F&V Capital Management, LLC
805 Third Avenue, 12th Floor
New York, NY 10022

H. Terrence Riley III, CFA
September 25, 2017

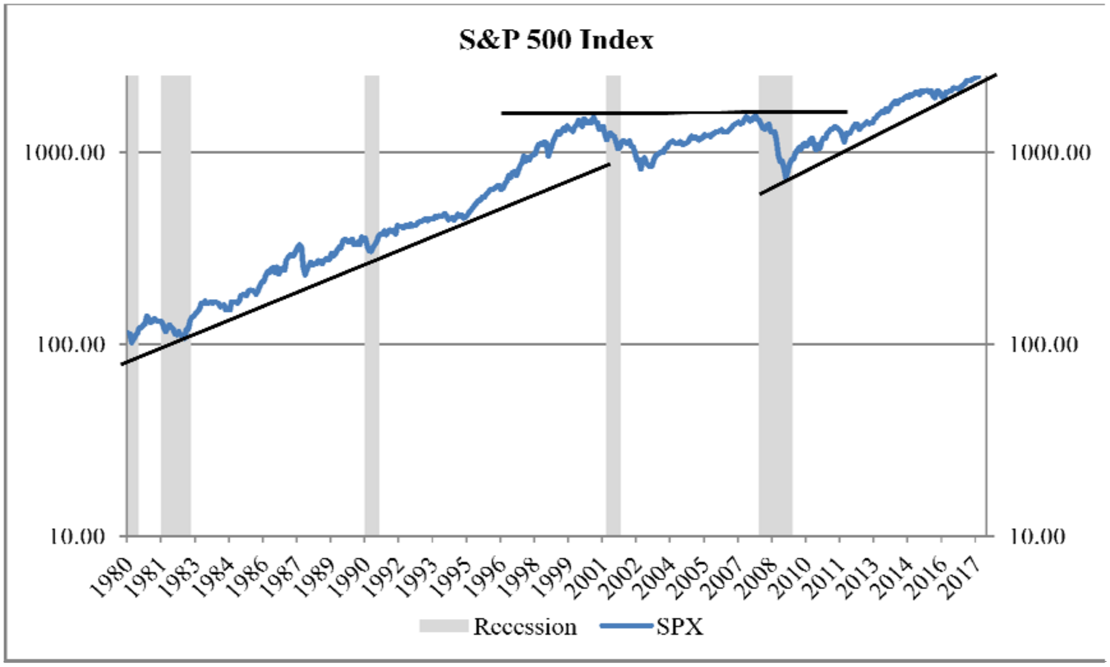
Contact: Karin Mueller-Paris
+1(212) 326 9533 kmm@fvcm.us

Summary

The most important factor to consider as an equity investor is seen in Chart 1 below. The most material declines in stock prices occur when recessions hit. Investors can, therefore, remain confident since most data, like the leading index of economic indicators, the shape of the yield curve, and the level of real interest rates and the Purchasing Managers Indexes, continue to point toward ongoing economic expansion. Furthermore, while some analysts are puzzled over the persistently low level of inflation, it should be clear that low inflation is not a problem, it is a benefit. Both bonds and stocks are worth more when inflation is low and it relieves the central bank from having to aggressively raise interest rates.

Clearly there are some seasonal and geopolitical risks as we move toward the fourth quarter of 2017, and it is the nature of stock trading that the possibility of a modest (~5%) pullback is always present. But the preponderance of evidence continues to indicate that the Bull Market that began in 2009 remains intact. If there is any pullback in equity prices during September/October, we would be buyers, and we recommend that investors stay long equities until the clouds appear and evidence begins to accumulate that a recession is on the horizon.

