THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

Jeffrey W McClure CFP®

Jacob A McClure CIMA®

PO Box 1029 / 918 N. Main Street
Salado, TX 76571

(254) 947-1111
(800) 914-7526

Serving Investors Since 1982

www.tpwc.com

jeff@tpwc.com

jake@tpwc.com

July 7, 2017

TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index (SPX), our preferred measure of "the market", closed out the week at 2,425.18. It rose 1.75% this week, running the year-to-date gain up to 8.32% although, because of the starting date, the one-year return dropped to 13.86%. Three years ago, the SPX was at 1,968, giving it a three-year average annual rate of return of 7.21%. This year's rise was despite the plunge in tech stocks that started about a month ago, which has dragged the Index down about a quarter of one percent since June 9. This week's rise was largely generated by financial and manufacturing stocks.

While it is not immediately apparent to a casual observer, the stock market's behavior this year is unusual. In most years, there is a slow decline in stocks starting in June as many traders go on vacation. That slump usually becomes quite pronounced around the end of the first week in July as cautionary selling gets on a roll. This year, not only did we not see the slump, but the volatility index (VIX) has remained both smooth and low.

Gold closed at $1,211.90, down 2.38% this week and about 11% down from last year at this time. The 10-year U.S. Treasury bond ended the week at 2.388%, the highest yield since March of this year.

The Economy

Employment Report

Each week has some item of economic news that headlines, and this week it was the release from the Labor Department's Bureau of Economic Statistics (BES) of its monthly *Employment Situation News Release.* The bottom line is that the American economy employed 222,000 more people in June than were employed in May. As is not too uncommon, the unemployment rate moved slightly the other way with the percentage of unemployed persons in the total workforce of people wanting to work rising from 4.3% to 4.4%. More good news was that April's employment gains were revised upward from 174,000 to 207,000 and May's numbers were up from 138,000 to 152,000. Despite the market jump and all the noise, this gradually growing employment trend looks to be very much the same as it was in the lasts six months of last year.

Employment growth has averaged about 180,000 per month so far this year, well ahead of the about 100,000 per month required to absorb new workers coming into the economy, so why did unemployment go up? The answer is that people who were previously not looking for work, but in most cases, were previously employed, are coming back into the workforce. Over the last year, the employment/population ratio has moved from 59.6 to 60.1 as a gradually increasing percentage of the work-age population decides to enter the employment market.

Since January the unemployment rate has declined by 0.4% and at the end of June there were 658,000 fewer people looking for work than at the beginning of the year. About a quarter of the unemployed are "long-term", meaning they have been jobless for 27 weeks or more. That set of "hard core" unemployed is shrinking, but very slowly.

Again, this month the anomaly of a shortage of workers but very low wage growth showed up. Over the last year, the average hourly wage only rose 63 cents, or about 2.5%. Average weekly hours worked rose by about one-tenth of an hour (2.8%) so our mythical average hourly worker is earning about $24 more per week than he or she was earning last year. Still, all this means that there are 2.16 million more people employed than a year ago, and they are collectively earning (and mostly spending) about $102 billion dollars per year that were not being earned last year at this time.

Energy on a Roll

We normally stick to hard facts in our economics section but there is an interesting trend under way that seems more like soft-data. The first data point is that even though oil prices have fallen about 13% since April, there are about 100 more U.S oil-drilling rigs in operation today than there were then.

On top of that counterintuitive change, Warren Buffet has offered over $9 billion in cash to purchase bankrupt Energy Future Holdings Corp (EFHC). If you have never heard of EFHC, you may know it better as *Oncor*, the company that owns almost all the energy transmission lines in Texas. Old TXU, once "the power company" for Texans, was purchased in a leveraged buyout by KKR and Goldman Sachs in 2007. Following the financial meltdown and then the energy price slump generated by shale oil, EFHC could not pay its bondholders and declared bankruptcy. Now Berkshire-Hathaway, Warren Buffet's company is swooping in to purchase the power transmission (Oncor) part of the business for which KKR and Goldman paid about $25 billion. One of the more interesting things about Buffett's bid is that it is about half of what was previously offered by two other companies. The Public Utility Commission of Texas (PUCT) rejected the two other bids because they involved a lot of borrowed money and the ensuing requirement to pay bondholders high interest rates. The cash offer from Berkshire includes a pledge to pay only minimal dividends and instead use the profits to build up the infrastructure and reserves.

