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# TPWC Market & Economic Update

By Jeff McClure

## The Drama Continues

### A Pair of Shakespearian Dramas

Over the last couple of years there have been two major productions underway, one as a traveling dramatic presentation appearing at various capitals in the Eurozone and the other in that greatest of theaters, the American capital. The European version is playing out as a tragedy while the American theatrical production appears to be a comedy.

Perhaps some form of reality TV show would be even a better analogy. The initial episodes were not too exciting but beginning in early August of this year the stakes were raised and the media hype jumped accordingly.

### The European Tragedy

The Eurozone is in a mess. I have written this before, but there is no record in history of a common currency surviving if there is no strong central government to control that currency. Here in the United States we had a currency debacle not too unlike the one going on in Europe. Before that we had the infamous *Continental Dollar*. Back in the now ancient 1950s and '60s it was not uncommon to hear one of my elders refer to some

worthless thing as, "not worth a Continental."

We Americans initially addressed the problem by creating a Constitution but did not really resolve the issue until the Civil War. It took us nearly 100 years to conclude that a strong federal government was needed and that only that federal government should issue and control money.

### Too Many Languages, Too Much Democracy

In Europe the governmental evolution is much like America before the Constitution. In fact, things are even less organized there than they were here. That is not too surprising when one considers that there are about twenty official languages used in the European Union (EU). Even the smaller European Monetary Union (EMU) has around 15 languages.

The Europeans did have a constitution drawn up last year and it was rejected. The problem was too much democracy.

Our Constitution was drawn up in the Philadelphia Convention from March to December of 1787. It was not ratified by the states until

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## The Markets

### From Recovery to Expansion

November was a microcosm of what we have seen both over the last decade and even over the last year. If we look at the pure numbers for the month, the S&P 500 Stock Index (S&P 500) was very slightly *down*. At mid-month it was down more than 5%, but recovered with a 7% jump in the last week of the month.

I have been asked why we do not attempt to get out of the market when we think it is likely to decline and then jump back in before it rises. Last week provided a good example of why.

It was pretty clear that the Euro was in deep trouble for the past several years, and more particularly since the second quarter of 2009. It doesn't take a great deal of imagination to see that when the Euro finally fails the markets are likely to react negatively. Had we jumped out of the market in March of 2009 awaiting the failure of the Euro before reentering, we would have missed the S&P 500 rising about 80%. Had we jumped out when the Italian bond market indicated that the demise of the European cur-

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1791, four years later. Two imperatives drove us to “Form a more perfect Union.” First, Great Britain was threatening to invade and reclaim her 13 rebellious colonies. Second, the collapse of the common currency (the Continental) had plunged the new United States into a depression from which it was having a very difficult time emerging.

Today, Europe is not directly threatened with invasion from without, although anyone with an eye for history can see that Russia is a potential threat. It is however facing the demise of its common currency and quite possibly a depression.

So, why did the European Constitution fail? To put it quite simply, when the various United States ratified our Constitution (including the Bill of Rights) in 1791, we had already suffered a collapse of our currency, and the threat of invasion was a “clear and present danger.” Importantly, we did not put it to a common vote. In each state the final decision was made by a simple majority of its legislature, not by a popular vote of its citizens. Notably, in several states, including New York, the ratification was accomplished by a margin of only one or two votes!

The delegates from the EU nations took several years to craft a constitution they could all accept, but rather than take it to their parliaments, several nations decided to hold a public referendum on the new treaty/constitution. The popular vote went against the new Union first in Ireland. There is little doubt that the Irish would love to rescind that decision today so as to have the rest of the EU assume their debt.

### **The Likely Outcome in Europe**

It appears to me that things will have to get a whole lot worse in Europe before they can get better.

There are only a few European states that are willing to give up much in the way of sovereignty (states’ rights) in return for a “more perfect Union.” A collapse of the Euro, accompanied by a continent-wide economic contraction will probably have to become a reality before the ancient European nations will be willing to surrender some of their national pride and sovereignty.

While I hate to even contemplate such a thing, it may well take a major war to finally unite Europe. Sadly, even then, the solution may come too late. The Europeans are confronted with a demographic dilemma. They are not having enough children. As a result the population is aging quickly. The strikes that have worsened the situation there are largely about governments attempting to increase the retirement age for government pensions.

