THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

Stocks

The S&P 500 closed out the week at 2,181.90, up 17.49 or 0.81% from last week's close. The *Wall Street Journal,* among others, bemoaned the small rise in the various indices when compared with last week's 3.8% jump. When we see such things it makes us wonder about the writer's sense. A 0.81% weekly rise in market values would add over 50% to an index over a year (52 weeks). We find that rate of rise to be nothing to complain about.

Now for the perspective. Today's close of the SPX, as the S&P 500 is known on the "ticker," was 19.29% higher than in mid-February when civilization as we know it was going to collapse because of low oil prices. Unfortunately, it is only up 2.4% from its high in May of 2015, 19 months ago. That is what it means when you see a disclaimer that goes something like "personal returns may vary." That means a hypothetical investment in that index for one person could mean a nearly 20% return in nine months, but only a 2.4% gain for another person who had been in the market for nearly twenty months! Those returns will tend to converge over a much longer period of time, but it remains a good idea to invest, or stay invested, when markets are down and not rush to get aggressive in a portfolio when everyone is singing the praises of the stock market.

Now that the dust has at least partially settled, it appears that President-elect Trump's win created a rise in the broad stock market of about 2%. Still, the dust has not all settled and we really won't know what the results will be for months and perhaps longer. The financial publications we read remain full of opinion pieces stating that the new administration will either cause the biggest bull market in memory, or on the other hand, produce a severe recession and stock market crash. In fact, the pundits still don't know, and won't until well after it happens.

The smart thing to do at this point is ignore the noise and clamor. A good portfolio before the election is still a good portfolio if it was properly allocated.

Credit Markets (Bonds)

We have changed the name of this section because we mostly write about the benchmark ten-year Treasury Note, which is not technically a bond. We often also write about short term rates, which are found on "bills." A credit obligation security is a "bill" if it matures in two years or less from the date of issue. It is a "note" if it matures between two and ten years out, and a "bond" beyond ten years.

The ten-year U.S. Treasury Note's annualized yield rose from last week's 2.152% to 2.357%. If you consider that the interest yield on that ten-year note was around 1.45% in July, that is an impressive rise in rates. There is a very good reason for the rise in this case. Members of Congress who long have held a "reduce the deficit" position are now loudly talking about substantial increases in spending while at the same time lowering taxes for both corporations and individuals. In an echo from the 1980s, those members also are claiming that lowered taxes and higher spending will so stimulate the economy that more tax dollars will come in and balance the budget. Unfortunately, neither the independent analysts nor the bond market seems to agree with them. Traders selling credit instruments, which drives interest rates up and market values down, say that the consensus they see from the new administration and Congress is one that will lead to higher deficits, and an increase in both interest rates and inflation.

That is not necessarily at all a bad thing. The Federal Reserve has been striving to get inflation up to around 2% and the credit markets seem to be predicting that a 2% inflation rate is right around the corner.

The Economy

It was hard to find the real economic news this week amidst the noise and fury of Trump economic forecasts based on scant data, but it was there. There were, in fact, several things that would have been prominent in the news at a different time.

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Leading Economic Indicators and the Federal Reserve

First, the Conference Board's Index of Leading Economic Indicators rose 0.1% in October. The rise is not impressive, but the fact that it was up and not down even as the stock market slowly declined in October is. More important is what caused the rise, a rise in weekly hours worked and a decrease in unemployment insurance claims. That Index has been an historically accurate predictor of a no-recession time-frame of from six months to a year in the future. It occasionally will sound a false alarm about a coming recession, but as long as it rises consistently there have been no imminent recessions for the past 50 years or so.

The good old Bureau of Labor Statistics released another bit of data this week. The Consumer Price Index (CPI) rose 0.4% from a month earlier and 1.6% from this time last year. Digging a little deeper, if we take out the volatile prices of food and fuel, the CPI was up 2.1% for the one year trailing period. You may remember that the Federal Reserve has targeted a 2% core inflation rate as it has attempted to stimulate the economy. It looks like it got it, and the credit markets are forecasting it is here to stay, and perhaps get higher. That means it is time for the Federal Reserve Board to start raising its short-term rates back to a "normal" range from the abnormally low rates it has been using for the past decade.

We will go out on a limb, albeit a rather large and sturdy one, and forecast that when the Fed meets in December, it will elect to raise rates by about a quarter percent. If they do, then expect to see mortgage rates start up and bank certificate of deposits start to pay a wee bit of interest.

Bond Market Indicators

At some point, presuming the trend and the intents expressed by the members of Congress who plan to drive the show don't change, interest rates will rise to the point that there may be a bond panic. Jeffrey Gundlach, a man with a good choice of first names if nothing else, has forecast that in a few years we will see the ten-year Treasury note yielding 6%. We are no fan of bond managers, but Mr. Gundlach was the only investment guru of whom we are aware who forecast Donald Trump would win the election. More, he made that forecast back in January and has held to it!

