The Capital Management Corporation

FOCUS Newsletter

Economic Comments | July 2019

LOWER US INTEREST RATES FROM FOREIGN MONETARY POLICY

The central banks of the European Union (EU) and Japan have maintained negative overnight interest rates (of negative -0.4% and -0.1% respectively) to encourage savers to utilize their funds in ways that stimulate economic growth.

The Japanese ten-year bond trades at a negative -0.2% yield-to-maturity, the ten-year German Bund yields negative -0.4% and the ten-year Swiss bond yields negative -0.7%. All Danish government bonds currently have a negative yield. For the first time ever, French government ten-year bonds carry a negative yield. Almost one-third of all government bonds in the world today have a negative yield-to-maturity.

Many banks and other financial institutions must hold a percentage of their assets in high quality government bonds. Despite currency risk, foreign institutions are buying US Treasury bills, notes and bonds in order to receive a positive interest rate. This heightened bond buying has raised bond prices and lowered the interest rates on the US Treasury ten-year note and 30-year bond to 2.0% and 2.5% respectively.

Meanwhile, the US Federal Reserve (the Fed) has maintained its overnight interest rate in a range of positive 2¼% to 2½%. As such, more aggressive foreign purchases have resulted in an inverted yield curve (i.e. overnight interest rates exceeding many long-term interest rates). Since this was not the Fed's goal, within weeks the Fed might lower overnight interest rates by ¼%.

FLOOD OF FOREIGN BOND DEMANDS INVERTS YIELD CURVE

Usually, an inverted yield curve is caused by central banks aggressively raising overnight interest rates in order to slow the economy to control high rates of inflation. Higher interest rates lower the attractiveness of borrowing and raise the incentive to hold high cash balances (i.e. savings and money market accounts). This results in less money moving through the economy. By lowering the movement (or velocity) of money, the economy slows to a point where a recession may occur within the following 18 months.

However, the current yield curve inversion was not the result of a huge increase in overnight interest rates; rather, excessive foreign quantitative easing has produced a flood of foreign bond buyers seeking positive interest rates in a reserve currency. Consequently, foreign funds are flowing into the US and lowering interest rates in the US.

As the US interest rate yield curve approached inversion, Wall Street's quantitative analysis and algorithmic computerized trading thresholds were triggered. Having been programmed to sell stocks upon such a sighting, massive amounts of automatically generated trading created additional market volatility and contributed to the late 2018 bear market.

Key Dates

07/05	Unemployment Report
07/11	June Consumer Inflation (CPI)
07/26	GDP 2Q 2019 Advance Estimate
07/31	FOMC Press Conference
08/02	Unemployment Report
08/13	July Consumer Inflation (CPI)
08/29	GDP 2Q 2019 Second Estimate
09/02	Labor Day Stock Market Closed
09/06	Unemployment Report
09/12	August Consumer Inflation (CPI)
09/18	FOMC Press Conference
09/26	GDP 2Q 2019 Third Estimate

While Wall Street cried recession, US job growth continued, domestic employment levels set new all-time highs and productivity accelerated. Major US stock indices rebounded as experts realized that the US was experiencing growth instead of a recession.

STRONG DOMESTIC ECONOMY & NEGATIVE HEADLINES COEXIST

While underreported, positive news is both broad and deep. Currently, the US has the largest and most diverse economy in world history. Consumer confidence just reached an 18-year high. Within the US, the number of employed continues to achieve new records on a monthly basis. Job postings outnumber job seekers. Wage growth is near ten-year highs despite 10,000 retirements per day from the highest paid generation (baby boomers). Productivity growth rebounded to 3.6% earlier this year.

As a percentage of assets, US household leverage is at a 34-year low. 30-year mortgage rates have fallen below 4%. While home prices are rising throughout most of the country, home building is restrained by the lack of skilled workers. In order to better match worker skills with employer needs, businesses have created education partnerships with local schools and colleges.

Tariffs, logistics, labor and sourcing challenges could accelerate capital spending as US businesses focus on automation, business-education partnerships, capacity expansion, dual-sourcing, DTC (direct to consumer), efficiency, intellectual property, IOT (internet of things) and reshoring. In turn, this should further accelerate productivity and real economic growth.

Meanwhile, US energy production has surged. The US is now the world's largest energy producer and is a net exporter of energy. The only countries producing more energy than Texas are Russia and Saudi Arabia.

Moreover, the US economy should benefit from numerous international events. Mexico has approved USMCA (AKA NAFTA 2.0) and Canada is nearing approval. Japan approved a new round of fiscal stimulus and may announce a trade deal with the US next month. China is cutting taxes, loosening credit restrictions and restarting trade negotiations. Previously announced tariffs are on hold and some aluminum and steel tariffs are being removed.

The combination of trade negotiation progress, positive domestic interest rates, healthier banks, tight credit spreads, eased banking regulations, low energy prices, full employment and near-record consumer confidence has resulted in a rising velocity of money in the US.

Adding to these positive fundamentals is an enormous capital inflow of hundreds of billions of dollars per year. The current magnitude of capital flows into the US from foreign capital buying bonds and repatriation of foreign profits (discussed last quarter) might be unprecedented in world history. The combination of capital inflows, high velocity of money, a potential overnight interest rate cut, and an extremely strong economic base might result in the US becoming the driver of future global economic growth.

FUTURE CHANGES: WHERE TO INVEST

In recent years some investors have searched for the highest yielding investments including junk bonds, emerging market bonds, limited partnerships, preferred stocks and utility stocks. Other investors were attracted to younger "unicorn" companies needing cash for growth initiatives. Meanwhile, many attractive long-term investments in the middle ground were ignored.

As institutional investors focus on venture capital, private equity and unprofitable start-ups, shares of some small and mid-capitalization companies with track records of rising earnings and cash generation are overlooked. Some of these thriving cash generators are leaders in growing niches and specialty industries with increasing product demand. They can include 5G equipment distributors, biotechs with late stage pipelines and potential product extensions, leaders in energy quality and technologies, lithium refiners, logistics and storage solution providers, specialty finance companies, and media firms moving into OTT (over-the-top) delivery.

Similarly, as other investors have sought the highest yielding securities, some stocks with a long history of dividend growth have been ignored. Through history, the dividend growth category has provided long-term results, increasing and recurring streams of cash dividends and lower volatility than commensurate market indices.

Long-term investors should not have to sacrifice liquidity, quality and diversification in order to achieve envious long-term results. Attractive stocks and bonds of companies with strong balance sheets, financial trends and managements can be found across various economic sectors, company sizes, and geographic exposures.

Investors should assess their goals, objectives, risk tolerance, time-frame and unique circumstances for each of their investment accounts.

- Timothy C. Call, CFA, President & CIO

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