Chart 1



Source: FVCM, Wall Street Journal

What World Events Could Do

It is worth reviewing some historical evidence regarding the risk from an "exogenous shock," and why it is not as significant as our imagination may suggest. At nearly every point in recent decades, there have been areas of political change and instability, wars and threats of war, terrorism and geopolitical events that have caused disruptions in energy supplies. As shown in the table below, most global events of this nature have not had a significant or long lasting impact on stock prices. The most severe event listed was the Arab Oil Embargo of 1973, when it took the stock market 6 years to regain losses. But we would point out that the Bear Market of the 1970s was primarily due to the sharp rise in inflation caused by excessively expansionary monetary policy after President Richard Nixon ended the convertibility of the dollar into gold in 1971. In fact, it is fair to say that sustained rise in oil prices was not due to the 1973 Oil Embargo itself since prices should have reverted when the embargo ended, but rather the depreciation of the dollar at that time. This brings us to our main point: The primary risks to the capital markets are inflation and recession, not terrorism or even wars.

Table 1

S&P 500 responses to select acts of war and terrorism since WWII

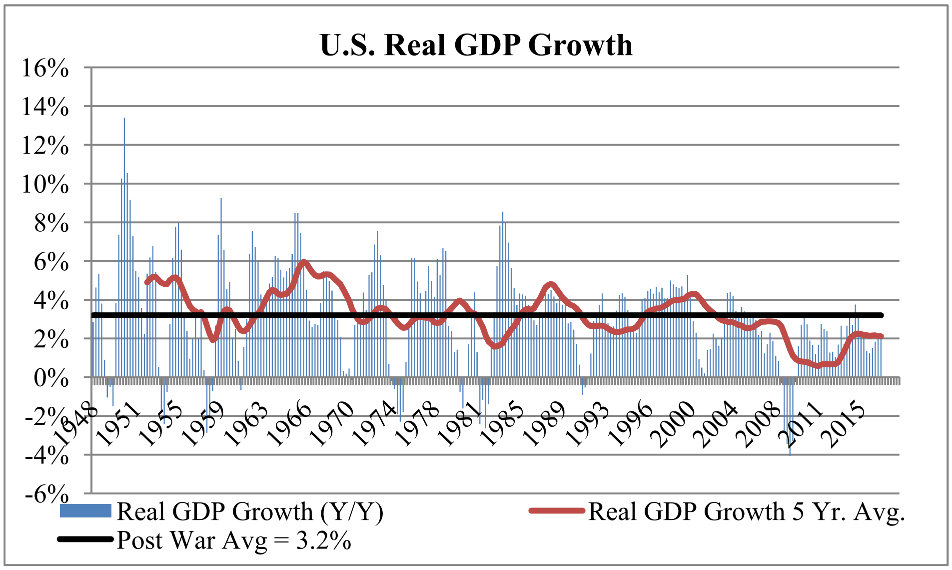
Events	Start date	# trading days to trough	% change to trough	# trading days back to even
Acts of war				
U.S.				
U-2 spy shot down; cover unwound	May 7, 1960	2	-0.6%	4
Bay of Pigs invasion	Apr 15, 1961	6	-3.0%	14
Cuban Missile Crisis	Oct 16, 1962	6	-6.3%	13
Gulf of Tonkin incident (Vietnam)	Aug 2, 1964	4	-2.2%	29
Tet Offensive (Vietnam)	Jan 29, 1968	25	-6.0%	46
Cambodian Campaign (Vietnam)	May 1, 1970	18	-14.9%	86
U.S. invades Grenada	Oct 25, 1983	11	-2.8%	15
Lead-up to U.S. Panama invasion	Dec 15, 1989	2	-2.2%	8
Lead-up to Gulf War: Desert Storm	Jan 1, 1991	6	-5.7%	13
U.S. spy plane captured in China	Apr 1, 2001	3	-4.9%	7
War in Afghanistan	Oct 7, 2001	1	-0.8%	3
Lead-up to Iraq War	Feb 5, 2003	24	-5.6%	28
External				
N. Korea invades S. Korea	Jun 25, 1950	15	-12.9%	56
Lead-up to Six-Day War (June 6)	May 14, 1967	15	-5.6%	20
Yom Kippur War / Arab oil embargo	Oct 6, 1973	42	-16.1%	6 years*
Soviet-Afghan War	Dec 24, 1979	7	-2.3%	10
Iraq invades Kuwait / oilfields seized	Aug 2, 1990	50	-15.9%	131
Average		14	-6.3%	30
Terrorism				
U.S. Embassy seized in Iran	Nov 4, 1979	3	-1.0%	6
U.S. Marines killed in Lebanon	Oct 23, 1983	12	-2.5%	15
Oklahoma City bombing	Apr 19, 1995	1	-0.1%	3
U.S. Embassy bombings in Africa	Aug 7, 1998	5	-2.5%	7
WTC, Pentagon, airplane attacks	Sep 11, 2001	5	-11.6%	19
Madrid train bombings	Mar 11, 2004	3	-1.7%	5
London Underground bombings	Jul 7, 2005	no S&P decline; FTSE -1.4%		
Paris Bataclan, restaurant attacks	Nov 13, 2015	1	-1.1%	2
Nice Bastille Day attacks	Jul 14, 2016	1	-0.1%	2
Average		4	-2.6%	7

