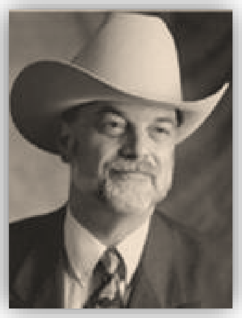

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TPWC Market and Economic Update

The Markets

The S&P 500 Stock Index (SPX) ended the week down about 1.83% at 2012.37. Year to date it is down 2.26%, and measured from this time last year it is down 1.13%. Bonds aren't helping portfolios much either with the Barclays Aggregate Bond Index up 0.90% over the last 12 months with all interest reinvested. Ten-year corporate bonds are down 2.74% over the last year, again with all interest reinvested. Even the Utility category, long known as the ultimate safe haven, with all dividends reinvested, is down 10.79% for one year.

The good news takes a longer look, as is so often the case. For three and five years the annualized return of stocks is quite good averaging in the high single and low double digit returns. Bonds, in general, have been a drag with low single digit returns for the longer period. In short, the larger and longer the "risky" asset percentage of a portfolio held over the past several years, the higher the portfolio's return, and that is the way it should be.

Still, things look pretty bleak over the past year or so. So what happened? Probably the single biggest factor this year in the essentially flat market performance has been the price of oil and low interest rates. A large portion of our economy is and was devoted to the historically very profitable industry associated with getting oil out of the ground, transported, refined, and purchased by consumers or industry. We will write more on this below, but if you look at the price per gallon of gasoline, you will have an idea of what the profits in the oil business have been doing. Energy companies are losing money on large investments. Meanwhile low interest rates and stricter controls have crimped the profits of the financial firms. The indicators for 2016 still look good, but for the moment, the losses in the oil patch and in high yield bonds have got investors scared.

Despite the bad news, the stock markets have held their own. That, believe it or not, is a big positive. Bonds are another story. Third Avenue Focused Credit Fund, a high-yield fund that specialized in a form of alternate high-yield (high interest) bonds, has blocked redemptions and filed with the SEC to make an orderly liquidation over the next several months. There has been a lot of speculation about the "thinning" depth of the bond markets, meaning that if there was a sudden demand to liquidate a class of bonds, there might not be enough buyers available to do the liquidations. That is what happened at Third Avenue Focused. A lot of the high-interest bonds were from oil companies, and those companies are headed into bankruptcy. Normally, there would be buyers, even for such bonds, but the potential for the assets of those companies being worth anything is getting pretty poor.

Just as a side note, gold is down about 30% since mid-2014 as well. If it looks like there is no place to get a stable, reasonable return without risk, it is because there isn't. Any company that promises a "guaranteed" return higher than that you can get in a CD at the bank or a short-term Treasury note is taking a risk, and conceivably, a really big risk.

All of that is why historically, long-term investors who ***stay*** in a well-diversified, mostly equity portfolio over the long-term, tend to get a higher total long-term return than those who use or move into "safe, guaranteed" savings vehicles. Staying put when short-term results are less than ideal is a large part of what separates the winners from the losers.

The prime lesson to focus on in this flat period can be seen in historic results. Historically, when the underlying economy is improving, but the market stays flat one or more years, it makes up for lost time suddenly and relatively dramatically. We are still in that transition we have written about before as we move from a recovery to expansion. Now we are in the waiting game. Sometimes those are the hardest times, but if history is any guide, patience will be rewarded.

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

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$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 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.

The Economy

The same low oil prices that are contributing to the no-gain market we see this year have a great deal of potential to kick-start the rest of the economy. Airlines are closing in on record profit years., You may remember that just a few years ago Airlines were facing bankruptcy on a regular basis, but with the price of fuel dropping, their margins are rising, and right at the busiest time of the year for them. Consumers, the largest portion of our economy are effectively getting a bonus from low gasoline prices, and probably will spend it on Christmas presents. With stock traders focused on the oil patch, they are quite possibly overlooking retail profits.

