VICTORIA
Capital Management, Inc.

Financial Markets Perspective

April 2016

OIL AND MONEY AND VOLATILITY

For the first time in three years, the overall economy has not been negatively affected by an unusually cold winter. As a result, weather-related economic distortions should be minimal and overall growth for this year could be better than anticipated.

During the first quarter, there was a close relationship between the price of oil and the level of the stock market and a lot of volatility. Stocks fell by more than 10% in late January and then rallied in early February only to make new lows before eking out a gain of 1.35% in the first quarter as measured by the S&P 500 Index. (The S&P 500 index was created in 1957 and was the first U.S. market-cap-weighted stock market index. Today, it's the basis of many listed investment instruments such as exchange-traded funds. This world-renowned index includes 500 of the top companies in leading industries of the U.S. economy). During the first three months of this year, the foreign exchange value of the dollar weakened and the Fed kept interest rates low.

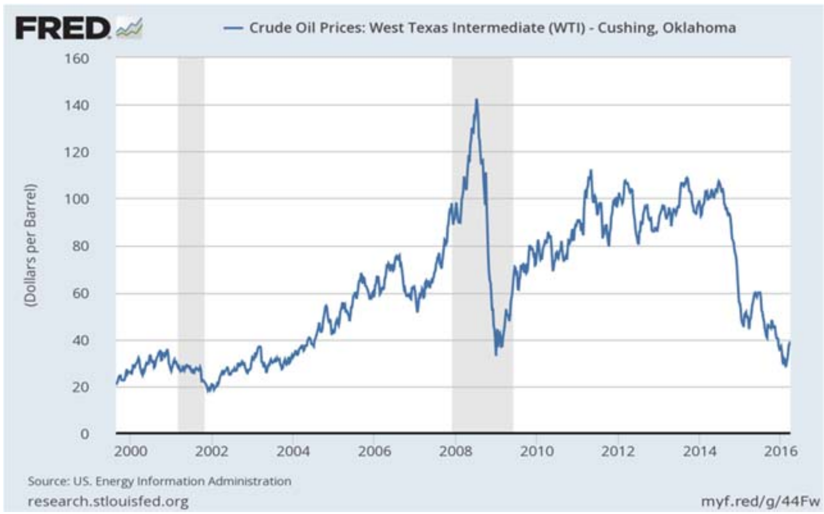
Consumer spending produced the bulk of economic growth during the quarter and further spending increases tied to an increasing number of employed suggest that strength will continue as the year progresses. Interest rates remain surprisingly low and, in Europe, an experiment with negative interest rates (where savers have to pay banks to hold their money) is keeping downward pressure on monetary policy on the Continent.

As the national election grows closer, there may be some additional stock market volatility depending on the implication of election polls and proposed economic policies. Undoubtedly, this election will be one of a lifetime and the outcome could have a critical effect on financial assets and the future direction of the U.S. political economy. As always, exogenous shocks and acts of terrorism remain a threat to financial markets.

