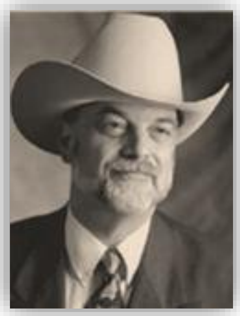

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TPWC Market and Economic Update

Admin Note

This is a longer than usual letter. While we love to make them short, sometimes there are big things to write about, and it behooves an investor to understand the economic world in which we invest in a much deeper fashion than can be conveyed in short comments.

The Markets

Our most-favored index, the S&P 500 (SPX) rose an anemic 0.26% for the week, closing at 2587.84 and were it not for Friday's 0.31% gain, would have ended the week with a loss. The numbers get more impressive as we look a bit further into the past. For one month it is up 1.51%, for three months 4.48%, year-to-date, it is up 15.59%, and for 52 weeks, up 24.11%. The legitimate question has arisen in the minds of many, "Is that too much?" and "Are we in for a fall after such a gain?" The reality is that stock market is priced based on the ratio of corporate earnings to share prices, the *price-to-earnings (P/E) ratio*. That P/E ratio remains about at its historical average and has not risen significantly in the last year. For more on this, read below.

The ten-year U.S. Treasury note closed out the week yielding 2.334%, down just a tiny bit (0.053%) from last week. Bonds being very different instruments from stocks, the contrast can be seen in the total return of the Bloomberg-Barclay's U.S. Aggregate Total Return Bond Index which has a net gain (with all interest reinvested) of 0.99% for one year. The five-year average annual total return on that Index is 2.09%. Given that the interest is taxable, either immediately in most cases or eventually in a retirement account, that equates to a net *loss* after taxes and inflation. Still, we are seeing record inflows to bond funds from individual investors.

To provide some idea of why we think bonds are overpriced and potentially in for a fall, a $1,000 U.S. Treasury bond maturing 23 years from now sells for $1,260 in today's market. That 11/15/2040 maturing bond, if purchased today, would have an effective yield of 2.71%, but has a guaranteed capital *loss* of 26% if held to maturity. In contrast, the stock market simply does not have *any* 23-year periods in its history in which it would not have turned in a substantial gain. At some point, that loss will be realized and there will be pain.

Gold closed Friday down 0.35% for the week and down 4.13% for one year at $1,270.20. U.S. crude oil was up 2.13% at $55.70 for the week and up 13.42% from a year ago. U.S. produced oil remains about 10% less expensive than North Sea Brent, the other benchmark, and continues its expansion in the world market as a result.

The Economy

The big noise this week was the release of a federal income tax proposal from the House Ways and Means Committee, but before we jump into the possible future, we believe it prudent to report on the facts at hand.

Record-low Unemployment

The dearly beloved Bureau of Labor Statistics (BLS), part of the Department of Labor (DOL), reported that U.S. unemployment dropped to 4.1% last month as employers hired a (seasonally adjusted) 261,000 employees. In an adjustment from September, the change in the number of persons employed in September was changed from a -33,000 to a +18,000. That means that U.S. employers have been hiring more than firing now for a record 85 consecutive months. The three-month average, which is a better indicator, is now at 162,000.

The BLS goes on to add that the 4.1% unemployment rate is the lowest since December 2000, right at the end of one of the longest, biggest expansions and bull markets in U.S. history. 17 years ago, that unusually low jobless rate was accompanied by stock market valuations that made little or no sense to any thinking observer with the average price-to-earnings (P/E) ratio of an SPX company running at about 30.

This recovery and now expansion phase in our economy are different from any we have seen in decades. To find any form of comparison we must go back to the 1950s and '60s, the time commonly referred to as the "post-war" era. During those post-depression and post-World War II decades, our economy grew at an accelerated rate, but did so with unexpected stability as it digested both the host of technological innovations from the war effort and the influx of relatively well-educated workers who had been schooled in industrial skills during the war and by the GI Bill education benefits. That generation of young families bought houses, had children, and worked both hard and long to make up for the lost years of the late depression and war.

Once again, we are seeing low unemployment, high corporate earnings, and a stable, long-lasting economic and market expansion with low to no inflation. Note here that back then, as part of the post-war Bretton Woods Agreement, all the major economies of the world were on an agreed-to gold standard with governmental controls on the price of gold and silver. The economic stability that ensued has often been credited to that "gold-standard", but today we have no gold-standard, yet low inflation and an amazingly stable economy are evident.

