Financial Markets Perspective

January 2019

A Tale of Two Equity Markets

One Year Later:

One year ago, we made the following forecasts about the global economy and financial markets:

"Passing the president's tax proposals is ushering in record reductions in tax rates that will contribute to a better economy for several years. On the earnings front, narrowing wage differentials, lower energy and logistical costs, and political stability are just some of the factors that should contribute to healthy profits. We believe that investors are over-estimating the risks within the United States and that domestic stocks will finish out the year in positive territory. There will always be some intermediate declines along the way, but we believe stock investors will continue to be rewarded by staying the course."

Here is what we expected (with follow-up commentary):

✓ *Stability in the price of oil ranging from $45-$55 per barrel with expectations for a target price of $50 per barrel by year- end*

- Oil prices were on a roller coaster ride in 2018 peaking at almost $76 per barrel on October 3rd and then falling to a low of $43 near the end of the year. See Exhibit #1.

✓ *Stable oil prices are a key contributor to keeping inflation low*

- Volatility in oil prices during the first three quarters led to a rise in inflation as measured by the consumer price index that rose to a rate of 2.2%.

✓ *As the U.S. economy improves or grows, the dollar will get stronger.*

- The dollar continued its upward trend hitting a new high near the end of 2018.

✓ *If trade barriers are not renegotiated, there will likely be continued volatility in financial markets*

- After reaching a record high in September, investors feared that a trade resolution was not forthcoming, sending U.S. equity markets into bear market territory by the end of December.

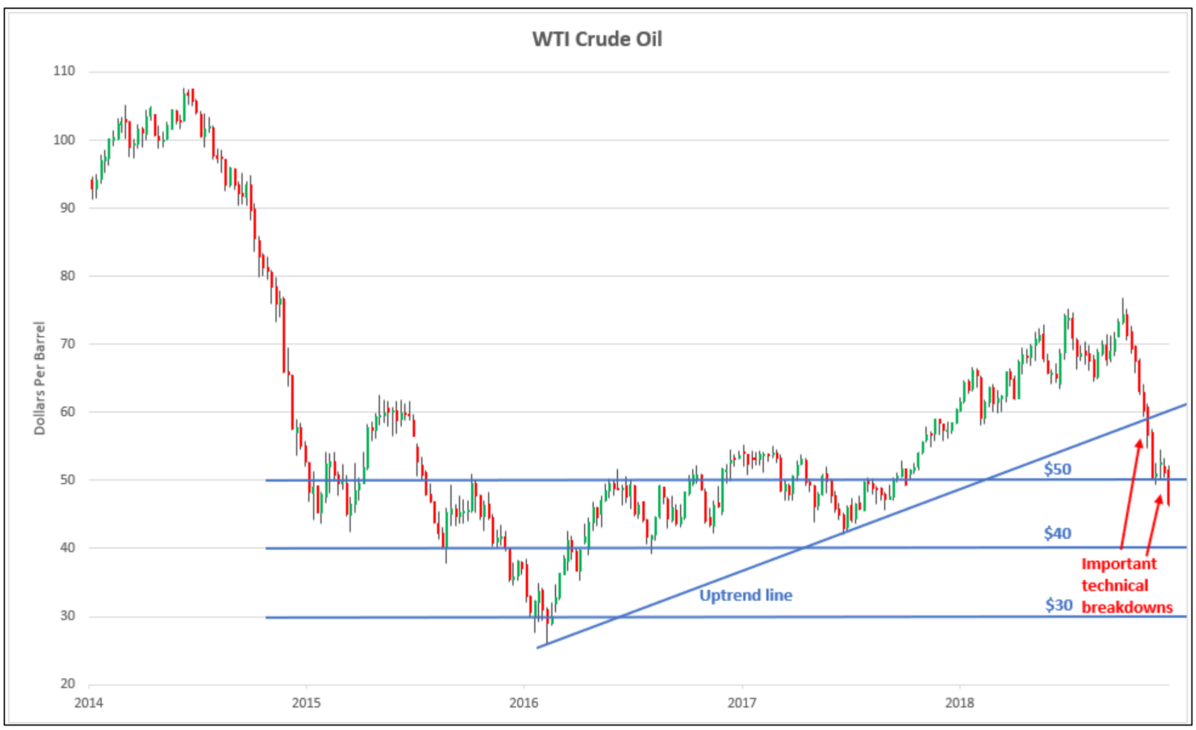
✓ *The fundamental underpinnings for a continuation of the bull market in stocks remains intact.*

