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TPWC Market and Economic Update

The Markets

We love it when the markets go up. Even when they are down by many measures, an "up" week makes for good feelings. Four weeks of market rises in a row are delightful, and that is what we have had these last four weeks. The S&P 500 Stock Index closed out the week at 2,022.19, up 1.11% from last week, but still down 1.06% year-to-date. From a year ago, it is down 1.52%, but from its high last May, it is still down 5.8%. Of course, that was a record high, so you could see that as a glass 94.2% full! Another way of seeing it would be to note that on February 11, the Index closed at 1,810.10, so this week it is 11.1% higher than it was about a month ago.

To put this all in perspective, we are going to try a small digital experiment and post a couple of graphs in this letter. If you don't see the graphic, please reply so we can continue to refine what we are doing in an attempt to make this missive a bit more vivid!

What you (hopefully) see below is the S&P 500 graphed over the last twelve months. While we do not use that Index or one of its surrogates as part of any portfolio outside of retirement accounts where the funds offered restrict our choices, it does reflect the general level of stocks here in the United States. As you can see, the last twelve months do not appear to be very encouraging. Extending the graph out another year does not markedly improve on the image. In fact, we must back off to a much longer view to see the lure of the stock market come into focus.

We used bigcharts.com to generate both of the graphics you hopefully are seeing here and more specifically used its interactive graphing function. Because the furthest back that the website portrays data is 1994, below is the graph beginning that year.

If you look carefully at the graph, you will note that there was a correction in 2011 with a pattern very similar to the dip you see in 2015-2016. The fears then were as powerful as they are today. Back then the fear was of three things, even as we see today. Back then the fear was that 1: the Euro would collapse because Greece was going to default, 2: the Federal Reserve was going to stop buying billions of dollars worth of bonds each month and possibly raise interest rates slightly, and 3: that Congress was going to cause the United States to default by not raising the debt ceiling. Greece did default, but in a socially acceptable way; the Fed did stop buying bonds and did raise interest rates; and Congress finally approved a full-up budget and stopped threatening to shut down the government. The result was a rise in the S&P 500 from below 1,100 to today's 2,022.

The perspective of seeing the Index rise from about 600 to over 2,000 presents the growth progress in a very different light. Note that because we are using the nominal index numbers represented by the symbol “SPX” we have omitted the dividends. That, perhaps coincidentally, almost perfectly adjusts the values for inflation. Other than the observations that stocks, even after inflation, have well over tripled in value over the past 22 years, and the very irregular manner in which they have done so, there is a deeper message in that mountain chart. That message is that the average annual compound rate of return for the S&P 500 for the period was 5.68%. If the average annual return were to have occurred in a uniform manner, the smooth black curve would represent that value.

In any of the upward moving bull markets, and more particularly, during the market rise from 1994 to 2000, double digit annual increases were the norm. Those high average annual returns included inflation, which at the time was running about 6% per year. In retrospect, it is now quite clear that from about 1998 until mid-2002 the S&P 500 Stock Index inflated to unsustainable levels. It is also apparent with the benefit of perfect hindsight that the follow-on market collapse from 2007-2009 left U.S. equities depressed to unrealistically low valuations. Such is the nature of highly liquid, free financial markets. The goal of prudent investment management is to capture a reasonable portion of that long-term increase in value, while, at the same time, attempting to reduce the severity of the *variance*, or fluctuations in value, that are both frightening and potentially damaging to any long-term investment.

Today we are involved in a stock market that in light of historical norms is neither severely overpriced nor markedly underpriced. We are also witnessing a market that, over the last couple of decades, has produced a *real return* (after subtracting inflation) of close to 6% per year. Perhaps coincidentally, if we extend the observation back to when detailed, accurate records begin in the late 1920s, we find that same, after-inflation, average, annual return is substantially the same. We *feel* like something is wrong with our system because, in the absence of any meaningful inflation, equities have demonstrated a net return over the past several years that appears to reflect the performance we have seen in American publicly traded shares over nearly a full century. We are also witnessing the reality that it often takes years of patience to see that net return realize itself in an investment portfolio.

