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Market and Economic Update

By Jeff McClure

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A Bumpy Road

Last week the Dow Jones Industrial Average (the Dow) dropped 6.4%. So far this week it is up over 5%. It is basically where it was back at the end of 2010. The purported reason for the decline last week was the same non-news about the potential default of Greece. I call it "non-news" because there is no alternative to a default by Greece on its sovereign debt, at least there is none that I have seen.

In reality there is another element here even as there was at the end of July and into early August. Congress failed to pass a bill funding the government beyond the end of September. A stop-gap measure was passed by the Senate which looked like it would be acceptable to the House Republicans and the stock market immediately rallied over 5%. Today, the news is that the House will hold a "pro-forma" voice vote tomorrow (Thursday) to extend current funding for four days. If even one Congressman objects then the bill dies. The reason is that Congress is formally not here, but on a short vacation to celebrate Rosh Hashanah. Congress is scheduled to be back at work on Tuesday when they will vote on whether or not to keep the government doors open. Each of these votes is coming at the last possible moment. If either of them fail to pass, as did the bill last week, then the federal government stops paying its workers and stops paying its bills.

If this sounds familiar, it is because it is. In this case the battle is over whether to provide sufficient funds to allow FEMA to fund disaster relief in the Northeast following the hurricane damage there. No matter that the grand compromise that was passed on August 2 actually allows for exactly that funding, the House conservatives insisted that defunding of a relatively small federal research grant for automobile fuel efficiency research and development be eliminated or they would not agree to fund FEMA. Whether or not you agree with the demand, the fact is that when funding bills finally pass, just before a scheduled vacation by Congress, the market rises. When funding bills fail at or near a deadline, the markets fall.

The Greek default drama makes for some good background to all of this melodrama in Congress, but at least in the short term, when the biggest customer of publicly traded companies in the world threatens to not pay its bills, it does have an effect on the prices of the stocks of those companies.

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The Real World

Last week as the market fell, news reports I read claimed that part of the fall was because of disappointment with FEDEX. I found that at least as amusing as the Greek story. FEDEX did report its earnings last week. They were up 22% when compared with this time last year. Going forward, the CEO warned that earnings for the next four quarters would probably not grow as fast as some were expecting. His explanation was that with the threat of the federal government default hanging over their heads, businesses and consumers were holding off on purchasing electronic components and products.

FEDEX is one of the best barometers of what is happening in the economy, both domestically and world-wide. So, I took a look at the consensus of earnings estimates for the next year. FEDEX is expected to have about a 33% increase in earnings between now and one year from now. That was disappointing? That estimate is right in the middle of the CEO's estimate as well. The story at UPS is the same, great growth in the last twelve months and even better growth ahead. Of course in both cases the stocks have fallen.

The FEDEX CEO warned that while he expected good growth in the domestic market, a slowing in China was hindering their total financial growth. That sounds pretty bad so I turned to the East Asia area to examine what was happening. Mainline China considers any information about GDP growth to be highly sensitive data and puts people in prison for talking about it, so there is not a lot to learn in that area. Taiwan, on the other hand, is pretty open on the subject. It appears that a sort of slowdown in growth is indeed forecast there. The Taiwanese economy is widely forecast to only grow about 5% over the next year and exports to the US are only forecast to be up by about 7%, based on manufacturing orders they have already received.

The FEDEX CEO was asked in his earnings call if he expected a recession to occur in the near future. His answer was a simple, "No." The earlier answer from UPS was the same. Back when the Dow Jones Transportation Index was really just transportation companies (railroads) it was an excellent forecaster for the Industrials. The logic went that if companies were going to have earnings they would need to sell and ship things, and that would reveal what was really happening. UPS earnings are currently forecast to rise only about 26% in the next twelve months. That too was apparently disappointing.

The Economy

Greece is teetering on the edge of default. Their parliament is scheduled to vote this week on a major property tax increase. If it does not pass, then theoretically the rescue money will not go to Greece and they will finally default on their government bonds. Even if it does (and I think it will) the bill calls for the tax to be collected through electric bills. The electric workers union has stated firmly they will not allow it to be collected.