- The equity market as measured by the S&P 500 reached a record high on September 21st on the back of strong corporate profit and revenue growth only to begin its 19.7% decline on October 3rd to finish out the year with a loss of 4.4%---a decline nobody predicted or expected! This drop was triggered by the collapse in oil prices, the liquidation of at least 150 hedge funds, tax-loss harvesting and algorithmic (automated computer) trading that follows short-term trends, **not** the underlying fundamentals.

The Stock Market, Oil Prices and the U.S. Dollar:

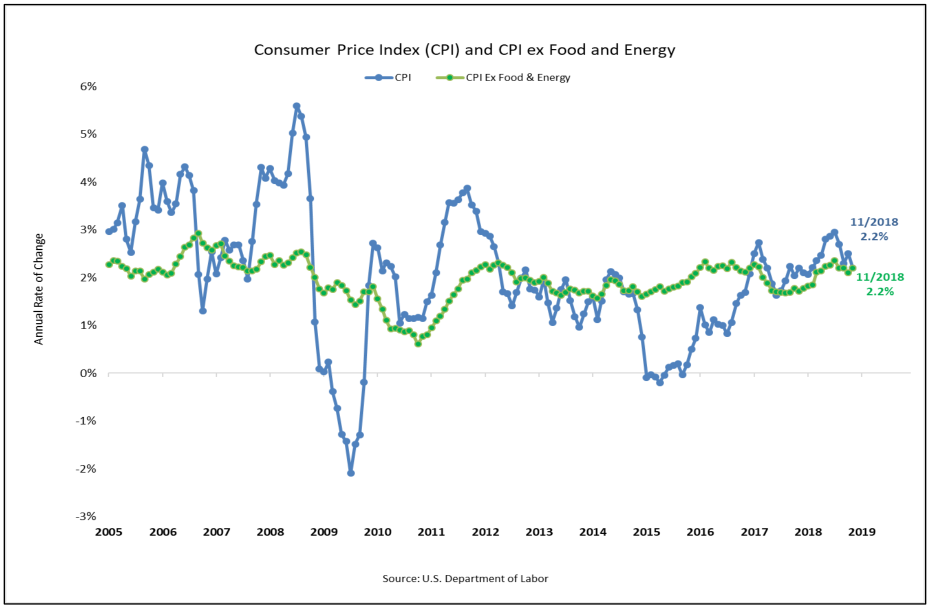
As we reflect on our forecasts from last year, we see a tale of two markets. The first tale was one of an ebullient economy and stock market; continued strong economic growth, modest inflation, gradually rising interest rates, stable oil prices, strong corporate profit growth and investor optimism helped define the market during the first nine months of 2018. However, beginning in October these favorable trends were upended and a new market reared its head. A surprising crash in oil prices amounting to a whopping 45% decline reminded us of the fact that the U.S. is continuing to grow as the world's largest producer of oil and is not subject to decisions by OPEC to cut production. The experience is eerily like the plunge in oil prices in 2015-2016 and a related two-week plunge in stock prices that triggered fears of a meltdown in the energy sector (see Exhibit #1 below courtesy of Investing.com). The only way that OPEC can influence world oil prices is to drive prices down to a level where it becomes uneconomical to produce oil in the U.S. In other words, these efforts can lead to further price declines before U.S. output falls as happened in 2016.

