Capital Management, Inc.

# Financial Markets Perspective

July 2017

## Growth in the Slow Lane

*The stock market extended record highs in the second quarter mostly on the back of information technology stocks that have rallied by more than 17% this year. While some valuation measures of equities appear stretched, an acceleration in company earnings and revenue growth, low inflation and low interest rates are providing impetus for further gains in the stock market. Meanwhile, the bond market continues to surprise. After a yield surge in late 2016 and a 0.25% increase in the Fed funds rate, long term bonds have rallied as witnessed by the near-4% gain through the end of June! Even foreign markets came back to life with the MSCI World ex U.S. Index rising nearly 11%.*

### The Economy

First quarter GDP rose a weak 1.4% falling well below the 3% potential growth that economists tell us is a reasonable expectation based on historical analysis. Our current economic growth of less than 2% is one of the slowest growth expansions on record. From our perspective, the culprits are the absence of favorable fiscal policy and the burden of over-regulation. Even though stock markets have risen to record levels both in the U.S. and abroad, we still have not seen any traditional stimulus efforts coming out of Washington. However, steps to reduce regulation across the economy may be having the intended effect of lowering the costs of being in business. Both consumer and business confidence have risen to record levels -- an important contributor to future economic activity. Slow economic growth is favorable as we are not experiencing demand pressures that will elevate traditional measures of inflation. On the other hand, slow growth inhibits rising standards of living and limits the ability of the federal government to pay its bills through rising tax revenues.

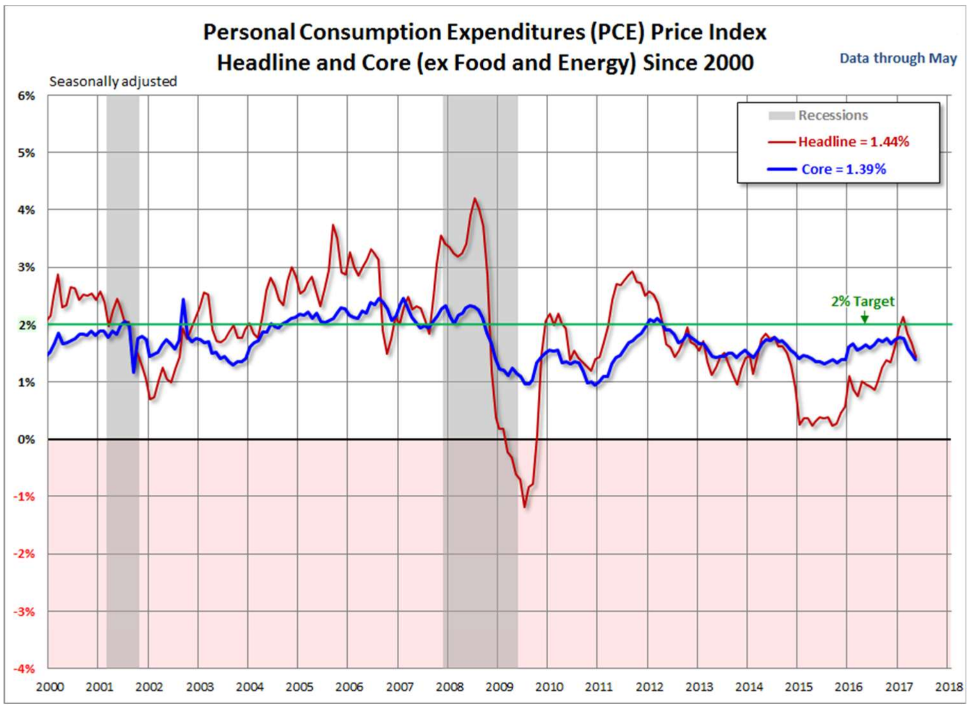
The most important factor in keeping our economy growing has been the low and stabilizing oil price -- somewhere between $45 and $55 a barrel. As lower oil prices work their way through the economy, there is downward pressure on prices across the economy as companies incorporate lower energy costs into intermediate and final goods prices. As output from the U.S. increases, the revenues generated by those sales stay in the U.S. rather than being shipped off to OPEC nations. On one hand, the decline in oil prices has been great for consumers and should continue to put downward pressure on inflation. On the other hand, those lower prices penalize our domestic producers that must dance to the tune of OPEC's efforts to put them out of business by driving oil prices down. If oil prices soar above that $55 level, then there will be a surge in U.S. production or if oil collapses below the $45 level then domestic production will shrink accordingly. These supply forces will tend to keep oil prices in a general equilibrium.

On balance, we expect to see improving economic growth for the second quarter but little if any improvement above a 2% real growth rate for the balance of 2017 unless we get tax rate reductions or federal spending increases.

## The Federal Reserve, Inflation and Interest Rates

The biggest surprises for 2017 have been inflation and interest rates. After the November election, bond market participants thought that a booming economy was around the corner and they sold bonds and interest rates rose. Once 2017 got underway, long-term interest rates began to fall as growth expectations faded. Keeping downward pressure on interest rates was also surprisingly low inflation. The traditional measures of inflation, the producer price index (PPI) and the consumer price index (CPI) are signaling inflation that is below 2%. Exhibit #1 below depicts inflation as measured by the Personal Consumption Deflator (PCE), the Federal Reserve's favorite measure of inflation that is also showing less than 2%.