There is another historical pattern that is not particularly obvious here, but can be seen if one studies stock valuation behavior going back to the early 19th century. That pattern is that when the overall price rises well above an historically sustainable rate, as it did in the late 1990s, it will later pay that back with a decline to well below reasonable values at a point not too much later. The good news is that such large-scale ups and downs tend to come in twos, and once stock values have “reverted to the mean" they tend to become more a reflection of the underlying health of the companies that make up the market and less subject to speculative frenzy and depressive collapse. In short, stocks tend to become far less exciting and volatile.

While we do not have the ability to predict the future, we can see historical patterns and markets do tend to repeat themselves. Of course, it could be "different this time," but our experience and our study of history suggests it is never "different this time."

One more lesson is obvious. If bonds have an average yield of 2% or less, and they do, and stocks average around 6%, a portfolio with a standard mix of 60% stocks and 40% bonds is likely to have a long-term average annual real return of about 4%. Using smaller capitalization stocks, and perhaps getting a bit higher yield from other sources could raise that rate to as much as somewhere between 5% and 6%, but, in the very real world in which we live, that is about as far as it could go. It is critical to recognize that reality and live within its constraints.

The Economy

Crude oil rose to $38.50 per barrel at week's end as the short-sellers exited the market found themselves forced into a buying frenzy that took the price of crude up 7% in a week. The International Energy Agency officially stated that the bottom in crude prices appears to have been in mid-February, as producers have cut output faster than analysts predicted. Apparently, the oil production infrastructure is considerably more flexible and able to adapt to price changes than it has been in the past. The back-side to that flexibility is that it is unlikely that we will see a dramatic increase in the price of oil either as there is a large reserve of non-pumping wells with owners ready and eager to produce if oil rises to the point where those producers believe they can make a profit.

One irony in the oil drama is that TransCanada, the company that was advocating for and would have owned the Keystone pipeline is now apparently in an urgent search for someone to purchase it as the oil it was going to transport now costs more to get out of the ground than it is worth on the market. Had the Keystone project gotten started, it appears that it would have had to shut down without completion, and would have possibly plunged TransCanada into bankruptcy.

With oil just below $40 per barrel, there still will be companies failing, and in fact, many already have, but apparently the threat to the banking system that was given much press has vanished. The Bears are scrambling for something to panic about and are hard-pressed to find anything of substance. The current fear-mongering on Wall Street seems to be about the potential for our next President to be one of the candidates who have publicly come out with pledges to raise tariffs and start a global trade war similar to the one that precipitated the Great Depression of the 1930s. Since if any of those pledges were fulfilled, they would, at a minimum, plunge us into a severe recession, it sounds like a legitimate worry. Of course, the President does not have the Constitutional authority to set tariffs, but as none of the other fears that have driven the market down in the past year were based on facts, that new fear is as good as any.

Mario Draghi, the President of the European Central Bank (ECB) announced a new round of economic stimulus for the Eurozone. The ECB will now be charging banks an annualized rate of 0.40% to hold their deposits, but will loan them money at 0%. Better yet, the ECB will pay its member banks 0.40% on money it loans to them if they will, in turn, actually loan the money out! Yes, you read that right, the European Central Bank will pay interest to banks that borrow money from them if they will just loan the money to someone, and presumably earn interest from the borrowers. More, the ECB will raise its monthly purchase of Euro-based bonds on the open market to about 90 billion dollars per month. To do the math for you, that equates to the ECB injecting one trillion dollars (in Euros) into the Eurozone economy over the next year. Not coincidentally, loans made by Eurozone banks have suddenly increased in both number and value.

The idea of paying interest to an entity when it borrows money is the essence of negative interest rates. The current situation in the Eurozone is that large-scale depositors will pay the bank interest, and the largest borrowers (the banks themselves) will be paid interest to borrow money. I recently reviewed my economics textbooks and could not find any reference to that scenario. It is now part of economics though and has been bestowed with a name, "NIRP," standing for "negative interest rate program."

