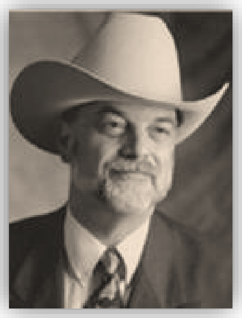

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TPWC Market and Economic Update

The Markets

Before we get into the stock market numbers let's talk about how to deal with market corrections and bear markets. There is a very popular widely held myth that if someone has a really well designed portfolio, then whenever the stock market plunges, there will be another part of the portfolio that rises, and thereby offsets at least part, and hopefully most of the decline. That may have been true at some point in the distant past, although in our 34 years of professional observation we never saw it work. It works probably less well today than at any time in the over three decades of our personal experience as well. Having a well-diversified portfolio by asset class can reduce the variance, or market risk, but if an investor wants a return higher than is available in an insured bank deposit, market value fluctuations are part of the price we must pay.

The myth holds that if one holds a balanced portfolio of bonds and stocks, then when people start selling stocks, they will buy bonds and thereby cause the bonds to rise in value as the stocks fall. If that were true, then one could find a "balanced" mutual fund that does exactly that. I have looked, and looked hard for that magical fund, and can say with confidence that it is not there. Because no one could cobble together a portfolio that behaved in that benign manner, hedge funds got started. The theory behind hedge funds was that they would "hedge" things like stocks with obscure derivatives that would offset market downturns. Unfortunately, most of those theories seem to have been blasted into oblivion in the past ten years or so. One of the financial statistics that 2015 currently holds a record for is the number of hedge funds that collapsed and liquidated at great loss. So far this year the number is higher than it was at this point last year, so I suspect another record will be set and a lot, and I do mean a LOT of investors' money will vanish. You may have heard of "alternatives" which, like bonds, are supposed to offset the stock market yet still make money. So far, my observation of "Alts" as they are called, is that they tend to not fall when the market does. Instead they simply vanish, taking most of their investors' money with them. What actually happens appears to be that when stock investors get scared, they move to money market funds. That drives short term interest rates down, but doesn't do much else.

Because we can now see the events of 2008-2009 with 20/20 hindsight, what became quite obvious was that nearly everything went down together. If stocks fell, then it was because the companies issuing the stocks were in danger of failing. If the company fails, the stock goes to zero, but there may not be any money to pay off the bondholders! Because of that simple logic, bonds fell about as hard as stocks. Because, in the 2008-2009 market downturn, the source of the collapse was in the bond market, finding a safe place there was somewhere between difficult and impossible. As it turned out, the one safe place to be was long-term U.S. Treasury bonds. Note, however, that the talking heads at the beginning of the crisis were screaming that runaway inflation was about to hit, which would have devastated long-term Treasury values. So, in order to choose the right asset class, one would have had to go against all the advice being spouted on television, in the papers, and in the magazines. Had those trillions of dollars that poured into the economy actually caused the much forecast inflation, that investment in long-term Treasuries would have quickly become a disaster.

Of course, with 20/20 hindsight one could always determine that, "If we had sold everything and gone to cash at this date, and then bought back into the market at this other date, we would have made a killing!" I don't think I am capable of counting the number of schemes that people have come up with over the years to try to figure out when to sell and when to buy in order to accomplish that. For better or worse, so far absolutely none of them have worked, and so far, as far as we can find, they have produced a far worse than performance than the simple, "buy and hold" method. There is a mild variant of market timing we do use, which we explain below, and which historically has been demonstrated to improve long-term performance. Our philosophy on market timing by getting out when the market peaks and reinvesting at the bottom is simple: If companies with huge resources and hundreds of analysts have repeatedly failed at something, we are not going to risk our clients' money by attempting to do it.

So, what are we to do? The answer is to focus on what we can do with some degree of certainty and accept the nature of the investment markets as a given. We can be reasonably confident that cash and investment-grade, conservatively managed, short-term bond funds will be liquid and not participate much in market movements, up or down. We can also be confident that the higher the long-term return we expect from any other asset class, the larger and longer will be their downs and their ups. We can say with a great deal of confidence that market panics, such as the one we are currently experiencing, will happen, and will generally happen, on average about once every 18 months to two years. Sometimes they will come more often and sometimes less, but they will happen. Another thing we can depend on is if interest rates are at extreme lows, below that which is sustainable over the long-term, they will eventually rise, and in rising they will damage longer-term bond values. Last, but not at all least, we can expect that when stocks, as an asset class, are priced at a forward price-to-earnings ratio well below their long-term average, they are cheap and will show a better return in the future. Conversely, we can depend on the fact that when they are priced above their long-term average, they will have a lower return into the future. Sometimes, it takes years for that future to arrive, but, so far in history, it always has.

