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March 25, 2016

TPWC Market and Economic Update

The Markets

On this foreshortened market week the S&P 500 Stock Index closed yesterday at 2,035.94, which was not a bad number when compared with its level of 1,829.08 on February 11, just over a month ago. The Index is now up 11.31% from that bottom, but still down just under 1% from one year ago, and down about 4.63% from its record high last May. That decline fairly describes the status of fourth quarter 2015 profits of S&P 500 companies as they have reported this quarter, down about 3.6%. There was a legitimate fear that the decline in profitability by S&P 500 companies at the end of last year might be a harbinger of worse things to come. As we will note below, that decline in profits was almost exclusively in oil and export related industries and the financial institutions that either invested or loaned in those areas.

The practical result of that fear is a stock market level that, in the words of Barron's, is "moderately undervalued." Mark Hulbert, in a March 24 column, "Hulbert on Markets," points out that a very consistent indicator for longer-term investors is that when the dividend yield of the S&P 500 is at or below the yield on the 10-year Treasury note, the market is undervalued. The current dividend yield of the Index is 2.13% while the yield on the 10-year Treasury note is 1.90%. Those figures would suggest that the stock market is about 12% undervalued.

Another theory of market valuation is derived from the earnings yield of the Index, currently at about 4.85%. Again, the argument is that as long as the earnings yield of the Index is higher than the 10-Year Treasury note yield, the market is not overvalued. Note here, as always, that these are long-term returns. In the short-term just about anything can and probably will happen!

As we have written before, in this near zero inflation environment the real source of long-term market return is revealed. Stocks, in general, are generating earnings of about 4.85% per year and bonds are yielding about 2% per year. The long-term numbers the markets have supported historically (in real, after inflation terms, are stocks provide about 5% per year and bonds about 2%. Thus a portfolio composed of 60% stocks and 40% bonds has historically provided about a 4% longer-term total real return. Add inflation to that number and a nominal return emerges. If the Fed's prediction is correct and we get 2% long term inflation, then the reasonable withdrawal range for that 60/40 portfolio would have been somewhere between 4% and 6%, depending on your comfort zone with the market and your need to increase your income with inflation.

The Economy

Those of us who see the glass as half full rather than half empty can point to a growing number of facts that indicate what we have seen (and are seeing) is an oil-related bump rather than a looming recession. For the entire year of 2015, corporate profits were 3.3% higher than in 2014. More, if one excludes the oil-related bust that emerged in the last half of 2015 and continued into this year, the rest of the economy had an entirely reasonable growth in profitability. The Labor Department revised its wage growth report for 2015 to 4.4%, which is another strong indicator that corporations were planning for and experienced growth. Consumer spending was up 2.4% in the fourth quarter while exports were down 2.2%.

When the Commerce and Labor Departments finished revising their fourth quarter numbers, the result was a pretty clear picture of what was going on in the economy. Capital spending was down, as anything related to oil was slipping. That resulted in one set of negatives while our growing economy, almost alone in the developed world, caused the value of the dollar to rise, and thus hurting our exports, generated another. Despite those two pieces of bad news, the Commerce Department revised the annualized GDP growth during the last quarter of 2015 upward to 1.4% from the previously reported 1%.

Over the even longer-term, the U.S. economy grew 2.4% in 2015 while consumer spending accelerated to 3.1%. Residential investment, one of the biggest drivers of long-term growth, increased 10.1%. It takes time for the movement of underlying economic growth to show up in corporate profits, but when the fundamental elements are growing, corporate profits will show the results over time. That our economy grew at all in the face of an oil industry bust of the magnitude we have seen in the last year is incredible. That we managed to hang on to the 2.4% growth rate we saw almost every year since the banking panic of 2009 is evidence we do have both a healthy system and a healthy economy.

As a last note, inflation appears to be returning. No, there is no indication of the run-away inflation that can be so damaging, but wages for workers who have been on the job more than a year are up about 4% over a year ago. We are not yet to the 2% annual inflation rate target set by the Fed, but we are getting there. As we have mentioned before, a little inflation is a good thing. When there is the prospect of higher prices next year, people tend to buy more things and buy them sooner. More purchases mean more jobs, which in turn creates more money to be spent.

In Closing

Several people have commented on our “eternal optimism” about the economy and the markets and contrasted it with what they hear on talk radio and from the talking heads on TV. We have been listening to people claim in highly emotional and passionate tones that America is failing and even from many politicians about making “America great again” over the years. America is great now. When the Dow Jones Industrial Average was crossing through 1,000 back in 1982, the naysayers were predicting a plunge and a depression. They came out in force in 1987, in 1994, in 1998, and particularly in 2002. They have been loudly proclaiming the end is near in 2009, 2011, and over the last year.

Through all these forecasts of disaster, depression, and failure; through Democrats and Republicans in the White House and in Congress, the Dow has risen from 1,000 to 17,500 and the S&P 500 has risen from 117 to over 2,000. Along the way, the Soviet Union, the nation that was going to “bury us” collapsed, China converted from pure communism to mostly free enterprise, and the powerful Euro that was going to supplant the dollar is in a struggle to survive even as have a need to slow things down a bit.

We live in the greatest nation that has ever existed on this planet, past or present. We believe that it is already great and is destined to become greater. We, indeed, are optimists. We see no reason to be otherwise. The only threat we face is that we might turn our backs on free trade, freedom of religion, and our openness and acceptance of those who are willing to uproot themselves to come here in search of dignity, freedom, and a fair reward for hard work.

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