A legitimate question would be, "Why in the world would a bank pay interest to another bank that borrowed money from it?" The answer is that Europe is in *deflation*. It is very easy to go from deflation into a deflationary spiral, and very, very difficult to get out of that spiral if it starts. In a deflationary economy, people defer purchases because they believe things will be cheaper in the future. That very thing has occurred here as well. The real problem arises when those deferred purchases cause employers to lay off workers as there is a reduced cash flow to the business. Fewer workers mean fewer people are buying things. That leads to a fear among those still working that they too might lose their jobs, so they stop spending and start saving their money against a future layoff. That pattern can quickly become a feedback loop that plunges an economy into a depression. It is already happening in several countries along the southern border of the Eurozone. The experiment the ECB just announced will charge a fee for excess savings and provide a bonus for borrowing money.

Excess borrowing, one of the issues that got us into the banking crisis eight years ago, is very dangerous, but the opposite action, inadequate loaning and borrowing, is what economists and historians generally agree was a prime cause of the Great Depression of the 1930s. Across the Western world, loaning and borrowing have dropped to dangerously low levels. Borrowing money to build a new home, expand a business, or buy equipment actually *creates* new money. As money is being "lost" constantly through the aging of equipment, bad investments, and unpaid loans, in order for an economy to avoid collapse, it must constantly be creating new money. When fear of loss halts or dramatically slows the regular bank-borrowing activity, central banks need to step in and buy bonds. When a bond is purchased, the purchaser is, in effect, loaning money to the bond issuer, who is the borrower. Central bank bond-buying is a blunt instrument though and free market bank loans are far more efficient. The ECB is trying to encourage Europeans to do what we in the United States have done in the past few years as we have seen a record number of car sales and a significant uptick in housing sales. Those increases in sales cause employers to hire more people, who, in turn, have more money to buy things.

Unless the Euro-zone can find a way to put most of the about 11% of Eurozone citizens who are out of a job but want to work back into the ranks of the employed, it will remain on the cusp of a recession and any economic shock could push it over the edge. The urgency that has caused the ECB to finally take action years after our Federal Reserve and federal government used similar tactics to get the American economy back in gear is the potential that shock could come as soon as June. In June, the United Kingdom will hold a referendum on whether or not it will leave the European Union. Economists and business owners appear to agree that the *Brexit* as the British papers call it, would be an economic blow to both the Eurozone and the United Kingdom. Either the Eurozone gets its economy moving again and finds a way to reduce unemployment or it faces the very real threat of falling apart.

So, what happens here if that does occur? As exports constitute only about 12% of our GDP, a complete shutdown of exports to Europe would cut about 0.03% from our total GDP growth if all other elements stayed the same. There would be what the British would call a “knock-on” effect as other of our trading partners found themselves in a hurt because the Europeans stopped buying things, so it would probably be a little worse. Contrast that with the plight of Germany, where about half of its GDP comes from exports. A Eurozone crisis will not be pretty, and the market Bears will surely scream that the sky is falling if the Brexit occurs and the European Union starts to unravel. From a purely economic perspective, as long as we can buy from the Pacific rim and have open trade with Canada and Mexico, we would probably weather the storm.

The other thing that the Bears are growling about is the potential for the Federal Reserve to raise rates. In our opinion, that is probably going to happen, and two rate increases this year are the most likely scenario. Even if the Fed raised the interbank lending rate twice, to 0.75%, it would still be below neutral and unlikely to damage our economy. That does not mean that the Bears will not howl, and the Presidential candidates will not proclaim that the Federal Reserve is trying to wreck the economy. In reality, though, we believe that a small interest rate increase this year may be good for both the economy and for the markets. Just don’t panic when the Bears proclaim the end of civilization as we know it. They do that a lot.

As always we welcome your questions, comments, and suggestions.

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