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A CHECKLIST FOR FINANCIAL MARKETS

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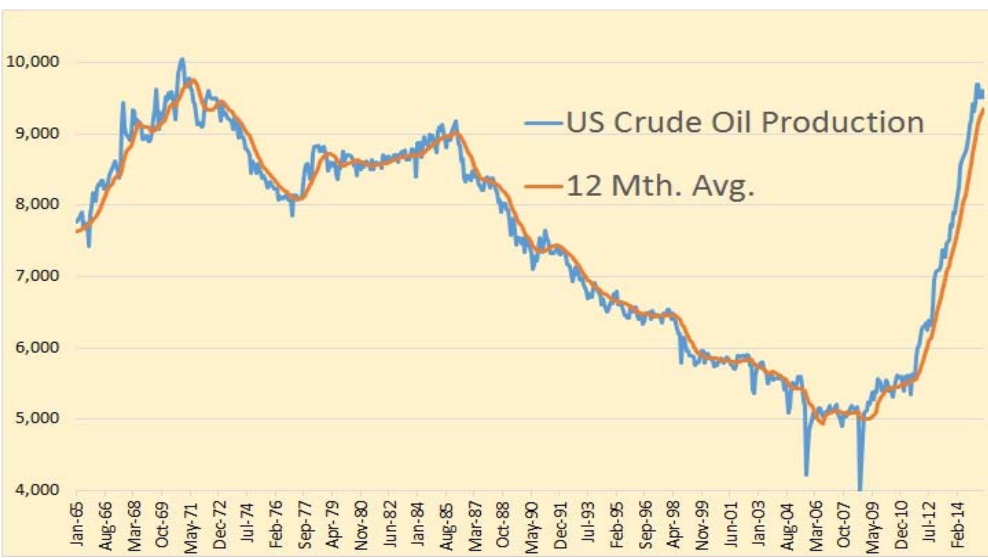
THE CHANGING FINANCIAL MARKET OUTLOOK

The U.S. economy is into the sixth year of recovery with few signs that a traditional business cycle experience is underway. According to Wikipedia a business cycle is the downward and upward movement of gross domestic product (GDP) around its long-term growth trend. These fluctuations typically involve shifts over time between periods of relatively rapid economic growth (expansions or booms), and periods of relative stagnation or decline (contractions or recessions). For 2015, the quarterly change in GDP was almost identical to the 2014 experience with a cold winter penalizing growth and a strong recovery in the second quarter. Absent Mother Nature, economic growth has been below average relative to other post WWII business cycles. Since the economic cycle is a reasonable proxy for the long-term direction of stock prices, investors should be aware of where the economy is during the current business cycle and what factors may influence the length and breadth of this cycle based on the identification of new factors. Over the past few years we have discussed important changes in the economy that can affect financial asset prices. We thought a review of the factors might be of value in modifying investment expectations. Here is a checklist of events that can affect both the economy and financial markets.

THE ENERGY RENAISSANCE



The discovery of fracking technology and the tremendous increase in the availability of oil reserves in the “lower 48” has changed the global energy ball game. From the initiation of the original Arab Oil Embargo and the creation of OPEC (Organization of Oil Exporting Nations), the Mid East has extracted an enormous amount of wealth from oil consuming nations as the inelastic demand for oil and the monopoly of OPEC combined to control oil prices. From that point in 1971 through the early 2000s, OPEC dominated global economic behavior.

The fracking revolution in the U.S. changed the rules of the oil pricing game. With an enormous increase in domestic supply, OPEC appeared to lose the power to dominate world oil markets. As the price of oil collapsed from a high of $110 in 2013 to a recent low of $40, the benefits of this shift accumulated to the energy consumer. Unfortunately, U.S. energy producers also suffered from falling oil prices and the fracking revolution was put on hold as the production of oil from fracking operations is substantially more expensive than traditional methods of drilling.

