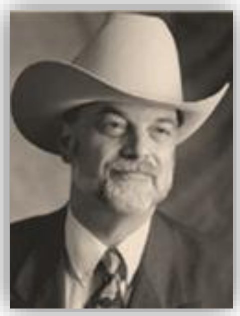

THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

The stock market, as represented by the S&P 500 Stock Index, ended this last week before Christmas down 7.05% at 2416.62. That was the lowest point of the week and down 17.51% for the trailing three months and from its high back in late September. Since a drop of 20% is considered to be a "bear" market, that puts us closer to that mark. Friday's low also equates to a loss of nearly 10% for the year despite or perhaps because of the overwhelming fiscal stimulus of a $1.5 trillion tax cut and one of the larger increases in government spending in recent history.

The cause of the market slide was, as is normal, elusive but there are several factors that are clearly worrying both institutional investors and corporate executives. First on the list is the existing and promised tariffs on trade with China. The U.S. and Chinese economies are highly intertwined and a price increase of 25% on most of what comes from China along with the probable counter-tariffs would either trigger a significant increase in consumer prices or an equally impressive reduction in corporate profits. Presuming the increase in consumer prices, two reactions are forecast. First, the increase in prices is highly inflationary which will drive the Federal Reserve to raise interest rates faster to counter. Second, consumer spending is likely to slow suddenly in the face of higher prices. Both issues would impact corporate earnings and thus lead to lower stock valuations.

A further negative for the market was what appeared to be an imminent government shutdown. The actual economic effect of a government shutdown is small, as long as it is a short event, but the confidence effect is big. The most discussed but perhaps the least important element in this downturn is the Federal Reserve's decision to raise interest rates another quarter of a percent from 2.25% to 2.5% max. The increase was widely expected but the stock market responded as if it were a surprise. The Fed continues to signal at least two more increases in 2019, which could lead to a problem, but that problem is most of a year in the future.

Our observation is that it is not the likelihood of bad economic news that is panicking the market but rather political uncertainty. In March, a combination of a disruptive Brexit, 25% Tariffs, and a likely deadlock on the U.S. debt ceiling causing *another* government shutdown coming at the same point have got investors spooked. If in the intermediate and long-term, markets are indeed driven by corporate earnings (and they are), then this downturn is a massive overreaction and will soon pass. Meanwhile, fasten your seatbelts.

The 10-year U.S. Treasury yield followed the market down, ending the week at 2.781%, down about 10% from where it was a month ago. West Texas Intermediate Crude Oil fell to $45.42 per barrel, down nearly 12% for the week, 35% for the trailing 90 days and 40% from highs in October. The consensus cause for the decline was slowing global demand in the face of trade wars and rising interest rates.

Market Actions We Are and Will be Taking

You may remember that we have discussed "dry powder" to be used in significant market downturns. This is one of those and we have switched to drawing from that dry powder (cash and short-term bonds) for those making monthly systematic withdrawals. We do consider this contraction to be the equivalent of a "cold" and not a life-threatening case of influenza or pneumonia and while it may be unpleasant, we suspect it is more of a temporary inconvenience than a catastrophe. We also expect, based on historical precedent, that there will be a pronounced market shift as we emerge from this downturn. That shift may cause us to make some strategic changes in asset allocations, although it is too early to say what they will be.

The Economy

While a lot is going on in the economy the single most important and reliable indicator, the Conference Board's Index of Leading Economic Indicators (LEI) report rose 0.2% in November to 111.8 following a 0.3% decline in October and a 0.6% rise in September. Following the pattern we have seen in the last several months, the Coincident indicator rose slightly (0.1%) and the lagging indicator was up 0.4%. Those numbers signal that we are in an economy largely driven by things that happened in the past and that economic growth is likely to slow over the next six months, but it still does not forecast a recession. The indicators suggest that U.S. GDP growth should be around 2.8% in early 2019 but slow to about 2.2% as the year progress.

The Bureau of Economic Analysis (BEA) revised the third quarter U.S. GDP down from 3.5% to 3.4% but indicated the economy was still firing on all cylinders and likely to continue to grow substantially for some time to come. Just as importantly, the BEA report put the Real Gross Domestic Income, the sum of all income earned while producing goods and services within the U.S., at an annualized growth rate of 4.3%. That high-income growth with core inflation running at about 1.8%, continues to be a strong positive for the economy and particularly for consumer spending, which makes up about 70% of U.S. GDP.

Negative news concerning the housing industry continues to accumulate. It does appear that housing starts for multi-family buildings have risen a bit, but the individual housing market is suffering. Increasing mortgage rates, and oddly a shortage of existing homes for sale causing prices to stay high in some areas, are creating a slowdown in sales. New houses, still not being built at a high rate, appear to not be selling well in many areas. A slowdown in residential activity is a worrying sign, but typically precedes a recession or bear market by a year or more so we think the current market malaise and residential issues are unrelated other than psychologically.

The bottom line here is that the economy is strong, corporate earnings continue to rise, and this Christmas retail season is on track to be the biggest in history. Unemployment is the lowest it has been most of our lifetimes and wages are rising faster than inflation. All that points to at least another six months to a year of healthy economic growth.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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