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

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TPWC Market and Economic Update

The Markets

Stocks

Although you wouldn't know it from the headlines, the Standard & Poor's 500 Stock Index (S&P 500 or SPX) rose 0.53% this week. As the year-to-date chart below shows, the SPX is up about 17% from its low in February, and is well ahead of where it started the year. The not-so-good news is that the same SPX is only up 0.39% from where was in May of 2015. Interest rates appear to be rising, reducing the value of bonds, and the stock market is, in essence, flat over the past 15 months.

There is a glimmer of good news for those who have a well-diversified portfolio though. The MSCI Emerging Markets (price return in U.S. dollars) index is up 10% for one year and about 12% year-to-date. Here is the oddity about those numbers; despite the fact that long-term treasuries made what may be their last bull-market run over the last year or so, the MSCI-EM index turned in almost exactly the same return. The Morningstar Real Estate (stock) Index, an area where investors have shown great caution, is up 17.71% for one year and 8.74% year-to-date.

Back in the late 1990s, John Bogle, the guru of the index-fund surge that dominates much of the mutual fund universe today, stated repeatedly that all a long-term investor really needed was a low-cost S&P 500 Index Fund. Since then, largely as a result of the organization he started, fund expenses have come down, but what we have seen in the last year suggests that his advice may have been a bit extreme. Over the really long-haul, the broad stock market is a good investment, but if you want a portfolio that has not experienced the decline in value soon after he made those claims and then stayed down for over a decade, diversification in a well allocated portfolio is, we think, a better way.

It remains critical to have a mix of asset classes in one's portfolio and to have that portfolio well-diversified into a reasonably large number of funds.

There is another interesting (at least to us) pattern showing in the chart above. The pronounced absence of volatility in the stock market from about the second week in July though the end of August is a very rare thing. The S&P 500 went 43 trading days without a single day's move exceeding 1%. That last time that happened was in 1963, when John Kennedy was President. What followed was a market that went five months without a single day it did *not* move less than 1%. In other words, if we presume that history is a guide here, we may see some relatively high volatility in the markets over the next several months.

The good news is that there is at least a long-term relationship between "variance" and return. In a low variance market like the one we have seen recently, Modern Portfolio Theory suggests that we are not likely to see any great gains, and we haven't. That same theory holds that in order to see significant gains we must also see significant variance, or volatility. A caveat is due here. It is quite possible to have variance without evidence of gains, but it is rare to non-existent for there to be significant gains without variance.

Bonds

The annual yield on the ten-year Treasury note hit bottom at 1.385% in early July, but is now up to 1.71%. Amazingly the German ten-year note has managed to rise above its previously negative rates to a whopping 0.04%. Those small numbers may sound like insignificant moves for those of us who well remember double-digit CDs, but starting from its low, relative interest rates for the benchmark T-note have risen about 23.5% in about a month and a half. As we mentioned earlier, July may have been the interest rate bottom in a trend that goes back to about 1980. Falling interest rates cause the value of existing bonds to rise and the opposite is true as well. Many bond investors today were not aware of the bond market in the years leading up to 1980 when rising interest rates crushed insurance companies, drove banks to their knees (remember the Savings and Loan Crisis?) Rising interest rates created a very different world in "safe" investments than we have seen since.

For the past 36 years, making a good total return on a high quality bond simply meant waiting long enough. Yes, there were a few bobs in the interest rate environment, such as in 1994, but it was just a matter of time until one could sell a bond for more than one paid for it. If, as it appears, we have made the turn from 36 years of falling interest rates to an environment in which interest rates will rise over the next decade or more, a lot of pain is going to ensue.

There have been signs that institutional investors have already started an exodus from longer term bonds, and the very real possibility exists that at some point there will be a stampede for the exits. The bond "market" is ill suited for that. As we have written before, there is no equivalent of the New York Stock Exchange in the bond markets. Instead, hundreds of financial firms each "make a market" for a few of the many thousands of individual bond issues. One of the things that characterized the meltdown of 2008 was that suddenly market makers for mortgage bond issues stopped doing so. That type of thing is unlikely to happen again, but when there are a lot of people and institutions that suddenly decide to sell their bond holdings, there may not be any buyers at a price close to what the seller hopes to get for the bond. In the mid to late 1970s, as inflation heated up and interest rates rose at a rate few, if any, were prepared to see, the price of longer-term U.S. Treasury bonds declined as much as a net (after inflation) 50% in about 18 months.

