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Chart 1
S&P 500: Blue = Current Price; Red = 200 Day Moving Average; Green = 50 Day Moving Average

Good News is Bad News

- The Chairman of the Federal Reserve touched off a correction in stock prices with comments he made in an interview on October 3rd.

- Trump's pro-business tax cuts, reductions in government regulations, encouragement of energy production and pro-growth rhetoric have lifted U.S. economic growth.

- The median 2018 growth forecast of the Federal Reserve's Open Market Committee (FOMC) was raised to 3.1% at their September meeting. That is up from a median estimate of 2.8% in June, 2.7% in March and only 2.1% a year ago.

- The recent increase in growth estimates by the Fed is unlike the first eight years of this business cycle when the Fed had to consistently reduce estimates. The forecasting errors reflect the Fed's use of Keynesian analysis which focus' on demand-side spending stimulus rather than the supply-side impacts that tax rates and regulations have on investment and production.

- Because of the good economic news, the FOMC raised interest rates at the September meeting, the third increase this year, and indicated that rates would be raised again in December. Three or four more increases in the Federal Funds rate is now expected in 2019 as well.

- Ten year U.S. Treasury bond yields have broken out of a 30 year downward trend reflecting expectations that the Fed will continue to tighten monetary policy.

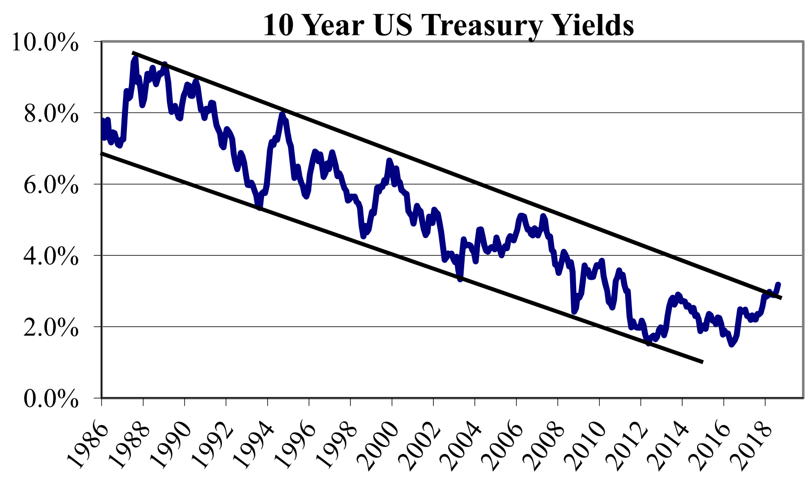
- History suggests that the economy can continue to grow and asset prices can continue to rise in the face of higher interest rates until a recession is on the horizon, which is not now the case. Therefore, we remain Bullish on the stock prices for the next twelve months at least.

- The increase in U.S. growth and interest rates is requiring adjustments to the global financial markets and has created elevated risk. In particular, investors should remain wary of emerging markets, including China, which are suffering because of the higher interest rates and downward pressure on their currencies. In this environment, the U.S. is an island of relative stability and economic strength. Stock investors should continue to be well rewarded.

The S&P 500 was within 0.2% of its all time high on October 3rd, the day the Chairman of the Federal Reserve gave a lengthy interview. The S&P 500 fell everyday thereafter through October 11th until it had declined 7%. In Powell's interview, he said the U.S. is experiencing "remarkably positive set of economic circumstances" and that "the really extraordinarily accommodative low interest rates that we needed when the economy was quite weak, we don't need those anymore." Furthermore, he indicated that the Fed was willing to push short term interest rates above the "neutral" level, while admitting that no one really knows what the neutral level is. Importantly, Powell indicated that there are risks in raising interest rates too slowly, and specifically noted the risk that "the economy overheats, and that can show up in form of too high inflation or *financial market imbalances*. (emphasis added)" In other words, it's not good enough that inflation stays low. Powell seems to be saying that the Fed is concerned when asset prices, e.g., stocks, bonds, real estate, get too richly valued, without saying whether he thought that was the case now. This means that the "Bernanke put" is finished and that even if asset prices decline, investors should expect the Fed to continue to tighten as long as real growth stays high and unemployment stays low.

