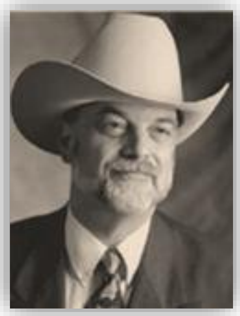

THE PERSONAL WEALTH COACH®
An SEC Registered Investment Adviser

Jeffrey W McClure CFP® Jacob A McClure CIMA®
PO Box 1029 / 918 N. Main Street
Salado, TX 76571
(254) 947-1111
(800) 914-7526
Serving Investors Since 1982
www.tpwc.com

jeff@tpwc.com
jake@tpwc.com

June 23, 2017

TPWC Market and Economic Update

The Markets

In yet another eventful week the S&P 500 Stock Index closed out the week about where it started. Today it closed at 2,438.3, up 0.21% from last Friday's close. It did get up to 2,455 early Tuesday morning but sunk on fears of lower oil prices before recovering back to about where it started. It is still up about 8.91% year-to-date and nearly 20% from a year ago, so no complaints here. We are pretty clearly in the summer doldrums as far as the stock market is concerned, but unlike many another summer, the doldrums started off with no decline in values. Treasury notes and gold followed the lead of the stock market and went nowhere this week as well.

It is worth noting that West Texas Intermediate (WTI) crude oil has dropped from around $57 per barrel at the beginning of the year to around $43 today. Both WTI and the Brent price are now down about 24%, putting them in classic "bear market" territory. The culprit is a combination of innovative fracking in the U.S. and a dramatic decline in fuel usage around the world as users turn to more efficient methods. Despite the drop in price, the U.S. oil rig (drilling) units in use rose 11 to 758.

The Economy

The U.S. and world economies continue to perk along and it appears that our economy is on track for a 2% growth in GDP this year. We can reasonably expect to see much of the rest of the world produce a slightly higher growth rate as they continue the process of catching up with us. Beneath the surface though, there are some worrisome trends.

Greece was back in the news this week as a chunk of its debt comes due in July and it simply does not have the Euros to pay it. One newsworthy aspect of the situation is that markets did not plunge and there were no headlines warning of the dire results of a Greek debt default. The factual condition is that The Grecian government cannot pay its international debts. There is no one who sincerely believes that the Greeks will be able to do so in the future, but about once a year as Greek government bonds owned by mostly the German and French governments come due, a crisis ensues. It is not less threatening than it has been in the past, but there is now an expectation that somehow the International Monetary Fund (IMF), the European Central Bank (ECB), and the various countries who have the means to make more loans will somehow figure out a way to muddle through until next year.

This year, the issue is that the IMF has clearly stated that it will not loan more money to Greece to cover its annual interest and principal payment due unless Greece's creditors agree to reduce the loan balance to a level that the Greeks could reasonably cover on their own someday. This week the IMF agreed to a new loan "in principle" giving the German government some moral leeway to go to the voters with a plan to loan the Greeks money to cover the payments due. In fact, the IMF has not made a commitment to loan more money because its charter prohibits it from loaning out money that is unlikely to be repaid, but the "in principle" statement makes it sound like the IMF will share the burden.

We bring this up to illustrate a problem that appears to be global. Kicking the can down the road is one of the most popular sports played by politicians and governments from one side of the globe to the other. Measuring the debt of a country is difficult as they mostly have different currencies and categorize their debt differently. Perhaps the best way to measure the debt of a nation is to first figure out what obligations are backed by the full faith and credit of the nation's taxing ability and then comparing that to the total gross domestic product (profits) of the nation.

Japan is an example of what has been going on and continues to happen. In the 1980s, Japan's debt to GDP percentage was about 51%, which is to say that the country owed full faith and credit obligations totaling about half of the total profits made in the country for a year. Today, Japan's debt to GDP percentage is 250% (per tradingeconomics.com). The good news (for the Japanese) is that Japanese five-year government bonds are yielding a *negative 0.80%.* Even the 30-year Japanese government bond only pays 0.80% to those who loan Japan their money. Unfortunately, the Japanese population is shrinking and getting older, resulting in fewer available workers each year. By any measure of which we are aware, it will be impossible for the Japanese government to ever pay off its debt. Still, for the short term, the vast, majority of Japanese debt is held by citizens of Japan, and they are famous for never demanding payment of the principal.

