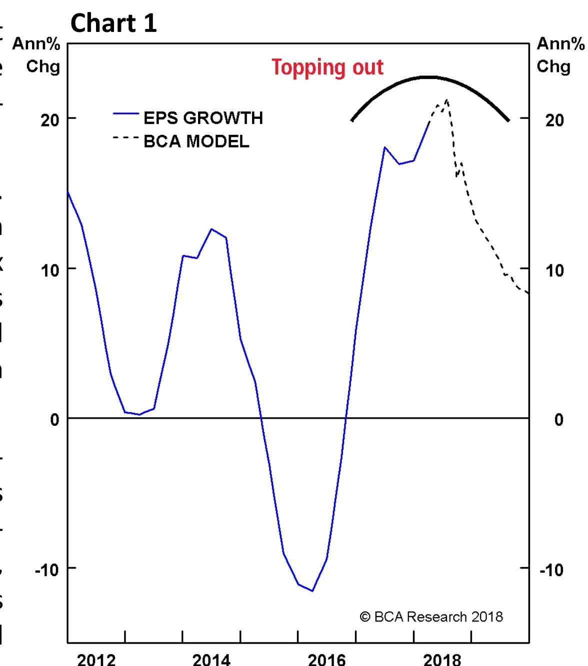
Notes From the North: Market Outlook

May, 2018

Corporate earnings rose more than 20% in the first quarter, but stocks did not respond with as much enthusiasm as might have been expected, possibly because one-time tax reductions accounted for 30-50% of those earnings gains. The market continues to weigh a positive background of strong earnings gains and share buybacks against concerns over tariffs, trade talks, rising inflation and rising interest rates.

Caterpillar's (CAT) first quarter earnings report and the stock's action provides a window into the market's mood: After reporting Q1 earnings that were 30% higher than expected and raising 2018 guidance by $2.00/share, CAT's Chief Financial Officer mentioned in a brief side comment during the company's conference call that Q1 would be the "high water mark" for 2018. Instead of responding to the strong earnings beat, the stock reacted to the CFO's comments and fell sharply on the day, casting a pall over the entire market. Of course the company retracted and clarified the statement, but traders had already extrapolated those comments into the outlook for many cyclical firms.

We would be surprised if earnings did not continue to increase, but it seems prudent to be prepared for a slower *rate* of increase than the torrid 20% growth recently posted. Chart 1 (right) shows BCA's forecast for earnings growth rates into 2019.



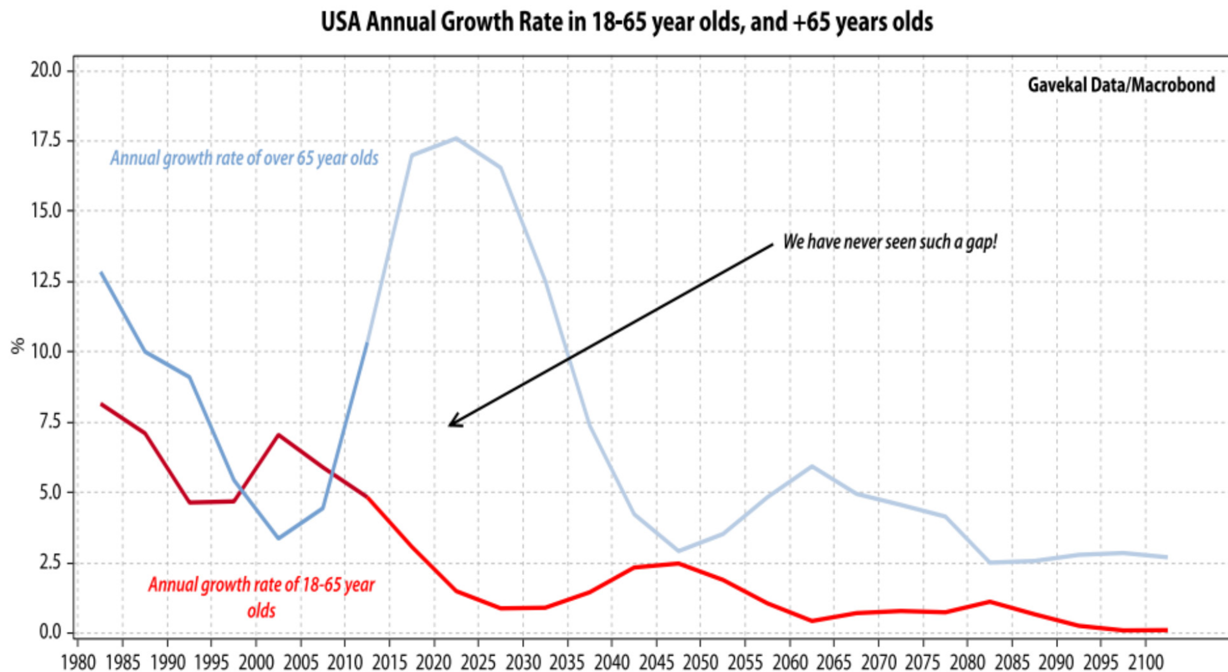
Earnings are strong, but inflation and interest rates are headwinds. Inflation, while subdued, is moving upward. Interest rates are also on the rise. The Federal Reserve has increased the Federal Funds rate six times since rates bottomed at 0.25% in 2016. Higher interest rates have not yet hindered growth or stock prices, but the Fed is expected to continue increasing rates by about one-quarter of one percent each calendar quarter well into 2019.

