NOTES FROM THE NORTH: MARKET OUTLOOK

November, 2016

Sometimes, as you might imagine, there are times when it is difficult to find enough new developments to fill a monthly investment letter. This is not one of those times! The Trump victory in the presidential election has given us (as well as late-night comedians) a wealth of new material about which to write.

Prior to the election, fear of a Trump win dominated the consensus thinking. Estimates of market impact if he were to pull out a win ranged from a 5% drop to a 12% drop. The overnight futures action on Election Night confirmed those fears, but the market shook off the overnight concerns and closed up strongly on Wednesday, the day after the election. Now many Wall Street strategists believe that Trump's pro-business attitudes will accelerate growth and push stock prices higher. This change of heart may have been partly inspired by the fact that the equity indexes continued to stretch for new highs last week.

The downside to this shift in attitude was a significant increase in interest rates. The price of the iShares 20 year Treasury bond ETF (symbol TLT) fell by 7.4%, which is the largest weekly decline since the ETF was started in 2002. Interest rate sensitive stocks such as utilities, telecom and REITs also fell in price. Just this summer, interest rates around the world went negative due to continued sluggish economic growth. Now, post-election, the thinking is that in the U.S. at least, rates have bottomed and will continue to rise. The Fed, which controls short term rates, is indeed likely to increase the Fed Funds rate in December and perhaps another two times in 2017. If they do, and the entire yield curve shifts up (rather than flattening), a strategy of concentrating in short and intermediate term bonds will finally pay off as those bonds should avoid the potentially large price declines in long term bonds. In laddered portfolios, we may finally have an opportunity to reinvest proceeds from maturing bonds into new issues with higher yields.

President Trump may not pursue all of the changes he promised during his campaign, but with a Republican House and

Chart 1: Strengthening U.S. Dollar

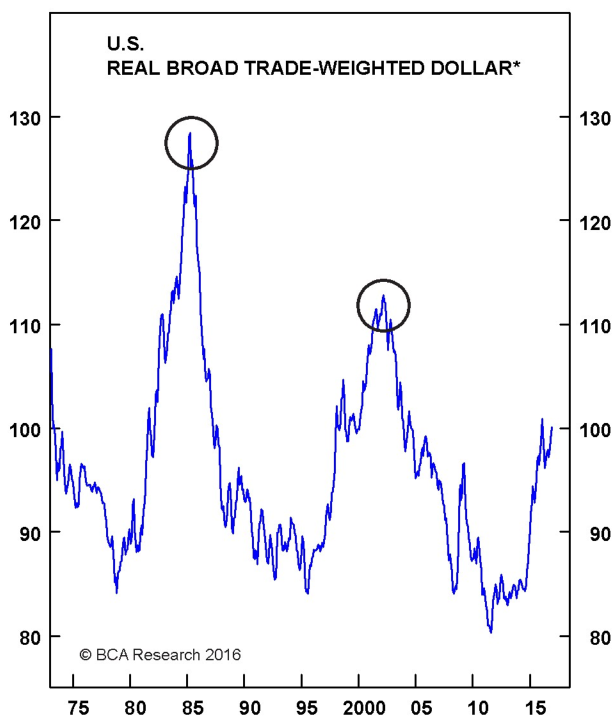
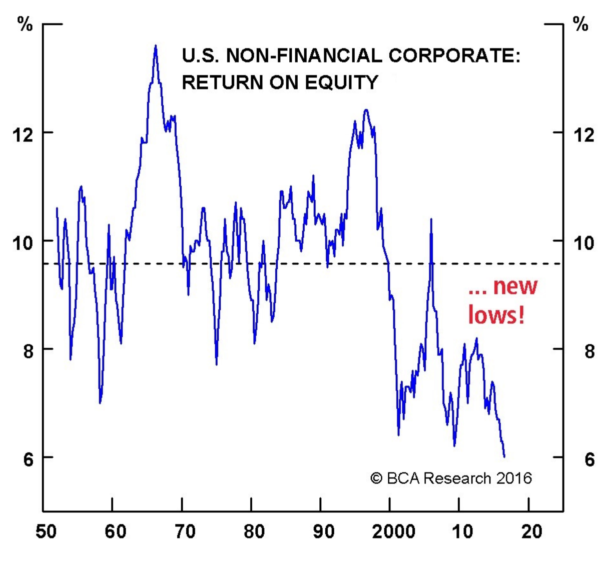


Chart 2: Return on Equity (Ex-Financials)



Senate, he will be able to make significant changes. All of the policies that President Obama fashioned with only his pen (by Executive Order) rather than with Congress can be easily undone. Writing for GaveKal, Anatole Kaletsky states that tax reforms that should have been implemented years ago, such as partial tax amnesty for repatriated profits, will finally become possible. Reduced taxes for businesses and individuals, a relaxation of regulations and increased spending for infrastructure and defense could double the rate of GDP growth over the next two years. Financial, energy, healthcare and defense stocks all rallied last week.

Kaletsky has less positive feelings about Trump's ideas on trade. It is unlikely that we will actually see a 45% tariff on imports from China, but some trade restrictions and new trade agreements are expected. Trump's hard line on trade and illegal immigration should benefit low-skilled workers. Tariffs and trade restrictions would hurt emerging market firms and those stocks reacted accordingly last week.

Another area of concern is the value of the U.S. dollar. Kaletsky previously thought the dollar's appreciation was over. He now expects it to resume and possibly turn into a full scale dollar short squeeze in emerging markets. The Bank Credit Analyst thinks the dollar could rise by another 8.5% over the next 11 months. As shown in Chart 1 (on the previous page), this would still leave the greenback below its previous 1985 and 2001 highs but a strengthening dollar still acts as a brake on the economy by making our exports more expensive to foreign buyers and by reducing the value of overseas earnings.

Both BCA and GaveKal agree that a Trump administration will enhance the value of domestic stocks vs. overseas equities. BCA goes a step further in preferring U.S. firms whose operations are primarily domestic as opposed to multinational. A tight labor market would increase wages, putting further pressure on profit margins. The combination of higher interest rates, higher inflation and a strong dollar could restrain stock prices.

While we may be making modest revisions to our holdings, we believe most of the companies we own are capable of doing well during a Trump era. They are strongly financed, well-managed firms that can adapt to changing conditions. The question is less whether earnings will continue to rise than what multiple investors will be willing to pay for those earnings. The Fed's easy money and low interest rate policies have helped stock prices and diverted attention from the problems that U.S. businesses have encountered. Those problems are clearly reflected in chart 2 which shows that return on equity (financial sector excluded), an extremely important measure of profitability, has fallen to its lowest level in more than 60 years. Without the Fed's extraordinary measures, stocks would not have risen to today's historically high price/earnings multiples. If interest rates are about to rise, more growth will be necessary to sustain current valuations.

For those with a bond component to their portfolio, the turn in bond prices has offset some of the benefit from the rally in equities. Bond returns will not look good if interest rates continue to increase, but take heart! If that process does unfold, it will end the safety-punishing period of almost non-existent returns from bank accounts and bonds. It would be nice to return to a world where good quality bonds provide safety, certainty, *and* an income a reasonable person could live on. We cannot eliminate the sting of the transition, but we have undertaken strategies to reduce it and the return to normalcy will be worthwhile.

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