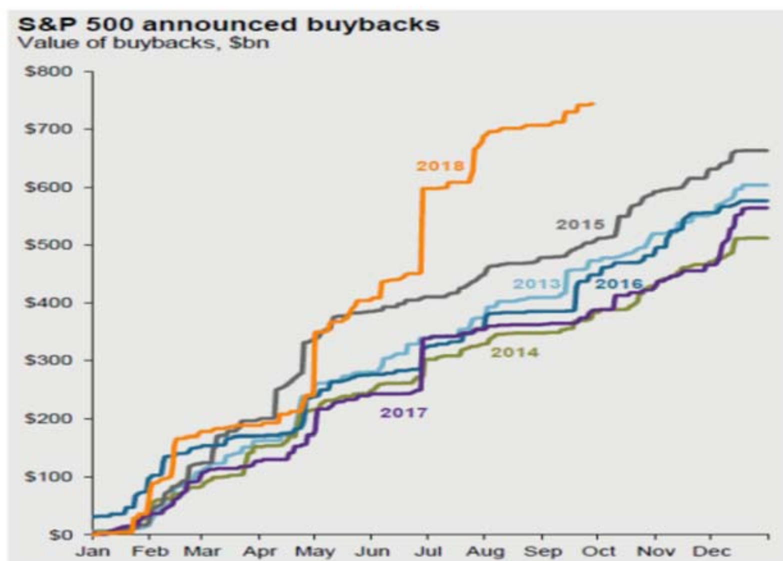
NOTES FROM THE NORTH: MARKET OUTLOOK

October, 2018

While it is impossible to accurately predict the timing of market corrections, we doubt anyone was really surprised when stocks hit an air pocket this month. The U.S. market rose sharply in the third quarter, but the rally showed poor "breadth" and the continued concentration of returns in a handful of growth stocks was not likely to be sustainable. We had noticed early in the fall that although year-over-year the *market* was up 16% at the time, the *average* stock within the market index was already in correction territory. Measured from a 52-week high rather than a specific date, the average constituent decline was about 11%. In fact, over half of the S&P 500's strong performance over the last 12 months was concentrated in the returns of just 13 very large stocks, while the median stock in the S&P 500 has underperformed the index by nearly 700 basis points.

One factor contributing to domestic market strength over the summer has been share buybacks. The chart below illustrates just how much more stock has been bought this year than in years past, with particularly large jumps in May, July, and August. Unfortunately, insiders are not buying their own shares for their personal portfolios. Vito Racanelli notes in Barron's that while firms are aggressively buying their own shares, executives at those firms are increasingly offloading their personal holdings. According to TrimTabs, corporate insiders sold $10.3 billion worth of stocks in August. This is the highest amount of August selling since



2008. In September, insiders sold an additional $7 billion worth of shares, topping the previous 10-year high of $5.7 billion in 2012. While this is clearly not a sign of rampant optimism, insider selling tends to not be as strong an indicator of corporate ill-health as insider buying is an indicator of corporate strength.

The recent rise in the yield of the 10 year Treasury firmly above the 3% threshold is good news for savers, but it likely played a role in last week's market sell-off. Everyone has been watching the Federal Reserve's "normalization" of interest rates for a hint of the formal shift from an easy monetary policy to a tight one. Chairman Powell's comments that the Fed may raise rates above the "neutral" rate and that we remain a long way from neutral led some to believe the shift was imminent. Recall, however, that BCA has consistently warned that rates could go a lot higher than investors were expecting.

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Monetary policy matters because the low interest rates that have prevailed since 2008 have supported rising price/earnings ratios ("P/Es"). As well, the lower cost of capital has contributed to historically high operating profit margins. Typically, as interest rates shift from accommodative to neutral and then restrictive, P/Es will contract. Higher interest rates also raise the cost of doing business, as does wage inflation, which is now underway. Although wage inflation can lead to a positive cycle whereby workers earn more and spend more, thereby helping corporations, more typically wage inflation will pressure margins and earnings growth.

Perhaps less well understood is the potential impact on corporate earnings of tariffs on Chinese goods. JP Morgan now expects a full-scale trade war, with 25% tariffs on *all* Chinese goods in 2019. If this situation materializes, JP Morgan projects that this headwind would shave $8 per share off S&P 500 earnings (from their original 2019 projection of $179). Rising energy costs and a dollar that continues to strengthen could also penalize profits. While cooler heads may prevail in the current trade "skirmish" and energy prices and currencies may follow a different path than current consensus, earnings growth will likely be far less than the 20% or better gains we have seen thus far in 2018.

Have recent developments changed expectations? While market sentiment has grown more cautious, and bearish pronouncements from Doubleline's Jeffrey Gundlach and Swiss guru Felix Zulauf are duly noted, we continue to believe that market uncertainty elevates the role of experienced active management. Indeed, part of Zulauf's recent Barron's interview that we find most interesting is his forecast that what worked the last 10 years (index funds) will not work in the next 10 years. In the years ahead, Zulauf predicts that traders and active investors will regain the upper hand.

While no one forecasts with consistent precision, we have long found the forecasts of Peter Berezin, chief global strategist at BCA, to be among the most consistently logical and dependable. Part of the strength of his process lies in his willingness to adjust forecasts as data develops (rather than getting locked into a single position and only looking at data that confirms that position). In June, Berezin downgraded global equities from overweight to neutral, while maintaining his bias against emerging markets. More recently however, he is saying that another leg down of 8%-10% would present an opportunity to accumulate U.S. stocks. He firmly believes that we remain at least 12 months away from an equity bear market, and reminds us that the last year of a bull market often provides exceptionally high returns.

For our clients, we take the position that we should maintain benchmark equity weightings, but be keenly focused on extremely high-quality issues and/or those that are clearly undervalued. Should we be wrong on timing, the high quality holdings can at least be expected to weather a storm and come out of a slowdown with even larger market shares, while those that are undervalued should not decline much more in the face of a market selloff.

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