Market Musings

Volume II
2019

VICTORIA
Capital Management, Inc.

January 1, 2019

VICTORIA Capital Management, Inc.

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 2, ISSUE 1

The chart to the right shows the top 5 trading partners of the United States and the levels of imports and exports in billions of dollars. The important fact to note is that 25% of trade is with our Northern and Southern borders (Canada and Mexico) and the newly formed USMCA should benefit us all.

Tariffs and Trade: Another View

Are President Trump's "tariff wars" an opening chapter or are we halfway through the book?

Every country's producers of goods and services have a power base and they use their power to set the rules of the game to protect its industry. As an example, the latest U.S. farm bill is laden with protection for the dairy farmers and the sugar producers, just to mention two. And tariffs aren't the only tool in the "protectionists'" tool bag. Quotas and embargoes are far more punitive than a simple tariff or subsidy that simply raises the price of the product—consumers just must pay more or do without. Then there is the sticky problem of technology theft, an underhanded policy that is included in the tariff negotiations.

The bottom line is whether a tariff, or lack thereof, will be a win for producers or consumers. Obviously, both can be losers when the rules overwhelm commerce. One example is the imposition of the oil embargo back in the early 70s. Both consumers and producers suffered as prices skyrocketed and demand collapsed. Many countries rely on tariffs to augment tax revenues and the tariff's purpose of protecting a domestic industry against foreign competition gets lost in the tax shuffle. President Trump said that he was impressed with the taxes collected from his tariff pronouncements.

There may not be a truly tariff-free world environment as proposed by President Trump. Let's hope that the tenor of the "war" will not be of such magnitude that world trade will be seriously impacted as it was back in the 1930s. But, keep in mind that the U.S. is negotiating from a position of power that most other countries must respect. And while we don't expect to ever see a tariff-free world, reducing inefficiencies in global markets should be a win for producers and consumers worldwide.

"Buy when you are scared to death; sell when you are tickled to death."

Cabot Market Letter, April 12, 2001

Market Commentary

An astute market observer asked the question: "What happened?" — referring to the collapse of stock prices in December. From our perspective, the interaction of ten years of low interest rates and risk taking by investors who could borrow funds at a close to zero rate led to an enormous increase in buying on margin. When the Fed began to raise interest rates the cost of that borrowing rose dramatically. Those costs combined with hedge fund liquidations, tax-loss harvesting and algorithmic trading resulted in a selling landslide. If we have cleansed the market of a meaningful number of these speculators, 2019 could return to a more normal market environment.

Twice as many American homeowners were created in the last year as had been created in the previous 10 years. The number of US homeowners grew by 1.8 million over 12 months ending 6/30/18. *(Source: Census Bureau latest data available)*

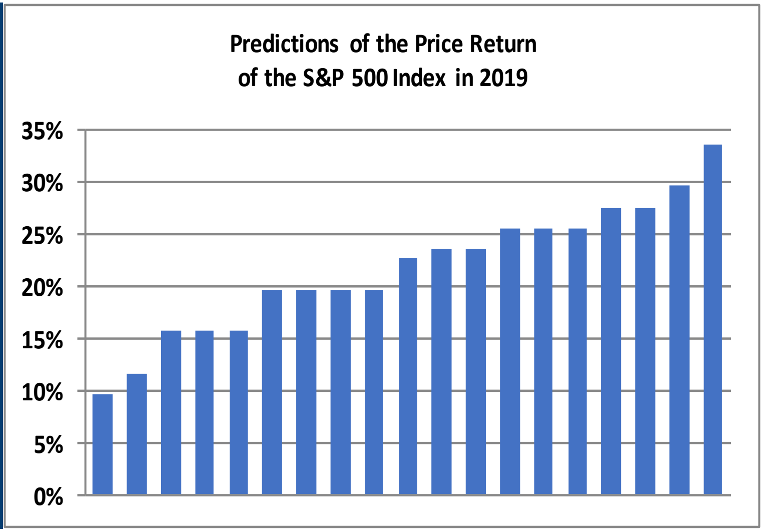
Capital Management, Inc.

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 2, ISSUE 2

The chart to the right shows the predictions by 19 major Wall Street strategists for the price return of the S&P 500 for 2019. Note that all the firms' strategists are predicting a higher stock market in 2019; with a mean prediction of 22% and a max of 34%. (Source: CNBC)



"Well done is better than well said."
Benjamin Franklin

That's What Makes a Market

One thing becomes apparent when volatility is prevalent in equity markets: differing opinions. Yes, we all have them, and some would argue that certain opinions are more "valuable" than others. Here is just a sample of some of the "valuable" forecasts opined since the December Decline:

Bullish Commentary:

"...courage will be rewarded in the equity market, just as it has for most of the past 10 years." - Bill Miller (Miller Opportunity Trust)

"Fears about a 2019 recession appear overblown. We see global growth slowing, not enough to end the expansion but enough to keep major central banks on hold." – Richard Turnill (Blackrock)

"Economic and earnings growth continue to look solid, which should help stock prices over the longer term." - Robert C. Doll (Nuveen)

"While the market environment has been challenging, we think recent weakness increases the chances of a positive market response post-tightening cycle." – John Lynch (LPL Financial)

Bearish Commentary:

"The most recessionary signal at present is consumer future expectations relative to current conditions. It's one of the worst readings ever." – Jeffrey Gundlach (DoubleLine Capital)

"...risks remain and we don't believe that stocks are yet fully in the clear—volatility will likely persist and our tactical recommendations remain modestly defensive." – Liz Ann Sonders (Charles Schwab)

James Stack, president of InvesTech Research, "believes that the worst isn't over and that the Dow and S&P 500 will soon be down 20 percent from their peaks, retreating into a bear market." – James B. Stewart (New York Times)

The one thing that is an absolute truth is that no one knows where the market is heading or when a change in the trend will occur. Expect back and forth action until the geopolitical uncertainties become more clear. However, fundamentals drive the overall direction of capital markets so a thorough analysis of global economic and financial conditions should be the basis of an investor's or advisor's opinion.

