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TPWC Market and Economic Update

The Markets

Not much to say this week except that the recovery from the August meltdown has and is continuing. This week marks the third week of market gains in a row. The traders have largely come back from vacation. As you know I follow the S&P 500 as the indicator of choice, and it is back up at about 2032. Just for the record, the all-time high was 2,134, and it closed today only about 100 points below that. That puts the index down about 5%, which, oddly enough, is logical. Why? Because corporate earnings for the third quarter, which have started coming in, are widely forecast to be down about 5% from their highs earlier this year.

The obvious question that follows is, “Why are corporate earnings down?” The answer to that one is a bit complex, but suffice to say that we are, as I noted earlier this year, in a transition from a recovery focused on what happened in 2008-2009 to the next phase of a secular bull market: expansion. When financial collapses occur, everything to do with investing gets focused on the near-death experience we just went through. Companies cut costs, demand more work for less pay, and generally focus on reducing expense and building up reserves. That tends to create good profit margins (earnings) as companies squeeze out unprofitable areas and improve productivity. At some point in the austerity, savings, and productivity push, companies start to cut into areas that enable their firms to actually function. My observations suggest we hit that point this year.

To use a physiological analogy, companies have started cutting muscle because they have run out of fat, but remained in “cutting” mode. To perhaps a lesser degree, government has hit the same point. It has come as a shock to many companies that there is a point beyond which asking people to do more for less becomes counterproductive. The signal is when cuts occur and earnings drop instead of rising. At that point, companies (and governments) realize that if they are going to survive, they have to grow, and if they are going to grow, they are going to need more people, and so labor demand begins to rise. Moreover, companies will notice that good employees are starting to go to other places where they can get hired for more money, and wages will start to rise. Yes, technology can go a long way toward improving productivity, but in this case, for the moment, most companies have pretty much reached the limit on replacing people with machines. As robotics and computers continue to improve, we will see other waves of technology replacing labor, but that is in the future.

So, as companies start to pay more and hire more, there will be more money to spend, and the consumer will start to drive earnings back up. That is the definition of “expansion.” Once it gets started, it becomes a self-feeding movement and will continue until the consumer is once again “tapped-out,” inflation reasserts itself, and interest rates rise enough to kick us into a “normal” business cycle downturn, but that is also years in the future.

Another area that has shown its true colors recently is the very poorly defined universe of “alternate investments.” In a time of low interest rates with traditional income investments only yielding 1% to 2%, Wall Street firms are good at coming up with “no-risk, high yield” options for the unwary. One of the more popular options was the Master Limited Partnerships (MLPs). MLPs were commonly in things like oil and gas pipelines where they promised a steady stream of income with little to no volatility. Often the income levels were 6% to 8% per year. Many of those have fallen 30% or more this year as it becomes apparent that the oil and gas companies who have long-term contracts to pay for use of those pipelines may not be around to pay their dues much longer.

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Meanwhile, Goldman Sachs and UBS have been hit with some serious fines for misleading sales practices and undisclosed, large markups in the sale prices of supposedly “safe” high income, low risk, structured notes. Less well noted was the instability of some exchange traded funds (ETFs) during the recent semi-correction in the market.

The lesson here is that there is no such thing as low-risk high-income investments, and that it is a poor idea to invest in something as complex and hard to understand as many ETFs are.

The Economy

More and more, a realization is setting in that China is not on the verge of some kind of collapse. China, too, is going through a transition, and transitions are bumpy. The Chinese leadership realizes that exports are a poor way to create a steady and stable economy. It is far better to have the largest share of a nation’s output consumed by its residents. The Chinese growth miracle was almost totally based on exports, and much of that was to the European Union and the United States. The EU part of that equation has definitely hit a rough spot as the Germans have focused on exactly what American corporations saw as critical, austerity. The EU, like American corporations, has hit the wall there, and now realizes that expansion will come with increased spending and some constructive borrowing. The EU will take a while to produce the economic results that China needs to export as much as it wants. Thus, the Chinese are looking about for someone to buy their goods, and they have realized that the biggest set of potential consumers in the world is not in Europe or the United States, but rather in China! It is a difficult transition to go from making goods for the rest of the world to making goods primarily for domestic consumption, but it is a healthy move.

