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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index as well as the rest of the market continued its slow decline this week as political reality slowly is wearing away the optimism that was generated by political rhetoric. The S&P 500 followed last week's 0.10% decline with a slightly greater 0.15% drop this week. The Dow Jones Industrial Average, which rose more than the S&P 500 following the election, echoed that difference with a 0.29% decline. Year-to-date, the Dow is only up 0.33% while the S&P 500 is still up about 1.45%. The numbers still look good when measured from a year ago with the S&P 500 up over 19%. That one-year number is likely to look better and better as we progress into 2017 because last year at this time, the collective wisdom in the stock market seems to have been that the world was about to come to an end as oil prices fell. The S&P 500 remains up over 24% from mid-February of last year and still has a gain of 6.59% from May of 2015.

Oil remains around $52 per barrel and is remarkably stable, particularly in light of the panic last year about oil prices. The dollar has fallen slightly against the Euro with the Euro now priced at about $1.07. Gold closed out the week at $1,207.07, down about 12% from last July, but up about 9.85% from a year ago.

The benchmark 10-Year Treasury note ended the week yielding 2.469%. The nearly doubling of interest rates since last summer explains the sudden collapse in mortgage activity as refinancing issuance came largely to a halt. The new world of rising rates has started to have a direct effect with the average 30-year fixed refinance rate rising to 4.10%. Believe it or not, the average 1-year, bank-issued certificate of deposit rose to an amazing 1.19% this week! If you are willing to lock in for five years you can get an astounding 1.79% per year. Unfortunately, with inflation running at 2.1% even those rates would create a real loss, but at least it is a secure and insured loss.

The Economy

What follows is a (believe it or not) short summary of what is going on at the macro level in the world and U.S. economy.

Our New President and Congress

All eyes seemed to be on the inauguration of President Trump today and the economic news media was packed with forecasts of what a Trump presidency would entail for the economy and markets. The reality is that no one knows. Our advice is to tune out all the forecasts, whether they be of the doom and gloom or delightful future variety. From the President's speech and recent statements there appear to be two distinct elements, one that would depress the American economy and another that would very likely give it a boost. Cutting regulations and the corporate tax rate both seem to be universally endorsed by economists as having the potential to jump-start an economic expansion. On the other hand, putting tariffs on imported goods and materials would likely start a global trade war and has the potential to create a global recession that would be strongly felt here in the U.S. History indicates that the proclamations of an incoming President normally do not come to pass in the form we (or he) imagined, so wait for the reality and do not pay much attention to the forecasts or promises.

Our Constitutional system is so designed that the President only has limited power to change things. Members of Congress, and more particularly the House of Representatives, are intensely aware of the shorter term effects of new policies. It is, as a result, unlikely that a policy that would put a large number of jobs at risk in the many companies that depend on making things to sell from imported goods will be enacted. Ending regulations is a slow and cumbersome process. Cutting corporate taxes will require either large scale new borrowing, higher taxes somewhere else, or a significant cut in federal spending. The only areas where that cutting could take place on a large enough scale to meet the need is in defense or the Social Security/Medicare arena. There are some hard choices ahead.

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Another quandary that the President and Congress must face is what to do with the approximately 22 million people who now have health insurance under the Affordable Care Act (Obamacare). If, as both the new President and members of Congress have pledged, Obamacare is eliminated, those millions of people will generally be unable to either get or afford health insurance. The President has pledged that no one will lose their coverage. Does that sound familiar? The only viable proposal we are aware of in Congress is a "high risk pool" insurance plan paid for by the federal government. In short, eliminating Obamacare will be expensive, very expensive. Again, Congress is faced with a choice between cutting popular programs, borrowing a lot of money, or raising taxes.

A lot of promises have been made, but, at least to the best of our knowledge, there are no viable plans for how to pay for those promises without breaking other promises. The traditional approach is to borrow a lot of money and hope that somehow future revenue will somehow pay it back. Whether that will fly with a Congress run by a party that as recently as a couple of years ago was willing to shut down the government to reduce the debt is yet to be seen. The fact is that no one has a clue how this will work out. That suggests to us that there will be changes, but they will likely result in policies that no one currently expects. In short, wait and see, but be prepared for some bumps.

Economic News

Our beloved Bureau of Labor Statistics announced on Wednesday that the Consumer Price Index for All Urban Consumers (CPI-U), better known simply as "The CPI," rose 2.1% for the year 2016. That number almost perfectly meets the Federal Reserve's target of 2% annual inflation. The other Fed target, 4.8% unemployment, was already met. That means that we can expect interest rates set by that venerable institution to be increased as the year unfolds. Notably, food, clothing, and vehicles decreased in price, while fuel, housing, and medical care rose. Low-level inflation appears to be returning. So far, so good, but the Federal Reserve Board has a primary objective of holding down inflation while maintaining low unemployment, so expect it to act preemptively to head off future inflation.