We have chosen to approach this issue by first acknowledging that corrections and panics will happen. They also come to an end, and equity market levels historically have always recovered to a higher level than before. If you are investing with several years before you need to liquidate funds to spend, then a market downturn is an opportunity to buy low. On the other hand, if you are either closing in on a need for cash or taking monthly income, then we need another strategy. We have seen that relying on bonds to cover us in a stock market downturn is unreliable, so a reserve of cash and high-grade, short-term bonds is our lifeboat. We have elected to target holding 18 months of planned monthly withdrawals in "dry powder," or more specifically in short-term bonds and cash. But, what happens if the downturn lasts longer than 18 months? We then turn to the second level of what we call "preservation assets," conservative and moderate allocation funds. We seek out funds where the relatively conservative securities in those funds have historically recovered within 18 months following a market meltdown like the ones we had in 2000-2002 or 2007-2009. If we are in a truly major downturn, then as we run low on short-term bonds and cash, we begin a systematic withdrawal from the preservation funds.

We have already executed this strategy in the Pershing accounts, and will do so early next week for those holding funds at Jefferson National. If you are taking systematic withdrawals, you can expect to see the changes in where the money comes from in the near future.

The prime purpose in this strategy is to avoid taking too much money from the "appreciation" asset classes and funds while they are severely depressed. Sure, it would be great to be invested in some magical asset class or classes that creates growth but does not decline, but history does not suggest that there is such a thing. The second part of that strategy is fundamental, but hard to do. In a panic there will generally be one asset class that really plunges into the depths. That asset class is generally also the one that will have the greatest gain on the other side. It is nice if we can invest in that asset class while the market is down, but more important is being patient and not jumping out of it. It, in this event, is diversified emerging markets.

Market Numbers

The S&P 500 closed out last week at 1,880 and ended this week at 1,865, so for one week we had a slight loss (about 8/10 of one percent), but if you consider that on Thursday the Index opened with a plunge and sunk to 1,813 before starting a recovery late in the day, it rose nearly 3% in just over a day. The Index is still down about 12.4% from its high last May, so we are still in "correction" territory. The pessimism feels like a bear market, but, in fact, both the Dow and the S&P 500 seem to find a very firm bottom about where they ended the day yesterday. The close of the markets this week was almost exactly at the same level they were at during the panic supposedly engendered by the impending collapse of the Chinese economy last August. That tells us something. The market is down because a bunch of people are scared. They are searching for something to be scared about and whatever comes to hand will do. That behavior makes this a classic "correction." There is more on that below.

A little perspective is in order here. Five years ago the S&P 500 was around 1,328. That was 2011, and it went on from there to drop about 12%, or about as far as it has dropped this time around. 2011 was a rough and unpleasant year with negative returns in the Index. No one could see any hope anywhere. Greece was about to collapse and the European Union with it. Congress had failed to pass a budget or an authorization bill, and the government shut down. As a result, Standard and Poor's lowered the long-term credit rating of the United States from AAA to AA+. Here we are five years later and the things that we feared would wreck everything seem both distant and hard to recall. There is a lesson here.

Bond markets declined today as the 10-Year U.S. Treasury Note increased its yield to a whopping 1.75% from the 1.66% yield it hit on Monday. Oil rose from about $27 per barrel to just over $29 in one day. That makes it the greatest percentage rise in the price of oil since 2011. Hmmm, 2011. Do I see a pattern here?