There are several major trends underway on the Continent, some or all of which may mark the early stages in what is to come.

- Russia is rearming. Vladimir Putin is about to return to the Presidency and he has already pushed a bill through the Duma dramatically expanding the military budget. Since the rest of Europe is busily cutting military readiness, Russia’s rearming move reminds me of Germany’s similar move in the 1930s.
- Poland, Sweden, Germany, and France are discussing a political and economic union. This could be the beginning of a new Eurozone, but with the political authority to make it work. It could be the core of a United States of Europe.
- Europe has held together and avoided a major war for a generation because the United States has kept troops stationed

there. Budget and political pressures may cause the United States to pull out. If so, then history suggests the nations of Europe will soon be rearming and preparing for war.

### **In the Short Term**

In the shorter term, the Euro, at least as we know it today, is on life support. I would give it a less than 20% probability of survival. Presuming that it fails, there will likely be a short term panic in the markets.

Unlike the unexpected failure of Lehman Brothers, which could have resulted in a total worldwide financial meltdown, the failure of the Euro is widely anticipated in the financial community. The surprise would be if it *didn’t* fail.

Banks and other financial institutions have been and are running scenarios and drills for just that event. Here in the United States, the impact would be minimal and short. The Federal Reserve has made contingency plans and set up the channels by which it would supply dollars for use by European companies that owed money to American companies.

The upshot of this is that there is a very real possibility that the dollar could effectively replace the Euro as the European common currency, at least for the short term. European companies and nations are purchasing dollars at a record rate. A potential freeze-up in the European banking system was averted last week with the announcement that there would be a coordinated effort by all the major banks in the world to supply European banks with U.S. dollars in order to facilitate the orderly continuation of commerce. That was a major step and amounted to an acknowledgement of the American

Dollar as the European backup reserve currency. At the same time it provided a means to get the surplus dollars being held in China, India, and other major exporters into Europe where they are needed.

That, in turn, allows those same dollars to be used to purchase oil, food imports, and equipment needed to keep Europe running. As you may guess, the suppliers of those things whether they happen to be in Africa, Asia, or America, insist on being paid in dollars.

There is a certain irony in all of this considering that Russia, China, Iran, and several other countries were calling for the Euro to replace the dollar as the standard currency for oil purchase a few years ago.

This week the heads of state of EU will meet. If they do not come up with a definitive resolution to the problems they are facing, then it may all be downhill from there.

### **The Bottom Line**

The odds are very high that the Euro will collapse, and even if the system is somehow patched together, Europe will have a very long-term and severe recession. Unless the Eurozone breaks up, the debt load of the insolvent countries will drag down the rest of the continent for years to come.

If the Eurozone comes unraveled, expect a short term market panic, very likely followed by a relatively quick “relief recovery” here in the United States. Every economic indicator here (except for housing) is pointing upward. The reverse is true in Europe and even in China.

Our major trading partners are in North America with our secondary market along the Pacific rim and India. We can not only survive without Europe, we very probably will prosper if the Euro fails. Meanwhile give thanks you are in America rather than Europe. \$\$

### *The Markets (Continued from page 1)*

rency was imminent, we would have missed that 7% rise in value we saw last week.

### **The Economy and the Markets**

Growth in real gross domestic product here in the United States is ratcheting up to the 2.5% to 3.0% annualized rate based on November data. Unemployment dropped from 9.1% to 8.6%. I know that many commentators have attributed that to people giving up on attempting to find jobs, but the underlying details of the Labor Department report do not support that.

The *Wall Street Journal* reported that U.S. auto sales in November were at a 13.6 million annual pace. That is the highest rate since the recession hit in 2008 and up 13.9% from a year ago. During the third quarter of 2011, consumers increased their “durable goods” purchases at an annual rate of 5.5%.

Perhaps the most important number for those with domestic stock investment portfolios is the degree of corporate profitability. According to Mark Zandi, the chief economist at Moody’s Analytics, who has been uncannily accurate in his assessments over the past several years, publically traded corporations are averaging a 15% profit margin today. That is the highest level since 1969.

If the economy is growing at a meager 2.5% rate, how are corporate profits the highest they have been in over 40 years? Like most other things, there are several factors at work here. First, corporate productivity has risen dramatically. More specifically, here in the United States our manufacturing productivity has been rising at an annual rate of about 5%. At the same time, expenses per employee in the U.S. work force have been

declining at a 2.5% rate.

