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TPWC Market and Economic Update

The first half of 2015 is most notable for what did not happen. The market did not rise (or fall) much at all. The Federal Reserve did not raise interest rates. Greece did not exit the Eurozone. The negative GDP of the first quarter did not create the widely feared recession. And, Russia did not invade any new countries. A relative small footnote in history will be generated by another disaster that did not happen: the Supreme Court did not overturn The Affordable Care Act (popularly called "Obamacare").

I stated that the non-event of the non-overturning of the Affordable Care Act (ACA), as the averting of a disaster. I also recognize that there are no small numbers of people who see the continued existence of Obamacare as the real disaster. Whether or not any of us like it, at this moment in time, a Supreme Court ruling overturning the ACA would, in reality, be an economic disaster. A small evidence of that reality is the fact that across the nation, for-profit healthcare stocks fell as the date for the decision approached. Following the positive decision by the Supreme Court, those stocks jumped upward. About 16.7 million people have health insurance because of the Act, and we, as a nation, insist that a hospital cannot turn away sick or injured people just because they cannot pay. Without the insurance those nearly 17 million people have, it is questionable whether healthcare institutions in the U.S. would be able to survive. More, the ACA included a tax on all forms of higher income (above $250,000 per year for a couple filing jointly), equal to what lower income workers pay into Medicare. Without that tax, Medicare would likely be bankrupt in a couple of years and the Medicare system would be legally unable to pay for healthcare without a specific tax increase by Congress, or a much larger borrowing authority. Neither of those would be politically palatable, so we would have a real crisis on our hands.

Obamacare is now vital to our economy and our healthcare system. The good news is that as of 2017, any state can come up with an alternative to the ACA to insure their residents, and as long as it does not increase the federal deficit, can institute that plan. So far, no state has even suggested that a better plan is in the works, which, given all the rhetoric, is a bit surprising.

The Markets

The S&P 500 was up a whopping 1.39% in the second quarter and just under 2% in the first half. Mid-cap value, the prime area of US stock market exposure for our portfolios, was up 2.11% for the first half of 2015, and actually was down 0.24% for the second quarter. When we look at Diversified Emerging Markets normally we see a very different performance than in Mid-Cap Value or the S&P 500, but this year they are cooking along at about the same (low) rate: down 0.24% in the second quarter, but up 1.88% since the beginning of 2015. Conservative Allocation is up 0.71% for the first half but down 0.91% in the second quarter. Like I wrote above, so far 2015 is more notable for what didn't happen!

On the other side of the coin, intermediate term bonds, an asset class we got out of last year, were down just over 2% in the second quarter and declined about a quarter of a percent in the first half. Short-term bonds, an asset class we moved into as part of our replacement for Intermediate-Term, is up about 0.68% so far this year. The Barclays US Aggregate Bond total return is now down about 2.36% year to date, so our move out of intermediate term bonds is finally saving us from some loss!

The stock market (as measured by the various indices) does not rise in a straight, smooth line, but either runs flat or dips for a while before suddenly, and unpredictably, exploding, sometimes in just a couple of days, to new highs. We are in one of those flat to slightly-down periods. Meanwhile, the underlying health of the companies whose stocks compose the "stock market" continue to see growth. Stocks will catch up, and most likely, with a very sudden move.

Long-term, the stock markets are poised to appreciate. Short-term, I am reasonably confident we will see dips. I have no idea what will be the listed cause of the next short-term market decline, but we have gone a long time without a good "correction" in the U.S. markets. Short-term investors are a lot like sheep or a flock of birds, always ready to be spooked by surprises, real or imagined. The fact is that we are a blessed nation, thriving as the rest of the world does have some legitimate

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things to fear.

The Economy

We don't know yet what the GDP of the United States did in the second quarter, but all signs suggest that it was positive, and overall growth is on track for a 2.5% to 3.5% GDP rate in 2015. Unemployment just dropped to 5.2% as we continue to add about a quarter of a million jobs each month.

The U.S. Economy is currently, by any measure, the largest, and clearly the strongest and healthiest in the world. All the leading indicators continue to suggest that 2016 will be an excellent year for the United States, no matter what happens in Europe. Rumors continue to abound that the Chinese will soon pass the United States in having the largest economy. Frankly, I doubt that will actually happen. China is hitting the point of diminishing returns and its infrastructure is currently at about its maximum capacity.

The Greek Drama and the Remaining Issues

The Greek drama appears to have more acts to play out, but the most significant thing about the present culmination of this part of the excitement is that the Germans, who previously were considering giving Greece the boot, have reconsidered and instead are willing to back a $100 billion loan that no one who understands anything about such things could reasonably expect to be repaid. The Germans, and possibly the rest of the Eurozone has figured out that maintaining the pretense of future Greek solvency is a far better solution than dumping a Eurozone nation into chaos (and possibly the hands of the nascent Russian empire).

