THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

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TPWC Market and Economic Update

The Markets

Stocks

Once again, despite breathless anticipation and dire warnings, since last week not much happened. The Standard and Poor's 500 Stock Index (SPX) ended the week at 2,169.04, 0.68% below last week. For reference, a movement that small is less than the average day's price change over the long-term. That it occurred after five days means nothing of any significance to stock valuations happened. Actually, quite a bit did happen, but the market did not react, or at least reacted and then promptly countered the reaction. Today's close was 18.59% higher than the mid-February low but only 1.79% higher than it was in May of 2015. While it is old news now, the SPX ended 0.63% lower at the end of 2015 compared to where it started. Through both 2015 and 2016 the moves up and down in the market indices have been fear-inspiring, but in the end, not much happened that changed valuations enough to make a difference.

Bonds

The ten-year U.S. Treasury interest rose to 1.62% from the 1.43% it returned at the end of July. Higher interest rates are both an indication of expected rate increases from the Federal Reserve and a recognition that as the economy continues to grow, so will loan demand, which will cause interest rates to rise.

The Economy

As we have written before, this flat period in the stock markets, with multiple false alarms followed by impressive looking recoveries which in turn ultimately just erased the downturns is not historically unusual. The most important takeaway in this type of market environment is not that the market has not appreciated, but that it has shrugged off losses and returned to its previous level.

Just a few years ago, the remarks Federal Reserve Chairman Janet Yellen's made today at the Jackson Hole economic summit, in which she suggested that interest rate hikes may be closer than some think, would have tanked the markets. By the end of the day, the Index had initially risen, then fell, and finally whimpered to a close. Federal Reserve Vice Chairman Fischer even warned that we might see two interest rate hikes before the end of the year. Again, the news media credited such talk a few years ago with causing market corrections that approached the down-20% bear market line.

So, why did the market not tank? There are several possible explanations, like the fact that household spending appears to be rising, but the market lives or dies on corporate profits. Since the beginning of the 4th quarter of last year, corporate, after-tax profits are up about 14.27%, according to the Federal Reserve Bank of St. Louis. On the other hand, after-tax profits are still down 8.2% from the same point in 2014.

A little deeper look at the data reveals that the decline in profits was almost all in one area, oil. The profit decline extends across many sectors of the economy, from heavy manufacturing to railroads, and of course, all the oil-related industries. Still, it was the collapse in oil prices that was the root of the corporate profit decline of about 20% from its high in early 2014 to its bottom at the end of 2015. Once again, the amazing thing is that while there were market declines that were scary, today's market values are largely where they were in 2014.

While the loss of oil-related profits was quite real, the rest of the economy has continued to grow. Quite literally everything else has been on a steady growth curve. Even manufacturing continued to grow, other than anything even vaguely related to oil production. So, stock investors see an economy that continues to grow, despite an oil crash that by every account should have plunged our economy into a recession and the market into a bear. Instead, the United States of America is the growth engine of the world. The European Central Bank Chairman is more frightened of an American interest rate increase than of about anything else. Across the world, central banks are cutting interest rates, buying bonds, and taking actions that now have placed about one-third of their government debt instruments in a negative interest position. The Eurozone has an unemployment rate of about 10% while the Mediterranean countries are trying to survive with about 30% unemployment. Here in the United States, our unemployment is 4.9% despite a landslide of new workers entering the job force.

What does this mean to you?

First, the stock market is not overpriced. Rather, it is quite rationally priced. We are bombarded every day with dire warnings that the stock market is in a bubble and about to crash. We must see the ad that says, "The stock market to drop 80% in 2016" several times each day. The reasoning behind such warnings, where there is any, is based on the weak corporate earnings over the last year. The pundits are proclaiming that when profits fall, and the market does not, then a crash is coming. The reality is that markets rise and fall on expected earnings, not those that are in the past. Corporate managers are seeing orders come in and hearing their customers talk about expansion.

Second, as we have written before, businesses want to invest, and they are as they hire new employees, but they are not buying large, capital items that will need to be profitable for the next several years to pay for themselves. Why? Frankly, because of Donald Trump. As we have written before, his stated policies and promises, even if he were only to enact a few of them, amount to a body-blow to American businesses. For many, and even perhaps most, American corporations, the ability to have goods and services flow freely between nations is the difference between profit and loss. Breaking treaties and trade agreements while pulling back from a pledge to participate in the defense of Europe, Japan, and Taiwan is a recipe for a severe recession or even a depression. Several commentators have noted that as his poll numbers decrease the stock market rises.

Third, there is a lot of anecdotal information that business and even consumers are waiting until after the election to commit to large-scale capital spending. That pent-up demand, if it is unleashed, has the potential to kick us back into a more rapidly growing economy and stock prices with it.

Forth, and perhaps most practical, is the reality that for the last couple of years your total portfolio return has been minimal. That means that if you are drawing from your portfolio for income, keeping that withdrawal rate within reasonable levels is critical. We have faith that appreciation, interest, and dividends will eventually return to historic norms, but as we wait, we must be cautious to not draw on future gains today.

We are making no promises here but after nearly four decades of observing and striving to understand both the markets and the economy, we are optimistic.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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