What these two data points suggest is that some very smart people with both deep pockets and large research staffs have concluded that energy production and transmission in the United States is likely to be a major growth industry for a long time to come. That conclusion has to rest on a fundamental assumption that the U.S. economy will be much larger in the future than it is today. Very notably, at the same time, major global oil-exploration firms like BP and Total are cutting their budgets for new oil discovery outside the U.S.

Manufacturing Up

The Institute for Supply Management (ISM) released their index of national factory activity this week, and it rose from May's 54.9 to 57.8 in June. Any reading above 50 indicates expansion, but a 3-point gain this far into a recovery that began in 2009 is notable. The ISM reported that surveyed firms told it that new orders, production, employment, backlog and exports were all growing and they were struggling to keep up with orders.

Interest Rates and Bonds may be Making an Historic Turn

Perhaps one of, if not the most successful bond investor working today is Jeffrey Gundlach, the CEO of Doubleline Capital. He warned this week that the 30-year bull market in bonds is over and a sell-off has begun. At about the same time, futures contracts on long-term U.S. Treasuries dropped in value, providing some good confirmation. This is not the first time that an obituary for the seemingly never ending bond bull market has been issued, but this time the data is lining up to support that conclusion.

A year ago, the 30-year U.S. Treasury bond yielded 2.11%. Today it is at 2.93%, almost 40% higher. At least part of that rise is a result of the Federal Reserve continuing to suggest it will soon be selling off some of its hundreds of billions of dollars of bonds accumulated during the financial crisis. This week, the European Central Bank (ECB) again hinted that they will soon stop buying bonds on the open market. More selling and less buying of bonds create falling prices. Falling prices in bonds are seen in the market as higher interest rates.

Long term Treasuries and other indicators are not quite as high as they were in May, but are trending upward, and unlike May's increase in rates, this time there are solid fundamentals behind the move. Not the least of those fundamentals is the simple fact that the world economy is, by any definition, better off than it was a year ago, and healthily growing. Meanwhile there is about $9.5 trillion in negative-yielding government debt floating around in the world. At some point the low and negative interest rate bonds are going to become very unattractive if the world's economy continues to improve. At that point we are very likely to see a rather sudden and violent sell-off in the bond market unlike any we have seen since the end of the 1970s. In that 40-year ago event, the real market value of longer-term, high-grade and corporate bonds dropped by as much as 50%. Combine that potential drop with the fact that for the last year record cash-flows from investors have been flooding into those longer-term bonds and we think you can see the problem. Bill Gross, the former "bond king" has called it a "supernova that will explode."

On the bond market today, a 30-year Treasury bond purchased about a year ago for $1,000 is selling for about $860.45, for a 14% loss before commissions. Over that same year, the owner only saw about a 2.1% income yield. That kind of loss may tolerable if one believes the stock market is due for a fall, but if the economy continues to behave as it appears now, at some point as the losses rise the bond-holders may bolt for the door. There is some suggestion that if the yield rises to 3% on new bonds, it may trigger just that rout.

The intent of this warning is not to cause panic. Instead, it is to let you know that the potential is there for a "panic" event that will hit the headlines. The bet that was made by all that money buying bonds was that the economy was in trouble and would soon drop into recession as the stock market plunged. The economy apparently did not get the message, nor did the stock market. The bet is still on, but it is looking bad for the pessimists.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
M.S. Personal Financial Planning

Jacob A. McClure, CIMA®