Japan ran up its debt largely in the global real-estate collapse we know as the "Savings and Loan Bubble" that triggered in 1992. Rather than allowing large banks to fail and face the pain of huge lost investment values, the Japanese decided to prop up the banks by softening regulations and allowing them to borrow from the government to establish new reserves without acknowledging they were, in effect, bankrupt. Those non-performing debts generally are still there on the books of the banks, and the banks in Japan have borrowed money from the government at negative interest rates to provide them with enough capital to avoid declaring bankruptcy. The result of all that stagnant capital is that Japan has effectively been in a recession for a couple of decades. To keep unemployment from soaring, the Japanese government has built infrastructure, highways, bridges, airports, and railroads, all with borrowed money.

On the other side of the globe, the European Union has been unwilling to recognize that most of the Greek debt is unpayable. To make that recognition a few years ago would have caused banks across Europe to fail, and, as the EU does not have an FDIC to insure deposits, result in immense losses to investors and probably a full-fledged depression in Europe. As the 2008-2009 Great Recession set in, the governments bought the Grecian debt from the banks to head off the crisis. In the mid-2000s, the Greek debt to GDP percentage was just over 100%, but today, even after some debt forgiveness, the Greek government owes about 180% of GDP, and most that debt is to foreign governments.

Sadly, Greece is not alone. Portugal owes 129% of GDP and Italy owes 132%. That is compounded by the fact that Greece and Portugal both have unemployment rates of about 23% while Italy's unemployment is running at about 11%.

So, why is Japanese debt considered "safe" while Grecian debt is sub-junk? Japan has a 2.8% unemployment rate and the government revenue is good enough to pay the "carrying cost" of its debt. Both Greece and Portugal must have annual loans granted to them by their creditors to avoid default. If either country defaulted, the repercussions would be immense. Malta, for example, holds a portion of the Greek debt large enough that a default would potentially bankrupt its government. The acknowledgment that Greek bonds are worthless would very likely plunge the Eurozone into another recession. Japan can carry the interest rate cost for a time, but at the expense of economic stagnation. The way out of that mess is not clear, but would start with closing the bankrupt banks and dealing with the fallout in much the same way we did here in the U.S.

The one workable solution to the ongoing debt problem in Europe is for the more well-off creditors like Germany and France, to simply write-off much of their Greek debt and issue debt forgiveness to Greece in a manner not unlike that of a company or family entering bankruptcy here in the United States. The reason it has not been done is that banks and nations across Europe are still carrying the Greek bonds on their books as if they will eventually be paid in full. If they acknowledged that those bonds are probably worth about 20% of their face value would create a financial hole that would have to be filled. The filling would need to come from governments and those governments would then either need to borrow the money to make up the difference, or raise taxes to cover the losses. Politicians don't want to raise taxes, so they kick the can down the road.

How does this relate to us? Congress is in the process of attempting to cut taxes, provide greater defense spending, and promising other benefits. We, like Japan, have low unemployment, but we do not have negative interest rates. Our debt to GDP percentage is around 100%, which is still manageable, but if we both cut taxes and increase spending the road ahead is potentially perilous. Yes, it is possible that increased growth in the United States could offset the greater debt, but if we make that bet, there is much risk down that road. We know this is going to be a very unpopular statement, but if our government is determined to spend more money, then a tax *increase* is in order. If we hold to current spending levels, then current tax rates combined with reasonable growth may get us out of the woods, but if we do need more spending on infrastructure and defense, then we need to be willing to pay for it.

If we kick the can down the road, we will eventually come to the pile of cans we have been kicking. Eventually we will need to clean up the mess but the longer we wait to start the harder it will be.

Until next week, we remain your faithful servants,

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

Jacob A. McClure, CIMA®