*Exhibit #1*




*Source: Federal Reserve Bank of St. Louis*

The recent declines in oil prices may also keep inflation under control. However, given the importance of oil prices in the determination of the cost associated with the basket of goods that make up the CPI, it is likely that fluctuations in this measure of inflation will parallel changes in oil prices.

Interest rates are an important determinant of borrowing costs. As banks raise interest rates in response to increases in the Fed funds rate by the Federal Reserve, borrowers should pay more for their loans. On the other hand, savers benefit as banks may pay more on their deposit accounts. Investors who purchase individual bonds in today's environment are experiencing interest rates well below historical norms. One of the better methods of forecasting returns from fixed income investments is the current interest rate. However, when investing in either a bond mutual fund or an exchange-traded fund, a rising interest rate environment tends to benefit investors as the income from the fund could rise as the fund manager invests in bonds with higher yields. Funds also have the benefit of being well-diversified versus the risk associated with owning individual bonds.

Recent economic data point to a deceleration in commercial and industrial lending as well as a slowdown in overall debt issuance by quality companies. On the other hand, there is a continuing demand for fixed income securities that should be keeping interest rates low. So, the good news is for borrowers and the bad news is for investors going forward.

## Global Monetary Policy

*Exhibit #2*

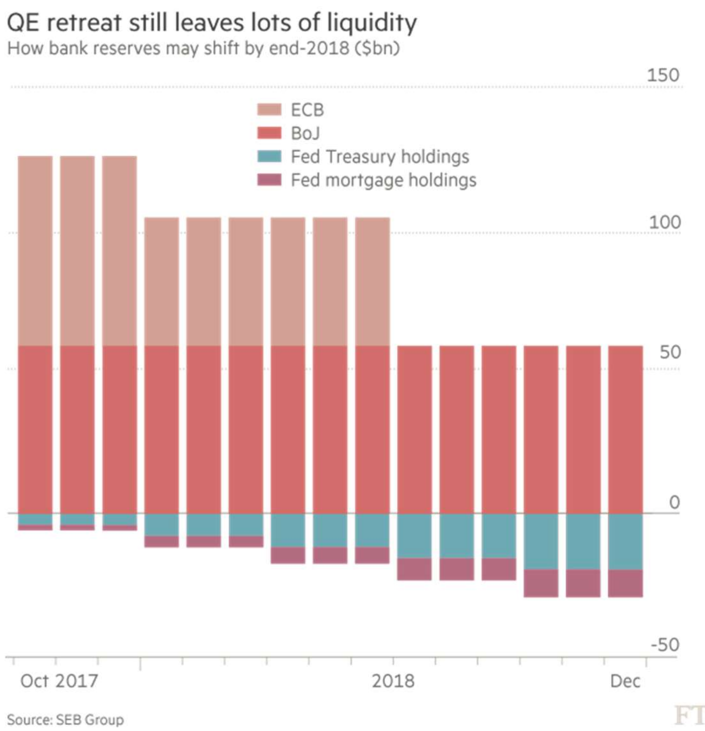



Exhibit #2 shows the liquidity levels of the world's major central banks. According to Robert Berquist, SEB Group's chief economist, the amount of excess liquidity in the world economy is around $15 trillion -- or one-fifth of global stock market capitalization. So, even if the Federal Reserve starts to unwind its balance sheet as soon as September, the pace towards normalization will be so slow that even by the end of 2018 there will still be plenty of liquidity lubricating the financial system. The Bank of Japan's umbilical link to quantitative easing is responsible for a large slice of unconventional monetary policy over the next year. Global monetary policy may be entering a new phase, but talk of a shift to a "tighter" policy is overblown. We believe that monetary policy will continue to be very expansionary for many years. The overall liquidity situation, together with a very slow adjustment upwards for nominal policy rates, will continue to provide strong support to asset markets. Any correction in asset prices is likely to come from other factors, not the expected changes of monetary policy. Bank reserves will continue to rise and the Fed's monetary policy downsizing will have a limited impact on stock and bond markets.