Exhibit #1

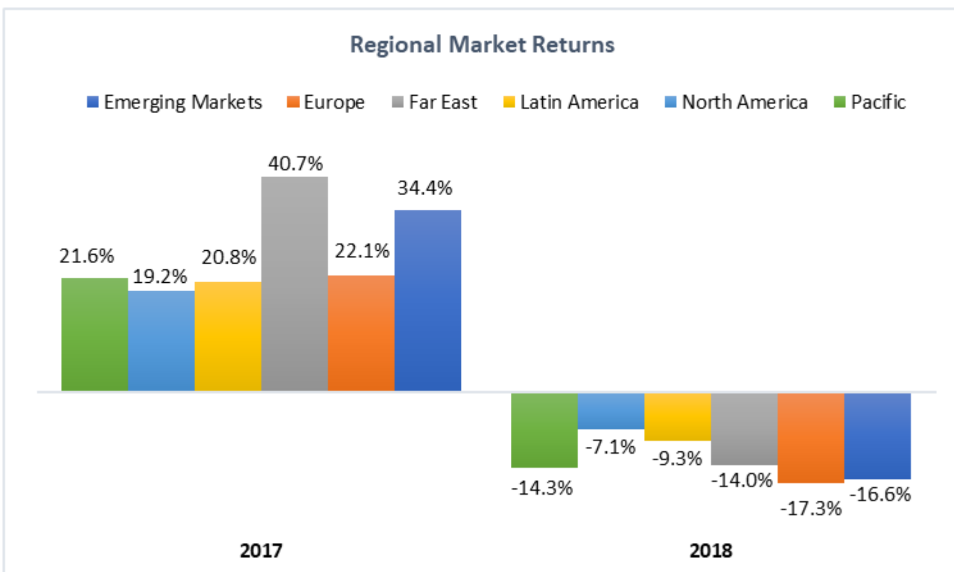


Without stable oil prices, measures of inflation are affected accordingly. Since the Fed targets a 2% inflation rate, an increase above that target can, and did, trigger the continuation of a policy of gradually raising interest rates. Note in Exhibit #2 on the next page what happened to inflation when oil prices plunged in 2015. The current oil price decline could have a similar impact on inflation in the first half of 2019, driving the consumer price index (CPI) back down toward zero or even lower. If the CPI does decline the Federal Reserve may very well reconsider its policy of raising interest rates to slow the economy. We are still encouraged to see the retracement from $75 back into the price range we forecasted last year. This range is still a fulcrum point for both inflation and oil output, and 2019 should bring lower oil price volatility as OPEC cutbacks and stable U.S. production work to keep oil prices in a range.