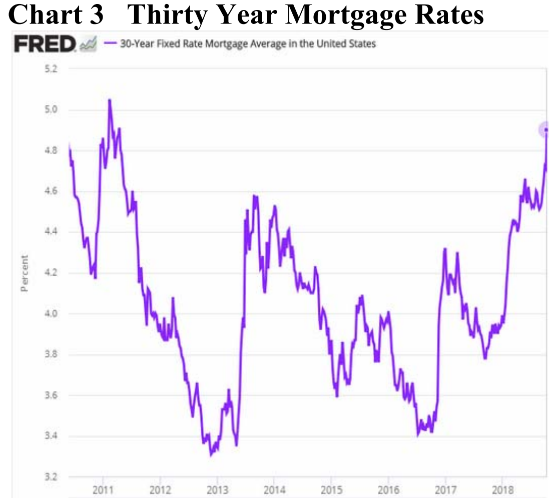
Not coincidentally, bond yields broke out of a 30 year downward trend on the very day of Powell's interview. On October 2nd, the 10 year U.S. Treasury bond ended the day with a yield of 3.065%, still within the upper bound (see Chart 2). On October 3rd, yields spiked and ended the day at 3.187%, above the upper bound. This has immediate implications as home mortgages tend to have a similar "duration" as the 10 year government bond and the yields tend to move together. The stocks of home builders had already been under some pressure with the recent rise in yields and they sold off even more in recent days. We recently reduced our exposure to this area specifically for this reason.

Chart 2



Source: Federal Reserve, FVCM

Chart 3 Thirty Year Mortgage Rates



Source: Federal Reserve

The growth policies of the current administration explain why the Fed is now becoming more aggressive with monetary policy. The U.S. previously had the highest corporate taxes in the industrialized world. By cutting the Federal tax rate from 35% to 21%, U.S. corporations now have much less incentive to export capital, production and profits. Also, for tax purposes, businesses can now fully write off 100% of its investment in both new and used equipment for most assets. Many tax breaks were given to small businesses, including relief from previous healthcare laws and regulations that discouraged business owners from hiring new employees. In addition to a policy of reducing federal regulations, the current administration has fast-tracked government approval of business permitting and approved projects like the construction of oil and gas pipelines that had been stalled by the previous administration.

Budgetary effects of the current policies were outlined by economist Steven Moore of the Heritage Foundation, who noted that the U.S. was in a 1.9% path of real economic growth prior to Trump:

- Comparing the economic forecast of the Congressional Budget Office (CBO) on June 2017, before the tax cuts passed, with the August 2018 forecast, after the cuts, shows higher economic growth than previously expected for every year over the next decade.

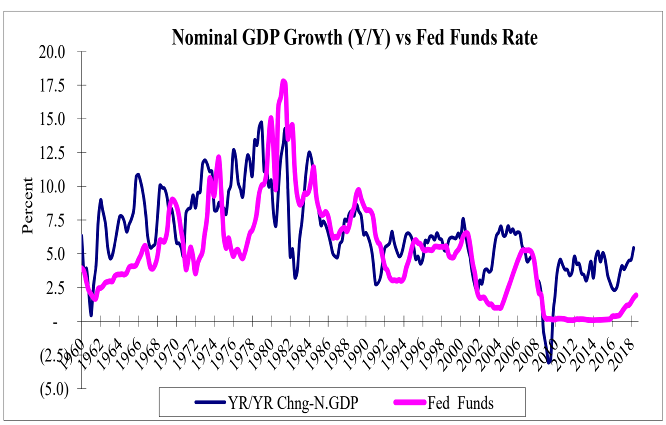
- Real GDP is now expected to be $179 billion greater in 2018. Even if growth returns to previous 1.9% rate, economic output will be $465 billion greater in 2019, $654 billion in 2020, etc. because of compounding effects. Over a ten year period $6 trillion in additional GDP would be created thanks to expansion in the economy *already achieved*. And clearly a return to 1.9% growth is a conservative assumption and apparently thought unlikely by the Federal Reserve.

- The Federal Government is expected to capture about 18% of that already achieved economic expansion in the form of tax revenue, or about $1.1 trillion over ten years. That is well above the $400 billion to $500 billion in expected tax revenue losses by the corporate tax cut.

- Corporate tax revenues are down this year, but tax receipts from nearly every other source are rising thanks to greater business activity. States and cities are expected to receive $20 billion in additional tax revenues this year thanks to the additional expansion in the economy.