In some form and in the not-too-distant future, Greece will default on its debt. The Germans could stave off the date for a while by loaning more money, but the reality is that the Greeks will need a cratering experience to realize that this all is for real. The public response to the recognition that great sacrifice must be made else they will default was and is to go on strike. It is not too different from our Congress which at each crisis climax votes to allow all the borrowing and spending needed and then takes some time off. We can afford to do that because we have the wherewithal to pay the bills, albeit with borrowed money. The Greeks don't have that luxury.

When Greece finally does default the markets will probably act as though the end of the world has finally arrived. Then, someone will look east and see the sun rising and exclaim, "Wow, the earth is still turning!" at which point people will rush back into the market to purchase stocks. Unfortunately as the people who need to notice the sun rising live in New York City where they can't actually see the eastern horizon, it may take them a while to realize that the world has not ended after all. They may notice that the European Central Bank (ECB) has been flooding the banks around Europe with cash (mainly dollars) to ensure that they can weather the storm. The ECB has also served notice that it will buy as many Italian and Spanish bonds as are needed to stave off the short sellers who will attack those markets.

In short, Greece will probably default. The markets will panic. Then, after a bit of soul searching and hand wringing, business will head back toward normal. Meanwhile American and many foreign companies will continue to have record earnings, high earnings growth, and immense quantities of cash on hand.

That will only leave three problems to solve.

1. We will still have a few million more houses than we have households to live in them.
2. We will still have more personal debt on the books than we are comfortable with... and

3. We will still have a faction (or two) in Congress that will keep threatening to blow everything up if they don't get their way.

Numbers one and two will solve themselves over time.

Sales of existing homes were up 18% in August over last year. Given a couple of years and the phenomenally low mortgage rates being engineered by the Federal Reserve, the housing overhang will be getting close to gone.

We will see a slow growth economy and high unemployment probably through next year as we Americans buy down our debt. At that point, probably in early 2013, the economy will surprise all the pundits as it kicks into overdrive.

Forecasting the American electorate's behavior is a loser's game, but let us all pray that we can come to our collective senses and get some folks into the halls of Congress who can work together. More, let's pray for a President, of whatever persuasion, who can inspire and lead us.

Europe is going to be in a shambles for a while. This is an amazing opportunity for the United States to cement itself as the sole economic super-power in the world. We the people will make that decision next year in November. I have faith in us that we will make some good decisions. No matter what, we will be on top of the world. Our system has its warts and pimples, but it is so much better than anything else on the planet that there is no real comparison. We Americans are at our best when we are faced with a challenge. Good times are hard on us. We have a challenge, --actually more than one. I firmly believe we will triumph over those challenges and emerge as a guiding light to the world. That is what we have done over and over. We are still who we are.

Forecasts

I am going to make some forecasts here that frankly scare the bejibbers out of me. I don't like making forecasts but right now that is what I believe we all need.

1. Greece WILL default. Germany will ride to the rescue but in return demand that the Euro-zone countries turn over a lot of what they currently believe is their sovereign right to spend other people's money to the European Central Bank, which will be placed under the control of some hard-nosed Germans. If the other countries don't go along, the Eurozone will shrink to include only those who will. Greece will be kicked out and will suffer horribly. This will not be a pretty picture, but will be necessary.
2. Russia will elect Vladimir Putin as its President. He will then begin to rebuild the military strength of Russia with an eye on reestablishing the old Soviet empire. We will have the option of facing him down or things will be very interesting in a few years.
3. Congress will not wreck the Republic. Yes, they will continue to posture, but following the elections in 2012 people will be completely tired of such foolishness and Congress will get the message.
4. We will pay down our personal debt and suddenly start to spend like mad. That process is already started and will accelerate though 2013 at least.
5. The Dow Jones Industrial average will reach 20,000 in the next five years (or sooner).
6. The world will not end anytime soon.

Meanwhile those who keep invested and/or invest in the shares of well run companies here and around the world will see that appreciation they have been waiting on for so long.

Your thoughts and comments are always welcome.

Sincerely yours,

Jeff McClure