



jeff@tpwc.com

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Jeffrey W McClure CFP® *Jacob A McClure* CIMA®

Serving Investors Since 1982

PO Box 1029 / 918 North Main Street, Salado, TX 76571

(254) 947-1111 / (800) 914-7526

www.thepersonalwealthcoach.com



jake@tpwc.com

Market and Economic Update

By Jeff McClure

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The Perception Recession

I read an article this week written by Joe Duran in which he called the economic and market events that have roiled the markets in August, "The Great Perception Recession of 2011." It was such a good description and had such a good sound that I had to use it!

The Chart below shows the S&P 500 Stock Index from July 11 through last Friday, August 26. As of July 22, the index stood at about 1,350, and was cruising along with good gains from both last year and year to date. It started down from there and by the beginning of August was in what appeared to be an apocalyptic free-fall. As of Friday's close that "end of the world" market crash really amounts to a decline of about 12.8% from the high in July. So, what happened between the beginning of the last week in July and two weeks later that so spooked the traders?



Identifying the Cause

The answer is not going to make very many people happy. From an economic and business perspective, "nothing" happened. Actually there were a few bits of news here and there, but when we distill the news reports so as to remove the opinion and sentiment information, almost all of the factual data were good news. The facts match up quite well with a rising market, just as we saw for the first half of the year.

The gray bars on the chart are the number of economics and market related news stories published each day. There is an interesting correlation there. There were relatively few stories around mid-July as the market continued to rise, then as the news stories began to increase, the market began to fall. A careful examination of the stories does indeed reveal what was generating the newsprint surge and the market decline. It was the debt ceiling battle in Congress.

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Chairman Bernanke spoke Friday at the annual Federal Reserve retreat in Jackson's Hole. The centerpiece of his speech was not about economic data or the money supply or any of the other technical issues on which Chairmen of the Federal Reserve have waxed eloquent for so many years. He did mention those items, but most of the data, as I have noted, are positive. No, he commented that the principal reason for the sudden surge of fear, increase in layoffs, and general perception of economic distress was the threatened default of the United States of America.

Note here that the level of debt we owe is not the issue. Huge quantities of money have been rushing to Japan as a "safe haven". Japan's market has even done better than ours over this period. At the same time, Japan has *twice* the debt to GDP ratio of the United States! Let me state that again: **Japan has twice the debt for every dollar (or yen) of GDP that we have.** More, their economic situation is far worse than ours and they have been changing Prime Ministers about once every two years for quite a while. In essence, they don't have a glimmer of a plan to dig their way out of the mountain of debt that has buried their economy. Worse, their population is aging so fast that even holding their own will be a major challenge. Again, note that a goodly portion of the money that has been exiting the U.S. Stock market has been seeking safety in Japan.

So what do the Japanese have that caused a rush of money into the Yen? First, unlike the Euro, the Yen is the result of a functioning governmental system that is extremely unlikely to collapse. Second, the Japanese have made it very clear that they will repay their debts no matter how much it hurts. We, on the other hand, just threatened to *not* repay our debts if it hurt too much.

As I wrote in my last letter, the big decline in U.S. stocks happened around and almost certainly because of the downgrade of the United States credit rating from AAA to AA+ by Standard & Poor's. Again, as I wrote last time, the vast majority of the money exiting the stock market was used to purchase those same downgraded U.S. Treasury securities.

Have investors lost all sense, or is there something else going on here? From all the research I have done, it appears that there is a certain level of logic to the market movements. The selling was an expression of both emotion and opinion. It involved ignoring the current and even projected economic data and instead focused on the statements made by supposedly responsible men and women who have the ability to wreck the world economy. In other words, the market did not decline because of a fear of a slowing economy, a possible recession, or any of the other elements that might reduce earnings for the corporations represented in the index. It has declined almost 13% out of a fear that the conservatives in Congress will keep their word. S&P's downgrade statement said very much the same thing. It was not the degree we are in debt, or even the deficit that resulted in the downgrade, but the demonstrated potential that members of the House of Representatives might decide that the United States of America would not pay its legal obligations.

I have recently read some very thoughtful commentaries which have suggested that we may well be headed back into a recession. They all agree that if we do see an actual contraction of the economy it will be a recession created solely by the fear generated by the politicians and media personalities who have been so loudly preaching the end of the world as we know it. Another point here that is worthy of repeating is that most Americans seem to believe that the Germans have their act together while we Americans are in debt up to our eyebrows. In fact the public debt owed by the German government equates to about 87% of GDP while ours is about 68%. The bond market is demanding about a 50% higher interest rate from the Germans for more borrowing than it is charging us.