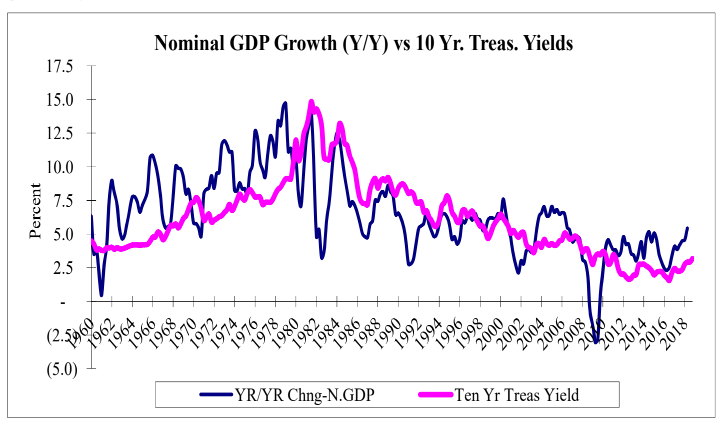
Historically, interest rates have followed changes in nominal GDP growth (see Charts 4 and 5). For that reason, higher rates are not a shock. Nominal spending growth actually went negative after the start of the Great Recession of 2008-9 and the Fed was concerned about the possibility of deflation. An ultra low interest rate policy and quantitative easing was designed to ensure that spending growth remained positive. This policy appeared necessary at the time, especially in 2016 when growth started to stall. However, with the most pro-business, pro-growth administration now in power since the 1980s, these easy monetary policies have been judged by the Fed to be unnecessary.

Chart 4



Source: Federal Reserve, FVCM

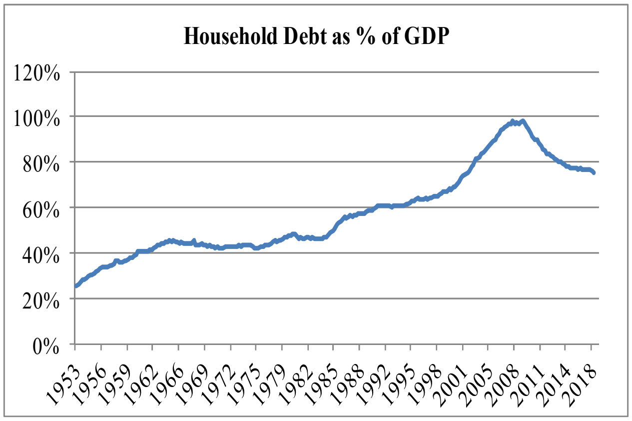
Chart 5



Source: Federal Reserve, FVCM

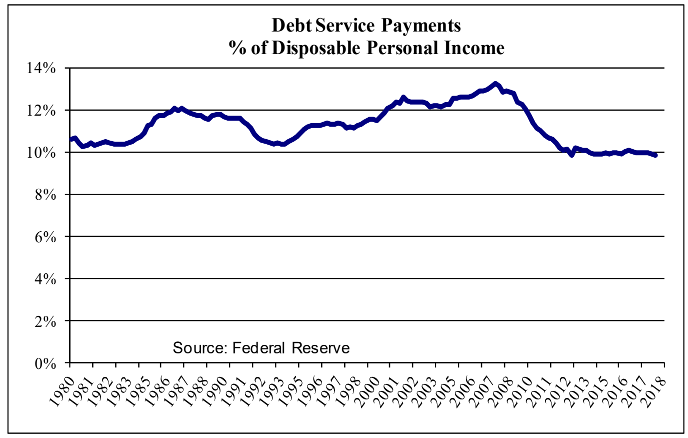
Equity investors need to be concerned if higher interest rates will overcome the positive economic momentum started through fiscal policies. Household debt has declined relative to the overall economy since the peak in 2008 (Chart 6). Student loan debt has been increasing sharply, but mortgage debt has fallen since the last recession. And because interest rates are so low, the relative cost of servicing debt is the lowest it's been in about 40 years (see Chart 7). These factors would suggest that the American consumer has the ability to absorb some increase in higher interest rates, at least in the near term.

