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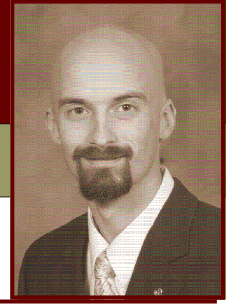
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TPWC Market & Economic Update

By Jeff McClure

The Markets

What's High in a Low Market

July presented us with a gain of over 7% in the Dow Jones Industrial Average (the Dow). That was pretty much matched in the other indexes. With about 80% of S&P 500 companies now having reported, the vast majority have earnings and revenues far higher than were expected. So of course for the week ending August 13th, the Dow dropped 3.3%. Why? To put it simply it was because of irrational...

~~~~FEAR~~~~

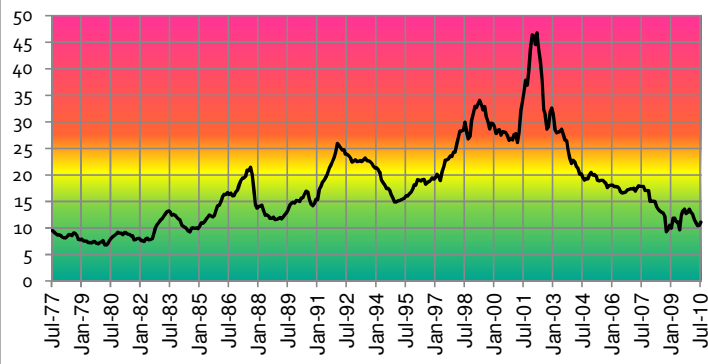
First it is important to realize that the stock market is *low*. Yes, I realize that 18 months ago the Dow closed out at 6,547 and today as I write this that same widely followed index is just over 10,300. That is a gain (not counting dividends) of about 60% in a year and a half. But, the highness or lowness of a stock index is not based on where it was at some point in the past, even the recent past, but on another metric, namely its *forward* price-to-earnings ratio (P/E).

I know that I have harped on this

issue before, but it is *important* to understand that *the best time to invest or to be invested is when the forward P/E is low*. A low forward P/E is always generated by *fear*. It is at the point of maximum fear that bull markets are born.

When the P/E ratio gets into the yellow band on the chart below (between about 17 and 25) the overall price is reasonable but can result in some steep, albeit short, bear markets as we saw in 1987. When the P/E gets above 25 we are in the danger zone. Chairman Alan Greenspan's famous pronouncement of the term "irrational exuberance" in late 1997 is a

### S&P 500 P/E Ratio



classic case of that warning. Sometimes though, as happened in the years that followed his statement, the broad stock market can remain irrationally high for so long that people cease to believe in the

(Continued on page 2)

## The Economy

### Recessions and Recoveries

We are in the process of recovering from a *structural* recession. Structural recessions are very different from the far more common *business cycle* recessions.

### Business Cycle Recessions

Business cycle recessions involve too much inventory build-up and too many people hired. Businesses have to anticipate what they think will be happening several months in advance in order to have the goods and services available to meet the need.

For example, this morning on the radio I heard about the high volume of cargo being unloaded at the Port of Virginia. What was coming off the ships was *Christmas* goods. Those goods were ordered about 60 days ago in order to be in the stores in November. Add up the months and you can see that the orders went in six months before the businesses planned to sell the goods.

When business is booming and consumers are on a buying spree, businesses sometimes get further ahead than even that. It takes months to train employees and stock goods, but it sometimes takes a year or more to set up stores and get equipment in place for other activities. That means

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danger! Even after the market has come down in nominal terms, it can still be too high.

The reverse of that trend can be seen on the left side of the chart. From about 1973 through the early 80s, America was in the grip of protracted pessimism. President Carter was reputed to have described the condition as a “national malaise” in which we found ourselves obsessed by fear of inflation, depression, decline, and facing what appeared to be an ever increasing price of oil. Meanwhile we were being defeated on almost every front by the our enemies even as the Japanese clearly demonstrated they would soon own the whole country.

