Notes From the North: Market Outlook

June, 2019

Recent news headlines have been unsettling! Tariffs, anti-trust investigations, the Mueller report, attacks on oil tankers in the Strait of Hormuz…. It is an unsettling and uncertain time, for sure. While the market typically dislikes uncertainty, stocks have recovered from May's sell off, and appear to have instead been "climbing the wall of worry."

Bob Pisani of CNBC, a pundit skeptical of the rebound, has quipped that the move is based on "Hopium." First, there is *hope* that the Federal Reserve will cut interest rates, and second that there is *hope* that the U.S. and China will resolve their trade differences, since it is so clearly in the economic interest of both parties to do so. Let's take a look at both of these ideas.

Data on the domestic economy does not suggest it needs the stimulus of a rate cut. The Atlanta branch of the Federal Reserve, for instance, is forecasting that personal consumption expenditures will rise 3.2% in the second quarter. Real interest rates are already very low, and unemployment is at record lows. These are not typically conditions calling for stimulative action (rate cuts) by the Federal Reserve Board.

However, U.S. monetary policies affect the rest of the world in a tangled web of interconnectedness. For instance, the U.S. dollar is used as a medium of exchange in roughly $800 trillion worth of international transactions each year. A relatively strong U.S. economy and relatively high interest rates (yes, our rates are high relative to the rest of the world!) have both helped to increase the value of the dollar. A strong dollar penalizes international trade and makes foreign-currency debt (roughly $13 trillion) more expensive to repay.

Exports from Korea, Taiwan and Japan, a leading indicator for world growth, are falling. Would the U.S. Federal Reserve reduce rates in order to avoid *overseas* recessions? The Fed's mandate is to manage employment and inflation in the United States, not overseas, so they would have to see overseas weakness as having a potential impact on the health of the U.S. economy before they took such an action. Nevertheless, the market is currently expecting interest rate reductions of 80 basis points. Although low inflation levels do give the Federal Reserve leeway for a cut if they feel that trade uncertainties need to be offset, the economic research team at BCA thinks it is unlikely that the Fed will meet the market's expectations for rates. At most, they envision a single "insurance cut." There is some short-run risk that the Federal Reserve will sound less dovish than investors are expecting, which could lead to a temporary selloff in stocks.

The biggest problem with the hope that the trade dispute will be resolved with China is that political considerations may outweigh the economic realities, at least in the short run. In the U.S., protectionist sentiment as applied toward China is politically popular. BCA's geopolitical team remains skeptical of a grand bargain in trade talks with China; they think some truce or settlement is still probable, but perhaps not until a stock market selloff has provided a greater incentive to reach a deal. The most extreme view can be summed up by hedge fund manager, Kyle Bass, a long-time bear on China. In his opinion, we may never get a satisfying agreement with China because in his mind, "...it is a country that never sticks to its agreements. The government lies, cheats and steals as a national ideology." There are likely views in China about the U.S. equally as extreme.

As we all know, it's important that investors not get caught up in news flow that should only interest

traders. For instance, BCA's "call" for a market correction of 5-10% is interesting, but probably not useful to an investor since BCA thinks that after correcting, stocks will be higher a year from now.

Typically, bull markets end only when, in response to a heating up of economic activity and/or inflation, the Federal Reserve raises interest rates to a level that chokes off economic activity, resulting in recession and a downdraft in profits. Because economic growth has been consistent but subdued and inflation is so low, this is unlikely to occur before late-2020 at the earliest. On the other hand, the U.S. economic recovery is now officially the longest post-WWII on record, and appears to be in its later stages (see Table 1, below). For a variety of reasons, it's prudent to plan on equity returns over the next 5 years being modest compared to what we have experienced over the last 10 years.

Unfortunately, risk can't be avoided completely. Even going to cash will be risky in the long run, as inflation will almost certainly eat into spending power. It's important to remember that risk comes in many forms and has different meanings for different clients. Once the problem is defined, however, there are many tools in the risk management tool box! Among these are portfolio allocation to different asset classes (stocks and bonds), the structure of the bond portfolio (both for total return and as it relates to income and cash flow planning), the geographic and economic exposures of the equity portfolio, and the individual stocks selected.

When compared to some of the large, standard-setting products and funds, many of our portfolios have benefited from our emphasis on equities overall, and within the equities an emphasis on US companies with relatively little allocated to international stocks. The incorporation of quality into our value analysis has helped portfolios, as well.

While we do not generally recommend wholesale changes in asset allocation because market timing successfully is just not possible, after a good ten-year run we have been shifting most portfolios gently towards a more conservative positioning.

Table 1

Length of past US expansions post-WWII		
Start of Expansion	End of Expansion	# Months
Nov-45	Nov-48	36
Nov-49	Jul-53	44
Jun-54	Aug-57	38
May-58	Apr-60	23
Mar-61	Dec-69	105
Dec-70	Nov-73	35
Apr-75	Dec-79	56
Aug-80	Jun-81	10
Dec-82	Jun-90	90
Apr-91	Feb-01	118
Dec-01	Nov-07	71
Jul-09	Current	119
Average		*62*
Minimum		*10*
Maximum		*119*

Source: NBER

In the fourth quarter of last year, it felt like we should have done more. For most of 2019, it's felt like we should have done less. Nevertheless, we'll happily use 2019's market strength to continue to make incremental moves from return-seeking towards risk-avoidance.

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