Exhibit #2

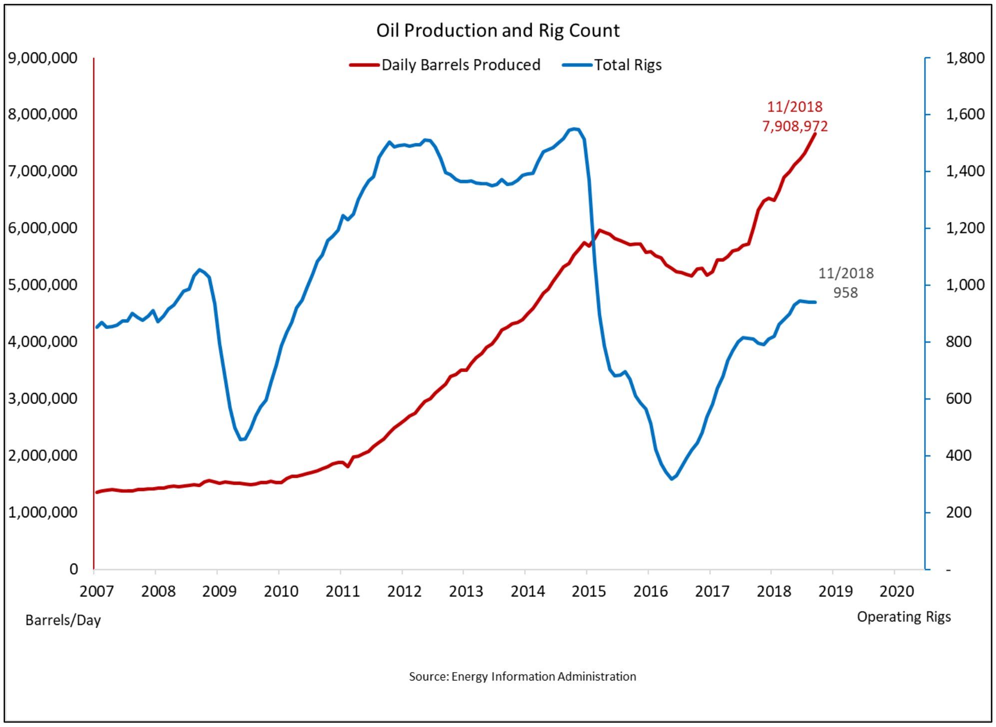


One casualty of the runup in oil prices has been foreign markets. Those countries heavily dependent upon imported oil to keep their economies operating normally were hit hard last year. The surge in oil prices knocked some of these countries' economic plans off track and stocks of these countries plummeted in 2018. These losses are after double-digit gains in 2017 as can be seen in the chart below. What a difference a year makes!!



The good news is that oil production in the U.S. is rising, productivity is increasing, and the rig count is growing as can be seen in Exhibit #3. When the U.S. imports oil U.S. dollars go to foreign vendors and continue to act as a medium of exchange in the global financial system creating wealth abroad. A shift in production means that domestically produced oil is replacing imports and the sale of domestic oil means that those dollars stay in the U.S. and, instead of circulating the global economy, those dollars will circulate in the domestic economy and create wealth here at home!

Exhibit #3



Another factor affecting equity markets has been negotiations with countries that have trade barriers against U.S. products. President Trump has successfully negotiated a new trade agreement with Canada and Mexico that lowers tariffs on U.S. goods. This new deal, known as USMCA, replaces the NAFTA agreement established in 1994 and is substantial since Canada and Mexico are our second and third largest trading partners after China. In fact, the U.S. imports 25% of all goods from these two countries. The U.S. has already implemented a 10% tariff on Chinese exports to the U.S. and officials have demonstrated a willingness to negotiate in good faith—something the U.S. is waiting for Chinese officials to do. Over the next 90 days, American and Chinese officials will continue to negotiate lingering disagreements on technology transfer, intellectual property and agriculture.

Uncertainty creates a difficult environment for financial markets. Each time there has been some indication that a trade resolution is in the wings, stock markets rally. When uncertainty increases, as it did when the second round of tariffs on Chinese goods was temporarily extended, markets declined. Moreover, economic data in coming months will be distorted because of these postponed tariffs. When a tariff is proposed current imports will increase in order to avoid the forthcoming tariffs. This shift of economic activity to the present from the future will likely lower GDP because imports subtract from that number. Economic data for the second and third quarters were, therefore, distorted negatively. A similar phenomenon is occurring because of the perceived 15% tariff to be effective early in 2019. The pending tariff is distorting economic activity in the third and fourth quarters.

Another economic reality is that tax reform made the U.S. more competitive in world markets, pushing the dollar higher. Dollars that are used to purchase an ever-increasing amount of domestic goods means that there are fewer dollars in foreign markets to provide liquidity for transactions. Back in the Reagan years, the impact of tax cuts triggered a run into the dollar as you can see in Exhibit #4. Between 1980 and 1985 the dollar had appreciated by about 50% against the Japanese yen, Deutsche Mark, French Franc and British pound, the currencies of the next four biggest economies at the time. The Plaza Accord was established to allow those countries to depreciate the U.S. dollar against the Japanese yen and the Deutsche Mark in order for the U.S. to regain global competitiveness. This agreement was replaced by the Louvre Accord in early 1987 which aimed to stabilize the international currency markets and halt the continued decline of the U.S. Dollar. The value of the U.S. dollar has been somewhat less volatile since that time.

Exhibit #4: The Value of the U.S. Dollar

The Federal Reserve and Interest Rates:

The Federal Reserve had promised to gradually raise interest rates as the U.S. economy expanded. They have since raised the Fed funds rate ¼% three times in 2017 and four times in 2018, bringing the current rate to 2.5%. The Fed's concern is that the Fed funds rate has been too low for too long and that a return to some equilibrium level would produce modest inflation accompanied by reasonable economic growth. This policy of monetary gradualism would appear to be the best way to achieve this goal. However, equity markets recoiled in the face of the last rate increase on December 19th. Although the rate increase was widely expected, the Dow Jones Industrial Average swung over 900 points during intra-day trading. Despite higher short-term rates, long-term interest rates continued to fall as measured by the 10-year government bond yield that peaked in the third quarter at 3.23% and then declined to 2.79% by year-end.