In retrospect we can see that what really was happening was what later would be called a “once in a lifetime” opportunity to buy shares in great American companies at a huge discount to their fair value. In other words, the fear people had of the market being too *high* generated a market value that was actually *low*.

Today, with the forward P/E ratio between 10 and 11, *we are back in the green zone*. Even though the market has risen about 60% since its bottom last year, in the very real terms of the forward P/E ratio, the market is as low today as it was in March of 2009 and as low as it was in 1928! The market has risen a lot, but corporate earnings have risen more.

As always I make no claim to be able to see the future, but history indicates that we will look back at this time as a golden opportunity as many investors lose their nerve and bolt for a low interest guarantee.

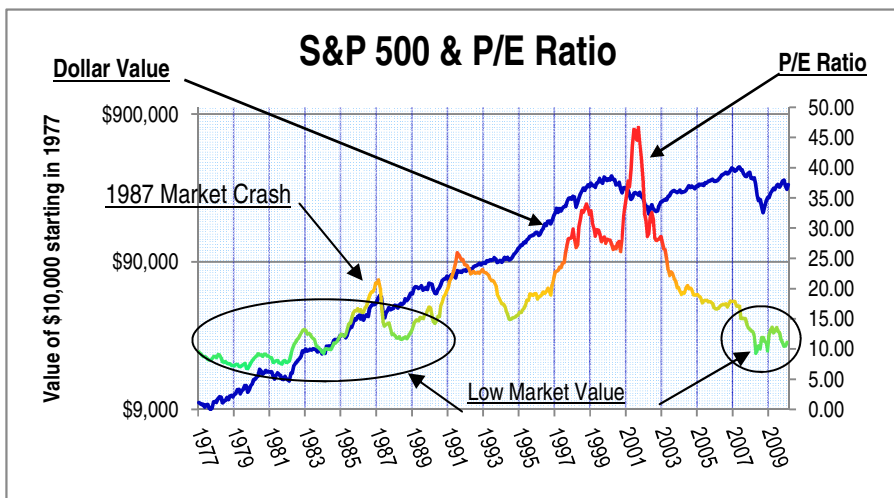
### Market Variance

Another thing that is *high* when the market is *low* is *variance*, often referred to (inaccurately) as volatility. There are two times when the stock market typically shows a distinctly higher level of variance, when it is *high* and when it is *low*.

As the blue chart on this page shows, through about the end of April, the day to day stock market levels were rising, but not showing a great deal of variance. Then, in early May traders suddenly awoke to the fear that Greece would default on its debt.

Note that the entire Greek economy constitutes less than 2% of the Euro Zone, and the Euro Zone itself is only a relatively small part of the global economy, but fear being what it is, panic ensued.

Since then the S&P 500 lost about 200 points (17%) to



bottom in July at just above 1,000, struggled back to the 1,125 level only to suddenly plunge back to about 1,080 today. There is no need to understand statistical analysis to see that the pattern of the market since the beginning of May has had a heck of a lot of variance! That kind of activity is commonly

referred to by market professionals as “frothiness.” Frothiness typically indicates that the market is likely to make a big move either up or down in the near future.

### So, Is the Market *High* or *Low*?

If the market is actually too high, then the high level of variance we are seeing is an indicator of a *top* and we are, as many political pundits are warning, likely to see a serious decline in market values in the near future. On the other hand, the same type of variance is typically present just before a major jump upward.

One very critical issue that must be present before anything can *fall* is that it must be *up*. It is hard to imagine



this market being defined as “up” by anyone who has the least grasp of what has driven stock valuations for the past couple of centuries. Long term, the stock market is driven not by what China may or may not be doing or even by American GDP. It is driven

by the profitability of the corporations whose stocks trade on that market. However, in the short term, it is driven by the twin emotions of *fear* and *greed*. When fear is rampant it is time to buy... or at the very least to *not* sell.

