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THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

Stocks put in another "little bit lower" week with the S&P 500 down 0.69% to close at 2.126.41. That leaves it up just barely over 4% year-to-date, but only ahead 2.26% since this time last year. That slight drop also put it in a small loss position when compared with May of 2015, but still up over 16% from mid-February of this year. All that is a very detailed way of saying that the stock market continues to mark time until the uncertainty of this scorched-earth election process finishes.

As the next section reveals, when routine selling of various investments happens, investors appear to be accumulating cash rather than reinvesting. We have seen this before and it is a waiting game now. Historically, this type of fear-driven behavior typically culminates in a relatively sudden rush to invest as the accumulated worst fears fail to materialize. The real surprise is that the slump in corporate earnings during the oil price collapse followed by the avalanche of negativity surrounding the Presidential campaigns has not sparked a market selloff. Sometimes winning is just not losing, and this may be one of those times.

Bonds, at least as represented by the benchmark 10-Year Treasury note, fell as the 10-year interest rate rose to 1.850%. That is still below where it was in 2015, but is closing the gap fairly quickly. To provide a bit of perspective, this summer as bonds hit a low-interest point in July, that low almost perfected matched the low we saw in mid-2012. After the July 2012 low, the ten-year Treasury rose to about 3% in a bit over six months. That doubling in interest rates chopped off a large chunk of the market value of bonds, but those that held on saw their resale value rise back to par after only waiting four years. Once again the pattern is reasserting itself. There are obviously more than a few bond investors who believe that once again, the economy will slide toward recession and provide them with a gain or at least a break-even.

We don't agree. Our reading of what is going on in the U.S. and to a lesser extend the world economy suggests that we are muddling through a slump that is only surprising for its resilience. As we mention above, the big surprise is that we didn't have a recession. It is a bit much to ask, but if you will remember back to as recently as February of this year, there were a lot of pundits who were bad mouthing the U.S. economy and warning that the oil price slump was going to plunge the world (and the U.S.) into a recession. Today's GDP news release from the Commerce department seems to have rather pointedly proven them wrong. If the U.S. and the world are about to finally start a real recovery, and we think they are, then interest rates will rise and the value of the bonds that have been so widely purchased in the last few months will fall accordingly.

We have been warning about this for a long time, but it is rather like our long-standing warning about living in New Orleans below sea level or blissfully enjoying life in Southern and Central California. It is not a matter of "if" something unpleasant is going to happen as much as it is "when."

The Economy

The big news this week, released today by the Commerce Department's Bureau of Economic Analysis (BEA) was that the U.S. economy expanded at a 2.9% annualized rate in the third quarter (July-September) of 2016. That is nearly double the rate of the 1.4% rate of the second quarter, and is the strongest growth we have seen in two years. If we pull out adjustments, the "current dollar" GDP grew at an annualized rate of 4.4%. To say that is good is to make an understatement. At the same time, inflation still appears to be quite mild, with the Personal Consumption Expenditure (PCE) index up an annualized 1.4% during the quarter.