Source: Royal Bank of Canada

The Things that Count

Policies advocated by the Trump administration would certainly have a positive effect on growth in the U.S., but we have become increasingly uncertain whether such policies will become reality. In the decades since the end of World War 2, real economic growth in the U.S. averaged 3.2%, but in the recent years following the financial crisis, growth has averaged only 2.1% (see Chart2). Understanding why productivity growth has slowed is one issue, and doing something about it is another.

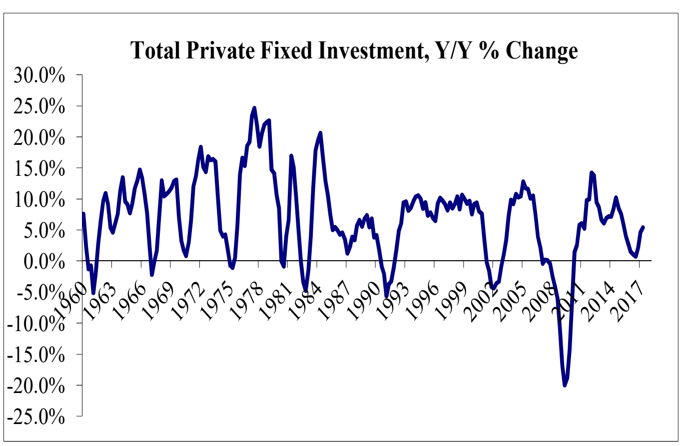
Chart 2



Source: Federal Reserve, FVCM

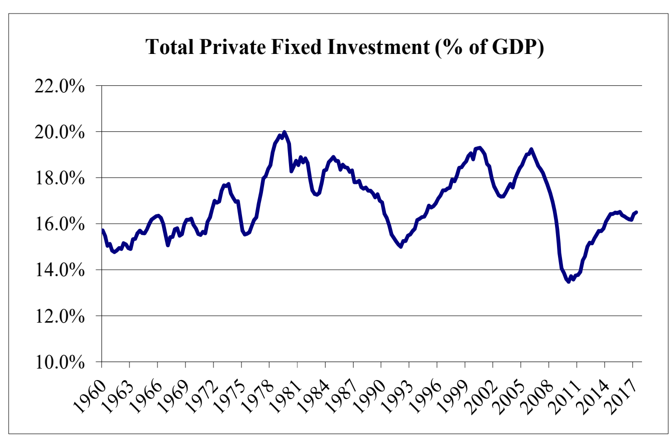
Abnormally slow growth in GDP and productivity is related to a depressed level of private fixed investment since the financial crisis (see Charts 3 and 4). Over the past 10 years, investment has averaged only 15.5% of GDP, compared with 17.1% in the period before that going back to 1960. Investment in the U.S. has been depressed in large part because the corporate tax rate has stayed at about 40% (including state taxes) while corporate taxes have been sharply reduced in the rest of the industrialized world. U.S. companies have been reincorporating overseas though mergers known as inversions, and capital has been stranded overseas because U.S. corporations don't have to actually pay taxes until profits earned in foreign countries are brought back to the U.S. The very rapid increase in Federal Regulations since the financial crisis has also been blamed for the dearth of investment and, hence, productivity growth.