The big news this week is not the upcoming interest rate increase by the Federal Reserve, despite all the sound and fury over that subject during the past couple of years. The big news is that West Texas Intermediate (WTI) crude oil dropped down to about $36 per barrel in the futures markets. To put that in perspective, WTI was over $94 per barrel as recently as July 2014. It is down over 44% this year alone. We have discussed this before, but it is a simple issue of a whole lot of supply coaminge on line in an uncoordinated manner. It took years and many billions of dollars to develop those oil fields, and once the investment is made, they are going to pump oil. In a truly classic manner, most of them all started producing at about the same time. Meanwhile, Iran is reentering the oil export market, and not one is willing, or for that manner, capable of cutting back. OPEC, once the king of the oil pricing in the world, is now just a mutual complaint meeting. OPEC's oil output is approaching all- time records, even as oil, after adjustments for long-term inflation, returns to lows not seen in 30 years.

The best news out there is that hiring, productivity, and wage growth are healthy; more so than they have been since in at least the last eight years. As we have noted many times, thisere is the big indicator of the future.

Fair Warning

In the financial press, the latest news indicates that the sales of indexed fixed annuities areis breaking records. That is scary. We have had several inquiries about those incredibly complex contracts, but here are some simple facts that should help anyone make a decision on them:.

First, a fixed annuity, indexed or not, is a contract through which the purchaser loans a given amount of money to an insurance company. The money loaned effectively becomes the property of the insurance company and is co-mingled with its general fund. Note here that a variable annuity is a completely different vehicle and the invested money does not get co-mingled with the insurance company's money. In a fixed annuity the money a purchaser loans the company is subject to claims made by creditors of the insurance company, whereas in a variable annuity the investments in the underlying funds is protected from the insurance company's creditors by the Investment Company Act of 1940.

If the underlying investment portfolio of the insurance company does not do well, and the insurance company cannot pay its obligations, a fixed (indexed or not) annuity holder is simply an unsecured creditor of the insurance company.

Remember I said that the profits of financial companies have been crimped. They have, and insurance companies are financial companies. More, the majority of the investments made by insurance companies tend to be in longer- term bonds. If interest rates rise, those will be the places with the greatest market losses. If those bonds can be held to maturity, then all will be well, but in the event that deferred annuity holders decide they want to take their money back because the stock market is doing well, or because

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they can get a higher rate to maturity on new bonds, the insurance companies will have to sell bonds to pay back the annuity holders. That is exactly what happened to Third Avenue Focused Credit.

Insurance companies tend to have far more conservative portfolios than the Third Avenue fund, but here is the rub: . The Third Avenue fund investors will get their money back, albeit at whatever the fair market value of the underlying securities was at liquidation, but they will get it back. Third Avenue is a mutual fund under the Investment Company Act. If you hold an annuity contract at a given insurance company and they hit the wall, there is nothing backing your contract except perhaps a state guarantee fund that may or may not be obligated to provide some of your money back. Banks are insured under the FDIC. Stock brokerage accounts are insured under SIPC against the insolvency of the brokerage firm, and mutual funds are protected by the Investment Company Act. No federally chartered insurance company or act of Congress backs insurance companies.

The bottom line is that fixed annuities do a very good job of hiding the daily values of the underlying investment portfolio that backs them, so a fixed indexed annuity holder has a sense that all is well. When they go under though, and I have witnessed that happening, they are suddenly gone, often with little or no warning. Even if you were to see it happening, state laws allow insurance companies to defer refunding your cash value for up to six months without any reason. If they are in financial difficulty, that delay can be extended for many years. In the not very distant past, Executive Life of New York was finally liquidated by the Insurance Commissioner of New York, about 15 years after the a freeze on all liquidations. Many of the annuity holders got back about thirty cents on the dollar.

Remember, purchasing a fixed - , including indexed - , annuity contract is effectively making an unsecured loan to a single company for the duration of the contract. It is exactly as safe as purchasing a bond from that same company, except that there is no market on which you can sell your annuity contract.

As always, your comments and questions are welcome. We plan to be on the radio tomorrow from 10:00AM until noon (KTEM AM 1400, or ktemnews.com), so tune in, call in, and feel free to comment.

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