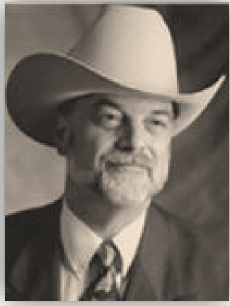

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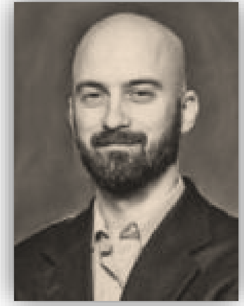

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January 6, 2016

TPWC Market and Economic Update

@ the New Year

2015 is finally behind us and bravely we sally forth into 2016. Well, I don't know how bravely, but we don't have much choice in the matter, so we might as well be brave about it. We continue to be optimistic about 2016 as we have been for the past six or so years. The wild card has been the dramatic reduction in oil and other mineral commodities prices. Cheap commodities have the potential to be a long-term plus, but in the short term have an equal potential to cause some pain.

The Markets

Both the S&P 500 (SPX) and the Dow Jones Industrial Average (the Dow) declined about 1% for the year 2015. I wish I could tell you that bonds, the traditional alternative to stocks, did a lot better, but they didn't. According to Morningstar, the average long-term bond fund in the United States lost about 3.25%, even with all interest reinvested. Even if a person had selected domestic asset classes from the beginning of the year knowing the end, the result in a reasonably balanced portfolio would have still been negative. Along the way, rises and falls of more than 1% per day were, if not common, at least frequent. That unpleasant news is compounded when we look at, for example, Diversified Emerging Markets, historically both the highest return asset class we track, and the most volatile. The average fund there was down about 16% for the year. Conservative Allocation funds, traditionally one of the safer places to invest, declined about 2.30%.

The one reasonably bright spot was short-term bonds. We include that asset class in portfolios because sometimes all the places that over the long term have made the most money, don't. Short-term bonds turned in a whopping 0.16% on average for the year. That is a very, very small gain, but it was not negative!

The worst news and record was turned in by just about anything that was "high-yield." As is common when interest rates are low or even falling, individuals and yield-hungry companies turn to some form of "sure-thing" that will pay a higher interest or dividend rate than more conservative securities or the bank. According to Morningstar, the average high-yield fund was down about 4% for the year, but that masks the reality that the high-yield funds that were paying the best interest rate were typically down about 7% to 8%. Note here again, that those numbers assume all dividends and interest reinvested. If an investor was taking the interest as income the decline in invested value was typically double-digit.

Possible Market Indicators

There is a stock market indicator that has proven to be reliable over the long-term when it comes to market valuation, but which seems to be widely ignored in the short term, and is the most basic of real issues. The fair market value of a stock is at least theoretically based on the profits, or "earnings" of the company. In order to understand that number, one must also look at the "no-risk" return for a given period of time. A person investing in a well diversified stock portfolio should plan on a holding period of at least ten years. That is what we call the "time-horizon." The idea is that given a reasonable valuation in the markets, like we have now, at the beginning of the ten-year period, historically the market has a good, measurable, gain ten years later.

The exceptions are those times like the year 2000 when the S&P 500 had a price to earnings ratio of about 30, and which quickly rose to 45 in 2001. A P/E ratio of 30 equates to a 3% earnings yield on stocks. A P/E of 45 equates to about a 2% yield. As inflation in 2000 was running at about 6%, and the ten-year Treasury Note was yielding about 6.6%, the S&P 500 was pretty clearly in for a bad time ahead and indeed, took over ten years to recover.

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So where are we now? Currently the trailing earnings yield looking back one year on the S&P 500 is 5.21%, based on the price of the Index on 12/31/2015. That number looks better when we look at the consensus earnings estimates for 2016. Based on that number the earnings yield of the S&P 500 is about 6.14%. Note here that since the late 1990s, consensus earnings estimates have consistently been lower than the actual numbers that came in. On January 1 of this year the yield on the ten-year U.S. Treasury note was 2.25%. Very interestingly the dividend yield, that is to say the actual cash payout of the S&P 500 for 2015 was 2.25%.

The bottom line here is that if one has the willingness to hang on to an investment for ten years, the stock market is paying the same cash-yield as a U.S. Treasury, no-risk note and additionally is reinvesting about another 4% per year. The difference is that the stock market investment has the potential to be worth a lot more in ten years while the Treasury note will only pay out exactly what is on the face ten years hence. History seems to indicate that major bear markets start when the S&P 500 earrings yield is less than that of a ten-year Treasury note.

Another indicator that we have talked and written about for years is that of investor sentiment. With stocks starting the years in decline, there is, of course, some reason be concerned, but historically reality is the reverse of that. Bear markets begin on "irrational exuberance" as investors across the board deny that there could possibility be any serious losses. In my reading today, I cannot find a shred of optimism, which leads to the other side of that formula. "Bear markets climb a wall of worry." The worry is thick and deep while the exuberance as we begin 2016 seems to be totally absent. As strange as that sounds, the very fear I sense in the markets is a strong indicator of better times ahead.

