Victoria Capital Management, Inc.

Financial Markets Perspective
April 2014

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THE BUSINESS CYCLE REVISITED

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A Brief Summary of the Current Economy

Economic progress was hindered during the first quarter as the winter of 2014 was one of the coldest and snowiest in the past 30 years—at least in the population centers in the East and Midwest. Meanwhile, the fruit and vegetable belt of California continued to suffer from an historic drought. Mother Nature has a bad habit of interfering with the best laid plans for an economic recovery and the arctic freeze limited both consumers and producers from fully engaging in planned activity. After a reasonable 2.6% growth rate in the fourth quarter of 2013, the first quarter's results may fall well short of that and could come in as low as 1%. Fortunately, recent data show an economy that is coming out of hibernation as witnessed by March auto & truck sales that show the fastest growth rate in seven years! Would you drive a brand new car off the lot into slush?

The continuing strength in the energy sector due to domestic natural gas production and revitalization in manufacturing due to low energy prices are giving a lift to the economy. With an increase in industrial production and retail sales—two of the broadest measures of the economy—we should see an improving growth rate as the year progresses. Our perspective this quarter focuses on the business cycle as an important ingredient in understanding the outlook for financial markets.

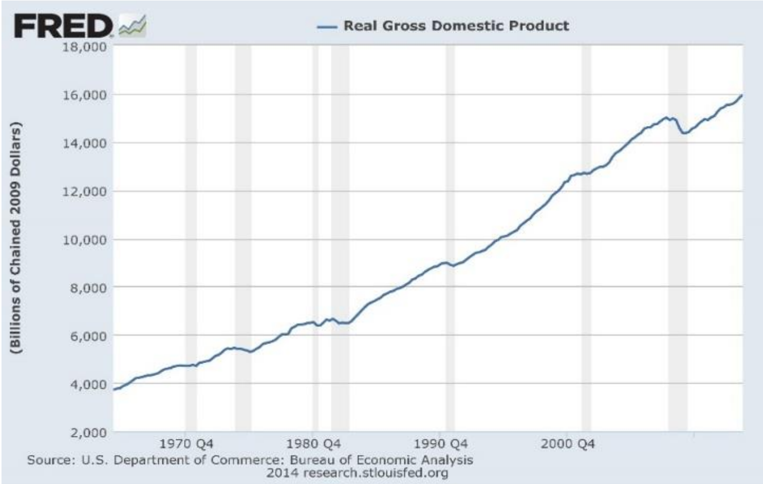
An Overview of the Business Cycle

Definition: The fluctuations in economic activity that an economy experiences over a period of time. A business cycle is basically defined in terms of periods of expansion or recession. During expansions, the economy is growing in real terms (i.e. excluding inflation), as evidenced by increases in indicators like employment, industrial production, sales and personal incomes. During recessions, the economy is contracting, as measured by decreases in the above indicators. Expansion is measured from the trough (or bottom) of the previous business cycle to the peak of the current cycle, while recession is measured from the peak to the trough. In the United States, the National Bureau of Economic Research (NBER) determines the official dates for business cycles.
Source: Investopedia

The following exhibit from the Federal Reserve Bank of St. Louis tracks the growth of the U.S. economy (GDP) since 1964 reflecting periods of growth and periods of recession that are shaded gray. The importance of the business cycle is that is has an impact on financial markets in the short term causing "bear" markets early in a recession and "bull" markets during periods of economic expansion. Note that the periods of rising economic activity are usually long while the periods of recession are usually short in duration. Since the depression in the 1930s, we have not been faced with such an economic crisis other than the financial collapse of 2008-2009.

