The Capital Management Corporation

FOCUS Newsletter

Economic Comments | April 2019

RAPIDLY CHANGING MONETARY POLICY

The US Federal Reserve (the Fed) signaled that its overnight interest rate target (Federal Funds Rate) could remain unchanged in the range of 2¼%-2½% throughout 2019. This abrupt policy shift ends a series of nine ¼% point interest rate hikes from December 2015 to December 2018.

The Fed also announced intentions to stop shrinking its balance sheet, effectively ending reverse quantitative easing. Starting next month, the Fed will lower its holdings of US Treasury bonds, notes and bills (USTs) by $15 billion per month from the current rate of $30 billion per month. In October, the Fed expects to reverse course and start increasing its USTs by about $20 billion per month. Meanwhile, its holdings of US Agency mortgage backed securities (MBS) should continue to decline at a rate of $20 billion per month throughout 2019. Under this plan, the Fed's assets at year-end will be $3.68 trillion, down from $4.45 trillion in early 2018.

MONETARY YIELD CURVE INVERSION QUICKLY REVERSED

In recent years, the vast majority of the Fed's UST purchases and reinvestments have been in 10-year US Treasury notes. The Fed's enormous purchases of ten-year USTs and recurring increases of overnight interest rates led to a flattening yield curve. On March 22nd the 3-month UST (at 2.42%) barely yielded more than its 10-year equivalent. This inversion proved fleeting and quickly reversed.

Going forward, the Fed will make a dramatic shift to buying mostly short-term (0-4 year) USTs. This large change in supply and demand of various bond maturities may greatly affect bond prices and yields. As the Fed stops buying 10-year USTs and becomes the largest buyer of short-term USTs, expect 0-4-year UST interest rates to remain close to 2½% while the 10-year rate rises. Consequently, the yield curve should not invert again in the foreseeable future.

Meanwhile, money supply measured by M2 (total domestic currency and deposits) continues to grow at 4.3% due to 6% growth in outstanding paper currency, increased bank lending, rising level of transactions and the repatriation of foreign profits.

REPATRIATION OF US CORPORATIONS FOREIGN PROFITS

Before 2018, US corporations could avoid US taxes on foreign profits, by keeping those funds in lower tax jurisdictions like Ireland and Switzerland. However, in late 2017 US federal tax law was changed and mandated a federal tax (of up to 15.5%) on all past foreign profits (estimated at over $3 trillion). Moreover, taxes of current and future foreign profits were reformulated to remove the incentive to keep profits offshore.

Key Dates

04/05	Unemployment Report
04/10	March Consumer Inflation (CPI)
04/19	Good Friday Stock Market Closed
04/26	GDP 1Q 2019 Advance Estimate
05/01	FOMC Press Conference
05/03	Unemployment Report
05/10	April Consumer Inflation (CPI)
05/27	Memorial Day Stock Market Closed
05/30	GDP 1Q 2019 Second Estimate
06/07	Unemployment Report
06/12	May Consumer Inflation (CPI)
06/19	FOMC Press Conference
06/27	GDP 1Q 2019 Third Estimate

US corporations can move this money back into the US as they free-up their overseas cash. The estimated federal tax revenue of over $300 billion is due 8% per year for 5 years starting in tax year 2018 (payable March 15th 2019).

The remaining 60% of the tax is applied in tax years 2023 (15%), 2024 (20%) and 2025 (25%). Whereas, any state income tax incurred in 2018 will be paid during the first half of this year. As states receive this windfall, many will revise their budgets and increase spending.

While some past foreign profits were spent on foreign acquisitions and expansions, the majority is believed to be held in some form of cash equivalents like USTs. During the first 10 months of 2018, over $20 billion of USTs held in Switzerland and almost $40 billion held in Ireland were sold. It is thought that this may be part of the US corporate funds turning into cash in order to exit low-tax foreign jurisdictions.

Foreign profits held in countries that restrict currency from leaving, like China, may take years to repatriate. Profits trapped in other countries like Venezuela could be worthless.

