VICTORIA
Capital Management, Inc.

Financial Markets Perspective

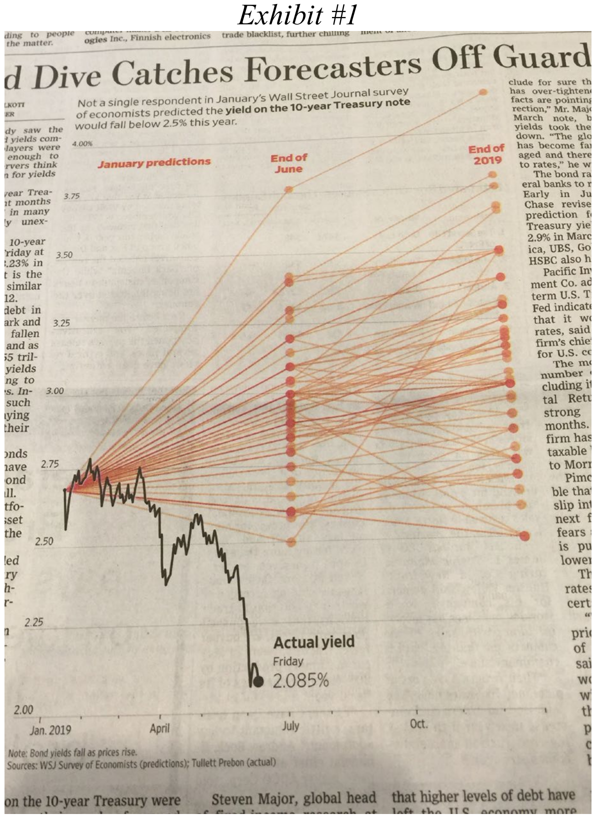
July 2019

Is Capitalism Back?

Trying to Rationalize the Longest Bear Market in Bonds

At this writing, the current economic expansion is the longest in U.S. history – greater than ten years and counting. Looking at traditional business cycles, this expansion is not only a record but one that has been characterized by low inflation, low unemployment and low interest rates. Even the professional economists can't figure this one out. Take for example the inaccuracy of interest rate forecasts provided by economists at the beginning of the year. How could these guys be so wrong? After a couple of weeks of being on the mark, the forecasts began to fray as interest rates plummeted as can be seen from the black line in Exhibit #1 below, a feature article from the Wall Street Journal. The orange lines are the economist's predictions for July and December of this year.

Exhibit #1



Ten Wall Street economists predicted a year-end range of 2.75% to more than 4%! At the end of June, the yield on the 10-year Treasury note had fallen to 2.01%. Go figure!

The shock to the financial community of this unexpected interest rate "U-turn" is blamed for an about face by the Federal Reserve. Through December of last year, the Federal Reserve had been raising interest rates since 2015 for a total of 2.25%. The rationale for this policy was traditional: slow the economy before inflation begins to rise. "Too many" people working caused the Fed to be concerned about "cost-push" inflation where labor gets the blame. Yet, we have seen rising wages, too many job openings and a falling unemployment rate to a low of 3.6% -- so what is the Fed to do? President Trump has called for a cut in the fed funds rate, but other economic statistics do not support such a notion. For example, most economic statistics continue to confirm ongoing economic growth. And a cut in the fed funds rate will lower the borrowing costs of speculators who are known for triggering market volatility. We would prefer to see stability in the fed funds rate precisely for this reason.

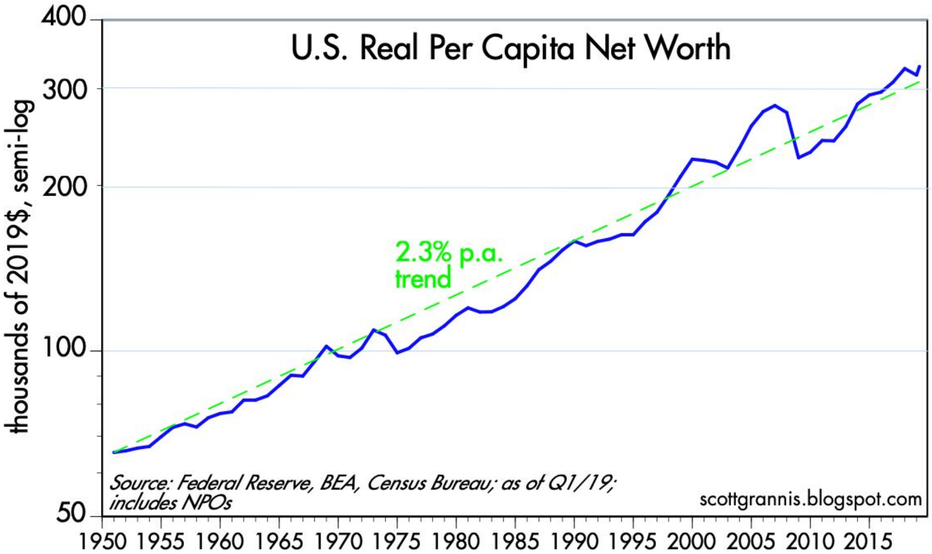
Although the bull market in bonds has benefitted the global consumer by continuing to provide record low interest rates, the retiree who is reliant upon income from their investments has been hurt. For these folks, this period has been a very long bear market as coupons and reinvestment rates continued to fall. Buying a bond today locks an investor into extremely low interest rates. Investors could capture some capital appreciation but any reinvestment in new, lower yielding bonds would offset those gains. On January 1st of this year, the yield on the 10-year government bond was 2.69%-- by the end of June this rate had fallen to 2.01%.

