthwhile return on stocks for at least the next 12 months.

The stock market usually starts to anticipate a recession about 6 months in advance, but the lead up to a recession has produced very good months in the market over recent business cycles (see table, below). Asset allocation firm GMO has very low expectations for the long-run, but their founder, Jeremy Grantham, is currently forecasting a better than 50% chance of a stock "melt-up" in the next 6 to 24 months. Our own institutional memories are harking back to the bull market of 1995-1999. Three years into it, the S&P 500 had more than doubled. By early 1998, valuation would have forced a rules-based value investor into cheap but low-quality stocks or cash, a very painful position to be in as the market continued to appreciate another 50% over 1998 and 1999.

Faced with the dilemma of a rising market, investing basics always help: asset allocation, diversification, security selection. The strongest tool in our tool box is an awareness of the strengths and weaknesses of our own approach to investing. Whether at a market top or a market bottom, a melt-up or a melt-down, an unemotional approach has always served us well, especially when others become consumed with fear or greed.

ANNUALIZED REAL RETURNS (%) PRIOR TO RECESSIONS	MONTHS PRIOR TO RECESSION					NON-RECESSION MONTHS
	13-TO-24 MONTHS	1-TO-24 MONTHS	7-TO-12 MONTHS	1-TO-12 MONTHS	1-TO-6 MONTHS	
S&P 500	Returns tend to be strong in the late stage of the business cycle...				...but don't overstay your welcome	
AVERAGE RETURNS POST-1950s	14.2	6.8	8.0	0.1	-7.8	10.1
JUL 1953 - MAY 1954	21.9	12.0	17.8	2.0	-13.8	14.7
AUG 1957 - APR 1958	15.8	7.1	-17.0	-1.6	13.9	19.3
APR 1960 - FEB 1961	31.3	16.8	6.6	2.2	-2.2	15.8
DEC 1969 - NOV 1970	13.4	-1.3	-11.0	-15.9	-20.7	5.8
NOV 1973 - MAR 1975	16.9	4.9	-11.3	-7.0	-2.7	6.2
JAN 1980 - JUL 1980	0.5	2.2	6.8	5.4	4.0	3.1
JUL 1981 - NOV 1982*	...	...	32.2	10.5	-11.2	4.0
JUL 1990 - MAR 1991	14.3	13.1	22.2	11.9	1.6	14.0
MAR 2001 - NOV 2001	8.9	-0.7	20.0	-10.3	-40.6	12.5
DEC 2007 - JUN 2009	11.6	7.6	13.6	3.6	-6.3	4.0

In more recent business cycles, investors have reaped strong returns in the 7-to-12 months prior to the recession

* FIRST 2 COLUMNS OMITTED DUE TO OVERLAP WITH PREVIOUS RECESSION PERIOD.
NOTE: MONTHLY RETURNS ARE ANNUALIZED AND DEFLATED BY THE CONSUMER PRICE INDEX; CALCULATIONS ARE BASED ON TOTAL RETURN INDEX.

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