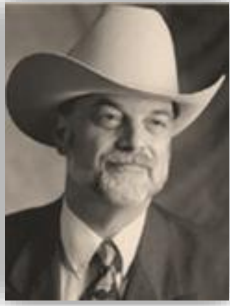

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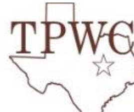

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August 12, 2016

TPWC Market and Economic Update

The Markets

Stocks

The venerable S&P 500 Stock Index (SPX) finished out the week at 2,185.04 a whopping 1.18 points or 0.05% higher than last week. On Thursday another landmark was created as the NASDAQ, Dow Jones Industrial Average, and SPX for the first time in 18 years simultaneously hit new record highs. That sounds quite impressive if you don't consider that the SPX, probably the most representative of the three, is only up 2.50% from where it was just over a year ago. Of course, that is only one perspective. If one measures instead from mid-February when the common consensus of both traders and pundits was that the United States and the world were headed for a recession, then the SPX is up 19.41%.

So far this year, the Dow is up 6.8%, the SPX 6.9% and the NASDAQ composite 4.4% according to the Wall Street Journal. The Journal also reported that a survey of traders found that there is a consensus that the Dow will cross the 20,000 level this year, up from its current level of 18,576.47. "Dow 20,000" was once some kind of insane pipe-dream but it is within reach, and from our perspective seems to be a not-unreasonable forecast. Like the other superlatives surrounding market reporting this year "Dow 20,000" sounds impressive until one considers that the Dow Jones Industrial Average hit the 10,000 just over 17 years ago and a doubling of value in 17 years equates to a compound average annual rate of return of 4.24%, the excitement diminishes a bit. The better news is that over the past 19 years since the Dow crossed the 2,500 level, the real average annual rate of return has averaged about 7.58%.

Note that because many of the Dow and SPX companies pay dividends that result in an average yield for the indexes about or a bit more than inflation over the long-haul, those numbers do not have to be adjusted for historical inflation. They are pretty much what they appear to be.

There is a big lesson here and perhaps several. First, since this time in 1987, just before the famed "Black Monday" market crash that year, the broad U.S. stock market has produced a real (after adjustment for inflation) compound average annual rate of 7.58%. If one looks about for a class of investments that created the greatest return over the long-term that is about as good as it gets. Gold was relatively low in mid-1987 at $447 per ounce and spurted in price as stocks crashed that year. Despite then being a sweet spot to buy gold, the average annual inflation adjusted return of a one-ounce gold bar from then to now was 5.9%. Residential real estate is often cited as the investment with the best return, but using the same inflation adjusted numbers, residential real estate has appreciated at an average rate of 2.33% over the same period. Another observation is that the 7.8% return of the broad U.S. stock market is almost exactly the same as one gets when measuring over a 50 or even 100-year historical time-frame. Yet another glimmer of light is to be found in the historical observation that following a 10-year period of very low returns in stocks they have historically produced an unusually high return over the following 10-years as the market makes up for lost time to get back to that 7% to 8% average annual rate.

The catch is that the amazingly consistent historical average we just quoted historically requires about 20 years to appear, so one must be willing to hold a broadly diversified portfolio of U.S. stocks for two decades to reasonably expect to see that return. That is what we mean when we talk about a long-term investor versus a short-term speculator. The dark side of broad stock investing is that were one were to liquidate when a market panic hits and then go back and buy in when the consensus is for high returns, an investor would actually lose money over that same twenty-years.

What does this mean to you? Well, first it is not a prediction of future returns. Rather it is an observation that there is a class of investment that historically has outperformed other classes over twenty-year periods. Secondly, it also is an observation of the consistency of that return over very long historical periods. We cannot know the future, but we can identify things that over very long periods have been consistent. History suggests that such very long performance characteristics tend to continue. Finally, it supports the economic theory that investments that are based on creating greater value in their products, as do American corporations, will tend to have a higher long-term rate of return when compared with investment classes that do not create additional utility.

As an additional note, we have not included the relatively high transaction costs associated with either gold or residential real estate in these calculations. Given the approximate 12% cost of selling a home in the United States (commissions, fees, and repair/refurbishment costs), the average real annual gain for residential real estate returns to very close to 0%. The buy/sell cost of a one-ounce gold bar too reduces its average return to about 4%. Today's cost of buying and selling a low-cost mutual fund or ETF is often zero, so the real, net number does not materially change. Another factor we have not included is income taxes. Fortunately, selling a primary residence, presuming a gain of $500,000 or less, is not taxed (although if you figure in the annual property taxes, the average return figure becomes negative). Gains on a gold sale are taxed at regular tax rates, and are not indexed for inflation. That element alone would reduce the average gain on gold to about 2% per year. Stocks are taxed at sale, but presuming you have an adjusted gross income for a joint filing of $250,000 or less, would be at 15%, taking the average return down to about 6.5%. Alternatively, if the stock investment was in a qualified retirement plan or IRA, then the full return of 7.58% per year would be intact, and even after average income taxation in retirement, would only drop to about 7.5%.

