Notes From the North: Market Outlook

February, 2019

What a difference a month makes. The sharp drop in stock prices in December was partially attributable to the notion that the Fed would continue to raise interest rates in 2019, perhaps causing a recession. However, as the calendar turned, so too did the Federal Reserve's stance on rates, with the Fed formally asserting that it "will be patient as it determines what future adjustments" are necessary. Now, it appears possible that there will be no additional rate increases in 2019. In fact, according to CME Group, Fed Futures contracts prices now suggest that market participants place slightly greater odds that the Fed's target rate will be *lower* (not higher) by December. Equity markets embraced this news with enthusiasm in January. They have recouped the December losses, although they have not rebounded to the September highs.

The White House and administration have also helped buoy markets by taking a more optimistic and conciliatory tone regarding trade talks with China. Reassuring statements from the White House have left Wall Street with the perception that the March 1 deadline on trade talks can be extended - and the threatened 25% tariffs delayed - provided both sides have made progress towards resolution.

The third factor helping stock prices recently is that, thus far, fourth quarter corporate earnings have exceeded expectations. However, corporate earnings outlooks for 2019 have been more subdued. Many firms have reduced earnings guidance for 2019, or at least offered weaker guidance in the first quarter. Estimates of gains for 2019 are now relying on accelerating growth in the fourth and final quarter of the year.

Many investors believe that the Fed's policy of keeping interest rates low has been a key contributor to the very sharp rise in stock prices since 2009. We agree that Fed policy has been a factor, however Europe and Japan have also had extraordinarily low rates and their markets have not prospered like ours. Perhaps a bigger factor than interest rates has been the rise in profit margins for large U.S. firms. Chart 1 (below, left) shows the amazing rise in profit margins at a time when revenue growth was modest. JP Morgan's chart (Chart 2 below, right) demonstrates the extent to which margins have been a *much* larger contributor to earnings growth than either revenue growth or stock buybacks. This begs the question… "where are margins headed next?"

Chart 1

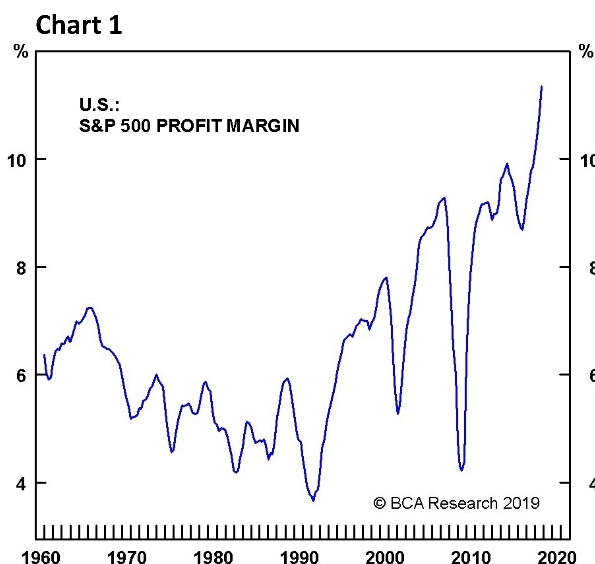
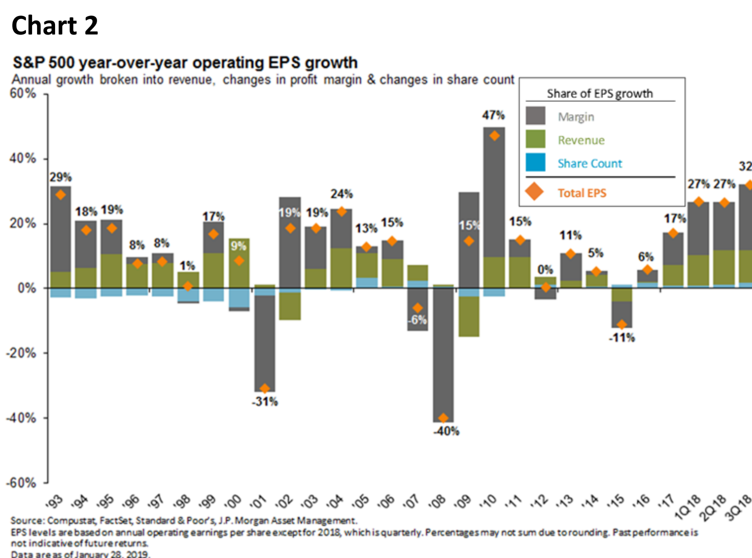
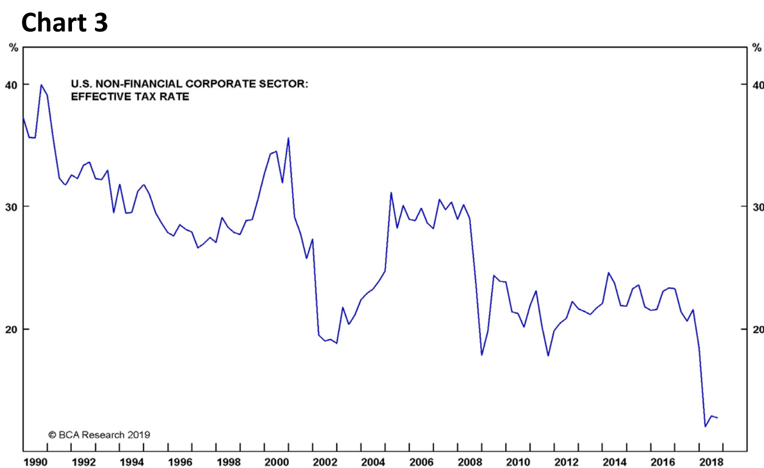


