# THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser


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June 3, 2016

## TPWC Market and Economic Update

### The Markets

The S&P 500 Stock Index ended the day today at 2099.13, just short of 2100 and virtually where it was a week ago. During the week, it climbed all the way to 2104 and dipped down to 2095, for a variance of ten points, or about 0.2% up and down. It is still up about 15% from its low in mid-February, and down just a bit from where it was last year at its high.

Meanwhile, corporations have continued to earn money, and the GDP of the United States has continued to grow. In our many years of managing investments and watching the economy and the markets, we have seen this before. Companies are continuing to be profitable, the economy keeps growing, but the stock exchange gets stuck waiting for something bad to happen. As is usual with such things, when traders are waiting for bad news, terrible things generally do not happen. It is when they become convinced that no bad news will come along to upset things that we should get worried. As John Templeton is reputed to have said, "Bull markets climb a wall of worry." They sometimes get stuck in that climb, but as long as there is plenty of worry to go around, the bull is still here.

Interest rates and dropped a tiny amount this week, and like stocks, are pretty much where they were a year ago. Short-term rates are very slightly higher, and longer term rates are very slightly lower.

As we have written before, until the Presidential race is over, investors, both in the exchanges and in the business world, appear to be putting things on hold.

### Municipal Bonds

A warning is in order concerning municipal bonds. There are bond offerings out there with coupon (stated) yields of 5% or more, and they look very attractive when a broker (financial advisor) offers them. We have investigated them as bond brokers have asked us to buy them on behalf of our clients.

They come in two general categories. The first, and most enticing, are the highly rated general revenue bonds. The misleading part about the 5% (+) yield is that the price of the bond one would buy on the open market is above "par" or 100. While for every $1,000 of the face, or maturity value, the owner does indeed receive $50 per year, because a buyer must pay more than $1,000 for every bond on the open market, when we calculate the yield-to-maturity, the real return is about 1.5% per year. The second category is "revenue bonds" where the price is well below 100, and the yield-to-maturity is 5% or higher. The problem with those "revenue" bonds is that they may not pay off at maturity! Be warned! Any financial product offering a yield higher than a 10-year Treasury carries a risk, and the higher the interest rate, the higher the risk. The risk, for example, in highly rated general obligation municipals is that some carry a price of $1,200 or more but the bond-holder will only receive back $1,000 at maturity.

### The Economy

Nonfarm payrolls rose by a seasonally adjusted 38,000 in May, the weakest performance since September 2010. At the same time unemployment, the percentage of people in the workforce actively looking for jobs, dropped to 4.7% from 5% in April. About 458,000 people left the workforce last month. Very interestingly, the average wage grew by 0.2% in the month, or on an annualized basis, by about 2.5%.

Those numbers taken together seem to make little sense. Employers are willing to pay existing workers more money but appear not to be ready to hire new workers. It is when one looks at another weak number, durable goods purchases by businesses, that it starts to come together. Hiring a new employee in a low unemployment environment is a significant investment by a business owner. So is buying a new piece of equipment. Managers base both decisions on assumptions they make about the economic and tax environment a year or more into the future.

My discussions and reading suggest that Donald Trump has got them scared. A combination of an unknown tax environment and potential trade wars with our biggest trading partners seems likely to be disastrous for businesses. Making a long-term investment in an environment


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that is this uncertain is just something they don't want to do. The same fears, although to a lesser degree, are keeping stock investors on the sidelines.

## Annuities and Annuity Companies

In another area, MetLife Inc., one of the three largest insurance companies in the United States, announced that it intends to begin selling off large portions of its life insurance activities. It is not the first company to make this decision, and, in our opinion, will not be the last. It is not life insurance that is creating concern at insurance companies, but rather annuities. Life insurance is, in essence, a bet by the life insurance company that a policyholder will live a long time. Given the fact that we are living longer, that appears to be a good bet. A "guaranteed" annuity is the reverse of that bet. When a life insurance company sells an annuity, and particularly a "deferred annuity," it is making a gamble that its bond portfolio will earn enough money to pay the interest it has guaranteed. More, the risk that a deferred annuity holder will liquidate at some point in the future when interest rates are higher, and the bonds are worth less than they are today is a frightening prospect. The even bigger danger is that the annuity holder will demand a stream of income for the rest of his or her life. If that person's life winds up being much longer than anticipated, the results for the insurance company are potentially devastating.

Bond portfolios are the mainstay of insurance companies. If the company holds the bonds to maturity, they are also quite predictable. The risk to the insurance company is that to offer competitive annuity rates; they are buying long-term bonds (typically 20-30 years) that carry higher rates. Since the "surrender charge" period on the deferred annuities is much shorter than the maturity of the bonds, typically around 10-15 years, a potential for disaster looms for the company. If interest rates are significantly higher in 10-15 years than they are today, the insurance companies will be forced to sell bonds at a loss and pay more to the deferred annuity holders than they receive for the bonds. Regulators are becoming more aware of that risk and are demanding that annuity companies set aside larger reserves in cash or short-term bonds to offset the risk. That need to set aside reserves, while prudent, cuts into the profit from selling annuities and has turned the practice into a money-losing transaction for the insurance company.

The good news is that in the past, the annuity company could sell the contracts today, but the day of reckoning would not come for ten or fifteen years, long after the salesperson and company executives had moved on. Historically, by then, some enterprising new executives would have effectively "sold" the business to investors who were clueless about the risk. That happened in the 1970s and early 80s, the last time interest rates rose. Few are around to remember the series of big annuity-issuing companies that vanished, taking much of the annuitant's money with them. This time around it appears that the regulators may have learned from history. Still, in our opinion, there will be deferred annuity purchasers who are in for some very unpleasant and expensive surprises in a decade or so. There is no such thing as a higher than Treasury or incurred CD interest rate without some form of risk. Add in the word "guaranteed" and a higher rate, and the risk multiplies.

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