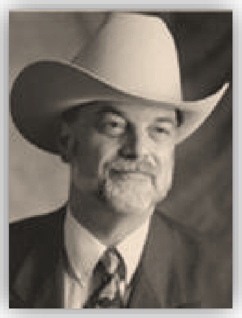

THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

First, we seem to have an unusual event to report: the major stock indexes are up for the week! The S&P 500 was up 1.4% for the week and the Dow Jones Industrial Average up about 0.7%.

Wednesday about mid-day, we noticed that the S&P 500 was in an unusually high-speed decline, and so decided to open up the real-time monitor and watch it. Sure enough, it was down a bunch, but as we watched, it first fell to about 1814, then leveled off, and then started to rise. At first it was a slow rise, but then it began to speed up. By mid-day Friday, it had risen to 1908, up over 5%. That still left the Index down about 6.6% so far this year, and the market remained in "correction" territory, but it did offer some relief.

This morning the market opened with a violent, sudden upward jump in stock prices that, had it been downward, would have been called a "crash." Of course, that did not make the headlines. We actually don't have a word for an anti-crash. Notably, the sudden upward jump coincided with just one piece of significant news: a blizzard is predicted for the Northeast U.S. Normally, by the way, a blizzard forecast would cause the market to decline as it might hurt earnings for the first quarter.

That inflection in prices occurred despite no sign of a recovery in the Chinese stock market. Admittedly, there was some evidence of a slowing of the decline, but that was the limit of good news there. What was pretty obvious was that the price of oil hit an apparent bottom mid-day Wednesday, and the U.S. stock indexes have moved pretty much in time with that recovery. A second observation about the behavior demonstrated by traders in the market is that this decline turned around at a point very close to where a similar reversal occurred in early September.

A couple of observations can be made about this market action. First, the August-September decline was blamed on the Chinese market rout, while this one has been given the headline cause of oil prices, but both have been very, very similar. When that type of market behavior manifests itself, the underlying cause is not what is in the headlines, but is a simple price war between the bears and the bulls. The bears believe that the underlying corporations making up the index will do worse in the next year or so while the bulls disagree. The indicator the bears are headlining at any given moment is just that. It is not a real "cause," but is rather whatever the pessimists are watching and using to justify their emotional position.

The second observation is that the bears are capable of driving the market down about 15% before even the neutral traders see it as a bargain and come back into the fray to buy up stocks, not because they have a position on where the economy is going, but simply because the fundamentals in those stocks have created a bargain. The last observation that the recent behavior of Wall Street traders seems to present, is that when oil finally stops falling, the stock market is likely to recover. Of course, that is based on the apparent reality that the world economy will not collapse if oil goes to and stays somewhere in the $20-$30 range, as it is quite likely to do.

The underlying reality of what is happening in the economy is reflected in recent earnings reported in the market. Despite a massive decline in earnings at any and all oil related companies, the overall earnings for the 500 companies that make up the S&P 500 Stock Index appear to be about the same as one year ago. That translates into gains in the rest of the market that offset the losses in oil companies. Considering what a big part of the Index is composed of Exxon and the other big oil companies, that is good news.

The stock market is priced for a recession, but someone forgot to tell the rest of the economy about it. Healthy, cash-rich, high-growth companies are commonly selling at price-to-earnings multiples of about half their annual growth rate. Their normal traditional trading price is typically a P/E multiple that about equals their annual growth rate. If we are headed into a recession, then the market is about where it should be. If, as the rest of the economy seems to indicate, we are still growing and healthy, then when Mr. Market wakes up to reality, he is going to have a lot of climbing to do.

The Economy

The Commerce Department reported that both existing home sales and home prices jumped in December. Sales were up 14.7%, the biggest monthly increase ever reported. By itself, a monthly number is relatively unimportant, but as sales were up 7.7% over last year at this time, that *is* significant. More, total home sales in 2015 totaled 5.26 million. That is the best since the all-time record set in 2006 of 6.48 million. The difference this time is that just about all the houses sold will actually have someone living in them rather than being speculative purchases with the intent of "flipping" the house for a quick profit. Home prices, nationwide, year-over-year, rose 7.6%. Home sales probably will not continue to rise at 7% per year simply because there are not enough houses on the market to support that rate. That observation leads to a rather obvious observation that with home prices rising and a shortage of houses to sell, construction, and thereby employment and economic activity in the construction industry has a distinct opportunity to rise in 2016.

Meanwhile, with the market priced for a recession, the Conference Board's press release today on the Leading Economic Indicators (LEI) has a headline that says it all: "Moderate Economic Growth to Continue in Near Term." The LEI tends to be highly predictive based on a three-month moving average, and the three month average is a positive 0.26% which annualizes to about a positive 1.1%. While that is not an indicator that the U.S. economy is about to go on a tear it is, to say the least, significant, in a time when oil prices have fallen about 50% in a year. The Leading Index rose an even more positive 0.7% for the six months from June to December.

Only time will tell, but the largest economic driver in the world is the American consumer. With gas prices down and wages up, there is certainly more money out there for the American consumer to spend. One of the conundrums facing economists is why more of it is not getting spent. The answer is actually pretty obvious: Americans are saving more than they normally do. They far too well remember the layoffs and economic panic that hit us seven years ago. Every survey seems to agree that younger people who a decade ago would be borrowing and spending to furnish and improve on a new home purchase are instead saving up for a relatively large down payment on their future home. Presuming employers keep hiring and raising wages, that will come to an end, and the way things work, it will tend to happen suddenly.

