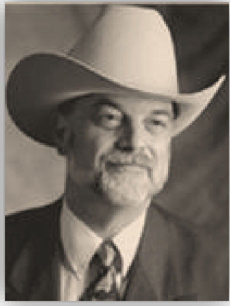

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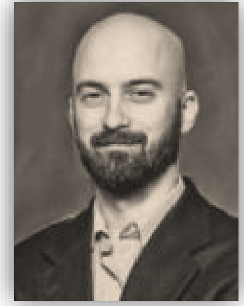

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TPWC Market and Economic Update

The Markets

It's official! We are now in a full-fledged "correction" with the S&P 500 closing today at 1857.83, down 12.98% from its high of 2134.72 on May 20 of last year.

As a quick refresher, a "correction" is when a major stock market index falls at least 10% from a previous high mark. On the other hand, a "bear market" is called when a major index drops 20% or more. There have been 21 corrections and, officially, 12 bear markets in the 70 years since the end of World War II. On average, we have seen a significant market decline about every two years and one or two months. Our last official "correction" was in 2011, so we were a bit overdue.

The big question is whether or not we are looking at a bear market, like we saw in 2008-2009, or in the previous one that occurred in 2001-2002. Technically the one before that was in 1987, and the fear level was there for that one, but it lasted such a short period of time that some analysts have long suggested it was more of an overblown correction than a true bear market.

So, let's look at the characteristics of a real bear market, the kind that devastates investment portfolios and seriously threatens the financial well-being of not only individual investors, but the entire economy. We certainly had one of those in 2008-2009. I have been around long enough to remember the bear markets in 1973-1974, the 1982 bear, and, of course the panic of 1987, as well as quite vividly the bear of 2000-2002. All had some distinct things in common, but the really serious bears were preceded by some special characteristics. First, each bear market was preceded by overwhelmingly bullish sentiment in which every financial publication had issue after issue of optimistic forecasts, and a mania of irrational expectations was firmly in place. In that mania, the "hot stocks" soared into price-to-earnings ratios (P/E) that defy any reason. It happened to the "nifty-50" stocks that "everyone should own" in the late 1960s and early '70s. The price-to-earnings ratio on an equally weighted basket of those 50, "sure-thing" stocks was at 30 when the market started to fall, and rose to 50 before the owners of that "absolutely safe" list of major U.S. companies began to dump them. Most of those high dividend, supposedly rock-solid, cornerstones of the American economy do not exist today.

Just in case you are not familiar with P/E ratios, a ratio of 30 means that it would take 30 years of this year's profits to equal the current price of a share. Another way of looking at a P/E ratio of 50 is that the earnings yield of that company would be 2%. Currently the S&P 500 earnings ratio is a bit above 6%. Considering that bonds are paying 2% to 3% from those same companies, stocks look pretty attractive.

In 1973 as the market peak was hit, there had been a rush into stocks over the previous several years as the media proclaimed a new era of unlimited growth. Then, the U.S. was hit by a double whammy of the Arab oil embargo with the price of oil more than doubling and the first loss of a war in U.S. history (Viet Nam). The President took us off the gold standard as France demanded an exchange of dollars for gold, and the immediate effect was suddenly accelerating inflation. Note that the underlying economic cause of that severe bear market was oil prices rising and accelerating inflation. Remember that combination.

The next bear was in 1982, and was both relatively short and clearly caused by a massive increase in interest rates by the Paul Volker chaired Federal Reserve. That bear market and accompanying recession were consciously engineered by Chairman Volker in his successful effort to knock out runaway inflation.

In 1987 we had a very short bear market with a recovery in about six months. That 30% decline started in August, hit bottom shortly after "Black Monday" in October, and by the spring of 1988 was history. That one was caused by a mass purchase by individual investors of "portfolio insurance" that purported to guarantee high returns with no risk of loss in individual stocks. It, in essence, was orders to automatically sell individual stocks if they declined more than about 10%. When they did, a huge wave of automated sell orders hit the market and there were not enough buyers to fill them. The prices, as a result, went into free-fall. There was no associated recession, and, in the long term, no economic effect except on those who tried to sell when the market fell.

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Many of you remember the dot-com mania of the late 1990s that preceded the bear market that stared in late 2000 and bottomed in August 2002. The 2000 bear dropped the markets about 50% and we did not see a full recovery for over ten years. Very notably that type of bear is sometimes referred to as a “secular bear market” as opposed to a “cyclical bear”. Cyclical bears are associated with the business cycle of ups and downs in inventory and sales. Secular bears take a long time to fix and are preceded by a massively overpriced stock market. Those are the ones to fear. We have had just three since the beginning of the 20th century. The first started in 1929 and did not fully recover until after World War II. The second started in 1973 and did not see a full recovery until late 1982. The third was the secular bear that began in 2000 and, in reality, did not end until 2011.

What we face today, and note this, is extremely low inflation that could go lower and *falling* oil prices. Very notably, we had a correction in 2004 linked to *rising* oil prices. The major bear market of 1973 was almost certainly a result of a combination of a sudden rise in oil prices and rising inflation. Rising inflation equates to a rapidly falling dollar and feeds on rising oil prices. Again, today we are seeing short-sighted investors panicking because of *falling* oil prices and a *rising dollar*. Throughout our history, falling energy prices equate to faster future economic growth. While a rising dollar definitely hurts our ability to be competitive in exports, the idea that it will damage our economy is foolish! For the last four decades and more, we have maintained a negative balance of trade, which is to say that we import a lot more stuff than we export. Since a high dollar creates a reduced price for imports, again that is ultimately good for our economy.

