Financial Markets Perspective

October 2017

The Benefits of Stability

Imagine if the Bureau of Weights and Measures decided to periodically change the number of inches in a foot. Imagine if it made those changes monthly or quarterly. What would happen to construction? Uncertainty is the bain of output. When there is certainty, there is economic progress.

Over the past two years we have been moving toward stability in key economic variables. Even though the economic expansion has been the second longest on record at eight years, interest rates remain low and stable. This stability facilitates plans for borrowing and lending. Corporations benefit from low rates as does the federal government—the major borrower in the U.S. After a roller coaster ride for oil prices, we see stability in the price range of $45-$55 per barrel with expectations for a target price of $50 a barrel in 2018. The value of the dollar has partially retraced the losses of this year as investors perceive that stability is on the horizon and is an important contributor to world trade. Even though we anticipate a reduction in tax rates, the tax code has been stable since 2012 contributing to effective business planning. As the stock market continues to reach new highs, we can thank stability for this record performance.

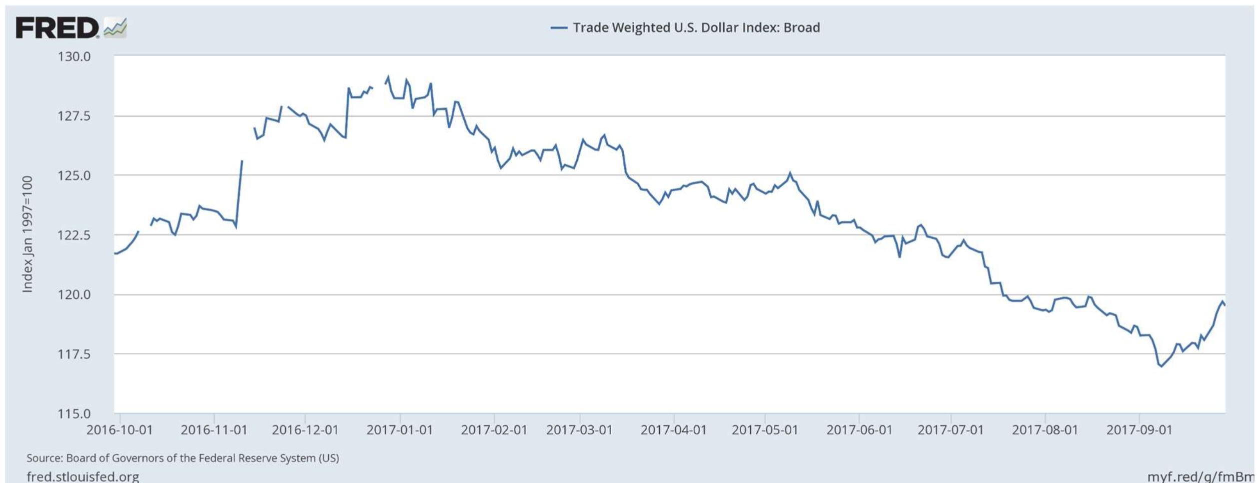
The Economy

Second quarter GDP rebounded from a weak 1.4% first quarter gain to a more robust 3.1% surge, the level that some economists see as an appropriate rate for noninflationary economic growth. Even with a bounce, inflation has remained below 2% -- surprising for this stage of an economic cycle. However, stable oil prices are a key contributor to keeping inflation low. As we have pointed out in prior communications, there is a flow-through effect at all levels of economic activity because of the need for energy for production. Lower oil prices are working their way through these economic levels and one outcome is the ability for businesses to lower prices in a competitive world. In turn, an industrial renaissance is occurring in the U.S. rust belt as lower energy costs encourage the production of industrial goods—another factor that will keep the U.S. economy on a continued growth track.

An important factor that does influence the global economy is the exchange value of the U.S. dollar. Since the U.S. currency is considered the global reserve currency, many countries benchmark or manage their currency to the U.S. dollar. As the U.S. economy improves or grows, the dollar will get stronger. A strong dollar may also signal higher interest rates and foreign investors will seek dollar-denominated investments (stocks and bonds in the U.S.) which benefit from price appreciation and relative strength to their home currencies. The following exhibit tracks the strength and weakness of the U.S. dollar since 2005. During the decline in oil prices and the growing influence of the U.S. oil industry due to fracking, the dollar gained strength. This rally in the dollar provided an umbrella for foreign companies that competed with U.S. companies allowing them to increase production and sales in their home countries. In 2017, the dollar suddenly weakened with the expectation that the U.S. economy was going to weaken and

the Fed wouldn't increase interest rates in that environment. Over the past two weeks, the dollar has begun to rally again in the face of a rebound in the U.S. economy. While the impact of hurricane season has destroyed billions of dollars of wealth, there is an offset for massive spending to repair the damage that will contribute to higher economic growth in the quarters to come. Tax reform and continued economic growth over the next few quarters leads us to believe that the dollar will stabilize in the range between 118 and 128 as reflected by the band on the graph (Exhibit #1).