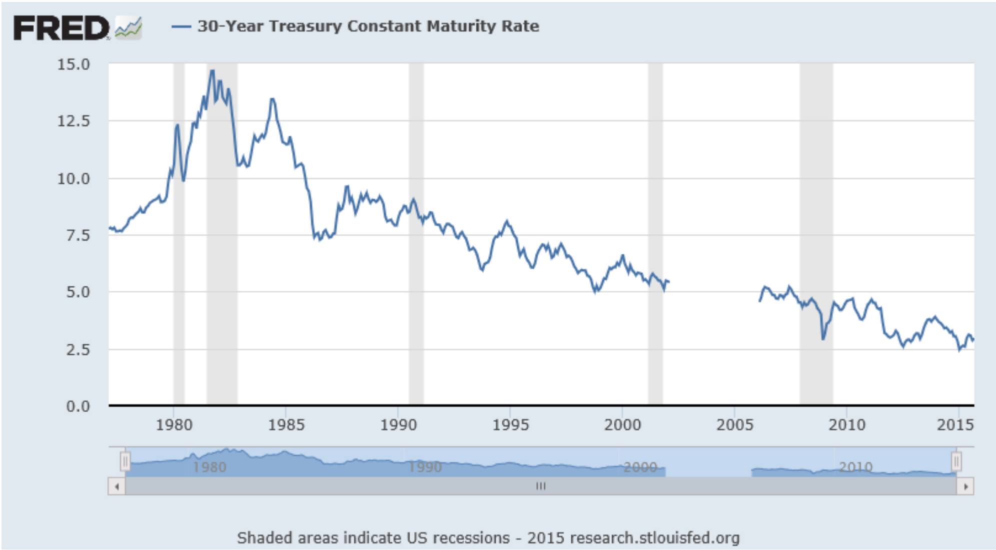
Equity markets in the U.S. have suffered from the selloff of energy-related stocks that are being buffeted by OPEC's willingness to let oil prices fall to a level that shuts down fracking in the U.S. The bad news is that a collapse in oil and gas exploration and development will have reverberating effects across many consumer activities in states where the energy business slips into recession. The offset is expected to be a resurgence in consumer spending where the savings from low energy prices translates into increased discretionary spending. In the early Seventies this shift of wealth to the energy producer was a painful experience for consumers who labored under both double digit inflation and interest rates. After adjusting to high oil prices in the Seventies, OPEC raised them again at the end of the Seventies triggering the recession that accompanied Ronald Reagan's first term as president. The manipulation of oil prices was an important contributor to the volatility of the business cycle and, in turn, the volatility of stock prices.

Fortunately, the trend seems to be going the other way. If OPEC and Russia continue to pump oil to the detriment of U.S. producers i.e., forcing per barrel oil prices into the low thirty-dollar range, then the transition to a consumer-led economic boom will take time to materialize but is likely to last a lot longer. On the other hand, if oil prices are allowed to rise, then fracking will be the beneficiary. Given the history of oil price changes, lower prices will foster a more robust economic expansion that can last longer than many observers anticipate.

THE INTEREST RATE PUZZLE

Six years into an economic recovery and interest rates are at or near record lows. Last week the Treasury sold 3-month Treasury bills at a rate of zero! A ten-year Treasury note yields 2.09%. The thirty-year Treasury bond is yielding 2.92%. After inflation and taxes, many investors are under water in their government bond holdings.

Since the crash of 2008-2009, fixed income markets have favored borrowers at the expense of lenders and savers. Back in the early 1980s, long-term government bond yields were near 15%. Ever since those peaks were reached, interest rates have been in a general downtrend with a few Wall Street economists referring to this fall as the great bull market in bonds. For investors, that decline was also a continuous decline in income as maturing debt was constantly being replaced with lower yielding debt. The chart on the following page demonstrates this bull market in bonds. Note the period from 2000-2003 is not reflected due to the fact that the Fed ceased issuing Treasury bonds during this time.



If we were experiencing a normal business cycle, interest rates would be on the rise. However, the federal government has been able to shrink the federal deficit by over $1 trillion since the peak in 2009. With an ever-shrinking menu of securities' offerings and a surplus of global savers, those bonds are in demand -- even if they don't yield anything.

