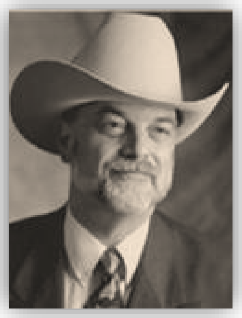

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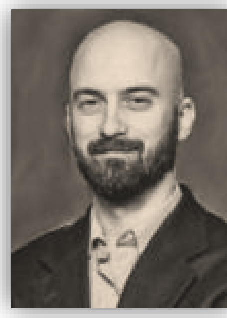

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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index (S&P 500) started last week at 2088 and ended the week at 2099, a rise of 11 points, or 0.95%. This week the Labor Department announced that (after a seasonal adjustment) employers hired 271,000 more people in October. That hiring surge, combined with signs that consumers were spending more, is a huge positive, but traders are hesitating because they don't know whether a Federal Reserve rate increase in December will be a positive for the market or a negative. The odd thing is that, in the short-term at least, those traders *are* the market!

The stock markets, in whatever incarnation one might choose, remain essentially flat for the one-year time frame with the S&P 500 up just 3.31%. The five-year return, while positive, is nothing to get excited about, and the ten-year return is still not much better than inflation. This sounds pessimistic but is actually just the opposite. Equity markets in the United States have fairly consistent returns over very long periods of time. That means the longer they are flat, the greater the historic rise was when it finally came. Things are not "different this time." We are still in a climate of fear, but the economic facts are piling up, and all of them are indicating good times lie ahead. Another characteristic of markets is that they rarely move smoothly. Instead they limp along as we have seen and then move suddenly as the herd of traders stampede to buy stocks while they are still low. As usual, there are no guarantees here, but a rising economy—and we do have a rising economy—means rising corporate earnings, and increased earnings drive market values.

Meanwhile the 2-year Treasury note jumped to a nearly 1% yield on Friday, while the 10-Year Treasury rose to 2.332%, the highest it has been since July. The interest rate increases we have been waiting on for so long once again seem to be emerging. Again, neither we nor anyone else can predict rates in the near future, but presuming the economy and wages continue upward, those rates are very likely to follow close at hand.

The Economy

ISM Index Rises to Nearly 60

First, in news only an economic geek could get excited about, the Institute for Supply Management's non-manufacturing index rose to 59.6 in October. Any reading above 50 indicates growth and a reading that close to 60 suggests strong growth. We are a service society, and we have much of our manufacturing done in low-wage countries around the world. The primary driver in the American economy is made up of Americans buying things from companies here in America, and about 67% of what we buy is categorized as "services." So, about 47% of our GDP comes from the purchase of American services by Americans. That, by the way, is a very healthy condition. The alternative, which is predominant in much of the rest of the world, is to be dependent on people in other countries buying what is produced locally. In that situation, a nation's economy is dependent on other nations not only for prosperity, but often for economic survival.

Here in America, about 70% of our GDP is a result of domestic consumer spending. More, about 40% of our exports are in the form of services, so another 5% of GDP is composed of exported services we provide the rest of the world. So, a total of about 52% of our GDP is services. When the purchasing managers index, a survey of what service organizations see as what they are already committed to spend on services, says "accelerating growth," that accounts for over half of the American economy getting ready to "lift off." There is another 20% of the economy that is about to take off as well, and there is more on that below. Between those two elements, about 72% of the U.S. GDP is on the verge of what may be one of the more memorable growth spurts in history, at least in our view of things. Only time will tell, but remember that we wrote this, and a year from now we will know whether or not our analysis is right or wrong.

That ISM Index rise confirms the report by the Commerce Department that consumer spending in the second quarter rose at an annualized rate of about 3.9%. Meanwhile the Labor Department announced that U.S. Employers hired 271,000 new employees in October (seasonally adjusted), more than making up for the reported slower hiring in September. That new set of hiring also brings the total number of people employed in the United States to a number higher than it was in 2007, just before the recession. More people working equates to more money to spend and that, at this point in the economic cycle, means that earnings and stocks have a high potential to finally get back into growth mode. For investors, that is really, really, good news!

Of course that means that the Fed is far more likely to raise its interbank lending rate from its current "0% to 0.25%," to a full "0.25%" at its next meeting in December. Frankly, the unhappiness reported about that prospect is silly. A 0.25% lending rate is still well below current inflation and very stimulative to the economy.

At the same time, the manufacturing index was reported to be "only" at a reading of about 52. The news reports seem to suggest that is bad news, but again note that any reading above 50 indicates growth. If manufacturing is still growing, albeit slowly, and services are growing at a high rate, that equates to excellent news and a strong indicator that probably the fourth quarter and 2016 will be surprisingly good economic periods.

Note here too that the slow manufacturing growth report is from a period before the renewal of the Export-Import Bank, the passage of a long-term highway bill, and a two-year federal budget (more on this below). If the economists are correct, that relatively slow manufacturing growth may have been at least in part a result of Congressional inaction as anything else.

