Notes From the North: Market Outlook

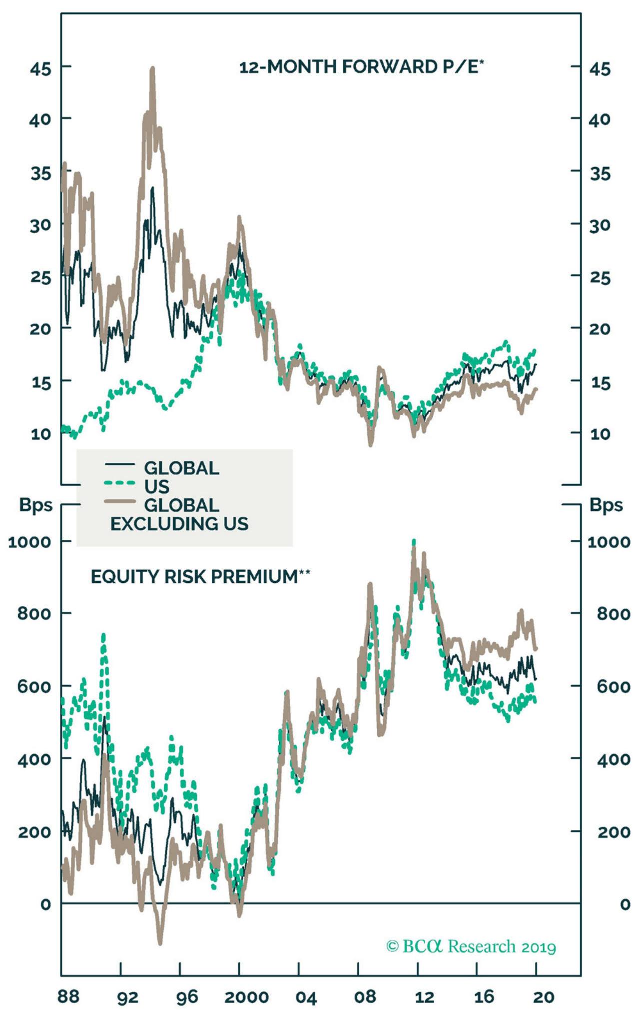
December, 2019

Consumer spending in the U.S. has been strong all year. (How could it not be, with unemployment at record low levels?) If there has been an area of concern, it has been the manufacturing sector. However, the most recent data have provided evidence that the global manufacturing cycle is bottoming out. Stock market participants have long thought that the primary problem with trade and manufacturing has been the U.S.-China trade dispute, which introduced tariffs. The phase one deal announced last Friday should be a positive for the entire world. Another uncertainty resolved is the election in Britain. It is expected that the Conservatives will negotiate a Brexit deal and then sign an expanded trade agreement with the United States. BCA (the Bank Credit Analyst research organization), thinks both of these news items provide a "Full Speed Ahead" for investors. They expect global growth to accelerate in 2020 and think that estimates of a 10% gain in corporate profits next year are realistic.

Another component of the more bullish outlook is dovish monetary policy. After raising interest rates from 2016 to 2019, early in this year the Federal Reserve backtracked and has now reduced them 3 times. Moreover, the Fed and most other central banks are signaling that the now dovish monetary policy will remain in place throughout 2020. The Fed has indicated it plans to allow inflation to rise measurably before raising rates again. BCA thinks this will allow the bull market to run until the end of 2021.

While the Fed may keep short-term interest rates low, longer-term rates are expected to rise modestly in 2020. That is a reflection of a stronger economy and somewhat higher inflation. Higher long-term rates would not be good news for the price of long-term bonds, and most strategists think stocks will out-perform bonds next year.

Equity Risk Premium Remains Quite Elevated



One way to measure the relative appeal of bonds versus stocks is the equity risk premium. The calculation involves determining the expected earnings yield of stocks and reducing it by the expected real return on long-term bonds. Although "risk premium" sounds somewhat alarming, the equity risk premium is the reward offered for undertaking the risk of owning stocks versus bonds. Thus, for a stock buyer, the higher the risk premium, the better.

As shown in the chart (right, top half), the price/earnings (P/E) multiple on the expected earnings for the next 12 months is about 16. Thus, the earnings yield is 6.3% (E/P, or 1 divided by 16). The inflation-adjusted yield on long bonds is almost nil, giving us an equity risk premium of 6% (chart right, bottom half, expressed as 600 basis points or "Bps"). That number is not extreme, but it is higher than normal.

Looking more closely at the chart, it is clear that non-U.S. stocks are even more attractive from a valuation standpoint. P/E multiples and bond yields are both lower overseas than in the U.S. The next chart (over) from I/B/E/S

12m Fwd PE			
	Current	30Y Average	Current vs Average
Japan	14.0	25.6	-45%
Italy	11.8	15.3	-23%
Spain	11.4	12.9	-11%
UK	12.5	14.0	-11%
Germany	13.7	15.2	-10%
EM	12.0	12.6	-5%
Eurozone	14.0	14.3	-2%
Europe	14.2	14.3	-1%
France	14.6	14.6	0%
World	16.4	16.1	2%
US	17.9	16.0	12%
Switzerland	17.5	15.1	16%

Source: I/B/E/S

reinforces this conclusion by showing that the P/E multiple in the U.S. market is 12% higher than its 30-year average while Eurozone stocks sell at less than their historic multiple.

One of our largest active decisions in portfolios over the last decade has been a relatively low weighting in international stocks. (About 45% of the global stock market is non-U.S. stocks). We have no regrets: Sales and earnings have risen faster in the U.S. and P/E multiple ratios on those earnings have expanded. U.S. stocks have out-performed their overseas peers by 137% since 2008. However, as BCA points out, between 1970 and 2008, European stock prices and earnings per share rose slightly faster than in the U.S. In fact, both JP Morgan and BCA now expect foreign stocks to outperform U.S. stocks over the foreseeable future. Some of the reasons for this forecast include:

- Foreign stocks sell at lower valuations.
- U.S. profit margins have less scope to rise. According to MSCI data, net operating margins currently stand at 10.3% in the U.S. and 7.9% abroad. Higher foreign unemployment rates should limit the problem of rising wages whereas wages could pressure profit margins in the U.S.
- The presidential election could adversely affect U.S. stock prices if it appears that the winner will raise corporate tax rates.
- A stronger manufacturing cycle will probably help Europe and Japan relatively more than the U.S.

While the valuation argument has been around for several years, the latter three points are more timely and they make the valuation differential a little more interesting. We are unlikely to raise foreign stock holdings to reflect global market levels, but this is an area of investing that warrants more attention.

Martha Cottrill, CFA — *President*

Carl Erickson — *Principal*

Edmund R. Taylor, CFA — *Chief Investment Officer*

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