Exhibit #1



Another Sign of Stability

Stability is the opposite of volatility. Stock price swings usually reflect uncertainty when volatility is high. During the month of September, volatility in the stock market reached record lows. Looking back further we can see that these are unusual times. Current low volatility has occurred very infrequently as measured by the CBOE Volatility Index that can be seen in Exhibit #2 below.

Exhibit #2

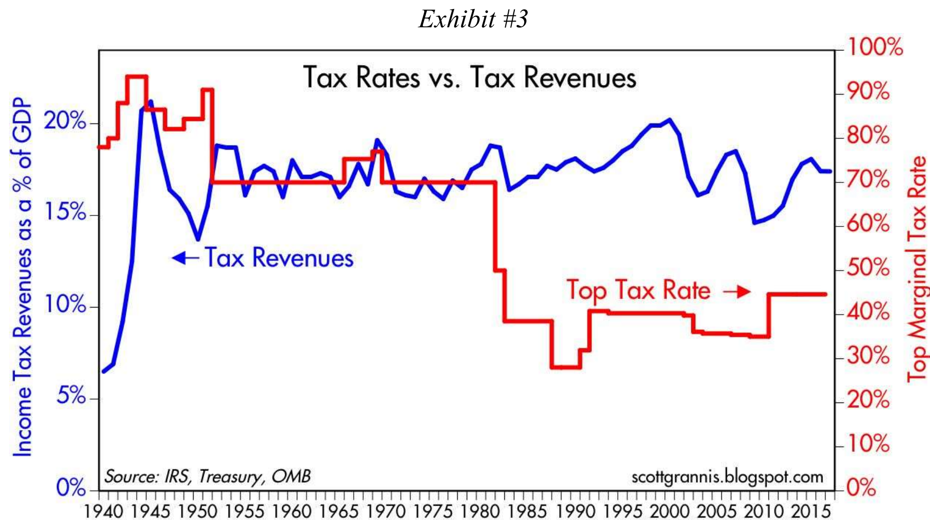
To experience lower volatility than today, one would have to go back to the Sixties and Seventies. Explaining the reasons for low volatility is another matter. Our best guess is that low volatility is reflecting greater certainty in the economy and the expectation that, with or without

tax reform, economic growth will be moderate and inflation and interest rates will remain low. Remember that our primary thesis is that the "Energy Renaissance" is a permanent change in the dynamics of world energy markets. From 1973 through 2012, the U.S. was held hostage by the OPEC monopoly that dictated oil prices and imposed higher energy costs across America. Many of those costs have melted away and the domestic oil industry is insuring a growing supply of U.S. oil that doesn't have to be purchased from foreign oil companies.

Anatomy of Tax Reform

The primary reason that president Trump was elected is his major tax reform proposal that would be highlighted by vital income tax cuts for corporations and individuals. Opponents of the tax cut argue that there would be a major decline in federal revenues. They reject the notion that more economic growth would produce higher tax revenues to offset the shortfall from the tax cuts. Exhibit #3 supports the idea that tax cuts, both during the Kennedy and Reagan presidencies did not affect tax collections as the level of income tax revenues relative to GDP during these periods remained relatively stable. One factor missing in this analysis is the growth of the economy during and shortly after the effective dates of these full tax rate cuts.