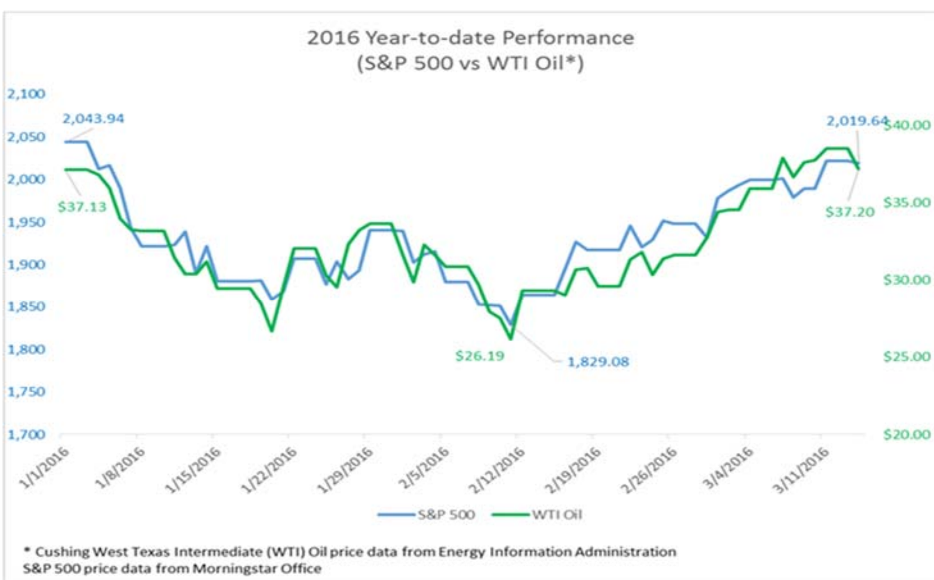
OIL PRICE VOLATILITY AND FINANCIAL MARKETS

The New Year opened with a continued decline in oil prices--a phenomenon that will change the world in which we are living for many years to come. The chart below reflects the history of the price of oil and the fact that the price has periodically declined dramatically—primarily due to a collapse in demand unlike the current situation where we have had an explosion in supply. Only a year ago, knowledgeable oil industry titans predicted the price of oil would not fall below $57 per barrel. Earlier this year the price fell to $26! Even though we have seen a rally in oil prices from this low to the $37-$42 level, there remains enormous supply that could continue to pressure prices. While consumers continue to benefit from lower oil prices, the system could be threatened if there is too much of a good thing—further substantial declines could lead to additional bankruptcies and stress on financial institutions who have provided financing to these entities. This "knock-on" effect would not be good for the U.S. economy.

Even though volatility and prolonged lows will likely be felt in energy sector earnings for the foreseeable future, low oil prices were a boon to consumers in the first quarter. Though gasoline prices will likely rise as refineries switch to summer blends ahead of the peak summer driving season, the average cost per gallon hit a 12-year low in the first quarter. The national average for the quarter was $1.86 per gallon--saving Americans nearly $10 billion—roughly $45 per licensed driver.



So far this year, equity markets have reflected swings in the price of oil. The following chart shows the close relationship between oil prices and stock prices. Within the overall stock market, the energy sector has been the biggest loser as could be expected. Energy producers continue to revise earnings down and cut dividends resulting in increased selling by investors. Nevertheless, the energy sector finished up 4% for the first quarter. The top outperforming sectors were telecommunications and utilities as yield-hungry investors drove these stocks higher by 16.6% and 15.6%, respectively.

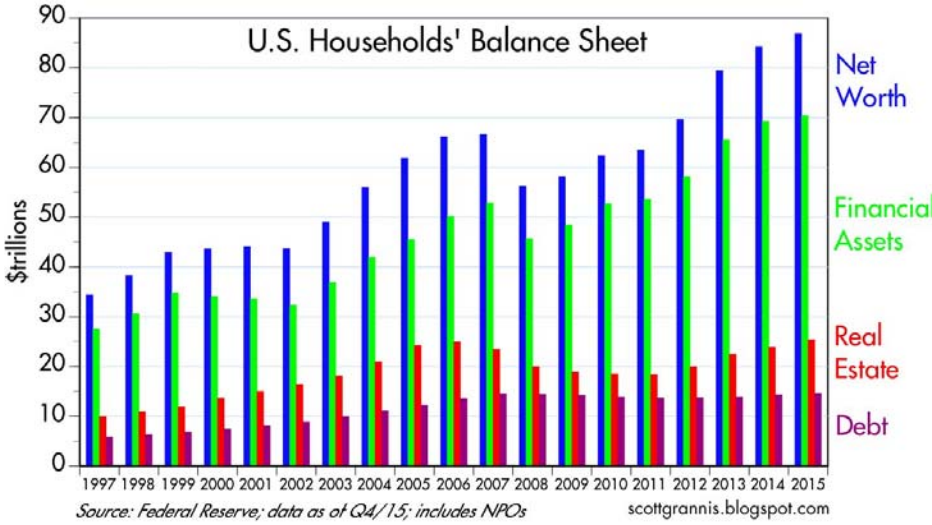


Courtesy of PlanMember Securities

So where do we go from here? Expect continued volatility in oil prices unless OPEC (Organization of the Petroleum Exporting Countries) steps in to keep oil prices stable. As investors become more comfortable with this firmness, the stock market should be less unpredictable. Another positive for the stock market is a weakening of the dollar that should boost profits of multinational corporations over the course of the year.