Market Commentary

Devised by Yale Hirsch in 1972, the January Barometer states that as the S&P 500 goes in January, so goes the year. When the month is positive, the indicator has been correct nearly 90% since 1950—but 2018 was an exception! Furthermore, the indicator has never been incorrect two years in a row. After a brutal fourth quarter last year, stocks across all market capitalizations had positive returns with lower volatility in January. A welcome relief as much of the country is looking for relief from the Polar Vortex. Now we can sit back and see who's predictions are more reliable: Wall Street's or Punxsutawney Phil's.

The price of oil for Saudi Arabia to breakeven and balance their budget is $88 a barrel. For Russia, the breakeven price is $53 a barrel. The breakeven price for oil produced in the Permian Basin (located mainly in Texas) is $50 a barrel. *(source: IMF, Federal Reserve Bank of Dallas)*

VICTORIA Capital Management, Inc.

Market Musings

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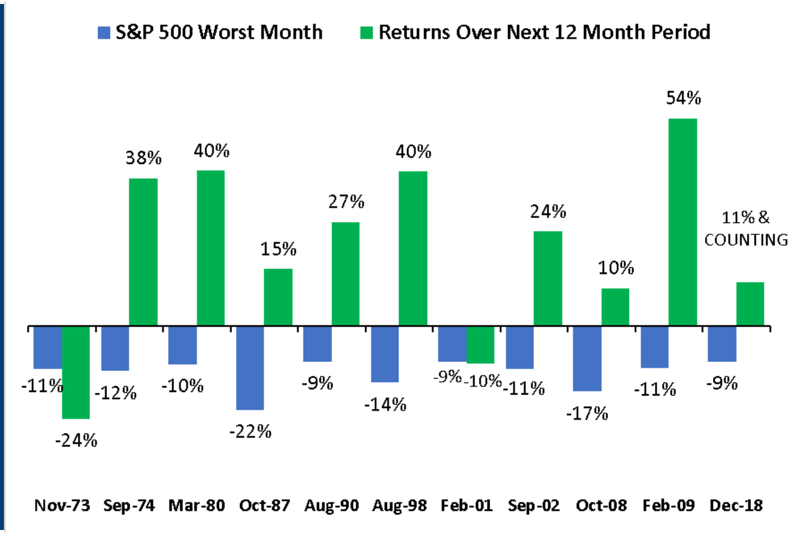
VOL. 2, ISSUE 3

The chart to the right shows the worst 11 monthly returns for the S&P 500 index in blue, including December 2018. The green bars represent the return over the following 12 months. Note that 80% of the time, returns are higher than average. We will have to wait and see what's in store for the remainder of this year.



"'Don't tell me what you think, tell me what you have in your portfolio "

Nassim Nicholas Taleb

Some Things Are Certain

Volatility is a common concept in the investment industry but is often misrepresented as the primary concern of investors. Defining risk is important since professional investment managers are getting paid to take risk. First, "risk" is different for everyone. Some investors do not like large swings in the value of their portfolio, which is understandable. The important differentiation here is that most investors consider large upward movements advantageous. So what then is volatility if it is not risk? Volatility in an investment portfolio is measured by standard deviation; a backward looking measure that calculates the degree of variation among the entire group. This definition describes how large the changes in returns are from the average return, but does not differentiate between positive and negative outcomes. By not distinguishing between good and bad results, how can this measurement truly give an investor an idea of how much risk is being taken? The short answer is that it can't. Volatility can only tell you how much return variation there is, not whether it is good or bad variation. Most measures of portfolio risk are incomplete, at best, and nearly worthless or confusing at worst. The three most common risks for investors are described below:

1. **Underfunding:** Not contributing enough assets to meet future liabilities.
2. **Underperforming:** Investing in a portfolio that is too conservative to grow assets to meet future liabilities.
3. **Black Swan Events:** Events that have never occurred before and were not expected to happen.

While most common measures of risk have a place in portfolio analytics and manager selection, investors must dig deeper and define risk on a personal level. Investing in securities contains some level of uncertainty and there is no "free lunch." Uncertainty is an expected part of investing. Do not confuse "risky" events that are certain or expected with actual risk, which is the unknown, black swan event that cannot be managed or diversified away. Investors need to focus on saving enough, finding a strategy that has the ability to meet future needs and ignoring the "noise" that comes along the way.

Market Commentary

The stock market is off to its best start since 1987, surprising everybody—especially the bears who predicted the end of the bull market. Not so fast. Let's put one and one together: companies are reporting healthy earnings and revenue growth with only a slight slowdown on the horizon. Why would anyone continue to be bullish 9 years into a bull market? The answer is easy: the stock market is shrinking and demand from corporate buybacks will keep the market on an upward trajectory. Corporations will buy back roughly $700 billion of stock this year and maybe more next year!

Nearly 70% of 1,000+ adults surveyed in January 2019 think that they will be in a better financial situation in January 2020. This figure is within 2 basis points of an all-time high that was reached in March 1998. *(Source: Gallup)*

April 1, 2019

Victoria Capital Management, Inc.

Market Musings

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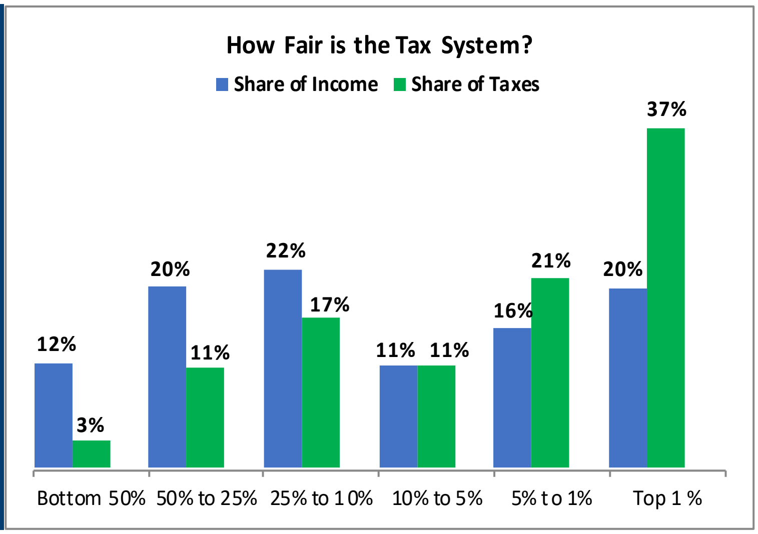
VOL. 2, ISSUE 4

The chart to the right shows the share of income and share of taxes for different percentile groups in the U.S. *(2016)*. Note that the top 1% paid more taxes than the bottom 90% combined and that the bottom half of income earners paid only 3% of all federal income taxes.