Companies are finding creative ways to bring cash home. US firms can borrow against illiquid assets (e.g. a factory or foreign subsidiary) that had been purchased with past profits. Some firms are issuing “reverse Yankee bonds.” This is a bond issued overseas by a US company. These are increasingly popular in Europe and Japan as their ten-year government bonds trade near a 0% interest rate (about 2.5% points below the corresponding UST). European and Japanese bond investors are likely buyers of new international bonds with positive yields.

Last year, US firms brought over $600 billion dollars of past international profits back into the US. Additional funds should be repatriated in upcoming years as “cash equivalents” (i.e. foreign bonds, international bank CDs, etc.) and other investments become cash. US corporations earn more than $30 billion per month in overseas profits. Most of these funds can also move into the US.

If the repatriated funds are used to retire domestic debt, then the US debt holders being paid back will likely lend those funds to other companies. Repatriated cash sitting in a domestic bank can fund new bank loans. Some companies will directly use the funds to support capital spending (new buildings, machinery and technology) while others will add employees to expand and improve research & development, sales, customer service and manufacturing. Portions sent to shareholders via dividends and share buybacks can be reinvested in other companies including start-ups and venture capital. Directly rewarding shareholders benefits students, charities and retirees as endowments, foundations and pension funds own the majority of US stocks. The eventual repatriating of billions of dollars will move through the domestic economy creating additional jobs and investments.

ECONOMIC OUTLOOK: GROWTH ALBEIT SLOWER GROWTH

In 2018 the US economy, measured by US Gross Domestic Product (GDP), grew by more than 5%. After adjusting for inflation, Real GDP grew by over 3%. Economists expect slower growth in 2019 due to slower international growth, trade negotiations and difficult comparisons. The first quarter of 2019 may report the weakest growth figures due to seasonal adjustments, weather, government shutdown and tax refund delays.

However, economists and the consensus can be proven wrong. There are many reasons the economy could strengthen later this year. A 5½% and 5% surge in business investment in 2017 and 2018 respectively should boost technological efficiencies, productivity and economic output. A China trade agreement that increases US exports by $1 trillion over six years could add about 1% to annual economic growth. Meanwhile, trade negotiations with the European Union, Japan and others are quietly progressing.

The coming wave of 5G-enabled automation could boost productivity and economic growth by another 1% per year. When 4G launched in 2009, there was no Airbnb, Game of Thrones, IOT (internet of things), Prime Video, Uber, $200 3D printers,

$240 50-inch FHD TV screens or mass-produced electric cars. There was almost no mention of AI (artificial intelligence), big data, nanotechnology, self-connecting devices, self-driving cars or YouTube. Your entire life was not on Facebook. 4G enabled productivity, entertainment, connectivity and endless data that could not have been imagined a decade ago.

5G is 20 times faster than 4G. It has improved quality, less interference and more connectivity (can connect to 1,000 devices per meter). It is scheduled to roll-out next year. Future economic productivity enhancements should be enormous.

Meanwhile, for the first time in recorded history, there are more job postings than job searchers. The US Department of Labor reports that weekly jobless claims are at a 49-year low. The labor force growth has astounded forecasters as people reenter the labor force in record numbers. Wage growth was 3% last year, the strongest in ten years. The combination of more jobs and higher pay allows for rising consumer spending (68% of the economy). Business investment (ex-housing) has been growing at 5% (14% of the economy). Because of entitlements and increased state/municipal receipts, government continues to grow (17% of the economy). Housing (4% of the economy) has stalled due to weather, the lack of skilled workers and temporarily higher mortgage interest rates. The annual trade deficit (imports minus exports) represents negative -3% of the economy.

In aggregate, 99% of the US economy is experiencing strong growth. When combined with full employment, technological advancements, positive monetary supply, and hundreds of billions of repatriated cash that has only started moving around the economy, the US economy remains strong. For these reasons, the largest and most diverse economy in the world continues to overcome slower international growth. Once trade agreements are finalized, the US might lead the rest of the world toward stronger growth.