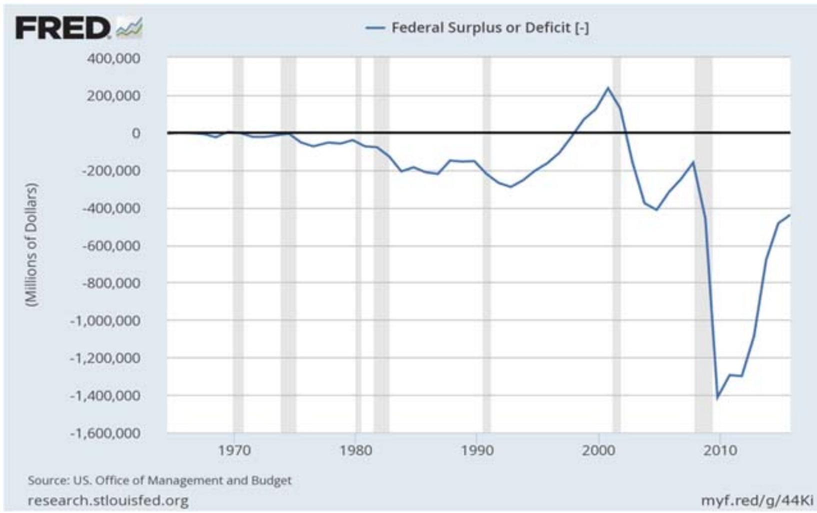
THE BRIGHT SIDE: GROWING CONSUMER WEALTH

The political establishment seems to be going off the rails in this election year as debate after debate highlights how "bad" the U.S. economy is and how the middle class has been suffering for many years. How accurate are these claims? One measure of the health of the U.S. economy is the U.S. Households' Balance Sheet as reflected in the following exhibit. As is indicated, the net worth of Americans is at record levels and has recovered from the financial crisis of 2008. This overall gain is amazing in the face of an economy that has grown at a sub-par rate of about 2% since the beginning of the economic recovery in 2009. The major component of this growth has been increasing prices for financial securities—primarily gains in the stock market.



Another area of continuing concern among the political class and many economists is the growing level of federal debt. (When the U.S. government spends more money than is raised from increased revenues and borrowing, that is a budget deficit. The cumulative amount of deficits is equivalent to the federal debt.) Politicians have deplored the level of the federal debt and ongoing budget deficits and fear that such levels are unsustainable and will undermine our children's future. In some cases, they call for a law that balances the federal budget.

The size of the federal budget deficit is heavily influenced by the level of business activity. When the economy recovers, the budget deficit shrinks. After the financial crisis of 2008, the budget deficit plunged to almost 1.4 trillion dollars as you can see in the chart below. In essence, the federal government stepped in and supported the private sector to avoid a depression. Once the economy stabilized, the budget deficit began to shrink. Conservatives across the board called for major policies to reduce or eliminate the deficit. But the natural forces of the business cycle were allowed to function and, even though economic growth has been subnormal at only a 2% annual rate, the federal budget deficit has shrunk by over $1 trillion. This unexpected shrinkage is partly attributable to that surge in employment that suggests further improvement in the deficit-- even in the face of a pickup in federal spending that resulted from a bipartisan agreement in Congress to override the sequester passed in 2011.



