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An SEC Registered Investment Adviser

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TPWC Market and Economic Update

The Markets

One of the bigger things happening in the market world is a that a lot of people are turning blue from holding their breath waiting for Dow 20,000. The Dow Jones Industrial Average closed out this week at 19,963.80, up 201.2 points or 1.02% for the week. It was up 64.51 points today and if it does even close to that well on Monday the Champaign corks will be popping! There is nothing financially or economically significant about a round number like that, but the psychological effect will be immense. In the end, stocks are mostly priced on people's mental image of value, which is pure psychology, so those round figures do have meaning. What we were thinking about in this was watching that same Dow Jones Industrial Average rise from 1,000 in mid-1982 to the soaring heights of 2,000 about five years later. Our views are shaped by the fact that the Index has grown in value by a factor of *20* since we have been at this.

Coming back to the mundane reality of market returns, the S&P 500 Stock Index, aka the S&P 500, rose 1.70% this week, closing at 2,276.98, and is nowhere near any round figure. It is, however, at an all-time high. Compared with a year ago it is up 18.9%, which is impressive by any standard. Still it is good to bear in mind that its gain over its high mark in May of 2015 is only about 6.85%, and that over a long 21 month period. It is good to be right, but we do have an advantage in being long-term optimistic about stock returns. One long look at a multi-decade chart of stock market index values and it is pretty obvious that assuming the long-term trend is "up" is likely to be a pretty good bet!

To balance that out, the S&P 500 hit 1,500 in March of 2000 and has taken almost seventeen years to rise from there to today's about 2,277. Based purely on the price return of the Index, that equates to a net return of less than 2% per year! Of course, the Index has a dividend yield that would kick that compounded annual average rate of return to about 4.5% over that same period, but that is still a lot less than what our mental image of "stock returns" wants to acknowledge.

The U.S. 10 year Treasury Note yielded 2.420% at the market close today. That is a bit below its recent high yield on January 3 of about 2.5% but a lot higher than last summer's 1.36%. The Euro remains at about 1.05 to the dollar, moving in a narrow range over the past few weeks. The bond and currency markets appear to be in a holding pattern awaiting how much and to what degree tax and fiscal policy changes will be made by the new Congress and President.

As we will discuss further below, there is a growing consensus in Congress to change the federal corporate income tax system to reduce the maximum corporate tax rate to 20% but effectively impose a 15% corporate income tax on imported items. At the same time the new code as it is reported will forbid corporations from taking a normal tax deduction for the cost they pay for imported goods or materials. If that proposal becomes U.S. tax law, then the probable cause, at least according to no less an economist than Martin Feldstein, is that the dollar will rise in value, as will interest rates, while at the same time the federal government will see a lower deficit. Whatever else happens, a major tax reform is in the works and that will dramatically affect the value of the dollar and of bonds. Stay tuned!

The Economy

Considering that this is the first week of the year, and our observation has been that less gets done on the first and last weeks of the year than at about any other time, there was a lot of economic news to read.

- Preliminary reports suggest that 2016 auto sales will break all previous records.
- A survey of business leaders suggests that internal business investment to improve production capacity is very likely to rise substantially in 2017. The reasons given by the executives surveyed include their perception that the economy is about to hit a growth phase, regulations are likely to be reduced or at least stable, and, strangely enough, interest rates are likely to rise. That last reason may take some explaining.

A big drain on corporate finances since the great recession has been funding requirements for company pension plans. One of the oddities of finance is that the lower the federal mid-term rate goes, the more a company has to put in a defined benefit pension plan each year to meet minimum funding requirements. Funding requirements assume that the mid-term rate is the rate of return that the pension will be able to achieve over the long term. Thus, the lower the ten-year return, the more money it will take to fund future retirement promises. With the ten-year Treasury note, which is effectively the federal mid-term rate, in the 1% to 2% range, it takes twice the annual company contribution than if the rate were in the 4% range, its historical average. As interest rates rise, borrowing costs may go up, but for the larger American corporations, the reduction in cost to maintain their pension funds will be a much bigger number.

- U.S. factory activity accelerated in December finishing 2016 with the highest indexed reading since the end of 2014. That information comes from the Institute for Supply Management's Purchasing Managers Index (PMI). The PMI has consistently been one of the best indicators of what manufacturers have contracted to do over the next year or so. Before a factory can make a product, its supply manager must order the materials or parts from which the end product will be made. Those orders take time to result in a material or part delivery, so the PMI tells us the level of production manufacturing companies are committed to over the next ten to twelve months.

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Over the past several years, the PMI has gradually trended downward. There are more than a few reasons for that happening. They include the fact that between the beginning of manufacturing something and the sale of the manufactured product prices tended to fall. That means that a planned manufacturing cycle can look profitable in the planning stages, but by the time the product is sold to the end user, it could result in a loss instead of a gain. We call that situation a "deflationary" economy. Deflation makes things cheaper over time, but results in business stagnation and losses. That stagnation and loss leads to lay-offs, which makes for even more deflation, etc. Rising interest rates and inflation mean that when a manufacturer starts the planning process there is a reasonable hope that the end product will actually sell for more than the planners anticipated. That is good for profits and gives manufacturers an incentive to invest.

