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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index ended the week at 1,999.99 while the Dow Jones Industrial Average closed out at 17,006.8. Those numbers bring the two indexes to within 2% of where they were at the beginning of the year and at the highest they have been in two months. The S&P 500 rose 2.7% for the week and is now up 9.4% from its low on February 11, but still down 6.3% from its record high in May of last year.

There is a war on, and the Bears appear to be losing. As we reported earlier, the bottom of this market correction looks like it was on February 11th, but this is just one battle in what was a campaign. There is quite literally a war in the equity markets. In times like this, when the focus is wavering between looking back at the banking system excesses and the meltdown of 2008-2009 and the potential for higher and better growth ahead, stock market participants tend to break into two camps, and then go to war.

On one side there is a set of people (the Bears) who believe the market is unstable because it has gotten too high, and is, therefore, susceptible to falling a lot if they give it a push downward. That set of traders tends to "sell short" and then sound the alarm of a pending recession and financial disaster in the hope of panicking regular investors into selling and driving prices down. They first proclaimed that China was on the verge of financial ruin last year in August. When China failed to accommodate their forecasts of doom, the stock market recovered to near record high levels. Then, that same set of investors announced that the weakness in Europe and developing countries would certainly drag the U.S. into recession. When that was not alarming enough, they warned that the falling price of oil and gasoline would undoubtedly cause a banking crisis, leading to a market panic like that of 2009.

The Bears, many of them running hedge funds, hope to profit from a market decline by selling broad baskets of stocks they do not own and then buying them back at a lower price after the market has fallen. That practice is called "selling short." Their presence was clearly evident in mid-February when the percentage of stocks sold short on the New York Stock Exchange hit levels we had not seen in five years. If you watch or read the financial media, you will note that many of the authorities quoted as warning about some future doom are investors and hedge fund managers. It is not unusual to also see that some fine print goes by noting that the talking head is invested in such a way that if they are correct they will be better off for it.

On the other side of the war are the Bulls. The Bulls believe that although there are problems aplenty around the world, and oil-related companies are in for a very hard time, the rest of the U.S. economy is going to keep growing and more than offset the oil losses. Each time the Bears made an attack and forced the markets down, the Bulls jumped in and bought at the lower price. For most of the last year, it appeared the Bears were winning.

If the underlying earnings and the economy are bad, and a cascade of economic collapses is coming, the Bears win and make a lot of money. Meanwhile, though, the Bears had to borrow those stocks they sold short and must pay interest to the brokerage firm from which they acquired the stock. When oil did not decline to a level that would put the major oil companies at risk, and the banks started buying back their bonds, indicating they had money to spare, some of the Bears began to realize that the end of the world was not at hand.

The problem with being a Bear and selling short is that eventually, the Bear must buy the stock back and return it to the brokerage firm. Once they start buying, Bears effectively become Bulls. At that point, it is not unusual to see a "Bear panic." We saw a Bear panic at the end of September and another that started on February 11. The second wave of the Bear panic hit on March 1. Short-sellers lose money as the market rises. If the market rises enough, they can lose more money than they invested. In fact, in a rising market, their losses can be multiples of what they invested. Good news scares Bears. That is one of the reasons that negative sentiment is an indicator of a bull market. When the news is bad, short-sales proliferate, but all of those short-sales will eventually become purchases. When the short-sales hit historically high levels, we either are facing an economic disaster or are about to see a sudden increase in the markets. Unfortunately for the Bears, the economic disaster is nowhere to be seen.

For now, at least, the improving economic data has scared the Bears back into their dens. The sudden rush to buy stocks in mid-February and again on March 1 was not so much new money coming into the market as it was the Bears "covering their shorts." The rises since have been mostly investors who were sitting on the sidelines waiting to see who won, and only now starting to reenter the market. The Bears could reemerge, but they would need some notable economic bad news. Oddly the relatively weak good news is unlikely to set off a buying frenzy and with pessimism still thick, it would take some dreadful news to send things back down.