The commonality between the two eras is to be found in two areas: globalization of trade and dramatic technological innovation. Inflation and the form of economic instability it generates (bubbles and crashes) come when there is more money than goods and services available to purchase. In the past, commentators have fretted over the money supply as that is relatively easy to measure and could be controlled by the government and central banks. What we have seen in the past decades is that the money supply is not a good predictor of instability. Instead, the availability of goods and services appears to be the key. If there is an abundance of things to purchase that grows faster than wages, then prices tend to remain stable or decline while the average worker can buy more each year with the same level of income. that is not to say that the money supply cannot become a problem, but that it is not the sole cause of both good and bad times as some would claim.

We may complain about imports, but because of a global industrial expansion and increasing computerization, we can buy more for the same dollar value each year and thereby see our standard of living rise without any significant inflation. Moore's Law, that the computing power available will double every eighteen months, combined with a mushrooming low-cost international labor force that is better educated every year is the parallel of the industrialization and post-WWII labor force boom that happened in the post-war era. In the post-war era, that low-cost labor force was in rural America. Today it is in the developing economies around the world. Just as the removal of trade barriers and access to low-cost production nationally was the foundation of past expansions, so it is again today, just on an international scale.

In short, we are living in a golden age. Give thanks, enjoy it, but at the same time, be sure to set aside some of that affluence we are enjoying because golden ages come to an end. When they do, if you are like the ant and have accumulated and invested you can go on living well, but if you are like the grasshopper and have consumed all you received, you may be unhappy. The debt we are generating in these good times will come due. When it does, things will get "interesting."

A New Tax Proposal

The U.S. House Ways and Means Committee, where all federal income tax bills must originate, produced a proposal to overhaul the Federal Income Tax Code. We spent most of Friday reading and digesting the proposal and reading learned commentary on it. The news media is flooded with commentary, so you can get as much of that as you want. Remember that this is just a *proposal* and will be debated, argued about, fought over, and finally modified before it comes up for a vote in the House or the Senate. Then, presuming something passed both houses, the separate versions that may be passed will need to be reconciled in a conference committee, and once again be voted up or down in both houses. Only then will we begin to understand what all this means, presuming it survives the process.

Once the bill is passed and signed into law, presuming the President does not veto it, it will go to the IRS to have regulations written implementing the new law. Amazingly, we are still waiting for some regulations to be written on tax bills going back twenty or more years, so the final definitions are in the future. Still, we can comment on the foundations of this proposal.

While there are a lot of relatively minor changes in rates, credits, and deductions for individuals and families, they can be summarized as reducing the percentage of tax returns where people itemize from about 33% to about 10%, and will reduce some folk's taxes a bit and raise them a bit for others. Those commonly classified as being in the "upper middle class" who have played the tax code to get some deductions will likely be less than pleased, while the lower to mid “middle class” taxpayer may see some relief and a lot less complexity in their federal income tax filing. There is certainly a boon for "passive" business investors, but business owners who work in their own businesses will largely be taxed at the same rates as before, albeit under different categories. Very notably, the proposal reduces deductions for business loan interest. That will have a profound effect on large scale corporate bond issuance.

There are two relatively large changes at the heart of this tax proposal. First, and in our opinion, the biggest concept by far, is that the leaders of the House and Senate (Republicans) have agreed that adding a couple of trillion dollars to the deficit over the next ten years is a good idea. There will come a time when we, collectively, will need to pay for that, with interest. That day of reckoning will probably not come for more than a decade, but increasing deficit spending much faster than the economy is growing strikes us as a sure-fire way to create a future crisis. The attractiveness of tax cuts is so strong that we think it will happen, so prudence tells us that being prepared for the results that will very likely emerge in 10 to 20 years is wise.

The second thing that is big in this proposal is that cutting corporate and business taxes by nearly half will be tremendously stimulative to the corporate economy. Corporate earnings tend to drive stock prices, so we may be in for the most impressive bull stock market surge in memory. Enjoy it while it is here and make hay while the sun shines.

It will also be interesting to see what happens with a high level of fiscal stimulus and a critical shortage of skilled and unskilled workers. We suspect the result will be a rapid growth in robotic labor. The brave new world of the future may be at hand.

Right now, there are more questions than answers, so we will try out best to keep you posted as the proposal works its way through the process.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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