Yes, it is complicated to compare different investment classes and get average annual historical returns that have the same basis, but if an investor is looking for long term real growth in invested money, we believe it is critical to do so.

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Bonds

The Ten-Year U.S. Treasury note yield fell to 1.51% from last week's 1.59%. The bond market may be "in a bubble" and we believe, quite overpriced, but that can go on for years, and has in this case. The consensus among bond traders, according to the WSJ, is that the Fed will not raise rates until December. I tend to concur. While the U.S. economy is close to full employment, the uncertainty and gloom have put a damper on buying and thereby on inflation. Most American companies, municipalities, and families are still seriously intent on putting more in their bank accounts and those same businesses, municipalities, and consumers are generally avoiding borrowing like it was poison. That is typically irrational as borrowing at rates that are at or below probable future inflation amounts to being paid to borrow money, but borrowers are afraid and just won't commit.

We are confident that the reversal will come, but really do not have a clue as to when. What we can say with quite a lot of confidence, is that longer-term bonds are in for a fall, and that fall could be quite severe.

The Economy

The biggest single news item this week was the announcement that U.S. retail sales declined 0.1% in the month of July. The Commerce Department also confirmed the continuing shift in sales from store fronts to online purchases. Consumer surveys suggest that the single biggest reason for the reluctance to buy, as well as the driver in savings and debt reduction is the uncertainty surrounding the Presidential Election. The increasing chorus of economic warnings that were Mr. Trump to be elected and then be able to enact even part of his promised agenda America would face a recession, and possibly a bad one, is creating fear.

As with many such things, there is a silver lining here. The reluctance of municipalities, businesses, and consumers to spend now is likely to result in a surge of purchases in 2017 if the bad news does not come to pass. That, in essence, sets us up for a boom in the not-to-distant future. We certainly have the ability in this democracy to shoot ourselves in the proverbial foot, but both history and the economic nature of Americans is to avoid self-destruction at the last minute. We will soon see.

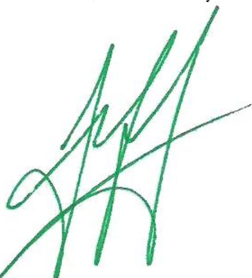
Another data point that appears to be considered negative by the pundits is the productivity levels of American workers. Worker productivity is down 0.4% from a year ago, and that sounds bad when one considers that wages are up 2.6%. More workers doing less for more pay is the classic recipe for inflation to start. The fallacy in that assessment is that during periods of large-scale hiring, as we have seen over the last year, productivity will decline. It is a simple observation that new hires are not as productive as those who have been on the job for years. More, when hiring is surging there is a requirement to raise wages or risk losing those longer-term employees who are highly productive. Nothing new here, but the media pundits have to have something scary to report or readers will turn away.

In other news, the federal budget deficit, or the amount our government spends above that it takes in in taxes and fees, declined 0.3% from a year earlier. The federal deficit, year over year, was about 2.6% of our GDP. Spending rose 1% while revenues rose about 1.3%. The culprits were increases in outlays for Social Security and Medicare. Once again there is a lesson here. If we wish to move toward a balanced budget, we either need to cut Social Security and Medicare payments to our citizens, or increase taxes to cover those payments. Neither of those are popular moves, but they are the stark reality of the federal budget. Perhaps because that reality is becoming apparent to voters and our elected federal representatives, both political parties avoided mention of shrinking the deficit or paying it down in their party platforms for this election. The Republicans initially included the fiscal restraint rhetoric in their official platform, but it was reportedly vetoed by the Trump campaign officials.

Both parties now officially have taken the position that the federal government needs to borrow more money and spend it on infrastructure improvement and previously deferred maintenance. We see that as a good investment, in that the decaying and outmoded infrastructure in America is restricting economic growth. In our opinion though, the increased federal spending on such projects will not be the stimulus that both parties have promised. As long as we have a manual labor shortage as severe as we are seeing today, it will be very hard to implement those infrastructure improvements quickly. More, as about all the available workers are already employed in that field, new hiring will be minimal.

On the other hand, if a large-scale investment in highways, digital communications, harbors, bridges, and the like was enacted along with comprehensive immigration reform that would allow workers to enter the United States to take those outdoor, heavy construction jobs, we could see a real positive economic effect starting at the bottom and working its way up. More full time (and overtime) workers paying more taxes and establishing households in the United States would be a fundamentally effective growth kicker. It could reduce the federal deficit, increase retail sales, and shore up the Social Security and Medicare programs in one fell swoop. Unfortunately, given the intense opposition to those actions in the House of Representatives, that positive scenario is, again in our opinion, unlikely to happen.

Until next week, we remain your faithful servants,



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