THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

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TPWC Market and Economic Update

The Markets

The venerable *Standard and Poor's 500 Stock Index* (SPX) ended this last week and the first quarter of 2017 at 2,362.72, up 0.80% for the week, but more notably, up 5.53% for the quarter. Since the end of the first quarter of last year, the Index is up 13.99%. What we wish is that kind of annual performance was the norm rather than the exception, but alas, our wishes are unlikely to be fulfilled.

Frankly, if that wish was fulfilled over the next few years, then it would be time to be afraid; very afraid! Since 1988, the earnings (profit) of the S&P 500 Index underlying companies have risen at an annual rate of return of about 6.2%. Were the index to rise faster than about 6.2% per year there would be a very limited number of possible underlying reasons. The first, and one we have seen recently, is that the Index was below a reasonable price to begin with and was catching up. The second would be because of a dramatic increase in earnings growth by the underlying companies. The third, and one to be feared, would be that a lot of money was being invested in the S&P 500 and had pushed the Index to unsustainable heights.

Be prepared for the second reason to become a reality in the coming months. Howard Silverblatt, the senior index analyst at S&P Dow Jones Indices, told the Financial Times that he expects the S&P 500 companies to report a 21.7% increase in first quarter profits compared with the 1st quarter of last year. Remember that last year the first quarter saw oil prices plunge and incited a real scare of a pending recession. It would be great to see the increased profits, but don't bet on that kind of rise going forward. It appears that at least some of the rise we have seen in the markets since last year was in anticipation of those increased earnings.

Note that the Index price we see quoted and which we use here is not the total return. In fact, the S&P 500 has a dividend payout that, if reinvested, has historically increased the total return to around 9%. Still, it is the index that we track, not the total return, and it is from the relationship of the Index to its earnings we can tell of it is historically over or underpriced. The (P/E) ratio of the S&P 500 since 1988 has averaged 18.74. S&P estimates the PE ratio for 2017 is 18.08. That leaves the market value slightly below its long-term average. If we look a little further out, to the end of 2018, estimated earnings give us a P/E ratio of 16.01. Since the lower the P/E ratio, the better it is for an investor, that is good and suggests the market has room to grow. If all this works out, then a fair market value would be 17% higher than today at the end of next year. A lot of things can happen between now and then, both pleasant and unpleasant, so as Yogi Berra is reputed to have said, "Making predictions is hard, particularly when they are about the future."

It is on that basis that we are optimistic about the future of well diversified, invested portfolios. If you are interested in what would make us pessimistic, all you need do is consider that the P/E ratio at this date in 1999 was 33.46. That is not the whole story as P/E ratios were only around 17 to 18 just before the financial crisis in 2007. Financial/banking collapses are a different issue, and we will discuss that another time.

The ten-year U.S. Treasury Note closed out the week yielding 2.39%, far above the 1.37% low of last summer, but still well below the 2.57% we saw a few weeks ago. Gold continued to follow bonds and closed at $1,250, little changed from last week.

The Economy

That exciting organization, the Bureau of Labor Statistics (BLS), made the news again this week as it reported a seasonally adjusted 258,000 people made new claims to unemployment insurance last week. The idea that a quarter of a million Americans suddenly found themselves jobless last week sounds like it should be bad news, but in the weird world of macroeconomics it was a sign of economic health. To understand that one must remember that in early 2010, only seven years ago, about twice that number were lining up for new benefits each week. Worse, back then employers were not adding but rather subtracting jobs. Better yet, the total number of people on unemployment is the lowest since the year 2000 and this the longest streak of below 300,000 per week new unemployment claims since 1970.

Our other favorite government organization, the Bureau of Economic Analysis (BEA), reported that February's personal expenditures price index (PCE) rose to 2.1% when compared with last February. While the consumer price index (CPI) is the headline grabbing number for inflation, the Federal Reserve prefers the PCE, and for good reason. One of the biggest elements in the CPI is the rental value of your house. Factually, for most Americans, the rental value of their house is not a very practical issue. The PCE, on the other hand, measures inflation based on what we spend each month.

The Federal Reserve, and other central banks, have long targeted a 2% inflation rate as being the ideal sweet spot for economic growth and stability. For the past seven years, the PCE has gone from near zero to around 1%, where it stuck for a while, and is finally up to the "just right" level the Fed has been seeking. If we extract food and energy, which tend to bound around quite a lot, the PCE was at 1.8%, indicating that we are closing in on the goal.

Hidden in the tables from the BEA was another bit of good news. Year over year, personal income has risen about 3.7%, or about 2% more than the PCE. Consumers at the same time, increased their spending by about 3%, and used the rest to save and pay down debt.

These numbers continue to signal the same thing, a slowly growing but healthy economy.

All that good news suggests that for the immediate future we are on economically solid ground. Some other news tempers that optimism when we look out farther into the future. The Congressional Budget Office (CBO), quite possibly the organization with the best forecasting record and greatest respect in Washington, released its long-term forecast Thursday. In it the CBO assumes that taxation and spending do not change and the GDP continues at about the same growth level we have seen over the past decade. Given those assumptions, our deficit and national debt are likely to grow to unsustainable levels over the next 30 years. Among the reasons reported for the bad news were substantially decreased immigration and a continued low productivity growth.

Things do change and we have the opportunity to make that happen, but we do need to pay attention.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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