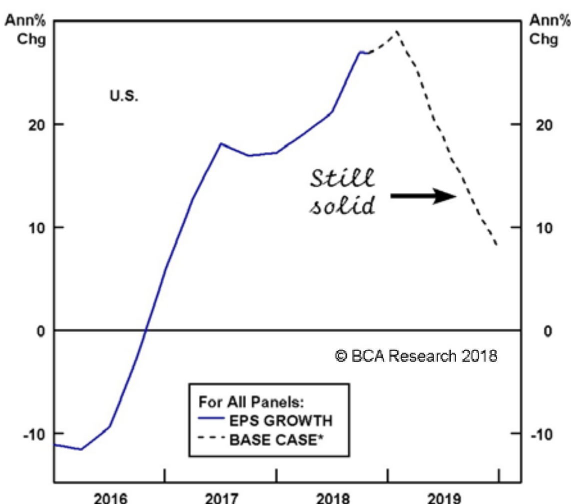
NOTES FROM THE NORTH: MARKET OUTLOOK

December, 2018

From the peak on September 20th to recent lows, U.S. stocks erased all their gains for the calendar year. The broad-based NYSE composite is down 8.2% year to date and foreign stocks are down about 15%. Although it's impossible to pinpoint the reasons, there appears to be increased concern about slowing economic growth outside of the U.S., as shown in the chart of Leading Economic Indicators (below, right). The political troubles of European leaders Angela Merkel, Teresa May and Emmanuel Macron are not helping investor confidence, and the fact that the European Central Bank is ending its Quantitative Easing program could be another restraint on European markets.

While somewhat insulated from problems overseas, the U.S. economy also seems to have lost some steam. Hardly a day passes without some analyst or company spokesman reducing 2019 growth expectations. The trend in earnings forecasts for U.S. firms is shown in the second chart (below, left). In truth, the long economic expansion resulted in persistent optimism, and future growth expectations had simply risen too high. Analysts recently polled by S&P Global still believed earnings for the S&P 500 would grow +13.4% per year for the next 3-5 years. Clearly the market disagrees. At current levels, the market itself is now discounting 2019 earnings growth of about +3% (assuming a price/earnings multiple of 15.5x is reasonable).

For context, S&P 500 Index earnings have grown about +7% per year for the past two decades, and revenues have grown at a +4% rate. For the optimistic +13.4% growth projections to be met, profit margins must rise even further from today's elevated levels. This seems highly unlikely given that margins have already absorbed a one-time boost from the tax cut. Instead, we concur with BCA, which suggests that corporate profit margins are broadly at a peak and will be pressured by rising wages, dollar strength and higher borrowing costs.



On a more positive note, the most reliable predictors of a recession are *not* flashing red. Those who are calling for a recession starting in 2019 or 2020 base their conclusion partly on the expectation that the Federal Reserve will raise interest rates too far. Indeed, when Federal Reserve chairman Powell recently softened earlier pronouncements that we were a long way from neutral, and said instead that rates are nearing the neutral rate, the stock market rallied, albeit briefly. The bond market is now pricing in only 40 basis points (0.4 percentage points) of rate hikes through the end of 2019 whereas BCA thinks the actual number will be 125 basis points (1.25 percentage points).

While the Federal Reserve's decision to stop buying bonds has gotten less attention than what it will do with rates, the former is still a contraction in monetary policy. Benn Steil and Ben Della Rocca of the Council on Foreign Relations calculate that the reduction of the Fed's balance sheet has already had an effect equivalent to 68 basis points of rate rises. They expect the Fed to continue its $50 billion per month sell-down program, which would be equivalent to an additional 220 basis points of rate increases. If they are correct, and the Fed proceeds down parallel paths of raising rates and shrinking their balance sheet without attention to real econ-

omy reverberations, it is likely that both stock and bond markets would be adversely affected.

BCA expects the 10-year Treasury yield to peak sometime in 2019 or early 2020 in the 3.5%-to-4.0% range. By comparison, today's 10-year Treasuries yield 2.9%. Accordingly, BCA expects total returns for bonds to be negative in all major bond markets in 2019. Moreover, they warn that lower quality bonds do not provide a high enough yield to compensate for the extra risk. The Moody's Covenant Quality Indicator, which measures how protected investors are in the case of default, has remained at its lowest level for 18 consecutive months, even as the leveraged loan market now exceeds $1.3 trillion. According to Bank of America Merrill Lynch, loans with no requirements to meet financial tests (like maximum leverage or coverage ratios) have risen to 80% of debt, compared with just 25% in 2007. With this in mind, our recent bond purchases have emphasized good quality issues with short to intermediate maturities.

While recent price declines have improved U.S. equity valuations, stocks are still not broadly undervalued. The elevated price to sales ratio shown in the chart on this page demonstrates a good reason to be concerned about profit margins. Revenues are not cheap, and if revenue growth disappoints or profit margins decline, the market could be disappointed. Considering this backdrop, we have been taking partial profits in stocks with valuations that seem elevated relative to underlying business trends. In addition, we have sold certain stocks to harvest losses in taxable accounts that had realized capital gains earlier in the year. This will save money on taxes, but runs the risk of missing the usual January tax bounce in depressed stocks. Thus, in many cases we have reinvested in similarly depressed issues that could likewise bounce in January.

Amidst the recent market weakness and frequent "doom and gloom" headlines there is some offsetting good news...the good news is that some stocks have indeed overreacted to bad news and/or have simply been victims of overall (negative) market sentiment and selling pressures. We believe that these stocks now offer attractive longer-term value. As we perpetually survey the landscape, we continue to want to participate in the U.S. equity market, nevertheless we remain intentionally careful and abundantly selective in our choice of specific issues.

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