Financial Wanderings

May 2016

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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May

Market Numbers:

S&P 500: +1.5% to 2,097

NASDAQ: +3.6% to 4,948

DJIA: +0.1% to 17,787

10-Year Treasury Yield:

+0.05% to 1.84%

Gold: -5.5% to $1,218/oz

Although the commentary in this newsletter has been thoroughly researched, well-reasoned and contains many impressive multi-syllabled words, please enjoy it responsibly. There are many economic minds that are far smarter than mine—and even they can't agree on even the simplest economic questions. In other words, please enjoy this newsletter with the full understanding that it may be entirely wrong.

Why it did what it did

The S&P 500 is up almost 3% on the year. From where we stand now, you could almost forget about the wild and crazy start to the year we had. But it's always good to reflect back on the hard times.

So, I thought it would be good to look back at the things that spooked the markets so much earlier in the year. Have they improved enough to justify this calm stock market? Or, are the markets setting up for another fall?

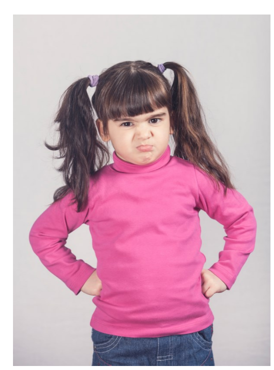
Oil

Given the benefit of hindsight (which still is far from 20/20), the plunging price of oil was the major factor that caused the markets to fall so steeply at the start of the year. In less than a year, a barrel of oil dropped from $100 to $27. That spooked the markets in a major way.

I never understood why the markets were so worried, but the price of oil has almost doubled from the low price it reached in February. So, whatever it was that spooked the markets, it's long gone.

The Fed raising rates

Near the end of last year, the Fed indicated they expected to raise rates 4 times during 2016. The markets were not pleased by that.



But here we are, nearly halfway through the year – and the Fed hasn't raised rates at all. For the markets, that's a cause for celebration.

(Cont'd on Page 2)

(Why it did what it did.....Cont'd from page 1)

The Global Economy

Another reason for the nervous markets was the weak growth across the globe, especially in China. Those problems haven't gone away, but they also haven't gotten worse. In today's world, that qualifies as good news.

So what should you make of all this?

I really hope I'm right, and the market panic earlier in the year was mostly about oil, because it's really hard for me to imagine a repeat of oil dropping so steeply.

But that doesn't mean there aren't lots of things to be worried about. The thing that worries me more than anything else is the one thing the markets don't appear to be worried about, which is the US economy.

Don't misunderstand me; the US economic numbers are still solid. But economic growth doesn't last forever, and the weak global economy is slowly pulling us down. In my mind, it comes down to this:

Can the US economy hold on long enough for the global economy to pick back up?

If the US economy falls into a recession before the global economy recovers, it could be the start of a downhill spiral. However, if the global economy begins to gain speed, it could finally push America into impressively strong growth… I'm hoping for the latter.

If _________ wins the Presidency, will the markets crash?

I can't blame you for being a little spooked about our presidential race. It's easy to imagine the stock market panicking as the world comes to the realization that our next President is going to be Donald Trump or Hillary Clinton.

As horrifying as that is, I'm guessing the markets will take it in stride. To support this point, I'd love to be able to amaze you with impressive scientific evidence as to the effect of presidential elections on the markets. But that's an incredibly hard thing to do. Over the last 100 years, we've only had 17 presidents. I'm no scientist, but that's a very small sample size. So, it's really hard to look back historically and get any real sense of what's going to happen for this election. And even if there was some sophisticated science to look to, I'm not sure the world has seen anything quite like this.

"I like people who weren't captured"

However, allow me to calm your fears just a little. Let's start with Hillary Clinton:

As much as I'd love to express dramatic angst about Hillary Clinton, the S&P 500 rose 150% during Bill Clinton's eight years in office, and has nearly tripled under Obama. That doesn't mean the markets will boom under another Clinton presidency, but more of the same isn't going to spook the markets.

Donald Trump, of course, is a different story – and I'm pretty sure that's how he likes it. The best part about Trump is precisely what could spook the markets: He's a wild card. There's no arguing that our political world needs a good shake-up, but the markets hate uncertainty – and who knows what to expect of a Donald Trump presidency?

