# Notes From the North: Market Outlook

***October, 2019***

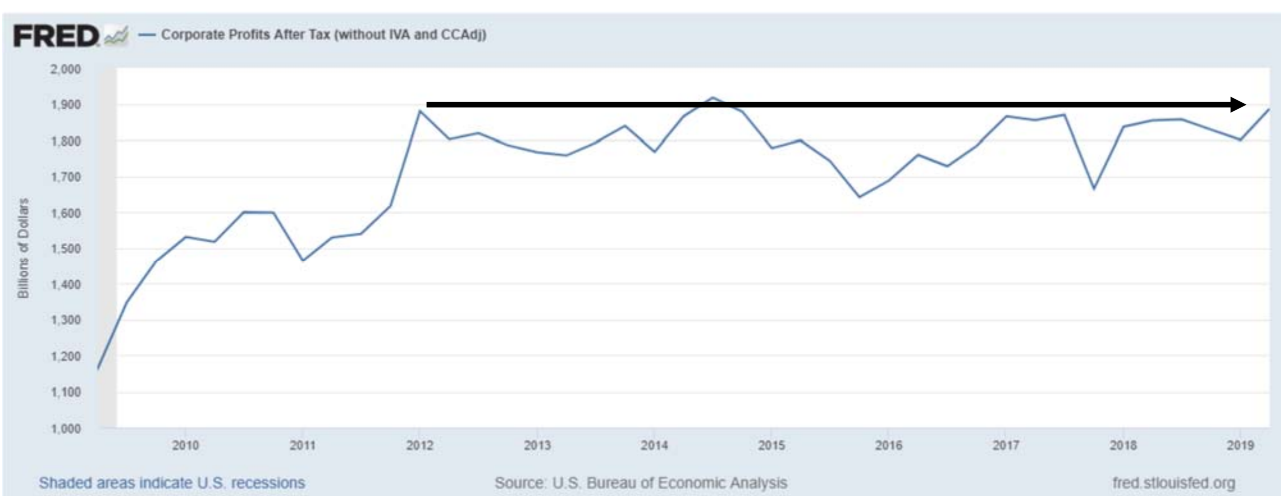
Large cap U.S. stocks have moved sideways recently, but they have overall held the price gains achieved in the first half of 2019 despite a flurry of seemingly unfavorable developments in the last couple of months. Among those developments were the following:

1. Workers struck General Motors whose output is important to many parts of the economy, especially parts makers.
2. A drone strike damaged a portion of Saudi Arabia's most important oil facility. Oil prices spiked at least temporarily and investors wondered if this could be the beginning of another war in the Mid-East.
3. FedEx significantly reduced its earnings guidance, citing continued softening in global economic conditions.
4. The Organization for Economic Cooperation and Development foreshadowed FedEx's concerns when it projected that worldwide growth of 2.9% in 2019 would be the slowest since the financial crisis in 2008.
5. FactSet reports that estimates for third quarter earnings growth for the S&P 500 have been reduced to a decline of -3.6%
6. Elizabeth Warren moved up in the polls for the Democratic party's presidential candidate. BCA warns that her proposals would likely hurt the drug makers, health care insurers, defense contractors, banks, oil and gas companies and the tech firms. These groups comprise the major portion of stock market averages.

Perhaps the negative developments haven't caused too much dismay because this year's return has been less about forecasting strength than about a reversal of the sharp price decline from the fourth quarter of last year. Compared to a year ago, the S&P 500 is only up about 2% and the broader Russell 2000 is down more than 8%.

Since 2012, the S&P 500 Index has gained about 130% including dividends. The strong market would suggest strong earnings, but the chart (below) from the Federal Reserve Bank of St. Louis shows that earnings have actually plateaued since 2012. This chart provides some ammunition to those who claim that although they've paved the way for higher asset prices, quantitative easing and lower interest rates have done little to improve underlying economic conditions.

Some of the fourth quarter 2018 decline was driven by a worry that the Federal Reserve had raised US interest rates too far. More recently, it has reversed course and reduced short term interest rates twice, an easing that has likely supported stocks in their 2019 gains. The European central bank has also just announced another easing in policy. However, interest rates in Europe are so low already that many suspect that lowering rates even further will not inspire corporations to borrow money in order to build plants or buy inventory that they do not need. In essence, the question is

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whether central banks are now "pushing on a string," the economic description of an economy that has moved to a place where monetary policy is *not* effective. Even Europeans are beginning to suggest that economic activity needs more help from fiscal (government spending) rather than monetary policies.

Jeff Gundlach, founder and chairman of DoubleLine Capital, has often made non-consensus predictions that turn out to be accurate. He is now saying there is a 75% chance of a recession before then next presidential election. He recommends selling lower quality corporate bonds and focusing on short to intermediate term government bonds. BCA, the Bank Credit Analyst of Montreal, also has a reasonably good record of economic forecasting. Unlike Gundlach, they think that global growth will bottom early in 2020 and that the U.S. will avoid a recession until 2022. They expect stocks to outperform bonds over the foreseeable future. They do agree with Gundlach that investors should use the next 6-9 months to sell their lower-rated corporate bonds.

We have not been making major changes in our portfolios. To the extent we have changed asset allocations, we have generally been taking profits in some stocks that have become extended and bringing equity allocations back down to originally planned levels. Our stock purchases have focused on good quality value stocks that offer a reasonable dividend yield. It is not often that one can find a dependable dividend yield that exceeds the yield on a 10-year Treasury. With 10 year rates at only 1.7%, that task has become easier.

One final thought: The chart below compares the price action of Vanguard's ETF for growth stocks (VUG) with that of its ETF for value stocks (VTV). Historically, value stocks have usually provided better returns than growth stocks over a cycle. With earnings growth so elusive in this decade, the market has come to vastly favor growth stocks. After 10 years of outperformance, however, JP Morgan finds that the relationship is at an extreme level. There was some rebound in value stocks in September, which JP Morgan attributes to short covering, but they are also expecting a more extended leg up in the value portion of the market, especially if there is an upturn in the business cycle. We are well aware that tax loss selling could once again hit depressed value stocks before year end, but we would not bet against Morgan's expectation of a reversal in this relationship.


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