We are witnessing not only record earnings (profits) from publically traded companies, but guidance from the leaders of those companies that indicate they have orders in hand for a *lot* of business through the end of this year

and well into next. In the midst of the panic stemming from rumors that China might be wanting to slow their economy and the news that Americans are buying a lot of stuff from China (and other places), what did not get reported very well this last week was that Disney reported a 43% jump in profits with a similar increase in revenue. Adecco, the largest temporary worker supplier in the United States, came in with profits and good news today too, citing record demand for workers. Meanwhile, Fossil (the watch company), reported that earnings *tripled* over the past year and it is seeing record demand for stylish watches.

What does all of this mean? Simply put, temporary worker companies are the first to feel the pinch in a downturn and likewise, the first to lead the way out in a recovery. People who really are in a hurt financially don't flock to Disneyland or to the expensive movies Disney shows in the theaters. Above all they don't run to the store to buy a new watch. What we are seeing is strong indicators that the recovery is real and that a year or two from now the rest of the world will wake up and realize they missed a great opportunity.

That leads me to another thing that is high when the market is low.

### Opportunity

True *opportunity* in the broad market comes rarely. Opportunity is defined by Webster as:

1. a favorable juncture of circumstances, and
2. a good chance for advancement for progress.

In this case opportunity presents itself as *high* because that is the nature of a fear-filled, low valued market.

Fundamentally there are two reasons for a market to be *low*. One is that the corporations whose shares effec-

tively *are* the market are now worth less because the corporations themselves are worth less. That reason for *low* would be that the corporations have, or are expected to have lower earnings into the future.

The other reason for a low market valuation is far more complex but can simply be characterized as *unreasoning fear*. Fear can be a reasonable reaction to a real threat, or it can be a result of an overload of negative information from unreliable sources.

Opportunity in investing presents itself when fear-generated low valuations are not supported by the evidence. Evidence is not found in the opinion of your favorite talk show host, or even your neighbor or friends. In far too many cases they are simply repeating rumors, or possibly making them up. Evidence is a citation of fact in its entirety. Half truths do not count as anything but propaganda.

To perhaps belabor the points I have already made, here is the evidence:

#### The Positives

1. Sales and revenue are growing, and forecast by company executives to continue to grow.
2. Profits are at record levels for publicly traded companies, and also forecast to grow.
3. Companies are hiring more workers than are being laid off.
4. Inflation is effectively zero.
5. Interest rates and borrowing costs are the lowest they have been in decades.
6. In terms of present and forecast earnings the stock market is trading at the lowest price since 1982.

#### The Negatives

1. The U.S. stock market has risen around 60 percent since March of last year.
2. Residential real estate is still de-

pressed and likely to remain so for an extended period of time.

3. Corporations are not hiring as many people as are coming into the workforce every month (on average).
4. Consumers and corporations are "deleveraging" (paying off debt) rather than spending money.
5. If the federal government decided to seriously cut spending *deflation* is likely, accompanied by a possible second leg of recession.

That last item is worth restating. There is one thing that could turn me from a bull to a bear in short order and that would be a dramatic retrenchment in government spending. Consumers are saving and paying off debt. Corporations are doing the same thing. Our imports, mainly oil, are significantly higher than our exports. Until the consumer gets back into spending mode, the burden is on the government. See the *Economy* story for more on this.

So, if you are a long term investor, after taking a careful look at the evidence, do you think the value of money invested in a diversified equity and bond portfolio today will be higher or lower five or ten years from now? Remember that the way to do well in investing is to *buy low and sell high*. Remember too that most investors do it the other way around. The reason is simple. Markets are low when people are not buying, generally out of *fear*. Waiting for the fear to leave and buying with the herd means, by definition, buying "high."

In other words, "Hang in there. Better times are not far ahead." That is my opinion, and history tells me I am right. Remaining rational in a fear filled world is quite a feat, but can create great rewards to those who can stand the heat. \$\$\$

(Continued from page 1)

that if businesses are anticipating a big selling year in 2011, they have to already have ordered and committed by the beginning of July!