The on-again, off-again Greek debt crisis is just the most visible of the hangover issues from the great speculative frenzy that began in the mid-1990s. As the cold war ended, a lot of money around the world that had previously gone into military spending went looking for something from which to profit. The Germans absorbed the states of the previous East Germany and found themselves with a lot of low-cost labor and a deeply wrecked economy in the former communist state. The German government and industry worked in concert with the other northern European nations to create a common currency across Europe. Once the Eurozone was established, Germany led the rush to sell a huge quantity of consumer goods, houses, cars, trucks, and all the delights of modern northern Europe to the traditionally impoverished Mediterranean nations and their citizens, all, of course, on credit. The Germans not only were then able to pay for the modernization of the former East Germany, but, as a nation, became quite wealthy.

It was happening in the United States as well. The Internet boom was on, and stocks soared as unemployment fell to near zero. States and corporations increased their pension levels to retain workers, and the stock market made their pension funds into huge piggybanks. Then the stock market collapsed, first in 2000-2002, and again in 2008-2009. In a futile attempt to make up the difference, the building industry, banks, and insurance companies worked together to sell houses in what any rational analysis would show to be a fool's game. As with Greece, it was the wealthy profiting from the poor and even from well off people who thought buying and selling empty houses was a sure fire way to get even more wealthy.

At the end of the cycle, much of the inflated value had disappeared but the debt remained. It is obvious in Greece, and to a lesser extent in Portugal, Spain, Italy, and Ireland. What is not so obvious is that Russia and China owe Eurozone investors amounts that make Greece's debt look tiny. Here in the United States, first Puerto Rico, and probably the states of Illinois and New Jersey, and the city of Chicago among others, are going to have to find a way to reduce their debt because they simply do not have the means to pay it back. Municipal and state debt defaults are not over, and may get worse before they get better.

Fortunately, the United States Government is not in deep debt. In fact, our government holds more than sufficient gold reserves, not to mention the millions of acres of land and other assets it has on hand, to pay off its entire debt held by the public. The federal government is quite financially capable of coming to the aid of defaulting cities and states, but there is no law authorizing it to do so. The folks left holding the bag will likely be the municipal bond owners. This debt cycle is working itself out, and in a few years we will very likely emerge from it and start the stock market boom cycle again. Meanwhile, for bonds and those who hold them, the hazards are legion.

The Danger Inherent in Higher Interest Rates

There is a fundamental issue to be learned from the debt crisis; unfortunately most investors with whom I have spoken don't seem to have grasped that issue. We are in a time of very low interest rates, and the "safe" savings vehicles such as bank certificates of deposit or short-term Treasury securities, pay less than 1% per year. Even a ten-year Treasury note, which carries a risk of loss if sold prior to maturity, currently is paying 2.38% per year.

Those are the only truly "safe" rates and, as I just noted, the ten-year Treasury could be worth less than you paid at any point prior to maturity. If that is true (and it is) then what does it mean if an annuity company offers you a higher "guaranteed" interest rate if you will buy one of their annuities? It means that you are taking a significant risk that you will lose money! In fact, if someone offers you an interest rate guarantee higher than that of a Treasury security or CD at any point, you are accepting a level of risk that rises faster than the promised rate.

Beware of any offer or history used as a suggestion of future returns where both short-term safety and high returns are combined in an effort to sell something. Those elements do not work together. There is no return without risk, and if someone suggests that high return can be accomplished without risk, then the hidden risk is so great that were you to see it, you would not give them your money!

Inflation and Gold

If you think back a couple of years, you may remember the talking heads, particularly on Fox, warning about the coming hyperinflation and urging you to buy gold. In 2011, the futures contracts on gold priced it at around $1,900 per ounce. On July 20, gold hit a five year low around $1,095, and appears to still be falling. We said at the time that *deflation* was the threat, not inflation, and that buying gold was a really bad idea. As things stand today, had you timed the market perfectly in 2009 and bought gold at the exact bottom of the gold market, in the midst of a market panic, today, after the buy/sell markups, you would have made $0 on the gold, but would have paid some fairly substantial storage fees over the ensuing six years. In other words, gold was and is a losing proposition. It has been declining in value for about 650 years, and there is no evidence that trend will change.

The domestic inflation rate continues to run along at 1% per year or less. There is some evidence that we could see that rate rise to the 2% per year that the Federal Reserve has set as its target, but there are literally no signs anywhere that suggest a higher rate in the works. The recent decline appears to be at least partly generated by the Chinese government selling large quantities of gold. It is reasonably clear that the Chinese have determined that dollars are more secure than gold. That actually makes a lot of sense.