So then if that is all true, and it is, then why is the stock market down almost 13% from its highs last May? More, is it likely to fall a lot further? Those are the real questions.

First, corrections occur when investor sentiment turns negative. No one has ever figured out how to effectively predict that. During the transition from *recovery* to *expansion* following a major bear market, in every historic case I can find, there has been a correction that marked the shift. Sometimes that correction was pretty severe, and in others it was minor, but it was there. Bear markets are created on, as Chairman Greenspan so quotably said, “Irrational exuberance.” Corrections are spawned by slowly rising fear that culminates in a panicked selloff. What we saw in the markets today was clearly a panicked global selloff following a slowly rising tide of worry.

Market declines, such as the one we are seeing today, have successfully predicted 15 of the last 8 recessions. Yes, I wrote that correctly. Mr. Market, when he slumps, has predicted the negative event that the slump was in fear of about half the time. The other half of the time, the economy was just fine and the traders suddenly woke up and realized that shares in the market represented a huge buying opportunity in a healthy economy. Usually even more suddenly than the decline hit, the market jumped upward with a vengeance. To date, absolutely no one has come up with a method of forecasting when that will occur, but the strongest indicator is the absence of bullish sentiment. According to the American Association of Individual Investors, their members report the lowest bullish sentiment since the market bottom in 2009. In short, this is a pretty classic correction. Corrections generally last between a few months and about 18 months. As this decline started in May of last year, the odds seem to be in our favor for a recovery that will be sooner rather than later. Still, only time will tell.

The Economy

The big news this week is that West Texas Intermediate (WTI) oil futures fell below $30 per barrel. There are a lot of factors behind the massive decline oil prices, but the biggest is that a heck of a lot of oil came on line in the United States as a result of those prices hitting $147 per barrel a few years ago. This cycle of high oil prices, followed by huge investment and technological advances in extracting oil has repeated itself since that black smelly stuff was first used as fuel. Those advances take several years to bear fruit. If only a few companies got in the game, that would work out well, but what happens is a LOT of companies get on the wagon. A lot of banks loan them money to get some of that $100(+) oil, and they pretty much all start pumping oil at about the same time. In this case, that problem is compounded by the fact that both Iraq and Iran are coming on line with some pretty high volumes of oil too.

China is getting the blame for just about everything, but the reality is that China, while a big exporter, is a low importer of what we make. Yes, the Chinese economy appears to be growing at a lower rate than before. We have warned about that for several years. There is a simple principal at work here called the law of diminishing returns. The larger something grows the less fast it can grow in the future. China is not immune to that law any more than is an elephant or a mass of algae. The U.S. exports to China constitute a very small part of our economy. China’s reduced speed of growth is an economic plus. We get cheaper imports and China focuses on internal matters instead of trying to claim a large swath of the South Pacific as its territorial waters. Yes, those economies that were focused on selling raw materials to China are going to hurt, but that is an issue in any economy that runs on raw material exports. Boom and bust are the norms.

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Meanwhile, as fourth quarter earnings are starting to be reported, the banks are starting out with earnings higher than forecast, and generally are hitting levels not seen in a decade. Citibank reported today that it earned about ten times as much in the fourth quarter as analysts had expected, and the main source of those earnings was from consumer credit card transactions. MasterCard reported that card transactions over the Christmas season ran about 7.9% higher than last year. Wells Fargo reported very slightly higher than expected earnings while J.P. Morgan reported earnings about 5% higher than expected. What does that mean? Primarily, it means that the consumers that make up about 70% of our economy are spending more. It will take a while for that activity to show up in the official numbers, and then, I suspect it will be disbelieved. That behavior, by the way, is the reverse of what we see in the opening months of a bear market. The early stages of a bear market are marked by bad economic news and falling earnings, with the media pundits proclaiming that we should not pay attention to the "temporary" bad news. Early bull markets are marked by good news and good earnings, particularly in the consumer financial area, with the pundits ignoring it and proclaiming that the world is coming to an end.

The Bureau of Labor Statistics (BLS) reported that non-farm payroll employment rose by 292,000 in December and the unemployment rate held steady at 5%. What that means is that while almost 300,000 people became employed who were unemployed before, at least that many entered the labor force. That group entering is mostly folks who were out of work and had given up, but are now returning. Over the last year, the number of people who are looking for work but unemployed has declined by 800,000. During 2015 the United States created and filled 2.7 million new jobs. Construction, one of the better indicators of economic growth, added about 263,000 new jobs for the year. Hourly earnings for those workers was up 2.5% for 2015 too.

Lots of numbers there, but they are important. In 2015 the newly employed people earned about $118 billion that was not earned the year before. Add that to the earnings of the rest of the employed people who saw, in total, a 2.5% raise, and you have some real additional money in the system. The most important aspect of that is that employers are very hesitant to take on new workers and only will do so when they see that business is likely to rise enough to justify both the expense of paying them and the cost of training them. Businesses hiring are the strongest indicator of what the near future is likely to hold. As an example, those rises include the layoffs that are and have been sweeping the oil fields. The future there is reflected in layoffs. The rest of the economy is more than making up for it. That is the economic reality as it stands today.

We fully intend to be on the radio tomorrow, so if you have any questions be sure and give us a call. (254) 773-1400 or (866) 597-1400 from 10:00 to 12:00 on KTEM AM 1400, or www.ktemnews.com. We, of course, always welcome your calls, letters, or email here at The Personal Wealth Coach®!

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