THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

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TPWC Investor's Letter

The Economy

The Department of Labor reported that in February the U.S. economy added 295,000 jobs and in that same report added a total of about as many to the previous couple of months' reports. That number was well ahead of what the consensus of economists' estimates had predicted. This month, the number of new jobs reported for March was 126,000, or not enough to match the new workers entering the labor market. So what gives? Is the economy going great guns, or is it about to slip back into recession?

There is, amazingly, a simple way to find the answer. The Conference Board is a non-profit organization that has been around since 1916, and in that time has almost universally provided accurate predictions on the direction of the American economy over the next six months to a year. Its prognostications only very rarely make the news because it is, frankly, *boring*. For example, The Conference Board Leading Economic Index® (LEI) increased 0.2% in February following a 0.2% increase in January, and a 0.4% increase in December. Those numbers don't make very riveting headlines.

They may be boring, but the LEI is so predictive that it seems we cannot have a recession without the Conference Board's prior written permission. From time to time the LEI suggests we may be headed for a downturn, but then turns around and cancels the alert and we don't have the decline. What it does not do is forecast good times when a recession is looming. A rise of 0.2% in a month may not sound like much, but it is a good indicator of what is and has been happening. The U.S. economy has been growing at a rate between 2% and 2.5% per year for the last several years.

The slow growth of our economy in the recovery from the 2008 recession has been quite out of synch with the relatively fast growth we have seen in other recoveries from recessions over the past half-century. Those recessions and recoveries were "cyclic," while this one is what is sometimes called "secular." In other words, this one is different from those other recoveries we have experienced in that past 50 years.

Previous recessions and recoveries were primarily the result of businesses ordering a steadily higher quantity of goods to sell as sales increased. Eventually, the consumer runs out of money and credit to spend and pulls back. The businesses are left with too much inventory and too many employees. Those businesses start to lay off workers and stop ordering new products, resulting in more layoffs, which, of course, reduces the number of consumers with excess money to spend. Eventually, the consumers pay off their credit cards and start buying things again, business start ordering and hiring and things recover nicely. That is called "the credit cycle" or sometimes "the business inventory cycle" because it was in place and cycling long before we had common consumer credit.

The "great recession" of 2008 (which in previous centuries would have been called "The Panic of 2008") was different from those cyclic recessions. In the 2008 event, major financial institutions vanished, taking with them the vast majority of the dollar value they previously held. Holders of stocks and bonds issued by the old General Motors, Lehman Brothers, or any of the other bankrupt, seized, or vanished companies saw the total value of their investments disappear. That obvious loss of value is but the tip of the iceberg. For

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every dollar a shareholder or bondholder lost, literally thousands of dollars held on the books of banks, pension funds, and insurance companies ceased to exist.

A good analogy can be made to the functioning of the human body. When a person gets a viral infection such as a cold or influenza, their ability to function normally and productively is reduced, but once the infection is beat, the recovery is generally fairly fast and brings the person back up to speed in short order. On the other hand, if a person has organ failures and needs a massive transfusion and even transplants, the recovery is slow and it may be years before full functionality is restored. Our economy lost a *lot* of capital. That is the equivalent of a person losing a *lot* of blood. The federal government and the Federal Reserve pumped fresh capital into the system at an unprecedented rate and volume. That huge transfusion of literally trillions of dollars into our economic system, combined with artificially removing and replacing large systemic parts of our economy, appears to have saved the patient's life, but the recovery has been slow.

In Europe where the same malady appears to have struck, the remedial treatment was much more conservative and gradual. As a result, that economy is still in crisis. Continuing the medical analogy, our economy is recovering nicely, and is functioning on an "out-patient" basis. The Federal Reserve is now suggesting that we may soon be declared to be in full health and taken off the ongoing medication of effectively zero percent interest rates.

