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25 YEARS

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THE SPIRIT OF 17,000 AND '76

July, 2014

The Dow Jones Industrial Average crossed over the 17,000 threshold on July 3rd. The next day, Americans celebrated Independence Day to mark the anniversary of our emergence as a sovereign nation. Judging by the price action of the past eighteen months, stocks seem to be declaring that they too have broken free of their shackles.

Major market number 9

Stock market records do not go back to 1776. In fact, the Dow Jones index was not actually first calculated until a century and a score later, in 1896. But it is clear that stocks tend to move in long cycles and, since that time, there have been eight structural, or long-term, bull or bear markets. The operative question is whether stocks have embarked on a ninth one.

As we can now all recognize with hindsight, stocks entered a structural bear market in early 2000 following the implosion of the tech bubble. The years since have produced two recessions and a global financial crisis. And as is typically the case, the period has been marked by violent stock sell-offs followed by sharp rallies. The net result is that over a long stretch of time, stocks ended up essentially moving sideways; a frustrating but classic long-term bear market.

But with the Dow Jones and broader S&P 500 indexes breaking back out to all-time highs, some observers believe the market has embarked on a new upward cycle. Of course, pundits may claim whatever they wish, but one cannot really know the answer until more time has elapsed.

Who's afraid of the big bad bear?

We *can* observe that the stock market seems rather quiet at the moment. Trading volumes have been light. In June, an average of 5.6 billion shares traded hands daily on all American stock exchanges, compared to 7.1 billion the previous June. Also, the S&P 500 has not experienced a 10% correction since the fall of 2011. The VIX — a "fear gauge" that measures the anticipated volatility of the stock market (specifically, the expected movement of the S&P 500 over the next 30 days on an annualized basis) — has moved down to a seven-year low. Meanwhile, over in bond land, yield spreads are very narrow, indicating that fixed-income investors are not particularly concerned about credit or liquidity risks.

Are investors merely calm or have they become complacent? The economic landscape does appear to be generally favorable, but there are some anomalies that investors are shrugging off. Most notably, how does one square a recovering economy with low and still *falling* Treasury bond yields — particularly with the Federal Reserve now on a path to normalize monetary policy? Conventional wisdom holds that a strengthening economy leads to wage and other inflationary pressures, which in turn prompt interest rates to move up.

So the implication is that either the recovery is suspect — or the mechanism by which inflationary pressures gain traction has broken down. Or perhaps we're just experiencing *irrational complacence* by both stock and bond investors.

Soft and steady

It has indeed been a grudging and uneven economic recovery. The recession officially ended in June 2009, but it was not until this past May that the job count finally returned to pre-recessionary levels. And gross domestic product actually *contracted* at an annualized rate of 2.9% during the first quarter. But that disappointing performance seems more a function of the harsh winter weather that gripped the country than the beginning of a new downturn. Most cyclical indicators, from bank lending to rail car loadings, still point toward economic growth, not contraction. To us, the odds of a recession looming around the corner are still low.

The one benefit to soft rather than robust growth is that it has allowed the Federal Reserve to maintain an accommodative policy stance. At the moment, the Fed is not touching the brakes, but it has been taking its foot off the accelerator some. *Quantitative easing* — the Bank's bond-buying program — is winding down, but investors are thinking that the Fed funds rate (now at 0.25%) will stay where it is at least into 2015.

Interestingly, last year, the mere hint of a slightly tighter Fed caused markets to convulse. Stocks fell briefly, and bond yields moved up. This year, however, bond yields have fallen even as policy nears normalization. Perhaps this backdrop reflects the view of some that there is a *new normal* for policy rates that is lower than the 4% to 5% range typically seen. The ultimate outcome will depend largely on inflation expectations and where they head. In any event, interest rates seem inexplicably low at the moment.

Iraq erodes ...

As we look out over the balance of the year and consider factors that may cause stock and bond markets some indigestion, the risks today seem more geopolitical than economic in nature. Perhaps the most meaningful threat, in part due to its intersection with the global economy, relates to the evolving crisis in Iraq. So far, most U.S. investors have dismissed the turmoil, but the oil markets have certainly begun to notice.

Iraq is turning into a vacuum, as the Shia-dominated government of Prime Minister Nouri al-Maliki finds itself under attack by a Sunni jihadist movement. Call it karma. For years, Saddam Hussein's Sunni sect repressed the Shia majority. Maliki assumed office in 2006 with a charge of building a more inclusive Iraq. It did not happen. Like Hussein before him, Maliki systematically destroyed the Iraqi state, replacing it with his own office and political party. He sacked professional generals and purged Sunni political opponents. And he built close ties with Iran.