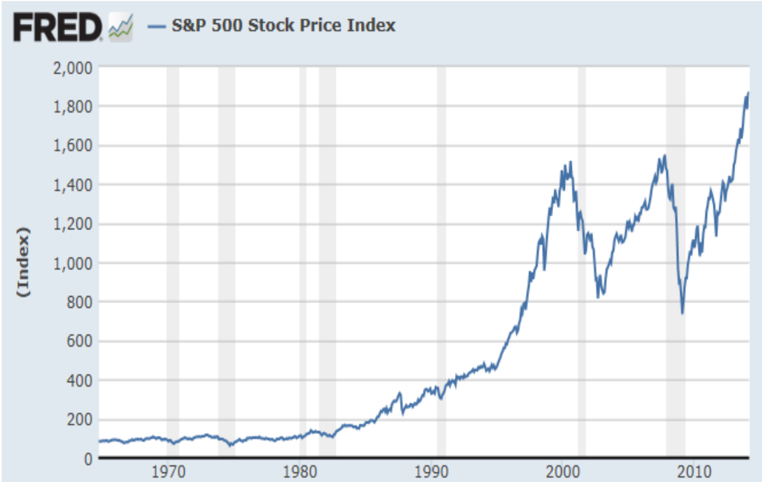
By comparison, previous recessions (periods of time when the real economy declined for two consecutive quarters) were mild by comparison. As this exhibit demonstrates, we have fully recovered from the financial collapse and have reached new highs in economic output.

Exhibit #1



As we mentioned earlier, swings in the business cycle can have a chilling effect on equity markets. Exhibit #2 reflects the wide swings in stock prices as measured by the S&P 500 index that have occurred over the past 20 years with major market declines following the Y2K crisis of the early 2000s and the financial collapse of 2008-2009. Note that prior declines in stock prices in the 1980s and '90s were substantially smaller. The recent gain from the lows of 2009 has resulted in all-time record highs. More importantly, there are periods during a bull market advance where the stock market will retrace gains. During this five year bull market, there have been 15 retracements of 5% or more. In 2011 there was a major retracement of 17.2% in just 24 days! May we remind you that investing in the stock market is not for the faint of heart.

