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Neither a Bull Market nor Bear Market
By Scott P. Noyes, CFA® CFP®

After starting 2016 with a full blown panic, financial markets found their footing and rebounded back to year end price levels. Three key concerns were resolved:

1) The U.S. economy is not slipping into a recession and is expected to grow at a moderate 2% rate;
2) The Chinese economy is slowing, but not collapsing, and there appear to be no imminent plans for further Yuan devaluation;
3) Oil prices rebounded from a panic low of \$28 to \$38-\$40 per barrel and provided support for energy bonds and global equities.

Most importantly, Federal Reserve Chair Janet Yellen signaled that the Fed would not be raising interest rates anytime soon due to "global uncertainty". Interest rate risk is currently off the table. The reduction of these concerns resulted in a Fed-induced stock market rally and a weakening of the U.S. dollar. However, without a reacceleration of global economic and earnings growth, continued market improvement beyond these levels may be difficult.

Chart 1: The S&P 500 has Turned Choppy Since June of 2015

Political Discord

It has been difficult to watch the recent Democratic and Republican primaries. The candidates are tripping over themselves to be the greatest anti-free trader and anti-Wall Street crusader. Populism at its best. Surprisingly, the two frontrunners have the most unfavorable ratings. Hillary has been pushed to the left and The Donald is a loose cannon. My bet is that there will be a low turnout election come November! In the meantime, President Obama and Congress have all but checked out - gridlock at its finest. With all the negative vibes emanating from both parties, it is hard to believe that anything constructive for the economy can occur prior to the elections. This political dialogue is unlikely be good for the financial markets over the summer months.

Prospects for the U.S. Economy

Leading economic indicators such as employment, business confidence, retail sales and new home sales all suggest the U.S. economy is on a positive growth track. While the last two years saw the economy slow in the first quarter due to unusually cold weather, the reverse of this situation could occur in 1Q 2016 as warm weather has allowed construction and other outdoor forms of economic activity to proceed at a unhampered pace. This was reflected in the upward revisions to GDP and employment reports which were recently announced. The Consumer, Healthcare and Construction sectors continue to lead the economy. I do not believe investors should worry about a U.S. recession at the present time.

The S&P 500 Remains in an Earnings Funk

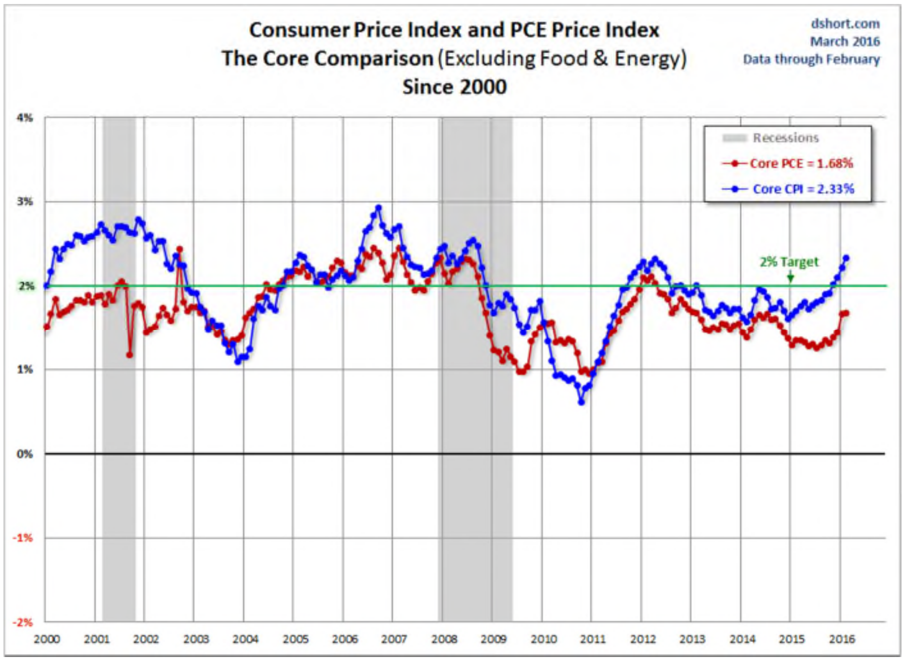
For the third quarter in a row, analysts projected that estimated earnings for the S&P 500 would decline in the 1Q 2016, projected at -8.4%. Profit margins continue to be squeezed. Of the 121 companies that have issued earnings guidance for the first quarter, 94 have been negative and 27 have been positive. Seven sectors are projected to report a year-over-year decline in earnings, led by Energy and Materials. Three sectors are anticipated to report year-over-year earnings growth, led by the Telecom Services and Consumer Discretionary sectors. Hopefully, many of these companies are lowering expectations to make it easier to beat analyst estimates.

Looking at future quarters, analysts currently do not project positive overall earnings and revenue growth to return until Q3 2016. The forward 12-month P/E ratio is now 16.6x, which is still 2 points above the 5-year and 10-year averages. One way or another, this 2 point gap is likely to compress, either by a decline in stock prices or increase in earnings.

