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TPWC Market and Economic Update

First, an apology is due and hereby presented for not getting this out yesterday. Jeff was helping Jake to locate to a new abode here in Salado. The hours to put this together and have it validated were simply not there. This is a bit longer than the usual message, so again we beg your indulgence. We do believe that reading it though will be worth your time.

The Markets

The S&P 500 rose 1.5% for the week, but it still down 4.65% year-to-date, and down 7.43% since this time last year. There are two ways of looking at that level. Either the glass is half empty or half full. If you are a bear, and pessimistic about the future, the S&P 500 is down about 8.6% from last year's all-time high in May. If you are bullish, the Index is up about 7.6% from its low on February 11 of this year.
The S&P 500 closed at 1,948 Friday, having hit what looks more and more like a bottom for this correction of 1,810 on the 11th. On the other side of the coin, the S&P 500 Bond Index is down 0.94% for one year, and that is despite it being up 0.87% year-to-date. We are technically no longer in a "correction" and it looks very much like we are in the rebound phase. Stocks are not screamingly cheap as they were seven years ago, but they are quite inexpensive when compared to their historical norms. Meanwhile, money market funds and bank deposits are still paying a half percent or less per year, and, again by historical standards; bonds are overpriced.

The takeaway here is that stocks and bonds have had a negative return for the last year and more. The good news is that we may well have turned the corner. The better news is that when we look back more than five years, we see some quite substantial gains in even the more conservative portfolios. There is no doubt that this is a time when the markets are "down" as *Barrons'* reported today that a net $23.4 billion was liquidated from equity mutual funds over the seven weeks ending February 17. Historically, mutual fund investors are a good counter-indication of where the market is likely to go over the next several months. The peak liquidations have tended to hit at or near market bottoms. Not too surprisingly, the equity fund liquidations appear to have been at their peak around February 11, and have slacked off since.

The Economy

West Texas Intermediate Oil ended the week at $32.78 per barrel. That puts it reasonably above the much feared $25 level where a lot of companies have warned of insolvency. That does not mean that the pain if over. There are at least hundreds of oil-related companies that either are in bankruptcy or will be at this price, but the bigger, more stable companies seem to be in position to weather the storm. The fourth quarter U.S. Gross Domestic Product (GDP) was revised upward from 0.7% to 1.0% as the data came in better than the first estimates suggested. The dollar rose about 1% against a basket of other currencies; not a good thing for exports, but an indication of what the rest of the world thinks about our economy as they appear to be buying dollars. Home Depot, a nation-spanning company that tends to reflect the underlying strength of the economy, reported a 10% rise in sales in the fourth quarter. (That does not mean that we recommend purchasing the stock.)

The Commerce Department reported that durable goods orders, a category that covers everything from toasters to aircraft, increased 4.9% in January. That came as a surprise to many economists as they had assumed that the strengthening dollar would hold down exports, and thereby manufactured goods orders. The increase in orders was in primary metals, fabricated metal products, machinery, computers and electrical and electronic equipment. That report confirms the employment report from earlier in the month that metal-goods manufacturers had accelerated hiring to a level not seen in decades. It also comes in the face of a dramatic decrease in manufacturing orders from the companies that support mining and drilling. Once again, the evidence suggests that the rest of the American economy is strong enough to offset the losses in oil related enterprise and still keep growing.

The economic news out of China was, as usual, mixed and confusing. The official data shows an economy that is growing a bit less fast than in the past. The government is expending a lot of foreign reserve money, mostly dollars, to buy yuan on the open market in an attempt to hold the value up against the dollar. Meanwhile, the anecdotal information is that the wealthiest Chinese business owners are doing whatever they can to convert their yuan into dollars before another devaluation of the Chinese currency. If we assume that billionaires are smarter than the rest of us, and that they vote with their dollars, then the conclusion is that the United States economy is vastly preferable to that of China.

The consensus in the Eurozone appears to be that Mario Draghi, the President of the European Central Bank (ECB) will be announcing a new set of "stimulative measures" on March 10 in an attempt to get the that economy out of the ditch. That word is that he will announce that the ECB will be pushing its interest rate on deposits even lower than the *negative* 0.3% it has now. At the same time, he is expected to announce the ECB will increase its bond buying from the current level of 60 billion euros per month to a higher number. The ECB is on a Quantitative Easing (QE) binge about as large as the Federal Reserve version of a few years ago, just later in the game. It does looking increasingly like Ben Bernanke and our Federal Reserve was on the right track.

