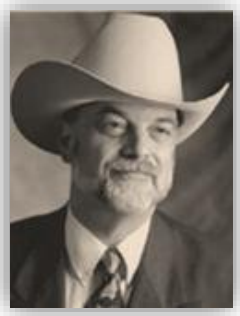

THE PERSONAL WEALTH COACH®

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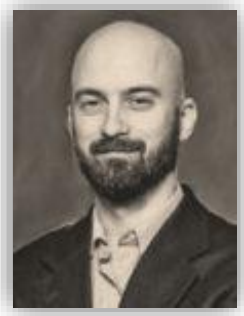

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September 30, 2016

TPWC Market and Economic Update

The Markets

Stocks

The S&P 500 Stock Index closed the week at 2,168.27, up a whopping 0.17% for the week! To maintain consistency with our previous missives, it is up 18.54% from mid-February's lows, but only up 1.76% from 2015's high.

To provide yet another perspective, it is up 3.11% for the trailing three months, 6.08% year-to-date, and 11.12% for twelve months. Fair warning here though: A year ago we were in the "China meltdown" correction, so in the next months the one-year numbers will probably show a far lower one-year gain, barring a runaway bull market this year. The reality, of course, is that for the last two years the stock market has been running up and down as much as 20% at a time, only to return to a very narrow range just above 2,100.

After three and a half decades in this business, we still find it amusing how different the shorter term market returns look depending on where one starts the time for measurement. The good news is that for longer periods of time, measured in decades, the return is amazingly consistent when viewed in inflation adjusted "real" terms. The odd thing is that the events we see with great fear in the short-term appear to make very little difference in the long-run. Most of them don't come to pass, but even those that do, like the banking collapse of 2007-2009, actually have little or no long term effect on the longer term returns of the stock market. Here in the United States of America, we have an extremely robust economic system that seems to thrive despite our best efforts and greatest fears.

Bonds

The benchmark 10-year Treasury note annual interest rate *dropped* about 2.6 tenths of one percent this week, closing at 1.595%. Once again we are seeing a serious distortion in the Treasury bond market. As we report below, the second quarter GDP growth was revised upward and estimates for third quarter growth (July-September) are around 3% (annualized). That, in combination with the various inflation measures gradually rising strongly suggests that the Federal Reserve will increase short term interest rates sometime this year. As rising rates cause bonds to decline in market value, economic good news has traditionally resulted in Treasury market rates *rising*, but this week they *fell*. Falling rates are the result of increased bond buying.

In short what we are seeing is increased bond purchases in the face of a high potential for increasing rates. Once again, the buyers are mostly sophisticated and institutional investors, many of them foreign, who are looking for a safe, guaranteed place to invest their money. To paraphrase Will Rodgers, "People nowadays are more concerned about the return *of* their money than they are about the return *on* their money." Fortunately for those living in the United States, the return *of* our money is considered by the more sophisticated investors in the world to be a near certainty. That cannot be said of Euro-denominated, or, for that manner, almost any other currency. The one exception to the general uncertainty about the future of a currency is interestingly enough, Switzerland. It is a mark of the way the rest of the world views our financial stability that the United States and Switzerland are generally considered to be approximately equal in financial stability.

Among other factors, Italy is due to hold a referendum in October which has the potential to bring down the government. The replacement Italian Government in the case of a "no" vote to constitutional reform would likely be the *Five Star Party*, whose stated intent is to take Italy out of the EU. As the European Union becomes more unstable, more European money is looking for a safe home. Note here that a negative interest rate purchase of dollar denominated bonds by a European purchaser would probably be very profitable to the bond buyer if the dollar were to rise and the euro fall. If the European Union fell apart that is exactly what is likely to happen. Foreign purchasers are willing to accept negative interest rates as a price they must pay to for insurance against a collapse of their local currency.

Meanwhile, the bond bubble continues to inflate. Another driver appears to be pension funds and annuity companies which depend on bond coupon yield to meet their future obligations. When pension and annuity projections were made by those entities a decade or more ago, the yield of bonds ranging from five to ten years was about the same as a 30-year bond today. In order to stick to their stated stock/bond mix, created to avoid as much market risk as possible, the underlying investment portfolios have had to "reach" for longer and longer termed bonds. Their assumption is that employees and annuity holders will not demand a liquidation for decades, so the investment portfolios supporting pensions and tax-deferred annuities can ignore the shorter-term market risk and just hold the long-term bonds to maturity. That sounds logical enough except for the assumption that there will not be much demand for early liquidation.