Another major shift is going on that relates to what happened in the years between the 2000-2002 recession and the 2008-2009 recession. In the years following the collapse of the “dot-com” bubble, major corporations in the U.S. and EU shifted from being creators of actual goods and services to largely being shadow banks. General Electric became the largest corporation in the world not by building more equipment, but by enlarging GE Capital to an entity larger than the rest of GE combined. This year marks what is probably the final set of spin-offs from GE of their financial business models. Earlier they started moving GE Capital into a separate company and Jeff Immelt, the GE CEO, proudly proclaimed on October 16 that “Our GE Capital exit plan is ahead of plan...” It is noteworthy that as GE exits the shadow bank/finance orientation it has had, its third quarter earnings, reported today, came in 16% higher than at this time last year.

A large part of what caused the financial collapse of 2008-2009 that so nearly became the Great Depression of the 21st century was that shift from actually producing goods and services to much of the world economy creating profits by shuffling around more and more sophisticated financial derivatives. Derivatives start off as being real money, used to build real things, but with each level of derivative created to make another layer of profit for some investment company or bank, both risk and cost were added.

Meanwhile, Goldman Sachs, the financial lion of Wall Street, came out with disappointing earnings, and much of the earnings slump this quarter is in the area of finance. Finance was the “dot-coms” of the recent boom and bust cycle, and as it hopefully fades back into its more moderate role, we will transition into something more productive. I am quite pleased to say that GE via GE Capital is no longer the largest corporation, but instead that a manufacturing and service company, Apple, is now the world’s largest corporation.

Last but not least, it is probably a good idea to get used to nation-states in what we once called the “Third World” coming apart at the seams and disintegrating into chaos. If history is any guide, the places where tribal animosities were papered over for years with borders and governments based on colonial boundaries is coming to an end.

Syria's plight is likely to be closer to the rule than the exception. The good news is that here in the United States we largely worked out those issues in the 1860s, when we disintegrated and collapsed into civil war. The entire world was going through that mess at the time, although we did not much notice. This is that cycle come again, as it did in the first part of the 20th century and culminated in World War I.

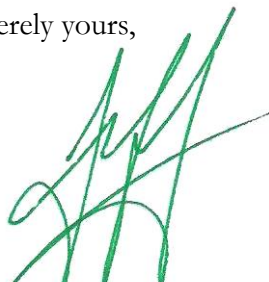
As the year progresses, in my opinion, the major threat to the economy and the markets continues to be the ultra-conservative faction in the House of Representatives. I am not questioning their motives, or even their good intent, but members of the "Freedom Caucus" have repeatedly and publicly stated that they will shut down the government if they can find a way to do so, and that they will block any election of a Speaker of the House who does not meet with their approval. Were we in a position where things would continue to run on autopilot without a Speaker in the House of Representatives or several new bills passed in the near future, this would just be a political move generated by an ideological minority. Unfortunately, that is not the case at this point.

We have several critical items that, under our Constitution and laws, must originate in the House and that, if successfully blocked, will potentially create a financial crisis. Perhaps the most critical is the increase in the debt ceiling. It is important to understand that an increase in the debt ceiling only represents allowing the Treasury to borrow the money necessary to pay for bills already passed by Congress. It certainly would be legitimate to repeal laws requiring the United States to spend money for whatever Congress elects to cut off, but to refuse to allow the Treasury to pay bills already incurred, like the pay and allowances for our armed forces, has the potential to further damage both our economy and our creditability as a nation. If the approximately 10% of the members of the House who identify themselves as the Freedom Caucus are successful, it very likely will create a market selloff, but I suspect that will be only a very temporary issue.

For whatever it is worth, I have had questions as to why I would blame the conservatives. I have no intent of blame in any form, it is just that if a certain group of people state that they wish to and intend to do something, I will likely credit them with the intent they expressed. Their political affiliation is immaterial. My responsibility is to provide warning of the consequences and probable result and to counsel action if it is needed. Our federal deficit is declining and has reached the point where federal revenues and our GDP is rising faster than our debt, which, if it continues, will serve to effectively reduce our federal debt. The conservatives in the House may have been an important factor in accomplishing that. Still, if a shutdown occurs, expect losses, both at the national and personal level. Our AAA credit rating for long-term debt has not been restored following the last shutdown and that has increased our borrowing costs. Let's just hope it doesn't happen again.

Until next week, we remain at your service,

Sincerely yours,



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