THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

Jeffrey W McClure CFP® *Jacob A McClure* CIMA®

PO Box 1029 / 918 N. Main Street
Salado, TX 76571

(254) 947-1111
(800) 914-7526

Serving Investors Since 1982

www.tpwc.com

jeff@tpwc.com

jake@tpwc.com

July 1, 2016

TPWC Market and Economic Update

The Markets

Stocks

The S&P 500 Stock Index (SPX) closed at 2101.95 today, up 3.17% for the week. It is now up 14.92% from its low in mid-February and only down 1.16% from its record high last July.

Had you read about the Index's close on June 10, gone on vacation and arrived back today, you could have concluded that nothing had happened. More, had you started your vacation at the beginning of the year and just now returned as the year is half gone, you would note that the SPX is up 2.69%, and apparently headed for an annual return of about 5.5%.

You would have missed the "correction" that took the market down in February as fear gripped both traders and longer-term investors. By the way, does anyone remember what it was that inspired so much fear just a few months ago? How about the fear-generating event that gripped the markets back in October of last year?

If you are like just about everyone else, the thing(s) that were so threatening just a short while ago have vanished from your memory. Why? It is because they were not real. Like dreams, phantom fears generated by rumor and amplified by the news media tend to fade quickly. So, how does one tell the difference? The answer is to look at the evidence. In each of the mini-panics we have experienced recently, the underlying economy both from the perspective of government reports and from our personal observation looked healthy and poised to grow. The Wall Street rumors of this or that, when held up to the strength of the U.S. economy, did not amount to anything big enough to cause a problem, even if they turned out to be true.

Bonds

The yield on the 10-Year U.S. Treasury Note touched a record low of 1.38% early Friday and closed out the week at 1.44%. That yield is only 0.04% above the record low closing rate reported in July 2012. Once again, while our rates are touching record lows, they are still the highest in the developed world.

As we have written before, the ultra low government obligation interest rates we are seeing here in the United States are a result of trillions of dollars fleeing other places and nations and being used to buy dollars and then those dollars are used to buy U.S. Government debt. Those who have the means to do so continue to demonstrate that the world considers the United States of America the most secure place on the globe to store their wealth. The reality is that there is a panic going on in Europe and in much of the rest of the world. Investors are looking for a safe port in what appears to be a growing storm, and the United States offers that port.

Interest rates in Germany, for example, are lower and actually now negative out to and beyond ten years, but those low rates (and high bond prices) are primarily generated by the continued large-scale purchases of Euro-based bonds by the European Central Bank. There is a secondary reason that the German Bunds are behaving as they are, and we will discuss that below.

The other big bond news is that Puerto Rico officially defaulted on about $1 billion in constitutionally guaranteed bonds due today. Congress passed a law last week that heads off a disaster in Puerto Rico, but the default is still a major event. Had Congress not passed a special law, Puerto Rico would have been forced to cease law enforcement, fire department funding, sewage processing, and many of the other things that are vital to the functioning of society.

The counter to the news that the Puerto Rico default on its “full faith and credit” municipal bonds is an important event is the argument that Puerto Rico has been on a well-published route to default for a decade or more. Our response is to note that Illinois, among other states, is on the same path, and investors are still buying their bonds. Bonds in general have significant risk right now, and government bonds of any type may have a much higher risk than many people appreciate.

It appears that the municipal bond insurance companies will be able to cover the default for those investors who have insured Puerto Rican bonds, but it is questionable if those firms could do the same for a larger default, such as the one on the horizon for Illinois. Those who hold uninsured Puerto Rico bonds are likely in for an unpleasant surprise.

The Economy

Purchasing Managers Report

The Institute for Supply Management (ISM) reported its June 2016 Manufacturing ISM® report on business today, and we think the best way to approach that report is to quote it: "PMI® at 53.2%. New Orders, Production and employment Growing…" [The Purchasing Managers Index (PMI) indicates expansion and growth when it is above 50.] "Economic activity in the manufacturing sector expanded in June for the fourth consecutive month, while the overall economy grew for the 85th consecutive month…"

New orders rose from 55.7 last month to 57 in June, and the employment index rose above 50 to 50.4. That is an important move as prior to June, even as manufacturing production and orders rose, new hiring was negative. That the manufacturing sector of our economy has shifted to a positive hiring stance is a strong indicator of what managers see for the future.

