jeff@tpwc.com

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Jeffrey W McClure CFP® Jacob A McClure CIMA®

PO Box 1029 / 918 N. Main Street
Salado, TX 76571

(254) 947-1111
(800) 914-7526

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www.tpwc.com

jake@tpwc.com

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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index (SPX) ended the week at 2,439.07, up 0.96% for the week, 8.94% year-to-date, and 16.19% for one year. That puts it up a full 33.3% from the low it hit on February 11 last year, and up about 14.47% from its high back in May of 2015. Once again the major stock indices closed out the week at record highs.

With 97.3% of the companies in the SPX having reported earnings for the first quarter, the trailing price-to-earnings ratio (P/E) is 18.76 and the forward P/E is 16.54. What those numbers mean is that based on the earnings over the last year, (looking backward) the stock market is about 12% overpriced versus its average level of the past three decades, but looking forward at earnings estimates for the next year and a half, it is about 12% undervalued. It is good to remember at this point that over the last year, earnings have risen about 15%, so what corporations were earning as profits last year is not a good indicator of the future. Earnings estimates are generally fairly accurate out to about 18 months into the future. The consensus of analysts' estimates is that the corporate profits of the SPX will grow by about 31% by the end of next year.

The numbers may be arcane, but they strongly suggest that we may see a significant growth in corporate earnings in the next couple of years, and if the stock market remains at the same, mid-range average, we could easily see the SPX rise to between 2,700 and 3,200 by the end of 2018. There are no guarantees, but we must admit the future looks good for U.S. stocks.

Gold closed at $1,281 per troy ounce, up 0.87%, but still down about 6% from last July. The ten-year U.S. Treasury note also rose about the same amount as the yield dropped to 2.162%.

The Economy

<u>Employment and Manufacturing</u>

Today's big news is that per the Labor Department's announcement today, the official unemployment rate dropped to 4.3%. That low number marked the lowest unemployment rate we have seen in the United States since May of 2001, 16 year ago. By any measure, 4.3% unemployment means that just about everyone who wants to work has a job. At the same time the three-month average of new jobs filled in the economy dropped to about 121,000, far lower than it has been over the past several years. Still, because our population growth is not as high as it was in the past, we only need to add about 100,000 jobs per month to fill the influx of workers. Part of that is result of a declining birth rate, but the larger component appears to be that tougher immigration policies may have caused our workforce growth to decline.

As we reported in the recent weeks, we now have more unfilled employment positions than we have people looking for work. We are, then, effectively at what economists call "full employment." Another trend that appears to be asserting itself is that the number of people quitting existing jobs and moving to better paying positions is rising. Companies across the country are reporting that they simply cannot find qualified employees for some of their positions.

Another indicator of the health of the labor market was that the layoff rate has held below 300,000 for a near record 117 consecutive weeks. The last time we saw layoffs this low for this long was in 1970, and given that these are absolute numbers and the labor force was a fraction of what it is today back then, this is effectively a record.

An ongoing conundrum remains in that wages per hour for non-supervisory personnel have only risen about 2.5% over the past year. Historically, when unemployment gets this low, as it was in May, 2001, wages rise at around 4.4%. Part of the reason may be the globalization of labor markets and another may be that employers are simply willing to leave positions unfilled in a time of political uncertainty. The Federal Reserve and other economists are forecasting that wage growth may start rising faster in the near future.

The *Institute for Supply Management* (ISM) reported that its index of national factory activity moved up to 54.9 in May. It was nearly as high in April, but any reading above 50 indicates growth in factory manufacturing in the U.S. Perhaps even better was the reading of 59.5 in the New Orders index, indicating that the growth will likely accelerate in the next few months. The ISM also reported that companies were concerned that their inventories were too low given the demand they were seeing.

The Atlanta branch of the Federal Reserve Bank, issued a forecast that the U.S. GDP would rise to a 4% annualized rate in the second quarter, ending this month. That is a relatively large jump from the first quarter's revised 1.2%.

On the other side of the coin, Ford Motor Company announced plans to cut 10% of its salaried workforce in Asia and North America amid reports that General Motors was also cutting 4,000 from its employment numbers. Both automakers announced that the pent-up demand from the recession years was now waning and the better quality of automobile sold in the last decade is resulting in cars staying on the road far longer than they have historically.

The bright side of auto manufacturing can be seen in Tesla; whose market capitalization now is at or above General Motors. The high-tech company is adding workers, but takes fewer workers and fewer worker hours to make a car than do the major established companies.

<u>Finance</u>

Things do not look so rosy in the financial world. Standard & Poor's Global lowered the rating on Illinois municipal debt to BBB-, one step away from "junk" bond status. The partisan battle between Republicans and Democrats there has resulted in the state going two years without a budget. If the stand-off continues through the end of June and into July, the state may default on some of its debts and be unable to pay its employees or fund its already underfunded pension system. In the many decades that bonds have been rated by general rating agencies like S&P, no state has had their bonds lowered to junk status, so Illinois may break a record.

Large banks were some of the biggest beneficiaries from the rapid rise in the market following the presidential elections, but now they are suffering. From their highs in March, Goldman Sachs is down 16.5%, Wells Fargo is down 14% and Bank of America and JPMorgan are each down about 12%. The rise appears to have been largely based on the prospect of a major revision of the U.S. Tax Code. As the Republican controlled Congress appears to be unable to agree on a healthcare bill, the prospects for a tax revision seem even more unlikely.

The Congressional Budget Office rating of the House healthcare bill makes is extremely unlikely to pass the Senate, and the milder versions being considered by the Senate appear to both not create enough cost cutting to enable it to pass the house. Tax reform appears to be dependent on either a significant tax increase somewhere in the system or very significant cuts in domestic spending. Neither option appears to have enough support among Republicans to cause them to unite and pass either health care or tax reform. That impasse appears to have produced a decline in interest rates and a forecast of poor business prospects for banks.

To put a bit of perspective on this, prior to the Great Recession of 2008-2009, manufacturing was weak while finance was soaring. That relationship was a concern for economists who warned that something had to give. Trading around increasing numbers of bonds and making large profits off each trade as the economy produced less than was being borrowed is an economic recipe for disaster. We are seeing the reverse of that this year as manufacturing and services rise while finance enters a slump.

There is more, but there always is more, so we will end on a warning note. The *Wall Street Journal* reported today that there is an idea being floated among Senate Republicans to finance repealing Obamacare and funding tax reform by taxing health insurance premiums paid on employer-provided health plans. By increasing the income tax paid by employees and employers in the private sector who provide health insurance coverage, the tax on upper income earners can be abolished and corporate income taxes can be cut without too much additional borrowing. That would work out well for corporations where the income tax rate would decline from the current 35% to around 25%, but it would be a heavy burden for employees and owners of small businesses. Corporations could pass on the tax savings to their employees, leaving everybody about as well off as before, but for small business, few of which are incorporated, it would simply mean higher taxes both for the owners and the employees.

While we applaud the idea of cutting the corporate income tax rate, it strikes us as less than wise to cause workers at small businesses, not to mention their employers, to pay higher taxes in order to cut taxes for the highest income people in the country. If you are interested in doing so, a message to your two senators and perhaps one to your House Representative might be in order here. They ultimately tend to do what we want, and if they conclude we don't want that tax increase it may well not happen.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
M.S. Personal Financial Planning

Jacob A. McClure, CIMA®