THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

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April 15, 2016

TPWC Market and Economic Update

The Markets

The S&P 500 (SPX) closed last week at 2047.60 and finished out today at 2080.73, up about 1.62% for the week. A year ago today, it was at 2081.18. We don't recall being this excited about seeing a one-year SPX return approaching zero in a long, long time. It still has about 55 points to go to for it to reach the 52 week (and all-time) high it hit last May, but little by little we appear to be getting there. In short, the S&P 500 Stock Index is up about 15% from where it was back on February 11, but still down 2.5% from where it was last May.

Short-term interest rates, as exemplified by the 90-day T-Bill, still have an annual yield of 0.23%. The one-year Treasury note will pay a whopping 0.515%, but if you are really aggressive and purchase a 10-Year Treasury Note, you can get an annual interest rate of 1.75%. Current year-over-year inflation in the United States has been 0.90%, so your 90-day or one-year Treasury note is running at a negative 0.77% or negative 0.385% for a 10-Year Treasury note.

Perhaps putting that in a dollar perspective will help to illustrate the impact. If you were to go directly to the Federal Reserve Bank of Dallas, so that you would pay no commission, and had purchased one-year Treasury bills today using $100,000, over the next year you would be paid $510 in income. Were you to somehow take that income each month, your $100,000 purchase would pay you $42.50, minus whatever tax rate you owe. If you are in the 20% tax withholding status, then you would get $34.00 per month for your $100,000 investment. If you committed your money for ten years, you would receive a net $140 per month. Of course, if inflation rises to a level above 1.4% per year over the next decade, your real total return would be a negative number.

The Economy

As bad as those interest rates sound, Japan and China think they are great! According to The Economist magazine, China and Japan purchased $15 billion and $10 billion in U.S. Treasury securities respectively during the month of February. Both countries are lined up for a relatively large roll-over Treasury auction next week and appear to be ready to purchase as much as the Treasury will allow them to buy. Why? Because the alternative is to buy things like German bonds, where the ten-year yield is 0.13%. More, with the British poised to possibly exit the European Union in June and Greece again on the verge of default, the Chinese quite legitimately see some risk in buying Euro-denominated ten-year bonds.

U.S. crude oil (West Texas Intermediate, WTI) crept above the $40 level to close at $40.45 per barrel. Despite the stabilization in crude prices, energy companies continue to issue bankruptcy notices. This week saw Peabody, the world's largest non-government coal mining company, file for Chapter 11 bankruptcy protection. Peabody is the 50th coal company to file for bankruptcy in the last four years. Peabody's stock closed out 2014 at $116.10 and had collapsed to near zero today, although it was still technically listed at 74 cents per share. Just over a year ago Peabody Coal was widely considered to be a stable, dependable and even vital part of the American economy. Today an investment in Peabody has become nearly worthless.

The factors that crushed Peabody from an over century old cornerstone of the U.S. economy to bankruptcy was a combination of global warming and fracking. Fracking has made natural gas abundant, and quite importantly, cheap. The specter of acid rain, global warming, and health concerns about polluted air and water shoved the coal industry over the cliff.

Here is the economic lesson: At the end of 2014, we knew that there were abundant supplies of oil and gas buried in the shale rock of North America, but the conventional wisdom was that the cost of extracting that relatively clean form of energy was so high that we could never use it. By early 2015 it had become clear that there had been a technological breakthrough that was going to change things. What was not apparent was the enormous economic repercussions that would develop from that breakthrough. Peabody was a steady source of dividend income and widely believed to be able to continue as a source of real income, as it had been for the last half-century and more. Peabody survived the Great Depression and prospered. It thrived through two world wars. Like Dow Jones member Montgomery Wards, who would have dreamed it would collapse in such a short time, but it did!

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Many of the same beliefs today surround other companies that pay dividends higher than the interest rates one can get from banks, Treasuries, or even highly rated bonds. The thing to remember is that any income rate greater than that paid by Treasury securities or banks carries some risk, and that risk rises much faster than the interest rate! There is a lot of evidence at hand suggesting we are about to see a wave of new technological innovation. Such times historically have produced astonishing economic growth while at the same time being disruptive to old ways of thinking and investing. As an example, the long-term or even intermediate term effect of driverless automobiles and trucks is so disruptive that there is no way we can predict the outcome. We can say that there will be profound effects as a large number of jobs disappear in many parts of the economy, and it is likely that the falling demand for oil will be magnified. At the same time, there will be new opportunities open up that we cannot imagine today. Driverless vehicles are not a science fiction dream, they are on the roads today, but they are only one innovation.

The only thing we can say with some degree of certainty is that change will happen, and it will likely be greater than we expect and effect areas we never dreamed of.

A Conundrum

Another issue we face today is something we have not had to deal with in many years. We have been in the investment advice business for almost 34 years and over nearly all of that time the first and most fundamental choice we when designed an investment portfolio was the balance between stocks and bonds. The standard assumption was that cash would provide about 3%, bonds would yield about 6%, and stocks, over the long term, would provide a 12% total return. Stocks tended to be more volatile while bonds were far more stable and dependable. Conventional wisdom taught that if stocks went down, we could depend on bonds to rise, and if interest rates increased, causing bonds to fall, we could depend on stocks to rally.

Today we are in a market environment where stocks appear to have gone flat while bond interest rates are so low they are effectively negative. The choice between stocks and bonds, at least in the short-term, looks to be simply a choice between zero and zero. Frankly, that is depressing. Yes, there are older bonds that still have a reasonable coupon rate, but when we look at the yield to maturity on investment grade bonds, we still see numbers that are at or below the probable rate of inflation.

Across the world economy, negative interest rates are causing unexpected and unanticipated results that are not at all what economists thought they would see. Instead of encouraging lending and investment, the negativity, both from political speeches and in interest rates, seems to be creating a greater urge to save and avoid spending. The news on the stock front is so bland to negative that it is depressing to read. There is simply no good news or "green shoots" as Chairman Bernanke spoke of back in 2010.

Here is where faith and a bit of historical knowledge come into play. It is when there is no good news to be found that we are at the bottom. Just as no one could see a way to limit the use of relatively high pollution coal without outrageously raising the cost of energy, we cannot imagine what is going to kick the world economy into gear and get things moving again. What happened as coal was removed from a prime source of energy was not an unsustainable spike in the cost of energy, but instead, a destabilizing collapse in that cost.

We don't know what it is that will resurrect the world economy, get things rolling, and, as a result, generate higher interest rates, but we have faith that it will come. Why? Because given freedom and opportunity, we humans, and particularly, we Americans have always made our greatest advances in times of adversary and gloom. Somewhere, someone is or already has started something that we will look back upon in a few years and say, "Of course!" The only question is who will still be invested and believing that our system always produces the right answers when we most need them.

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