VICTORIA
Capital Management, Inc.

Financial Markets Perspective

January 2017

A Different Beginning

Outlook

The surprising outcome of the national election will have a profound effect on the economic and financial structure of the U.S. and the potential for greater economic growth. President-elect Donald Trump has committed to many new programs that will take our economy in a new direction. His pledge to reduce tax rates on both corporations and consumers as well as reduce the enormous regulatory burden should provide a new level of incentives to work and invest in America.

As we discussed in our mid-2016 Perspective entitled: "The Fiscal Policy Vacuum," there has been no meaningful economic stimulus flowing from either the Congress or the president. The only good news has been from the contribution that fracking has made to our economic growth. If anything, ballooning regulation has held back growth. The economy has been bumping along at a 2% rate or less even though the U.S. has been benefiting from this enormous increase in domestic oil and gas output. While this production has contributed to a global oil glut, the resulting fall in oil prices has benefited both consumers and domestic industries that rely on these inputs for chemical and plastic products.

The outcome of the race for presidency was unexpected as was the across-the-board election of Republicans in both the House and Senate. With a Republican majority in the Senate, the new president should have a "bullet proof" majority to get his ideas about growing the economy into law with little resistance. President Obama had this power structure during his first two years as president but only made one major change in policy—the passage of the Affordable Care Act. Given the background of the president elect and his dedicated commitment to grow America, the new power structure should allow him to make a lot more changes in the regulatory environment to duplicate the economic environment under president Reagan.

We are only a few days away from the inauguration yet the stock market has risen about 9% in two short months. Some market sectors are up over 20%! While the composition of that rise has been centered in the financial and energy sectors in expectation of a quick change in regulations that impact these industries, virtually all sectors have participated in this unexpected surge. On the other hand, the bond market has suffered during this stock market gain. Bond interest rates are low and as the economy grows and borrowing expands, interest rates are likely to rise. When interest rates rise, outstanding bonds fall in price to provide a higher yield that is needed to compete with newer bonds. Even with the selloff in bonds since the middle of June, interest rates are still low by historic standards so they could continue to rise this year especially if the Federal Reserve fulfills its commitment to raise interest rates during the year.

The reason that the stock market rally is gaining adherents is the recognition that fiscal policy is about to change dramatically in the direction of producing faster economic growth. President-elect Trump is not confronted with an economy that Ronald Reagan faced when he became president—double digit inflation and interest rates along with high unemployment. Even though president Reagan's 30% tax rate cut proposal contributed to his election victory as did Trump's proposed corporate and individual tax cuts, Reagan was forced by Congress to implement those tax cuts gradually. Instead of a one-time 30% reduction, the president was forced to change the cut to a 5% reduction in 1981, 10% in '82, 10% in '83 and 5% in '84. The effect of this phase-in was to encourage the postponement of economic activity into future years when tax rates were going to be lower. The result was a serious recession during Reagan's first term and the backlash that the tax cuts really couldn't work. President-elect Trump hopefully has either learned from this experience or is listening to his supply-side advisors who lived through that experience. To avoid distorting economic activity, the new president must press for retroactivity for any newly approved tax.

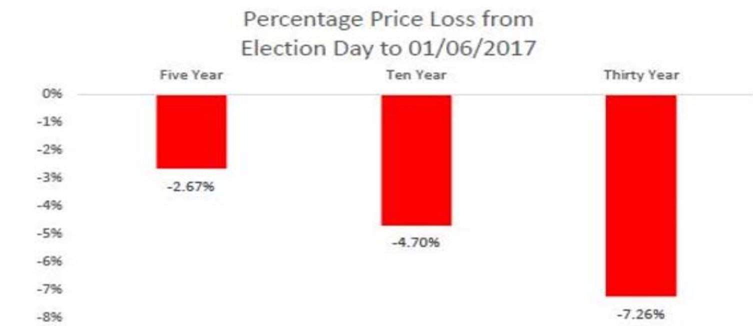
The stock market rally may also be attempting to quantify the effects of broad tax rate cuts on the corporate world and on the consumer's pocket book. While stock prices appear high when measured by current corporate profits, the changes proposed by president-elect Trump could have an unusually positive effect on future profit growth for the following reasons:

1. Corporate tax cuts will allow companies that currently pay a high tax rate to experience a sharp increase in earnings.
2. Personal tax rate cuts will provide consumers with additional funds to spend increasing the volume of business and contributing to higher profitability.
3. Reductions in regulations will be a factor in lowering corporate expenses that will also contribute to higher profitability.
4. A stronger dollar will put downward pressure on imported prices.

