The Capital Management Corporation

FOCUS Newsletter

Economic Comments | October 2019

MORE INTEREST RATE CUTS

The European Union (EU) Central Bank (ECB) cut its overnight interest rates from negative 0.4% to negative 0.5% in order to stimulate lending and investment. The ECB also resumed quantitative easing by "printing money" (expanding its balance sheet by buying most of the newly issued government debt of and within the EU).

This excessive buying of government bonds has contributed to more bonds having negative interest rates. About one-third of all developed nations' government debt effectively has negative interest rates.

As traditional EU depositors and government bond investors prefer positive interest rates, funds from the EU (and from other countries with negative rates) are moving into the US to buy US bonds.

This massive inflow of funds helps stimulate the US economy. Meanwhile, most countries with negative interest rates are barely growing due to demographics, a preference for cash over deposits, a weak banking system and the fear of deflation.

Consumers expecting deflation might delay purchases until there is a lower price. When widespread, delayed purchases can lower economic growth, which may in turn result in lower prices and the fear of more deflation. Central bankers dread such a vicious deflationary cycle.

US 30-YEAR TREASURY BOND YIELDS 2%

Foreign buying of US Treasuries is adding to a surge of money entering the US and strengthening the US dollar while pushing down interest rates. For the first time in history, the 30-year US Treasury Bond yields only 2%. A new record closing low yield of 1.94% was reached on 8/28/19.

While declining (positive) interest rates can stimulate economic growth, a strong dollar and escalating tariffs can lower economic growth via declining exports.

In reaction to lower bond rates, an inverted yield curve, slower global growth and a stronger dollar, The Federal Reserve (the Fed) has lowered interest rates by ¼% twice in the last four months (its first interest rate cuts in over ten years). The Fed's target overnight interest rate range is now 1¾% to 2%. Domestic savers should once again experience declining and negligible interest rates on their bank and money market accounts. Borrowers will benefit from lower mortgage rates and low interest expenses.

Key Dates

10/04	Unemployment Report
10/10	September Consumer Inflation (CPI)
10/30	GDP 3Q 2019 Advance Estimate
10/30	FOMC Press Conference
11/01	Unemployment Report
11/13	October Consumer Inflation (CPI)
11/17	GDP 3Q 2019 Second Estimate
11/28	Thanksgiving Day Stock Market Closed
12/06	Unemployment Report
12/11	November Consumer Inflation (CPI)
12/11	FOMC Press Conference
12/20	GDP 3Q 2019 Third Estimate
12/25	Christmas Day Stock Market Closed

GROWING DOMESTIC ECONOMY

While these lower interest rates should bolster domestic economic growth within a year, the US economy is already strong as seen by record employment and 3% aggregate wage growth. In turn, the US consumer is receiving about 6% more cash, most of which is being spent on goods and services.

Due to demographics and entitlement spending, federal government spending should continue to increase through the foreseeable future. Combined, consumer spending and government spending represent 85% of the US economy as measured by gross domestic product (GDP). With 85% of the economy experiencing 5% to 6% of nominal annualized growth, the overall economy should continue to grow.

The remaining 15% of GDP has less growth. Business spending growth has slowed to 2%, housing starts remain sluggish due to a shortage of skilled labor, and international trade has slowed partly due to new tariffs. As such, overall quarterly Core GDP growth is about 4¾%.

As tariffs were announced, companies tried to avoid them by importing and warehousing goods before they were needed. The drawdown of these inventories could lower overall economic growth by one percentage point over the next six months; thereby, lowering overall nominal GDP growth to 4¼%.

If the Federal Reserve is able to achieve its target inflation level of at least 2%, then real (inflation-adjusted) economic growth could be about 2¼% over the next six months. The financial markets pay close attention to the government's first calculation of real economic growth.

Uncertainty over the 2020 election could lower consumer and business confidence in early 2020. However, as election day approaches, more people think they know what the outcome could be and uncertainty declines. By that time, inventory adjustment headwinds should have abated and economic growth might accelerate.

ADDITIONAL MONEY FLOWS

Several other developments remain positive for the domestic economy.

Total commercial loan and lease growth is 6.8% year-to-date.

Over the last twelve months, measures of money supply (or liquid cash), M1 & M2, have risen by 4.2% and 5.7% respectively.

Hundreds of billions of dollars are flowing into the US due to foreign buying of US bonds and net energy exports.

With massive inflows of cash, a healthy banking system, full employment and declining interest rates, the US economy remains vibrant. Speculation of an immediate recession appears dubious.

Behavioral economics (the study of human emotions and money) suggests that concerns weigh heavier on our minds than comforts. Today's concerns can include inverted yield curve, tariffs, investigations, debt and geopolitical events. Relative to concerns of both recent and distant times, today's troubles appear moderate.

FUTURE CHANGES: WHERE TO INVEST

Typically, the financial markets experience short-term volatility. Over longer time horizons, investors might spot recurring multi-year trends. These may include relative performance swings of growth stocks vs value stocks, dividend payors vs non-dividend paying stocks, and large vs small company stocks (measured by stock market capitalization).

While small-capitalization stocks appear to outperform large-cap stocks over very long periods of time, in the last three years large-caps (the Dow Jones Industrial Average) has outperformed small-caps (Russell 2000) by about 31 percentage points!

During that same time period a growth stock index has outperformed its value counterpart by 30 percentage points. Whereas several decades of cumulative performance of growth and value can be similar.

Over the last three years, the Dow Jones Industrial Average outperformed a stock income index by 22 percentage points. Yet, over longer periods of time, dividend paying stocks can provide stronger results than comparable general market indices. Today, some equity income portfolios yield 4% (about twice that of the 30-year US Treasury bond).

Endowments and individuals dependent on their savings to support annual spending need to be mindful of both their withdrawal rate and future inflation. Annualized inflation rates of 3% and 4% would reduce the value of a dollar by over 50% after just 24 and 18 years respectively. Using a long-term 5% spend rate and 3% inflation rate infers that underlying portfolio returns should be at least 8% in order to avoid depletion. Low interest rate bonds make this feat more challenging.

Greater investment opportunities may be found in certain dividend paying stocks, smaller company stocks and stocks with low valuations. When researching these areas, investors should focus on companies with recurring growth of revenue, earnings and cash flow generation.

A concentrated investment portfolio of “best ideas” having many of these traits could produce compelling results over the next three to five years. Moreover, the rising stream of cash dividends produced by dividend growth stocks might support a large portion of the client’s long-term, recurring cash needs.

- Timothy C. Call, CFA, President & CIO

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