Chart 6



Source: Federal Reserve, FVCM

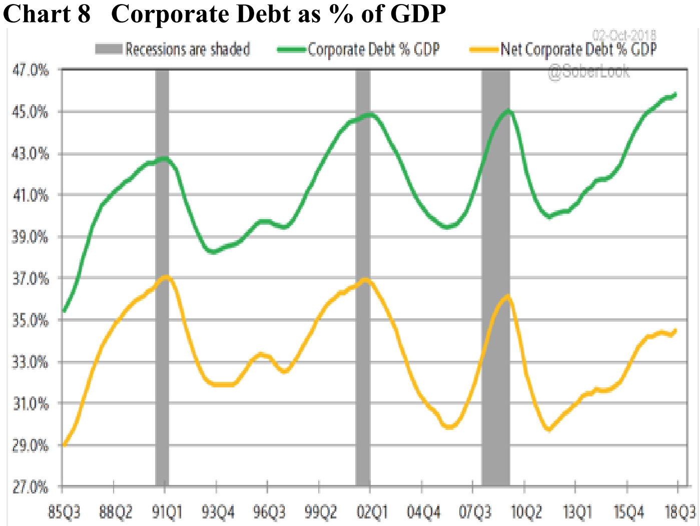
Chart 7



Source: Federal Reserve, FVCM

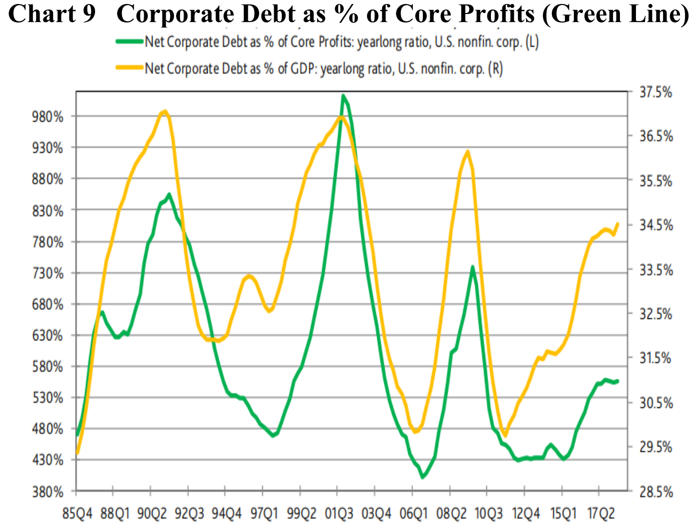
Corporate debt is also not as bad as some of the headlines have indicated. Much has been made of the fact that corporate debt recently hit a high of 45.7% of GDP (see chart 8). However, corporations have a substantial amount of liquid assets, like bank deposits, money market funds, treasury securities, etc. on their balance sheets. Those assets total \$2.5 trillion. Deducting those assets from corporate debt results in net debt of 34.5% of GDP, which is well below prior peaks. Excluded from this measure of liquidity are equity securities. If we went further and subtracted corporate holdings of equity securities, net debt would be only 23.6% of GDP. In either case, U.S. corporate debt does not seem quite so excessive. More importantly, corporate earnings and cash flow have been rising sharply and capital investment is being largely financed internally. As shown in Chart 9, corporate debt remains in a downward trend relative to core profits (the green line).

Chart 8 Corporate Debt as % of GDP



Source: Moody's Analytics, Wall Street Journal

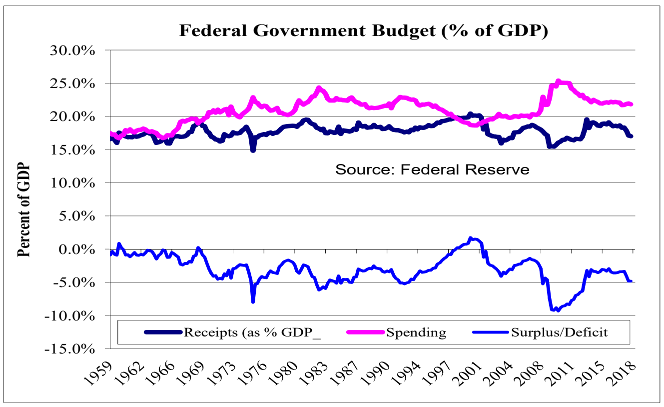
Chart 9 Corporate Debt as % of Core Profits (Green Line)



