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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index finished out the week at 2,258.07, down 0.06%. It remains up 3.84% for one month and 12.59% from a year ago. Three years ago it was at 1,809.60. That nearly 25% rise in the Index over three years may sound impressive, but if we convert that simple rise in value into an annual compounded rate of return, it is 7.66%. As average inflation has run at a 0.66% rate over that same period, the Index has appreciated at almost exactly a 7% rate. As we have mentioned before that happens to be very close to the real rate that the average price of stocks have risen over the past century.

The 10-yeaer Treasury yield finished the week at 2.60%. Considering that it was around 1.7% in mid-July of this year, that is a big rise. Reflecting that rise in interest rates, the iShares Core US Aggregate Bond ETF (AGG) peaked at $113.25 on July 11 and has since declined to $107.23, down 5.32% in less than half a year. What continues to be apparent is that July 11, 2016 marks the top and end of a thirty-six year bull market in bonds. If history can be considered a guide, the losses in the bond market that we will see over the next several years may be quite substantial.

We continue to harp on this because there are very, very few bond traders or investors who remember the last bear market in bonds back in the 1970s. When market for a given type of security has almost constantly gone in a single direction for over thirty years, a long-term trend reversal is very likely to cause disruptions. What we saw in 2008-2009 was a reversal in the mortgage bond market that triggered a disruption that was far larger than anyone I know of predicted. There has been a lot of discussion about the effects of rising interest rates, but we think the risk factors are higher than the mainstream commenters recognize. What we are concerned about is not simply that bond values tend to move inversely to interest rates, but that at some point enough owners of interest rate related products will start to move their money to higher return positions that bond prices fall precipitously. If an instance, or instances of delays in liquidation or a sudden drop in those prices occurs because of a shortage of willing buyers, a panic could easily ensue. The panic about which we are concerned would not come from professional bond traders, but from individuals and institutions that assumed that their interest bearing investments were "safe" and "conservative."

We tend to think this is not situation of "if" but rather of "when." The repercussions of such a bond panic are likely to be significant and will extend to areas in the economy where we are not used to seeing disruption. Again, we have written about this on multiple occasions, but our reason for doing so are that you would not join in the panic when it occurs. As panicked money leaves interest bearing positions, the stock market, as it tends to do, will probably join in the panic in the short run, but history tells us it will then recover quickly. From there is where we think that a serious bull market in stocks will start.

We can and probably will write a lot more about this in the future, but that is enough for now.

The Economy

For once, the big economic news this week was something totally expected by anyone who cared about it. The Federal Reserve Board Open Market Committee ("OMC") raised its benchmark interbank lending rate from its previous 0.25% to 0.50%. At least until the next meeting the new rate window will be 0.50% to 0.75%. Again, that raise is more commonly reported as "The Federal Reserve raised rates from the previous 0.25% to 0.50%." We who understand that when the Fed sets rates they are actually a quarter-point spread between two rates often find the press reports confusing. The bottom line though is that the OMC concluded that the economy is healthy and growing. The press release and conference following the decision also revealed that the Committee anticipates a series of quarter point increases next year that would total another 0.75%. That would put the interbank rate at 1.25% by this time next year.

For a wee bit of perspective, just over a year ago the interbank lending rate was at 0% to 0.25%, or as was widely reported, "0%." In December of last year, the Fed raised the rate to 0.25%, and the stock market dropped about 20% by mid-February. That

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drop was at least partially triggered by an oil price decline, but much of the fear was that the Federal Reserve was moving too fast and a recession could be triggered. Instead, despite the increase in interest rates, the economy and average stock prices have risen, unemployment rates have fallen, and the economy has added about 180,000 jobs per month. As those gains have been largely concentrated in the second half of the year and most of that has taken place in the recent months, the pattern suggests the economy is accelerating in its gains.

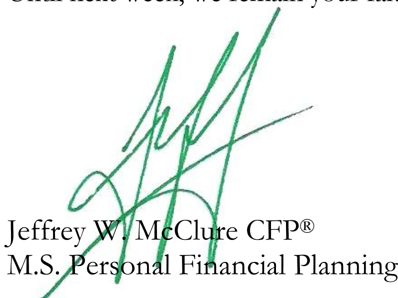
The Fed's rate increase is intended to begin the process of slowing that acceleration and eventually limiting it to a sustainable rate of growth. The potential problem the Fed is seeing down the road is *inflation*. Just a short while ago we in the United States were experiencing mild *deflation* as prices fell and employment was stagnant. According to the Atlanta branch of the Federal Reserve, wage growth has now risen to an annual rate of 3.9%. Rising wages and rising employment produce more money to be spent. When the purchasing money grows faster than the quantity of products to be purchased, those selling thing tend to raise prices. Higher prices without higher quality or quantity is the very definition of inflation. As is normal in and after financial-based recessions and depressions, there was a great deal of fear of inflation in the years of the crisis, followed by years of deflation. Now deflation is the thing we are used to, so we are probably going to see some inflationary price rises. In our opinion, the Fed is moving in a timely manner to address this.

Countering that trend is the strength of the dollar. Today the U.S. dollar hit a 14 year high against a standardized basket of currencies with only $1.04 needed to purchase a Euro, just barely more than the record low for the Euro/high for the dollar of $1.0367 set in early 2015 and a long way from the $1.40 range that seemed to be "normal" as recently as mid-2014. Another benchmark we use in understanding the strength of the dollar is the relationship between our dollar and that of our neighbor, Canada's dollar. Today one U.S. dollar will by about $1.33 Canadian dollars.

It is a good time to take a vacation to Canada (other than the weather), and a good time to visit Europe. There is a backside to that though. U.S. goods and services exported to the rest of the world become more expensive overseas as the dollar rises. At the same time, imports, and we do a lot of importing, become less expensive. This is one of those areas where economists do not have clear answers. Presuming that our exports fall it will have a negative impact on our economy. At the same time, a drop in imported goods prices will tend to minimize inflation. Fortunately for us, exports are a very small part of our total economic calculation in the United States. Many other countries such as Germany and China live or die on their exports. In the United States about 70% of economy is driven by consumers here in the United States buying things. That gives us a lot of economic security and stability that is simply not there for export driven economies.

The dollar is rising because we are offering a higher interest rate than any other developed country. Europe is beginning to show some signs that it will not plunge into recession again, but the crisis there is far from over. It remains questionable whether the European Union will survive without fundamental restructuring. History suggests that fundamental restructuring only comes as a result of crisis. We are just glad to be here rather than there.

Until next week, we remain your faithful servants,



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