Investing in a rising-rate environment is trickier than it may seem, given that rate rises are generally accompanied by strong earnings growth and low unemployment. Unfortunately, monetary policy almost always overshoots. Unless the business cycle has been repealed, strength will give way to weakness just as weakness sows the seeds for a rebound. Thus, while things seem strong, we begin looking ahead to the possibility of recession. Recession does not imply catastrophe; stock prices retreat, but under normal circumstances they eventually rebound. We have survived many recessions in the past.

One valid concern about the next recession is that the typical tools used to moderate and reverse a downturn may prove to be less effective in the future. The two primary tools for counteracting an economic slowdown are fiscal policy (government spending) and/or monetary policy (interest rates). Both strategies rely heavily on debt to transmit their effects to the broad economy. Debt has played an important role in spurring growth historically, but on its own the tool does not have unlimited power. Without balancing contributions from increased natural resources or labor (or higher productivity from the same amount of labor), debt will eventually become an overhang rather than a growth tool. The evidence is mounting that each new helping of debt around the world is gradually becoming less effective in the amount of growth it can generate. The economic theory posits that continuing to press for growth through the use of just debt will eventually turn it from even a mild positive for growth to a distinct negative. We do not appear to have reached that tipping point yet, but it's clear that leverage has not increased the economy's growth rate in this business cycle the way that it has in past. (For detailed numbers on this subject, we recommend pages 4 and 5 of Hoisington

Investment Management's first quarter commentary, available online.)

Compounding the reduced productivity of debt is the prospect of its increasing cost as interest rates rise. If interest rates rise, the annual cost of interest payments on current debt levels will consume a large portion of the budget for many countries. Unfavorable demographic trends further challenge the budgets of many of the developed economies. Chart 2, below, highlights the demographic dilemma in the U.S., delineating the rate at which collectors of Social Security and Medicare will be rising (the blue line), compared to the payors (the red line).



The consensus on Wall Street seems to be that stocks can continue to rise modestly over the balance of this year and throughout most of 2019, but no one can know. "Timing the market" has consistently proven itself to be one of the worst strategies. Fortunately, there are some steps that are prudent for anyone seeking some protection in the event of a downturn. Diversification amongst asset classes, economic sectors, and individual stocks is always a good idea. Check in with us and yourself on your asset allocation. If the level of equities in your portfolio is one that might make you uncomfortable in the next market downturn, now is a good time to rebalance. As well, any identified cash needs in the next several years should be held in bonds whose maturity matches the need. (This will help avoid having to sell stocks at an inopportune time.) For more cautious investors, an additional allocation to short-term bonds would provide an added layer of comfort as well as ammunition to buy stocks when things get tough. Between these steps and our search for high-quality, cash flow-generating companies that can weather a downturn, we should all sleep well at night.

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