As we look at the global economy, what is increasingly evident is that the United States economy is in good shape and accelerating while much of the rest of the world is striving to avoid slipping into deflation and recession. We believe that there is a fundamental reason for that difference, which we discuss below. Whatever we have appears to be working. Not coincidentally, the economy most like ours in the world, that of the United Kingdom, is one of the few bright spots, with net growth in evidence.

The Faith and Logic of Investing

Investing in a diversified portfolio of securities in the United States is both an act of faith and an act of supreme logic. We live in what economists call a "socioeconomic system." The Chinese have another one, as do the Europeans and other cultures around the world. We, here in the U.S., have an advantage in that our system has been around longer than any of the others. Yes, their histories may be longer as people who have lived in the same place with more or less the same language, but the system of economics we use is well over two hundred years old, dating back to when other nations and groups of nations were kingdoms. The peculiar form of economic freedom we have here is similar to that enjoyed by Europeans, but not the same. Ours is far more chaotic, and economic freedoms we take for granted are at least partially nonexistent outside of the United States of America.

In the United States, businesses are far more able to gain an advantage in a free market system and adapt quickly to maximize their profits. More, anyone who has a few dollars can invest in many of those companies, and add their capital to that of the richest of us. Both sets of capital then have largely the same net results. Any individual company may do well or poorly, but if one owns shares in enough companies across the economy, then that investor can participate in the overall profitability or loss of the broad corporate economy. We assume the right to invest in corporations, or groups of them in mutual funds, is just natural and normal, but in reality, it is rare both historically and geographically.

Since World War II, Japan and Europe have emulated our system and have made great strides toward becoming economically more like us, but, outside of the United Kingdom, they have a long way to go. What is different about our system is that the potential for profitability is greater than in others and our founding fathers designed our legal and regulatory system so that corruption is relatively rare. We also enjoy a system protected by law and regulation so that equality of economic opportunity is a fundamental right. As a result, a family of limited means and without noble birth can directly participate in the economic engine that drives what is arguably the most powerful and profitable economy on this planet.

When we invest, though, presuming we are well diversified, we take on some of the short-term risks of the corporate economy. Investing is a long-term proposition of converting money into capital with the intent of turning it back into more money than we initially invested. The difficult part is that we often need to wait several years to see that potential become reality. A prudent time frame appears to be about ten years. In many ways, it is like farming. No matter how well planned, husbanded, and cultivated a farm is, there will be years, and even multiple years when it costs more to operate the farm than it returns in sales. Farming, no matter how scientific, is a matter of having faith in the down years and not getting too carried away in the up years. It requires faith that both the science of agriculture and the functioning of the food markets will work.

In the United States economy, publicly traded corporations have historically had a reasonably consistent average profit level of about 5% to 6% per year. When we have inflation they can raise prices, so that in, for example, a 3% inflation environment, nominal corporate profits can rise to 8% to 9%. Smaller companies tend to have slightly higher profit margins. From an investor's perspective, companies whose shares are priced lower in the stock markets have the potential to have a greater percentage of profit as well.

If one could get such profits without some form of difficulty, then there would be no money in the banks! Everyone would put all their excess savings into the stock market. Of course, that is what happens in the last years of a long-term, secular bull market, like the one we had in the last half of the 1990s. Many, and perhaps most investors tend to keep their money in the bank when prices are low and then invest too much when the stock indexes are unusually high. Both faith and science support doing the opposite, investing or staying invested when the markets are low and being willing to remain prudent when they are high.

Today, investing takes faith, belief that the American economic system is still working, that companies are still likely to be profitable in the future. Unfortunately, several people are dominating the news media who seem to believe they will be elected by encouraging the belief that our system is broken and unless we fundamentally tear much of it down and rebuild it their way, we are doomed. We, on the other hand, believe that our system is the best in the world. We assert that it is better than it has ever been, and has the potential to become even better in the decades to come. We also firmly adhere to the faith that buying into or staying in the equity markets when others are selling is both prudent and wise. We also believe that committing our capital to the collective management and corporate enterprise of those who have proven successful in the past is the best method available to see its value grow.

As always we are available to take your calls and answer your messages and letters. Don't hesitate to contact us with questions or comments.

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M.S. Personal Financial Planning

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