Chart 3



Source: Federal Reserve, FVCM

Chart 4



Source: Federal Reserve, FVCM

Although the negative effects of the U.S. tax system are widely recognized, the chance of tax reform this year may only be 50/50 at best. Complicated legislation like healthcare reform or tax reform always creates benefits for some and costs for others. Getting politicians in the Congress to compromise and vote for legislation that is less than ideal from each of their individual perspectives requires a skill set that Donald Trump apparently lacks. Despite the fact that the Republicans have majorities in both the House of Representatives and the Senate, and that nearly all Republicans supported the "Repeal and Replace" of Obamacare, they could not pass legislation—at least so far. The winners and losers in tax reform are spread even wider. Some people will be upset by the loss of deductions (loopholes some would call them) and others will not like the loss of other shelters or benefits in the current law in exchange for lower tax rates. Typically it is the President who is the person who can convince the people in Congress to give up things they prefer in order to achieve the greater good. Unfortunately, it appears that Trump is sufficiently disliked by even members of his own party and it is now quite uncertain that he will be able to bring the party together in agreement. The same goes for an Infrastructure program.

Stocks are likely to continue to do well even if the Republicans fail to pass tax reform and other growth initiatives. If the Republicans succeed in passing growth initiatives such as heathcare and tax reform and a sensible program to increase infrastructure spending on the U.S., private investment spending is likely to increase, the demand for labor will rise and more people will be drawn into the labor force as wages rise, and real growth could reach the historical average of more than 3% per annum. Without these legislative changes, growth is likely to stay mired at the current level of a bit more than 2% per annum. Nevertheless, even the status quo growth of 2% is enough to keep corporate profitability and stock prices in an upward channel. So from our perspective, the outlook for the economy is not a question of growth or recession, it is a question of whether growth will be at a 2% or 3% rate.

As previously mentioned, there are many indicators that are helpful in anticipating a recession. Below are just a few of the things we look at that make us confident that there are no symptoms yet of illness (i.e., recession).

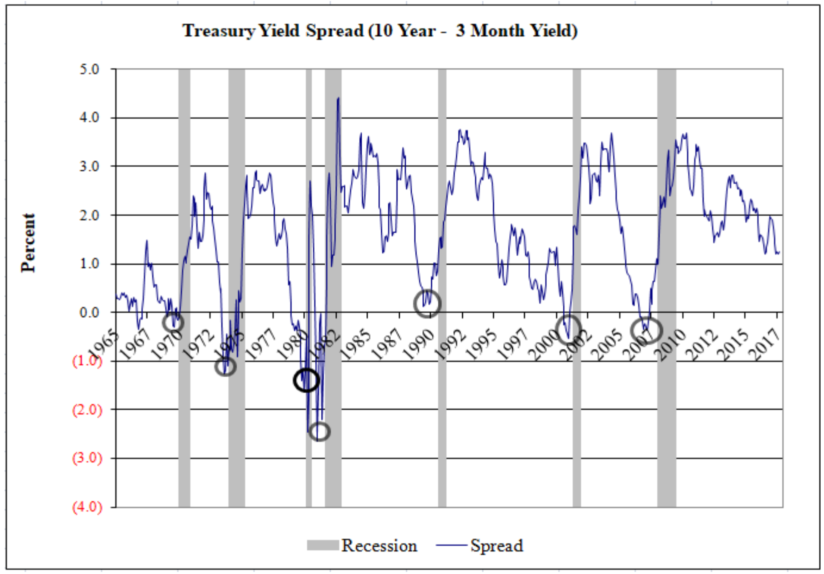
In the past, recessions started more than a year after the Conference Board Leading Economic Index (LEI) peaked. That index increased a strong 0.4% in August and is showing no signs of fatigue. This suggests that the next recession is probably not coming until 2019 at the soonest.

Chart 5

Source: Evercore ISI

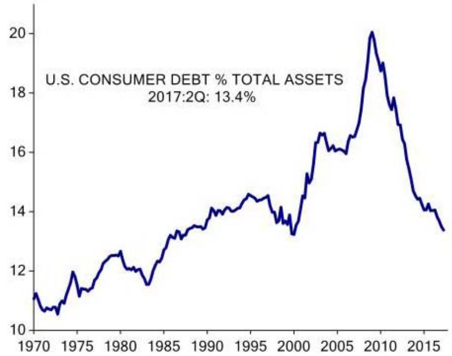
The shape of the yield curve, which can be measured by subtracting the 3 month Treasury bill yield from the 10 year Treasury bond yield (Chart 6 at right), has been one of the most reliable indicators of recession. If the spread falls below 1% it will get our attention. When it approaches zero, we know we have a problem. Neither is the case now.

