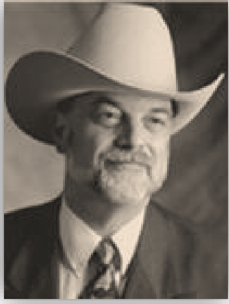

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TPWC Market and Economic Update

Admin Note

As you may or may not have noticed, our weekly missive missed publication last week. The primary causative factor was the Thanksgiving Holiday. Getting this missive out requires the efforts of multiple staff members to edit and review prior to publishing. When we get our letter out late on a Friday following the major economic releases and market reaction, the TPWC staff members often put in late hours. Over the Thanksgiving weekend we all took a little time to ourselves and our families. We do plan to be on the radio and internet tomorrow morning (Saturday) on KTEM 1400 AM from Temple and on ktemnews.com on the internet at the same time. Of course, we also are recorded for posterity on podcasts waiting on our website, www.tpwc.com.

The Markets

Stocks

This week ended with the The Dow Jones Industrial Average (The Dow) rising 370 points on Friday, or about 2.12% in a day, matched by similar gains in the S&P 500. That capped a week of downs and ups that, after a great deal of drama over interest rates that may or may not rise or fall here and in Europe, ended with a net change of very close to zero. The S&P 500 ended the week at 2091.57.

Last week too the markets were basically flat. That description applied not only to the week, but to the year-to-date figures as well as for the last twelve months. The S&P 500 Stock Index (SPX) started November at 2079 and ended at 2080, in a rise only an accountant could appreciate. During the last twelve months, entire forests have been felled to produce the paper for printing volumes about fears, hopes, and predictions about imminent stock crashes, swoons, recoveries, earnings, and on and on, but in the end we are pretty much back where we started. The SPX started 2015 at 2059. Had you left the planet and returned at the end of November, you would note that the SPX had risen a whopping 1%. Of course you would have missed several mild and not so mild panics as the doom-sayers predicted the end of civilization as we know it when the Federal Reserve either seemed about to raise rates or failed to raise rates, or, of course, when the tiny Chinese stock market panicked for no particular reason. 2015, at least with regard to the stock market, has reminded me so far of nothing so much as Shakespeare's Much Ado About Nothing.

This week's small rise was reported to be because A.) The European Central Banks might lower rates to a more negative number than was already in place, and B.) Because the Federal Reserve was almost certain to raise rates at its next meeting. No, that doesn't make any sense. It is not supposed to. The market moves in value and at the end of the day someone comes up with a rationalization. That is not cause and effect, it is random movement rationalized. In the short term the markets are random, but in the long-term they are driven by earnings and the laws of supply and demand.

Meanwhile, average corporate earnings for the companies that compose the SPX have actually declined year over year. In light of that fact, the question is not the commonly asked, "Why have stocks not risen this year?" but, "Why have stocks not fallen in value?" As with many other complex systems, the average can be misleading. Some companies, like Apple, have seen their earnings rise, and rise significantly, while anything that has the price of oil as a profit center has fallen equally significantly. The dollar has risen to the point where it is approaching par with the Euro, currently at about $1.09 to the Euro, but two days ago at $1.05, which has dampened export profits. The West Texas Intermediate (WTI) oil price, has declined to $39.00 per barrel, crossing the much feared $40 "resistance line." As the U.S. is a net exporter of petroleum, mostly as finished products, that hurt earnings, but at the same time, we are also the primary beneficiary of the tech gadget revolution as we effectively export phones, tablets, watches, and all the other stuff we used to equate with Switzerland and Germany.

Investors recognize that we are not seeing a decline in America, but rather a shift from old-style manufacturing, which includes refining, to the manufacture and export of new personal tools packaged in small metal boxes. We are also the center of innovation for practical robotics, with semi-automated cars probably coming to market within two years. Even more, while average corporate earnings fell, the American consumer, whose spending makes up about 70% of our economy, was recently reported to have

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increased that spending by 3.9% in the last year. Stock investors are fully aware that there is a lag between all of those things and the corporate earnings that they create, thus there has been no selloff.

2016 continues to be a subject of a growing consensus that the markets will repeat 2015 and do nothing. The opposing camp is insistent that 2016 will bring a full market correction. So, the consensus, at least among those market prognosticators that are being heralded by the news media, is that 2016 will not be a good year for stocks. Read on, good reader, to the end of the bond commentary, and you will see what at least we believe those forecasts portend.

Bonds

Bonds have traditionally been viewed as the alternative to stocks, but in 2015 they have been no salve, and particularly for American investors. Barclay's GlobalAggregate Bond Index is down 3.51% year-to-date and a negative 3.82% for twelve months. Its U.S. Aggregate Bond Index is up 1.13% YTD and 1.46% for the twelve months. If you had held one of the larger and least expensive total bond market mutual funds starting on January 1 of this year, Vanguard Total Bond Market Index Fund (VBMFX), you would have seen the price of your shares fall from $10.87 to $10.70 by the end of November. The posted fund expenses in VBMFX total 0.20% per year, which is among the lowest. If you had purchased bonds on your own or used a different fund, you probably would have seen a far greater loss.

