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Financial Markets Perspective

Living in Better Times

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Introduction

Five years ago, the 2008 global financial crisis resulted in the threat of total collapse of large financial institutions, the bailout of banks by national governments, and depression-size downturns in stock markets around the world. For years, the federal government demanded banks and financial institutions provide mortgage loans to unqualified buyers. As this bubble expanded into a profit guarantee for many institutions, greater risks materialized as investors defaulted on their mortgage loans. On September 8, 2008, the U.S. Treasury seized control of mortgage giants Fannie Mae and Freddie Mac and pledged a $200 billion cash injection to help the quasi-government agencies cope with mortgage default losses due to a decline in the housing market. A week later, the government bailed out American International Group Inc., or AIG, with $85 billion. Around September 15th Merrill Lynch was on the verge of collapse and was purchased by Bank of America. A day later the government's strategy changed and the Fed refused to save Lehman Brothers and the company was forced to file for bankruptcy.

These events occurred after the failures of Countrywide Financial--a major mortgage lender and Bear Stearns--a global broker earlier in the year (the former was acquired by Bank of America while the latter was scooped up by JP Morgan Chase) and resulted in the worst recession since the Great Depression. As the crisis spread across the globe, the situation worsened. At that time, the U.S. economy contracted at an annual rate of more than 8%, banks were failing right and left, 800,000 jobs were lost per month and the auto industry was on the verge of collapse. Households suffered a decline in net worth of almost 25% during the 2008 collapse taking almost 50% off U.S. stocks. Fast forward five years to today and we see that we are living in better times. Few would have suspected that, five years later, the stock market would have risen to new highs, up by over 175%!

The Economy

Taken as a whole, this economic recovery has been weak by historical standards and is partly the result of a substantial decline in federal government spending. This decline is without post-war precedent. There has been no growth in federal spending since the recession ended in 2009. As a percent of GDP, spending has declined by over 15%.

Conversely, government revenues have grown by 17% over the same time period resulting in a shrinking budget deficit. So in less than three years, the federal budget outlook has gone from ominous to nearly normal. The primary contributor to economic growth has been the private sector that has increased at a 3.5% annual rate through the end of the June.

During the third quarter, data released by the Federal Reserve showed that household net worth stands at nearly $75 trillion—up more than $18 trillion from the recession low. Nearly every measure of the financial health of households has shown significant improvement. Owner's equity in real estate has surged 50% since 2009; net worth and financial assets are up by 35% from their 2009 low; the value of household's real estate holdings is up by 17% in just the past two years and equity as a percent of household real estate has jumped to almost 50%. More importantly, household debt is back down to levels seen in early 2007.

Corporate profits are at an all-time high of nearly $1.7 trillion, up 7% from a year ago and non-financial companies have $1.48 trillion in cash. This liquidity will allow corporations to make capital investments, increase dividends, engage in share repurchases and make acquisitions—all activities that contribute to economic growth.

One drag on the economy has been the continued high level of unemployment that is understated because the government does not include individuals who have dropped out of the workforce—a number that would push the rate above 10%. As a company's bottom line is being bolstered by higher productivity due to the deployment of information technology, the cost of retaining people relative to machines and/or computers is very high. The implementation of the Affordable Care Act will continue to undercut the hiring of full time employees due to the costs of having to provide mandatory healthcare. These costs encouraged the federal government to exempt themselves and certain unions and companies from compliance even though the "law" is to be implemented across the board. Unfortunately these circumstances dictate a continued high level of unemployment.

The Energy Renaissance

Recently, the Wall Street Journal reported that the U.S. is overtaking Russia as the world's largest producer of oil and natural gas—a shift that is reshaping markets and eroding the clout of traditional energy-rich nations. The U.S. energy market has expanded rapidly by employing hydraulic fracturing or "fracking". As a result of increased production equivalent to about 22 million barrels a day of oil, natural gas and related fuels, U.S. imports of natural gas and crude oil have fallen 32% and 15%, respectively, over the past five years. An important by-product of this discovery is the revival of U.S. manufacturing as low cost fuels attract many companies to resume operations here in America. This trend will continue to fuel economic growth.

