Financial Markets Perspective

October 2016

Politics, Politics & More Politics—Enough Already

Summary

As we approach a very unusual national election, we look forward to winding down the intense focus the media has had on politics for nearly two years. Entering the fourth quarter, continued political mumbo-jumbo dominates the financial market landscape. Most Americans are fed up with both presidential candidates and have become apathetic about electing the best representatives and senators for Congress.

More than seven years after the end of the "Great Recession", the fallout from the downturn continues to shape the American economic and political landscape. Moreover, advances in information technology have made trading in securities almost seamless across the globe and financial markets have become more highly correlated. As a result, the asset allocation decision has become more difficult—risk on/risk off—continues to be the favored trade. Once the election is over, this uncertainty should be partially removed and stocks could rise through yearend as the impact of the result should not be as great as is hyped by the media. Major decisions about the direction of the economy under a new administration will have to wait until early 2017 when the new president and the new Congress come together to make decisions that may take economic policy in a different direction. We do not have enough information to make a strategic change in our investment strategy that is based on the belief that we will have continued economic growth (albeit low), easy monetary policy, low inflation rates and growing corporate profitability.

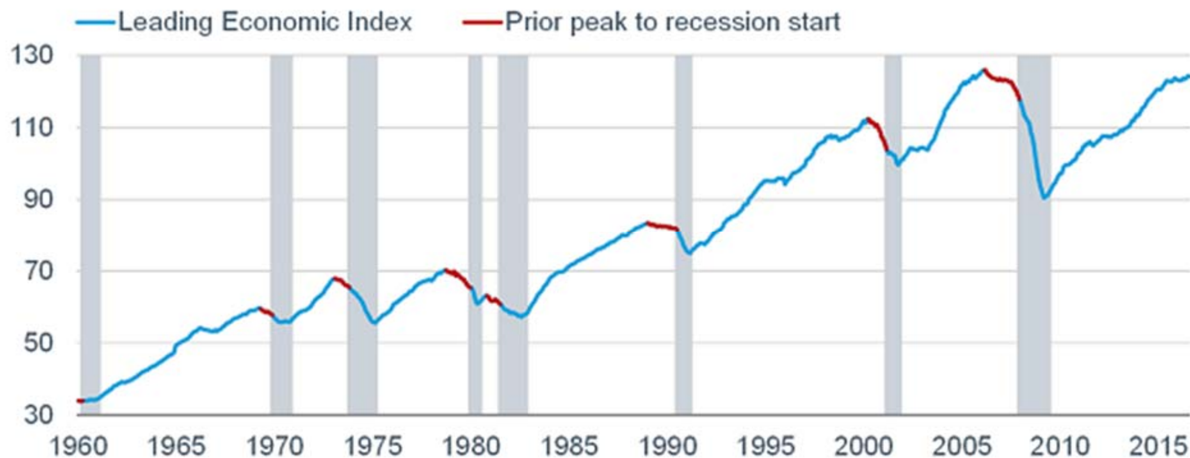
The majority of the national polls indicate that Hillary Clinton could be the first female president of the United States. Her economic priorities are tax increases on the very wealthy and an increase in the estate tax and new regulations that are intended to increase employment. Generally speaking, her programs could produce an increase in government spending and higher deficits. Her adversary, Donald Trump, offers a different approach; he advocates stimulating growth though major tax rate reductions to provide increased revenues from that growth resulting in lower budget deficits. He also is in favor of reducing government regulation that has been such a weight on economic growth. Regardless of who wins the election, investors should be sensitive to market volatility driven by expected tighter monetary policy and potential wide swings in oil prices. While long-term investors should continue to capitalize on the ongoing expansion for now, it will also be important to recognize that achieving investment objectives in the near-term will be challenging.

Economic Update

Following the financial crash of 2008-2009, the U.S. economy embarked on a slow but steady growth path that is now more than seven years long. Monitoring economic cycles is a factor that enters into the process of investment decision-making as corporate profits depend on

economic growth. Historically, the stock market does well during periods of expansion while tending to temporarily lose value during recessions.