Very importantly, manufacturing in and for the oil industry is still contracting. The growth in the PMI indicates that the manufacturing economy in the United States has overcome not only that headwind, but the near-record high level of the dollar against other currencies, which causes our exports to be more expensive for foreigners to buy.

The power behind this news is the American consumer. We have a profoundly healthy economy in which we primarily manufacture for and sell to ourselves. We are not fundamentally dependent on others to buy our goods and services, although it is nice when they do. Globalization has been good to and for us. We conceive of ideas, get the hard, grinding work done overseas, and then bring the parts home to assemble. We then sell the finished goods to our domestic consumers. It is a delightfully productive sweet spot.

Yes there are those here who have seen their jobs disappear, but it they had not gone overseas, they soon would have been automated. In a changing technological world, things change. Those who insist on trying to turn the clock back will suffer and cause pain for those they influence. 51.9% of British voters elected to attempt to return to the past. Odds are they will feel a great deal of pain and risk being passed by and made into an historic footnote as a result.

The only real threat is that we might mess it up by starting trade wars with the countries that do the hard, grinding work. They do raise their standards of living by doing what we do not want to do, but in the end U.S. companies realize the main profit and U.S. consumers realize the low prices and higher standard of living.

The Brexit

David Cameron, the Prime Minister of Britain, was harshly rebuked by the members of the European Union when he suggested that the United Kingdom could negotiate a favorable set of trade arrangement with the EU nations after leaving. Germany and France led the smaller nations in declaring that if Britain wanted to leave the EU, it must announce its departure formally under article 50 of the Lisbon Treaty and two years later all deals would be off. Such a hard departure would likely plunge England into a severe depression.

Quite notably, this week the leader of the "Leave" campaign, upon realizing that the EU was not going to cut a sweetheart deal with Britain, declared that he had changed his mind and would not stand for Prime Minister in the upcoming elections. The Economist Magazine speculated that upon realizing that the United Kingdom would almost certainly be far worse off after leaving the EU, he decided to let someone else take the blame.

It is critical to remember that the United Kingdom composes only 2.4% of the world's GDP. The United Kingdom in recession and decline would have an effect, but the effect will only appear several years in the future and be relatively minor. Yes, there are major elements of the world financial system that are headquartered in Britain and in the event of a departure from the EU, would need to relocate to other countries, but in the end, that might be profitable to the financial centers in the United States.

The larger threat is that if Great Britain actually leaves the European Union, other nations are likely to follow. The EU itself will be weakened by the departure of one of its larger members and that departure might be the tipping point that causes the fall of the Union. The disintegration of the EU would very likely be economically devastating to Europe. Europeans from other nations are selling their local government bonds and buying German bunds against the very real possibility that the European Union's days are numbered.

Those that are buying German bunds are betting that the economic devastation following the collapse of the European Union would not lead to a European war. History suggests otherwise. In the event of a war in which Russia takes advantage of the disunity of Western Europe and takes back terrain that once belonged to Russia or even the Warsaw Pact, U.S. Treasury securities could easily be the single best refuge for European wealth.

There is a growing hope though that Britain will not actually leave. The referendum was not legally binding, and the Scottish Parliament could technically veto the departure. The English Parliament too could veto the referendum. A new election is coming this year to replace the Prime Minister, and the sobering effects of the referendum might cause the voters of the United Kingdom to elect a majority of representatives who have declared against leaving. Only time will tell.

If we here in the United States can avoid repeating the British self-destructive tendency and recognize that breaking trade treaties and starting trade wars commonly leads to real wars, it is yet possible that things will return to an improved form of "normal." Very notably, one of the prime slogans of the "Leave" movement was "Let's make Britain Great again."

There is a deep, long game going on here and things are not and will not be what they appear. Keep watching.

Jeffrey W. McClure CFP®
M.S. Personal Financial Planning

Jacob A. McClure, CIMA®