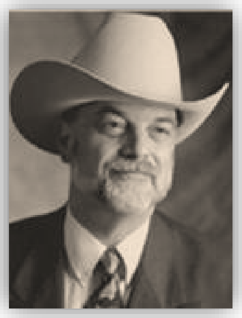

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Jeffrey W McClure CFP® *Jacob A McClure* CIMA®

PO Box 1029 / 918 N. Main Street
Salado, TX 76571

(254) 947-1111
(800) 914-7526

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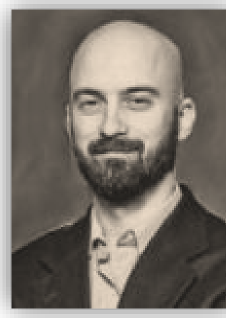

jeff@tpwc.com jake@tpwc.com

November 13, 2015

TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index started the week at 2092 and ended it at 2023. That amounts to a 3.3% loss for the week, and the first weekly decline in two months. It also amounts to a slight loss for one year (52 weeks). It was hard to find anything positive in the economic news today.

In times like these we must wait patiently for that fundamental force known as "reversion to the mean." If we measure the S&P 500 from 1993, just before the advent of what Chairman Greenspan called "irrational exuberance," over the ensuing 22 years the average annual return has been right at 7.2%. That, as it happens, works out to be about the same as the long-term average back to the early days of the 20th century, and thus is the "mean" or "average." So, when we get a year in which we have no gain at all, it is like when we here in Texas experience a drought: the rain will come, but it will come pretty much when we don't expect it, and there will be a lot of it when it gets here.

Leading up to 1993, things were pretty dry, and the market was pretty flat for several years. For the seven years following 1993, we experienced double digit returns every year. We are confident that, like the rains we have seen this year, market returns will return, but waiting for the rain that is hard. Still, double digit returns are not really on the horizon at this point, but a return to 7% per year would be welcome.

The Economy

Leading Economic Indicators

The Index of Leading Economic Indicators continues to indicate moderate growth in the U.S. economy through mid-2016, but oil and energy prices continue to exert a drag on the economy as they decline. There continues to be a potential for the Eurozone to slip back into recession. Here in the United States, the potential for a major economic downturn is extremely low.

A report from the International Energy Agency suggested that the price of oil could continue to be low and fall further through 2020. That is going to take some getting used to. Parts of the economy that rise and fall with oil are going to hurt, but those elements that have petroleum as a cost factor will probably do better once the economy shifts from oil. A disproportionate part of stock valuation growth in the S&P 500 over the past few years has been from oil-related companies as they rose with both the price of oil and new production. Part of the flat market this year is a result of those same elements falling.

Another report suggested that we might have seen oil at $100 or more for the last time as developed countries reduce their oil use per capita through a combination of conservation and alternative sources of energy. That, combined with discoveries and technological breakthrough events in oil production, has created a situation where oil supply growth is faster than demand growth. Remember "peak-oil?" What we may have seen instead is "peak price."

The Shadow of the Great Recession

Since the economic collapse of 2007-2009, the world economy has been stuck in, at best, low gear. In some parts of the world the transmission appears to be stuck in low-gear reverse! What happened?

There are several issues that appear to be the cause but all of them are traceable to a psychological issue known as "hysteresis." Yes, I know that is a mouthful, but it is probably a pretty logical mouthful. It means that we tend to behave as we do because of things that happened in the past.

Before the great recession, businesses invested heavily in productivity enhancing technology and, as a result, individual worker output rose measurably each year, as did their wages and company profits. In order to buy that technology, companies and governments borrowed money—lots of money. The idea, and it is a good one, is that by borrowing money now, the improvements in profits or lowering of costs would greatly exceed the cost of the loan over the long-term.

When the great recession hit, orders dried up and people in general reduced spending and increased savings. That meant that companies that had borrowed money, generally an irrevocable act, suddenly found themselves with low to no profit to offset the loan cost. That same effect was seen where people with what had been quite reasonable mortgages suddenly found themselves without a job and unable to pay those previously reasonable monthly payments. Even those who had plenty of income to pay their debts were frightened by the stories of those who didn't.

As people reduced their spending and increased both debt payoff and saving, the economy shrunk and interest rates dropped. It is a simple issue: interest rates rise when more people want to borrow and fall when they don't. Usually the lower interest rates encourage people to borrow again, and the economy recovers well. This time, as with other historic financially-based economic downturns, lower interest rates were not enough to offset the *fear* that was generated by the perception that disaster was close at hand.

Employers largely cut back on investing in productivity enhancements as those items required long-term investments. Why? The reason is found in "uncertainty" and remembrance of that sudden collapse. The good news is that a large element of that uncertainty disappeared last week. The recovery was proceeding at a fairly normal pace until April 2011, when a threatened government shutdown was avoided only at the last minute. Two years later in 2013, over two million government workers and millions of contractors didn't receive a paycheck as the government actually did cease all non-essential activities for 16 days. Until a week ago, the threat of another shutdown was hanging over our heads.

When the federal government, which makes up about 20% of the U.S. economy, is under a constant threat of suddenly not paying its employees or its bills, the uncertainty ripples through the economic system. Companies and employers start thinking short-term, accumulating savings, and deferring investment. That produces a measurable reduction in economic activity, and effectively freezes wages. When that happens it is very hard for companies to grow their profits. Over the last twelve months we have seen that effect as the earnings (profits) of the S&P 500 companies have actually fallen year over year.

It took several years for the combination of austerity and uncertainty to reduce profit growth to a negative number, and it will take time for the new reality of a slight increase in government spending combined with governmental fiscal certainty to penetrate the fear many business planners are experiencing now. It will take time, but the pieces are all in place.

The good news is that as weak as our growth has been and as slowly as our markets have risen, the United States remains the best place in the world to be. Job openings have risen to over 5.5 million and the limiting issue appears to be finding skilled, effective workers. Meanwhile, hiring, as measured by a moving average, is stuck at about a quarter-million per quarter. Another report this week that carries hope is that the most recent reported weekly filings for jobless benefits is at a 40 year low!

There is a logical, and with the increased stability at the government level, likely response to all of this. If employers raise wages, they might be able to fill some of those new openings. There is some evidence that may be happening.

- We are planning to be live and in living sound on KTEM, 1400AM, tomorrow morning from 10:00 to 12:00 or at ktemnews.com. Feel free to call in. As always, we welcome your comments, suggests, and questions.

Jeffrey W. McClure CFP®
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