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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index (SPX) closed out the week at 2037.41 Last week it ended the week at 2071.22, so for the week the market, or at least the SPX, was down 1.63%. It is up about 11.4% from where it was in mid-February and down 2.61% from its all-time high last year. Those are the numbers, but if you read the headlines or listen to the pundits, it is clear that the U.S. stock market "plunged." If you have been following this letter for any length of time, you will have read of many weeks in which the SPX rose or fell as much as it did this week, and without anything, in particular, causing it to do so.

At CNBC, the muted reaction of both the U.S. and British markets caused the panic mongers there to publish headlines proclaiming that the Spanish IBEX 35 stock index had fallen a shocking 12.35%, and the Italian FTSE MIB fell a similar amount. Huh? Italy and Spain are by most measures in what we would call a full-fledged depression. If a news organization has to turn to those two countries to find bad news, then the bad news was hard to find. Yes, the British voters have elected to leave the European Union. That is not a good thing for businesses, and particularly for financial companies, but it is not the end of the world.

Government bonds, as you might expect, using the Vanguard Long-Term Government Bond, I Shares, as a proxy, rose 2.36% today but were only up 0.06% for the week. The average bond price rose very slightly to 119.99, still promising a minimum loss of 20% at some point in the future.

The Economy

The U.S. Economy received \$348 billion in direct foreign net investment last year. That does not count securities purchases or Treasury securities purchases. Yes, American companies have been doing a lot of direct investment overseas; things like building factories, buying equipment, and investing in existing physical enterprises, but there was more money flowing in than out.

That fact says a lot about what the rest of the world thinks about our economy, our system of government, and our stability. In this time of political mud-slinging, it seems to be very popular to proclaim what is wrong with our government, our economy, and our very system, but the money says that whatever our warts and pimples, they are far less than anyone else's. That was confirmed further this week as the dollar rose to levels not seen in years. When the world faces uncertainty, it buys dollars.

Now let's get on to the elephant in the room, otherwise known as the "Brexit."

The British have formally chosen by popular vote to leave the European Union. Despite repeated polls indicating that the electorate was almost perfectly divided with a small edge to the "leave" vote, business and financial leaders insisted it could never happen. They were wrong. Frankly, this should not come as a surprise. Great Britain made another clear decision a decade or more ago to not participate in the Euro experiment, and that has worked out well for them. The Euro is a thinly disguised German Deutschmark. The British did not want their currency to be German. It was that simple.

We proclaimed on the Radio and in print that the failure of the European Union to create and adopt a constitution was the death knell of this weird political entity that was not quite a nation and yet somehow more than a free trade zone. Without a written and ratified constitution, one element or another would rise to ascendancy and exert more power than the stronger members would tolerate. A breakup would follow. The EU central administration in Brussels has published what seems to be an endless stream of detailed regulations on just about everything done in Europe. They have done probably the best job of encoding a defining law for all economic and many personal actions since the Byzantine Empire. To state that such a set of rules and regulations is stifling is an understatement.

The key element irritating the British though has been immigration. Once a person enters the European Union and registers anywhere, they are granted the ability to freely travel from state to state much as we do here in the United States. The problem is that getting into a EU country like Greece or Italy or Spain is just a matter of getting there. We have much the same situation with Cuba. U.S. law states that if a Cuban citizen can get a foot on U.S. soil, that person automatically gets a residence permit. For better or worse, the Cuban government is not at all fond of letting its people leave, so mass immigration is unlikely.

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The bigger picture is that there is a huge economic and political difference between Europe's neighbors to the south and east and the European Union. Whenever there is that big a difference, people will leave their homes and move to the better civilization if they are allowed to do so. Throughout history, civilizations have had difficulties dealing with the "barbarians at the gates." The Romans suffered mightily from economic refugees pouring across their borders until they figured out that by employing them, the Empire could profit greatly. They were given a route to full citizenship by, for example, serving 20 years in the Roman army and receiving an honorable discharge. That opportunity was later extended to 20 years gainfully employed, with all taxes paid, plus a substantial fee to become a citizen. Some of you may be familiar with Paul of Tarsus. That is how he became a Roman citizen.

The bottom line here is that we may have just seen the beginning of the end of the European Union. Europe was divided and injured in each generation for over 1,000 years as nation fought nation, often in alliances that shifted from generation to generation. On two occasions, the inter-European war wiped out about 80% of the population of Central Europe. After World War II, the United States strongly suggested to the Central European Nations that they would be better off cooperating than they would be by fighting each other. We then formed the North Atlantic Treaty Organization (NATO) to encode that suggestion into law. The newly cooperating European allies formed a free trade zone, then the European Union, and finally the Eurozone. The problem was that they skipped the constitutional convention and ratification. Without a constitution there can be no EU.

We, here in the United States, had a very similar organization after 1776 and before the ratification of the Constitution in 1787. How were we able to effect the compromises and surrender of national rights previously held by the states? The driving force was that the British fully intended to come back and take possession of their rebellious colonies just as soon as they were done fighting the French. We were faced with an external threat that caused Benjamin Franklin to famously state, "If we do not all hang together, we shall all surely hang separately." When our former British masters came back in 1812 they found, instead of a fractious set of individual states, a United States of America, and were soundly defeated.

It was not finished though. We finally settled the issue once and for all in the War Between the States from 1860-1865. Our Constitution has reigned supreme ever since. It may take Europe that long, or it may not happen. If Europe does not unite, it will cease to be a significant player in the world. The Chinese, the Russians, and the United States of America will vie for leadership. Unfortunately for Russia and China, demographics are working against them. As The Economist forecast in 2002, the 21st century is likely to see America rise to become the single world-dominating entity. That is, of course, unless we turn away from that opportunity and responsibility and sink into isolationism. Historically that has led to a world war, and we may then be forced to engage as we were in 1941.

Barring an external threat to Europe, like, for example, Russia, the EU will most likely fail. It will not be pretty and it may lead to economic shocks in Europe and very possibly war, but we will survive that and just might prosper from it. The European Union is about the same economic size as the United States, at least before Britain leaves. As it falls apart, the U.S. will become more dominant. That may be good or it may be bad, but it is likely to happen. The splintering of the European Union, officially applauded by Donald Trump today, will also very likely lead Russia to extend its borders. That could easily be the starting point of the next European war. Such is history, at least in Europe.

The economic results of the Brexit are yet to be seen, but here in the U.S. we have such a flexible and robust system that we will likely find some way to prosper from it all. It will take time. One item on the uncertainty agenda is on its way to being resolved, the other (The U.S. elections) will continue to depress the markets until it too is resolved. In some ways we have just lost a competitor, in others we have lost an ally and a trading partner. It can go either way, but I have confidence we will adapt and prosper.



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