Source: Moody's Analytics

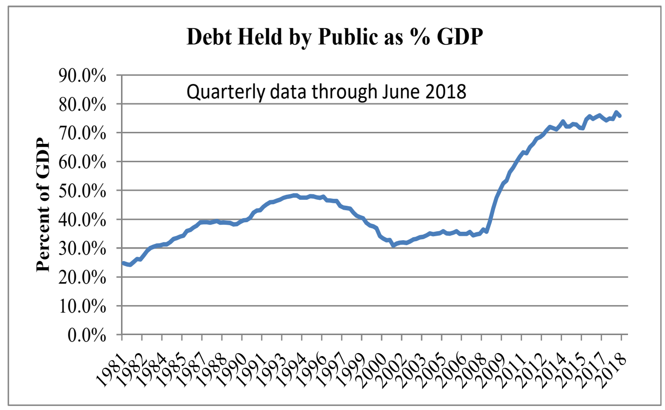
Lower tax revenues and faster spending has sent federal budget deficits upward, although debt outstanding has stabilized at about 76% of GDP thanks to faster growth. The federal deficit has recently been running at about 5% of GDP and there are concerns that the deficit will continue to rise largely due to greater spending for public pensions (Social Security) and government health spending (Medicaid and Medicare). The demographic challenges of an aging population are something that most western countries are facing. The most logical solution is probably the one the Japanese are pursuing by raising retirement age to 70. Like the U.S., Japan is also facing shortages of labor and a higher retirement age solves many problems. However, we are not optimistic that the politics in the U.S. will enable entitlement reforms. Trump has specifically said that he wants to preserve Social Security as it is, and the leftwing of the Democratic party actually wants to increase entitlement spending. Rising interest rates will also add to the federal budget deficit. Therefore, we see little likelihood budget deficits will materially decline. The best outcome may be that the economy continues to grow faster than expected and the higher debt is absorbed by a bigger economy. In other words, absolute debt rises but not as fast as GDP.

Chart 10



Source: Federal Reserve, FVCM

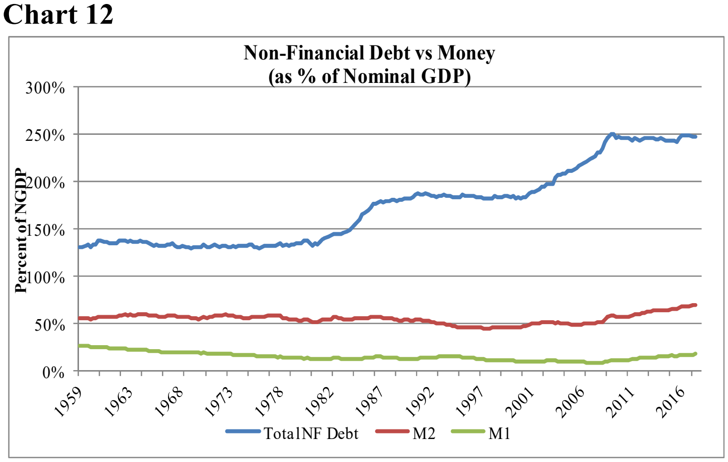
Chart 11



Source: Federal Reserve, FVCM

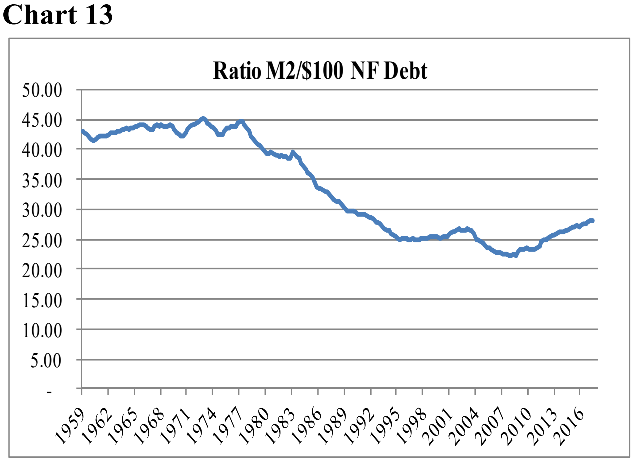
Long term interest rates are not likely to go sharply higher because private sector borrowers are expected to reduce spending if they did. Despite the rise in government debt, total credit market debt in the U.S. has been stable at 250% of GDP in recent years thanks to deleveraging in the private sector (Chart 12). Nonetheless, we view the economy as being relatively illiquid in the sense that while debt has grown sharply relative to the economy over the past 50 years, the money supply has not. There is now about $28 in M2 money for every $100 of debt (Chart 13). That level has risen over the past ten years thanks to QE, but liquidity is still low compared to where it was before disinflation began in the 1980s. In our view, the economy is relatively saturated with debt and demand for more debt has become increasingly elastic, meaning that the willingness to borrow declines more intensely as interest rates rise.