There are two possible explanations for this unusual development. First is the anticipation by Wall Street economists of a coming recession. Some forecasters see a recession (two consecutive quarters of declining real GDP) either late this year or in 2020. While there are a few economic indicators showing such weakness, this belief could be a result of the tax cut adrenaline shot of 2017. High yield bonds, a usual predictor of economic problems ahead, continue to do well and are not signaling difficult times ahead. Second is that inflation remains unusually low for this stage of the business cycle. If inflation expectations remain low, market participants are willing to accept a lower nominal bond return reflecting scarcer fears that interest rates will rise due to higher inflation prospects.

These rationalizations are related to traditional business cycles. Over the past few years we have postulated that we are not in a traditional business cycle but at the beginning of a new secular trend that began with the invention of "fracking" that has ushered in an era of wellbeing for America. The "Energy Renaissance" began around 2012 when fracking accelerated and the production of oil and gas in the U.S. exploded. The importance of this phenomenon and the follow-on increase in oil production cannot be underestimated. In mid-2012, production of crude oil in the U.S. was 6.2 million barrels a day. By mid-2019, that number had grown to 12.2 million barrels according to the U.S. Energy Information Administration -- an increase of 6 million barrels a day!

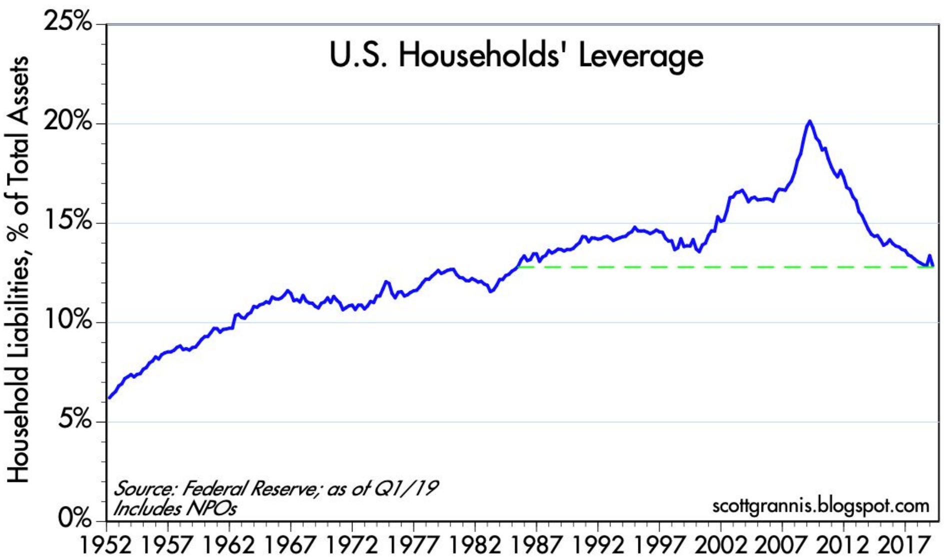
The price of oil is approximately $60 per barrel, so the contribution to the U.S. economy of this surge is $360 million a day! This increase effectively replaces much of the oil that had been imported from OPEC and other oil producing nations. By shifting purchases to U.S. producers from foreign ones, billions of dollars remain in the U.S. thus increasing the wealth of Americans rather than Mideast oil producers. The bottom line is that Americans are richer-- ushering in a healthy level of wealth as can be seen in the following exhibit.