The Economy

As we have written before, the United States economy is showing no signs of an approaching recession. Before we get into the mass psychology that is the most probable cause of the current market correction, let's touch for a moment on that unpopular area called "economic reality." The U.S. Census Bureau announced this morning that U.S. retail and food services sales for January were up 3.5% from a year ago, and the trailing three month sales were up 2.5%. Sporting goods, hobby, book and music stores sales (note that these are brick and mortar stores) were up 9.1%. Here's the kicker: "…non-store (online) retailers (sales) were up 8.7%." People who are in fear of a downturn don't run out in the midst of a blizzard and buy record amounts of sporting goods, hobby materials, books and music from their local stores. In the 33 years we have been in the business of observing the economy, the American consumer has consistently been one of the most reliable forecasters of future economic growth, or non-growth. Consumer purchases make up 70% of our economy, which is one of the secrets behind why we have and are doing so well while the rest of the world is not. We are largely self-sufficient. We are not dependent on exports to survive. Sure, a mass elimination of trade would hurt us, but we would survive. As an example of where the rest of the world is on this, Germany's GDP is about 46% composed of exports. For Germany, a slowdown in the world economy has got to be terrifying. Our GDP is about 12% exports. Cut our exports in half by eliminating all trading partners except Mexico, Canada, and Europe and our GDP would slow by 0.15%.

Still, we cannot ignore the fact that the markets, both bond and stock, are clearly acting as if an economic collapse is at hand. So what is the cause of this panic? Markets do not function well in uncertainty. There is a great deal of uncertainty about China, about the price of oil, and what that will do to companies and banks. Compounding that problem is the fact that we have just witnessed the Democrat and Republican parties select the winners of the first state primary. Both have clearly stated they will, if elected President, enact economic policies that will be poisonous to our economy and business profitability in general. One has pledged to start a trade war and repudiate the multiple trade treaties that have enabled much of the prosperity that has emerged over the last twenty years. The other wants to build a wall along our southern border and basically seal our borders in a form of isolationism that makes anything we did to trigger the Great Depression of the 1930s look mild. Even the trailing candidates have advocated things like "carpet bombing," a term that originated in the Viet Nam war, and we know how well that worked out.

We have faith that such things will not happen, but a majority of voters in normally sane New Hampshire chose those two candidates. That creates uncertainty about the sanity of the American electorate. With the two currently leading candidates for President both demanding a trade war with our allies, the fear factor just moved up a notch.

If oil drops below $25 in current dollars and stays there, a lot of unpleasant things will likely happen to some big oil and gas companies. The price was below $30 this week and the oil storage tanks at Cushing, Oklahoma were reported to be 95% of capacity. The same level of capacity is reported to have been reached for gasoline storage across the United States. The potential exists for a sudden collapse in oil, natural gas, and gasoline prices. While those who buy and use gasoline and natural gas and even electricity find that potential to be delightful, we are faced with the uncomfortable reality that a lot of money has been borrowed to finance oil wells, pipelines, and other infrastructure with the assumption of oil priced at least at $85 per barrel. No matter what assurances the regulators and banks announce, investors are scared that the horrific over-leveraging that was associated with mortgage bonds has been repeated.

We don't think that is so. First, the regulators have been on the lookout for just that, and secondly, the bankers, contrary to popular belief, are capable of learning. Some of those Wall Street brokerage houses and bankers are just now having to cough up tens and hundreds of millions of dollars in fines for their misdeeds a decade ago. Still, there will be corporations that have been dependable, dividend paying, sacred cows of Wall Street that are at risk of plunging beneath the waves.

As an example, one of the largest utility companies in the United States, Chesapeake Energy, is now trading at $1.76 per share and is generally considered to be facing a 50% probability of bankruptcy. To give you some idea how far such a thing would reach, Chesapeake is one of, if not the biggest owners of oil and gas fields in Texas. Another example can be seen in Energy Future Holdings, the owner of TXU Energy. It already is in bankruptcy. It was attempting to resolve the issue, but the collapse of oil and gas prices may have caused the plan to fall apart. Thus, the owner of most of the electric production in Texas, has a profoundly uncertain future. See why investors are running scared? There are a many more companies in the same condition and one of the problems facing the market is that we really don't have a clear understanding of which ones are there and to whom they owe money. That factor, along with the interest rate issue explained below, is why bank stocks have plunged.

The thing to keep in perspective is that all of those loans and hedge funds (like Energy Future Holdings) really don't amount to a big chunk of the American economy. The total contribution of energy-related companies to the U.S. economy is 5.9%. If we had a pretty much worst-case collapse in energy companies, the reduction in U.S. GDP would be about 0.07%. There is a further risk if one assumes that investment banks are doing what Merrill Lynch, or Lehman Brothers did with mortgage bonds in the mid-2000s, but as we note above, that is an extremely remote possibility. Additionally, real estate and related industries historically have equated to about 20% of the U.S. GDP and, as a result have a potential for a much larger impact. Real estate, unlike last time around, is *not* in trouble.