(Source: taxfoundation.org)



The Furor over Taxes

Suddenly, massive tax increases on the "rich" have been proposed by politicians who plan to change the way our financial system functions. The first offering was to raise income tax rates on the "rich" to 70%. The next proposal was to raise estate tax rates to 92% on the "rich." Another novel idea is a wealth tax on the "rich".

The question is: Do higher taxes on the wealthy make everyone else better off? Over the past fifty years there have been three major tax rate reductions. The first one was the Kennedy tax rate cuts enacted in 1965 that reduced the top personal income tax rate from 91% to 70%. For the wealthy, this cut was a windfall since their after-tax income went up from 9% to 30% of what they earned.

The next major tax rate cut was implemented by President Reagan who reduced the highest marginal personal income tax rate from 70% to 50%. He also reduced the capital gains tax rate to 20%, the lowest rate since the Hoover administration. His second major reduction in the maximum personal income tax rate was to 28%!

The third major tax rate cut was implemented by President Donald Trump. While the maximum personal income tax rate was only reduced from 39.6% to 37% (the rate had increased due to tax increases imposed by presidents Clinton and Obama), the corporate income tax rate was reduced from 35% to 21%! These tax rate cuts have contributed and will continue to contribute to healthy businesses and consumers.

What impact did all these tax cuts have on the economy? Thanks to the tax cuts (and deregulation) the economy boomed last year and enjoyed its fastest rate of growth since 2005. Unemployment is at record lows. Real wages are finally starting to increase after a long sleep. The after-tax user cost of capital, or a business's cost of making additional investments, fell 10%. And, contrary to official forecasts, the labor-force participation rate rose, reversing years of decline. There are 1 million more jobs available than there are unemployed workers. All in all, the tax rate cuts increased the amount of disposable income and contributed to the increase in private wealth to its highest level in history.

"The wisdom of the ages is the fruits of freedom and democracy."

Lawrence Kudlow

Market Commentary

Stocks rallied for the first quarter of 2019, recapturing most of the declines of the fourth quarter of 2018. Bonds also rallied on the back of the Federal Reserve's decision not to raise interest rates. The U.S. is in an economic world of its own. A global economic slowdown is being fueled by slower growth in China & Europe and predictions that the U.S. is headed for a slowdown, possibly even a recession. This argument reflects political and ideological thinking, not a substantive analysis of the domestic economy. April is normally a good month for the stock market but until a trade war resolution, expect additional volatility. Earnings season is arriving and will shed a brighter light on corporate profitability.

The 12.8 million manufacturing jobs in the United States as of February 2019 is the nation's largest total since December of 2008.

(Source: Dept. of Labor)

Victoria Capital Management, Inc.

Market Musings

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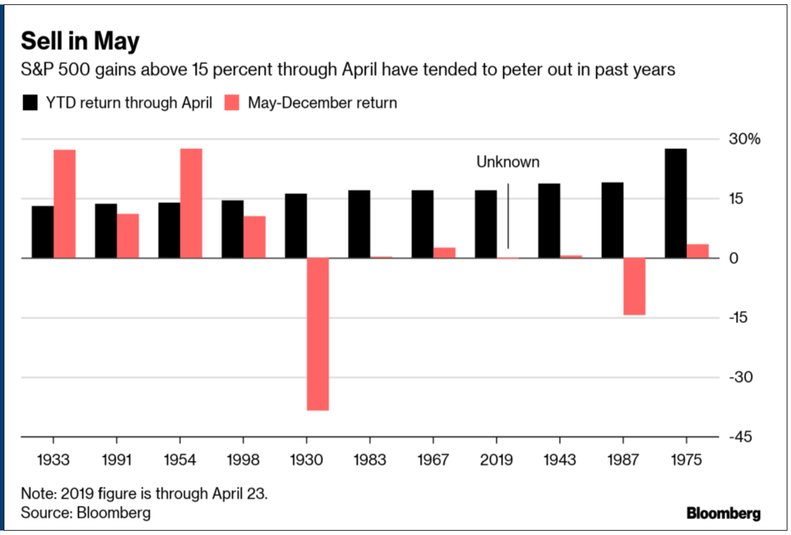
VOL. 2, ISSUE 5

The chart to the right shows that when the S&P 500 has returned more than 15% through the end of April, the return from May to December tends to be lower. As we enter summer, trading activity typically declines and volume drops making it difficult for individual investors to get good prices.

(Source: Bloomberg)



Sell in May and Go Away?

This saying is one of several old financial-world adages, based on the historical underperformance of some stocks in the "summery" six-month period commencing in May and ending in October, compared to the "wintery" six-month period from November to April. The fact is, however, the practice of selling in May and "going away" is for traders, not investors, and should be ignored by long-term shareholders. According to Mark Hulbert, a well-known market observer, the statistical significance of this adage relates only to the third year of a presidential cycle—meaning this year! The other three years are statistically insignificant. Giving additional support to this adage in 2019 is that the stock market is hitting new highs after double-digit growth rates through the end of April.

Another "gimmicky" barometer that sports fans may follow is the Super Bowl Indicator which states that if the NFC team wins the Super Bowl the market closes up for the year and if an original AFC team wins, then the market closes down for the year. One would think that the success of the AFC's Patriots over the past two out of three years would signal hard times for the market and that last year should have been positive with the NFC's Eagles win but it wasn't. And in 2017 the Patriots beat the Falcons and the market went on to a strong gain. This looks like a year when the adages and indicators have an easier time of being right. Just when the speculators thought they had one-up on the market.