Exhibit #2



As American wealth increases, there is a reduced need for borrowing or financing. Despite high levels of student debt, consumers, in general, have been deleveraging since 2009, meaning that they are paying off their debts. Exhibit #3 below reflects this fact. Household debt as a percent of household liabilities has fallen from over 20% at the beginning of this economic expansion to about 13% today.

Exhibit #3

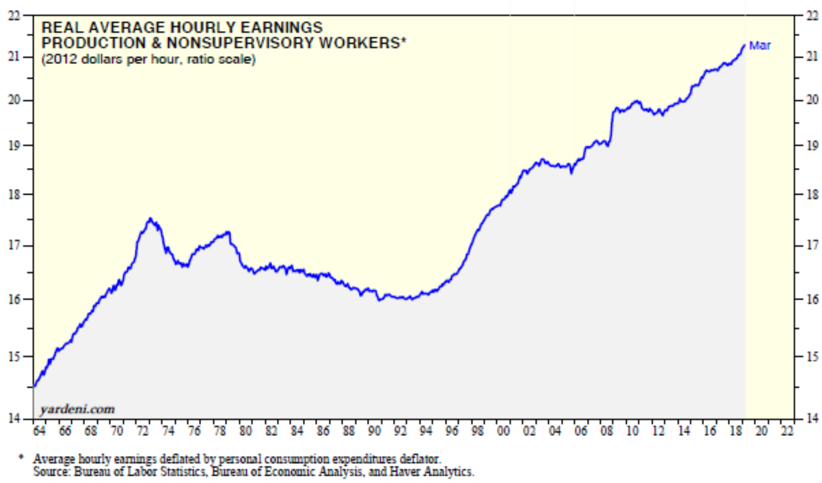


How important is this deleveraging trend to the resurgence in capitalism? Even with a surge in federal debt as a percent of GDP, interest rates remain in a downtrend. Deficit boogeymen have continued to warn us that federal budget deficits will lead to higher interest rates, yet the opposite is occurring. Rising domestic consumer wealth is reducing the need for government budget deficits and is creating a rising savings pool thus putting further downward pressure on interest rates.

Some argue that income inequality has been increasing thus widening the gap between the "rich" and the "poor". This cliché is inaccurate in that it ignores the fact that today rising domestic oil production "tides are lifting virtually all boats." Increasingly the number of Americans doing well in this growing economy is swelling and that includes most minorities.

One measure of the broadening of consumer wealth is reflected in Exhibit #4, where the real (inflation-adjusted) average hourly earnings of production and supervisory workers reached a record high in March and continues an uptrend that began in 2012—again, the date is coincident with our identification of our Energy Renaissance theme.

Exhibit #4



The excitement about how fracking is increasing domestic wealth should grow as the recognition of what is happening becomes widespread. As domestic oil production continues to surge along with the production of increasing levels of natural gas that is liquified and exported, domestic wealth will continue to grow. The broad need for borrowing will shrink and interest rates could fall further.

For investors seeking safety in fixed income securities, this fall in yields make most fixed income investments risky in the sense that there is the possibility that interest rates could rise. The total return on such "safe" investments may turn negative after considering inflation and taxes on those interest payments.

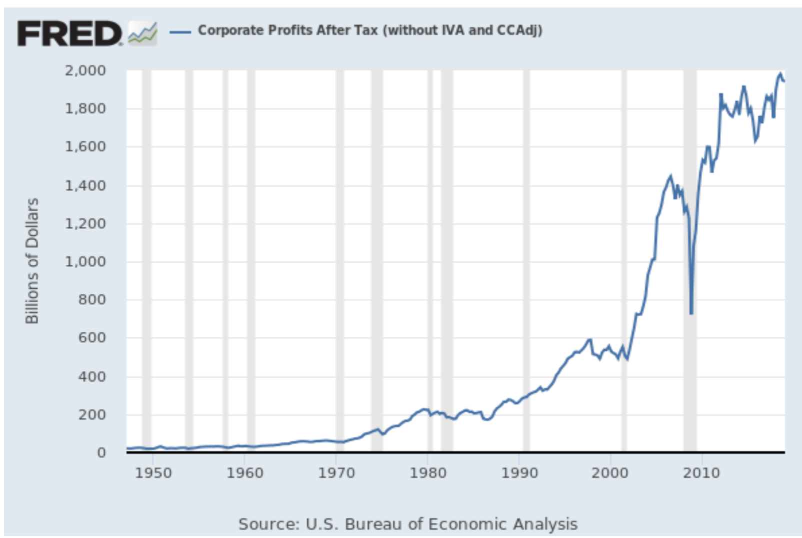
Trying to Rationalize the Longest Bull Market in Stocks

The S&P 500 index set a record high in June with other domestic indices following to new highs in July. Even though market returns year-to-date are well-above average for the first six months of the year (with June being the best since 1955 for the S&P 500!), market observers are still wary about where equities are going as reflected by substantial equity outflows in May. Cash holdings soared and had the biggest jump since 2011. The rationale for selling equities was concerns about the ongoing trade war, a possible recession and inefficient monetary policy. The fact that these concerns did little to deter the market advance offers hope that the end of the bull market is far away even though global political and economic turmoil keeps us vigilant.