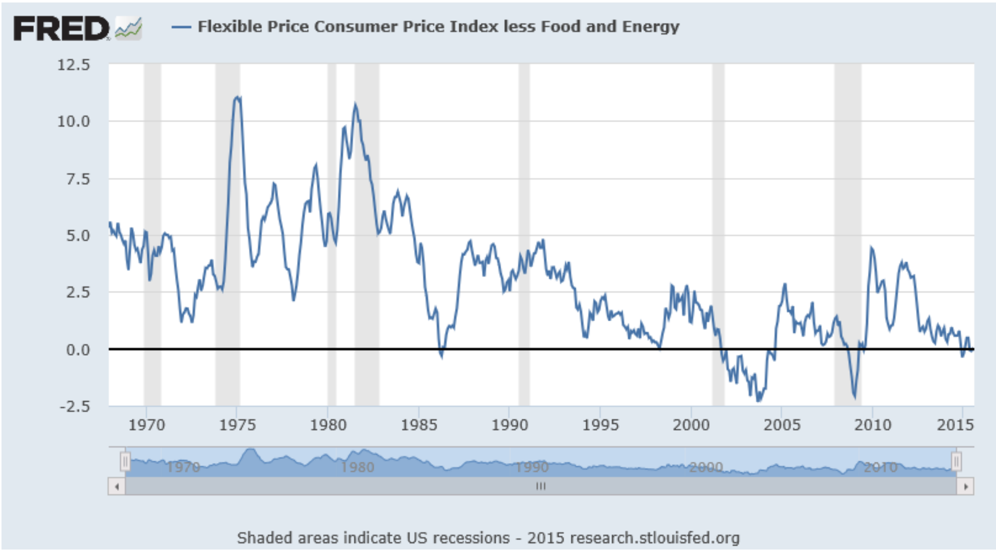
Media commentators also focus on the role of the Federal Reserve in affecting interest rates. Calls for an imminent change in Fed policy to raise interest rates are increasing yet the Fed has done nothing over the past six years relative to tweaking the Fed funds rate (this is the rate that the Fed controls by buying and selling government securities to influence the rate that banks lend to each other overnight). Given the low level of interest rates and the prospect of the Fed NOT taking any major steps to raise rates of any significance. This policy contrasts with the Volcker Fed back in the Reagan years when the fed funds rate would be changed multiple times—sometimes weekly.

Manipulating interest rates was believed to be a key tool in the Fed's bag to influence inflation and economic growth. In today's world that power would seem to be a remnant of the past even though many of the regional Reserve Bank presidents prefer to speculate about the next Fed rate hike and how it will affect the economy. Somehow we just can't see how a 50 basis point increase in the fed funds rate or an even greater amount would have a long lasting effect on the economy. The real value of the Federal Reserve is that, as a lender of last resort with an infinite checkbook, it has the ability to stretch a safety net across the economy whenever necessary.

WILL THE REAL INFLATION STAND UP?

For most of our careers in the investment business, inflation was a constant concern. Most questions from investors were about the outlook for inflation. While the concern has abated, many investors opt for inflation protected government securities where interest payments fluctuate with the rate of inflation.

The bulk of our inflationary experience occurred during the 1970s and 1980s paralleling the increase in oil prices. Since energy is, in most cases, a critical component of virtually everything we buy, that rise in energy costs was passed on through general price increases. The good news is that the reversal in energy prices is likely to reverse the historic trend in inflation as lower energy prices will flow through to all other energy intensive businesses.