Should you follow the calendar or the Super Bowl outcome when investing in the stock market or a time-tested investment discipline? Fundamentals matter more than adages and, while there may be some ups and downs in coming months, there is no logical reason why the bears will dominate the summer. Strong economic growth, surprisingly strong earnings' gains and low inflation support a better market environment. One factor that keeps us smiling is the lack of euphoria that characterizes market peaks; through the first quarter of 2019, fund flows favored bonds (+$110.2 billion), international stocks ($3.2 billion) while ignoring U.S. stocks (-$16.5 billion). As far as adages go, don't sell your stock portfolio until your barber starts telling you which stocks you should be buying.

"A weak currency is the sign of a weak economy; and a weak economy leads to a weak nation "

H. Ross Perot

Market Commentary

And the beat goes on! The S&P 500 continued its remarkable move higher last month on the back of positive first quarter earnings and healthy economic data releases closing at a record high of 2,946 for the first time since September 2018. To put the strength of the rally into perspective, the S&P 500 is now up 18.25% year-to-date through April 30th which marks the best start to a year since 1975 and the second best start over the last 75 years!

This rally seems to confirm that 3.2% annual growth in the economy is sustainable. Another surprise, to most, is that inflation and interest rates are going down even when oil hit $67 per barrel in one of the longest economic expansions in history. After such a positive run, a consolidation is likely but we remain positive on the equity market longer term and would use any near-term weakness as a buying opportunity.

45% of the 76 million "Baby Boomers" in the USA have NO retirement savings.

(Source: Insured Retirement Institute)

June 3, 2019

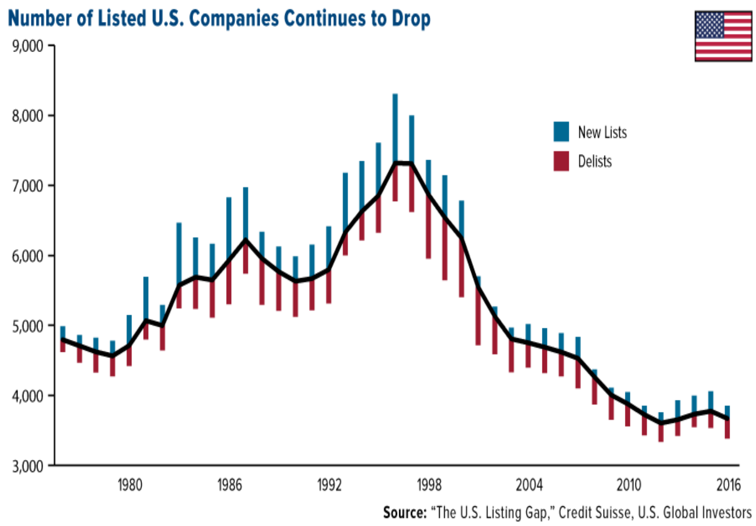
Victoria Capital Management, Inc.

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 2, ISSUE 6

The chart to the right shows the number of new listings and delistings of U.S. companies on U.S. exchanges. The solid black line represents the total number of domestic public companies. The number of U.S. public equity securities has decreased sharply since the late 1990s.



The Incredible Shrinking Stock Market

No one pays attention to "scarcity value" when conversations about the stock market come up. Yet, the surge in corporate profitability is giving management the ability to buy back enormous amounts of stock. According to J.P. Morgan, corporate buybacks approached $950 billion in 2018 and, so far in 2019 those buybacks were on track to equal last year's record. Buybacks increase corporate profits as measured by earnings per share since there are fewer shares outstanding. In fact, the Wall Street Journal reported that buybacks increased corporate profits by 4% in the first quarter alone. But how do buybacks affect the stock market?

In the mid-1990s, there were more than 8,000 publicly listed companies. By 2016, there were only 3,627 according to the Center for Research in Security Prices at the University of Chicago Booth School of Business. While some of that shrinkage can be attributed to bankruptcies, there are other explanations. One is that the number of public firms has shrunk on the back of growing mergers and acquisitions activity: from $191 billion in 2014 steadily rising to $325 billion through the first quarter of 2018. Mergers and acquisitions have reduced listed stocks especially when realized using cash. If the economy keeps growing and corporate profits keep rising, these trends are likely to continue with the scarcity value of stocks rising. Undoubtedly, there are new companies coming to market like Uber and Beyond Meat but the number and size of Initial Public Offerings (IPOs) won't make much of a dent in this longer-term trend. Investors' money will continue to flow into quality investments, a reality that will push stock prices ever higher. Another factor that affects the number of stocks is a growing regulatory environment that interferes with the business practices of public companies. For example, managers are penalized or criminalized for failing to accurately forecast their sales and earnings. Such pressures are not present for private companies. Pressure on management to allow politicians to dictate policies is accelerating the trend to privatization. Investors who understand these trends will likely identify the candidates for going private and the price paid for these shares will provide an extra boost to returns.

"Successful innovation is not a feat of intellect, but of will."

Joseph Schumpeter
Theory of Economic Development, 1883-1950.

Market Commentary

The acceleration of the tariff tiff with China dominated markets during the month of May. Initially, stocks bounced on the news that a trade agreement was near. An abrupt turnaround in prices followed when the agreement was postponed. Then the May 10th tariff increase and further threats of tariffs coupled with a rumor that China would put an embargo on rare earth mineral exports pushed stocks lower through month-end. Interest rates plunged due to the linkage between tariffs and a slowing economy. Oil and other commodity prices also fell putting some skin on the economic bones of the brewing tariff duel. Investors will continue to focus on these short-term, political events which are somewhat predictable and preventable. Despite the summer fun between Memorial Day and Labor Day, investors need to remain engaged and patient with the market.

41% of the apparel and 72% of the footwear produced worldwide is manufactured in China.