We have been in recovery for six years since the so-called "Great Recession." During those years we have not had another recession, which is longer than the usual time between those events. The reason that there is no sign of a recession on the horizon is that we have been recovering so slowly that we have not gotten ahead of the consumer. In fact, there is still a sizable pent-up demand rather than an unsustainable buildup of credit. There is a great deal that suggests that we will see better growth in the next few years than we have seen in the recent past.

Stock Markets

The stock and bond market indexes are vital indicators for the economy. While for periods of time the financial markets may fail to reflect underlying realities in the general economy, over a longer period they do return to that economic reality. Stock indexes perform well when the companies in those indexes are more profitable, and what we call the U.S. economy is measured by the total profit we all collectively make.

We are transitioning from a recovery to an expansion phase in the markets even as in the economy. As we transition from the recovery, we should expect to see, and have recently seen, increased volatility in the markets. The traders in the market, who by their actions create the day-to-day movements, have been focused on elements that would speed or impede a recovery. As those elements become less and less critical, traders who have been making and losing money on those indicators for the past six years are very likely to jump at false alarms. The transition from recovery to expansion is very much like springtime here in central Texas. Spring is when we have volatile weather and the most severe storms, but it is also when life returns.

In the first quarter, both the Dow Jones Industrial Average and the S&P 500 Stock Index netted a gain of less than one percent. On something like 43% of the trading days during that quarter, the markets moved either up or down more than one percent. In short, on any given market day in the first three months of 2015, the market moved on average more than it did for the entire quarter. That is as good a definition of high volatility as I have ever seen.

The good news is that according to Morningstar, those major stock indexes are not overvalued to any significant degree. Generally, major market crashes come only after the markets, or at least some significant part of the markets, are significantly overvalued. The leading economic indicators suggest steady growth in the economy ahead, and the valuations in the stock market appear to be echoing that prediction.

If history is any guide, we are entering into a secular bull market and a long expansion. More, this expansion, at least so far, has had little to no inflation. With much of the world still stuck in a slump, the potential for growth is significant. Fear is rampant, and the old Wall Street saying, "a bull market climbs a wall of worry," is reassuring.

All this is not to say that there will not be some bumps in the road. An immutable truth of investment experience and theory, is that the greater the growth rates in an investment portfolio, the greater the *variance* in that growth. In practical effect, that means that the higher the long-term rate of return, the greater the short-term declines will be, and the longer those declines will persist.

An example may be seen in the NASDAQ stock exchange and its accompanying index. The NASDAQ has tended to have a much higher growth rate than the older indexes such as the Dow Jones Industrial Average (the Dow) or the S&P 500. If one where to hypothetically invest in the components of the NASDAQ in mid-2000, he or she would today still be in a loss position after suffering an 80% decline in value within the first two years of investing. The Dow fell about 50% in those two years, and has since (including dividends) recovered, hitting new highs before falling again in 2008 and recovering four years later. The S&P 500, with a bit more long-term historic growth fell about 55%, and was later in recovering.

We, here at The Personal Wealth Coach, attempt to damp out some of that variance by using a mixture of asset appreciation and asset preservation targeted asset classes. That approach is generally appreciated in down markets and even in the recoveries from those downturns, however; as the market enters the expansion phase, and participants are no longer fixated on the risk of loss, *greed* will replace *fear* as the driving emotion. There will be a temptation to ignore the risks of a too-aggressive portfolio and focus on how much one *could have made* had the portfolio been more aggressively invested. That emotion will hold sway until the inevitable bear market, at which point *fear* will again be the dominant feeling.

Bonds

At some point, probably later this year, interest rates will finally start to rise. There is some evidence that we could see a panic in the bond markets at that point. Reports are circulating that bond market liquidity is as low or lower than at any point in recent history. *Liquidity* in any market means that there are sufficient willing buyers to absorb the volume of securities people want to sell. One of the main purposes of the "quantitative easing" or "QE" used by the Federal Reserve between 2009 and 2014 was to provide that liquidity in the markets. QE in the United States is over.