Consequently, Iraq is in danger of becoming a failed state and the region the host of a Sunni-Shiite holy war. A militant group, the *Islamic State of Iraq and the Levant* (also referred to as the *Islamic State of Iraq and Syria*), has overrun much of north and central Iraq. Various disaffected Sunni groups have joined the movement. The ISIL's stated aim is to establish a caliphate, or religious state, in Sunni-majority regions of Iraq and Syria. Ironically, the combatants are using leftover U.S. military weapons to aid them in their quest.

… And oil's not well

For the United States, the foreign policy implications are enormous and complex. And this conflict comes at a time when many voters and much of the political establishment favor a new foreign policy of disengagement. The turn of events is tragic considering the thousands of casualties incurred and trillions of dollars spent attempting to put Iraq on the path to "democracy." But in more narrow economic terms, the threat to the crude oil supply is the obvious issue with which we must wrestle today.

Iraq represents OPEC's second largest producer of crude oil. In recent months, its output has totaled about 3 million barrels per day (b/d), the vast majority destined for export. Besides being a substantial producer, Iraq had been expected to account for the majority of OPEC's output *growth* over the next five years. At this point, the insurgency has not interrupted Iraq's oil output, because 85% of the production comes from unthreatened oil fields in the south. The possible impact on the country's refining capacity is a bigger near-term concern, as the largest refinery is located in the north. ISIL insurgents could also potentially cause outages to some of the other infrastructure in the supply chain such as pipelines.

The challenge is that the recent row in Iraq seems to be but the latest chapter of turmoil involving oil-producing countries. The number and degree of supply disruptions has really stepped up over the past several years. The oil market has always been susceptible to an occasional large disruption caused by war or weather. But generally, only 500,000 barrels of oil a day have been held off the market at any one time for various reasons. However, since 2010, it has been one event after another, from the Arab Spring uprisings, to chaos in Nigeria, to sanctions against Iran that have interfered with significantly more oil output. And now, the mess in Iraq. In the words of Citigroup energy economist Edward Morse, we are seeing "the failure of the petro-state."

Oil Independence Day delayed

Prices for Brent crude had risen about $10 to $115 per barrel by mid-June before backing off a bit. Entering the July 4th holiday weekend, gasoline prices averaged $3.67 per gallon nationwide, the highest for Independence Day since the record levels of 2008. And these moves merely reflect concerns about supply, not an actual disruption itself. A quick rule of thumb is for gasoline prices to rise about 2 cents per gallon for every $1 increase in a barrel of crude oil.

But wait a minute. Hadn't many politicians and media types previously declared our independence from foreign energy sources? Great strides have indeed been made, particularly given the *shale revolution* that has unlocked vast reserves of natural gas and oil in certain regions in the lower forty-eight. And outside of petroleum, the country *is* pretty self-reliant, producing most of the energy consumed. However, due to the appetite of the transportation sector, the U.S. still must import a sizable amount of oil; specifically, about 6.5 million b/d. Enough that we cannot blithely dismiss potential supply disruptions.

This backdrop helps explain the annoying resilience of oil prices in the face of rising U.S. production. Other things being equal, one would have expected oil prices to have trended down. But two factors determine the price of oil: the fundamental laws of supply-demand and fear.

Keep an eye on the gauge

Fortunately, the country's reliance on foreign oil has dropped dramatically. And the U.S. Energy Information Administration forecasts that the news will get better. As recently as 2005, 60% of Uncle Sam's consumption of petroleum had to be met with imports. By last year, that figure had dropped to one-third, and in 2015, the EIA expects the import share to drop to 22% of our liquid fuels consumption. This cheery trend is being propelled by surging U.S. oil production and, to a lesser extent, improved fuel economy. Oil output rose from an average of 5.5 million b/d in 2010 to 7.4 million in 2013. By 2015, the output should reach 9.3 million b/d, which would mark the highest rate since the early 1970s.

The picture on the natural gas front is even brighter. U.S. natural gas production has risen by one-third since 2005. Domestic prices have dropped sharply, reflecting a market that is in surplus. In fact, facilities that were previously intended as import terminals to receive liquefied natural gas (LNG) from overseas are being reconfigured to *export* LNG. Perhaps some of this excess supply can ultimately help our European allies reduce their reliance on Russian gas. Putin's Ukraine incursion is but another example of a geopolitical conflict impacting energy markets.

In 1973, Richard Nixon went on the air to promise Americans energy "independence" within ten years. This statement followed by several weeks the Arab oil embargo, which led to a quadrupling of oil prices. Succeeding presidents have each given the same pledge. However, even as the overall stock market seems to declare its freedom and moves into a possible new stage, our energy independence is still a work in progress. And so we must not lose sight of the fact that every post-World War II recession but one was preceded by an increase in oil prices.

— Christopher J. Singleton, CFA, Managing Director

July 16, 2014