Inflation is on the Rise

To the surprise of many, the U.S. is undergoing a modest reflation in price levels. Core CPI is now at 2.3% and rising (Chart 2). With unemployment at or below 5%, labor market conditions are poised for wage increases in the future. Unemployment rates for those with college degrees remain well under 2.5% and credit growth is expanding at 10% annually. It may be time to end the discussion about deflation and low inflation. If core CPI exceeds 2.5%, I suspect the Federal Reserve will restart the discussion about raising interest rates. There is a 50-50 change of a rate increase in June and another towards the end of the year.

Chart 2: Inflation is Approaching Levels that Will Worry the Federal Reserve



Fixed Income Markets – Nowhere to Hide

When the Federal Reserve suggested that there would be 4-5 interest rate hikes in 2016, financial markets fainted, driving stocks down 10% in eight weeks and pushing the dollar upward. As it became clear that this policy was "data dependent", financial markets recovered. The market rally back to December levels was brought to a close with Janet Yellen's March speech indicating a focus on "global uncertainty." Since December, 10-year Treasury yields have declined from 2.3% to 1.75%. While several regional Federal Reserve presidents are recommending higher rates, all eyes are on Janet Yellen to keep rates low.

With interest rates extraordinarily low and inflation on the uptick, there is nowhere to hide in the bond market. Our inclination is to shorten overall bond maturities and move a portion of our high quality bonds to U.S. Treasury TIPS (Inflation Protection Bonds). In addition, high yield junk bonds are starting to recover from their implosion in December and January. However, foreign bond exposure remains a concern.

The U.S. Dollar Has Found Stability

The bull market in the U.S. dollar appears to be over for the time being. Since April 2015, the U.S. Dollar index (Chart 3) has been trading in a broad sideways range. Currently the currency is at the weaker end of that range due to the softer message coming from the Federal Reserve. Lower interest rate expectations when compared to those of other economies helps make the case for a weaker dollar. My guess is that we will stay in this dollar trading range for the balance of the year.

Chart 3: The US Dollar is in a New Trading Range

Foreign Political Problems Remain a Major Concern

There is a long list of foreign issues that have been causing market concern:

- In June, the British will vote on whether to stay in the Eurozone. Brexit polls are currently running in favor of those inclined to leave. The major issues are immigration and sovereignty from Brussels and the European Parliament. The cost would be open access to a market of 500 million people. Most U.K. companies are in favor of remaining in the European Union and a vote to leave the Eurozone would likely be devastating for financial markets.

- In Germany, Angela Merkel's fortunes have faded with her open access refugee policy. German voters will decide if her party returns to power in mid-2017.

- Europe's persistent economic stagnation is becoming quite troubling. The Continent has made slow progress in solving its longstanding economic, political and social problems. The relative prosperity of Germany and Austria diverges vastly from that of southern Europe, so much so that it calls into question the European Union's viability.

- There has been a surge of anti-immigrant parties throughout Europe. While none have crossed the threshold to power, many of the movements are gaining strength along with the idea that the costs of membership in a united Europe outweigh the benefits. There is a growing risk that either the European Union will have to be revised dramatically to survive or it will simply fragment.

- Iran is testing missiles again and Putin is becoming a major player in Middle East politics.

- Brazil is in the midst of a massive kickback scandal which could lead to the impeachment of the current president, Dilma Rouseff, while the economy remains in a serious recession.

- China's leadership has lost credibility as a result of its management of the recent stock market swoon.

- Japan continues to lower interest rates because it lacks other options to control inflation and weaken the value of the currency.

- Islamic terrorism is occurring randomly throughout the developed world. The recent attacks in Brussels and Pakistan are examples of the ongoing discord in the Middle East.

All of these issues create ongoing uncertainty which usually translates into negative moves for the financial markets. In spite of the problems in the U.S., we remain the most stable, growing force in the world economy. As seen in Chart 4, the U.S. stock market has outperformed the rest of the world by more than 25% over the last two years.

Chart 4: The US Stock Market Continues to Outperform the Rest of the World

<u>Market Outlook</u>

Over the past five years, whenever the Federal Reserve considers tightening, the financial markets have panicked. If the Fed were to tighten twice by the end of 2016 due to real inflation pressures, my guess is that both stock and bond markets will react poorly. Unfortunately, that may mean that the current Fed-induced rally could have a very short shelf life.

In terms of sector rotation, we are probably seeing the end of commodity deflation. There may be another test of the bottom in oil, copper and gold prices, or there may not. I suspect that owning hard asset providers such as energy and material stocks may be a constructive strategy as we move into 2017 and beyond. I continue to believe that the energy theme is in its infancy because over the next few years, I believe we will see oil prices easily exceed $60 a barrel.

I remain concerned about investments in Europe due to the upcoming Brexit vote and major elections in Germany and France in 2017. I prefer to reduce international exposure and direct more of it to Asia and commodity-rich nations such as Canada and Australia. In particular, Canada's stock market is poised to benefit from any hint of inflation given that the Looney is unusually cheap at current levels.

I do not believe that we are entering a bear market, but we don't appear to be in a bull market either. We are likely in a stagnant market where stock selection and sector rotation may be the best ways to find performance. With interest rates at exceptionally low levels, there is no alternative to stocks. However, with a neutral market outlook, we seek income and safety at a reasonable price. Equities and funds with strong dividends are emphasized in our portfolios.

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