We extend the secular Energy Renaissance theme that is affecting interest rates and the bond market to equity markets. Obviously growing consumer wealth as reflected in our previous exhibits on consumer net worth can provide the wherewithal for consumers to buy stock for investment purposes.

Complementing growing consumer wealth is growing corporate wealth. One measure of that wealth is growth in corporate earnings. The tax rate cuts, especially for corporations where marginal income tax rates were reduced from 35% to 21%, gave corporate earnings a major boost in 2017-2018. Corporations have also been a major beneficiary of lower interest rates, allowing them to refinance a major portion of their long-term debt and reduce interest costs in the process. Exhibit #5 provides a picture of how corporate profits have zoomed to record levels in recent years. Corporations have used this surge in profitability to raise dividends, buy back company stock, and acquire or merge with other companies. Workers have also seen an increase in their compensation at a time when inflation remains unusually low allowing them to benefit from higher real earnings growth.

Exhibit #5



In the short run, the tariff wars are causing uncertainty about the outlook for the economy, both domestically and abroad. As a result, corporations are slowing their expansion plans until the tariff turmoil is resolved. At this point we don't have a clue as to the ultimate resolution of these trade disagreements. Until solutions are evident, corporate profit growth may pause and companies directly exposed to the tariff wars will suffer proportionately.

Even the federal government is playing an important role in a bullish outlook for corporate America. Large budget deficits at a time when government revenues are expanding signals an expansive fiscal policy that will keep the economy on a growth path. J.P. Morgan estimates that budget deficits will average 4% over the next few years, a level that should keep the economy in good shape. Reduced federal regulations will have an ongoing positive effect on corporate earnings, although such a contribution will be hard to measure. Forecasters continue to expect slowing economic activity, a reasonable assumption after the bump in growth due to the tax cuts. Slowdown however does not equate to a recession and forecasters have already been fooled by surprising economic strength in the first quarter of this year.

The Challenges Facing Global Growth

While the political focus has been on the U.S./China tariff wars, the Trump global trade strategy has caused a stir among just about all industrialized nations who trade with the United States. Almost every day we read about another trade battle. The latest fight is between the U.S. and India. Here we go again… These disturbances are undermining global growth and the OECD (Organization for Economic Cooperation and Development) continues to lower its growth forecast as a result of the uncertainty surrounding how these tariffs will change the business environment.

In the early days of tariffs, the idea was to protect domestic industries from foreign competition. Suddenly, for the colonies, duties became a source of financing for a new national government. After World War II, the U.S. adopted a soft line and a policy of low or minimum tariffs on most imports. Over time, most countries levied excises on one another for numerous goods. Consumers benefitted from being able to buy “cheap” imports while U.S. exporters found themselves frozen out of many foreign markets. Not until President Trump came along was there any focus on these commerce inequalities. We are in an important transition among global trading partners. The best outcome would be no tariffs at all. The likelihood of that happening appears slim at this point as most countries are not ready to give up protection for many of their industries. In this interim period, ongoing negotiations may produce an ultimately favorable solution but, in the meantime, we see an impediment to strong global economic growth.

During June, we came close to another confrontation with Iran over the downing of a U.S. drone over the Gulf of Hormuz. The retaliation was underway before the U.S. recalled its attack force. This reversal contrasts with the missile attack launched into Syria in 2017 when the report of a chemical attack on civilians was launched by the Syrian regime. This reversal may provide a less tense atmosphere where global leaders give President Trump credit for taking global confrontations down a notch.

Conclusions

The U.S. economy has never been in better condition. Record low unemployment, rising real wages, record corporate profits and favorable fiscal policy all add up to a continuation of this record economic expansion and the bull market in stocks. There will be events in the short run that will guarantee market volatility but that is nothing new. Now, more than ever, the focus must be on the long-term. The growing power of the U.S. in the energy sector will be the key determinant of the rising standard of living in America. We may not see that today, but the transformation is gradually occurring.

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