Chart 2



Martin Barnes, the most senior economic advisor at BCA, believes the growth in profit margins is primarily attributable to lower tax rates and tight control over labor costs. Unfortunately, he has concerns that neither tailwind is sustainable

from present levels. The effective tax rate paid by domestic non-financial companies averaged 21.7% between 2010 and 2017 compared with 26.7% between 2000 and 2007. As shown in Chart 3, the effective tax rate fell even further in 2018. One year later, tax rates are still low but they are now stable, and thus they cannot spur earnings growth compared to this time last year. Moreover, there is a growing chorus of politicians calling to reverse course and **raise** corporate tax rates prospectively.



Barnes finds that labor costs have been even more important than taxes. Labor's bargaining power has been eroded by globalization and technological innovations. If real employee compensation had risen in line with productivity since 2000, margins would be at their historical mean, rather than at a high extreme. The current low level of unemployment has begun to generate an acceleration in wage costs. If the economy continues to be strong, this upward pressure is not likely to abate.

Summing up Barnes' thoughts, he finds that the period between the end of 1982 and 2018 to be perhaps the greatest 36 years in financial history. It was driven by falling inflation and interest rates, rising profit margins, and a huge expansion in debt and rising P/E multiples. Looking ahead, he predicts a very different environment, where the high single digit profit growth we've seen is constrained, possibly falling into the low single digits. Barnes envisions a scenario in which inflation and interest rates are more likely to rise than fall, profit margins will come under pressure, and equity multiples are unlikely to remain elevated. Surprisingly, Mr. Barnes is not pessimistic about the stock market for 2019. He and BCA expect stocks to outperform bonds and cash in the current year. Favorable market conditions could persist through much of 2020, as well. Barnes' warning is that the next 30 years will provide lower returns than those to which we have become accustomed.

We've been planning on this for several years already. While we might previously have planned on 10% equity returns, today we usually plan for 5-6%. Given the level of interest rates, we have also lowered our expectations for bond returns. Where the standard forecast used to be 4% for bonds, today we plan on 2.5-3.0%. Taken together, a balanced account that used to expect to return 8% is now more likely to return 4-5%. (Of course, this is all over the long term. In any given year, those figures will vary dramatically). We've found it's much better to build a plan based on conservative assumptions, that might under-promise and over-deliver, than to build one that is likely to disappoint.

Martha Cottrill, CFA — *President*
Carl Erickson — *Principal*
Edmund R. Taylor, CFA — *Chief Investment Officer*

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Taylor, Cottrill, Erickson & Associates* P.O. Box 7 * 224 Main Street * New London, NH * 03257 * 603-526-7400
800-526-4860