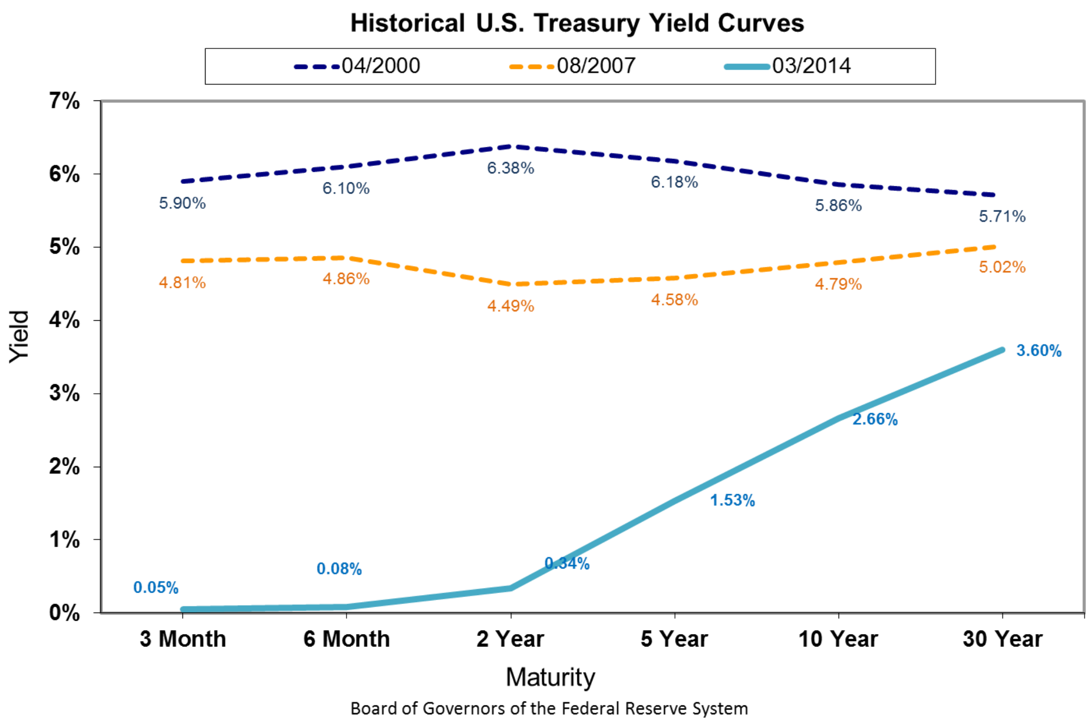
Exhibit #2



Source: Federal Reserve Bank of St. Louis

Even though the stock market has reached record levels, economic growth has been the slowest in recent U.S. history. Under normal circumstances, by the fifth year of an economic expansion, interest rates are on the rise and inflation is accelerating as growth puts pressure on the ability for the economy to produce sufficient goods and services to offset rising prices. This "slow growth" economy and accompanying low interest rates have been good for investors so far. The question is: "Can the good times continue?" After a five year surge in stock prices where the S&P 500 has risen 176%, many pundits are suggesting that the stock market is unlikely to rise much further. More pessimistic outliers suggest that a crash is imminent. However, unlike prior market peaks in 2000 and 2007, the level of interest rates do not imply a negative outcome. The following exhibit demonstrates that as the business cycle was overheating in both 2000 and 2007, the Federal Reserve moved to push short-term interest rates higher relative to long-term rates. The measurement between these two rates is known as the yield curve. Today's yield curve is substantially lower (blue solid line) than previous peaks implying the economy has a long way to grow before monetary policy becomes restrictive.

Exhibit #3



Source: PlanMember Services Corporation

One overriding reason for sluggish economic growth is the restraint on federal government spending. Exhibits #4 and #5 courtesy of Scott Grannis show the lack of spending growth and thus the shrinkage in the budget deficit. As reflected in Exhibit #4, the big reduction in the deficit has been the by-product of flat to declining federal spending in recent years and multi-year increases in tax revenues. Most of the reduction in spending can be credited to a deadlocked Congress and to declining costs for social safety nets—mainly unemployment insurance. As a result, the federal deficit as a percent of GDP seen in Exhibit #5 has plummeted from a high of 10.2% in 2009 to just under 3% ending in March of this year. Traditionally, the federal government plays an important role when the economy slides into recession and acts as a safety net by expanding spending while realizing a loss in tax revenues. As a result, the federal deficit can grow dramatically. The 2008—2009 period demonstrates how large a budget deficit can become in such a crisis. Today the picture is very different.

Exhibit #4

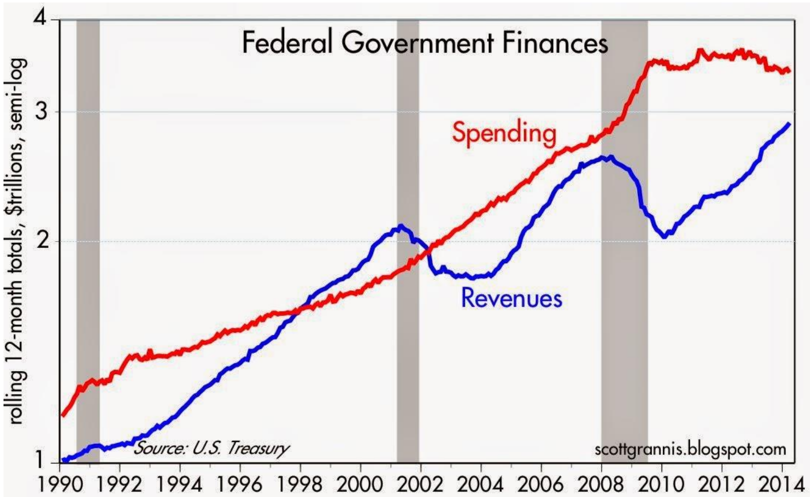
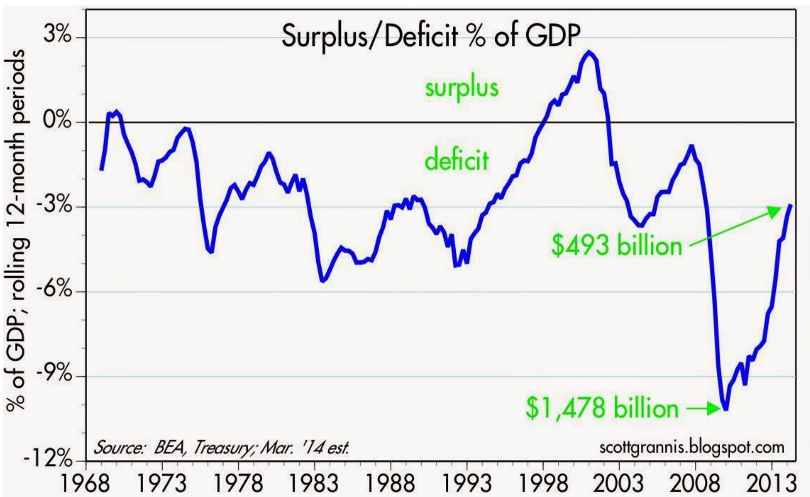