Chart 6



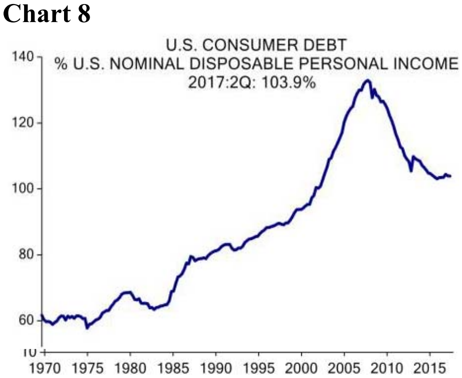
Source: Federal Reserve, FVCM

Chart 7



Source: Evercore ISI

Chart 8



Source: Evercore ISI

The U.S. economy has been able to expand at a 2% rate in recent years at the same time that consumers have been deleveraging their balance sheet. U.S. consumer debt has been falling as a percentage of assets (Chart 7) and Disposable Personal Income, which is the amount of income available after paying taxes (Chart 8). <u>We can have some level of confidence in the sustainability of the current expansion because it has been achieved without a relative rise in debt.</u>

This uncertainty related to the possibility of tax, healthcare and infrastructure legislation will shape the ongoing structure of market gains. For example, over the past ten years, the S&P 500 Growth Index is up 108%, whereas the S&P 500 Value Index has risen only 31%. This disparity is unusual.

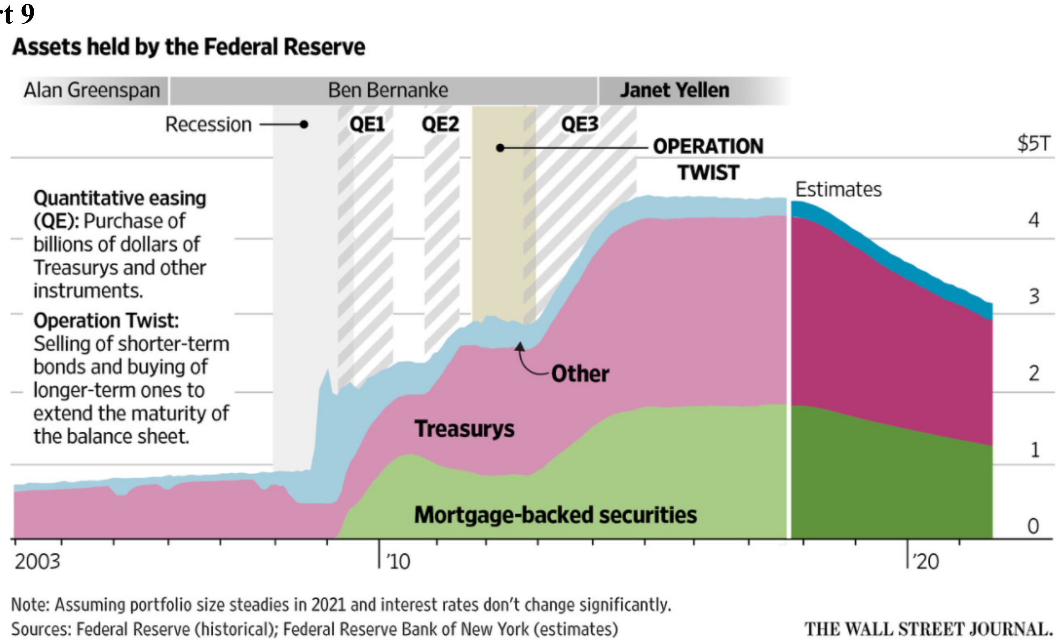
Going back to at least the 1930s with the publication of Graham and Dodd's "Securities Analysis," it has been an empirically tested point by researchers that value stocks provide better returns over time relative to growth stocks because of the latter's high valuations and propensity to disappoint. However, in recent years investors have been willing to pay ever higher premiums for stocks that are viewed as being able to grow regardless of the challenges to overall economic growth. In other words, as growth slowed from a 3% average rate to a 2% rate, the relative value of growth has increased.