Currently, many bonds are trading at prices well above their eventual maturity value. That means investors holding those bonds know that if they hold them long enough they will lose money, and in some cases a lot of money. That fear of loss is compounded by the fact that we have strong indications that many bonds are held in *leveraged* portfolios, portfolios where investors have borrowed money to buy the bonds. Over the past year or so, interest rates have actually fallen, so bondholders have seen their investments rise. Once they start to see them fall in the face of rising interest rates, there will likely be a very large number of bonds offered for sale on the bond markets.

Because there is a consensus that interest rates, once they start to rise, will do so for some time, holding bonds after that rise begins may well be a losing proposition, thus buyers for bonds may not be available. Such a situation would put the bond markets in a "free fall" until the market prices fell a *lot.* If there is indeed a bond panic as bond values plunge, that panic may spill over into the rest of the market. That scenario is a very real possibility right now, but if it happens it will only be a panic, and panics commonly vanish as quickly as they appear.

The good news is that once the panic subsides, much of the money that previously was in bonds will likely move into stocks. Once that occurs, the bull market in stocks will once again assert itself and the second major leg of this long-term secular bull will get started.

Oil

The price of oil is relatively low, as is the price of gasoline at the pump. That oversupply situation will very likely continue for some time. Compounding the supply side of the equation is the reasonable probability that Iran will agree to scale back its nuclear program in return for reentry into world commerce. If that happens later this year, one of the larger oil exporters will come into the market with a strong desire to make as much money as possible as soon as possible.

From a political-economic point of view, getting Iran back into the world commerce community, and thereby dependent on free trade is a very good thing. An isolated country has little to lose by inciting violence, while a country hooked on prosperity generated by more or less free commerce has a tendency to be less aggressive. More, the inclusion of Iranian oil and the reduced oil prices likely to accompany that new oil in the market, cuts the cash flow into Russia and other countries that have used the high prices paid for oil to fund some rather unfriendly actions.

Of course, the most immediate and at least short-term benefit is that low gasoline prices are a very effective economic stimulator for the U.S. economy. In our car-dependent society, gasoline is a very significant part of the consumer budget. Unfortunately, until fairly recently, much of the money spent on gasoline went overseas. Today we have the double effect of leaving more money available for consumers to spend on other things, while putting much of the oil related money they spend in the treasuries of American companies.

A secondary influence of low gasoline prices is one that will not make the environmental activists very happy. As the price of gasoline falls, Americans tend to buy larger and more expensive vehicles. They also feel richer, and buy things that are more expensive than they otherwise would. Whether or not you think that is a wise move, about 70% of the U.S. economy comes from domestic consumer spending, and when consumers spend more, stocks tend to do better.

Conclusion

The American economy is in a slow, healthy growth process. It is currently transitioning from its recovery phase following the devastating financial losses of 2008-2009 into an expansion phase. The dollar is as strong or stronger than it has been at any time since shortly after World War II, and is the absolutely unchallenged world reserve currency. Even our lead commercial competitor, China, bases its own currency on its U.S. dollar reserves. Our banking system is by far the most stable and healthy on the planet. According to the CIA World Fact Book, our manufacturing sector contributed $3.36 trillion to our GDP, and is by far the largest it has ever been in our history, and is second in the world, led only by China at about $5 trillion. Our unemployment rate is half that of Europe's at about 5.5%. Meanwhile our 2014 gross domestic product (GDP) was about $17.46 trillion, 70% ahead of our nearest competitor, again China.

In short, despite having a population that is only a fraction of that of some other countries, the United States has the dominant economy with an average standard of living and human development index in the top five in the world. In that top-five list are Norway, Australia, Switzerland, the Netherlands, and of course, the United States, all with standards of living that are close to identical. You live in by far and away the largest, richest, and most powerful nation on the planet.

Give thanks. We are well and getting better.