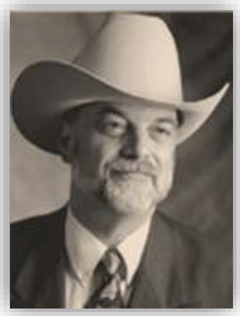

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July 14, 2017

TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index (SPX) rose 1.4% this week to close at a record high of 2,459.27, putting the venerable Index up 9.85% year-to-date and 13.76% for one year. This week's outsized rise was generally credited to the low inflation data released by the Labor Department today. One of the more time-tested measures of whether the stock market is over or underpriced is the relation of the S&P 500 dividend yield to that of the ten-year Treasury note. Since the unexpectedly low inflation report appears to be widely perceived as an indicator that the Federal Reserve is unlikely to increase interest rates more than one more time this year, the assumption is that the dividend yield of the SPX, currently at 1.89%, will continue to be competitive with the 10-year Treasury Note, and at or above current year-over-year inflation. More, as the dividend yield is on track to rise by about 7% this year, the expected yield is around 2%.

The 10-year Treasury note ended the week trading with a yield of 2.332%, down about 0.056% from last week, while gold closed trading a $1,228.20 per ounce, up about 1.34% from last week but still down 10% from last July.

The Economy

Inflation Sales and Wages

This week's big economic news was that nothing happened in the Consumer Price Index (CPI). As usual, quite a lot happened in the inner workings of the Index, but when the dust settled, the CPI neither rose nor fell in June. If one excludes the volatile food and fuel categories, then the Index rose 0.1%. For one year, the Index was up 1.6%.

Retail sales were down 0.2% for June but up a bit year-over-year. The rises were generally in the online (internet) areas and the declines were in the brick and mortar stores with the worst declines in department stores.

If you read our missive last week, you will have noted that when demand is greater than supply, prices go up, and when supply is greater than demand, prices go down. Historically, a growing economy creates demand that runs ahead of supply, so we have inflation (prices rising). Low-level inflation, around 2%, produces an incentive for businesses to expand by purchasing new equipment and hiring new workers. A precursor to inflation, wage gains, were reported as up 0.5% in June, but after subtracting inflation, rose only 1.1% since last July.

Industrial Production

The Federal Reserved reported that U.S. domestic industrial production grew 0.4% in June, and now has risen for five consecutive months. During the second quarter of this year industrial production rose at a 4.7% annualized rate, and is up 2% since this time last year. Manufacturing output, a different figure from industrial production because it does not include utilities and things like oil production, rose 0.2% in June and is up 1.2% after inflation for twelve months.

An aspect of industrial production that the Fed closely watches is "capacity utilization" as when that gets past a point, generally about 85% to 87% inflation historically has set in. June's "cap-u", as it is often called, was at 76.6%, up 1% for the trailing year, and about 3% below its historical average.

The Big Picture

When we stand back and look at the economy there is a pattern unfolding that reflects reality. We had a surge in nearly every aspect of economic activity following the November elections as a wave of optimism swept over both business owners and consumers. The promise of reduced regulation and tax reform produced what is now beginning to look like some irrational exuberance. There was a consensus that with the control of the federal government firmly in the hands of pro-business Republicans things would change to the advantage of both groups. The consensus now appears to be that change is more and more unlikely and the reality is setting in of continued uncertainty.

Slow Wage Growth Explained

As we have written before, an economic conundrum has emerged in the relationship between unemployment and wage increases. Historically, when unemployment has fallen to the level we see today, wage increases have quickly followed, giving a shot in the arm to the economy, and requiring the Federal Reserve to quickly step in with rate increases to head off inflation. This time has truly been different.

The best explanation we have heard to date on what is happening comes from Bob Johnson, the chief economist at Morningstar. He, too, was dumbfounded by the lack of wage increases and started digging through the numbers. What he found makes sense. His conclusion is that wages are not growing particularly well because our median workforce age is decreasing.

A lot of young people delayed entering the workforce because of the great recession and its cautious aftermath. In the past few years they have been entering the job market with a vengeance. At the same time a wave of older workers who delayed their retirements because of those same economic forces are leaving jobs across the country. Those older workers, with many years of experience, were being paid much higher wages than the new entries coming in with little or no experience, thus even in a high demand work environment, the average wage has not risen much faster than inflation. That demographic delay and now shift, also explains a lot about home purchase rates and a host of other economic issues that we economists have seen as abnormal. Combine that with the fact that at the top of the healthcare industry, where the physicians dominate, neither employment nor wages are significantly growing, and the reasons for slow wage growth become much clearer. Yes, healthcare is hiring, but the main hiring thrust is at lower levels and entry-level wages. If that hypothesis is correct, then the wage stagnation we are seeing is temporary and should improve over the next several years.

China Oil Demand Increasing

This week saw oil prices drop to the lowest level in a year mid-week as the International Energy Agency (IEA) reported that OPEC members were pumping more oil and largely ignoring their pledges to cut production. At the same time, U.S. production continued to ramp up, but, surprisingly, oil inventories in the U.S. declined. Some digging revealed that the U.S. inventories were down, despite higher U.S. production, because the demand for oil in China had risen significantly, and U.S. oil was filling the gap. China imported 8.55 million barrels per day so far this year, up 13.8% from this point in 2016. With that report, the global oil market rebounded as oil (Brent Crude) closed out the week up 5.52% at $48.42, while U.S. West Texas Intermediate (WTI) closed at $46.08, up 4.18% for the week.

What does that mean in practical terms? First, China is now the biggest oil importer in the world, having passed the United States. China's economy is largely a mystery, but imports and exports can tell us a lot. The fact that during the first half of the year oil imports were up that much suggests that the Chinese economy is not in trouble, but rather is growing nicely. It also means that the Chinese are increasingly becoming dependent on oil imported from the United States. Both of those issues are good news. While our trade imbalance with China is still large, it is one of our fastest growing export markets. Another factor is that nations are not in the habit of going to war with another nation upon which they are dependent for vital resources. Of course, it also means we are likely to see a small rise in gasoline prices as the price increase works its way through the system.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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