That rational, logical, reasoning is sound, but in the short term, as we have seen repeatedly, the market is anything but rational. China, as an economy, has very little impact on the U.S. economy, but we saw a market drop this week supposedly because the Chinese stock market and the price of oil declined. More, the worry is not that the Chinese economy might collapse, or even decline, but that it might not grow as fast as it has in the past. That the U.S. stock market should go into a mini-panic over that is just further evidence that we are still climbing the wall of worry inherent in a bull market.

The Economy

If there is a single economic indicator that tells us more about the real underlying state of the American economy than any other, it is new car sales (which includes light trucks). It appears that December 2015 may be the best car sales month in the history of the industry! It also appears that when the final numbers are tallied, 2015 will match or exceed the year 2000, the best year to-date. GM has already reported sales of 17.5 million vehicles, breaking the previous all-time record of 17.4 million sold in 2000. Another powerful indicator in the American economy is the Christmas season spending. That number appears to be up about 7.9% over last year, at least according to MasterCard.

The problem, and the most likely reason for the market decline on the first day of trading this year, was, and is, a fear of deflation. Note here that I wrote deflation not inflation. China again slightly devalued its currency on Monday and there is fear that will happen again. The net effect of that currency shift is to make goods manufactured in China less expensive here. That sounds good initially, then the realization hits that if prices start to fall, so will wages and spending. That is the dragon the Federal Reserve has been fighting.

At the same time the world economy is seeing a glut of commodities on the market. Copper mines, gold mines, oil wells, and just about every other kind of mine or well category have significantly increased their capacity to extract the materials we use to build or operate our economy. A lot of money was invested to create the super-mines and huge oil fields that are doing that producing, and as they all largely came online at about the same time, the production greatly exceeded the demand. When supply exceeds demand, prices fall. The logical thing to do would be to reduce production in the face of falling prices, but most of those facilities were created with borrowed money. Paying back the loan on schedule involves producing those commodities and selling them. As a result, the mines and wells are still producing, even though in many cases the cost of production is now greater than the price the extractors are getting from the market.

That issue is not over, but hopefully is in its final stages. By that I do not mean that commodities will rise in value, but that at some point we will see the decline stabilize into a more or less consistent but low set of mineral commodities prices. The problem, much feared and thereby unlikely to blind-side us, is that a LOT of money was loaned to companies to build those mines, drill the wells, and create the infrastructure needed to get the minerals to market. Current prices of just about all industrial commodities appear to be too low to support a successful payback of those loans based on the contracts in place. That means that whoever loaned all that money to the companies who did all that expansion is unlikely to get their money back on time, or potentially at all. The major banks, insurance companies, and any other company that bought the bonds or made the loans may see a severe earnings hit.

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Only time will tell what the impact will be of such dramatically reduced energy and minerals prices, but so far the underlying economy seems to be doing quite well. In fact, if one removes the oil-related companies from the S&P 500, the earnings rose about 5.7% this year. The fundamental economic numbers suggest that the rest of the economy will more than make up for the reduced earnings of the oil companies. In fact, the reduced energy cost may well filter through to the rest of the economy as a gain. That may well be what we are seeing in the vehicle sales and Christmas spending numbers.

As always we are here to answer your questions. Feel free to call, email, or write.

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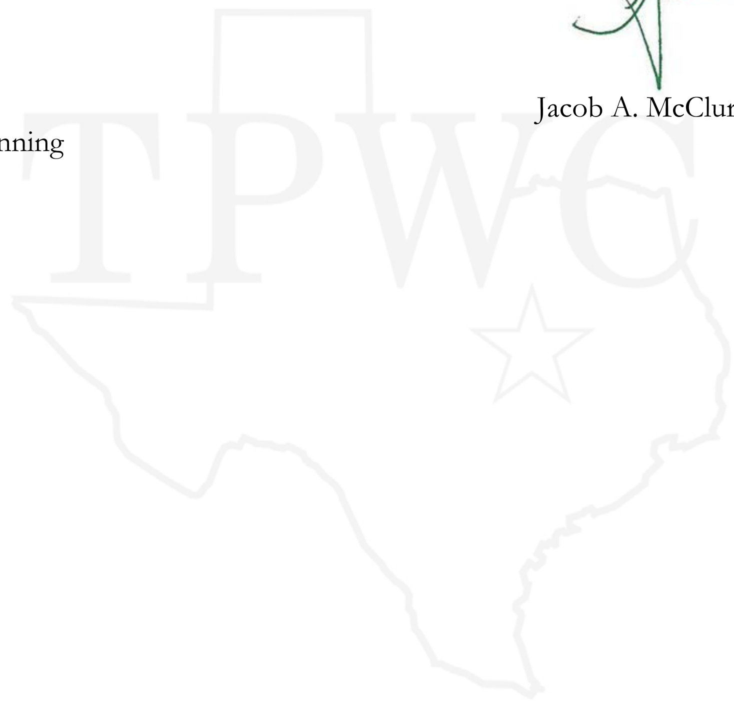

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