When they guess wrong and wind up with too many employees and too much “stuff” they generally try to hang on to those employees in the hope that business will “turn around.” When they finally become convinced that things are going to be really bad, they start laying people off. Then, in a few months, they have sold off the excess inventory and the customers have started coming back so they commonly rehire the same workers and start ordering again. Of course the same thing is happening at the companies that provide the goods.

### Structural Recessions

“*Recession*” may not be the right word here because most structural downturns become *depressions*, but in this case it looks like we dodged the *depression* bullet and are simply having a recession, albeit a pretty serious one.

Structural economic downturns are characterized by portions of the economy *collapsing* not just temporarily slowing down. In this one we saw the American automotive industry fail, as well as virtually all of the large Wall Street investment banks. The fact that the Federal Reserve and the federal government were there to catch them before they utterly imploded is what kept this event from becoming a *depression*. While there is a lot of grousing about government

interference and the debt incurred in doing that, we should be sincerely thankful. The alternative was a reprise of the events of 1929-34.

Structural downturns are also different in that the economy takes far longer to get back to full employment. They are led by business investment as restructuring and re-

little better.

There is real fear of a repeat of last year’s collapse, but the fact do not support that fear. There are a lot of factors in the GDP, including the fact that if we import more than we export it is subtracted from the final result. From a much more narrow perspective we can look at *real domestic purchases* which include business purchases for production, or *domestic final demand* which is effectively consumer demand for a more defined picture.

As the lower chart indicates, domestic purchases are not only rising, but are doing so at an annualized rate of 5.1%. Real final demand, things that will not be resold or used to make other things, was

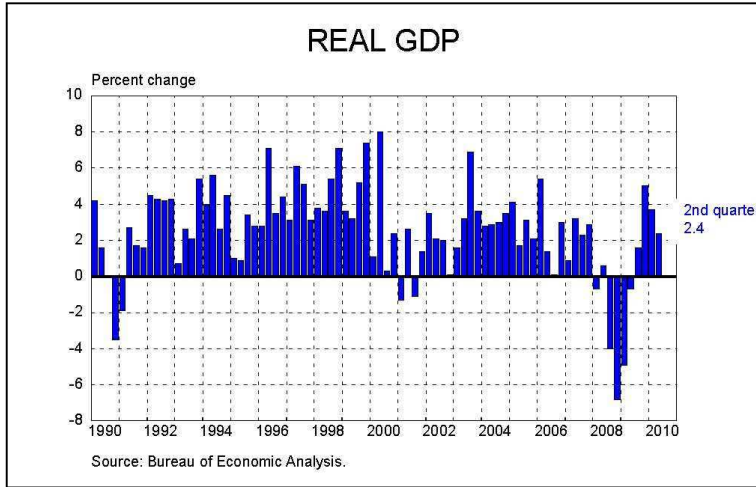
shaky until the last quarter, but was on the way up at an annualized rate of 4.1% in the second quarter.

What does that mean? The blue Domestic Purchases increases indicate that businesses are buying things they plan to use to make other things or to increase what they can do with fewer man hours. That is good for the economy but not good for the employment numbers. The Domestic Final Demand growth at 4.1% indicates the ultimate user of everything, the consumer, is coming back to life.

### Where We are Going

On the next page are the two best indicators of where we are going. The Index of Leading Economic Indicators closed out July at 109.8 while the Purchasing Managers’ Index stood at 55.5.

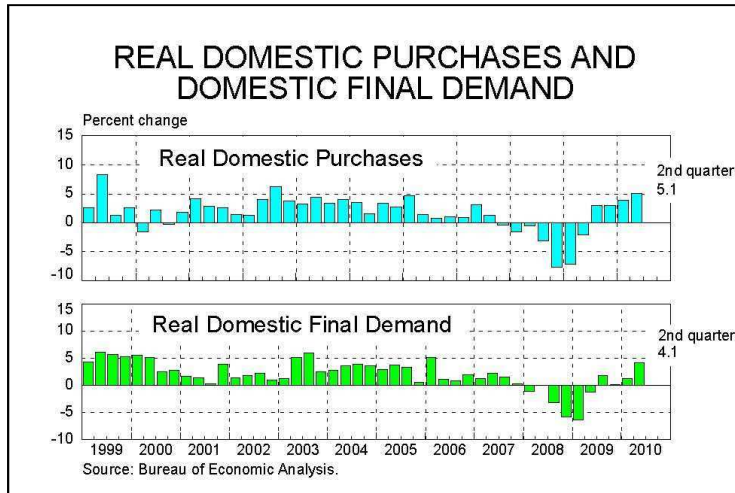
Focusing on the Purchasing



building must take place before the jobs are created.

