THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index closed today at 2017.22, down 1.23% for the week. That puts the Index up 13.24% from February 11, and down 2.61% from its record high last July 17. The larger picture is that the stock market, in general, has been effectively flat for the past couple of years. Nothing new here.

Bonds are another story. The Vanguard Long-Term Government Bond Index Fund, I shares, (VLGIX) is up 13.57%, year-to-date. That looks like a fantastic place to be invested until we dig down to the underlying numbers. The weighted average price of a bond in that index fund is $1,197.70. That means that when the average maturity date arrives, the United States Government has guaranteed that it will pay the owner $1,000, or about 20% less than said owner paid today to purchase that bond.

At the beginning of 2016, those bonds were "only" priced about 6.10% above their maturity value so that the loss would have only been that much. But wait! The bond fund pays interest. As this is one of, if not the, lowest cost ways to own a portfolio of long-term government bonds, the interest should make the difference, right? If we take the last monthly payment by VLGIX, multiply it by 12 and divide it by the share price, we get the annual interest yield, of 2.43%!

Again, that one can get 2.43% current interest on a portfolio of long-term, guaranteed government bonds sure sounds appealing. The catch is that the same government, and more specifically, the United States Treasury, also promises that, presuming you hold the bonds to maturity, you will lose about 20% of the dollars you invested. That effectively means that if interest rates remain constant, your (taxable) interest payments will bring you to a break-even position in about 8.15 years. If you figure in taxes due on the interest and 2% inflation along the way, you never have anything but a loss, interest included, even at maturity.

The sole reason that longer-term interest rates are falling, and bond prices are rising (two sides of the same coin), is because a LOT of money is being used to buy long-term government bonds. Much of that money is coming from overseas, and that cash flow is causing the value of the dollar to rise, as foreigners have to buy dollars to buy U.S. Treasury bonds (or mutual funds).

Every time we look at the asset classes available for us to use in investment portfolios, I am tempted by the siren song of a class that is paying a very attractive interest rate and has risen by double digits both in the last year and year to date. More, the underlying securities are backed by the full faith and credit of the United States Government. It is also the place where all the "smart money" investors seem to be buying. Nowhere do I see a notice, "WARNING! The underlying securities in this asset class are guaranteed to lose 20% over the long-term and could potentially decline in value as much as 50% for a decade or more," but that is the reality of what is there.

If you wanted something to be really concerned about, consider that if long-term rates rise to their historically “normal” 6% to 7% on Treasury bonds in the next ten years or so, the market value of that hypothetical 30-year treasury bond purchased today at $1,197.70 would likely decline to around $550. That would equate to about a 65% loss if an investor needed to sell ten years hence. That is very much what happened to someone who purchased long-term government bonds in about 1978 and then needed to sell in the early 1980s.

The Economy

A report from the Organization for Economic Cooperation and Development stated this week that the U.S. economy has grown more than 10% since the first quarter of 2008, just before the beginning of the Great Recession. In contrast, the Eurozone has increased less than 1% for the same period. Meanwhile, the Eurozone has a stubbornly high unemployment rate of about 10.2%, higher than the U.S. rate at its worst.

Business investment in long-term items, like physical structures and durable equipment, has risen about 10% above where it was in early 2008, even after dropping 25% to its bottom in late 2009. Germany is struggling to get back to the investment levels it had in 2008, while Japan is still down about 10%.

Employment rates and business investment are the best longer-term indicators of where an economy will be in a few years. Both are elements of the same set of decisions made by business owners to make a long-term commitment to better times ahead. They are also not just indicators, but causes of that longer-term economic health.

The Business Roundtable, an organization composed of the CEOs of America's largest companies, reported that their CEO Outlook Index rose to 73.5 in the second quarter of this year. Any reading above 50 indicates growth.

The big news this week was about something that has yet to happen. On June 23, next Thursday, the United Kingdom will vote in a referendum on whether to leave the European Union. There is a virtually complete consensus by economists and government officials that a departure from the EU will put Great Britain in a recession. It will also abrogate many of the trade agreements the U.K. has not only with the rest of Europe but with the world. In short, it will be an economic shock of relatively substantial size. It will, in fact, be a greater economic event than if Greece had totally defaulted on its Euro debts in 2011.

At least one of the reasons that the stock market is in the doldrums and Government Bonds are soaring beyond any rationality is the fear of a global disruption that might be triggered by the "Brexit," as the media has termed Great Britain's departure from the EU. The other primary sources of investor fear and inaction remain the potential that Donald Trump might become our next President and the possibility of a collapse of the Chinese economy. Those two concerns are linked, as Mr. Trump has repeatedly stated he will impose tariffs and trade penalties on Chinese imports. If the Chinese economy is at all unstable, a trade war with its largest customer would be very likely to produce that very collapse that investors fear. Unfortunately, the Chinese, like the Japanese, consider trade embargos to be an act of war. Given those facts, one can fairly easily understand the angst of business owners and institutional investors.

Gallup reported that American consumer spending, the largest element in the U.S. economy, has recovered to a level nearly as high as it was at its record levels just before the Great Recession. Despite an unemployment rate, and even an underemployment rate as good or better than any we have seen in this century, Americans continue to report to Gallup that they perceive the economy as weak and getting worse.

The prime element in the economic malaise we sense is to be seen and heard in the news media. Every business owner with whom we speak (outside of highway strangled Salado) reports good to excellent business growth and more demand than they can meet. Their limiting factor is almost always the ability to find good employees.

Each day as we open up the many sources of news we have available, the drumbeat of gloom and doom seems to get louder and more insistent. When we turn off the media and talk to the real people involved, the news is very different. Yes, we do tend to talk to business owners here in the local area, and in areas where we travel, but the official numbers from the Commerce Department and the Department of Labor echo the same story we are hearing from business owners. Business is good, the economy is healthy, and things are looking better down the road.

The politicians and the news media are much like the long-term government bond investors. They see short term advantages in doing what they are doing, but in the long run, they are wrong. We will get through this and in a few years we will have the opportunity to look back and see how foolish our fears were.

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