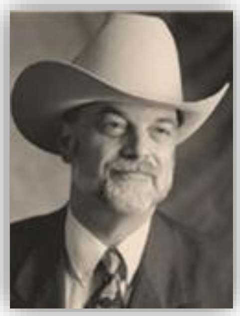

THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index (SPX) finished the week at 2,415.82, up 1.43% since last week. As we approach the end of the second quarter, it is up 7.91% year-to-date and 15.09% from this point last year. Today's close marks the 20th record high closing for the Index this year. For those keeping up with the SPX versus where it was at recent highs and lows, the Index is up just over 32% from its low last year on February 11, and up 13.38% from its high in May of 2015. Gold rose 0.04% this week to $1,207 per troy ounce, but is still down 7% from last July. Interest rates remain basically unchanged with the ten-year U.S. Treasury note yielding about 2.25%. Just for the record, that interest rate remains at a historically abnormally low rate, but is far better than the German 10-Year Bund, yielding 0.33%, about the same as most major European government bonds. Two year notes in Europe remain in negative territory reflecting the reality that the Euro economy is still not far from recession.

The Economy

Profits and Trade Balances

The Commerce Department, or more accurately, the Bureau of Economic Analysis (BEA) issued its third revision of U.S. first quarter 2017 growth in gross domestic product. The BEA's announcement was that after nearly 90 days of gathering and compiling an arcane series of numbers and then combining them together in a system first designed by Herbert Hoover, our economy officially is estimated to have grown at a 1.2%.

In that same report the BEA also reported that adjusted after-tax, non-financial corporate profits (NCP) were up 4.3% from a year earlier. What is quite interesting about that report is the difference between the reported profits of the S&P 500 stock index, commonly referred to as "earnings," and the figures released by the Commerce Department. The S&P 500 year-over-year earnings are up 15.3%. That is quite a difference in profit numbers!

The difference is primarily from two issues. The first is that the Commerce Department number (NCP) is arrived at by adding and subtracting a host of things, including subtracting inflation and imports, while the S&P 500 number is simply the profits reported by the various companies added together. The second, and in this case, larger difference, is that the S&P 500 number includes the profits earned from overseas subsidiaries of the Index. In many cases, the S&P 500 profits include profitability gained from importing something from somewhere else to the United States. The Commerce Department not only does not add those to its reported profit numbers, but rather, it *subtracts* them from domestic profit and GDP numbers.

This large a disparity of numbers between the GDP and NCP has not always been there. Before the "Great Recession" of 2008-2009, going back to 1985, the average GDP growth rate was 3.1% while the NCP grew at about 3.5%. From 2010 through the first quarter of this year, the GDP growth rate declined to 2.1%, but the NCP remained at 3.5%. Considering that the GDP and NCP are calculated using the same basic assumptions, there is a real possibility that our economy is growing faster than the GDP numbers indicate.

Why would we think so? The easiest answer is to look at the unemployment rate. We are at or very near to full employment today, yet a few years ago we had double-digit unemployment. Over the past seven years we have not only hired back those laid off in the recession, but our economy has also created new jobs for about an average of 150,000 new workers entering the jobs market each month. More, while the Commerce Department numbers have reported a steady, if historically low, growth in productivity. That means that not only are we employing millions more workers than just a few years ago, we are also producing more goods and services from each hour a worker works! When one adds up those extra worker hours and multiplies it by productivity gains, a 2.1% GDP growth is just too small to accommodate all that production. Of course it could be that we are producing more, but profits on that production are down. Looking at the S&P 500 profitability numbers eliminates that idea quickly. SPX profit margins are close to a record high.

It is, in our opinion, entirely possible that we have an outmoded system for calculating both GDP and our balance of trade figures. As we have suggested on the radio, when we create automobile components in the U.S., then export them to Mexico where the vehicle is assembled, then import it back to be sold here, the final product is more valuable than the parts, thus it creates a *subtraction* from U.S. GDP because of the "import." Since the entire process was accomplished solely in factories owned by an American corporation, the total profit accrues to the U.S. corporation, and shows up in dollars on its bottom line, yet because of what may be an outmoded numerical model, it gets subtracted from American production.

One could argue that the wages paid to the workers in Mexico along with any taxes paid there are indeed losses to the American GDP, but those are also losses to the corporation. The reality is that we live in a global economy, yet our national metrics are so constructed that they show a loss where we have a profit. That would certainly go a long way toward explaining why, for example, Germany and Japan have large export surpluses when compared to us yet have economies that are either in or near to recession, while we have a relatively large negative trade balance, but are by any measure the strongest large economy on the planet. In fact, were we to take the necessary actions to eliminate our negative trade balance, all indicators suggest that we would create a severe recession here in the United States.

Budgetary Gimmicks

The White House released its formal budget proposal this week. The bottom line is that the proposal would cut taxes, increase defense spending, increase infrastructure spending, decrease Medicaid and other programs for the poor, build a wall on the Mexico border, and then go on to balance the budget in ten years. If one adds up the numbers, it boils down to a proposal to cut revenues to the government while substantially increasing spending. In Congressional testimony yesterday, it was pointed out that the document appears to add back in the savings from domestic spending cuts twice while at the same time assuming a 3% GDP growth and then also adding that additional GDP growth back in twice as well.

Another assumption that seems to underlie the figures in the President's budget is that somehow we will dramatically increase the number of employed persons in the United States as well as give everyone a series of pay increases, but see no rise in interest rates. Considering that businesses across the country are reporting they are having a great deal of difficulty finding people to hire, that assumption too seems questionable. The final analysis from our perspective is that we cannot cut taxes, increase spending, and balance the budget all at the same time. We can indeed do the first two, but only if we are willing to roughly double our national debt over the next decade.

The take-away here is that the large-scale tax cuts hoped for following the election are more and more unlikely to take place unless we are willing to double our annual deficit, so we recommend not counting on a tax windfall from the Feds. Any cut to corporate taxes, which is, in our opinion needed, will need to be balanced by an increase in individual taxes or a dramatic cut to defense spending, Social Security, or Medicare. One idea to do that reportedly being discussed in the back rooms of Congress is to convert Medicare to a tax credit program and require those over 65 to buy their own health insurance in the state insurance markets. We somehow think that is a non-starter.

Until next week, we remain your faithful servants,

Jake

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