A rise to a 6% ten-year Treasury yield might well equate to a market loss of 40% for someone who bought an intermediate-term bond or bond fund this year. If history is any guide, much of that loss will come very suddenly as bond holders hang on to what they consider a "conservative" investment as they watch the market value fall. It seems to be human nature that a lot of people will keep hanging on until some serious selling starts, and then the mass will start a panic bond sale. At that point we may see some headlines.

The combination of a much higher regulatory burden on those who create markets for bonds and the exceptionally low interest rates of the past decade or more has reduced the number of "market makers." Those market makers have also reduced their "float" or reserve positions that allow them to buy credit instruments when they don't have an immediate customer who wishes to buy. That may sound complex, but it amounts to a potential problem. If a lot of people want to sell bonds or other credit instruments and there are fewer bids to purchase than sell requests, the value of those bonds on the open market will fall until someone comes in to buy. In a panic, that can be a long time. The shortage of market makers may exacerbate that issue. As we have noted before, there is no "bond exchange" central market. Instead there is a piecemeal network of individual broker/dealer firms that is hard to monitor.

A stock market panic is what we saw in 1987. Few now remember that event. Fewer still remember the bond panics of the mid 1970s as interest rates started rising rapidly after a period in which the Federal Reserve had intentionally held them down to assist in the recovery from the recession of the early 1970s. Don't be surprised when it comes again. We recently talked with a highly educated investment manager about what he experienced in his financial education. History of Markets was not included. As Jorge Santayana so famously put it, "Those who do not remember history are condemned to repeat it."

We know, by the way, that we have been sounding the alert about a bond market panic for a long time. What we are finally seeing is some well-respected analysts with national reputations for getting things right agree with us. The important thing here is to not be alarmed when it comes. There may well be a temporary stock market plunge as stock traders react to the panic, but history suggests that the stock sell off will be temporary, and likely followed by a sharp rise in stock prices. It is just a matter of supply and demand. As people sell their bonds they will have money that they want to invest elsewhere. Then, as the stock traders realize the world has not come to an end, just as they did when the drop in oil prices did not cause the end of civilization, they will start buying. As they do, the bond market will continue to fall and the stock market to rise. Historically, that has resulted in a rush to buy stocks, running the prices up.

Of course, there is no guarantee that history will repeat itself, but our experience is that, as Mark Twain was reputed to have said, "History doesn't repeat itself, but it rhymes."

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The Dollar is Soaring

In another tidbit of economic news, as of Friday afternoon it took $1.04 to buy one Euro. Just over two years ago, in mid-2014, one Euro was worth about $1.40. World political leaders and the international press may not like Donald Trump as President, but money is fleeing about every currency in the world and coming to the United States. One of the reasons is those higher interest rates. An investor when faced with a choice between a 10-year German Bund at 0.5% per year and a U.S. Treasury Note that promises 2.357% is not having a hard time deciding. Another reason is that the European Central Bank (ECB) released its recent meeting notes this week and there was a lot of concern expressed about the Eurozone sliding into a recession. Both governmental debt levels and unemployment rates there are dramatically higher than here in the United States, so the ECB indicated it will continue buying around 81 billion Euros per month of bonds, and thereby holding interest rates down.

A higher dollar equates to lower values for foreign currencies. That, in turn, means that U.S. exports cost more and become less competitive. It also means that if would like to take a foreign vacation, your dollar will be king! Another economic aspect to a soaring dollar is that our imports, and we have a lot of those, become cheaper. That will tend to hold inflation down. The back side to that though is it is hard to justify bringing jobs home to pay wages in vastly appreciated dollars. It also tends to put domestic manufacturing businesses in a bind as what they produce will cost more than something produced outside the United States.

Privately Funded Infrastructure Program

Last, but not least, the Trump campaign pledge to use private equity to build toll roads and bridges to replace the worn out public infrastructure seems to be gaining some traction in Congress. It also appears to be drawing in fresh overseas investment to U.S companies that may benefit from the program. If that program comes to pass (literally), get ready for a lot of toll roads that get built in about one quarter the time that it takes for a public interstate to finish. The one sticking point is the need for states to seize private property in order to turn it over to a commercial operator in order to build a tollway. That worked here in Texas for highway 130 around Austin, but crashed in the face of determined conservative opposition for the Trans-Texas Corridor.

If indeed that concept is put into law and effect, independent analysts have estimated that it will add about 0.4% per year to the GDP. To get the GDP up to the levels the Trump administration hopes for, a great deal of federal money must also go into daycare and worker training programs. There is a certain amount of irony in that for what appears to be the Republican agenda that is emerging from Congress to work, it will require both the imminent domain seizure of private property and a massive government training program the likes of which we have not seen since the Roosevelt administration.

Only time will tell, but the historical parallels are there.

Until next week, we remain your faithful servants,

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