THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

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TPWC Market and Economic Update

The Markets

Welcome to the second quarter of 2016! Most of us don't think in quarters, but as economics and earnings reports dwell on them like they are segments of eternity, and this new one rolls in on a Friday, we might as well embrace it!

The S&P 500 ended the week up about 1.8%, at about 2,073. That gave it a 1.35% gain for the year-to-date. As several publications have noted, had a person gone on vacation to a news-free zone at the beginning of 2016 and returned today, they would have seemed to miss nothing. The net result is that we are back to the starting point for the year. The Index is now up about 14.5% from its bottom on February 11, but still down 2.9% from its high last May.

Since we are shifting quarters, some Morningstar Category returns are in order for the first quarter. Mid-Cap Value (our favorite) was up 2.42%, while Large-Cap Growth was down 2.46%. That is a reversal of their behavior from last year. Generally speaking, value stocks, as a category, are up a couple of percent and growth stocks declined so far this year. The size premia were also in line with the longer-term trends with smaller stocks showing the extremes. One very long-term trend in the markets is that over the longer-term, value stocks have tended to outperform growth stocks, and smaller value stocks tend to outperform larger stocks. Over the couple of years leading up to the twin corrections of last fall and the first quarter of this year, large-cap growth stocks did better than value stocks. That does happen from time to time, but when it does, history suggests that a downturn is in the works, and that downturn returns value to the lead position. Of course, the future is uncertain, so we must wait and see what comes next.

The Conservative Allocation category, another of our favorites, was up 1.72% during the first quarter, while Diversified Emerging Markets, yet another category we routinely include, was up a whopping 3.88%. That last number may mark a turnaround, as the Emerging Markets category has been a drag on our portfolios for the last couple of years. It, like smaller value stocks, has been one of the historically highest return categories, and it's nice to see our patience potentially paying off! Real Estate Stocks (another category we commonly use) also came out ahead of the broad market, rising 4.69% so far this year.

In late 2014 and during all of 2015, we saw asset classes that are historically not the best performers roaring ahead like a jackrabbit, while the traditionally better-performing categories that we like to use plodded along behind like the proverbial turtle. 2016 started with both the jackrabbit and the turtle stumbling, but the turtle, at least for this leg of the race, appears to be returning to its well-known role in the contest.

Meanwhile, the dollar declined slightly against the Euro and other world currencies, which is a relief for our manufacturing sectors, and mid to long-term interest rates began a slow increase after falling for much of the quarter. More on that below.

The Economy

The Labor Department reported today that nonfarm payrolls rose by a seasonally adjusted 215,000 in March, while the unemployment rate increased from 4.9% to 5%. That seemingly contradictory statement is a sign of growing health in the economy. Around 369,000 more people started looking for jobs in March even as 215,000 found jobs. That means that individuals who were previously discouraged are re-entering the job market. If the discouraged workers had not started looking for jobs, the unemployment rate would have dropped to about 4.2%, and the Federal Reserve would quite probably have found that to be a dangerous sign. A 5% unemployment rate means that the market, at least to some degree, still favors the employers and is unlikely to generate inflation. 4% unemployment is the level where many economists believe that a bidding war will start for employees and the rising wages associated with that bidding might ignite inflationary pressures.

As we have written before, employment is the strongest indicator of what is going on in the larger American economy. No recession has ever started without a preceding series of declines in employment, and rising employment is the strongest sign of good times ahead for the economy.

In more good news, the Institute for Supply Management reported that its ISM Manufacturing Index rose to 51.8% in March from its previous level of 49.5%. A reading above 50 in the Index means that manufacturing is expanding while a reading below that number means decline. The higher reading came despite the continuing decrease in oil-related manufacture and suggests that the rest of the manufacturing sector has managed to overcome both the oil-related and dollar-related export slumps. Automobile and light truck sales joined the party with some areas and brands breaking all-time records, and the overall industry rising to the highest level in 15 years.

Interest Rates

Policy makers and economists have commented on the odd behavior of longer-term interest rates, but there appears to be a reason behind the strangeness. The Federal Reserve Board raised the overnight interbank interest rate level to between 0.25% and 0.50% in December, and has given guidance that two more quarter-point increases are likely this year. Historically that has caused the longer-term rates to rise as well, but this time, as in the late 1990s, the reverse appeared to be happening in the first quarter. The evidence is beginning to accumulate that what happened is that a rather large quantity of currency from around the world has been expended buying longer-term U.S. Treasury securities. That buying pressure has forced the prices up, and as interest rates move in the opposite direction of prices, the interest rates have been depressed. The Federal Reserve Board has stopped buying U.S. bonds but investors from outside America appear to have been replacing the Fed as buyers. That pumps more money into our economy, increases the value of the dollar, and drives interest rates down.

Even as the U.S. Fed warned of increases in interest rates later this year, the European Central Bank (ECB) was suggesting that deeper cuts into negative rates were coming and bond buying was to increase. Bond buying by the ECB is with the intent of forcing longer-term rates, already near zero, *down*. On the other side of the globe, Japan's central bank suggested the same policy is under consideration.

An obvious question is, "Why would the ECB want to push record low negative interest rates lower?" The answer to that one is simple: the Eurozone is in deflation and has an overall hard unemployment rate of about 10.9%. Note here that seven years after the world markets hit bottom in 2009 and the recovery started, the Eurozone still has an unemployment rate that is as high as ours ever rose! Negative interest rates equate to charging companies to keep cash in the bank. Their mattresses are not big enough to hold all their cash, so the intent is to get them to loan it or spend it somewhere, thus causing more people to be employed. It appears that some of that money is being funneled into the United States where we actually pay interest on saved money, low interest, but still interest.

America is recovering, and seems to be recovering well. The rest of the developed world is in a funk and seems to be having a very difficult time getting out of it. Meanwhile, the developing world, facing weak buying in Europe, has downshifted. The Chinese appear to have recognized the high risk that an export dependent economy faces and are converting to an internal, consumer-driven economy like we have here in the United States. That is good news for everyone, but in the short-term means lower demand growth from China. The rest of the emerging markets countries are adjusting, and they may have just turned the corner. Keep watching for more excitement!

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