(Source: American Apparel & Footwear Association)

July 1, 2019

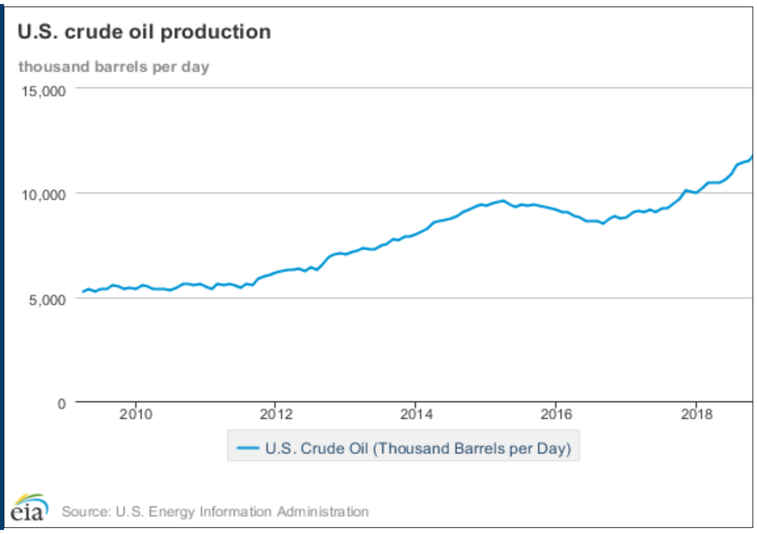
Market Musings

Victoria Capital Management, Inc.

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 2, ISSUE 7

The chart to the right shows the rapid growth in crude oil production in the U.S. We are the leader in oil production due to fracking technology. The trend is continuing and, in the process, rapidly increasing the wealth of America. Higher oil prices are no longer bad news.



The Bull Market in Stocks Rolls On

What was that old proverb about selling in May and going away? June is a good example of why we don't listen to adages. The Dow Jones Industrial Average rose 7.2% during the month and had the best June since 1938! The S&P 500 was up 7% and had the best June return since 1955! We are not only experiencing a U.S. bull market but a global one. Equity markets across the globe (except for a handful of emerging markets) had a positive June bringing year-to-date gains to double-digits for most foreign markets. These positive moves suggest that the global economy is not in as bad shape as the forecasters contend.

Imagine what stock markets might look like if we got a reasonable resolution of the trade wars. No more uncertainty and renewed optimism would likely benefit consumers. Maybe that outcome is what global investors are betting on. President Trump's meetings with North Korea's leader Kim Un Jong, Russia's leader Vladimir Putin and China's leader Xi Jinping at the G20 meeting in Osaka, Japan suggests there is a "cooling off" period that may lead to fruitful trade negotiations. The equity markets seemed to signal that investors are satisfied that the meeting went well enough and pushed stocks higher on the first trading day since the summit.

Usually the summer months are characterized by generally weaker equity markets. As we begin the second half of the year and the end of the first decade of the 21st century, we expect a continuation in the positive trend that should take equity markets to new highs by the end of this year. Our optimism is based on record low unemployment, rising real wages, low inflation and low interest rates. Keep your eye on corporate earnings reports early in July as an indicator of what sectors of the market may assume leadership for the rest of the year. While earnings may have passed their peak for this cycle, they are still close to record highs and may slow but should not turn negative for the foreseeable future. The only fly in the ointment might be a strengthening of the U.S. dollar. Thankfully over the past few weeks, the dollar has weakened and thus removing one of the threats to earnings of multinational companies.

"A rising tide raises all boats."

John F. Kennedy
35th President of the United States.

Market Commentary

While the S&P 500 surged to a record high in June, the bond market, as measured by the yield on the 10-year bond, fell below 2%. Investors can no longer count on any return from government securities when inflation (around 2%) and taxes are considered, never mind professional management fees. To save enough for retirement, investors will have to look at taking the risk of investing in the stock market to achieve any meaningful return. For long-term investors, history tells us that a diversified portfolio of stocks returns about 10% per year and that number goes back to actual results from 1926. Even corporate bonds are no competition for stocks as their yield runs around 4-5% for the highest quality bonds. This low interest rate environment could stick around for a while encouraging investors to take profits in bonds and buy stocks.

The S&P 500 has gained 441% since March 10, 2009—a period of 10 years and 3 months.
(Source: BTN Research)

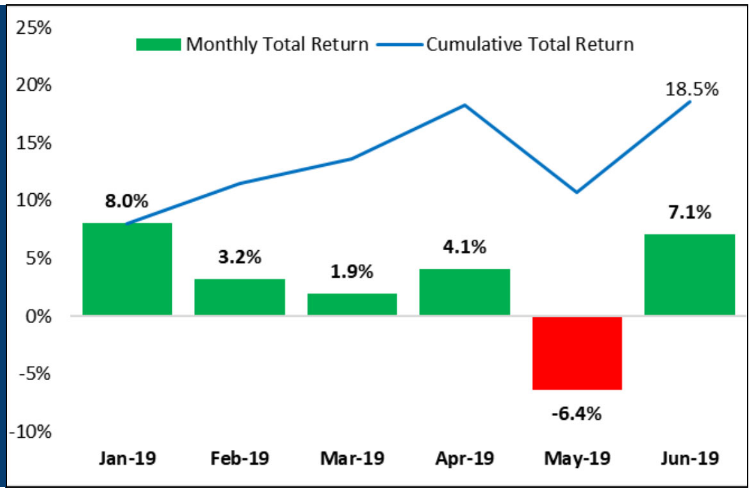
August 1, 2019

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 2, ISSUE 8

The chart to the right shows the monthly and cumulative total return for the S&P 500 index, a market capitalization weighted index of the 500 largest U.S. publicly traded companies. The Index earned 7.1% in June—the best return for the month since 1955. The six-month, cumulative gain of 18.5% is also the best first half for the index since 1997. *(source: S&P Dow Jones)*



Don't Bash Budget Deficits

The discourse between our current Congress and President Trump is like what we witnessed between President Nixon and his legislature. And, guess what? One argument was about how federal budget deficits undermine the economy. Now that 50 years have passed, we pause to look back, or are we looking forward? Since Nixon's administration, the U.S. has run cumulative budget deficits that have grown enormously (albeit with population growth) with only one meaningful period of budget surpluses in the late Nineties just prior to the 2000 recession. These deficits don't seem to be having the negative effect that many people claim. As government spending continued to climb, the economy has been the benefactor. Perhaps the size of the national debt should be measured in terms of economic growth in order to put it into reasonable perspective.

