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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index (SPX) finished the week at 2578.85, down 0.13%, but still up a tiny bit for one month. The Index remains up 15.19% year-to-date, and up 18.19% for 52 weeks. The equity markets have been basically flat for the past few weeks as the quarterly earnings reporting season winds down. 73% of the SPX members reporting so far have reported earnings that exceeded expectations, well above the 64% average over the past several decades. It appears the stock market is largely ignoring the drama coming out of Washington and instead focusing on the real market driver, net corporate profits.

Interest rates continued their slow rise with the 10-year U.S. Treasury note yielding 2.347%. A potential worry has arisen as the yield curve is flattening out. Short to intermediate-term interest rates have risen over the last year, but longer-term rates out at 20 to 30 years have *declined*. Part of that may be caused by the announcement by the Department of the Treasury that the relatively large-scale increase in borrowing it anticipates will be in shorter-term notes. A shortage of longer-term Treasury bonds tends to drive the price up and the resulting interest rate down.

Uncertainty about the tax bill appears to have caused some dollar sell-off and decline, which in turn caused the dollar value of gold to rise about 1.5% for the week, putting it up 5.67% in dollar terms for the year at $1,294.70. Ironically, the global market demand for gold at the same time dropped to the lowest level in eight years. The price differential reportedly came from heavy gold buying by the Russian and Turkish central banks. The "why" behind that buying is an open question.

The Economy

Obscured by the noise and fury of tax proposal speculation and negotiations, there are some good things going on in the economy. U.S. industrial production, a measure of factory, mining, and utility output, rose 0.9% in the month of October. That may not sound like much, but it is an annualized rate of just over 11.35%, and we haven't seen that type of production growth in decades. At least part of the surge was a rebound from the hurricane-related shutdowns, and other aspects appear to be in response to the rebuilding efforts. Still, we only saw a 0.4% growth in September, so this is significant.

Another obscure figure, capacity utilization, which measures the percent of manufacturing capacity we are using in the U.S. rose 0.6% to 77%. That is positive and suggests the manufacturing growth is enduring, but just as importantly, we are still 2.9% below our long-term average. Capacity utilization is an important historical marker for where we are in a recovery/expansion. Once Cap-U, as it is sometimes called, rises to about 84%, inefficiencies historically have appeared, prices and inflation have started to rise, and recession probabilities start to rise. As long as the Cap-U is at or below its long-term average, the probabilities of an economic slump are low.

Part of what falls under the general heading of "manufacturing production" is domestic oil production. On November 13, the International Energy Agency (IEA) announced that between now and 2025, growth in U.S. oil output will be the strongest seen by any country in the history of crude markets. More, at that point, we will be the "undisputed" leader among global oil producers. Between now and 2025 the IEA expects U.S. domestic oil production will grow by 8 million barrels a day. That growth would be about 80% of all oil production growth in the world.

To put that in perspective, the oil reserves available in the U.S. that can be and are expected to be accessed through fracking technology exceed the total of the oil and gas reserves either in the mega-fields of Saudi Arabia or the massive gas discoveries made in Siberia. Just as importantly, because of the extensive infrastructure already in place in the U.S. as well as the nature of fracking technology, those reserves will be able to be brought to market in a fraction of the time that earlier mega-production surges took place.

At the same time, China will need to add electricity production and distribution capacity equivalent to the entire U.S. power system by 2040 and will need a stable source of oil and gas to fuel that growth. As the world stands today, the only viable source for that volume of fuel will be the United States. That bit of information helps explain why our oil exports to China have skyrocketed over the past year. Instead of that event being a temporary glitch, it appears more and more that it is just the beginning of a powerful long-term trend.

As always, there is more, but time and space are limited. Here are a few of the more relevant points:

- Inflation remains abnormally low, with the Consumer Price Index inching up only 0.1% in October while producer prices rose 0.4%. At some point, those higher prices for raw materials and parts will need to be passed on to consumers, but the time appears to have not yet come.
- Eastern Europe appears to be emerging from the Euro-zone slump with rapid GDP growth of up to 4% per year, while Spain, Italy and the other Mediterranean-bordering nations are stuck with as much as 30% unemployment and a depression-like rate of economic activity.
- Blue-collar pay increased 4% over the last 12 months after subtracting inflation according to the Labor Department. Throughout this recovery, there has been a worrying stagnation in factory and hourly worker wages even as wages rose for upper-level executives and the trades. Those sectors seem to have moderated while blue-color wages have started to rise. The rise is likely to be a result of the abnormally low unemployment rate at 4.1% and a critical shortage of skilled manufacturing workers.
- Over the last two years, median household income, adjusted for inflation, has risen almost 10%. The additional money in workers' pockets may be a large part of what is fueling the rising corporate profits and higher than expected GDP numbers these last two quarters.
- New home starts hit the highest absolute level since 2005.

Until next week, we remain your faithful servants,

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

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