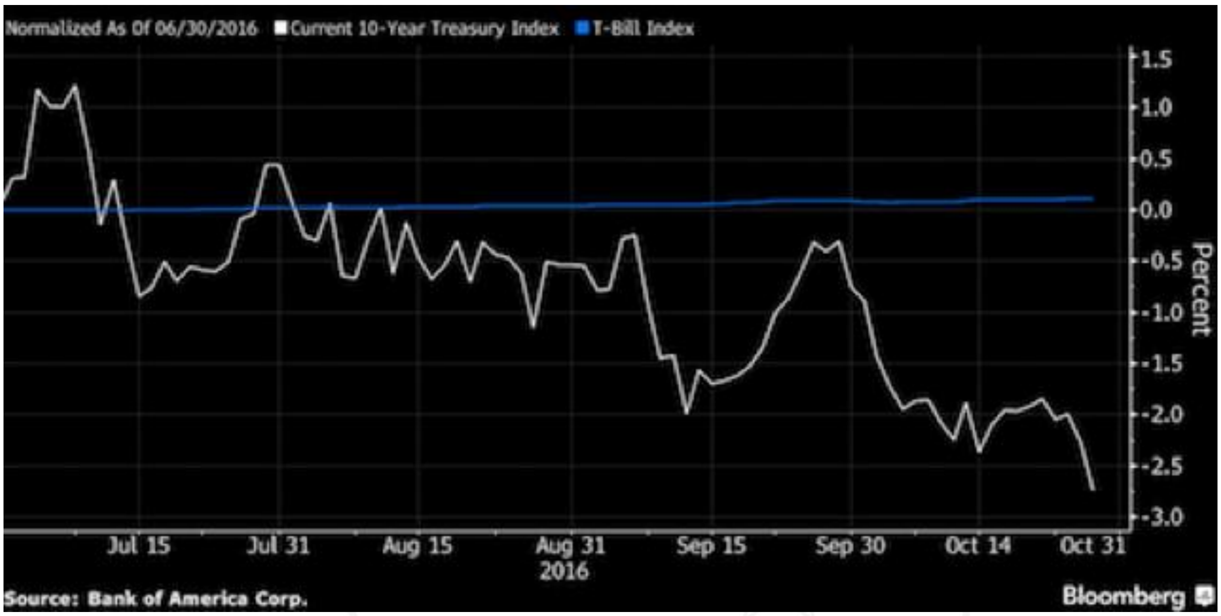
Disposable personal income, which is to say, personal income after subtracting all the expenses we routinely face, rose at a 3.6% annual rate. So, if disposable income is up, why are prices still not rising fast? A lot of the answer is in the savings rate, which has held steady at about 5.7%. Back in the 1990s and again in the mid-2000s, the personal savings rate dropped and even went negative, meaning people were buying goods and services faster than they were earning money. A lot of that excess was from capital gains, first in stocks and later in housing, but excess spending in a rapidly growing economy is commonly a harbinger of bad times ahead. Conversely, a high savings rate, much of which is going into debt reduction, is often indicative of a market bottom or an acceleration in both stocks and the economy in the future.

Unlike past quarters, consumer spending was not the big factor. In the third quarter business came out of their funk and started investing and building up inventories again. This probably at least partly reflects an adjustment to the oil price slump of late 2015 and early 2016.

Perhaps one of the more unexpected data points in the report was that U.S. exports rose at a 10% annualized rate. Given the rise in the dollar against just about every currency in the world, one would expect to see our now higher-priced exports fall. What appears to us to be happening is an issue of quality. "Made in the USA" more and more around the world means "high quality." No small part of that is because we have some of the highest regulatory standards for what we make in the world. Yes, when we make something it costs more than something made in China, but even when the components were made in China, the U.S. firm that assembled the finished product held the Chinese contractors to a higher standard.

Another major issue that was increasingly confirmed in anecdotal reports is that investor cash holdings are the highest they have been since 9/11/2001. Yes, as a percentage of money tagged for investment, U.S. investors actually had a higher percentage of their money in non-invested cash positions than they had at the bottom of the market in 2009! The main cash-hoarders appear to be institutional investors, and, again anecdotally, the main concern appears to be fear of a possible Trump presidency. Second on the fear list was concern that interest rates will rise in the next year and in doing so create a decline in bond prices.

That decline in bond prices may have already started as the graph of constant ten-year Treasury note prices since the beginning of July (below) shows. Rising interest rates produce a decline in bond market value.



Note that the Federal Reserve has still not raised rates beyond where they were in 2015, and there are still plenty of overseas buyers for U.S. Treasury notes. The prices have dropped and interest rates risen because a rising percentage of U.S. institutions are choosing to hold their money in short-term cash positions, which is to say, "dry powder."

What do all of those things mean to you? Just as a high savings rate commonly precedes an acceleration in the economy, so high cash positions commonly signal that the stock market may have a substantial rise in the next year or two. The issue is that there is a lot of cash out there that has not been designated for "savings" or "reserve" but is instead part of allocations tagged as "investments." The more cash there is in that category, the more cash there is to purchase stocks at some point. The reverse of that is true as well. If there is little or no cash in investment portfolios, then increased stock buying is not likely to happen.

In summary, businesses appear to be getting back into building inventory and investing, meaning they are anticipating more business in the future while at the same time the cash available to buy equities, again at some point in the future, is growing. This type of behavior is common historically as we approach the Federal Reserve raising interest rates and is a prime reason that rising Fed rates usually signal a rise in the stock market. Only time will tell, but we are optimistic. The other major factor is, as you are probably far too well-aware, a long period of poor returns in the stock indexes historically has been followed by outsized increases as the market "catches up" with reality.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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