Exhibit 1



Source: FactSet, The Conference Board, as of August 31, 2016.

One measure of evaluating the current condition of and outlook for the economy is the Conference Board's Leading Economic Indicators (Exhibit #1) that provides an historical view of past business cycle volatility. The exhibit identifies falling leading indicators in red and the gray areas represent recessions. When that index turns down at some future point, we should have a good indicator of an economic downturn. At present there is no indication that a recession is on the horizon but that doesn't mean that a recession is out of the question. Additional regulations and tighter fiscal policy (higher tax rates) could result in an economic slump.

While many investors are focusing on the outcome of the election as the driving force behind potential market declines, the real threat is another plunge in oil prices. Over the past year, the stock market has moved in tandem with oil prices, rising with higher prices and falling with lower prices. The risk is the fact that there remains a global oversupply of oil and OPEC members are hesitant to reduce output to get the supply/demand equation back in balance. When oil prices plunged to $26 per barrel from November of 2015 to February 2016, the stock market fell 14.5%. Fears of another financial meltdown were rampant as many energy companies were on the verge of bankruptcy. Beginning in February, oil prices rebounded and recently rose above $50 a barrel—double the price from the low point. The stock market rallied as well moving the S&P 500 to a 7.8% gain for the first nine months of the year. This rebound and stabilization in oil prices will likely contribute to global economic growth.

Looking beyond oil price volatility, the economic expansion continues to be lukewarm with the second quarter growth rate being revised up from 1.1% to 1.4%. Since consumer spending accounts for about 69% of GDP, we watch figures that measure this sector closely. The household sector fundamentals remain sound, job growth has remained strong and the Conference Board's Consumer Confidence Index has broken out of its recent range and is back to pre-recession levels. While consumers don't spend confidence, surveys show that

people are more optimistic about current job availability. Big-ticket purchases are slightly soft that may reflect uncertainty surrounding the election. These positives support our expectation that our King Consumer theme will continue to provide global investment opportunities.

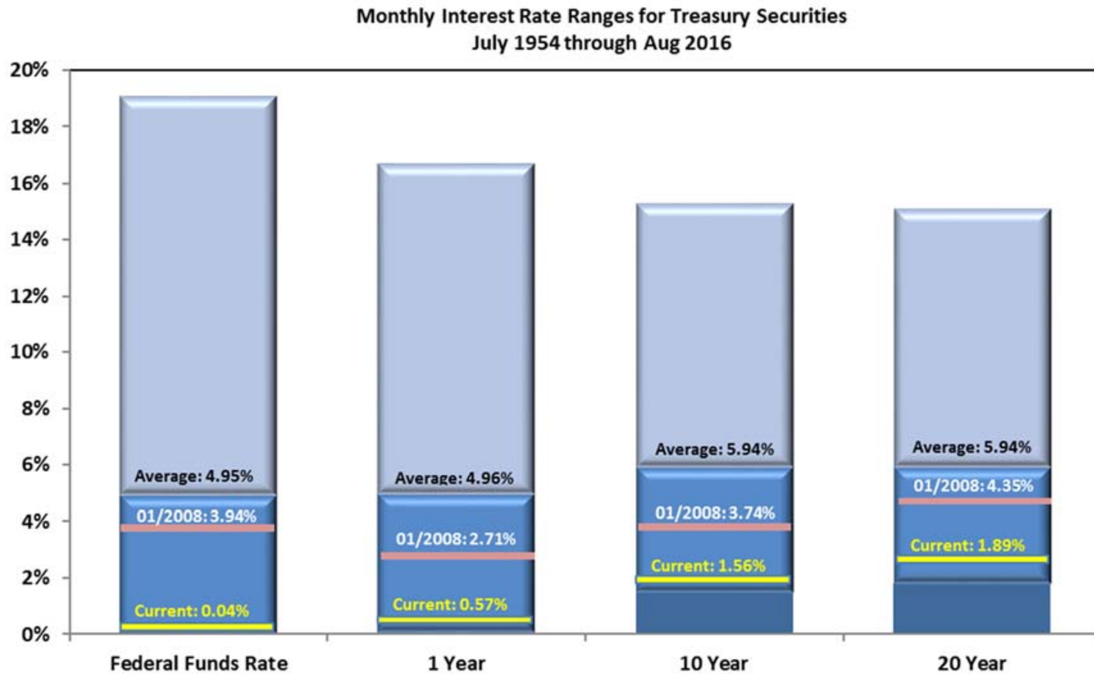
Conversely, the financial sector took two big hits from government intervention during the third quarter as Wells Fargo, the largest U.S. bank, was accused of fraud as 1% of their employees opened unwanted accounts for thousands of investors. One senator called for the chairman, John Stumpf, to resign and the state of Illinois pulled $31 billion of investment-related business from the bank. At this writing, Wells Fargo has replaced Mr. Stumpf with the President and Chief Operating Officer Tim Sloan. Across the pond, Deutsche Bank, a German global banking and financial services company was fined $14 billion after the U.S. Justice Department said the bank illegally sold U.S. mortgage-backed securities before the financial crisis. The size of the fine roiled markets and depressed the price of the bank's stock. Not only are banks under regulatory pressure but also the drug industry has been attacked by the government for the setting of drug/related prices. Mylan Laboratories agreed to pay $465 million to settle questions of whether it underpaid U.S. government healthcare programs by misclassifying its EpiPen emergency allergy treatment, which has come under intense scrutiny after a series of drastic price increases. Last year, political attacks on drug and biotech companies contributed to a substantial price decline in these companies.