Add to that the report that wages are up 2.5% from a year ago, consumer spending is up 3.9%, and the high hiring rate we are seeing, and it sure looks like things are finally taking off in the right direction. We've been saying for several years that the economy should finally start hitting on all cylinders in 2016, and things look more and more like that will come to pass.

A Miracle on Capital Hill

The big event last week occurred in the House of Representatives. Newly elected House Speaker Paul Ryan started off his time in what is arguably the second most powerful position in the United States with a victory so impressive that it almost rises to the level of "miracle." The House of Representatives not only passed a six-year highway bill, but attached to it was a renewal of the Export-Import Bank! It has also been reported that prior to his assuming the Speaker's office, he demanded that the conservatives in the House agree to pass a two year budget bill which included the authorization for the Treasury to borrow sufficient money to pay the obligations of the federal government already mandated by law. It appears that Speaker Ryan in less than two weeks may have transformed the House of Representatives from being a significant drag on the U.S. economy to a potential booster. As I wrote above, given the strong feelings and animosity that has ruled the House of Representative for years, that almost equates to turning water into wine and multiplying the bread.

As a bit of background, the House has only passed temporary extensions of a transportation bill for several years. Those extensions effectively prevented highway planners from doing any long-term planning and created a great deal of uncertainty even in existing construction. That uncertainty and stop-and-go funding raised the cost of building highways and caused planners to hold off on major projects needed to replace and repair failing infrastructure on federal highways across the country. Conservatives in the house wanted to turn a reduced amount of highway funds over to the various states to use on whatever projects they wished while Republican moderates and the Democrats in the House wanted to continue funding and planning on a national level for federal highways. There were heated differences on how to fund the program, as the gasoline tax does not come close to paying for the needed construction, and conservatives would not allow an increase in that tax. Speaker Ryan managed to find several innovative methods to fund the highway bill using offsetting cuts and asset sales and allowing open debate on the bill, including introduction of about 80 amendments, most of which failed on floor votes.

The U.S. Export-Import Bank, often called the "Ex-Im Bank", is an important and potentially critical part of our economy. In many cases companies like Caterpillar, Boeing, GE, and other large manufacturers need financing as part of the package to sell large export items to foreign governments and firms. The deals are often just too large for commercial banks to cover as well as putting them in the position of lending to foreign governments where they have no ability to foreclose on the equipment in the event of a default. The Export-Import Bank is perceived as having the ability to go to Congress or the courts in the US and freeze foreign assets, and as such, a loan from it is considered by foreign borrowers to be one that they had better pay. More, the money actually goes to American companies directly and is effectively a great boost to the U.S. economy. Historically, the Export-Import Bank has turned a profit, which is then funneled into the Treasury, reducing the deficit. The end result is a system that enables us to sell high-dollar manufactured goods to foreign countries and companies while getting that money invested into the American economy immediately. More, the Ex-Im Bank costs the Treasury nothing, and turns a profit for the government without taxation.

Fundamentally, the reason we need an Export-Import Bank in the United States is that all the other major manufactured-goods exporting nations have a similar institution. As an example of what the Ex-Im Bank does, the difference between whether Boeing or Airbus gets a major contract is largely in the financing. Since in many cases the purchase is made by a state-owned entity, a loan from a state-owned bank with low costs and a high probability of repayment is needed. We may not like the idea of a government agency making or guaranteeing a loan, but the alternative is surrendering the major manufactured equipment market to the French, the Germans, the Japanese, and the Chinese.

Why do we consider the passing of these two bills so important? The combination of a two-year budget plan, the highway bill, and the renewal of the Export-Import Bank has the potential to add about 1.5% per year to our GDP. That is no guarantee, but it does mean that businesses can now plan, bid, finance, and construct things that will need workers and improve our transportation and other infrastructure elements. That is a really big thing. Most major economists have agreed over the past five years or so that the log-jam on government spending bills in the House has significantly damaged our economic growth. If things get a lot better in the economy over the next twelve months, it will be an indicator that they are right.

Again, whether we like it or not, the U.S. Government accounts for about 20% of the U.S. economy. When it is running smoothly, that 20% adds to our GDP and tends to smooth out the bumps. When that 20% is uncertain, and there is a threat to cut it off, it is very much like a family facing a potential cut of 20% in their annual income. That family would be hesitant to replace their car, paint their house, buy clothes, and in general would restrict all economic activity. Because of that uncertainty, as much as half of the rest of the economy has demonstrated a tendency to not perform at optimal levels. With the passage of a two-year budget plan, a six-year highway bill, and the renewal of the Export-Import Bank, much of that uncertainty for businesses is removed.

Just as fundamentally, the House of Representatives has demonstrated an ability to govern and budget in accordance with their Constitutional role. That bodes well for 2016. The removal of that uncertainty combined with the very probable increase in business activity resulting from the passage of those three items could well be the tipping point that takes us from an economy that is idling forward to one that gets into gear and actually grows at a historically normal rate.

As always, we welcome your comments, thoughts, and questions. We plan to be on the radio on Saturday, so you are welcome to give us a call at KTEM either from listening on the air or online at ktemnews.com.

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