During the financial crisis in 2007, federal debt had not derailed the longest economic expansion on record. Many economists have a hard time tying government debt to government assets as most businesses and households do and the comparison is not that simple. However, liabilities (in the form of government debt) are always offset by assets (in the form of government ownership) – e.g. property, equities, bonds, etc. and the list goes on. Why is it that few economists analyzing these details can't evaluate this relationship given the underlying foundation of their education? A bit facetious, surely, but let's start simply. Take the example of when any president borrows money to pay for a new aircraft carrier. What happens next is simple; the government owns an asset (an aircraft carrier) that offsets the liability ("borrowed" dollars). In this sense, government spending is a good thing as a bigger defense department should protect us. Not to mention that the "borrowed" dollars put many to work; building, delivering, piloting and servicing the "debt" (in this case an aircraft carrier).

While business and household budgets drive the underlying economy, it is important to remember that money flows in both directions. Therefore, one entity's spending is another entity's income so a slowdown in government spending will undoubtedly hurt non-government entities. One perspective that we firmly believe is that deficit spending should not be feared.

"If you want to have a better performance than the crowd, you must do things differently from the crowd."
Sir John Templeton

Market Commentary

Equity markets around the world are experiencing double-digit returns through the end of July and U.S. equity indices are approaching a 20% gain. Bond markets, on the other hand, are another story. Rates have plunged globally, which causes a short-term increase in bond valuations. Even though there has been a wide disparity in returns between bonds and stocks, investors are still pouring their money into bonds, both domestic and foreign. The U.S. continues to have the highest "risk-free" interest rate, which is attracting foreign investors and contributing to ever lower rates. Foreign bond markets are feeling similar downward pressure. In fact, nearly 25% of investment-grade bonds across the globe have a negative interest rate.

The top five countries purchasing American exports in 2018 were Canada, Mexico, China, Japan and the United Kingdom.
(source: Commerce Department)

September 1, 2019

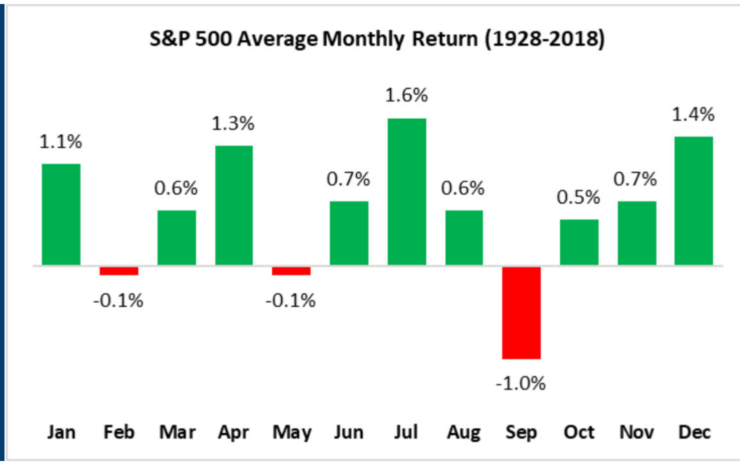
VICTORIA Capital Management, Inc.

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 2, ISSUE 9

The chart to the right shows the average monthly return for the S&P 500 index between 1928 and 2018. Note that while September has been the worst performing month historically, it leads into a fourth quarter (October to December) that has performed the best with a compound average return of 2.6%. *(sources: Yardeni Research)*



"The person who starts simply with the idea of getting rich won't succeed; you must have a larger ambition."
John D. Rockefeller

The Complexity of Tariffs and Trade

President Trump surprised financial markets in early August by announcing another round of tariffs on Chinese imports. This increase of 15% on top of the initial 10% levy brings the total rate to 25%—affecting billions of dollars of imports. What are some of the ramifications of trade restrictions? On a positive note, the federal government collects a bundle in tax revenues that may exceed $150 billion dollars per year thus reducing the federal deficit. Colonial America's tax system was founded on tariffs. When taken to extremes, tariffs such as the Smoot-Hawley tariff in the 1930s contributed to the Great Recession. As far as we can tell, the pain of a tariff war is shared by businesses and consumers. At one extreme, a trade embargo eliminates trade. In the case of the recent Chinese embargo on soybeans, our farmers take the hit and the Chinese must find another source for soybeans—probably at a higher price or be forced to eliminate soybeans from their diet. The last time we were confronted with a serious embargo was in 1974 when OPEC embargoed oil shipments to us.

Embargoes extinguish businesses while tariffs increase the cost of doing business. For example, a less painful adjustment for the consumer comes from changes in the value of a currency. For example, a falling yuan (Chinese currency also known as the renmimbi) can effectively reduce tariffs paid by U.S. consumers as the currency translation can offset some of the tariff increase. Both the producers of Chinese goods and the importer of those goods may reduce their prices to offset some of that tariff increase. To maintain short-term market share, the sellers of imported goods may lose money by reducing their prices. However, a weakening yuan will cause Chinese import prices to rise, thereby increasing consumer prices in China. Long-term, China may not be able to recover fully from the lost business as manufacturers mover their business from China to other countries in Asia.

At the end of August, there seemed to be some reason for optimism: one Chinese official admitted that tariffs benefit no one and comments from various Washington sources appeared conciliatory. Tariff talks will resume shortly, and we expect some favorable developments as the politicians see that a tariff war is not in the best interest of either party. President Trump's desire for a zero-tariff world is wishful thinking but the ongoing uncertainty of this "war" is having unfavorable economic and financial market consequences. Once we get some resolution of this discord, we expect to see a better stock market investing environment.

Market Commentary:

Stock market volatility during the month of August tested the nerves of investors. Trumped up fears of an imminent recession coupled with a volley of tweets from the president threatening an acceleration in the trade war with China kept short-term investors on their toes.

While stocks were bouncing around, bonds were on a tear as yields fell to record lows as measured by the 30- year government bond. With a yield below 2%, investors have nowhere to go. Moreover, yields on foreign government securities are in negative territory, so there is really no place to turn except for the stock market. Fortunately, the strong consumer is putting a damper on recession fears and stable oil prices coupled with low interest rates should keep a lid on inflation.