### Where We Are Today

As the Real GDP (gross domestic product) chart indicates, the economy of the United States actually shrunk



for about a year and a half. Growth has returned, but last quarter the annualized rate was only 2.4%. Our long term average is about 3.0% or a

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Managers' Index we can see a lot of what is going on in the economy and more importantly, what is likely to be going on about six months from now.

The Purchasing Managers' Index uses 50 as its point of reference. Any number higher than 50 indicates that the total value of goods ordered by the surveyed Purchasing Managers is expected to grow into the future. Conversely, anything below 50 indicates that the managers will be ordering less goods and services over the next six months. The peaks in the index are around 60, right where the Index was earlier this year.

Once the Index gets down to 50, as it was in 2007, we face a serious chance of recession. One thing that has to be watched though is the fact that just because orders are not likely to grow (Index at 50 or less) does not mean we will have a recession. A below 50 Index may not mean that we *will* have a recession, but it is extremely hard to have one with the Index above 50.

One of the things that has some people worried is that when the Purchasing Managers' Index does hit 60 over the last twenty years it has started a decline from there that has sometimes led to a recession.

The key (at least in my opinion) to understanding where we are going in that realm is to be found in the bottom chart, Capacity Utilization.

The capacity utilization number tells us what percentage of our manufacturing capacity is actually in use. The historic average is around 80%, and anytime we get up to about 85% we start to run into bottlenecks that can