Chart 12



Source: Federal Reserve. FVCM

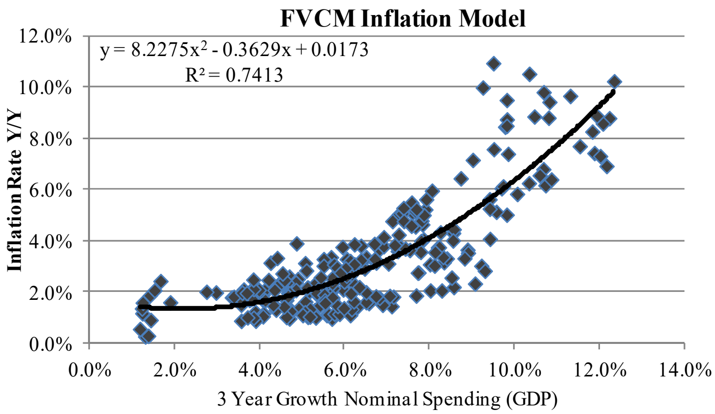
Chart 13



Source: Federal Reserve. FVCM

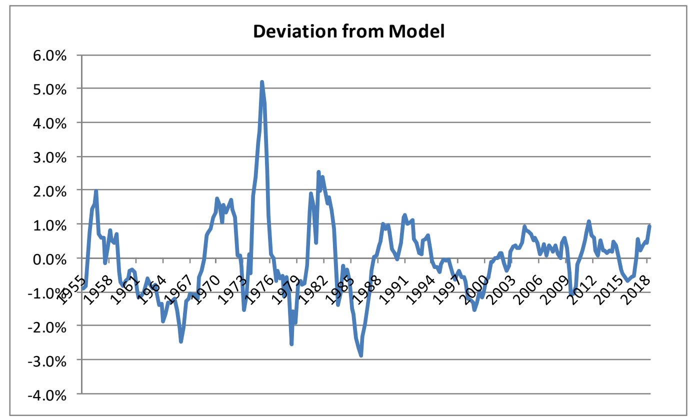
Inflation has been running at about 2.5%, which is a full percentage point higher than our model would indicate. We think that could change. The model is based on the idea that inflation today is a function of nominal spending over the past three years. When spending accelerates beyond the economy's ability to generate real goods and services, the price level rises with a lag. Nominal GDP did grow at a blistering 7.6% rate in the 2018 second quarter, but the trailing three year average is only 3.9%. Nominal spending would have to stay at high levels for considerably longer before inflation pressures build in a sustained way. In the past, the only 2%+ deviations from the model occurred during the Arab Oil embargo of 1973 and the Oil crisis of 1979 when the Iranian revolution occurred. Such events, while not predictable, do not appear on the horizon today. Furthermore, as we have argued, the recent jump in interest rates is likely to put downward pressure on borrowing and spending.

Chart 14



Source: Federal Reserve, FVCM

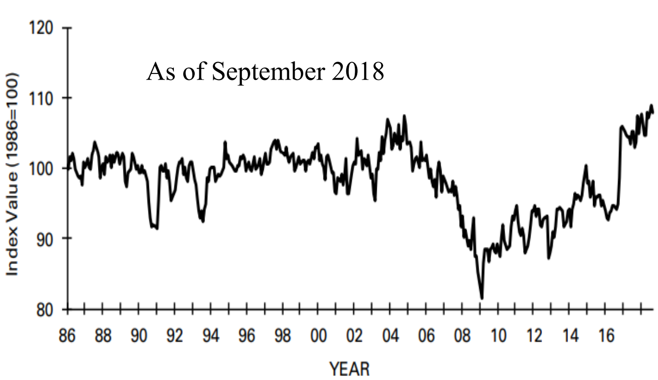
Chart 15



Source: Federal Reserve, FVCM

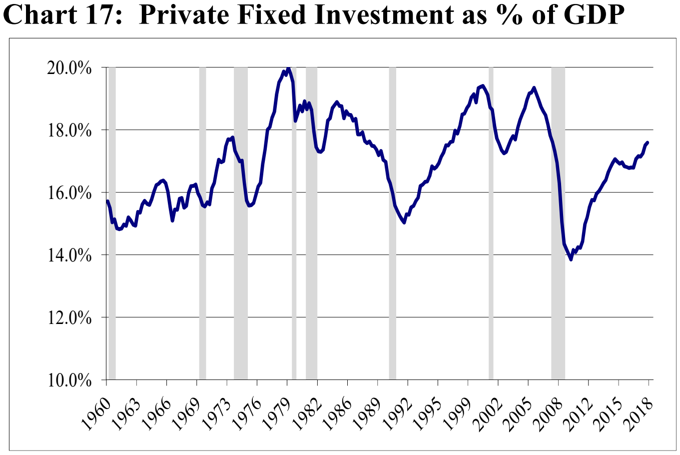
Real GDP growth for the second half of 2018 is likely to remain strong at approximate a 3% annualized rate, but that is down from the 4.2% rate in the second quarter. Data from business owners and managers continue to indicate growth ahead. Small business optimism is near multi-decade highs, and total private fixed investment was up 8.1%, year over year, in the second quarter and reached a cycle high of 17.6% of GDP. However, retail sales fell 0.1% in both August and September, and housing sales have also been weak, indicating that higher interest rates may already be having an effect. We will have to watch how the data plays out in the months ahead, but the outlook for 2019 continues to point toward growth of near 3% thanks to ongoing gains in employment and higher productivity growth as recent capital investment starts to have an impact.