## Corporate Profits

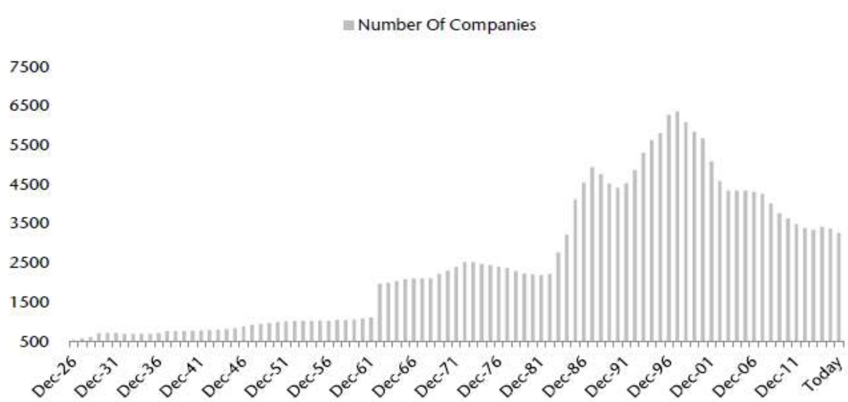
Aggregate company sales and earnings were hurt by the fall in oil prices in 2015 and 2016. Energy company weakness pulled down otherwise good earnings by non-energy companies. Relative stability in oil prices in 2017 has given a boost to aggregate corporate earnings. The good news is that 90% of those companies reporting earnings for the first quarter experienced gains that were above Wall Street expectations. More importantly, most companies have bettered the consensus revenue estimate. This revenue "beat rate" is positive since it has not happened since the second quarter of 2014. Importantly, more companies are raising forward earnings guidance than companies lowering guidance. Drilling down by sector, information technology and consumer discretionary companies have had the highest "beat rate", while telecom has the worst. One point of interest to note is that stocks with the most international revenues have performed the best. The outlook continues to look favorable especially for non-energy related industries. The bad news in these numbers is that Congress may look askance at efforts to reward successful corporations with sizeable tax rate reductions.

Another important factor affecting the distribution of corporate profits are the shifting priorities among major companies that are embracing technology to expand their business opportunities. One powerful example in the second quarter was the announced acquisition of Whole Foods by Amazon. The surprise change of direction for a powerhouse like Amazon instilled fear in many food retailers as well as companies that engage in prepared food delivery. The combination will undoubtedly add value to the consumers' pocketbook by providing a valuable time saving service as well as the potential to see lower food prices. Another interesting factor that has received a lot of attention recently is the shrinkage of total common stocks outstanding.

Exhibit # tracks the number of common stocks outstanding. The U.S. public equity market has evolved dramatically over the past 40 years. This fact is important because the U.S. equity market is 53% of the global stock market. Note in the chart the sharp decline from 1996---over the past 20 years listings fell by roughly 50%! Not only is there a substantial reduction in common stocks listed, but funds flowing into the stock market from both individual and institutional investors has been increasing. One reason is that the low returns on bonds is forcing investors to take more risk to gain a higher rate of return. Another important factor entering this equation is the usefulness of the traditional P/E ratio to value the stock market. Many investors look to owning specific stocks because of the aura surrounding them. A company such as Amazon may have rarity appeal and, as such, commands a P/E multiple that is unrealistic by normal market standards. The analogy might be to the scarcity value of classic cars or of classic painters whose work demands substantial premiums over generally available art work. As large company wealth continues to expand followed by stock buybacks or acquisitions of other large companies, that scarcity value may accelerate leading to higher stock prices in the years to come.

*Exhibit #3*

**Chart 1: Number of stocks in CRSP data lowest since 1984.**




Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies.

## Conclusion

In our last Financial Market Perspective titled: "Rationale for Optimism" we outlined the reasons for our continued favorable outlook for the economy and the stock market. For the second quarter, the S&P 500 index rose 3.09% taking the year to date increase to 9.34% -- a very positive first half of the year! The economy may be sluggish but equities are in the fast lane.

So where do we go from here? As stated, we have decent earnings growth and finally healthy revenue growth that is likely to continue, meaning that stocks are not too expensive (based on future earnings). As we have pointed out in the past, there are more high growth/high margin companies populating the S&P 500 index than ever before, which by definition, implies valuations should be higher. More importantly, there has been a huge shift from tangible assets to intangible assets on the balance sheets of companies. For example, in 1985 companies had some 85% in tangible assets and 15% in intangible assets. Today, that ratio has been completely reversed and that implies higher valuations. Finally, if you take out the abnormally low P/E's of the 1970s and 1980s due to high inflation and high interest rates and sum the beginning of the year P/E's starting in 1990, the average P/E works out to be around 23.8. Finally, as we have stated before, we are in a secular bull market "super cycle" that tends to last 15+ years so even starting from the low in March of 2009 we should have another 7+ years left in this cycle. However, as we have also noted in the past, this "bull market" likely began in either October 2011 or in April of 2013 which means that we may even have 9 to 11+ years left in the current "super cycle."

Despite mass migrations from the Middle East, continuing warfare in Syria and Afghanistan and numerous efforts to defeat ISIS, the foreign economy is performing better than expected and will likely contribute to gains in those respective financial markets. News from the Far East regarding North Korea and China appears to be an imminent threat to our safety and the situation is likely to get worse before it gets better. We feel that the potential for expanding military conflict while benefiting from the need to meet these challenges with better equipment could benefit those companies exposed to this industry.

The domestic economy is improving slowly and would grow a great deal faster if the current administration could push through tax-rate reductions and decreased government regulation. The private sector is improving due to rising consumer and business confidence. The prospect of reasonable oil price stability and a less volatile dollar should add to business certainty and improving output. If profit forecasts hold up through year-end we expect to see a continued rise in equity prices while interest rates remain essentially flat.

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

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