- Macy's department stores, once the flagship of America's retail economy, announced it was closing 68 stores and eliminating 10,000 jobs. Macy's is at the upper end of the economic spectrum for retail sales, but similar news can be found at the lower end. Wal-Mart Stores, Inc. (WMT), the world's biggest retailer, saw a 0.73% decline in sales revenue and its net income fall by 9.3% for the year. Meanwhile, Amazon (AMZN) experienced a 20.25% revenue growth for the year and a net income growth of over 200%. Before you get too excited about that 200% number, five quarters ago AMZN was still losing money as it gained market share. A 200% increase in a very small number doesn't really amount to a lot of dollars, but it is the direction of the trend that is important here.

The key takeaway from those numbers is, in our view, that Macy's decided to not get into the online retail business, Wal-Mart got in late and halfheartedly, and Amazon was the leader in online, digital sales. Our economy continues to change, and the companies and individuals who recognize the direction of that change have a great opportunity. Those who try to ignore changes or turn the clock back are likely to soon face disappointment and failure.

- The Labor Department reported that unemployment in December remained essentially unchanged at 4.7% and that for 2016 average hourly wages grew 2.9%. For 2016, the number of long-term unemployed persons declined by 263, 000. The number of "discouraged workers;" those who have dropped out of the labor force because they have given up on finding work, declined by a third from about 670 thousand to about 426 thousand by the end of the year. In the United States we created and filled 2.2 million new jobs in the year.

Combining this week's employment report with the analysis by the Atlanta fed suggests that in 2016 we had moderate economic growth, but toward the end of the year businesses started raising wages and increasing hours worked, particularly in manufacturing. The data also suggests that we could see an acceleration in economic activity in 2017.

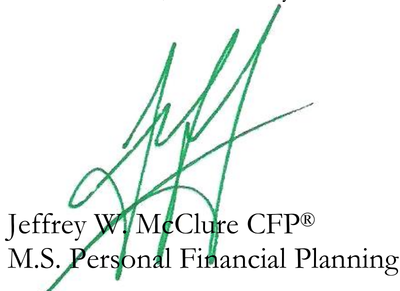
There are a few things that are shaking out as very likely for 2017. The tax proposal that seems to be gaining traction in the House of Representatives to cut corporate income tax rates to 20% but impose an import tax on goods imported for sale in the United States would likely cut earnings in half for companies like Wal-Mart while at the same time resulting in about a 15% increase in prices for most merchandise sold in the large retail stores. Wal-Mart is not only the largest retailer, it is also the largest employer in America. Ironically, the House tax plan's intent is to keep jobs in America, but it might result in some huge layoffs from retail businesses. All in all, such a tax scheme would likely be very good for both government revenue and business. Under that plan, goods and services exported by companies would be tax exempt, but imports would be taxed at around 15%.

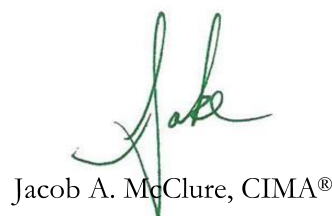
Most other developed countries have a value added tax (VAT) that amounts to about that same 15% levy on goods sold to the public. The idea in the U.S. plan is to cut corporate income tax rates to about the same average level as other developed countries by cutting their income tax level, but at the same time imposing a tax on imported goods. That is a methodology that has never been tried, but certainly looks good on paper. The only negative we (and major economists) see is that we Americans have become accustomed to buying imported retail products like clothing, small manufactured goods, and most of what is on the big-box retail store shelves at pretty much the lowest prices on the planet. The combination of the strong dollar, cheap overseas labor, and low transportation costs typically mean that we can buy something manufactured in China here in the United States for what is effectively a lower price than a person in China would pay for that same product. A 15% increase in retail prices would come as a shock to us and we would probably restrict our purchases, thereby hitting the bottom line of retailers.

The good news is that it would provide an incentive for companies in America to manufacture those goods. Again there is a negative though. We are about out of skilled workers. 4.6% or 4.7% unemployment is very close to full employment historically. That means to make those items either wages have to rese a lot, which makes the final product more expensive, or manufacturers will need to make those products using computers and an automated process. We think the second option is where things will go. This bears watching and only time will tell, but we think robots require lower wages and benefits than do human workers, even if the workers are in China.

As always, there is more, but there is always more news, but neither you nor we have more time, so we will end on this note. Things continue to look good for long-term investors. No one knows what the actual policies, tax, regulatory, and law changes will be, but change, and perhaps big change is likely to be coming. We are optimistic.

Until next week, we remain your faithful servants,





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