Chart 16: Small Business Optimism Index
Based on Ten Survey Indicators (1986 = 100)



Source: National Federation of Independent Business (NFIB)

Chart 17: Private Fixed Investment as % of GDP



Source: Federal Reserve, FVCM

Earnings growth for the S&P 500 remains very strong. Third quarter earnings reporting is underway and is forecast to deliver another quarter of double digit gains. Revenue is highly correlated with nominal GDP, although revenue is more volatile than NGDP. Revenues decline more than nominal GDP during recessions and rise more during recoveries. For the third quarter revenue is forecast to rise more than 7% year over year. Employment costs have been growing at a low and stable pace of about 2.8% and, with higher operating rates and leverage, operating margins are continuing to expand. Earnings are expected to be up some 21% in for the third quarter, and 22% for the full year. The biggest factors in the strong earnings expansion for 2018 is the rebound in energy earnings now that oil prices have risen, continued strong growth by the technology sector, and the reductions in corporate taxes.

Looking ahead to 2019, we now expect earnings to increase about 8% on a 6.4% gain in revenues. As we noted, the economy may grow somewhat slower in 2019 due to the Fed's tightening of monetary policy. And while additional good gains in the technology sector are still likely, the pace is not likely to match that seen in recent quarters. It will be most interesting to see what effect the trade dispute and tariffs between the U.S. and China have on profitability in the tech sector. We remain generally bullish on tech, but the past winners may not be the same as in 2019.

S&P 500 Revenue and Earnings

	Revenue	Operating Earnings	Special Items	GAAP Earnings	Oper Margin	Net Margin
1988	408.19	24.12	0.37	23.75	5.9%	5.8%
1989	461.15	24.32	1.45	22.87	5.3%	5.0%
1990	509.08	22.65	1.31	21.34	4.4%	4.2%
1991	512.57	19.30	3.33	15.97	3.8%	3.1%
1992	523.64	20.87	1.78	19.09	4.0%	3.6%
1993	527.22	26.90	5.01	21.89	5.1%	4.2%
1994	552.06	31.75	1.15	30.60	5.8%	5.5%
1995	598.41	37.70	3.74	33.96	6.3%	5.7%
1996	614.43	40.63	1.90	38.73	6.6%	6.3%
1997	640.40	44.01	4.29	39.72	6.9%	6.2%
1998	634.51	44.27	6.56	37.71	7.0%	5.9%
1999	663.21	51.68	3.51	48.17	7.8%	7.3%
2000	745.70	56.13	6.13	50.00	7.5%	6.7%
2001	736.88	38.85	14.16	24.69	5.3%	3.4%
2002	674.59	46.04	18.45	27.59	6.8%	4.1%
2003	710.81	54.69	5.95	48.74	7.7%	6.9%
2004	788.17	67.68	9.13	58.55	8.6%	7.4%
2005	874.32	76.45	6.52	69.93	8.7%	8.0%
2006	952.51	87.72	6.21	81.51	9.2%	8.6%
2007	1,025.08	82.54	16.36	66.18	8.1%	6.5%
2008	1,042.46	49.51	34.63	14.88	4.7%	1.4%
2009	908.40	56.86	5.89	50.97	6.3%	5.6%
2010	962.71	83.77	6.42	77.35	8.7%	8.0%
2011	1,052.83	96.44	9.49	86.95	9.2%	8.3%
2012	1,092.37	96.82	10.31	86.51	8.9%	7.9%
2013	1,116.81	107.30	7.10	100.20	9.6%	9.0%
2014	1,163.32	113.01	10.70	102.31	9.7%	8.8%
2015	1,127.13	100.45	13.92	86.53	8.9%	7.7%
2016	1,150.68	106.26	11.71	94.55	9.2%	8.2%
2017	1,231.57	124.51	14.63	109.88	10.1%	8.9%
2018(e)	1,337.79	152.19	18.18	134.01	11.4%	10.0%
2019(e)	1,422.99	164.37	18.73	145.64	11.6%	10.2%