We, as investors, have to determine whether we are going to act out of fear that our elected members of the House of Representatives will knowingly wreck not only our economy but that of the world or simply believe that they are blustering and threatening but in reality will accept whatever compromise is necessary to allow us to muddle through. Of course that is exactly what they did at the last minute before taking off for their summer vacations.

Reality or Perception?

We have the choice to look at the reality of the economic data and conclude what it indicates or to pay attention to the fear and dire warnings being poured out by some TV and radio talk show hosts and politicians. As has been far too common lately,

the two different perspectives do not have a lot in common. History is quite clear on what we should do. At any point in the recorded history of investing over the last two hundred years and longer, those investors who were later seen to have been successful have made the conscious decision to follow the measurable reality rather than either the fear or the euphoria published in whatever form of public communication that was popular at the time.

Another note regarding recent history: Two years ago Glenn Beck and other media commentators of similar persuasion warned of massive runaway inflation that would set in within twelve months. High inflation is automatically matched by high interest rates. Inflation has been very nearly zero as are interest rates. Some food prices have risen since then, but fuel is down as are houses, electronics, cars, and many other items. We are indeed at risk for *deflation*, but there is no sign of high inflation (unless you live in China).

Before we move on I want to point out that back in March of 2009, where there really was something to worry about, the S&P 500 Stock Index stood at 676. Today with it just below 1200 we are frightened and perceive that it has fallen. At today's levels the Index has (including dividends) risen well over 80% in under two and a half years. Despite that rise in value, the real price of the market, as measured by the price divided by corporate earnings, has actually *fallen*. In other words, the U.S. Stock Market is up 80% but still cheaper than it was in 2009! Every study that has been made on this subject agrees that the following decade's market performance is directly related to the P/E ratio. The lower the ratio, the greater the performance over the next ten years. Ten years ago the P/E ratio was 45. Today it is about 10. That is exciting!

Why, in light of all of this, is unemployment high and consumer spending low? There is more to follow, but the single largest reason is that we Americans are paying down our debt and that debt is about 24% higher than our comfort levels. Once we get down to a level with which we are comfortable, which should take about another two years at the rate we are going, then we will return to "spending as usual." Until then, slow growth, high unemployment, and negative commentary are likely to be the rule of the day. In other words, whoever is elected as our next President will get the credit for a "miracle recovery" that has everything to do with getting to the bottom of the debt pit and little to do with politics.

I want to emphasize at the same time that *are* some very real problems facing the world economy. None of them are new. Over the past twenty to thirty years there have been many, many articles in which serious thinkers warned that we were on a route that would eventually lead to a major crisis. We, the people of these United States quite literally elected to not only ignore those warnings, but to elect to office a series of governments composed of those who promised to give us more government benefits while charging us less taxes. George H.W. Bush's presidency was limited to four years because he signed into law a bill that slightly raised taxes on the highest incomes and slightly reduced entitlements for those who had ample incomes prior to age 70. Largely because of those changes, combined with a reduction in military spending, we arrived about ten years later in a position where we were actually on track to pay down the national debt.

The 2000 political campaigns were centered on whether we needed to pay down the debt or allow it to rise into the future by cutting taxes. We the People elected to not deal with the debt in return for lower taxes. If everything had gone smoothly and without unexpected events that might have worked out just fine. Unfortunately, unexpected events do happen with alarming regularity.

After 9/11 we had a dramatic increase in military spending, but again rewarded those who favored even more tax reduction. In order to avoid a violation of the Balanced Budget Act, President Bush and Congress kept the budget for the wars we were fighting "off the books" by passing an "emergency" funding bill each year separate from the budget. That worked so well that the President pressed for and Congress passed a huge increase in entitlements, the Medicare Prescription Drug Benefit. Again, that was officially listed as an off-budget "emergency" bill.

Had the economy hummed along at the high rate of growth projected at the time, even those expenditures could have been self repairing, however yet another tax reduction went into effect at about the same time. Then, we had a collapse of the financial infrastructure that had arisen around an intentionally unregulated sector of the securities markets. That collapse necessitated some rapid action including significant expenditures to prevent the collapse from becoming another Great Depression.