Japan recently replaced China as the largest foreign holder of U.S. Treasury debt by increasing its holdings by $90 billion in 2018. They now hold $1.12 trillion of US debt.
(source: Treasury Department)

October 1, 2019

Market Musings

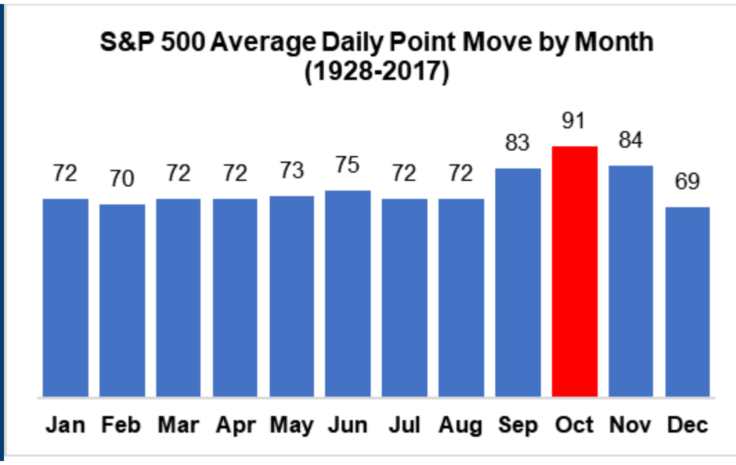
Victoria Capital Management, Inc.

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 2, ISSUE 10

The chart to the right shows the average daily point movement of the S&P 500 Index each month from 1928 through 2017. Note the heightened volatility in October with the index moving 21% more than the average and 26% more than the median.

(source: S&P Dow Jones Indices)



"More money has been lost trying to anticipate and protect from corrections than actually in them."

-Peter Lynch

Who's in The Pool?

September witnessed an unusual rotation out of large growth, momentum and low volatility stocks into value and small capitalization stocks (The Rotators). One could attribute the current shift to a decision by one or more institutional investors that the outperformance of winners so far this year was over and that owning the losers should prove more rewarding. History tells us that value stocks have had an advantage over their growth brethren over long time periods. So a move into value stocks could have been expected but the timing of such a move is fraught with risk. Then there are the income investors who might have also triggered some early portfolio rebalancing from growth stocks into value stocks that had better yields. (The Yielders).

Another theory for the rotation is that a bunch of growth stock owners decided to load up on aggressive growth stocks from the IPO calendar (Peloton, Beyond Meat, Zoom etc.) where several sizeable companies with no earnings garnered the attraction of the high rollers (The Speculators). To achieve a change in strategy, these players had to sell some of their long-term growth stock winners. Another factor for the shift was a rise in bond yields. Before September, investors appeared to be betting that bond yields would fall. And for a while, that trade worked. But the 10-year Treasury yield rose from 1.46% to 1.90% mid-month and the yield curve steepened. The rotation that we are witnessing in the equity market could be driven by volatility in the fixed-income market.

Equity market participants with varying investment objectives choose to swim in the same pool—the stock market. When investment objectives clash, unusual short-term market volatility that is unrelated to fundamentals is the result and affects the overall market. For example, on December 26, 2018 the Dow Jones Industrial Average rose a record 1,021 points for no reason except some players figured that the market's decline in the fourth quarter was overdone and it was time to take advantage of the market's slide (The Timers). Remember that the stock market is secondary in that there is a place where buyers and sellers meet. When there are too many of one or the other, market prices reflect that imbalance. For short-term investors (The Gamblers) there are opportunities or risks presented by this volatility. Long-term investors (The Planners) also have opportunities to take advantage of these price swings and buy good companies for lower prices.

Market Commentary:

The stock market as represented by the S&P 500 index, continued to consolidate during the month of September -- moving sideways just above its 50-day moving average and just below new highs. Beneath the surface, a rotational shift continued to play out. The tech-heavy Nasdaq underperformed slightly, due to former leaders' software and IT services giving back some of their strength. Despite leadership underperforming, information technology stocks remain fine as former laggards' semiconductors and hardware have been trending higher. Additionally, some cyclical sectors like banks and industrials have been holding up well. As the volatile October begins, be sensitive to development on the tariff front as a driver of further stock market opportunities.

The ratio of total public debt to total government financial assets has decreased by 27% since 2004; with debt increases of 192% being offset by asset increases of 300%.

(source FRED St. Louis)

November 1, 2019

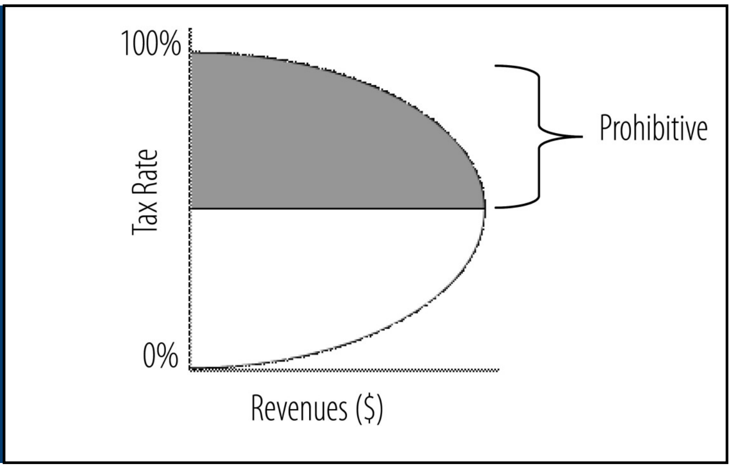
Capital Management, Inc.

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 2, ISSUE 11

The Laffer Curve shows the relationship between tax rates and government revenues. Note that at any point above a certain tax rate, revenues decline as rates rise. There is an "optimal" tax rate that produces maximum tax revenues.
(source: Arthur Laffer)



"As for it being different this time, it is different every time. The question is in what way, and to what extent."
-Tom McClellan

Understanding Rotation Risk

Stock investors who choose to invest in a portfolio of index funds avoid risks that are associated with active portfolio management. The latter strategy is usually designed to outperform an index, providing returns that exceed an index's total return, after management fees. Such active management strategies can have many risks besides that of overall market volatility. Investing in funds that focus on market sectors, industries, market capitalizations or investment styles can produce both above-average and below-average performance, depending on economic and market conditions.