That is both good news and bad news, depending on whether you are a wage earner or an investor. It also explains why our GDP is now officially higher than it has ever been, but we still have 8.6% unemployment.

Businesses are still purchasing new equipment for the long term. That includes computers and machinery that increase their productivity. The net result is that even in this environment in which prices on manufactured goods are actually falling, corporations are able to make things for less and thereby able to maintain their profits.

Our biggest driver in the economy today is a surprise for most people who hear of it. It is *exports*. Quietly in the background of all the noise and excitement our exports have been rising and our imports have been falling. Each quarter the Commerce Department reports that we are getting closer to being a net exporter of goods and services.

One milestone that was either hit or to which we are very close is the energy trade. We are now exporting about the same dollar value of petroleum products as we are importing. Our imports are primarily in the form of raw crude oil but we are exporting large quantities of gasoline and other end user products.

### **A Normal Recovery & Expansion**

There are business-cycle recessions and there are financial-recessions. The recession we officially emerged from in 2009 was a financial recession. The recovery and expansion following a financial recession is different from that of a business cycle recession.

Business cycle recessions are generated by an excess accumulation of inventory by businesses. They end when the businesses

unload their inventory and people resume buying new “stuff.”

Financial recessions are very different. First they can easily become depressions. In this case the Federal Reserve and Treasury executed a school-book rescue to halt the banking melt-down that sometimes results from such events.

### The Cause and Effect

Financial recessions result from an excessive accumulation of debt, mainly at the corporate and individual level. A key component in that debt before a financial recession is that much of it will be used to speculate. A study released by the Bureau

of Economic Analysis last month indicated that the largest single contributor to the housing mortgage crisis was not poor people buying too much house, but speculation by otherwise well-off people.

That speculation was enabled by mortgage companies and banks willing to loan money to people with good credit ratings so that they could buy houses with little or nothing down. In many cases the borrowers stated that they intended to move into and occupy the house, at which point they would sell their previous home and apply the sale price to the new mortgage.

In fact a significant number of those borrowers had no intention of living in the house they were having built or buying. They intended to “flip” the house to someone else at a profit.

The result was that home prices rose across the board, including for

those who were legitimately buying or building homes in which they were going to live. The same thing was going on in Ireland, Spain, and other countries. Now we are facing the results.

With the rise in real estate values, taxes collected by local governments rose and those same governments increased staffing and borrowing. The mortgage bonds which resulted from those speculative purchases were assumed to be for primary residences, and as such were considered to be a “safe” investment for banks, insurance companies, pension funds, and everyone else.



With the realization that far too many people and institutions were “gaming the system” in a speculative frenzy, the house of cards came down. Now we have a lot of debt on the books of a lot of institutions, people, and governments.

### Recovery and the Benefit

We are now well into the real recovery from that debacle. A financial panic and recession can be a good thing; that is, if the companies in the economy use it to “tool-up” and get better technology to become more competitive. That idea is the subject of the classic book, *Creative Destruction*. Here in the United States we have done a very reason-

able job of recognizing our errors and are well on the way to correcting them.

Corporate debt is at historic lows. Personal debt is coming down fast. While it may be hard to accept, even our national debt is at a not-unhealthy level. Yes, we do need to figure out how to deal with the projected expenses of our entitlement programs for the elderly, but that had little or nothing to do with the current crisis. The key is that the crisis is causing us to debate the issue.

The Congressional Budget Office has noted that if we do nothing and allow the Bush tax cuts to expire

at the end of 2012 we should be well on the road to paying down the national debt a decade later. Only time will tell.

### The Market

Meanwhile the S&P 500 is low. Historically, the average forward price to

earnings (P/E) ratio of that Index has been about 17. Today it is about 10. That means that when we finally get the Congressional reality show and the European tragedy behind us, even if corporate earnings were to remain flat, we would likely see a rise in market values of about 70%. That equates to a Dow of about 20,000. I know that sounds absurd, but if anyone (other than me) had told you in 2009 that we would see a double in market value three years hence, you would have thought that was crazy too.

In 1982, the last time the P/E ratio was this low, the Dow was at 1,000. \$\$

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