We are now facing some rather significant levels of unemployment and reduced consumer spending. Those elements dramatically reduce revenues to the government. An unusually large number of families have been reduced to poverty levels where they become eligible for state and federal aid at the same time as revenues have decreased. Those are not at all unusual events. What is unusual is that our federal taxation level is about the lowest it has been since before World War II. Not coincidentally, the percentage of the Gross Domestic Product of the United States that is being taken as revenue by the federal government is about the lowest it has been since the 1930s.

Now, we the People are faced with a problem of how to prevent our governmental debt from rising to the levels that the rest of the world seems to accept as normal. The solution is relatively simple. We need to decrease benefits and military spending while at the same time increasing revenues (taxes) back to the level they were when Newt Gingrich was Speaker of the House. Unfortunately, we have elected enough members of Congress who either are dead-set against any increase in taxation or alternatively dead-set against any decrease in benefits that we are dead-locked. Dead-set and dead-lock do not make for good governance. Presuming that the brief wave of sanity that appeared when Congress agreed to raise the debt ceiling returns as the members of Congress come back from their summer break, we can and will get through this.

That does not change the reality of what we face. Cutting benefits will not get us on a stable fiscal footing. We the People have decided that old people and children starving or the uninsured dying outside a hospital door is not an acceptable outcome. We have elected officials who have passed laws providing for money to prevent that from happening. We have also decided that fighting those who would like to destroy us needs to be done somewhere else and that we should have a relatively expensive defense policy that emphasizes taking the battle to those who would harm us before they can bring it here. Those are both rational, but expensive policies. Can we trim some expenses from both of those budgets? Yes, but to still accomplish those objectives we cannot cut a whole lot, and certainly not enough to make up for the difference between revenues (taxes) and expenditures.

Thus, a combination of unpopular benefit cuts for people with higher incomes will need to be combined with equally unpopular tax increases. Both will tend to be directed at those with more than \$250,000 annual income (for a couple). If, and that is a critical "if", we can agree to those provisions, then we can easily emerge from this self-imposed crisis as a very healthy and growing economy. If we continue to flail about and reduce ourselves to threatening to wreck everything unless we get our particular demands met without compromise, then we will indeed face a crisis. In that crisis we will almost certainly take the same actions that we could have taken before the crisis. Either way we will finally emerge a better People with a stronger economy. That is just the way we are. Why do I believe that to be true? Read on.

Our Strength

We the People of these United States of America are by nature entrepreneurs. We invent things, we engineer things, and then we move on to something else. Most of the time we don't worry too much about the future because we are too busy making it better. That spirit is still alive and well in America. Industrial production in the United States for the month of July was up almost 1%. That follows about 18 months of rising industrial production. General Motors is seeing dramatically increased demand both here and overseas for its vehicles. Across the board, corporate profits are at record levels and have been growing at near record rates.

Quietly, while very few were paying attention, American corporations used the recent recession to capitalize their processes. As assembly lines were rendered idle in 2009, many companies invested a lot of money into automating the processes carried out on those lines. The unpleasant side of that is that the people who were laid off in many cases will never be hired to to their previous tasks again. The resulting decrease in manufacturing costs has enabled American companies to increase their already impressive world lead in exports. Farmers have been doing the same thing. China is purchasing corn by the millions of bushels here in the United States. China is primarily an agricultural country, but the efficiencies of America's corporate farmers is so great that it is cheaper to purchase corn from us than it is to grow it at home. Profitable farms have become corporate food factories.

Much of the rest of the world has passed laws designed to stop industrial progress in agriculture. The bucolic image of the farming family with its cows, horses, pigs, and chickens is so appealing that in many countries it is protected by law. That makes about as much sense as prohibiting automobiles and computers from being made in anything other than someone's private garage. As of this year, America's annual corn production alone equates to 1/12 of all the dollar holdings of the

Chinese. Our corn production is rising much faster than the amount of debt held by China. We may look with envy at those nations that have oil to export, but that oil will eventually run out. Our corn exports can keep growing as long as there is demand. Noticeably the price of oil has fallen from \$140 per barrel a couple of years ago to about \$85 today; about a 40% decline. Over the same period corn has risen from about \$3.39 per bushel to well over \$7.00. In short, from the iPhone to corn, we Americans are the most productive and innovative population on the planet. Part of that, by the way, is from exporting the more labor intensive manufacturing tasks to other places where labor is cheap. We can't export the labor in agriculture, so we automate it. As overseas labor becomes more expensive, we invent ways to automate what we are doing here. We, as a culture have been doing that for about 350 years and are getting better and better at it.

