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TPWC Market and Economic Update

The Markets

Stocks

Another week, another record. The S&P 500 Stock Index (SPX) closed out this week at 2,161.62, up about 1.49% for the week, up 18% from mid February's low, and 1.45% above last year's record high.

It's probably a good idea at this point to remember that we started penning this weekly missive in the midst of a market panic toward the end of last August as the SPX fell from about 2,102 to 1,868, a drop of about 11.3% in just a few days. It is hard to remember now, but that panic was a reaction to rumors that the Chinese economy was about to collapse. After a recovery at the end of the year, both in the SPX and some semblance of sanity, again the market plunged. This time the fear was that somehow a large-scale drop in oil (and gasoline) prices would end civilization as we know it.

Yesterday, China's second quarter GDP was reported with an annualized growth of "only" 6.7%. West Texas Intermediate (the U.S. benchmark) oil closed today at $45.95 per barrel and the oil rig count in the U.S. is once again growing, slowly, but still not shrinking.

There is a lesson here, and more to follow. Buying or selling investments out of fear is, as far as we can tell, a very bad idea. An extension of that wisdom is that buying or selling investments out of any emotion is an equally bad idea. We once thought that the large-scale traders in the major Wall Street firms were focused on rational behavior, but now we are more and more aware that they more closely resemble a frightened herd of cattle than a set of rational individuals.

Bonds

The U.S. Treasuries market continued into what domestically appears to be some form of insanity. From the perspective of overseas investors, that perception is reversed. The ten-year U.S. Treasury Note finished trading this week yielding 1.468%. To put that in perspective, the Note was yielding well over 2% as recently as March of this year. Still, the rate today was better than the 1.38% range where the Note was trading a week or so ago. The Treasury had an auction of 30-year Bonds this week and another record was broken as the yield on the auction dropped to 2.172%. That is quite literally the lowest interest rate the United States government has ever paid for 30-year borrowing, including during the Great Depression of the 1930s. To give this a little perspective, the 30-year Treasury Bond rate was yielding around 4% two and a half years ago as 2014 began.

Low Treasury rates historically mean that investors anticipate that the United States economy will be in a recession or depression for the next three decades. In this case, there is a telling statistic that counters that historical assumption. The "indirect bidding", an indicator of the percentage of foreign entity money bidding for the Treasury issue, in this week's auction was 68.5%. This time last year, the indirect bid rate was around 20%. Over the last year there has been a very clear correlation between the quantity of foreign money bidding for Treasuries and the interest rate. The larger the indirect bid rate, the lower interest rates have fallen. Another number that is quite significant is the difference between the dollar value of the bids tendered and the amount accepted. For the 30-year Bond auction completed on July 13, investors (including the 68.5% foreign bidders) offered to buy with about three times the amount of money the Treasury wanted to borrow. World institutions are begging to loan us money at rates that are likely to be well below the 30-year inflation rate. They, in effect, want to pay us to hold their money for the next 10, 20, and 30 years. That says something very profound about what the rest of the world thinks about our stability.

The world of Treasury bonds has been turned upside down by the overwhelming demand. The German 10-year Bund also just had an auction and the rate was -0.10%. That amazingly low rate is not any reflection on the German economy, but rather a result of the European and German central banks (the equivalents of the U.S. Federal Reserve Bank) buying bonds on the open market in the hope of stimulating the Euro economy. Normally, the higher the interest rate a government must pay to borrow money, the greater the perceived risk of that government either not paying the debt back, or of its running a high inflation rate and effectively devaluing its currency. In this case, the investors perceive that the least risk in the world is to be found in U.S. Treasury securities, and their resulting rush to purchase those debt instruments has driven the effective interest rates down to about half that which we otherwise would see.

It is critical to understand, as we have written before, that abnormally low interest rates mean abnormally high bond prices. Between 1978 and 1982, U.S. Treasury Bonds lost about half their real market value in about three years. We may see that happen again. On the other hand, it is possible that abnormally low interest rates will persist given the instability of the European Union and other destabilizing factors. Commonly, a crisis of some kind is required to break the depressed economic environment that much of the world is experiencing. In the late 1970s and early 1980s, Federal Reserve Chairman Paul Volker generated an artificial crisis and triggered the recession of 1982 to break us out of the stagflation and "national malaise" so aptly described by President Carter. In the case before that, in the Great Depression of the 1930s, it was World War II that broke the back of a stagnant world economic environment. Both crises resulted in a short term market drop followed by record-setting bull markets in stocks.

In short, we may hit a speed bump before taking off. Refreshingly, there is some evidence that we may emerge from this without a major crisis. Only time will tell.

The Economy
U.S. retail sales, which are about 70% of our GDP, rose at a 2.7% rate in June from a year earlier. Sales have rebounded from the low first quarter numbers and hold promise that third quarter corporate earnings may rise substantially. Much of that increase is going to online retailers. Household spending rose at an annualized rate of about 8.73% in June. It appears that households may have paid down their debts to a point that they are willing to start serious spending to replace or purchase items they have been deferring. Again, that bodes well for corporate earnings in the next six months or more.

As we reported last week, net new hires in the U.S. were up 287,000 in June even as the average hourly worker saw their earnings rise 2.6% compared with a year earlier.

For those worried about the growth in U.S. Treasury debt, the official forecast now is predicting the deficit to fall to 1.7% of GDP by 2018 presuming that tax and spending remain in line with the current Congressional budget plan. Very notably, when the growth in Treasury debt is less than the GDP growth, our debt load is actually shrinking. More, the Office of Management and budget is forecasting that federal government spending overall will be 1.9% less in this fiscal year (ending on September 30) than in the previous fiscal year.

The rise in U.S. stock markets we have seen in the past two weeks reflects the rise in consumer spending as well as indicators that the Chinese economy rather than falling into recession is actually growing faster than forecast. There are even glimmers of hope coming from the Eurozone as house prices have begun to rise again. The missing element is business investment. Business owners appear to still be reluctant to make longer term investments in buildings and equipment until the uncertainty of the November elections is behind them. They also seem to be likely to further pull back if Donald Trump wins as they expect that will generate trade wars and a recession.

Until next week, we remain your faithful servants,

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

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