No matter what you think of Walmart, it is still the biggest retailer, and as such is an economic indicator of its own. On Wednesday, the same day the market turned upward, Walmart announced that it will be raising its minimum wage for all but trainees to $10 per hour. The across the board wage increase will be 2%.

Personal Economic Advice: How to Create Income from a Portfolio

One of the economic realities that is, to the best of my knowledge, not taught at much of any level in schools, is how to plan for and convert an investment portfolio into retirement income. As a result, we have observed otherwise intelligent people doing things that have a very high probability of causing a lot of economic pain in their future.

There is an old saying, "Don't touch the principal." That comes from the dark days of the Great Depression of the 1930s. That saying related to bonds, and more specifically long-term, high-grade corporate bonds, held by relatively wealthy families in the early 20th century. During that time, a ten-year U.S. Treasury Note had an average yield of about 3.5%, while a blue-chip corporate bond had an interest rate yield of about 4%. Note that those yields were not market-based, but based on a bond issued, typically in the 1920s, and held to maturity. Because of the drop in interest rates associated with the Depression, those bonds could commonly be sold for more than their face value, and thus presented a temptation to liquidate them. The actual yield-to-maturity on bonds in general in the 1930s was about 2% or a little more.

At the end of 2015, Treasury Notes were offering about 2% interest, and seasoned, high-grade corporate 10-year bonds around 2.94%. So, if one wanted to create a portfolio that was exclusively bonds, an income of about 2.25% (before taxes) would certainly be possible. Why not the full 2.94%? Unless you are a multi-millionaire and willing to make your purchases of single bond issues (one company, one issuance) in the six-figure range, you are going to have to pay something to purchase those bonds. In fact, one of the largest, least expensive mutual funds out there, the Vanguard Total Bond Market Index Inv Fund, has a real interest rate yield of 2.27%, and it is effectively a billionaire purchasing bonds and managing its portfolio at about the lowest cost possible.

Thus, if you want a higher income than about 2 1/4%, which you could not adjust for inflation, then you will need something else. Again, using a Vanguard Index Fund, the dividend yield on the S&P 500 in the real world is just under 2% per year, but the total earnings (profits) from the underlying companies, net of fund expenses, is 5.71%. While there is no shortage of opinions on what those numbers will be in the future, for now let's just use those numbers. (*This is, by the way, not a recommendation to buy those or any other fund.*)

If you had a portfolio composed of those two funds that was 60% stocks and 40% bonds, and had no cash, short-term bonds, or expenses in that portfolio, then the combination of the earnings yield on the stock and the interest on the bonds would provide you with an effective yield of 4.32% per year. The dividend and interest yield would still be just over 2%, so you would need to gradually sell shares in the stock fund to realize that yield. Unfortunately, that is going to cost you something, so a 4% draw has the potential to work for the long-term.

There are some elements in real world portfolios that can change that, at least in appearance. One is inflation. Stock prices tend to rise with inflation, as do the dollar amount of earnings. Bonds do not. The second element is earnings growth. If stock earnings growth averages 3% per year, then you have some hope of perhaps increasing your income in the future. Since only 60% of our hypothetical portfolio is in stocks, that really amounts to 1.8% per year, on average. The last element is price-to-earnings ratios. If the market rose to where it was in 1999 in terms of P/E ratios, then the S&P 500 would be around 4,000 and the Dow Jones Industrial Average would be around 35,000. If it rises in the future, then one could sell more stocks, although that would be a hazard when that same P/E ratio declined as it did from 2000 to 2002.

The bottom line is that if you are taking more than 4% per year from your investment portfolio in income, there had better be some elements in that portfolio other than plain vanilla stocks and bonds. And, as a result of those higher long-term asset classes being there, your portfolio is very likely to rise and fall more than the standard 60/40 mix. Can you take more? Yes, of course, it is your portfolio. If you do take more than the portfolio is earning, then there is a high potential for eventually seeing irreversible declines in the portfolio. The portfolios we design generally have other asset classes in them, and some of those asset classes have higher earnings than the hypothetical mix we just described. Still, taking more from the portfolio than it is earning carries a very real risk.

The last point, and this is something you and only you can control, is the discipline of not taking lump sums from the portfolio.

For some reason, many people believe that if they have a well-diversified portfolio and are taking, for example 4.5% per year from that portfolio, they can take a lump sum from it and continue to take the same monthly dollar amount without greatly increasing their risk.

Here is an example. If a couple had a $1,000,000 investment portfolio and was drawing $45,000 per year (including taxes), that would be a probably sustainable 4.5% draw. If that couple decided to take a lump sum withdrawal to purchase a house, and needed $200,000 after tax, they would likely need to take about $300,000 from the portfolio, leaving $700,000. Their withdrawal rate is now over 6.4%. Whether or not that rate is sustainable is a coin toss. In fact, in our experience is that when a lump sum for something like a home purchase is taken, almost without exception, it is followed by other lump sums as unexpected expenses arise. Soon, the withdrawal rate is approaching 10%, which is historically unsupportable. Throw in a market downturn and things can get dicey quickly.

While that purely hypothetical example is a bit extreme, a series of smaller lump sum withdrawals over time would have the same effect. No matter how relatively large or small the lump sums, they reduce the ability of the portfolio to support a stream of income.

This is, of course, all a bit simplified, but it does illustrate the reality of the markets and the economy.

We plan to be on the air with our usual mix of wit and witless comments tomorrow, so you are welcome to listen and call in! KTEM-AM 1400, or at www.ktemnews.com, 10:00AM-12:00.

We of course welcome your email, calls, and that rare thing, a written letter.

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