There is certainly room to run before we see inflation get serious as the manufacturing sector is only using about 74.8% of its capacity. Historically, inflation starts to rise above desirable rates when manufacturing gets up to around the mid-80% range. Wages and salaries rose about 2.4% last year, quite close to the inflation figure. In a bit of a surprise, during the third quarter, American worker productivity was up at an annualized rate of 3.1% while labor costs (wages, benefits, etc.) only rose 0.7%. Those are all good numbers and are positive for our economic future. As we mentioned above, all that is subject to change and as we roll into 2017, political change is the big unknown.

Some may remember eighteen months ago when the stock market took a swoon in fear of a Chinese economic collapse. The Chinese government released their latest gross domestic product (GDP) numbers this week. As it happens, the Chinese economy turned in a 6.7% growth for 2016. We are used to some skepticism when the Chinese government releases economic figures, but this time the external indicators matched the government numbers. Just as importantly, the price declines that have plagued the Chinese economy for several years appear to have abated as internal demand increased to match and then slightly exceed production. Yes, the Chinese economy was growing at about 9% per year about five years ago and is now down to the mid-sixes, but somehow that relatively centrally-controlled economy appears to have made the transition from hyper-growth, to mere fast-growth without a crash.

There is still the problem of debt to work out as the total debt held by the government and businesses in China makes the total U.S. debt look small. That was the root of the fear in late 2015 that caused the "correction" in the market. The Chinese economy has to grow as fast as it is just to cover the debt payments and still have something left. One of the uncertainties in the world economy is the fear that a trade war between China and the U.S. could easily destabilize the Chinese economy even at it could put the U.S. into a recession. There is speculation among economists that China's military buildup is at least in part intended to give China an alternative route of action if outside forces threaten to cripple its economy. Historically, that makes a great deal of sense. Japan's military expansion prior to WWII was at least in part a reaction to embargos and tariffs imposed by western governments. Again, the economic situation looks good, but political uncertainty abounds.

Meanwhile, the Euro-area 2016 GDP appears to be likely to come quite close to that of the U.S., but with a persistent unemployment rate of nearly 10%. That total number hides the bad news. Greece has an unemployment rate of about 23% and Spain is not far behind with 19.2% of its workers unable to find employment. The German and Austrian economies are the engines that keep the Euro-area looking good, but there is a hitch. We think of China as an export driven economy, but, in reality, the German economy is far more driven by and dependent on exports than is China's. One of, if not the major reasons

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the EU sticks together is that Germany needs the relatively poor southern countries (Portugal, Spain, Italy, France, and Greece) to buy what the Germans make. The Germans sell their overwhelming exports on credit to people and organizations in those countries. The credit is mostly debt issued by banks in those less-well-off countries.

That relationship has it perils. The governments of Greece and Italy, and before that Ireland, have had to come to the rescue of large banks in their respective countries. Those banks had loaned money to individuals and companies largely so that they could buy goods manufactured in Germany. Germany, in turn, is the biggest funder of the European Union's disbursement of euros to various "improvement" projects in those countries. Germany needs the poorer countries to keep its huge manufacturing base profitable and the poorer countries owe so much to Germany that they would face bankruptcy if they stopped borrowing.

The European Central Bank is striving mightily to keep all this in balance by buying up loans issued by those poorer countries' banks. In essence, the ECB is purchasing bank's borrowings so that the banks will not fail while the banks are continuing to loan money that may not get paid back so that the German economic system can continue to keep the Euro-area economy functioning.

If all that sounds wild and crazy, then you understand. Both China and to a larger extent the Euro-zone are pedaling their bicycles as fast as they can to keep from falling over. Both are doing so in the hope that things will get better, and there are indications that that may be the case. Once again, the global fear is that a trade war would upset this relatively delicate balance. The fear is centered on the new U.S. administration, but the United Kingdom's exit from the EU is another unknown.

I know that was a lot to digest, but there you have it, a short and incomplete summary of the world economy as it stands in January 2017. What we omitted was Russia and the emerging economies we used to call the "third world." They too are balanced on the edge. 2017 could be the years that things get a lot better or a lot worse. We wish we could see signs that one or the other is more likely to happen, but as usual, to quote Yogi Berra, "It's tough to make predictions, especially about the future."

Until next week, we remain your faithful servants,

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