same time unemployment is higher than it has been since the early 1980s. What gives?

That combination is very common as we *emerge* from a structural economic collapse, or in this case,

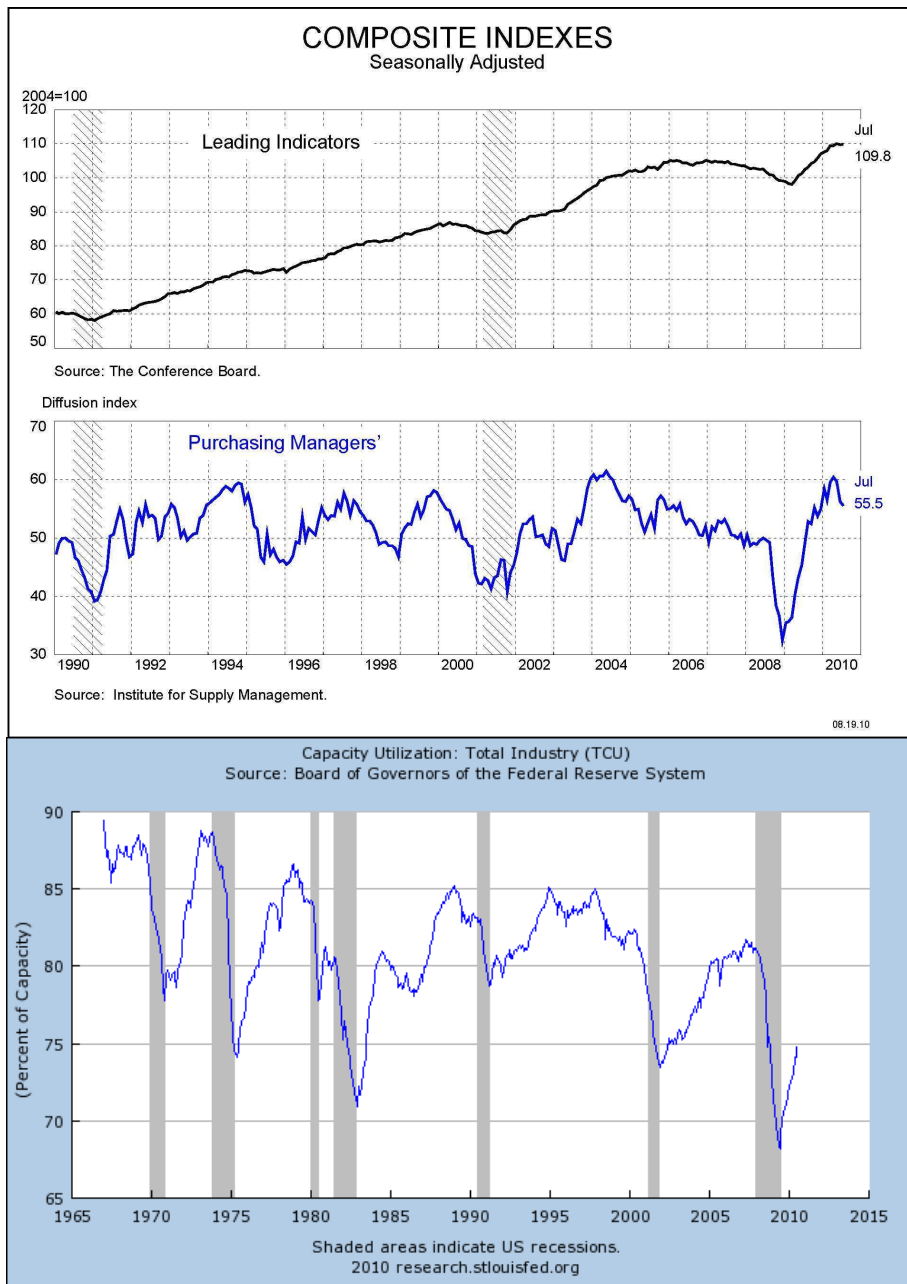
near collapse. Structural recessions involve dramatic increases in technology. Some companies find ways to integrate the technology and actually thrive in the recession, while others will not or cannot integrate the technology and are doomed to extinction or at least a major restructuring.

General Motors is a prime example. It came into existence because of the new assembly line technologies that doomed the small automobile makers. When the next wave of technological innovation came along, computerized manufacturing, it was unable to adapt because of its relationship with the unions and because of its internal adherence to traditional ways of doing things. It had to wipe out its shareholders' value as well as its union contracts to survive.

vive.

The restructuring has to come first, then when the consumer has paid down his and her debt and the pent-up demand hits the marketplace (and it will) the hiring will resume and the economy will accelerate.

In short the fundamental engine of growth in the U.S. economy is being rebuilt and is coming on-line nicely.



cause problems down the road.

This chart from the St. Louis Federal Reserve puts the utilization at about 74, and most notably indicates that it has been rising since last year.

### Structure Versus Employment

Corporate profits (as I mentioned in the other article) are running at an absolute record high level. At the

## The Bad News

All that is not to say that everything is rosy. History tells us that we have the capacity to plunge back into a recession/depression all too easily.