Interest Rates and The Dollar

Interest rates remain at record low levels even seven years into an economic recovery. The "interest rate" is the price of money paid by borrowers and received by savers. As a result of these continued low rates, retirees have suffered as their incomes have fallen along with bond yields. Complicating matters for the Federal Reserve that sets interest rates (monetary policy) is the surge in domestic production of oil and gas. In the old days, the U.S. flooded the world with dollars through payments to the OPEC nations for imported oil. As domestic production is replacing imported oil, the flow of dollars overseas is shrinking. At the same time as a global shortage of the dollar increases, foreign central banks have attempted to use monetary policy to stimulate their economies by also pushing interest rates near or below zero. In some cases, such as the Swiss central bank that is buying common stocks and the Japanese central bank that is buying equity exchange-traded funds, the demand for dollars can only go up. If the Fed acts to raise interest rates in such an environment, there might be an international imbalance of dollar demand as foreigners see an opportunity to gain from a positive interest rate differential and the potential for selling dollars at a profit in their local currencies.

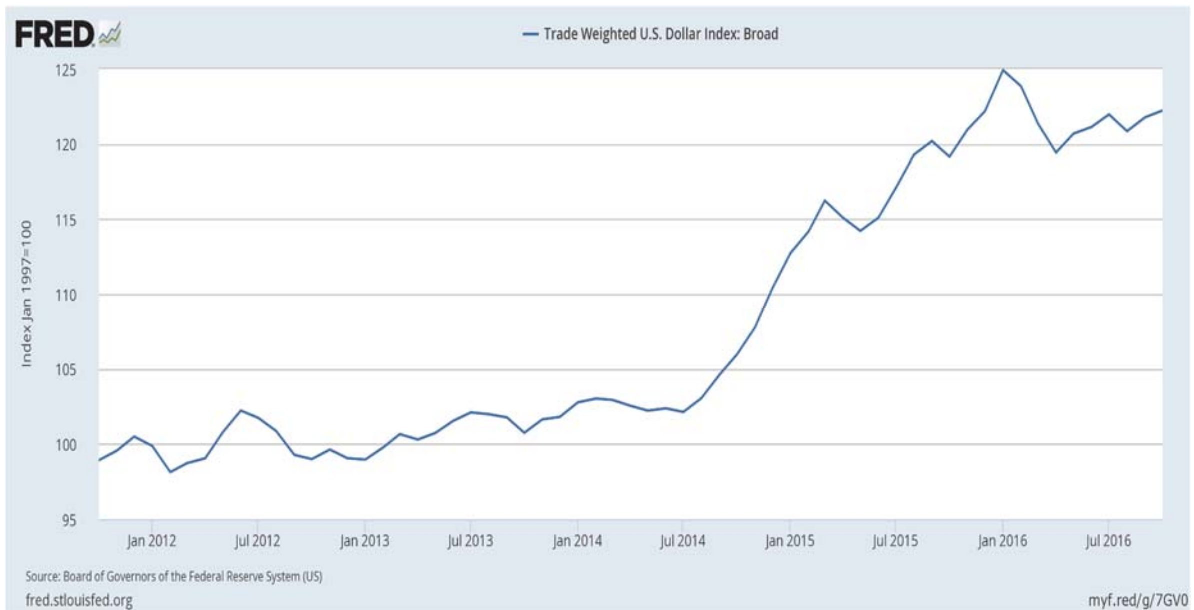
As you can see in Exhibit #2, interest rates for Treasury Securities across all maturities are at record lows. Holding a treasury bond that matures in 20 years will yield 1.89% and that is before inflation that is currently running at 1.70%. If rates stay at these levels an investor will only receive 0.19% for holding long-term securities. We are in an unusually slow economic expansion implying that interest rates will not be a factor in determining the business cycle. This scenario will only change if there is a change in fiscal policy resulting in an acceleration in economic growth. As interest rates rise, retirees who are reliant upon income from fixed-income securities will benefit from higher yielding bonds. Note the average annual returns from Treasury securities since 1954.

Exhibit #2



Even though the Federal Reserve will likely "normalize" (raise) rates in December, markets will likely remain skeptical about the speed and aggressiveness of the tightening cycle over the long term. Additionally, the European Central Bank and the Bank of Japan are running out of options to ease further while Britain under Theresa May will implement BREXIT in March of next year. As a result, the dollar has rallied against the Euro, the British Pound and the Japanese Yen as you can see in Exhibit #3 that shows the trade-weighted U.S. dollar index.

