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THE HEADINVEST QUARTERLY

MarketComment.

The US stock market has not done much but fluctuate since the end of 2014. At this writing, broad stock market averages are within hailing distance of their all-time highs, but are still only a smidgeon above their levels at the end of 2014.

Following the market low in March, 2009, a wave of increasing optimism about the economic recovery led to sharp market gains in five of the next six years. These gains reflected both earnings growth and a higher valuation of those earnings. But for well over a year now, the progress has stalled.

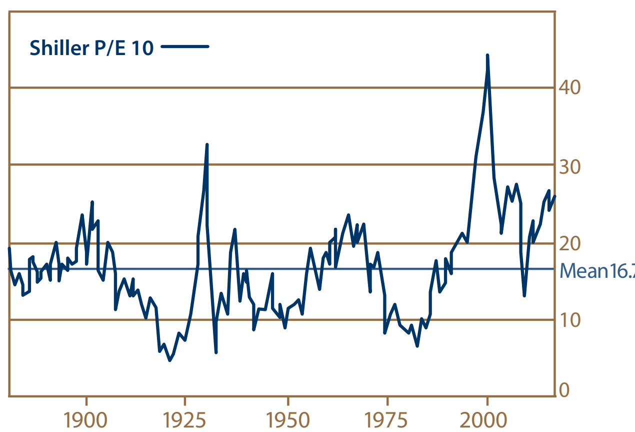
The most likely explanation is that earnings did not grow in 2015. Instead, aggregate operating profit of companies in the S&P 500 stock index fell 11%. The collapse in oil prices and the sharp appreciation of the dollar overwhelmed continuing growth in other sectors of the economy.

Though temporarily destabilizing—we have seen two corrections of 10% or more in the past nine months—worries about the earnings decline have now been overcome. Several factors appear to have contributed. First, oil prices are now well off their bottom. Second, the dollar has not continued to rise; instead, it has actually fallen against some currencies. A third possibility is that recent policy actions have addressed concerns that a hard landing was in store in China. In recent months, property lending has rebounded sharply and the government has also applied a degree of fiscal stimulus. Industrial production rose 6.8% in March, the highest growth in nine months.

Another factor was likely valuation. The end of 2014 marked a watershed in investor sentiment, when the cyclically-adjusted price earnings ratio returned to its pre-recession level. This figure, developed by Yale professor Robert Shiller— shown in the chart at right—shows the ratio of stock prices to trailing 10-year average earnings. Unfortunately, the current level has only been exceeded a few times in the past 100 years, suggesting that continued valuation expansion was not be in the cards. Instead, earnings growth will be required in order to re-ignite a market advance.

So, having re-gained the previous heights, the market now looks for confirmation that earnings growth will resume. Though earnings growth tends to rebound sharply after a recession, once the recession is over, it is a little harder to come by.

CYCLICALLY ADJUSTED P/E RATIO



Source: Gurufocus.com

Current expectations are that S&P 500 earnings will grow 2% in 2016, about the same level as expected revenue growth. The energy sector will once again be a drag, masking decent growth in many other sectors. But in 2017, earnings are expected to rebound at a much healthier rate near 14%. This level of growth, if achieved, would likely support a resumption of the market advance, absent a marked deterioration in investor confidence.

It is prudent to be skeptical of expectations for 2017, especially since early growth estimates almost always turn out to be overly optimistic. And predicting investor confidence is even more difficult than predicting earnings growth.

continued on page 2.

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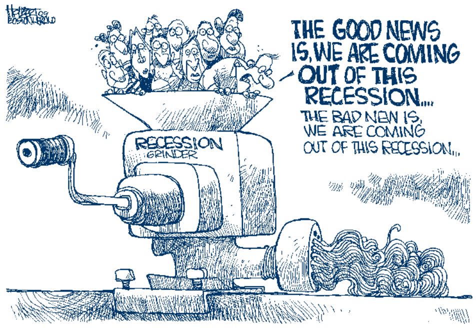
Market Comment continued from page 1.



Let's examine a few of the major risks facing investors today.

NEGATIVE INTEREST RATES

Robust economic growth has rarely been achieved without a healthy financial sector. Banks exist to make loans to expanding businesses at a spread to their cost of funds. But negative interest rates undermine the entire business model of the financial system. Central banks throughout the world have adopted negative interest rate policies that are even more difficult to contemplate than quantitative easing. The Wall Street Journal carried an article the other day about a Danish homeowner receiving a check from the bank holding his mortgage. Instead of being required to pay the bank interest, the bank paid him for borrowing. Already subject to increased capital requirements and greater regulatory scrutiny, banks will find it difficult to play their traditional role in the economy if rates remain this low, never mind going negative.

Negative rates are most prevalent in Japan and some European countries and have not yet arrived in the US, where the central bank actually wishes to raise rates. European growth seems to be improving, so perhaps the flirtation with negative rates will not last long. If economies continue to require stimulus from the government, it may be better for it to come through fiscal policy measures, such as infrastructure investment, than solely through monetary policy. In fact, government austerity drives, such as the one that led to budget sequestration in 2013, already seem to be fading.

SECULAR STAGNATION

Many are gloomy about economic growth because the rate of growth in developed countries has been slowing for decades. The term "secular stagnation"—first popularized in the Depression—was recently revived by Larry Summers, the former Treasury Secretary and President of Harvard University. Summers primarily argues that monetary policy is inadequate to address slack demand caused by demographics, technological change, and income inequality. But the concern about secular stagnation seems to overlook the fact that global growth has remained stable despite the slowdown in industrial countries. True, the composition of that growth has switched to emerging economies, which perhaps explains our obsession with the Chinese economy, for example. China is in the throes of an economic slowdown and we are at the mercy of their policymakers to manage it. Perhaps it will be easier to manage such things in a totalitarian economy than in a democracy, one of the few upsides of the Chinese political structure.

We are cautiously optimistic that earnings growth will resume, despite the risks, and we remain confident that maintaining the proper exposure to global equities will reward investors over the long term.

We value your Comments

Please provide us your thoughts and suggestions, by emailing your portfolio manager or info@headinvest.com. If you would like to receive The HeadInvest Quarterly by email, please e-mail: info@headinvest.com