The U.S. has been hostage to the OPEC oil pricing cartel ever since the embargo of 1973. Some 40 years later it is becoming evident that the U.S. will be able to function without the threat of such stoppages in the future. Regulations requiring much higher fuel mileage in coming years for cars and the conversion of larger trucks to natural gas will continue to put downward pressure on oil prices. Given the massive fall in natural gas prices over the past five years, it is not inconceivable to see further declines in oil prices as energy costs drop. As a result, we should continue to experience lower costs for energy in our daily lives--an important contributor to better times.

The Technology Story

The first part of this story is the broad adoption of personal computers and breakthrough software programs providing both business and consumers with a better way to function both at home and at work. The second is the introduction of the Internet enhancing the functions of the personal computer that launched many sub-industries offering a business or a consumer model using these two media. Part III began with the introduction of the iPhone and iPad (and follow on competitive products), along with the accompanying "apps" that allowed entrepreneurs to offer novel programs to meet specific needs in both business and in consumer lives. Most of us would agree that our lives have changed for the better because of these innovations. Of even greater importance are the business off-shoots that create new novelties and modernisms enhancing the way we work and play. We call this the Information Superhighway.

Political Logjams

The current battles in the Capitol—the budget battle and debt ceiling confrontation—are two politically motivated conflicts that have a negative impact on individuals, investors and, ultimately, the politicians themselves. The important fact is that both of these "problems" are self-inflicted. There is no limit, other than inflation implications, of the Treasury spending money. Since the Treasury makes money by selling bonds to the Federal Reserve to get deposits in its banking account, the Treasury can always write the check. Political logjams such as these are familiar and will likely play out as they have in the past with a twelfth-hour agreement that postpones any meaningful reform.

Investments

It has been a stellar year so far for the stock market while other asset classes have not fared as well. Small cap stocks are the leaders with a gain of 28.7% through the end of September. Slow but steady economic growth, record corporate profitability/wealth and a resurgent consumer propelled the S&P 500 index 19.8% while government bonds are down 1.9%. Municipal bonds fared even worse and are down 6.1% and emerging markets are still in the red—down 6.4%. The bond market is suffering from both low yields and fears that the Fed will allow rates to rise. The traditionally "safe-haven" asset, Gold, has declined by 24% to $1,325 per ounce as several analysts asserted that downward pressure on prices will continue due to an ongoing normalization of real interest rates resulting from a lack of inflationary pressure in developed markets. Some are even forecasting a drop in the yellow metal's price to $1,000/oz.

Conclusion

Not only have we experienced many threats to growth since the financial crisis of 2007-08, but the past thirteen years have included a danger that everything computer-related would fail at the dawn of the Year 2000; the September 11 terrorist attacks on America; and continued problems in the Middle East with pain and suffering inflicted on American troops in Iraq and Afghanistan—to name a few.

We have survived and learned from these predicaments and through it all the financial markets have provided opportunities to grow wealth. We can never know which asset will deliver the highest return, but history tells us that stocks are the vehicle of choice.

Utilizing our theme-based approach to investing, we are finding that accelerating production of oil and gas in the U.S. implies better times for consumers and businesses as we reduce our reliance on Middle East oil barons. This "Energy Renaissance" offers multiple opportunities for growth across many sectors of the economy. Developments in information technology continue to improve the productivity of corporations allowing them to make additional capital investments and deliver out cash to investors. We refer to these companies as "Productivity Facilitators" and they are expanding the "Information Superhighway" around the world. The tech battles between Samsung and Apple attest to how the world will be a better place with new products and services derived from free market capitalism. Once the follies in Washington DC end, investors will be able to focus on the fact that many pieces of the economy are getting better and prospects for growth investments continue to expand.

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