Exhibit #3



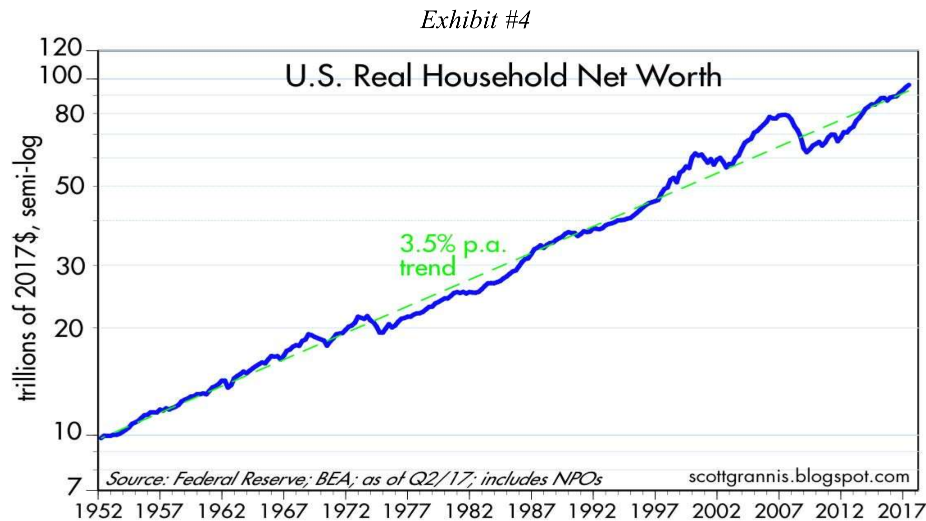
As a result, the exhibit doesn't tell us much about the effects on growth that these tax cuts triggered. If we go back and examine the growth rates that did take place during and after the tax rate cuts, we see confirmation that the changes in tax law were beneficial for economic growth. The problem with the early Reagan years (1981-1982) was that Congress forced the president to phase in the tax cuts that weren't fully in place until 1983. The lesson learned: don't announce a sale on new cars that will start a week from today!

The fourth quarter will be filled with battles over the president's tax reform proposal. There may be a need to bargain for an abbreviated tax cut if Republican support isn't there. The good news is that we are arguing over the size of a tax cut not the possibility of a tax increase. The equity markets' rally is reflecting the favorable options in either case.

Even if the tax reform isn't all we hoped it could be, there is certainty in stability. Economic statistics continue to report on a period of good times in America. The latest statistics on U.S. Real Household Net Worth (Exhibit #4) paints a favorable picture of an improving economic environment for Americans. Since the election, the U.S. stock market has risen $5 trillion in

value! We are back on the 3.5% growth trend for this broad measure of economic health, a trend that could be used to estimate the underlying growth rate in the U.S.

Exhibit #4



Another confirmation of a period of stability is the price of gold (Exhibit #5). Historically gold has been called the refuge of the wealthy. At the sign of any bad news the price of gold soars to new highs. TV and radio programs tout gold and gold coins as safe investments somehow protected from the profligate spending of the government.

Exhibit #5

Historical Price of Gold

Courtesy of Macrotrends

But as seen from the chart above, the history of gold prices is anything but stable. After Richard Nixon took the U.S. off the gold standard in 1971 and OPEC quadrupled oil prices, the price of gold soared and then fell back by the same amount it gained by the late 1990s. Once again there was a quintupling of gold prices but only back to the levels experienced in the mid-70s. Contrast the stability of the S&P 500 with the price of gold in Exhibit #6. Fear obviously affected the rise in gold after the financial crisis of 2008 but, as the memories of that experience faded, gold prices collapsed and stock prices continued in a stable positive trend. After gold prices were almost cut in half this decade, the price has settled down between $1,200 and $1,400 per ounce.

The recent stability in gold prices also suggests there is little concern about traditional factors that contribute to rising gold prices.

Exhibit #6

The third quarter wasn't without cause for concern. Four hurricanes smashing the U.S. mainland causing billions of dollars of losses, the ever-present threat of a North Korean "event" that could lead to an unwanted confrontation and the failure of efforts at reforming the Affordable Care Act took their toll on economic optimism yet here we are at record highs in the stock market.

Conclusion

Growing stability across the U.S. economy as well as a global expansion is the impetus behind continued optimism. Corporate earnings remain strong as businesses plan to expand in a stable environment. Monetary policy has kept interest rates low even though talk about the Fed raising interest rates has been omnipresent. Fiscal policy has been virtually non-existent since President Obama allowed the Bush tax cuts to expire in 2012. For commentators who say we are near the end of this bull market, we don't agree. The consumer accounts for over 70% of economic activity. Since the low point in 2009, confidence has been in an uptrend and has recently stabilized at 97.3 -- a level that is about at the midpoint of consumer confidence since 1977. There is no euphoria as there was back in the late 1990s that set the stage for the recession in 2001. Another important sign of stability.

We are coming up on the 30th anniversary of Black Monday when the Dow Jones Industrial Average plunged 22.6% in one day! (Today that would be the equivalent of a 5,000+ decline!) The reason for the magnitude of that decline had nothing to do with fundamental changes in the economy although pundits tried to put the blame on a variety of economic occurrences. The real reason was a technical meltdown in stock trading based on portfolio insurance and program trading. Today, such similar risks are carefully monitored by the regulators. However, there can always be an unexpected technical "glitch" that could temporarily knock the stock market off the growth track as happened in 1987.

Diane V. Nugent, *President/CEO* Thomas E. Nugent, *Executive Vice-President*
October 10, 2017