The Economy

It appears that U.S. auto sales hit the 1.34 million mark in February, the highest for the month in 16 years. That follows three months last year when sales hit 18-year highs. Sales of new light vehicles, including pickups and automobiles, are a strong harbinger of what consumers are feeling about the future. That indicator is confirmation of the news from the Labor Department that employers added 242,000 jobs last month. The report also added about 30,000 jobs to the December and January reports. Employment and auto sales have continued to rise despite clear evidence of layoffs in oil-related manufacturing, exploration, and production. The unemployment rate remained at 4.9% as about as many people entered the employment market as were hired. A large portion of those actively looking for work includes those who previously were discouraged and had ceased looking.

This run of job-creation is the longest sustained period of employment growth since the Labor Department started keeping records in 1939. In the years since 2010 the U.S. economy has created more than 13 million jobs. In all that time there has not been a single month in which the number of new employees has declined. The steady increase is what economists call a "virtuous cycle." The more people who are employed, the more money there is to be spent in the economy, resulting in employers need to hire more people, and so on.

Historically, as the unemployment rate fell below 5%, a shortage of skilled workers would create competition among employers, resulting in a bidding war raising wages. Rising wages for the same amount of work has been, again historically, the trigger for inflation. This jobs report, however, also revealed that average hourly wages declined by one cent. That is the conundrum the Fed faces. The traditional economic signals that inflation may rise are there, but the actual increase in wages and general prices is not! The key to understanding the difference may be the reentry into the workforce of previously discouraged workers.

Currently, economists seem to be expecting two increases in the Fed Funds Rate this year, which would bring the interbank lending rate from its current rate of 0.25% to 0.75% by the end of the year. The Fed's argument is that the time to halt inflation is before it gets started, and a worker shortage is at hand. 0.75% as an annualized interest rate may not sound like much, but compare it with the negative interest rates in Europe and Japan and the difference gains significance. In the United States, we have a central bank concerned about an overheating economy and a shortage of workers. In Europe, for example, the official unemployment rate remains stubbornly above 10% with rates of 20% and higher in southern Europe. There, the European Central Bank is worried about how to get employers to start hiring and avoid a looming recession. Europe is highly dependent on exports, and with much of the world hurting from the low cost of oil and other commodities, they are in pain. Here in the United States we are largely non-dependent on exports and could survive without them.

Part of the increase in the stock market this week was due to a 10% rise in oil futures prices to above $35 per barrel. Oil, like stocks, was suffering from short sellers who had beat the price downward hoping for a collapse. Russian Premier Vladimir Putin announced on Tuesday that Russian oil firms won't increase output in 2016. On Thursday Exxon CEO, Rex Tillerson told CNBC that even though drilling and producing shale oil at current prices could be profitable, Exxon would not be doing so. The story today was that the U.S. oil rig count had dropped to 392, an impressive reduction from last year at this time when 922 rigs were drilling.

Oil speculators appear to have assumed that oil companies would keep on drilling and producing to cover debts, and Russia would keep increasing oil production to fund its weakening economy. The oil price wars are not over, but the market seems to have found a rational bottom. Short-selling speculators commonly seem to believe that they can goad investors and producers into panicking. From our perspective, it is like a breath of fresh air to see nations and companies giving up short-term profits to focus instead on their longer-term wellbeing.

Last but not least, those that have followed our musings for the last several decades know that we have used a truck count on I-35 near our building in Salado to get a real-world handle on what is happening in the economy. At present that would be a difficult task, as the 18-wheelers are bumper to bumper here, but the construction of the highway may be distorting the picture. So, we turn to a more traditional method of truck-counting, the Dow Jones Transportation Average. The Dow Transports turned positive for the year on Wednesday of this week and just kept on rising.

That indicator has historically led the broad market, rising before the more general stock indexes and falling in advance as well. Perhaps more significant this time around than the traditional role of the Transports is that the biggest influencers of that Index are the railroads. Railroads were one of the prime beneficiaries of the oil boom as they took on the overflow that could not be shipped by pipeline. In early February, before the market bottom on the 11th, the railroads started rising as it became apparent that they were going to have plenty of goods to haul, even with the reduced oil transport requirements.

The story remains the same. Oil and oil-related industry are suffering, but the rest of the economy appears to be chugging on ahead with enough power to keep things moving forward. The new news is that it seems that the worst of the oil-related decline may be over.

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