We, as a culture, are focused on making a profit, making money, and rising above our current circumstances. We will continue to do that.

The Short-Term Threats

Over the long term, our national character will cause us to emerge as winners. In the shorter term, we may be in for some unpleasant bumps. Presuming we can come to grips with ourselves politically and get a plan in place to correct fiscal problems at the federal level over the long haul, we will do just fine, however we do face a couple of very real potential crisis abroad.

There are two other major socio-economic units in the world that are comparable with the United States in terms of size and wealth generation, the Euro-zone and China. We have a lot of trade with those entities and should either or both of them suddenly degenerate into chaos, we would feel the pain.

The Euro-zone has at best a 50:50 chance of surviving over the next few years. It suffers from the same issues that are bedeviling our economy and ability to function, the combination of partisanship and a lack of effective leadership. Partisanship is a condition where minority parties in a government or economy put their individual desires ahead of the welfare of the whole. We saw that play out in late July and early August here in the U.S. The second element, lack of leadership, is part of the institutional makeup of the Euro –zone and the European Union. The EU has a government, but the government must have the approval of all the member states before it can do anything. That form of government was one we tried under the Articles of Confederation in the 18th century. The South tried it during the American Civil War. It doesn't work. The poorer states have wracked up huge debts buying things from the more wealthy states and now the more wealthy states are balking at returning their profits to keep their customers from defaulting. If the Germans get tired of assuming responsibility for the loans they made to Greece, Italy, Spain, Ireland, and Belgium, then the house of cards will come down. That is going to be very unsettling to the markets, but in the longer term will resolve a host of difficulties and "clean the slate" to allow the European Union to restructure and perhaps create something that does work.

China is another version of the same potential crisis. The leadership there is certainly strong, but the centralized control and information (or perhaps more properly "misinformation") control is about all that is holding China together. China is an empire masquerading as a nation. There are five major languages spoken and it has a migrant worker population larger than the entire population of the United States. One stumble and the odds are that China will erupt into chaos. The leadership in Beijing is intensely aware of that potential and working very hard to get past this stage. Time is not on their side. Their population is aging and has a lower economic output per capita than Mexico. The infrastructure is already at its limits in many areas but in order to maintain stability their economy has to grow, and grow fast. Like the Euro-zone, China faces structural challenges that have proven throughout history to be insurmountable. The odds are that at some China will very suddenly erupt into chaos and revolution. That is why the Chinese government is so totally intolerant of free information flow and any form of organized protest. In a fundamentally unstable empire it would not take much to create a disruption that would quickly spread to engulf the entire structure.

The Good News

The good news in all of this is that the United States, where all of us currently live, is positioned to once again be the beacon of prosperity and propriety to the world. Should Europe and China collapse, it will have a short-term negative effect on our economy. We are blessed though by being right in the middle of the North American Free Trade Zone. Our two largest trading partners (by far) are Canada and Mexico. One provides an almost unlimited supply of raw materials, including, if we are willing to pay for it, oil reserves as large as any in Southwest Asia, while the other provides a very nearly unlimited supply of cheap

labor, again presuming we are willing to use it. They are also the two entities that buy more goods and services from us than any other of our export customers.

In the event of a collapse and restructuring of Europe, China, or both, if we here in the United States are willing to assume the mantle of world leadership that we bore following World War II, then the resulting world order will indeed be a new one and we will profit even as we did following that war. The new entities that arise (and they always do) will need to purchase finished goods, and we will be undamaged and actually better prepared than ever before with our newly automated and capitalized factories, management centers, and organizations. It was in the recovery from the Great Depression of the 1930s that we reorganized and unknowingly positioned ourselves to be the industrial support for the free world. A new free world is emerging in North Africa and West Asia. Birth is chaotic, bloody, and not at all pretty. Still, it is a beginning and not an end.

As I have said many times on the radio and in print. Our real economy is in great shape. Yes we are angry at our elected politicians because they are not leading and unifying us but dividing and appealing to our lower, selfish natures, but we are ripe for a leader that will reawaken our belief in ourselves. Whenever we have faced that situation in history a leader has come along and We the People have elected him to lead us. In each of those dark times we have emerged to be a greater, more prosperous, and better People than we believed was possible. That has not changed.

Jeff