Without the passage of new growth initiatives by the Republicans, growth will stay near the 2% level and the wind will remain at the backs of growth stocks, but beware of what can come. So many investors have poured money into big growth stocks that the valuation spread has become noticeably extreme. For example, Facebook's P/E ratio is 40, despite the fact that the company has a market capitalization of $500 billion. Netflix's P/E of 230 and Amazon's P/E of 250 are stratospheric and reminiscent of the extreme levels some technology stocks achieved in the 1999/2000 internet bubble. If the Republican's manage to pass tax reform in particular, there is likely to be a rotation back into value stocks, which have been neglected for years now. In addition, if the popularity contest turns back to value, these big growth stocks could correct very sharply. ETFs on Index funds like the SPX or IVV, which track the S&P 500, could also suffer dearly. Because the S&P 500 is a capitalization weighted index, it will be disproportionately affected by declines in the giant growth names.

Monetary Policy and the Dollar

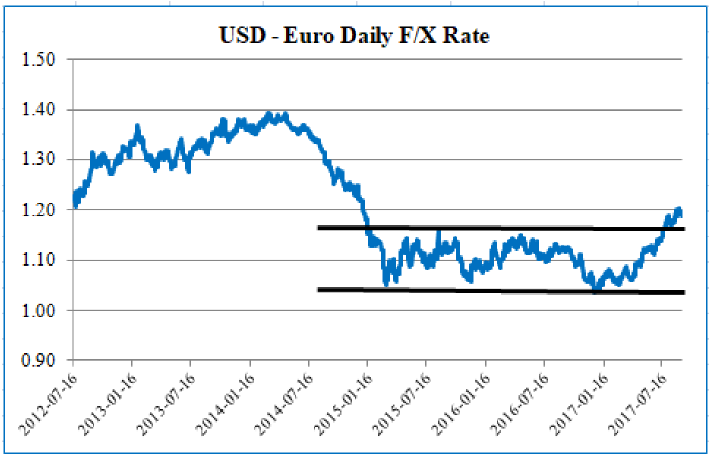
As previously noted, the indicators are still flashing green and the signs of a recession are not yet on the horizon. However, the Federal Reserve could someday spoil the party. Following the Great Recession of 2008/9, the Fed purchased U.S. Treasury bonds, mortgage backed securities and other assets in large quantities in a program called Quantitative Easing (QE). In doing so, the Fed was able to provide liquidity to the financial system by effectively swapping debt securities for money or short term liquid assets in the form of bank reserves. With the current expansion now 8 years old and showing signs of sustainability, the Fed announced plans to effectively reverse QE by allowing securities it owns to mature and not reinvest the proceeds. As indicated in Chart 9 below, the process is intended to be gradual. Nonetheless, combined with plans to raise interest rates, this represents a risk to growth in the years ahead, although the cumulative effect may not be enough to cause a recession for some years.

