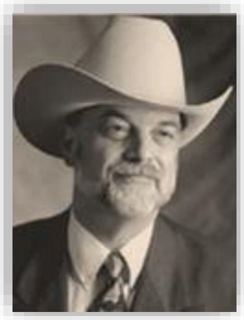

THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

Stocks

The S&P 500 Stock Index (S&P 500 or SPX) rose an impressive 25.53 points, or 1.9% this week, closing today at 2,164.69. That makes it about 18.35% higher than it was in mid-February but only 1.59% above where it was in May of 2015. The gains this week were concentrated toward the end of the day on the 21st as it became clear that the Federal Reserve Board not only did not raise rates at this meeting, but were unlikely to do so at their next meeting in November.

The starting point is critical. If we look at the SPX one-year return, it is a very respectable 12.08%. The problem with that beautiful number is that we were in a near-correction at this time last year. For those with less than a perfect long-term memory, the great fear a year ago was that the Chinese economy was about to implode. The good side of that is that if we go back five years the return is about the same, although we were at that time too in a correction. That time the correction was because the Federal Reserve had suggested it might reduce the quantity of bonds it was buying on the open market as a stimulus to the economy. In fact, the further we go back to choose a starting point, with a few exceptions, the more consistent is that double-digit long-term return.

We mention that to remind you, faithful reader, that there is just about always something worrying that we fear will cause a disaster, or at least that is what the news media tell us. The only exceptions are times where there really is about to be a shock. If you go back and research the headlines in mid 2007, or in late 1999, all is well and the consensus is that we are, as was said just before the 1929 crash, "on a permanent plateau of prosperity." The only thing we can say with any degree of certainty is that historically the greater the pessimism, gloom, and doom, the better the next several years of stock market returns tend to be.

Bonds

Just as stocks jumped a couple of percentage points immediately following the Federal Reserve announcement of "nothing happening here", so interest rates fell. They certainly did not drop back to where they were in July, in the 1.45% region, but did decline from last week's 1.71% to 1.62%, an interest rate decline for the benchmark 10-Year Treasury note of 11.6%.

Every week we see more articles in professional publications warning that bonds are in a bubble. Those articles would be a contrarian "good news" if weren't for the fact that so much money was still flowing into bonds, driving interest rates down and the values of portfolios up. About a third of all developed nation government bonds, in dollar terms, are now effectively pledging a loss if held to maturity. Rallies in bond values like the one we saw this week are both an indication that there still are plenty of buyers, and an assurance that the day of reckoning is coming, but there is no telling when. Bubbles are that way.

Mortgage bonds were in some sort of alternate reality for years before they suddenly collapsed. On the radio show we joked about "NINJA" mortgages (No Income, No Job, No Assets) that were pouring out of California mortgage brokers' offices, passing through intermediaries like Countrywide, and then being made into AAA rated bonds at the big Wall Street investment banking houses. Every serious professional observer agreed that this was a form of insanity and that a day of reckoning was going to come. Still many of them were unable to avoid being enticed by the gains in those bonds as more and more money poured in to "secure" the relatively high interest rates and safety traditionally associated with mortgage bonds.

A very similar insanity prevailed among the buyers of large-cap growth stocks in the last five years of the 20th century. Alan Greenspan famously suggested that some form of "irrational exuberance" was causing buyers to drive that set of stocks to levels that were insupportable in the long-term. In that case the bubble sustained itself and even grew dramatically for five and a half years before that day came.

History tells us that bond buyers have lost their way. Bonds are loans to governments or corporations in return for a stream of interest income and a repayment of the loan. When investors are purchasing bonds that are either actually or effectively nearly certain to lose money, something fundamental is out of place. When the wakeup call comes, it is very likely there will be a lot of fear, and even a panic in the stock market. Companies will fail and a lot of money is likely to be lost. No one can predict when that will happen, but prepare yourself. Panics are as irrational as the bubbles that precede them. Historically and fundamentally the only methodology that is rational is to have a well-diversified, rational, high quality investment portfolio and some patience. After the shakeout those who historically have held their ground have been well rewarded. Those that either have tried to time the event by selling out and planning to get back in, or simply bailed out, have paid a high price.