One of these risks is known as rotation, a process whereby many investors decide to move from one investment strategy to another causing volatility in stocks that are included in both, or either, strategies. One example of a rotation is the recent shift from growth to value stocks during September and October of this year. According to the Wall Street Journal, value stocks rose approximately 8% during this period while growth stocks rose only 1%. Some of this rotation could be attributed to rebalancing, where a portfolio manager sells an outperforming strategy and invests in an underperforming strategy to bring a portfolio back in line with a strategic portfolio allocation. Investors who attempt to capitalize on the latest rotational trends must be sensitive to the possibility of a sudden and unexpected shift brought about by a random rebalancing decision or one that is timed to a calendar event. Beyond random or calendar timed repositioning, rebalancing decisions can also be triggered by the degree which one strategy has outperformed another.

Rotation is a confirmation of the conscious decision of selling winners and buying losers at any time on the belief that deviant performance of one asset class will be rectified through a return to the mean expectation. Yet there is no solid evidence that such rebalancing strategies work consistently. One need only look at a portfolio consisting of bonds and stocks that is rebalanced during an extended bull market in stocks. Over the past ten years, such a portfolio would have been selling stocks and buying bonds—a strategy that probably has provided below-average returns. Such rotational events can undermine confidence in one investment strategy and lead investors to abandon a viable long-term investment based on short-term market disturbances that are not related to underlying stock or company fundamentals.

Market Commentary:

Stock market bulls received encouragement for their optimistic outlook during October as the S&P 500 rallied to new highs by the end of the month. Factors contributing to that achievement included the settlement of the GM strike, a better than expected estimate of economic growth at 1.9% and continued upside earnings surprises from company reports. As interest rates remained near all-time lows, investors seem to be drawn to dividend paying stocks as an attractive alternative to fixed-income securities. The recent strength of the dollar also encourages foreign investors to increase their holdings of U.S. equities. The last hurdle seems to be a reasonable solution to the tariff wars that may not come any time soon but, if so, would likely contribute to a Santa Claus rally.

Gambling generates more revenue each year than movies, spectator sports, theme parks, cruise ships and recorded music combined.
(source: Frontline)

December 1, 2019

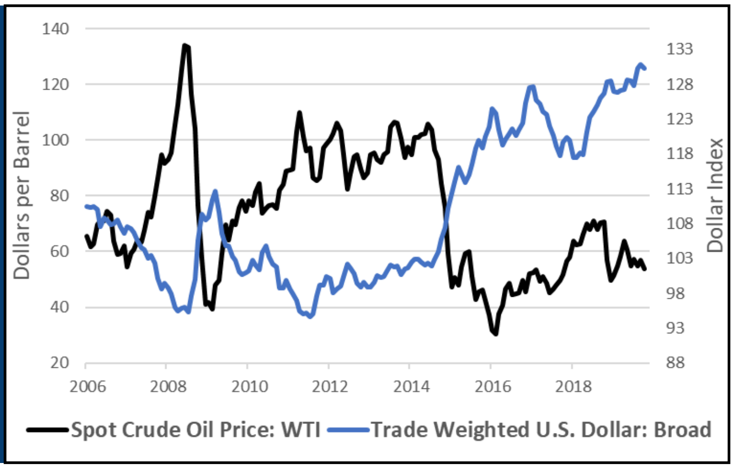
VICTORIA Capital Management, Inc.

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 2, ISSUE 12

The U.S. has become the world's largest producer of oil and gas. A surge in production has led to a substantial decline in the price of oil falling from $130+ per barrel in 2008 to under $30 per barrel in 2016. The decline has had a major positive impact on the dollar since 2014. *(source: FRED St. Louis)*



The Dollar Dilemma

As the U.S. has gone from a major oil importer to an oil and gas exporter, the shift in the global currency exchange markets is undergoing a marked change that will have long lasting effects on the global economy. As we have mentioned in previous commentaries, for many years the U.S. imported millions of barrels of oil to sustain economic growth and, in the process, exported dollars--primarily to OPEC. While the oil was consumed, the dollars were not; they became a medium of exchange for other countries to facilitate trade. The proliferation of dollars stimulated those economies that sold goods and services to other countries that paid for the purchases with dollars that were received for the payment of oil. Since the dollar was the world's reserve currency, trade grew rapidly. When OPEC exerted its power and implemented the oil embargo in 1973, the value of the dollar plummeted, and the world was flooded with dollars.

In 2012 everything changed. The rapid growth in fracking and related oil production in the U.S. began to reduce the flow of dollars abroad. Those dollars remained in the U.S. to stimulate growth here while reducing growth overseas. As the dollar shortage increased, the value of the dollar increased. Domestic producers benefited; foreign producers suffered. As the global surplus of oil increased, OPEC lowered production to stabilize prices.

The continued dollar strength has both benefits and drawbacks. A rising dollar lowers the prices of imports thus keeping inflation low. A stronger dollar also benefits foreign producers of goods as higher dollar prices in those countries allow domestic producers to compete on a price basis adding to domestic output in those countries. The downside is that U.S. exporters have to increase the price of their goods in foreign currencies and lose on a competitive basis. The translation of sales back into dollars undermines earnings growth of those international companies. If the U.S. doesn't step up the volume of purchases of foreign goods and services, the shortfall of dollars will continue to push the dollar higher. A stronger U.S. economy due to the retention of those oil related dollars will be partially offset by the rise in the dollar. At some point, the monetary authorities will be called on to remedy this situation. Watch for this concern to become front page news in the coming months and years as U.S. energy production dominance continues to expand.

"How many millionaires do you know who have become wealthy by investing in savings accounts? I rest my case."

Robert G. Allen

Market Commentary:

The surge in the stock market to record levels during November suggests that the Santa Claus rally is coming early this year. As opposed to the disastrous market decline last year at this time, the DJIA surge above 28,000 is surprisingly good news for investors. The NASDAQ composite is up over 30% this year with only a month to go and few obstacles in the way. Of course, the tariff "war" will be around for a while although the Chinese are feeling economic pressures more than the U.S. There is solid support for the domestic rally in stocks to continue: third quarter GDP was revised up to 2.1% from 1.9% due to stronger consumer spending, the corporate profits outlook for 2020 is positive and deregulation and fiscal policy reform is still trickling through to the bottom line.

After adjusting for inflation, an average millennial in 2019 has a net worth 41% less than the net worth of a similarly aged adult in 1989.

(source: FRED St. Louis).