Workers may depart in unexpected numbers for other companies, and be entitled to take their portion of the pension fund either as a taxable distribution (with tax-penalties) or to simply transfer to their new employer or an IRA. Deferred annuity holders could elect to liquidate despite a surrender charge penalty that typically goes for as much as 15 years. In both instances, there is disturbing assumption that because so few pension or annuity holders have demanded early liquidation in the past, that low demand can be projected into the future. The issue is that in the past interest rates generally fell with time so that a person purchasing a tax-deferred annuity with a stated interest rate guarantee would effectively lock in a rate that become better looking as time went by.

We have seen a significant number of those instruments with a 4% guarantee. In the 1990s when those instruments were issued, rates as low as 4% were unthinkable. Now we see a 4% guaranteed rate as astonishingly high. The issuing company sees it that way too, and can be hard pressed to create a conservative portfolio of investments to both meet the guarantee and be profitable to the insurance company. A result can be seen in the number of insurance companies that have been purchased or absorbed into larger companies with deeper pockets. The purchasing company often pays a very low price for the troubled company it is buying because of those interest rate issues. Even the purchasing companies do not seem to us to be discounting the effect of a significant rise in interest rates. This could get interesting.

The Economy

As we wrote above, the Commerce Department released a revised estimate of the U.S. second quarter GDP this morning. Its earlier estimate was that the U.S. economy grew at an annualized rate of 1.1% in the second quarter, but today that estimate was revised upward to 1.4%. A critical element in today's release was a revision in business investment. Earlier the Commerce Department had estimated business investment in the United States declined at an annualized rate of 0.9% in the second quarter, but this new estimate was modified to a *positive* 1% growth. With real final sales of domestic products up to 2.6% annualized growth, the one weak point in the picture was business investment, and now that appears to be positive and improving.

Just as importantly, there is a consensus among economists and forecasting firms that when the third quarter GDP numbers are released, domestic growth will come in at about 3%, again annualized. With today's revised estimate, the Federal Reserve raised its best guess for 2016 GDP growth to 1.8%. That does not sound like a huge increase, but considering that in the first quarter of this year, when we suffered through a decline in GDP as the oil boom turned into a bust, the 2016 outlook was essentially zero, 1.8% is huge!

For reference, this recovery from the "great recession" of 2008-2009 is the weakest we have seen since 1949. That one was just as troublesome and perhaps driven by many of the same factors. Europe was devastated following WWII as was Japan. China was in the midst of a civil war after being shattered during the war. The United States was left as the one healthy economy in the world and was essentially dragging the world into a recovery. We can certainly hope that history will repeat itself as the 1950s and '60s were tagged in economic history books as "The Post-War Boom."

The low interest rates we mention above have contributed to a new record. So far in 2016, corporations around the world have issued $5 *trillion* ($5 thousand billion) worth of new bonds. That is an historical record debt issuance. The logic is clear and hard to oppose. If a highly rated corporation can issue bonds at a rate lower than future inflation, it effectively gets paid to borrow money. Several companies have recently issued debt at negative interest rates, resulting in an actual situation where buyers are willing to pay the borrowing company to take their money. The complication is that the bond-issuing companies are tempted to do something with all that new money. What they are doing in at least some cases is buying other companies that are losing money. An example can be seen in the purchase of Yahoo, a corporation that has been hemorrhaging money for years, by Verizon. Just how a phone company is going to make a dying internet company into a producing asset is still a mystery. As we mentioned above, large financial companies absorbing money-losing insurance companies is another case where the presence of too much cash in the coffers of the purchasing company may lead it to make questionable investments.

The take-away from all of this is that if major, highly rated, successful corporations believe they will make a great deal of money by selling bonds, it follows that the assumption they have is that the domestic purchasers of the bonds will lose a great deal of money. The domestic bond-buyers are betting that they will make money on the deal. Why? Because, there is a wide-spread belief that this low to negative interest rate environment will go on for a very long time. When faced with the argument that this is abnormal and assuming it will persist is risky, the buyers respond with something like, "It's different this time." or "This could go on forever." Those two statements, by the way, have historically been the kiss of death to any abnormal market trend. They were heard frequently in the late 1990s referring to the growth rate of large-cap growth stocks and newly minted initial public offerings (IPOs) of tech companies. We have heard the same chant recently about oil, gold, and real estate investment trusts.

It always may be different this time and by some miracle, those asset class imbalances may somehow become normal levels, but history argues otherwise. Whatever is "hot" and producing outsized short term returns in the present tends to be the investment disaster of the future.

Until next week, we remain your faithful servants,

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

Jacob A. McClure, CIMA®