VICTORIA
Capital Management, Inc.

Financial Markets Perspective
October 2019

America is Great…Still!

The Economy

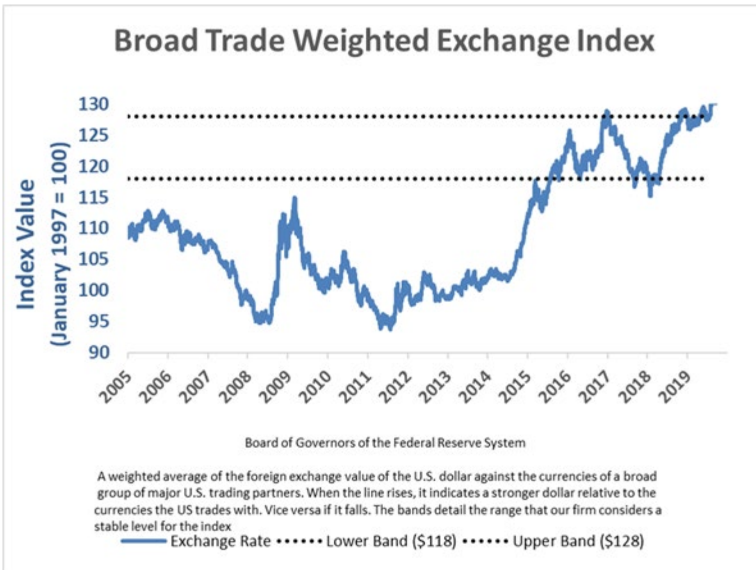
The primary concern on "Main Street" is the "R" word and economists and investment managers are split among three camps. One camp blames tariffs for the increased uncertainty that will trickle down to the economy leading to the feared recession. The second group wants to discredit the president's tax rate cuts and deregulation. The third camp has been predicting a recession ever since the last one ended! According to Brian Wesbury, economist for First Trust Advisors, total U.S. trade in goods and services was $4.9 trillion in 2016. In the past twelve months, it was $5.7 trillion, an increase of 14.5%! So, trade is growing faster than the economy. The problem with the failed economics of President Trump theory is that since the tax cut was enacted at the end of 2017 inflation-adjusted business investment in equipment has grown at a 3.4% annual rate and real business fixed investment has grown at a 4.5% annual rate. These are respectable numbers. Lastly, the perpetual recession neurotics will always find something to worry about. For every data point that signals an economic downturn, there are nine that don't.

Other arguments for continued growth in the U.S. are that labor productivity has surged to almost a 3% annual rate for the first six months of this year. Slower growth in jobs has been accompanied by faster growth in the average worker's value-added. This value has contributed to rising productivity over the past several years after having been dismally weak for most of the current expansion. Unemployment claims, which typically begin to rise in advance of recessions as businesses sense a deterioration in their outlook and attempt to reduce expenses, are much lower than ever before. This situation is described as a virtual "jobs nirvana" by economist Scott Grannis. Additionally, wage growth has been accelerating as witnessed by growth of 3.2% in average hourly earnings--up from the 2.0% pace that prevailed in 2014 and the 2.6% pace of 2016. Finally, there are more jobs available than people looking for work, and that's been the case for over a year. Slow jobs growth these days is not a sign of a deteriorating economy but one of a healthy labor market that continues to seek out new talent.

While the "R" word is losing ground to a growing domestic economy, it is gaining ground around the globe. The latest forecast for global economic growth from the Organization for Economic Coordination and Development (OECD) is lower again; estimating global growth at only 2.9%, down from a previous estimate of 3.2%. Germany, the engine of economic growth in Europe, looks like it is heading into a recession and president Macron of France is pushing for a major tax cut to turn the French economy around. Then there is Britain, struggling over Brexit and sliding into a deadline of October 31st for the planned break with the European Union. The tariff wars aren't helping either as China's economy continues to slow in the face of the tariffs and may see continued softness as the scheduled tariffs take effect later in October. For other Far East countries the news isn't all bad. China's pain is Vietnam's gain as well as other nations that are benefiting from businesses moving out of China to avoid the current and anticipated tariffs between the world's two largest economies. If the tariffs are implemented and there is no resolution to the trade negotiations, China may experience permanent trade damage as businesses shifting to other countries accelerates. For example, Apple has recently shifted plans to build a large computer manufacturing facility from China to Texas.