The same is true of China. China is far from being our number one trading partner. All our exports to China combined make up 0.8% of our GDP. That means that if all our exports to China suddenly ceased, our GDP would drop from about 2.5% per year to 2.48% per year (which still would round to 2.5%). Our number one trading partner is Canada, and number two is Mexico. A yuan decline and economic uncertainty in China would have an extremely minor effect on our economy, but sealing the borders and erecting trade barriers with Mexico would be a disaster. Again, I think you can see why fear is driving the markets down when a leading Presidential candidate is calling for "walling off" Mexico (and setting up a blockade if Mexico refuses to pay for the wall).

Last but not least among the reported economic fears is that about half of Europe and now Japan has credit markets that have devolved into *negative* interest rates. Remember that markets do not like uncertainty. Negative interest rates are not even in the text books, so that amounts to a huge uncertainty. The Chairman of the House Banking Committee challenged the Chair of the Federal Reserve, Janet Yellen, on whether she was considering negative interest rates in the United States. She, properly, stated that she did not think they would be necessary here, but it was prudent for the banks to be prepared for that possibility. Definitely scary. Not because negative interest rates are some kind of poison, but because they are part of that big unknown. Just in case they are scary to you, the first economy to institute them was Switzerland, and they are not exactly in financial trouble. The main fear expressed by traders and fear pundits is that the banking system would fail if they had to pay borrowers to borrow money and charge a fee for deposits, which is what negative interest rates really mean. Switzerland has been doing that for about a year now and their economy is humming along nicely. Their banks are profitable and their GDP is expanding. The main challenge in going to negative interest rates is the software. Bank computers are just not set up to pay people to take out loans and charge depositors for certificates of deposit. The Fed has directed the banks to modify their software to accommodate negative rates just in case we need them at some point. The Chairman of the House Banking Committee wanted to make some political points on that and wound up scaring a few tens of billions of dollars out of the stock market.

As a side note here, we have been stating for at least seven years that *deflation* is the danger, not *inflation.* Negative interest rates are a direct result of deflation. We think it is wise for Chairman Yellen to be challenging the banks to have their software capable of dealing with a financial reality that about half of Europe and all of Japan are experiencing. We think that raising that issue in a live, televised Congressional hearing was a scare tactic that has everything to do with politics and nothing to do with economic reality. Amplifying fear seems to be the political game of the day.

That is the biggest issue affecting the markets: the contagion and amplification of fear. In the wee hours of Thursday morning the Wall Street Journal reported that European markets were down because Asian markets had declined earlier. Then, when the markets opened in the United States, it reported that markets in the U.S. were dropping because the European markets had dropped. In each case traders were selling because they saw other traders selling and there was a developing consensus that "Those guys over there must know something we don't know. They are selling, so we need to sell too!"

So, is there any danger? In fact, there is. The danger we face is that the unreasoning fear that has overwhelmed the emotions of the traders will be propagated by the media and amplified by the negative rhetoric of the candidates and begin to infect the real world.

Here is the good news. My survey of real world business people reveals that they are uniformly seeing more business coming in than they can handle, so they are hiring. They are ordering new materials from which to make the things they sell. Even the consumer confidence polls are in the high range, which should not be too surprising as jobs are more plentiful than they have been in a decade. In short, the real economy is progressing from recovery to expansion. Yes, anything that has anything to do with oil or gas is hurting and hurting bad. Yes, Europe is still somewhere between neutral and reverse, and yes, the Chinese economy is only growing at about 6.5% per year. The United States economy is a powerful engine with a great deal of momentum. We are still largely in a debt-reduction and savings mode, but we are reaching the point where we will have excess cash to spend. Last year we, in mass, replaced our aging fleet of automobiles and in doing so committed to years of payments because we are confident we will have the cash flow to do it.

Today's Census Bureau report on retail sales in January is a solid indicator. If you read our last missive, you will recall that wages last year were up about 2.5% while gasoline prices dropped enough to add about 1.1% to the average American's available cash flow, even as unemployment dropped to 4.9%. You don't need a PhD in economics to recognize the relationship between those numbers and a 3.5% rise in retail sales compared with a year ago.

To quote Franklin Delano Roosevelt, "All we have to fear is fear itself."

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