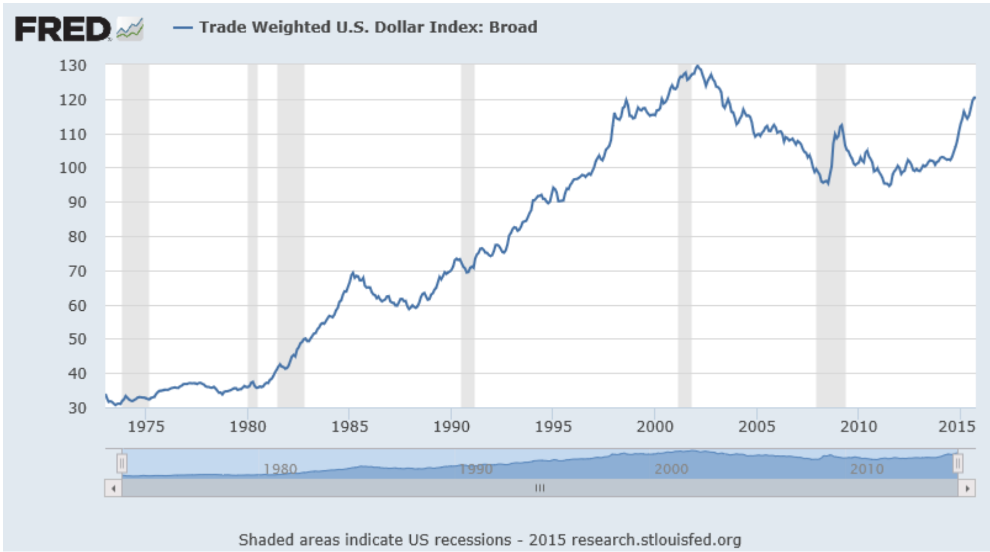


There are few signs that inflation will be a problem in a traditional sense i.e., that shortages or monopolists will drive prices higher. There will always be wealth shifts among market participants but a price increase that penalize buyers also benefits sellers. In coming years, the inflation threat may come from government regulation that affects free markets. Undoubtedly, the Congress and the President seem to be intent on implementing legislation that penalizes free markets thus increasing the costs of goods and services.

THE REVIVAL OF THE U.S. DOLLAR

A few years ago, the U.S. dollar was considered a lost cause. Our continued dependence on imported oil flooded the world with dollars and that excess supply pushed the dollar lower. A weaker dollar did facilitate improved earnings for multinational corporations but also contributed to domestic inflation as the price of imported goods rose. Speculation arose that the world would adopt a new standard global reserve currency as the dollar's value kept falling.

A turn in the dollar's fortunes paralleled the fall in energy prices. After reaching a trough of $95.88 in July of 2008, the dollar's trade weighted value has risen to a recent high of $120.37 -- a 25% increase in value. The winner when the dollar is strong is the consumer as import prices fall as do the costs of taking vacations abroad. Companies that import goods also benefit from a stronger dollar. Another winner is that group of countries that export to the U.S. The strong dollar benefits many European exporters who will likely see a rise in the volume of exports to the U.S. In the wake of the dollar's rise and the Euro's fall, the overall European economy is beginning to gain momentum. In effect, the U.S. will give up some growth to benefit other slower growing economies.



CONCLUSIONS

The unusual characteristic of this business cycle is long but not strong. Growing at a 2% annual rate, there is little of the typical boom/bust cycles that have defined past economic conditions. One might be concerned about what might have been if the U.S. did not experience the miracle of fracking and the explosion in domestic oil production. The last major fiscal policy decision was to allow the Bush tax cuts to expire and to continue to raise taxes through deferrals of the costs of the Affordable Care Act. Little can be expected from Washington until 2017 at the earliest. In the meantime, the outlook for fiscal policy remains neutral without any weight behind additional fiscal stimulus.

Corporate profitability in general is slipping due to the weakness in the energy sector and the net effect of a strong dollar. On the other hand, low inflation and low interest rates are keeping costs under control and financial costs near record lows. On balance, changes in the long-term outlook favor a positive trend for consumers and companies tied to retail markets. Also, companies that import goods and ones who produce and sell domestically should escape the negative effects of a strong dollar.

Spotty economic data will keep the Federal Reserve at bay resulting in a neutral monetary policy even if the Fed tepidly increases the target fed funds rate to 1% or less. With inflation near zero and likely to stay there in an environment of low energy prices and cheap imports, don't expect to see any Fed decisions that undermine slow economic growth and low inflation.

The global economy will continue to feel the effects of a slowing Chinese economy even though, as an energy importer, the country should benefit from that fall in oil prices and a strong dollar. The wars in the Mid-East continue to be a thorn in the side of optimism for all but those U.S. companies that provide armaments for the combatants. Since the crash of 2008 there has been many changes in the economy and financial markets. On balance these occurrences, as outlined here, give us reason to be optimistic about the continuation of an economic expansion and a rising stock market.

October 12, 2015