VICTORIA Capital Management, Inc.

Financial Markets Perspective
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# A PERIOD OF ADJUSTMENT

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## ANOTHER COLD WINTER

The first quarter of 2015 mirrored the cold winter of 2014. As a result, there has been some postponement of economic activity. On top of that, a West Coast port strike caused disruption to importers and exporters. Twenty-nine ports that handle more than 70% of imports from Asia further interrupted the delivery of goods throughout the U.S. detracting from economic activity. As a result, investors will be disappointed in growth for the first quarter of this year. Remember, these two events are temporary distortions in an otherwise modest economic expansion where a combination of low interest rates and low inflation are keeping the economy on a positive track.

Even though economic growth will come up short for the first quarter, financial markets largely ignored these temporary factors for the first three months of the year. Interest rates continued to remain low throughout the quarter and corporate America benefited as many large companies decided to tap the fixed income markets to replace high cost debt. This shift contributed to the bottom line and an increase in corporate profits. The S&P 500, a standard benchmark for large company performance, rose 0.95% for the quarter while the better known Dow Jones Industrial Average increased 0.33%. However, both mid-cap and small-cap stock indices fared a lot better with the S&P Mid-cap 400 increasing 5.30% and the S&P Small-cap 600 rising 3.96%. On the fixed income side, the S&P Aggregate bond index returned 1.42% for the quarter.

For twelve months ended March, the S&P 500 returned 12.7%, the DJIA 10.6% and the Aggregate bond index 4.8%. So, even after a tough 2014 winter and modest economic growth, equity markets produced rates of return that were slightly higher than their long-term trend returns. On the other hand, bond markets find it difficult to produce competitive rates of return due to the low level of interest rates. Over recent years, as interest rates declined, bonds appeared to provide above average rates of return as the prices of bonds increased because they carried higher coupons (the stated interest rate on the bond). The problem is that long-term investors could not capitalize on that increased price because their gains would be offset by reinvesting in bonds with lower interest rates. Given the outlook for continued low interest rates, investors may not be able to generate sufficient returns to meet their income needs from bonds alone.

## A GLOBAL PERSPECTIVE

In our last perspective, we focused on changes taking place in world commerce due to the emergence of America as a first rate energy producer -- a factor in the global collapse of oil prices from $110 per barrel to approximately $40 a barrel in a few short months in 2014. Clearly, this decline shifted economic power from energy producers to energy consumers. To the extent that the change is fundamental and long lasting, there is still a period of adjustment that will negatively affect oil producers. Oil production companies have been quick to cut back on capital equipment spending and have begun to lay off a substantial number of workers. Without a

sudden burst in consumer optimism and spending, the negative effects of lower oil prices may put a further crimp on economic growth. Global turmoil can also add to oil price volatility and such uncertainty may lower the belief that oil prices will stabilize in the $45-55 barrel range. So, don't go out and buy that executive jet just yet!

While the global economy is adjusting to the change in oil prices, the soaring value of the dollar has been more of a challenge to foreign economies. Not too long ago the dollar was left for dead and economists were concerned that another currency would replace the dollar as the global reserve currency, an honor that the greenback has held since World War II. In all likelihood, the strength in the dollar can be traced to rising U.S. oil and gas production and the fact that such production and some sales outside the U.S., will contribute to growing wealth within America. This dollar strength has important implications for global growth. As the dollar strengthens, countries with weaker currencies find that sales of products and services increase in global markets especially when sales compete against countries with stronger currencies. For years, the U.S. complained that China kept their currency, the yuan, artificially low to insure sales of their products abroad. The policy benefited U.S. consumers at the expense of U.S. producers who had to compete with those low import prices.

Another unintended consequence of a strong dollar and related impact on domestic economic activity is the effect on monetary policy. Unless the economy shows a couple of quarters of strong growth, the Fed may not implement a higher interest rate policy because such a policy could lead to another surge in the dollar's value as global investors see both a financial benefit from higher interest rates in the U.S. coupled with the potential profits of a strong dollar as an investment and not as a medium of exchange. Further dollar gains would lower economic output here in the U.S. so a high interest rate Fed policy would be counterproductive. In other words, the strong dollar is doing the Fed's job.

The implications of a shift in oil supply and the related accrual of financial benefits to the U.S. precipitating the dollar's "good fortunes" imply a period of time when the world economy has to absorb these shifts. The price volatility for both a barrel of oil and the exchange value of the dollar will continue while the process of adaptation is underway. Once economic forces have been re-aligned, the global economy should grow benefiting financial markets worldwide.

## ANOTHER ADJUSTMENT

On a less important note, we have re-located both our home and the office to Charleston, South Carolina after spending almost 15 years on Hilton Head Island. This move has been an unexpected challenge (we may never find some things) but we are excited about this new chapter in our lives. Having founded Victoria Capital back in October of 2000 in Rancho Santa Fe, California, we find it hard to believe that the firm is almost 15 years young and that assets under management are fairly evenly divided between private clients and institutional relationships. We look forward to continuing to serve individual families by implementing a multi-generation approach to managing financial assets while growing assets within both our existing sub-advisory roles and new partnerships.

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