Historically, longer-term Treasuries have an average yield of about 6%, today they are at 2.44%, up from 2.11% in early July. If the 30-year rate rose to its historical norm, the hit to the value of Treasuries in the open market would be profound. To give you some idea of what that means, a standard Treasury bond is valued at issue at $1,000. If you had bought a bond from the Federal Reserve (yes you can buy bonds directly from the Fed) in early July of this year, the United States of America will pay you $21.11 per year because you are the owner of that bond. That payment is guaranteed for thirty years, at which point you will receive you $1,000 back from the Treasury. If interest rates returned to their "mean" as such things tend to do, a bond bought at that 6% interest rate would produce $60 per year. How much would you pay for, as an example, a bond that will guarantee $21.11 per year when you can purchase one that pays $60 per year? If you are like most people, you would probably be willing to pay about $350. Why? Because purchasing a bond paying $21.11 for $350 creates an interest rate yield of about 6%.

That is all well and good for the buyer, but for the person who purchased the 2.11% bond, it equates to a 65% loss. If it were just Treasuries, that would be perhaps not such a big thing, but U.S. corporations have been issuing (selling) bonds to investors at something approaching record rates, not because they need money to invest in new equipment, but because the treasurers of those companies expect inflation over the next three decades or so to be higher than the interest the "market" demands they pay to borrow (e.g. sell bonds) today.

We may somehow muddle through this, but there is not much sign that insurance companies or other institutions are hedging their bets, not to mention that individual investors are gobbling up bonds like there is no tomorrow. Perhaps interest rates will never rise, as the behavior of many bond investors suggests they believe, but one of the most powerful forces in this universe is something called "reversion to the mean." If interest rates revert to the mean, it will likely produce interesting (pun intended!) times.

The Economy

From our perspective at least, the biggest news this week was the report by the Census Bureau that median household income, the income at which half of Americans earn more and half less, rose 5.2% in 2015. Yes, that could be considered "old news" except that this is the first definitive report on 2015 incomes. In case you are wondering where you are on the scale, the median American household earned $56,515 before taxes, deductions, etc.

Note that there is a great deal of difference between the median income and "wages" as reported monthly by the Bureau of Labor Statistics. "Income" includes *everything* while "wages" is literally a report on those who earn their income by the hour at a job. We Americans are an enterprising lot, and we find lots of ways to generate income. The median income includes things like Social Security, investment income, and rents, to name a few. It also includes self-employment income, which in these United States is a bigger element that just about anywhere else.

That 5.2% increase is very likely to have been the beginning of a trend that is still going on. Note, however that the real median income, after adjusting for inflation, is still 1.6% below where it was in 2007, and 2.4% below where it was in 1999 when it hit an all-time record. That reduced median household income is perhaps why many of us have a sense that we have not yet recovered from either the recession and stock market plunge of 2000-2002 or the "Great Recession" of 2008-2009. Economists and bureaucrats proclaim a recession to be at an end when the economy, and usually the stock market hits bottom and starts back up. For us real people not on an academic or government payroll, a recession is over when things are a good as they were before they started downhill!

Our reasoning in believing that the increase in income is still going on is that about 2.4 million more Americans were working at the end of 2015 than there were at the beginning. Since then we have increased employment at a brisk rate, and it appears that 2016 will likely be a better year for employment gains than was 2015. Current estimates from Census suggest that consumer spending has risen about 3% over the last year, and now we can see a bit of where that came from. It also means that about 40% of that income rise is going toward debt reduction, savings and investment; all good signs.

As another indicator of what is going on in the real world, the Producer Price Index for Final Demand, a generally reliable indicator of the potential for inflation, was unchanged in August according to the Bureau of Labor Statistics. More, the Final Demand Price Index is literally unchanged for the trailing twelve months. Services rose a bit and products fell a bit, but they all equaled out in the end. What that indicates is that inflation in the United States over the last year has probably really been effectively zero.

What is significant about that? Well, to us, it is a validation that the talking heads on cable networks who prophesied runaway inflation a few years ago were about as wrong as wrong can be. We, collectively, tend to not have long memories for such things, but it is a good idea to think back to where you saw or heard those warnings and recognize that the prophets of doom from those same sources are likely as wrong today as they were seven years ago.
Until next week, we remain your faithful servants,

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

Jacob A. McClure, CIMA®