The real surprise in not only VBMFX, but virtually every other bond portfolio with a maturity longer than "short-term," is in the average price of the underlying bonds. In this quite efficient Vanguard fund we reference here, the average, weighted market price of a bond is $105.12. The average effective maturity is 7.90 years. That means that the average bond in VBMFX is virtually guaranteed to lose 5.12% over the next eight years or so. If that was the end of the story, it simply would mean that of the 2.23% you would likely get in the next year, about 0.75% would simply be a (taxable) return of your purchase price, leaving you with a real yield of about 1.50%. The reality though is a bit different from that simple analysis. If interest rates rise over the next few years, and we would be quite surprised if they didn't, then that value of 105 could disappear in a very short time period and be replaced with the "par" or maturity value of 100. If intermediate-term interest rates (currently about 2.25%) rose to a level higher than the portfolio yield, then the average price per bond could decline below 100, and probably would.

In short, bonds have a distinctly possible long-term loss of about 5% to 7% built into them right now. Add in a probable 2.25% inflation rate and this very well and inexpensively run portfolio has a built-in potential loss of around 10% hard-wired into the system. As you may guess from this commentary, we are consciously avoiding all but short-term bonds in almost all the allocations we use.

Other Markets/Alternatives

According to The Economist, hedge funds are, on average, down about 7% this year so far, with some of the most famous down double digits. It appears that the really smart money is doing a lot worse than the "dumb" money, which, by the way, is, in the long-term, the way it really works. Alternatives, including the supposedly bullet-proof Master Limited Partnerships in oil pipelines, are hurting with more hurt to come. Other than losing money this year, the so-called "alternative investments" are also very illiquid, so even if losses are looming, the investors are stuck. We have stayed away from that trap. Anything that offers a supposed "sure-thing" promise of a higher yield than investment grade or government bonds, carries a risk, and that risk rises faster than the rates. Every "alternate" warns somewhere in the fine print that the investor bears the potential risk of losing all the money invested. No thanks.

The Economy

It is when recession is most feared that it is least likely to happen. Historically, in the securities markets, the future holds the outcome that is least expected. As an example, at the beginning of 2015, market prognosticators were pretty much equally divided between the bears, who predicted a major correction or a bear market, and the bulls who predicted high single or low double digit returns in stocks. We can find no evidence of any of the many predictions made as 2015 started that the markets would wind up in December almost exactly where they started in January. Markets work that way. Since the consensus appears to be for stocks in 2016 to either repeat their flat performance or decline, we are quite optimistic for a rise!

Last week the Commerce Department Bureau of Economic Analysis (BEA) announced its first revision to the third quarter U.S. Gross Domestic Product (GDP). Before we go on, it is probably a good thing to revisit just what that is. The Gross Domestic Product of the United States is the more or less official report of the net profits earned across the entire economy. It is composed of Personal Consumption Expenditures plus investment plus net exports plus certain government expenditures minus a particular form of inflation measurement called "the GDP deflator." It does not include government transfer payments, and interest payments are not included. Since our balance of trade is normally negative, the net exports figure is actually most often a subtraction from the GDP rather than an addition. In addition, the BEA includes "seasonal adjustments" in the components that

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make up the elements of the GDP.

All this adds up to the fact that the GDP is only part of the picture, but as long as the measurement stays more or less constant, we can get a pretty good feel for how things are going, while looking
at that number on an ongoing basis. There still is a bit of a problem though. The GDP of the United States is subject to no less than four successive estimates. Note that in each case the report is an "estimate." More, the "final" estimate (which may be revised later) is occasionally quite different from the first three educated guesses.

Having written all of that, the second estimate for the 2015 third quarter U.S. GDP was revised up from 1.5% (annualized, seasonally adjusted) to 2.1%. That amounts to a 40% increase, which is significant. Today, December 4, the Labor Department announced that employers added 211,000 jobs in the U.S. in the month of November, revised the October payroll gain upward to 298,000 and the September new job number upward to 145,000.

At the same time, despite nearly 750,000 net new hires in three months, the unemployment rate remained constant at 5%. No, that is not an error. What is happening is people who were previously not in the job market because they were not actively looking for a job have started applying for work. From an investor perspective that is huge! 70% of our economy is composed of consumer purchases. As more people enter the workforce and go to work a host of things begin to improve. First, they start earning money, which adds to the tax-base and increases government revenue, thereby decreasing deficits without a rise in tax rates. Second, after a lag that may last as much as a year, they start spending more money. That new spending increases corporate profits and corporate purchases, both of which increase earnings and stock prices.

Two other economic reports came out that together tend to confirm our belief that 2016 will be a great year for the economy and for investors. The Labor Department reported today that average hourly wages increased by 2.3% since last November. Better yet, an outsized portion of that increase went to earners at the low end of the spectrum. Low earners tend to spend pretty much all they earn. High income people tend to save and invest a large portion of what they earn. Yes, we need savings and investments, but spending is what increases corporate earnings. The second report that heartens us is that American worker productivity in the third quarter was revised upward to 2.2% on a seasonally adjusted, annualized basis.

To put that in a little perspective, wages were up 2.3%, but productivity was up 2.2%. If output had remained constant when wages were raised, productivity would have fallen. While adding the two numbers is not perfectly correct, what it actually means is that American workers are producing 4.5% more goods and services now than they were a year ago. More, employers are seeing that a 4.5% increase in production did not meet demand, so in the last moving quarter, they needed to hire an additional 750,000 people at slightly higher wages than last year. That number of new hired workers equates to about a 2% annualized increase in the number of workers. So, what we are seeing is the making of about a 6.5% increase in production in the making for 2016. Is that a sure thing? No, absolutely not. But, the historic record suggests that from that data, we are very likely to see a quite significantly better economy in 2016 than any we have seen in the last decade.

Until next week, we remain,

Sincerely yours,

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