VICTORIA Capital Management, Inc.

Financial Markets Perspective

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THE ENERGY RENAISSANCE AND KING DOLLAR

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FINANCIAL MARKETS IN 2014

September was a month to forget as global markets retreated in the face of weaker economic growth, increasing uncertainty over geopolitical issues, continued strife in Eastern Europe and month-end pro-democracy protests in Hong Kong. These events made markets jittery and only large cap stocks came out on top. At a time of usual stock market weakness, the S&P 500 index was actually up by 1.1% for the third quarter bringing year-to-date gains to 8.3%. The more widely followed Dow Jones Industrial Average gained 1.9% for the past three months and is up by 4.6% through the end of September. These favorable returns for large cap stocks have not been mirrored by their smaller cap brethren. The S&P Mid Cap 400 index fell 3.9% and the S&P Small Cap 600 index declined 6.7% for the quarter. Year-to-date the Mid Cap index is up by 3.2% while the Small Cap index is still in the red by 3.7%. The latter's decline was somewhat anticipated given the 38% return posted by small cap stocks last year.

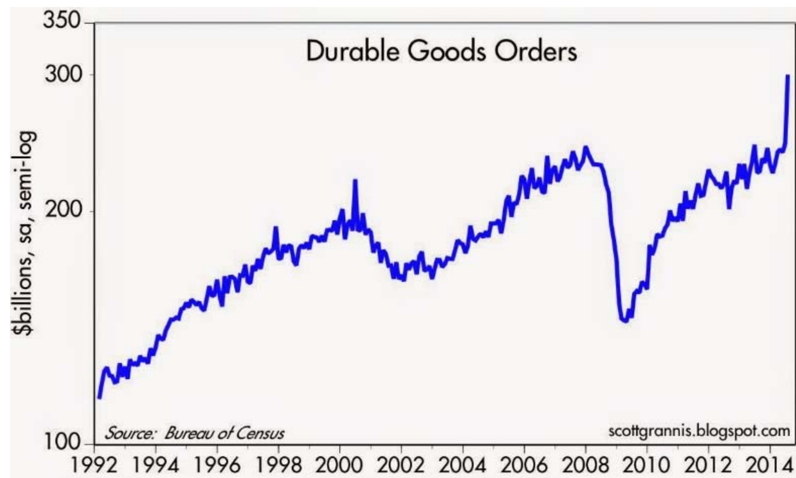
European stocks suffered a setback during the third quarter falling by more than 7% as the continental economy appears to be sliding into a no growth scenario for the balance of 2014--even though the European Central Bank (ECB) remains committed to moderate monetary stimulus. Germany, the engine of European growth, slowed markedly and investors were quick to sell stocks bringing year-to-date losses to nearly 12%. Embargoes between Russia and the European Union and the United States over the Ukraine uprising has slowed global trade and contributed to a decline of more than 20% in the Russian stock market so far this year.

Overall Asian equity markets were also weak during the quarter on the back of a slowing China and weakness in Australia and South Korea—two large trading partners. Year-to-date both the Far East and Pacific regions are in the red by almost 3%. Unrest in the Middle East has affected those stock markets near the conflict by as much as 15%. Overall, equity markets across the globe minus the U.S. fell 6.3% during the third quarter and remain in negative territory at this writing. So, investing in the good ol' USA has been a good strategy so far this year!

Bond markets were generally stable during the third quarter and have surprised most investors with favorable returns as interest rates continue to edge lower. Investors in investment grade U.S. corporate bonds have been rewarded with a gain of 5.8% this year while riskier high yield bonds have only returned 3.5% through the end of September. Even more surprising is the return from Long-Term (20-Year) Treasuries that have gained by more than 17% through the end of September.

Financial markets reflect the general condition of the U.S. and global economy. After a colder than expected winter, the economy rebounded in the second quarter at a 4.6% annual rate with another 3% gain expected in the third quarter. Strength in consumer spending especially on autos

contributed to the gain. The ISM manufacturing index that measures how well the manufacturing sector is doing rose to a three year high in August while durable goods orders surged to record highs (see the chart below) as global growth expectations contributed to a jump in demand for commercial aircraft.



Scott Grannis of Calafia Beach Pundit points out that one unique characteristic of the past two decades is the more than 30% decline in the ***prices*** of durable goods. “Outside of durables, prices of just about everything else have been rising. The decline in durable goods prices began in 1995, which not coincidentally was about the time when China pegged its currency to the dollar and launched its export boom. We have China to thank for deflating the prices of most of the durable goods that we enjoy these days. That's "good" deflation, since it's not monetary in origin, but rather the result of a huge increase in the productivity of the Chinese economy which has ended up benefiting everyone all over the world.”

Other positive economic statistics reported during the quarter was that unemployment fell to 5.9% at the end of September with the addition of 230,000 workers to the labor force and that inflation remains low with both the producer price index and the consumer price index running under 2% on a year over year basis. When combined with extremely low interest rates, consumers are in a position to pick up their spending in the months ahead as we approach the holidays. Add to that the fact that real household net worth stands at a new high and household debt has been reduced by 10% over the past seven years and you have the ingredients to keep the economy growing. Many forecasters are expecting the U.S. economy to grow at a 3% rate through 2015 with inflation and interest rates remaining low that should accommodate further gains in the equity markets.

