Financial Wanderings

A masterful examination of the previous month's financial events, written by Brad Blackburn, CFP ®

(and made even awesomer by Andrea Dickerson)

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July
Market Numbers:

S&P 500: +3.6% to 2,174

NASDAQ: +6.6% to 5,162

DJIA: +3.8% to 18,432

10-Year Treasury Yield: -2% to 1.46%

Gold: +2.8% to $1,357/oz

Why it did what it did

I guess these are the good times. The markets aren't worried about the US economy, or the global economy, or Brexit, or China, or Trump and Hillary, or oil, or negative interest rates, or all the junk that's happening in the Middle East…

Even with all that scary stuff, stocks just keep going up. What's odd is that at the same time stocks are setting records, bonds are doing incredibly well too. Bonds are usually seen as a more conservative investment. So, if bonds are doing well, it generally means that people are scared. In Germany, there are negative rates on their government bonds, which means investors are willing to actually pay the German government just to keep their money safe. Stop and consider that for a moment: Investors are PAYING for the privilege of loaning the German government money. That's not the way things are supposed to work.

Bond investors are eagerly snapping up investments that are essentially guaranteed to earn nothing. If they are willing to do that, they are scared.

The stock market is partying like it's a boom-time at exactly the same time the bond market is screaming at us to panic. So, which side is right: The stock market or the bond market?

Economy

The GDP report, which is the broadest measurement of the US economy, was pretty terrible for the 2nd quarter. After

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only growing 0.8% during the 1st quarter of the year, hopes were high for a rebound in the 2nd quarter. Sadly, those hopes were dashed as the GDP only grew 1.2% in the 2nd quarter.

Let's step back for a moment to look at the big picture: Over the first 6 months of the year, the economy averaged less than 1% growth -- and that's with the Fed and Central banks all over the world stomping on the gas pedal. That is not evidence of a strong economy.

Thankfully, the glorious American consumer is still holding this whole thing together. In the second quarter, consumer spending jumped 4.2% as Americans spent more on everything from cars to housing to groceries to recreational goods.

Unfortunately, despite strong consumer spending, businesses still aren't spending at all. Durable goods orders are still weak, and businesses cut their fixed investment by 3.2%, the biggest drop since the Financial Crisis.

Consumers can't hold up the economy forever. In fact, there are already sings that the increasing consumer spending isn't coming from income growth, but rather from depleting savings accounts. Unfortunately, spending your savings account isn't a sustainable model of growth. At some point businesses will have to have to start spending if this economy is going to hit the next level.

<u>The Fed</u>

Let's pretend that I'm wrong about the weak economy, and we are poised for increasingly strong economic growth in the coming months and years. Even that optimistic scenario brings up a whole new set of problems, because an increasingly strong economy would force the Fed to raise rates. We saw what happened when the Fed did that last year: Trillions of dollars flowed into America from across the world. That upset the global economy and made the dollar go up, which hurts the profits of corporations, which hurts the economy. It's a vicious cycle.

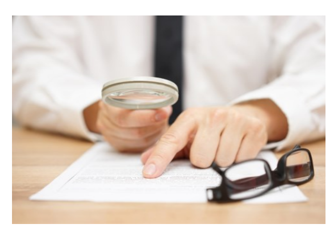
This is a key point in why I'm increasingly cynical about the markets and the economy: Even the best case scenario is a little spooky.

<u>Oil</u>

Has anybody noticed that oil has fallen 20% in recent weeks. The markets sure don't seem to be worried about it. But this is something I'm keeping a close eye on. The crashing price of oil was a major reason the markets fell so steeply to start the year. So if oil keeps falling, the markets might start to pay attention again.

<u>So what should you make of all this?</u>

At the start of this article, I asked the question of whether stocks were right or bonds were right, and to me the answer is clear: The bond market has it right. The US economy is slow, and the global economy is dragging us down. The scary part is that this weak growth is happening even with incredibly low interest rates all across the globe. The whole point of low rates is to spur on robust economic growth, right? Well, we've had low rates for a long time. Where's the growth?



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(Why it did what it did.....Cont'd from page 2)

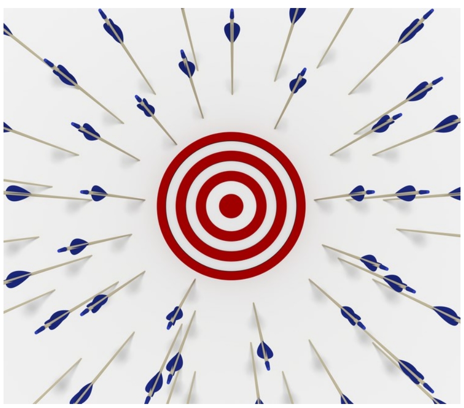
I'm not predicting a major recession starting tomorrow, or that the markets are going to tank. But I have a really hard time imagining a catalyst out there to accelerate our growth.

And if we aren't accelerating, then either we're stuck right where we are, or we're slowing down further. Neither of those are good scenarios.

I think I can summarize my feelings about this market like this: There's a lot of potential risk, and not much reward.

Are we headed for stagflation?

For years, the Fed and other central banks around the world have been pushing their hardest for economic growth and inflation. Despite their best efforts, so far they've achieved very little of either.



However, there are some signs of inflation picking up, which brings up a pretty spooky scenario: What happens if the Fed is successful in creating inflation, but without the corresponding economic growth? That scenario is what economists call "stagflation," which is high inflation combined with stagnating economic growth. Former Fed chairman Alan Greenspan recently said stagflation is "the primary thing" he's worried about in today's world.