The bond market is signaling slower economic activity partially as a result of a general global slowdown that is expected in 2019. Several foreign central banks have declared they are terminating their quantitative easing programs and several countries have established austerity programs that tend to lower economic growth rates. The OECD's (The Organization for Economic Cooperation and Development) November economic outlook forecast a slowing of global growth in 2019 to 3.5% down from 3.7% in 2018.

For the Foreseeable Future:

As the New Year rang in, equity markets were not reflecting the same positive outlook that is forecasted for 2019. The fourth quarter collapse in stock prices is reminiscent of the one-day collapse of stocks in October of 1987 and the one-hour stock collapses of the Flash Crash 1 in May of 2010 and the Flash Crash 2 in August of 2015. The dynamic swing in stock prices on an hour-to-hour basis suggests that the normal buying and selling of individual stocks has been replaced by formula-based computer trading where massive amounts of sell orders are hitting markets with a lack of buyers. An old-time institutional investor who has been in the markets as long as we have (and we don't want to say just how long!) calls this environment the "Vacuum."

One offsetting factor to this recent decline could be the start of institutional portfolio rebalancing where some have estimated that over $90 billion will flow into stocks. This inflow is expected as portfolios are strategically rebalanced to reflect the decline in stocks and the rise in bonds. We also estimate that there is additional demand for stocks coming from separately managed accounts that are also subject to rebalancing at the beginning of the year.

This time last year we had expected the equity market as measured by the S&P 500 to be trading close to 2,900 not far from the high of 2,930 achieved in September. Recently the index traded around 2,468 substantially below our expectation even though the fundamental factors that we rely on—economic growth, low inflation, low interest rates and strong corporate profitability—have been delivering as expected. We attribute the difference between forecast and actual results to uncertainty surrounding a bizarre series of events and forced equity selling through year-end.

One considerable beneficiary of this stock market decline has been corporate America. Companies with stock buyback policies have been able to repurchase billions of dollars of their own common stock at a discount. They have also deployed their cash to purchase other companies thus reducing the amount of equities outstanding. Maybe every bull market in stocks that has benefited from record low interest rates has to go through a cleansing period where speculators are weeded out so that long-term investors can benefit. We are still proponents of the fact that we are in a long-term secular bull market like we experienced from 1949 to 1968 that can experience 15-20% declines along the way.

Don't underestimate the fact that the economy's fundamentals remain healthy with strong corporate profits, very low unemployment, rising wages, a reasonably strong dollar and high business and consumer confidence. Add in Mr. Market's metrics: today's PE ratio is below the 60-year average of 16.9x and about equal to the PE ratio just prior to the onset of the Great Recession. Relative to the current yield on 10-yr Treasuries of 2.56%, stocks now boast an earnings yield that is considerably higher. Looking ahead, the S&P 500 is priced to a mere 14.4x one year forward expected earnings. During a year in which the economy has grown 3%, stocks have fallen from an arguably over-valued level to now an outright cheap one--the market is grossly oversold, and the long-term secular trend remains bullish. Short-term, technical and sentiment factors indicate that the market has reached a lower-risk, higher-reward juncture point. There is nothing to fear but fear itself.

Conclusions:

As we look at our cloudy crystal ball, we see the following for 2019:

- ✓ A continuation of economic growth in a range of 2.50-3.00%
- ✓ Oil prices stabilizing between $45-$60 per barrel
- ✓ Low inflation between 1-2% or lower depending on how long oil prices stay low
- ✓ Stable long-term interest rates with the 10-year government bond yielding 3%
- ✓ An acceptable resolution of the tariff wars between the U.S. and China
- ✓ Moderate growth in overall corporate profitability (ex the energy sector)
- ✓ A rally in stock prices back to the record levels achieved in September of 2018
- ✓ Continued volatility until global uncertainties unwind (Brexit, Trump, etc.)

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