There has never been a period when these positive changes have come together to affect the corporate sector. Few economists have even considered what happens to corporate profits in an environment of economic growth that could exceed the 3-4% potential growth rate for the U.S. economy.

Financial Markets

Record low interest rates over the past eight years are consistent with a slow growth economy and persistently low inflation. Finally, we have begun to see an expected increase in long term interest rates. For some, the increase in interest rates implies a "bear" market in bonds but, for long-term investors, rising interest rates mean higher future income. For bond holders, the rise in interest rates since mid-year has produced a temporary decline in the prices of those bonds. The following exhibit provides a graphic representation of the price decline of different maturities of government bonds. The decline in long-term bonds over such a short time will likely have bond traders thinking twice about the attractiveness of bond investments over the short term. On the other hand, if bond yields rise substantially from these low levels, they will become a competitor for the dollars that are going into the stock market. We wouldn't worry about that competition for some time to come.



Data Source: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield

The image above depicts the percentage price loss in US Treasury Securities from their yields after the 2016 election to January 06, 2017

Conclusions

We are at the beginning of another presidential cycle, whether it be for four or eight years. At this point we have only expectations that there will be new fiscal policies that will create a faster growing economy and all the benefits that flow from that growth. If promises become reality then we are confident that we are looking at the beginning of a new economic landscape that favors incentive-based capitalism, growth, profits and a rising standard of living with lower unemployment. A strong dollar will keep a lid on rising prices from abroad and pressure the Fed not to raise interest rates too quickly because a stronger dollar will negatively impact multinational corporations. So, don’t expect any orchestrated rate increases of the fed funds rate that would bolster the dollar.

The personality of the new president tells us that we can’t tell how various industries will be affected by ongoing tweets about the implementation of fiscal policy. We are not concerned about threats regarding a trade war even though he has vowed to “put America first.” We doubt a successful entrepreneur would precipitate such an event. Trade wars begin with politicians not businessmen. Digging deeper into these fears it appears that what is likely to happen is a struggle over making trade fairer for the U.S. after years of being taken advantage of by foreign governments. We don’t know how such realignment will take place but we believe that the playing field will be leveled in favor of American businesses.

After tax rate cuts, reductions in regulation could play a major role in keeping inflation low. In many cases, price increases raise the cost to one market participant but benefit another. The bottom line is not inflation but wealth shifts among these sectors. However, regulations produce a deadweight economic loss through forced compliance and rising costs that ultimately translate into rising inflation. Once again, depending on the approach the new president takes to address various forms of regulation, the markets will react accordingly and rush to find those stocks and industries that stand to benefit the most from these “deregulations.”

During 2016, our cautiousness did not allow us to fully participate in the mid-year market rally. The sudden surge in oil prices from $26 per barrel to over $50 per barrel bailed out the oil and related industries as well as the financial sector that supported those industries. However, other than a promise by OPEC to restrict output, the outlook for oil remains suspect. Since the rise in oil prices, drilling rigs operating in the U.S. have surged suggesting fracking will produce a major increase in U.S. oil output. Second, OPEC members have been known for cheating on output limits and current price levels will not sustain Saudi Arabia's spending programs. On balance, the risk of another plunge in oil prices is real subject only to the timing of a likely breakdown in the pricing structure dictated by OPEC. To resolve that risk, the U.S. should impose a floor on oil and gas prices in the U.S.

During the New Year we expect to see the following:

a. An increase in domestic economic growth to 3%+,

b. faster and broader economic growth around the world,

c. slower increases in the fed funds rate during the year,

d. modest increases in interest rates early in the year with further increases affected by the rate of overall economic growth,

e. a resumption in corporate profit growth that will exceed expectations,

f. improved business spending and consumer confidence,

g. another year of double-digit gains in stocks but weaker bond prices (higher yields),

h. continued turmoil in Europe with elections in France, Germany and the Netherlands,

i. the invocation of Article 50 of the Treaty of Lisbon that will formally start Britain down the path of Brexit.

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

January 10, 2017