If his fears are correct, and inflation begins to significantly pick up, the Fed might be forced to raise rates quickly (to combat the inflation). Unfortunately, higher rates could easily squash the meager economic growth we currently have. That could leave policymakers choosing between rampant inflation or squashing economic growth. Neither are good choices.

Supply and demand: The Best (and worst) argument for stocks

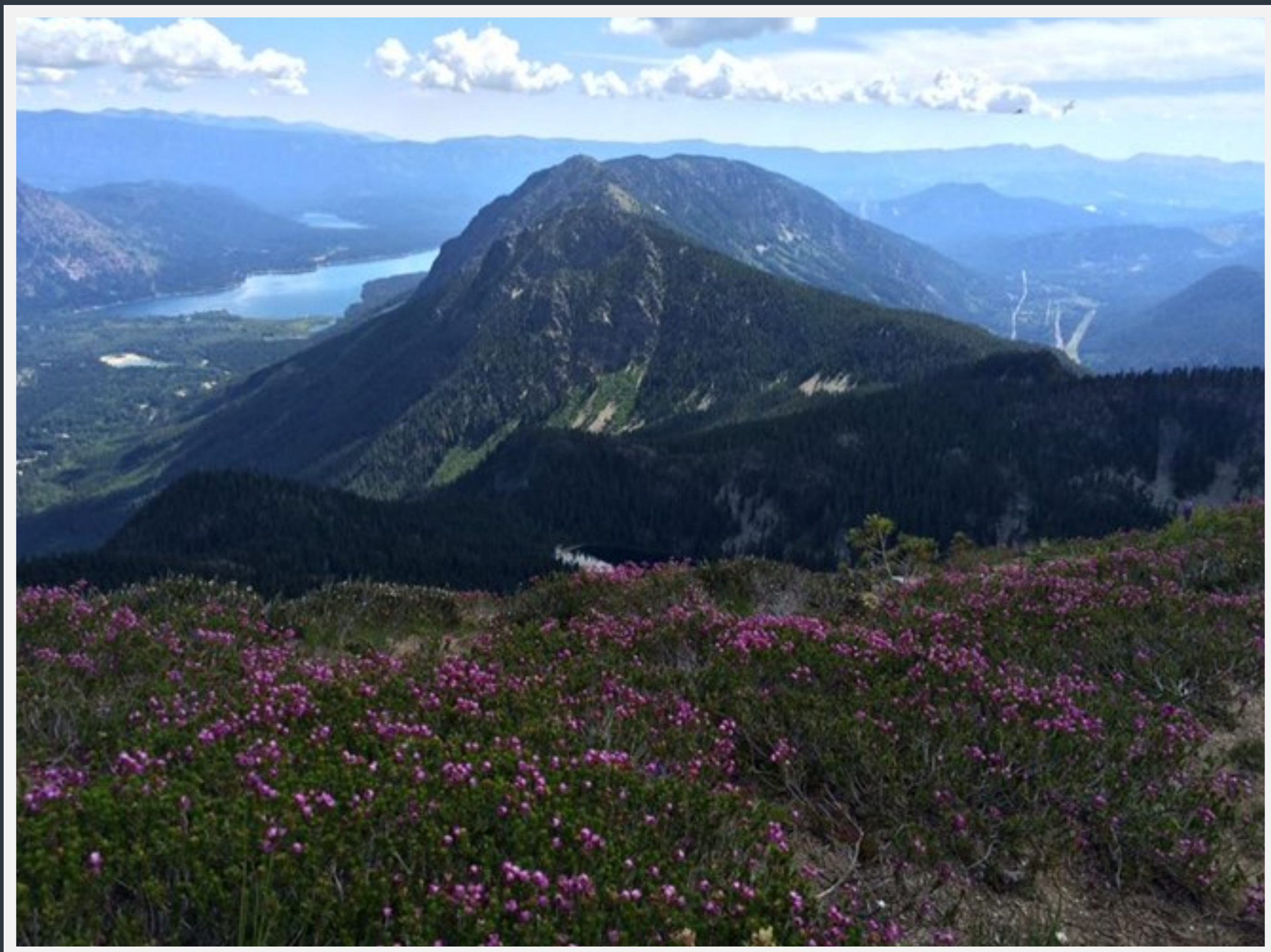
The American stock market is essentially at its all-time high – and bonds and real estate aren't too far behind. In fact, nearly everything in our financial world is really expensive. That's not really how things usually work. Typically when one asset class does well, another languishes, and another barely moves. That's the whole idea behind diversification, right?

So what's causing this strange world where everything goes up? It's all about supply and demand. There's an incredibly large amount of money in this world that needs to be invested somewhere. With rates as low as they are across the globe, and the global economy as weak as it is, American stocks and bonds are relatively appealing.

As a result, there's massive demand from all across the globe for American stocks and bonds. We all know from economics 101 that demand increases the price for things. So perhaps it makes sense that our major asset classes are all near record highs. But it worries me for the future. If the only justification for rising stock prices is high demand, what happens when that demand goes away? If stock prices keep rising without any corresponding strong economic growth -- that's the definition of a bubble.

Probably a Mountain or a Lake

This photo was taken from the slopes of Mt. Mastiff, which is a prominent peak visible from Hwy 2 as you're heading up Stevens Pass. I thought it was a really interesting (and beautiful) angle from which to see Lake Wenatchee, Nason Ridge and Hwy 2.



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