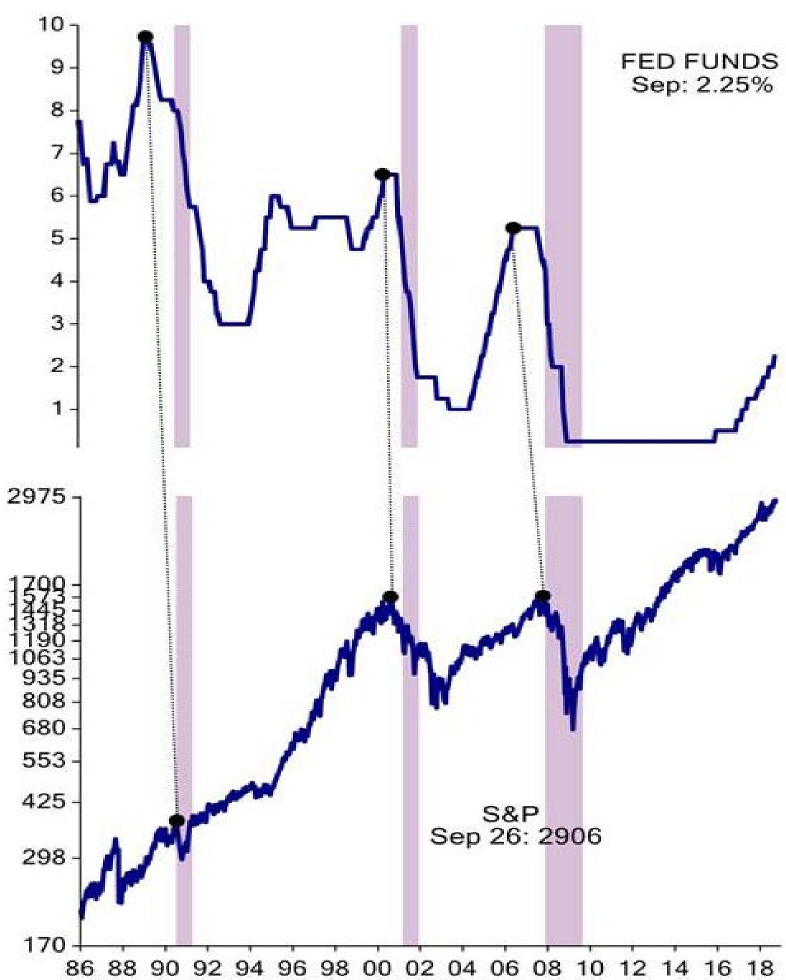
Sources: Standard & Poor's Corp, FVCM

The outlook for stock prices remains positive for the essential reason that both the economy, in general, and corporate profits, in particular, are likely to keep expanding in the quarters ahead. There is some fairly reliable ways to spot a recession coming before it occurs. The shape of the yield curve, recent monthly inflation data, the Purchasing Managers Index and new manufacturing orders relative to inventories, all continue to point toward expansion. Slowing growth in bank loans and leases, as well as the money supply, are something that needs to be monitored and parallels the surprising weakness in the housing markets. But taken all together, the data still points to growth with much of the strength in the technology and industrial sectors.

As for our concern about interest rates, the economists at Evercore ISI have noted that the Fed Funds rate tends to peak well before recessions and peaks in stock prices (Chart 18). With the forward momentum already underway, short term interest rates and stock prices should continue higher in 2019. We'll have to see the data next year before a firm judgment can be made about 2020, but the indicators are still pointing upward for now. Investors are encouraged to use dips like the one recently touched off by the Fed chairman to add to stocks in attractive business.

Our outlook for the U.S. equity market is positive for the year ahead because of strong domestic conditions, although volatility could result from developments overseas. China's economy and currency remain a concern to us mostly because of a rapid increase in leverage in recent years, and the potential that the currency could substantially decline. The Brexit talks remain unresolved and the developments with the Italian budget and banks are another area of systemic risk. Nonetheless Trump is scheduled to meet Chinese leader Xi Jinping in November and we're hopeful that the two will work towards a trade deal before a lasting damage is done. Similarly, we believe Europeans are motivated to resolve the issues at hand before the consequences become substantial. And in this environment, the U.S. is an island of relative stability and economic strength. Stock investors should continue to be well rewarded.

Chart 18



Source: Evercore ISI

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