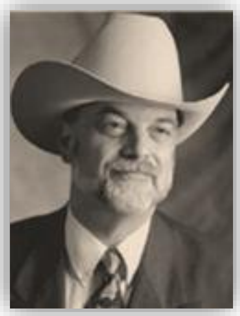

THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

In a week with escalating political drama, the Federal Reserve raising interest rates and announcing it was making plans to unload a few trillions of dollars in bonds on the open market over the next few years, the Standard and Poor's 500 Stock Index (SPX) did almost nothing. Well, technically, it did rise 0.06% to 2,433.15, but as that rise was well within how far the Index typically moves randomly in an hour or so during any given day, it amounted to a nothing week. It remains up about 8.68% year-to-date as we close in on the half-year point, and about 17.5% for one year. Its rise over the last year pretty much matches the rise in corporate earnings for the same period, which appears to be the sole reason stocks are higher.

There is an old saying on Wall Street, "Sell in May and go away." which has not seemed to apply this year. The SPX is up about 2.7% for the last month. As we have mentioned before, this market, driven by increased profits, seems to ignore many of the old reasons that typically cause market downturns.

Gold dropped about 1% to $1,256.30 and the ten-year U.S. Treasury Note slipped it's yield slightly lower to 2.152%.

The Economy

The Labor Department reported this week that the unemployment rate has sunk to the lowest level in several states since records were first kept on that statistic by state in 1976. The states were as varied as Arkansas, California, Mississippi, and Colorado. At the same time, housing starts in the United States declined for the third month in a row, not because of reduced demand, but because of a shortage of residential construction workers. In the western states the low unemployment rate appears to be a result of rapidly growing economies, while in the southern states the record low rates seem to be a result of employees relocating to those western states. The western states are seeing such a shortage of workers that in parts of Colorado, for example, a homeowner may have to wait a year or more for service from a plumber or electrician.

Only a couple of years ago, the mere mention of the Federal Reserve reducing its bond purchases and perhaps raising rates was the generally accepted reason behind a "taper-tantrum" dropping the stock market into correction territory and causing rates to soar. This week the Fed announced an as-suspected increase in the interbank overnight lending rate of 0.25%. With that announcement came a warning that we could expect yet another rate increase this year from the newly announced 1.25% rate announced this week to 1.50% sometime this fall or winter. The announcement also included news that the Federal Reserve would likely begin "shrinking its balance sheet" later this year or early in 2018.

"Shrinking the balance sheet." in plain English means that the Fed will, in effect, start selling bonds on the open market. Initially, it will simply not repurchase bonds to replace those that mature. As the principal is paid to the fed on those maturing bonds, it will turn the proceeds over to the Treasury, potentially shrinking the deficit. That was a much discussed subject at the Bank of New York-Mellon InSite conference we have been attending this week in San Diego.

That bond selling action is the opposite of "quantitative easing" when the Fed bought bonds on the open market in the years since 2009. As the Fed bought bonds it paid for them in cash, effectively increasing the money supply and forcing interest rates down. When it allows bonds to mature without replacing them, it will take money out of the system, in effect, shrinking the money supply and creating a process that historically has caused interest rates to rise. Since the Fed stopped purchasing bonds and started raising short term rates, a strange thing has happened; interest rates have *fallen* on longer term bonds rather than rising.

What has apparently happened is that whenever the Fed attempts to raise rates by either effectively selling bonds or raising short term rates, money floods from foreign investors into the United States to buy U.S. Treasury securities or high-grade corporate bonds. The logic is simple. Japan's and Germany's intermediate-term interest rates are between zero and a negative quarter percent. Those ultra-low rates are a result of the Japanese and European central banks' policy of flooding their economies with cash by *buying* bonds. Investors and savers in Europe and in Japan see the 1.75%, 5 year U.S. Treasury and corporate debt here in the U.S. as a wonderful place to park their money for a few years. The additional draw is the perceived stability of our financial system and the dollar.

At the same time, the uncertainty of what, if any, changes are going to be made to the tax code, NAFTA, and the general political situation is causing American companies to be hesitant to borrow money to buy new equipment or build new facilities. Low demand to borrow money and a high supply of people and institutions wanting to make loans (buy bonds) results in abnormally low rates. The opinion of the investment managers and economists we have heard is that U.S. interest rates will start to rise when the European and Japanese central banks stop forcing their local rates downward and allow their local interest rates to rise to a more "normal" level.

Another consensus we heard was that the U.S. economy is in good shape but was starting to hit limits on future growth, the most important being a shortage of both skilled and unskilled labor. The speakers also seemed to be in general agreement that as Europe, and the rest of the world moved toward recovery, American corporations would continue to see good profit and revenue growth for the next couple of years.

The obvious question was, "When will this expansion end?" which is another way of asking, "When are we likely to see the next recession?" Again, there was a consensus based on a lot of historical data points. That consensus was that sometime in 2019 or 2020 we are likely to see our next recession. The warning signs, expected to come about a year to 18 months before the downturn, would be unemployment to bottom and start to rise and the Fed interbank rate to rise to the level of the ten-year Treasury. With unemployment still falling and the Fed funds rate at 1.25% vs. 2.152% for the ten-year Treasury, we still appear to be in comfortable territory.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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