THE VAGARIES OF ENERGY INDEPENDENCE

At the source of energy independence is growth in the fracking of underground oil formations to produce both oil and gas. Transportation of domestic oil and gas is occurring through more pipelines and an increased number of tank cars. Companies that produce this infrastructure are benefiting as are states where fracking is taking place. The result of this new technology is reflected in the chart below demonstrating that U.S. crude oil production is at a 25-year high.

The impact of the energy renaissance is affecting virtually every American. Net imports are declining while production is rising that equates to a shift in power from producers to consumers. Here in South Carolina, a gallon of regular gas sells for less than $3.00 compared to the national level of $3.27. As a result of the energy renaissance, oil producers are losing market share as U.S. production replaces previous foreign oil supplies. These companies will have to pump more oil at lower prices to maintain their income. Energy infrastructure expansion will continue as domestic production replaces imports that are still running in the millions of barrels per day. Continuing weakness in the price of natural gas is also providing a wealth transfer from producers to consumers of natural gas. We do not see these transformations to the energy sector as a flash in the pan but rather a secular trend that will continue for many years to come.

The energy shift to U.S. dominance is having another critical impact: the value of the U.S. dollar. As the price of oil falls and domestic oil production accelerates, the dollar has been gaining strength as you can see in the chart below. As this trend is likely to continue, the demand for dollars will rise due to the expectations of higher prices for the dollar in other currencies. The good news is that a stronger dollar lowers the price of imports thus benefiting consumers who can buy more goods and services from abroad.

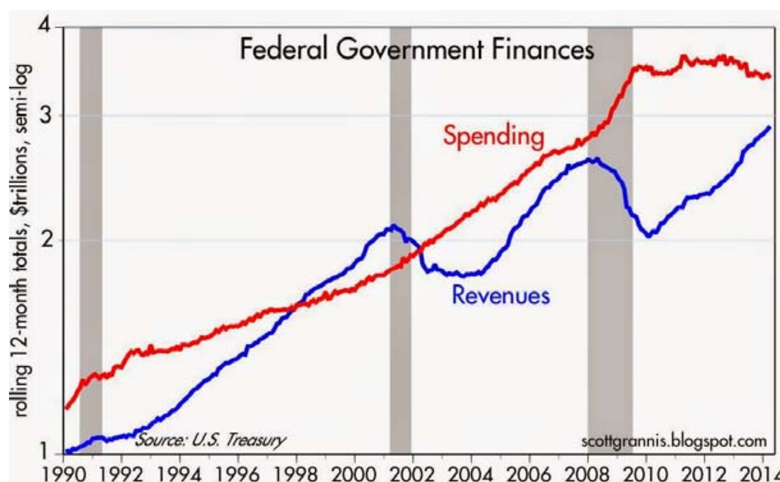
However, there is a downside to this scenario. Companies that depend on exports could see a shrinkage in sales while those that have a heavy reliance on foreign profits could also suffer. In some cases increasing domestic demand will offset these losses--but not all of them.

On balance, the Energy Renaissance is transforming America second only to the technology revolution that occurred at the end of the 90's. The transition will continue for some time but Americans in general will be major beneficiaries of these trends. Oil producing nations (OPEC) that have held America hostage ever since the Arab Oil Embargo of 1974 is no more; America is the world's largest oil producer—and consumer. The U.S. has essentially provided wealth to oil producing countries by purchasing their oil; that trend will continue to fall and, along with it, the price of a barrel of oil until it reaches a level that constricts profits from oil sales.

THE NOVEMBER ELECTION

We are less than one month away from another critical election that could determine the direction of growth in the U.S. economy. Ever since the 2010 elections and the split control of the Congress, there has been little legislation that has affected the direction of the economy. We are on "cruise control" as far as legislation is concerned. Many observers blame the Senate for blocking virtually all approved legislation coming out of the House. Therefore, the outcome of the election could dictate a new agenda dominated by a united Congress or a continuation of the stalemate that has existed for the past four years.

While economic growth during this business cycle has been tepid, the improvement in the budget deficit has been substantial. A moderate tax increase coupled with rising employment and the related decrease in mandatory government support payments has taken the budget deficit down from a high of $1.5 trillion to about $500 billion or a reduction of over one trillion dollars! The chart below shows the moderation of government spending and rising revenues from taxes. No wonder government bond interest rates are low given a dramatic reduction in the issuance of debt to finance the deficit. Where are all those deficit boogeymen who threatened gloom and doom for the American economy unless we took immediate and drastic measures to reduce the deficit? If current trends continue in a growing economy, the budget deficit discussion will be a non-event.



CONCLUSION

History shows that there is seasonality in stock market returns. Since the fourth quarter is traditionally a strong quarter for equities, this year should end slightly better than the long-term average of 8% for the stock market.

Bond yields remain extremely low after a business cycle expansion for over five years. We believe that we do not have the ingredients in place for a surge in bond yields anytime soon and that, with inflation low and economic growth muted, the Federal Reserve will maintain monetary policy especially if falling oil prices translate into a period of deflation--not inflation as expected. Another powerful reason for low long-term bond yields is a dramatic fall in the federal budget deficit and the shortage of U.S. government securities to satisfy the pool of global savings seeking a safe haven.

Investors are concerned about short-term events that negatively impact stock prices on a day to day basis. Demonstrations in Hong Kong, air strikes against ISIS in the Middle East, continued grid-lock between Russia and the West and fears of an Ebola pandemic send equity markets into temporary swoons before the actual fundamentals reassert themselves and drive stock prices higher. Understanding the economic backdrop of the current bull market is imperative for investors who have a long-term perspective.

October 10, 2014