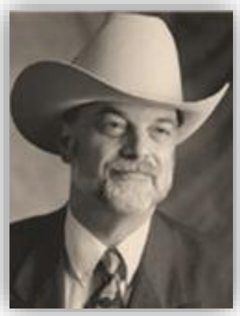

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TPWC Market and Economic Update

Administrative note:

We have been trying to get this letter out on Friday evenings, but sometimes that is a bit of strain. Not only do we have to write it, but we need to have staff members review it for accuracy and to weed out the typographical errors. If you have preferences, or even if you are willing to see the letter a few days later, please let us know.

Jeff is in West Texas, near Ft. Davis attempting to get more deep-space images, so this week's letter is coming out early in the following week.

The Markets

The S&P 500 closed out last week at 2065, down 1.26% for the week, 1.05% below where it started the year, and down 2.05% from where it was last year at this time. It remains up about 15% from its lows in mid-February. The good news is that the S&P 500 was up 4.9% for the month of April. The U.S. Ten-Year Treasury Note yielded 1.829% at the end of the week. Shorter-term rates remain below 1%.

The Economy

The big news last week was the first iteration of the Commerce Department's U.S. GDP estimate. The report stated that our economy grew at a meager 0.5% annualized rate in the first quarter of 2016.

Before you get depressed over that news, a little perspective is in order. Every year for the last five years, first quarter domestic growth has been initially reported to be somewhere between negative and anemic. For those same years, we have had what has now become the standard super-blizzard in the Northeast, skewing the data. The Commerce Department makes seasonal adjustments, and the change in the first quarter is negative. It is hard for the bureaucrats at the Bureau of Economic Analysis to list a recurring blizzard as a cyclical economic event, so the results of the blizzard are left in the data, unchanged.

Another consistency over the past several years is that the third quarter GDP estimates come in unreasonably high. The depressed first quarter and the elevated third quarter tend to balance each other out.

Yet another factor strongly affecting the first quarter's economic numbers was the collapse in oil prices and the wave of fear that accompanied that news. There was lots of fear that the drop in oil price would trigger another economic crisis with banks and other institutions failing as hidden connections to the oil industry revealed themselves. The reality was that Dodd-Frank, the law that attempted to address the structural issues that led to the panic of 2008-2009, worked! Banks have taken a hit, and their earnings have declined, but there was no danger of a chain reaction of bank failures such as we saw in 2008 and 2009.

We can observe a measure of the relative strength of both the American and world economies by considering what did not happen. Greece is once again teetering on the verge of default and Germany is balking at bailing it out. But there is no sense of crisis. At least part of the non-crisis feeling is the fact that Greece has tens of thousands of refugees held in camps. If the Greek government is forced to lay-off the government workers that run the camps, those refugees will likely wind up in Germany. The odds are that Germany would rather pay down the Greek debt than have a wave of Syrian refugees come visit.

At the same time, Puerto Rico will default on Monday. Unless Congress takes some action, a move that appears to be blocked in the House of Representatives, there will be a messy, unresolved, slow motion collapse of the Puerto Rican government and economy. Unlike states, Puerto Rico does not have the option to declare bankruptcy and have a court consolidate the issue.

Instead, individual owners of Puerto Rican government bonds will sue in different jurisdictions, potentially shutting down public services in the Commonwealth.

Between Puerto Rico and Atlantic City, there are hundreds of millions of dollars' worth of municipal bonds that will return less than their face amount to their holders. If you ever wondered why municipal bonds pay higher interest rates than Treasury securities, here is the reason.

That is all certainly unpleasant, and a tragedy at worst, but the notable thing is that the defaults are not making headlines. A couple of years ago the potential unraveling of the Commonwealth of Puerto Rico because of unpaid debt would have generated a mini-panic. Greece's pending default too would have triggered a worldwide economic panic and market selloff. We are far better off, better capitalized, and more stable than we were a few years ago.

Corporate earnings are down about 7% for the last twelve months, but the stock market is close to flat for the same period. That profit reduction originated in energy and financial companies. Oil and gas price declines hit not only businesses that produce or work directly with those commodities but rippled out to manufacturing firms that make equipment for energy companies. Banks and other financial institutions suffer from the double whammy of potential and actual loan defaults by the energy-related businesses and hyper-low interest rates. Still, bank solvency is not threatened, largely because of the laws passed to prevent another panic.

Good News

The market did not sell-off as the reality of corporate profit reduction, nor when the announcement of the weak GDP number appeared. Why? It is because the oil crisis is largely over and it was falling prices that had the impact. If oil prices are not falling, and we have survived the fall, then the threat is removed.

We still have deleveraging facing us around the world, but the evidence suggests that we now know and have a good grasp of what the problems and weaknesses are. There are still some places, like Greece and Puerto Rico, where parent governments need to come to grips with the fact that when an impoverished governmental entity does not have the income to pay its debts, squeezing it will not improve the situation. Still, we are past the crisis stage of this drama. That is not to say that the markets will suddenly wake up and realize that another major financial crisis is very unlikely. There almost certainly will be dips and starts as the traders react to their collective fear that they will be caught by another panic.

We are not sure when or what will break us out of this economic funk, but we suspect that once the election this November is in the rear view mirror, the road will be much smoother, and the economic vehicle we call the United States of America will pick up speed.

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