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TPWC Market and Economic Update

The Markets

The venerable Standard & Poor's 500 Stock Index (SPX) ended the week at 2575.21, up 0.86% for the week, setting another record high mark. It now stands up just over 15% for the year and 20.27% for one year. While we generally don't report on the Dow Jones Industrial Average, today merits an exception as the Dow crossed and stayed above the 23,000 mark for the first time. Today's highs come in a month marking the third longest running bull market in index history. Once again, good news in corporate earnings appears to be the driving force in this market.

The ten-year U.S. Treasury note closed the week yielding 2.383%, almost exactly where it was last week but still yielding about 0.58% more than a year ago. Gold dropped 1.83% for the week to $1,282.30 as the dollar rose against other major currencies. Gold is down 0.40% for one year. West Texas Intermediate Oil was little changed at $51.66, about $6.22 less expensive than North Sea Brent as the U.S. continues to break oil-export records.

The Economy

The Labor Department reported last Thursday that the number of Americans filing for unemployment benefits during the previous week had dropped to 222,000 the lowest level in 44 years. Not to undermine that very good news, but much higher numbers are expected in the next report as the filers in Puerto Rico and the U.S. Virgin Islands were not counted as they must file using paper forms as most of the islands' towns are still without electric supply. Considering how much the U.S. labor force has grown in the last 44 years, this level of unemployment claims is probably the lowest in U.S. history in terms of labor force percentages.

Another aspect of joblessness, voluntary quits, is also at a record or near-record low at 2.1%. Oddly, this record high job-retention rate comes as we are at or very near another record, the number of advertised job openings. Once again, economists are faced with another fact that seems to defy historical record and previously well-established theory. For some reason, despite job openings that offer higher pay but often require a move, workers are, in mass, electing to stay with what they have. This unwillingness to change jobs may be part of what is holding down inflation and wage growth.

The Senate followed the House in passing an FY 2018 Budget Resolution, albeit 20 days after the fiscal year began, but there were significant differences. The House bill called for a revenue-neutral position in which the deficits would stay as they are each year, but the Senate version authorizes a deficit increase of $1.5 trillion over the next ten years. A quick meeting of the leaders of both houses resolved the issue. The debt increase is a "go." There is still much negotiating to happen, but it appears that the budget resolution, which does not need a Presidential signature, will stick and allow Congress to move on to negotiation on tax reform.

Whatever tax reform bill is presented, it cannot exceed the $1.5 trillion in debt, above and beyond the already forecast deficits which the Congressional Budget Office (CBO) projects to be about $11.5 trillion over the ten years. The new budget resolution would raise that projected increase in debt to $13 trillion. As of June of this year, the U.S. debt held by the public was $14.168 trillion, or about 77% of GDP, a high but not unreasonable level. According to the CBO numbers, the additional debt plus interest over the next ten years included in the new budget resolution would raise the U.S. debt held by the public, not counting Social Security, Medicare, or civil service and military retirements, to about 100% of GDP at that point. At the same time, the annual U.S. federal deficit, now estimated at $585 billion per year, would have tripled to about $1.5 trillion per year.

All of those numbers assume no major recession and no emergencies that require additional "emergency" spending. In reality, we do have recessions and the world situation suggests that we may indeed have an emergency or two over the decade to come.

So, what can we do? The momentum for tax cuts without spending cuts is in place, and in our opinion, unlikely to be modified. That fiscal prospect suggests that interest rates will be higher in the future as annual federal borrowing needs triple. Higher interest rates cause bonds to fall in value, but tax cuts result in more money to spend in the economy. Thus, the bull market in stocks, already well underway, is likely to have more fuel to run on, while the clock is ticking for other than short-term bonds.

At some point, the piper will have to be paid, but that point looks more and more like it is being kicked further into the future.

A final point in economic news is that the debate on what to do about the Puerto Rican debt has kicked into high gear. The President suggested that the debt would have to be wiped out, but later the White House officially backed off that statement. Yes, Puerto Rico's debt is unpayable and it will need far more money to rebuild or it will remain a ruin. Wiping out the debt sounds like a good idea until we consider the implications of that move.

One of the underlying assumptions in our economy is that in the unlikely event a state was to effectively become bankrupt, the federal government would step in and provide a bailout. Indeed, if some banks are "too large to fail" would that not apply to a state? If the municipal bonds of a state-like entity in the United States were to be simply negated in value, it would first very likely cause the bankruptcy of the major municipal-bond insurance companies. It would also mean that a precedent had been set that would allow, for example, Illinois, to do the same. If that were to become the standard, who would want to buy a long-term municipal bond? Interest rates on "muni" bonds are already higher than their tax-exempt status would suggest as reasonable, but if the risk included the potential for a zero payback, muni interest rates would likely rise to a level exceeding today's junk bonds. Not only would that make the expense of local government rise dramatically, but it would crush the value of existing municipal bonds, many of which are held by small investors across the country.

Ultimately, the only non-catastrophic solution is to have Congress fund at least part of Puerto Rico's debt or the President negotiate a debt write-down for the Commonwealth with its bond-holders as has been done for Greece. The difference here is that Greece has not had its entire national infrastructure severely damaged by a natural disaster and the President has stated he is not interested in intervention.

There are no easy solutions here, but there is a lesson. Spending well beyond one's means in good times and thereby creating an overly large debt burden can suddenly go from being an inconvenience to a potential disaster. The question is whether we will take that lesson to heart.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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