An important factor to consider that is contributing to surprising domestic wealth creation and a weakening global economy is the rise in domestic energy production. When the U.S. imports less oil that is paid for in dollars, those dollars remain in the U.S. and stimulate domestic growth. As the U.S. continues to expand domestic oil and gas production it will reduce the amount of dollars circulating in the world economy.

If this shortage of dollars is accurate then the dollar is likely to strengthen putting major multinational companies at a disadvantage since a combination of higher selling prices of exports combines with adverse currency translation to lower profitability. On the other hand, falling prices of imports will increase imports and reduce inflation.



A weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners. When the line rises, it indicates a stronger dollar relative to the currencies the US trades with. Vice versa if it falls. The bands detail the range that our firm considers a stable level for the index

Financial Markets

The third quarter in financial markets was characterized by volatility—investors' worst enemy. After an above average year for markets through the end of July, president Trump announced additional tariffs on Chinese imports, triggering a fall in stock prices across the board. Even with the turmoil, equity markets are still experiencing above average returns through the end of September with the S&P 500 up 20.6% so far this year, the Dow Jones Industrial Average up 17.5% and the NASDAQ up more than 20%. All market capitalizations have double-digit returns year-to-date with mid-caps leading the way. Information technology, real estate and utilities are the top sector performers though the end of September.

Going forward, earnings reports during the month of October will be an important factor in the direction of stock prices for the remainder of the year. Remember that last year's fourth quarter was bad news for stocks as the S&P 500 fell more than 13% and other indices had similar negative returns. If this fourth quarter can weather the tariff storm, then 2019 should go down as an above-average year for stocks.

Foreign equities continued to enjoy positive gains so far this year with the Netherlands and Switzerland (+23%) leading the way in developed markets and Russia (+29%) and Taiwan (+16%) outperforming in the emerging markets arena.

Analysts are currently projecting S&P 500 earnings growth of 8.1% for the first quarter of 2020 and 9.2% for the second quarter—an increase from the pace of growth for this year. Many on Wall Street are saying these estimates are too high. When we look at National Income and Product Accounts (NIPA) profit data, referred to as "true economic profits" by Arthur Laffer since this measure is consistent and goes back a long time, we find that from 1959 through 2001, profits averaged 6.1% of GDP, and they were mean-reverting around that value. Since 2001, however, they have averaged 8.7%, with no signs of a mean reversion to 6%. In short, corporations today are generating profits on a scale never seen before 2001. For the past 17 years, corporate profits have averaged a higher percentage of GDP than they ever saw in prior years. That translates roughly into a 40% increase in profits when measured against GDP. In a rapidly globalizing world, expanding foreign markets have allowed U.S. corporations to significantly and permanently expand their sales and profits. While we expect a modest slowdown in profits next year, the long-term view remains intact.

Bond markets are reacting to fears of a recession as interest rates have plunged to near record lows. For example, the 10-year government bond yield has fallen to 1.52% and the 30-year bond yield fell to just 2.13%! Demand for the safety of Treasury Bonds is so intense that investors are willing to pay $66 for $1 dollar worth of annual earnings. (That's the inverse of the current 1.52% yield on 10-yr Treasuries, otherwise known as their PE ratio.) As we have said in previous financial market updates, the fall in interest rates is positive for bond holders but bad news for bond investors as the principal value of old bonds rise but the income of current bonds declines. One economist has estimated that the fall in interest rates has cost investors somewhere between $500 and $600 billion in lost interest payments. As demographics continue to shift to an aging population, that loss of interest income will continue to rise. One might ask the question, is the Federal Reserve's policy of lowering interest rates capable of stimulating borrowing to offset the growing loss of income for the elderly investor? If the answer is No, then a policy of lowering interest rates to stimulate growth is likely to fail.

Conclusions

The U.S. economy continues to surprise the pundits. Record low unemployment of 3.5%, rising real wages, record corporate profits and stimulative 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. This time around it is a combination of a trade war and domestic political upheaval—short term phenomena. Now, more than ever, the focus must be on the long-term. As these dark clouds clear, the stock market should continue to trend higher. Growing domestic energy production will be the key determinant of the rising standard of living in America. Exports of both crude oil and liquified natural gas (LNG) are accelerating rapidly and bringing dollars back home that were exported to OPEC. The strong dollar and weak oil prices in the face of global reductions in output are testaments to this accelerating trend. Just how good can it get?

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