Exhibit #3



Conclusion
Over the past three years we have based our optimism for investing in U.S. stocks on the Energy Renaissance. The unexpected collapse in oil prices and related weakness across the energy sector crimped our optimistic expectations—yet it is not time to jump ship. Lower energy prices were meant to stimulate consumer spending and economic growth but those expectations have yet to be fulfilled even though the consumer has never been better off. As of the most recent data release at the end of June, the balance sheets of U.S. households reached a new high of $89.1 Trillion! Our friend Scott Grannis puts this figure into perspective: that is about 40% more than the value of all global equity markets. This ongoing accumulation of wealth is not a house of cards built on a bulging debt bubble--household liabilities have not increased at all since their 2008 peak and the average household has cut its leverage by over 30%. Households have been prudently and impressively strengthening their balance sheets over the past seven years.

Another follow on to the benefits of the Energy Renaissance is a related cousin, the Industrial Renaissance. Cheap shale gas is luring over $170 billion in chemicals projects to U.S. shores. According to IBD, "shale gas and its associated liquids provide basic raw materials for plastics, fertilizers and a host of other chemical products." The authors of the article project that the completion of these projects in the industrial belt will add over 655,000 jobs in the U.S. and substantially increase our exports of these energy-related chemical products. Last month, the first shipment of ethane, used to make plastics, anti-freeze and detergents arrived in Scotland. This deal represents the first step in the American Industrial Renaissance.

As the New Year begins we expect to see the following:

1. Moderate increases in economic growth in the 2-2.5% range for 2017,
2. A 70% chance of an increase in the fed funds rate this December,
3. Minimal increases in both short and long-term interest rates,
4. A positive upturn in corporate profitability,
5. Another year of moderate increases in stock prices and,
6. Unresolved international crises in the Middle East and the refugee crisis in Europe.

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