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THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

-Stocks

The S&P 500 closed out today at 2096, down three points from last week's close of 2099. During the week, it briefly touched 2119, and its close today was the low point for the week. For all intents and purposes, the week's return was zero. As we wrote last week, the markets are on hold, as is much of the rest of the economy.

-Bonds

The bond market is in a bubble. That is a bold statement, but one we believe to be true. The United Kingdom issued 50-year "Gilts," their version of Treasury bonds, and the auction sold out at 2%. The inflation target both for the United Kingdom and for the United States is 2%. That means that after they pay taxes, investors are willing to accept what is effectively a negative rate of return for the rest of their lives. That sounds insane, so what is happening?

An article in today's Wall Street Journal suggested one possible set of reasoning. Japan too had long-term bonds with amazingly low-interest rates last year. The decision by the Japanese central bank to issue long-term government debt at negative rates resulted in a gain of about 18% to 23% for those who purchased bonds last year and sold them recently. German ten-year Bunds too have declined so much in 2016 that purchasers who bought them last year and liquidated them this week saw a gain of about 10% to 12%.

The German, Japanese and, for that matter, the United States bond markets do not have a useful index like the Dow Jones Industrial Average or the S&P 500 to track bond values, but large-scale bond investors are very aware of the value changes. If you think back to the last time that stocks gained as much as the long-term Japanese bond did in the last year, it was at the end of the "dot-com" bubble in the late 1990s. In that bubble, like this one, investments where there was no conceivable way an investor could have anything but a long-term loss rose by double digits per year. Then, when reality set in, the stock market dropped by about half and the investors in those massively overpriced investments lost most, and in some cases, all of their invested money.

Japan, Germany, and the United States are very likely going to be here in ten, thirty, or fifty years; however, buying a bond from those very dependable entities, in which they are solemnly promising to pay you less at maturity than you are paying to purchase their bond today is a fool's game. There is more evidence of a "bubble" visible if one looks at corporate bonds in Europe as some of those have also declined into negative yields to maturity. There is little question that major western governments will be here and still pay investors in the future, but corporations come and go, sometimes suddenly. That investors are piling into longer-term bonds to the point that they have become guaranteed losses is classic bubble behavior.

Compounding the danger in long to intermediate-term interest-bearing investments is the very real risk of what they will be worth on the open market when interest rates rise. If the market rate for that 50-year British bond increases from the current 2% to a still low 4% in the next few years, the market value of the bond will drop by half. That is what happened to the main indices in both the U.S. and British markets between 2000 and 2002. It also happened to longer-term bonds between 1978 and 1982. History may not repeat itself, but as Mark Twain is reputed to have said, "It rhymes."

We are in an environment where running to "safe" investments with a reasonable current interest rate may be one of the most dangerous things an investor can do.

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The Economy

Last week we wrote about the low hiring rate reported in the United States for April. This week the Labor Department reported that new jobless claims (layoffs) declined for the week ending May 28, and so did the four-week moving average. Employers did hire 38,000 more new employees than they laid off last week, but at least part of the net hiring rate was a lower layoff rate.

That new data point tends to confirm our view that businesses are on "hold." They are neither hiring nor laying off workers at a high rate. Nor are they investing in long-term equipment purchases. The combination of the potential disruption resulting from the United Kingdom leaving the European Union and the potential for our next President to be Donald Trump has them taking cover and building up cash reserves.

At the same time, the Commerce Department said Thursday that total revenue for U.S. service sector companies rose 3.6% in the first quarter of 2016. Businesses may not be investing, but their customers are spending.

In another indication that growth is still going on in the economy, the Federal Reserve reported that manufacturing output in the U.S. was up 0.4% in April. 0.4% may sound like a weak number, but in light of the reductions still underway at oil-related manufacturing companies, it actually suggests that outside of oil, U.S. manufacturing is growing at a healthy pace.

Last, but certainly not least, the Federal Reserve posted a press release announcing that the total net worth of Americans, individually and as families, hit a record high of $88.1 trillion in the first quarter. Since the bottom of the Great Recession in 2009, the net worth of American households has risen by $33 trillion! Much of that is in residential real estate, and as 63.7% of Americans own their homes, the wealth growth is widely spread. We may not feel more wealthy, but where we live has increased in value. Just as importantly, collectively, we have not taken on more debt as our home values have risen. Instead, we have been reducing our overall debt load.

Paying off debt does not contribute to our cash flow; in fact, it reduces it. It also does not contribute to corporate earnings or the U.S. GDP. Instead, it reduces both of those numbers. More, as we direct more money to pay off debts, it pushes interest rates down. We may not like low-interest rates, and consider them our enemy, but as Pogo O'Possum once wisely said, "We has met the enemy, and they is us!"

The good news in this is that we will eventually reach the point where we have paid down our debts to below our comfort levels. When that happens, historically we have seen a relatively sudden rebound in the economy, earnings, and the markets.

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