Cyber Security

You probably are aware that the U.S. Office of Personnel Management (OPM) managed to provide the security clearance application data on about 44 million people to the Chinese intelligence services. After looking at how that happened we could easily see pure idiocy in contracting out the job to write their database software to a Brazilian company which, in turn, subcontracted it to a Chinese company known to have close ties to Chinese Intelligence. But what about *your* computers?

First, it is critical that you have a good internet-security/anti-virus program running at all times. In choosing what company to use, I strongly recommend you NOT use Kaspersky, Bloomberg recently ran an article noting that Kaspersky's headquarters was literally "next door" to the Russian intelligence services. Eugene Kaspersky is a former Russian intelligence officer and his company has claimed a "close relationship" with the intelligence services of the Motherland. Kaspersky has, among their publicized contracts, one in which they serve as a provider of information and advice to the Iranian government, and its nuclear program.

The idea of having a company that openly acknowledges it shares information with Russian intelligence *and* the Iranian Revolutionary Guard with complete access to millions of American computers is rather alarming to me, but it is a reality. The only thing worse are the millions of computers here in the United States that have no protection and are routinely used as "agents" of foreign intelligence services and hackers.

The second thing I recommend is wherever you have the chance, to set up two-factor security. Two-factor security could, for example, send a text message with a code to your cell phone each time you logon to your bank account or credit card web site. Here at The Personal Wealth Coach, if you contact us digitally requesting money, a change of address, or any other activity that might be damaging to your affairs, we will call you on your phone to validate that request. That is an example of two-factor security.

The Chinese Factor and American Dollars

Something that *did* happen in the first half of 2015 was that the Chinese stock market came close to doubling in value and then started into a free-fall that may or may not continue. The Chinese economy is very much like a man carrying a heavy load on his head while riding a bicycle. As long as he keeps going fairly fast he will remain upright, but if he hits a bump or gets too slow, a crash is a given.

There is a lot of concern in the United States about our "national debt." The fact is, as I wrote earlier, that our federal balance sheet is in a very nicely positive position, and our current new-debt issuance is only about $50 billion per month. That may sound like a lot, but it is less than the growth in our economy, so in fact, it is resulting in an actual shrinking of the federal debt outstanding. The Chinese have a different situation.

The Chinese "national" debt is relatively small, however; the total debt owed by state-owned companies and guaranteed by the Chinese government is a *larger* percentage of their GDP than our federal debt owed to Treasury bond holders around the world. The Chinese do not have Social Security, Medicare, or Medicaid, so they theoretically owe nothing to their older citizens. That makes their debt seem lower than ours, but it is not so. Chinese law obligates the single child (that is all they could have) to provide payments to his or her parents at a level sufficient to provide for a reasonable minimum standard of living. If a couple has no living children in China, then the government will provide them with a stipend. When the Chinese figure their debt, they don't count those figures!

As a relevant fact in this commentary, the Chinese currency, the Yuan Renminbi, is backed by U.S. debt held by China, and the Chinese use dollars for foreign transactions. Oil, worldwide, is priced in dollars and mostly paid for in dollars. Whether anyone likes it or not, the world economy runs on U.S. debt instruments as its currency. There are those who seem to profit from spreading rumors that some mysterious new currency will come out of China to dominate the world. China has an unstable economy and has to import natural resources. Its official GDP does not match with other numbers that can be verified, and its currency is backed by and based on its U.S. dollar holdings. There are things worth worrying about, but the demise of the dollar is not one of those things.

A Final Word

I have spent most of my adult life studying history and have a small library of books on the subject. My focus has been to determine if there are patterns and if there are cause and effect relationships that can enable us to determine what is likely to happen to us in the near and intermediate future. I have concluded that there are patterns and relationships, and that they can be used to give us a reasonable understanding of what is likely to come.

My understanding of history tells us now very much the same thing it told us in 2009 when we predicted not a further collapse as some were promising, but a recovery that would put the United States in the number one position in the world, and keep it there for a long time to come. The United States of America is in better shape, in every aspect of its existence, than it has been at any point in its history. That is the good news. The even better news is that, in absolute terms, we are the fastest growing economy in the world. The 21st century is shaping up to be a truly American century.

Is there reason for caution? Of course! We could shift to isolationism, or enact laws creating strict austerity. Alternatively we could become irrationally exuberant and dump great quantities of borrowed money into schemes that produce nothing and leave devastation in their wake. We have done all of those things at different times in our history. What I see though is a growing sanity and a great potential for increasing growth and prosperity for the next decade and more.

As always we are open to your comments, questions, and general discussion.

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