## Deflation

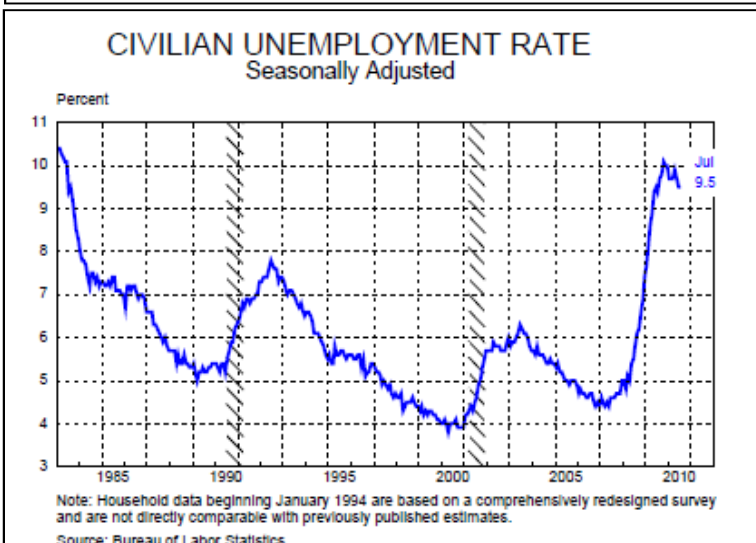
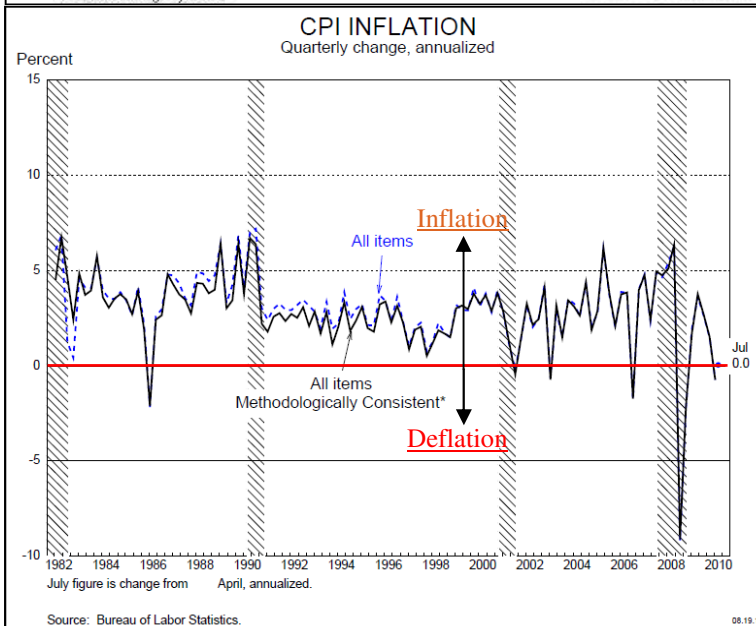
One of the most important things to understand about a true structural collapse is that it is *deflationary*. Deflation sounds like a good thing because the price of most items declines. The problem is that once prices start to decline, so do wages, employment, and the whole economy! Once structural deflation sets in it requires a massive shock infusion of money into an economy to jolt it out of the attendant depression.

There has been no shortage of talking and writing heads proclaiming the imminent threat of *inflation*. Inflation comes when the money supply grows faster than the economy. The chart at the top of this page shows the frightening reality of what is really happening.

For the first time since early 2008 our money supply is not shrinking as fast or faster than the month before.

It is important to note here that the *money supply* is a factor of the *volume* of money in the economy times the *velocity* of money. Money is considered *liquid* wealth. It is like water. If a city has a huge reservoir of water, it still does not have a water supply until it installs pipes, pumps, and water towers.

Corporations are sitting on record levels of cash as are banks and other



organizations. Consumers are saving at a rate we haven't seen since the early '80s. Corporations and consumers are also paying down their debts at record rates.

All of those factors combine to, in effect, prevent spending, lower

interest rates, raise unemployment, and push us toward *deflation*.

## Unemployment

The bottom chart tells the story. This is indeed the worst recession since 1982. It does not sound as impressive as "the worst economy since the Great Depression" but that is the reality.

The other reality is that unemployment is a *lagging* indicator. Coming out of a structural economic collapse, businesses, and sometimes even the government get much more productive. In order to survive, businesses learn to do more with less man-hours. Simply put, we typically see production and profits rise to new highs before employment really starts up.

If you think housing is in a funk now, go back and take a look at previous structural downturns! At least in the last one (1973-83) we had inflation to make us *think* house prices were rising. Back in that one though it was rental properties that took the hit. That was because the lower economic end of the working population, the ones who are always hit the hardest, were mainly renting.

Today, most people own homes, and most of those have mortgages. When we have a lot of people out of work, we are going to see a

lot of foreclosures and few homes being bought. Like unemployment that will take years to remedy.

Meanwhile, we *are* rebuilding and what we are creating is far better than what we lost. The future *will* be better than the past. \$\$\$