FINANCIAL MARKET OUTLOOK: ABATING FEARS OF RECESSION

Domestic large-cap stock market indices fell about 20% from their October 2018 highs to the market close on Christmas Eve. Similarly, domestic small-cap indices fell about 28%. Some stocks performed worse than their respective index and others performed better.

Many domestic stock indices rose 6% during the last four trading days of 2018. This was followed by double-digit returns during the first quarter of this year. Again, some stocks performed worse than their respective index and others performed better.

These large market movements and volatility resulted in many securities being greatly overvalued or undervalued at different times. Normal human emotions of fear and greed lead many investors to sell low when things do not feel good, and buy high after moods improve. Some investors who sold on Christmas Eve are now wondering what to buy now at much higher prices. Sadly, this is a recurring theme for investors.

Despite slowing international economic growth, Wall Street's fears of a domestic recession have not come to fruition. While some economic statistics may reflect a weaker first quarter, forward looking indicators remain strong.

The financial markets discount uncertainty; however, many of the first quarter's uncertainties are diminishing. The Federal Reserve has indicated a clear path to stabilize its balance sheet and overnight interest rates. The special counsel investigation has ended. China trade talks may lead to an agreement by this summer. In a time of resolving trade agreements, no country wants to be the last to negotiate with the US. Advanced talks and successfully negotiated agreements increase the US' negotiating power with others.

Some weak winter numbers and upcoming quarterly earnings announcements will cause market volatility; yet many companies are being helped by continued economic growth. As uncertainties diminish, investors in growing companies should be rewarded with higher valuation multiples.

FUTURE CHANGES: WHERE TO INVEST

With 3-month UST interest rates of almost 2.4% and 30-year UST rates at 3.0%, investors are not being rewarded for taking duration or maturity risk. If inflation rises to 3% or an investor has a spending rate of 3%, it will be hard to grow or even preserve wealth in bonds.

On the other hand, if an investor wants bonds for stability, modest income, diversification, and defensive characteristics, then a corporate bond ladder with various maturities up to 7 years in length or a municipal bond ladder of 1 to 10 years can accomplish this with less risk than a portfolio of 10 to 30-year bonds. Further diversification and returns can be derived from bonds of various issuers where the portfolio manager has high conviction.

Similar to bonds, a stock investor should know each stock holding's underlying company well. This includes the firm's current and future products, financial trends, industry trends, management, suppliers, customers and competitors. Investors should emphasize leading firms in a growing niche with high barriers-to-entry, innovation, expansion opportunities and an aptitude for success.

Investors should look for companies with strong financials including revenue, earnings and cash flow growth. The relative level and growth rate of operating cash flow and free cash flow generation can strengthen the company's balance sheet and support future growth initiatives. Excess cash can be reserved to fund future growth opportunities or returned to shareholders in the form of dividends and share buybacks. Firms with excessive cash generation might be able to take advantage of several of these opportunities.

On the other hand, investors should be wary of companies that desperately need cash. These firms may issue too much debt and dilute shareholders' ownership by issuing new shares. These companies can become especially desperate as the economy slows. Many will not survive recessions.

Valuation is a critical component of investment success. Paying too much for shares of a great company can yield poor results. Herds of emotional investors focusing on near-term results can move security prices to extremely attractive entry and exit points. Patient investors with a long-term outlook and a proven valuation discipline can take advantage of this temporary mispricing.

In an era of day trading, computer-algorithmic trading and index funds, disciplined long-term investment research has been overlooked. As financial market leadership shifts from mega-caps that dominate popular indices, investment professionals strictly adhering to a proven fundamental research process can create concentrated portfolios of high conviction investments. These portfolios of best ideas can have diversification from exposure to a variety of economic sectors, market capitalizations and investment style (growth, value and/or income).

Recent market volatility has presented extraordinary opportunities, especially in small-capitalization stocks. Within the Consumer Discretionary and Healthcare sectors several biotechnology, media and travel industry companies appear particularly attractive.

- Timothy C. Call, CFA, President & CIO

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