Exhibit #5



In conclusion, economics tells us that we have a long way to go before we reach a peak in the current business cycle. Slow economic growth, low inflation and low interest rates allow the U.S. to experience an unusually long business cycle experience. Such an environment is not likely to be good for fixed income investors but favors broadly diversified stock portfolios. There will always be unsettling events to cause equities to fall temporarily—the unusual weather in the first quarter of this year is a good example. While some market pessimists posit that conditions are ripe for a bubble, we don't believe that stocks are overvalued and that we will finish out the year in positive territory.

Global Update

Financial markets hiccupped when Russia decided to force a referendum on Crimea returning to the Soviet "fold." The bite wasn't as bad as the bark and the Russian move to possess the Crimean peninsula has gone smoothly so far with Vladimir Putin promising no more incursions. For market participants this may be a cloud with a silver lining. Europe's response to this takeover was not favorable for Russia as the members of the G-8 booted Russia out to become the G-7. The U.S. imposition of travel restrictions on key Russian businessmen was followed by a series of withdrawals from corporate deals with Russia. Of greater importance to the U.S. is the possibility that U.S. gas (in the form of liquefied natural gas) will begin to take a greater share of Russian exports to Europe. Given that Europe appears to be emerging from a long recession, stronger economic growth will translate into increased U.S. sales to the Continent.

Concerns over China's growth rate dropping below 7% has had a negative impact on commodity prices and sent fears around the world that the slowdown will lead to greater global economic uncertainty. Growing at a 6% rate is still a major accomplishment and reduced stress on commodity prices is not a bad thing as inflation will remain in check from this raw materials sector of the economy. Further complicating global growth is the geopolitical volatility in South America where Argentina, Brazil and Venezuela appear to be skating on thin economic ice and burgeoning inflation may push one or more of these countries into a financial crisis. Since the U.S. government appears interested in Europe and Asia, it looks like South America will not be a player in the global economy in the near future. Concerns in other emerging markets—notably India, Turkey and South Africa—still exist and could add to unanticipated developments this year.

Conclusion

As our regular readers know, fundamentals and a long-term perspective matter when investing in financial markets. Too often, investors are distracted by near-term events and focus on this week or this month—thus losing sight of the commitment that is necessary to best achieve investment goals. After five years of a bull market in stocks, the fundamental condition of corporate America has never been better and expectations are for continued increases in profits as the business cycle continues to advance with no signs of inflation. Interest rates are likely to remain low for the foreseeable future and, with Europe maintaining a loose monetary policy and individual countries implementing less stringent fiscal policies, global growth may actually accelerate. There will always be events that disrupt financial markets but we do not see any fundamentals that warrant a bearish view. We believe that the long-term bull market in stocks is on track and that individual security selection will be key to generating above-average returns.