As baby boomers move into their retirement years, there is growing concern about sufficient income and that there will be a collapse in the Social Security system. Some politicians say we must change the current formula for Social Security to lower payments, raise the age at which individuals receive payments or just make Social Security subject to means testing i.e., reduce payments because someone makes too much money. Social Security is a promise made by the federal government to retirees who have funded the Social Security Trust Fund with after-tax savings (as opposed to private pension plan contributions that are tax deductible). In other words, the federal government offers tax-free investment to individuals who contribute after-tax dollars to Roth IRAs yet for many Social Security recipients their benefits are taxed a second time at ordinary income tax rates.

Efforts to reduce budget deficits that rely on cutting government programs that maintain standards of living for many individuals are likely to cause hardship where a commitment to boosting economic growth should result in a healthier solution. Looking at the past eight years, a slightly higher economic growth rate could have eliminated the budget deficit without any painful cost cutting measures. The point is that most federal deficit spending is a necessary fiscal phenomenon and should not be used to undermine programs such as Social Security.

INTEREST RATES AND FEDERAL RESERVE POLICY

Ever since the fourth quarter of last year, financial markets have had a growing concern that the Federal Reserve will continue increasing interest rates to more normal levels after six years of a near-zero interest rate target to encourage a quick recovery from the financial crisis. These concerns have not been reflected in interest rates as bonds have continued to rally early this year. At a target rate of 0.25 to 0.50%, there appears to be little economic impact of such a rate on economic activity. Threats of further rate increases are being ignored even though both the unemployment rate and the level of inflation are within the Fed’s target range that would allow it to continue a plan to systematically raise interest rates. At this point in a long economic cycle, we still do not see any indication of an imminent rise in interest rates and a global slowdown is likely to keep any type of interest rate increase minimal. As a result, fixed income investments will continue to be a place to conserve principal but not a place to make long-term investments.

THE IMPACT OF THE TERRORIST THREAT

Events in Paris, Brussels and Lahore during the first quarter resurrected fears of a terrorist attack on U.S. soil. Warnings that the refugee crisis could accelerate wanton attacks on civilians seem to have fallen on deaf ears in Europe where a generally socialist regime in most countries pays little attention to such threats. European leaders are focusing on the migration crisis currently facing the borderless Schengen region and are reluctant to advocate getting the U.S. involved unless there is a firm commitment from NATO to adopt a new tactic to undermine the ability of terrorists to engage in killing civilians.

Americans may pull back on their trips to European locations such as Turkey after recent bombings there. After the news of Brussels, many travel related companies experienced declines in both bookings and stock prices. The bottom line is that a coalition is necessary to resolve the ISIS insurgency. So far there seems to be little interest in getting involved in defeating that enemy so there will be continued events that shake the confidence of Western nations and associated economic damage that will have a short-term impact on financial markets.

To finish, we quote Richard Russell in 1991-author of The Dow Theory Letters:

"The markets (any market) are seldom surprised by shocking events. But during those rare instances when the market is caught by a surprise a panic may result. My own definition of a panic is this:

A panic is a collapse (triggered by fear and unforeseen circumstances) which causes the price of the item to fall precipitously within a short span of time. That's a loose definition but it will do.

We've had a few panics declines in the markets over the last few years. Panics are particularly interesting for one reason. The reason is this: The surest action in the markets is the recovery following a panic. It is almost a rule (if anything in the markets can be called a rule) following a panic, there will be an advance that will recover roughly one-half of the price lost during the panic. This applies to individual stocks, to commodities, to indices, and to the averages.

. . . People forget that what prolongs a bull market, any kind of bull market, is the phenomenon known as the correction. A rocket-rise type of bull market, one with little or no corrective action, always ends up as a short bull market. Thus, seasoned investors tend to welcome corrective action during bull markets. They know that the more corrections and the longer and more often a bull market is held back, the bigger that bull market will be – and ultimately the higher that bull market is fated to climb. Of course, the same thing is true (in reverse) during bear markets. "

Remember that our mission is to put financial market events into perspective.

Diane V. Nugent, *President/CEO*
Thomas E. Nugent, *Executive Vice-President*