THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index ("SPX") closed out the week at 2,423,21, down 0.62% for the week, but more importantly, up 8.24% for the first half of the year. It is also up 15.24% from the half-year mark a year ago. Gold closed at $1,242.4, down 1.3% for the week and down 9% from a year ago. The ten-year U.S. Treasury note ended the week yielding 2.30%, up from last week, but still at an abnormally low interest yield.

Looking at other markets, the Nasdaq 100 Index rose 14% in the first half of the year, its best first half since 2003. Global stock exchanges turned in, on average, the best six-month performance since emerging from the great recession.

Amid all of this low movement an odd relationship may by evolving. Both stocks and bonds declined this week. So far, this year the traditional relationship between stocks and bonds, wherein when one rose the other fell, has been missing. Over the past several decades, stocks and bonds have moved in opposite directions so reliability that many investors have come to accept that relationship as if it were a law of physics. In the more recent past though, bonds have behaved oddly, or at least differently. It may be that international monetary flows searching for security tend to flee bonds when stocks decline. Only time will tell, but take care with assumptions about stock-bond relationships.

The Economy

Banks Return to Health

On Wednesday, the Federal Reserve declared that all 34 banks and other financial institutions to which they administered their "stress test" this year passed with flying colors. In other words, the Fed has declared the banking and financial industry in the United States fully recovered from the 2007-2009 financial crisis. The Fed, as a result of the test results, officially allowed all the financial institutions to increase dividends and conduct stock-buybacks.

Illinois Debt Headed to Junk Status

The state of Illinois is set to enter its third fiscal year without a budget or a plan to fund pensions or pay state employees. S&P Global Ratings has warned that if Illinois fails to pass a budget by midnight tomorrow, July 1, the ratings agency will lower the state's credit and bond ratings to "junk" status. If that happens, Illinois will be the first U.S. state to have its credit rated as "junk" since credit ratings have been available. Illinois is headed for bankruptcy, but it is not because they have no source of money, rather it is because partisan members of their legislature and executive branches appear to be willing to see the state government default rather than compromise. The critical issue is that if Illinois goes down, it raises the potential for the same scenario to come to pass in Washington.

Inflation Declines

At the beginning of 2017 inflation, as measured by the Price Index for Personal Consumption Expenditures ("PCE") was up to about 2%. As that was the stated goal of the Federal Reserve for a healthy economy, we, and economists in general, saw that as an indication of economic health. Since then though, the PCE has been falling and May's PCE was only 1.4% higher than it was last year. Month to month data is not as reliable, but in this case, the PCE *fell* 0.1% from April.

Those of us who remember the 1970s and early '80s when we had double digit inflation tend to think of all inflation as "bad." Most Americans who lived through the Great Depression of the 1930s, on the other hand, learned to fear *deflation* as the destroyer of jobs and all good things. In reality *deflation* is almost always destructive while mild *inflation* is a good thing. That is not to say that high levels of inflation are good, because they are not.

Inflation can be thought of as a form of heat in the economy that functions in much the same way as temperature in our bodies. There is a level that indicates good health. Get much below that temperature and death is near at hand. Get significantly above, and again, death becomes a risk. The most reported measure, the Consumer Price Index ("CPI"), was developed by Herbert Hoover when he was Secretary of Commerce. It has some rather strange elements, like the rental value of a house, that are major components. The PCE is a more effective measure as it is based on what people purchase each month rather than considering the potential rental value of houses. Both of those are best viewed without the food and energy components as those two measures rise and fall erratically and just as suddenly revert to longer term averages.

Prior to the "great recession" of 2007-2009, America's PCE minus food and fuel ("PCE(-)")was ticking along just above the 2% mark, about where it theoretically should be in a healthy economy. During the great recession, the broad PCE declined to about a negative 1.5%, a frighteningly low level. Since then the PCE in both formats has climbed to the 2% level twice; once in 2011-2012, and again this January. This week the PCE was revealed to have fallen to as low a level as we saw in the oil declines of 2015, and before that in the aftermath of the recession.

So, why do we need inflation, and what does it mean when it gets too low? In the world of economics, there are an enormous number of hypothesis (ideas), quite a few theories (ideas seem to work most of the time), but very few laws. One of the most fundamental laws of economics, and perhaps the most reliable, is the law of supply and demand. When supply exceeds demand, that is there are more things being created to sell than buyers for those things, prices decline. Conversely, when there is a shortage of available goods or services and a high demand to purchase them, prices rise. When demand is slightly higher than supply, businesses tend to be formed or expand, wages rise, and the economy tends to grow. When supply is higher than demand, businesses tend to form less often, not expand as much (if at all), and wages are stagnant or shrinking.

What we are seeing in the United States at this moment is stagnant wages, a falling, but still reasonably high consumer confidence level, and prices, at least for the month of May, *falling!* The good news is that personal consumption rose 0.1% for the month after rising 0.4% for the preceding two months. What we are seeing in the economy is a trend toward spending less and saving more. That trend appears to be growing both in corporate and consumer behavior. As spending growth declines and approaches zero, prices tend to stagnate while the additional savings depress interest rates.

So, what is causing this decline in economic activity growth? It appears to be the old demon, *uncertainty.* Our economy is primarily driven by consumers; people who buy and use things. The vast majority of that consumer spending comes from the lower 80% of the earners in the economy, and counterintuitively, the further down the economic scale we look, to a point, the greater the portion of the economy is dependent on those consumers.

The reverse is true as we move up the economic scale. Generally speaking, the higher the net worth or income a family has, the lower the percentage of that income gets spent. Instead, higher income families tend to save or invest a larger portion of that income as it goes up. While investment is important, what we have seen is a disproportionate amount of that investment funding flow going into bonds, which are loans rather than pure investment. That also depresses interest rates and inflation.

Once again, the question arises as to "why?" Congress is wrestling with a couple of health-care bills but all the ones currently on the agenda are projected to eliminate health insurance for around twenty million people. First, that means that people who are covered under the expanded Medicaid plans see themselves as facing what could be much higher medical expenses in the future. At the same time, future tax rates are extremely uncertain, so upper tax-bracket families are hesitant to take action. Add to that the announcement today that the Congressional Budget Office (CBO) found that the federal government will run out of money to pay its bills in just over three months unless Congress can reach an agreement to raise the debt ceiling. Given the recent ability of the majority party in both houses to agree on anything, and that becomes a concern. The list of uncertainties and knock-on results from those uncertainties goes on much further, but you can see what we mean.

This economic expansion is now the third longest in the history of the United States. Eventually, it will peak and we will have another recession. The question is, "When?" and "How severe will it be?" If we could reach some level of legislative and executive stability, there is room to grow. The dangerous element is that partisan and personal actions on the part of our elected leaders could put an end to this expansion prematurely.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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