Basis Points Weekly Market Commentary

Basis Points – March 7, 2019

westwoodgroup.com/weeklyblog/basis-points-march-7-2019/

Above the Fold

- The U.S. posted its widest monthly trade gap since 2008 in December and a record annual deficit in goods as steady economic growth caused higher spending by American consumers and businesses. The annual trade gap widened by 12% to $695 billion from $621 billion in 2017. During 2018, the White House imposed tariffs on a wide range of goods imported from China, which was intended to spur the signing of a new trade deal and lessen the trade deficit. The opposite has happened, however, as the tax reform bill signed in 2017 boosted the coffers of businesses and fattened the wallet of consumers, who then increased spending on foreign-made goods. Concern that the U.S. economy could overheat caused the Federal Reserve to raise interest rates four times in 2018, contributing to a strong dollar that made foreign goods relatively cheap for Americans. Ironically, the trade deficit widened most with China, the United States' largest commercial partner and the focus of White House trade war efforts. Chinese authorities responded to new tariffs by drastically cutting back their country's purchases of key U.S. exports like soybeans, cars and metals, which made the trade deficit worse for the U.S.
- Salesforce.com, the world's largest Customer Relationship Management (CRM) software company, reported earnings on Monday and said that it expects revenue to nearly double in four years, benefiting from companies shifting more of their spending to technology innovation. Salesforce.com said it expects about $16 billion in revenue in 2019 and $26 billion to $28 billion by fiscal 2023. Salesforce.com management pointed to strong demand from cloud computing, artificial intelligence and other areas as part of what is being called a Fourth Industrial Revolution. Founder Mark Benioff noted that, "Companies are continuing to make incredible investments in their customer experience. They know they need to invest in becoming more customer-centric, more efficient and more automated."

Three Things

Three Things

- Bloomberg News notes that the average stock traded on the U.S. exchanges is very old these days at about 20 years, which is twice the average age of public companies in 1997 during the dot-com craze. Given the rise of a huge pool of private equity capital, companies are doing just fine staying private for a long time while their business grows and matures, away from the prying eyes and demanding quarterly forecasts of Wall Street analysts and investors. Increased financial industry regulation, with its onerous oversight and high costs, has also incentivized small companies to remain private as long as possible. While there are some well-known companies planning to go public this year such as Uber, Lyft and Airbnb, they are going public at an average age that is four years older than 20 years ago. Some market watchers argue that an older market is a less volatile one, as companies that are older and more seasoned tend to be more economically stable and less prone to huge spikes in stock value, or prone to bankruptcy filings due to the collapse of unproven concepts; see: Pets.com.
- ExxonMobil and Chevron, the two largest U.S. oil companies, recently lifted their expectations for production in the Permian Basin. In a management presentation to Wall Street analysts this week, Exxon revised up its projection of oil and gas production in the Permian from 600,000 barrels equivalent a day to 1 million in 2024. Chevron lifted its estimate from 650,000 bpd to 900,000 bpd in 2023. The revised production schedules demonstrate the continuing spending on capex production in the region, and how the major oil companies are coming to dominate regions like the Permian, which only a few years ago were mainly energy plays for small and growing companies. The growth plans mean that both companies expect to triple their Permian production from 2018 levels over the next five to six years. Addressing the volatility of oil prices in the past few years, Exxon said that it expects to be able to be profitable in the Permian even at lower oil prices, saying it can earn an average return of more than 10% there even with crude at $35 a barrel.
- CNBC notes that the number of U.S. $100 bills in circulation is surging, and economists are not sure why. The number of outstanding $100 bills has doubled since the financial crisis, with more than 12 billion of them in global circulation, and now outnumber the total number of $1 bills in circulation. Economists think that the surge is related to people around the world wanting to hoard cash, fearing another economic crash or deflation from Japan and European Union countries. High-value currency notes like the $100 bill have also been a preferred form of payment for criminals, given the anonymity, lack of transaction record and the relative ease with which they can be brought across borders. The $100 bill has a longer shelf life than any other form of U.S. cash, as the average $100 bill stays in circulation for 15 years, vs. just five years for a $10 bill. The Federal Reserve Bank of Chicago estimates that 80% of all $100 bills are now in circulation overseas, up from 15% in 1980. There has been pressure from some experts to discontinue the printing of high denomination notes to deter international crime and money laundering and

of high denomination notes to deter international crime and money laundering and to hinder the easy hiding of cash in offshore havens.

Did You Know

If you are going to have a bubble, the best type of bubble is a productive asset bubble financed by the capital markets. For example, the dot-com era of the late 1990s produced much more fiber optic cable than was needed at the time and created many pie-in-the-sky companies whose valuations got far ahead of the worth of their business ideas or their profit potential. The technology sector crashed in 2001-02, but the fall of the sector did not cause great systemic disruption for the financial sector, as the capital spending and worthless ideas were not financed by the banking system, merely overzealous private investors and venture capital funds. The fiber optics and other productive assets were later sold and are in use today to handle the current day’s much larger internet traffic.

However, the housing crash of 2007 did cause a major systemic crisis in the banking system, as houses are not productive assets, and the bubble was acutely fueled by the banking system. With 85-95%, or even 100% leverage used by investors, a small crack in asset prices caused highly leveraged investors to be insolvent. When excess leverage is coupled with a severe decline in asset prices, the chaos spills over into the banking system, and that is when things get ugly for the economy and our financial system in general.

Fast forward to the bitcoin craze of 2017 that seems to be over — the massive rise in cryptocurrency prices certainly seemed like a bubble that was due to crash. However, since there was very little leverage involved in this speculation, any resulting effect on the financial system of the large price decline in cryptocurrency prices was minimal and focused only on the finances of the speculators themselves.