Chart 9



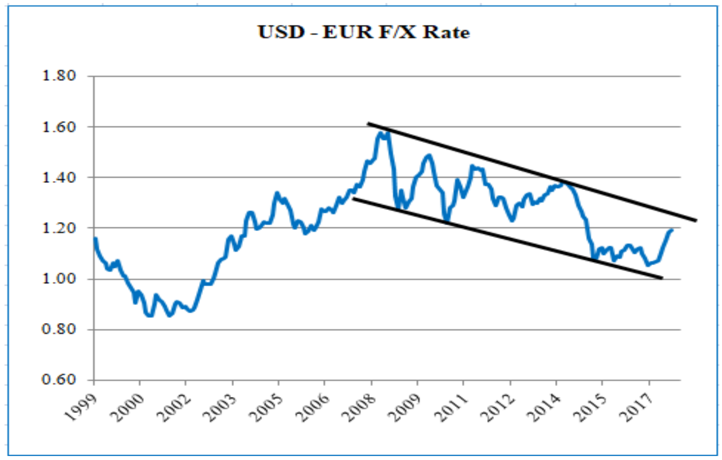
The Euro doesn't look like it has much more upside from this point. The Euro had been in a trading range between 1.05-and-1.15 dollars until its recent breakout to about $1.20 after Mario Draghi began to give some indications that QE in the Eurozone was in its latter stages (see Chart 10). But while the Euro broke out of the two year trading range, it is still within a downward channel established since the Great Recession. Investors must ask themselves whether the fault lines seen in the Italian banking system, as well as debt and other problems in Portugal, Spain and even France have been addressed during this period of easy money by the ECB. If not, it may be a reasonable question whether the Euro can really strengthen if the ECB ends QE, or whether the old fault lines reappear. From a chart perspective, the upside for the Euro looks to be about $1.25. The downside looks like it is below the old $1.05 floor.

Chart 10



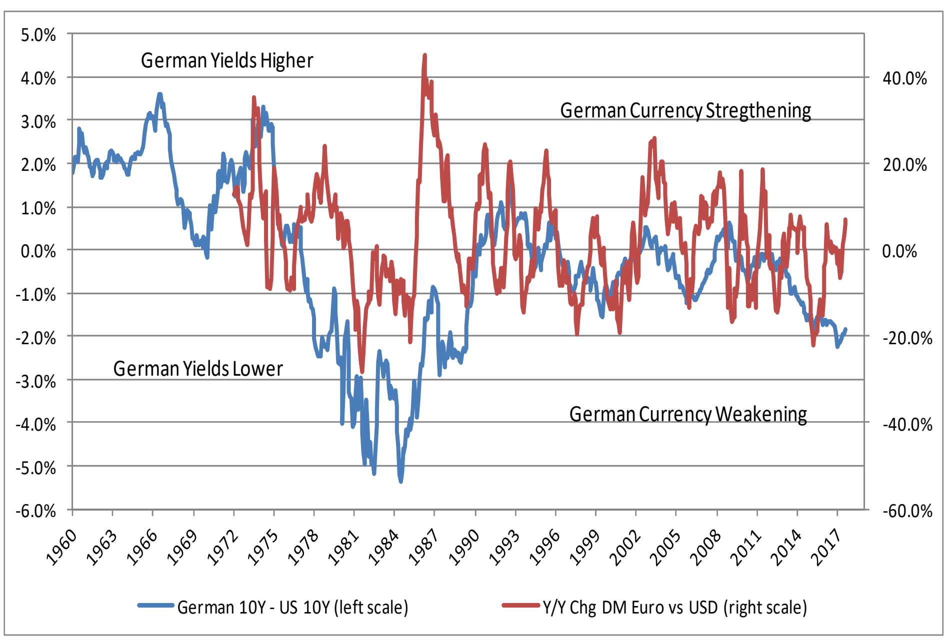
Source: Federal Reserve, FVCM

Chart 11



Source: Federal Reserve, FVCM

Chart 12



Another reason we are somewhat skeptical about the recent Euro rally is the chart to the left. There is an obvious correlation between the spread between the 10 year Bund and the 10 year UST. Please note that the recent rally in the Euro (the red line) occurred with little or no change in the spread between the Bund and the UST. It seems the F/X market is already discounting that the spread will start to narrow soon as the ECB eases up on QE. Any indications to the contrary will be a disappointment.

Source: Federal Reserve, FVCM

Closing Summary

Equity investors should stay invested and use any pullbacks to add to positions. The geopolitical events that lead the newspaper headlines are unlikely to have any lasting effect on stock valuations, and the things that could hurt the market—recession and inflation, are not yet on the horizon. The biggest unknown is whether the current administration and the Republicans in Congress can pass legislation that will stimulate business investment and real economic growth. If they fail, growth stocks will remain attractive as the economy plods along at a 2% rate. If legislation is passed, we think real growth could accelerate to a 3% rate. In that case, investor interest would likely shift back to value stocks and away from the giant growth companies and ETFs.