The Economy

As we mentioned above, the big economic news this week was that nothing happened. There is something perverse about the stock market rising two percent in a day because of an announcement that a committee decided to do nothing. As Benjamin Graham wrote, "In the short term the market is a voting machine, but in the long-term it is a weighing machine." People often vote in mass for something they later regret, but weights are not subject to a vote. Short-term investors are making bets in a casino while long-term investors are buying or holding investment priced at a fraction of their intrinsic value and are willing wait for that value to be recognized.

The press release from the Federal Reserve Board meetings is rarely quoted, as it is rather long and without much in the way of "sound bites." Still, it contains arguably the most accurate and succinct statement about the current and likely future economic conditions in the United States and to a lesser extent, the world. Here is the leading summary:

> *"Information received since the Federal Open Market Committee met in July indicates that the labor market has continued to strengthen and growth of economic activity has picked up from the modest pace seen in the first half of this year. Although the unemployment rate is little changed in recent months, job gains have been solid, on average. Household spending has been growing strongly but business fixed investment has remained soft."*

We do love it when perhaps the largest economic research staff on the planet comes out with a press release that so well reflects what we have been writing for months!

The Federal Debt

We recognize that there has been a lot of rhetoric and worry about the size of the federal debt. A bit of perspective is in order here. Perhaps the most quoted figure is the "total anticipated" debt owed by the federal government. Note that this figure includes all future military and civil service pension, Social Security, Medicare, and medical care for federal and military retirees. That large figure now equates to about 105% of our total annual national income (GDP). If we limit that figure to the actual borrowing the federal government has done and is constitutionally required to pay back over the next 30 years, it drops to about 76% of GDP. In other words, the total Social Security, Medicare, military and civil service pensions and medical costs equate to about 24% of GDP.

Now for the perspective: According to the September 22 issue of *The Economist* magazine, just the public sector pension obligations of nine countries in Europe: Austria, Britain, Denmark, France, Germany, Italy, Poland, Portugal, and Spain, *each* exceed *300% of their respective GDPs!"* That is not to say that we do not need to look long and hard at what we need to do to ensure that we can meet our obligations to those who depend on a federal pension. Still, the degree to which we have shown and are showing fiscal responsibility when contrasted with other developed nations is impressive. As we wrote earlier, even the much admired Chinese economy, despite not having Social Security, Medicare, or any other governmental old-age pensions, has a real debt-to-GDP ratio that exceeds ours.

A major difference between our system and theirs is that the European countries as well as Japan and China keep much of their public debt "off the books" and do not report it as a part of their federal government debt. It may be that ours is lower because we do report it and don't hide it in the footnotes.

Retirement Fund Portfolio Returns

Each investment portfolio we manage has a different return, if for no other reason, simply because each person and family has different goals and objectives. As you review your return an element of perspective might be useful here as well. The *California Public Employees' Retirement System* (CalPERS), the largest U.S. public pension fund, earned a total return of 0.6% for its last fiscal year, ending in June 2016. It lost 3.4% in the first six months of this year. Its ten-year average annual rate of return is now 5.1%. Last year the CalPERS earned 2.4%. Note that reported earnings do not take into account either payments to its beneficiaries or from the state. For the last year it reported on such things, 2014, CalPERS had sufficient assets to cover 76% of its future obligations, but that estimate assumed a future return of 7.6% per year.

North Carolina reported a similar gain, in this case 0.8%, for its pension fund. Quite significantly to us as we reviewed reported pension fund returns from across the nation, these multi-billion dollar funds disclosed that in many cases the only gains were in illiquid, alternate investments, like forest land. As you may surmise, there is no "forest exchange" market to put a real price on those "direct investments" as they are called in the reports. Historically, the estimates of value by pension funds has greatly exceeded the real sale price. A significant issue is that selling a few million acres of forest land tends to depress the price of that very land!

Why are we mentioning this? There is a natural tendency for those whose economic futures are dependent more on a transparent investment portfolio to have a degree of envy when considering the person who has a "guaranteed income" from some state pension or annuity company. The reality is that those "guaranteed" incomes may be, if anything, less secure than a well-managed, well-diversified personal investment portfolio.

Until next week, we remain your faithful servants,

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

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