THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

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TPWC Market and Economic Update

The Markets

Since we didn't publish last week (Jeff was in the desert), here are the two week numbers. The S&P 500 Stock Index closed today at 2046.61, down 0.9% for the two-week period and up about 1% year-to-date. It is up about 12% from its low on February 11, but down about 4% from last year's high at about this time. Interest rates have wandered around a bit, but the benchmark 10-year Treasury Note closed at 1.70%, down from about 1.81% two weeks ago. The dividend yield on the S&P 500 is at 2.14%.

There is a reasonably well supported series of studies which indicate that the "fair market value" of the S&P 500 Stock Index can be measured by the difference between the interest rate on a newly purchased 10-year U.S. Treasury Note and the dividend or earnings yield of the Index. Those studies suggest that when the T-Note has a lower yield than the dividend yield on the Index, the Stock Index is to that degree undervalued. The same argument states that if the Treasury Note yield rises above the earnings yield of the Index, then the Index is overvalued. The current difference between the T-Note yield and the Index dividend yield suggests that the stock market is currently undervalued by about 26%. Presuming that the historical studies remain correct, the low end of fair market value for the S&P 500 would then be around 2590.

We remain stuck in a low-return, low-interest rate environment. Contrary to the popular myth, hedge fund managers have generally not done any better, and most have done worse. The market is suffering from some rather extreme uncertainty. We have a presidential election coming up and the presumptive Republican nominee has claimed that, if he is elected, he will do some things that would be devastating to the business community and to the U.S. economy. What he might really do is uncertain, as he seems to change his position frequently, but it is hard to invest in companies that a year from now may be hit by severe penalties and tariffs and impacted by a global trade war. It is not unusual and even "normal" for the stock market and corporate investment to be depressed in a presidential election year in which the incumbent is not running, but it is none-the-less unpleasant. The Eurozone, Japan, Greece, and much of the rest of the world are big question marks. These are typical causes of an undervalued market. The good news is that historically, stock indices in the United States have consistently returned to their fair market value.

The key thing to remember here is that any investment that purports to offer a higher interest rate than those offered by a ten-year Treasury Note, a bank CD, or the yield on the S&P 500 carries a higher risk. Counter-intuitively, If the higher interest rate is "guaranteed" then the risk rises, and rises dramatically. We have heard of "guaranteed annuities" being offered with interest rates as high as 7%. Such an offer carries a high probably of either being fundamentally false, or a loss of a significant part of the original principal. We have been around long enough to remember when interest rates were low three or four decades ago. Then, too, annuity companies offered higher than Treasury or bank CD rates, accompanied by the word "guaranteed." We also have seen the results as annuity companies became insolvent and the investors, often years later, had only 30% or 40% of their original deposit returned, without interest. More recently, it was investors in hedge funds and illiquid "alternative investments" who have seen their principal vanish.

There certainly are "alternatives," such as gold, and gold has risen about 20% this year. It is good to remember that the "round-trip" cost of buying gold and then selling it can easily be as high as 10% to 20%. That means that in many cases one has to have a 20% gain in a gold investment just to break even. More, just a couple of years ago gold was 40% higher than it is today. There historically has no easy way to get a higher long-term return than one can get by a relatively simple portfolio of publicly traded, marketable investments. There is a price for everything, and the price for long term gain in today's environment remains patience. We often in the media of those who hit it big with a purchase of some exotic investment at just the right time. What we far less often hear of is the many, many people who lost much or even all of their retirement savings in such ventures.

The Economy

The Commerce Department reported today that retail sales in the United States advanced 1.3% in April, and were up 3% from this time last year. This looks very much like the turn-around from saving and paying down debt to beginning to spend some of the increased wages workers have received collectively over the last year. Last week the Labor Department reported that American employers filled 160,000 more new positions in April than layoffs. More, the average work week and average wages were up nearly 3% from last year.

Yes, there is a significant number of those jobs that are low-wage, but with each report we see more higher-paying jobs being filled. One of the problems causing the lag between new hiring and better earnings numbers for corporations is that many of the newer employees do not have the skills to be highly proficient at their new jobs. That results in lower pay for the employee and a greater expense as the employer trains the newly hired person. That lag is common following prolonged economic downturns, and is exacerbated when technological changes are happening rapidly, as they are now.

The second lag between a better economy and better corporate earnings we mentioned above. When people have been out of work, or at a sub-standard wage job for a while, they run up debts. After they are hired and start receiving better pay, they start paying down those debts, an action in the economy that holds interest rates down, and they are cautious. That caution causes them to limit spending and increase savings. Increasing savings rates also tend to depress interest rates, and their caution about spending hurts corporate earnings.

The Bureau of Labor Statistics reported that the Produce Price Index increased 0.2% in April. That equates to an underlying inflation rate of 2.4% in the cost of producing goods and services. Contrast that figure with the 12 month increase in Producer Prices of 0.9%. What that means is that companies are finding it more expensive to produce, and that increase in expense is from the newly hired employees. The increase in producer prices follows several months of declining numbers. Those declining numbers had economists worried that, like the Euro-zone and Japan, we might be headed for deflation and possibly a resulting recession. Those of us who have been around for a while are programed to see inflation as bad, but the fact is that low-inflation is healthy, and deflation is deadly.

Three final observations before we close:

First, the American economy is on the verge of phenomenal innovation that has the potential to surge us forward economically in a way we have not seen since the 1990s. Inventions and innovations that have been in the works for ten or more years are coming to market, many of them in the next four years. Those technical products and innovations are going to be disruptive, perhaps as much as the automobile and the personal computer, but they will dramatically improve our standard of living and wealth.

Second, the Wall Street Journal commissioned an in-depth study of the standard of living we had in the 1960s and 1980s compared with today. The results were quite clear. We are living on average about 10 years longer than in the 1960s (the good old days) and a typical low income family today lives better than the typical middle class lived back then. We too are living much longer and better than we were in the 1980s, the golden Reagan era.

Third, there are more good jobs available in the United States than there are qualified people to fill them. Those jobs though require a solid education based in math, science, and a mastery of English. We do actually have a higher percentage of the population who have those skills today, but we need to improve. Education is the divider between the unhappy, low-wage or no-wage person in the United States today and that mass of people who are being hired and earning more than ever before. Fundamentally, if a job is boring and repetitious it will likely soon disappear. If a job requires technical skills, education, and training, and if the employee is still learning, then it will be around and improving wages are likely.

We are fundamentally in the early stages of an industrial revolution. It is unsettling, disruptive, and sometimes scary, but as with the several revolutions our nation has experience before, likely to lead to a dramatically improved future.

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