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For that reason, I do think the markets might get a little nervous if it looks like Trump could win. However, a little nervousness doesn't mean a flat-out panic. I think the markets will take a Trump presidency in stride for 2 reasons.

The first is that if Trump is winning, it's probably because he's found a way to be less of a "character." If he is able to tone it down, and come across more "presidential," the markets may not be as worried about a Trump presidency.

However, the more important consideration for the markets is that presidents simply don't have much control over the economy. Sure, President Trump might have the power to bomb people, insult world leaders, and do all kinds of "creative" stuff I'd never think of, but when it comes to making laws and regulations that impact the economy and the markets, Trump will need Congress.

In other words, whoever our new president is, they won't be powerful enough to mess up the economy all by themselves. That's why it's such a good thing that Congress and the Supreme Court function so well.

Interesting Items Indubitably Involving Inflation

Inflation is always a hot topic in the financial world. However, in today's world, inflation (or the lack of it) is playing an even more important role. It's also a little bit controversial, which is always fun. So here are some of the most important things you should know when it comes to inflation:

Policymakers want MORE inflation

This is the key point in realizing why inflation is so important in today's world. I grew up with the idea that inflation is a bad thing. However, the Fed and policymakers all over the world are actively striving to increase inflation. To find out why, keep reading.

Inflation helps with debt

The basic idea of inflation is that your money gets less valuable over time. For any money you have sitting in your bank account, that's a bad thing. However, if you borrow money, inflation can be wonderful, because you pay back your debt with money that's less valuable.

If that doesn't make sense, think about it like this: Would you rather pay back a $100,000 loan in 1950's dollars or in today's dollars?

It's really about deflation

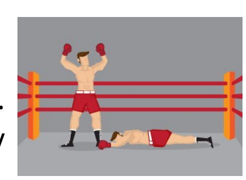
As helpful as inflation would be to a world with massive debt, deflation would have the exact opposite effect. That's a major reason the Fed, and other central banks across the world are fighting so hard to increase inflation.

With deflation, your money gets more valuable as it sits in your pocket. That sounds like a good thing, but deflation scares the heck out of economists because it encourages people NOT to spend. After all, if money in your pocket is getting more valuable every day, you might as well keep it in your pocket.

Unfortunately, globalization and technological improvements are long-term trends that are driving prices down (which is what deflation is). If you add to that a weak global economy (which is also deflationary), you can see why the world is so worried about deflation.

Inflation is political

In much the same ridiculous way that your political beliefs somehow affect whether or not you believe in global warming, political beliefs also seem to affect how you perceive inflation. In recent years, I've argued with many Conservative friends who were absolutely convinced that inflation was much higher than the official statistics showed (there's some truth to this as I discuss in the next point). However, at this point, nearly everyone agrees that inflation is low. So, they've officially lost this argument.



It's hard to blame Conservatives, who were rightly worried about the Fed creating out-of-control inflation. However, as much as the Fed has been aggressively trying, so far, they have failed.

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Inflation is hard to measure

Do you own a house, or do you rent? How much do you drive? How much medical care do you need? Are you paying for college…?

All of these questions have an enormous impact on the level of inflation you'll personally experience. But the official inflation statistics can't offer nearly that much nuance. They have to tie up all those variables into a tidy little package. Unfortunately, that oversimplifies it to the point of being nearly pointless.

$\boxed{1+1=2}$

But measuring inflation gets even more difficult. For example, how should economists handle the effects of "substitution?" If steak gets too expensive, people probably won't buy as much steak. Instead, they might choose to buy more ~~vegetables~~ chicken. So, should inflation statistics fully account for the rising cost of steak, even though lots of people will stop buying it?

These are just a couple of the intricacies involved in measuring inflation. Unfortunately, all of this uncertainty allows for ample evidence, and ample doubt, to support just about any conclusions you could possibly imagine. So maybe this whole article has been a waste of time.

The glass is 2/3rds full

Be warned, the conclusion of this article is strangely positive. But it's an important idea, so I'm going to risk the potential damage to reputation.

There is a major problem with our economic calculations: They don't measure technological improvements very well. Imagine being back in the 1980's. If you had a gadget with as much incredible information, art, culture, and entertainment as a smartphone, it would have sold for millions of dollars. However, in today's world, nearly all of us hold that treasure chest in our pockets. Does that mean we are all millionaires?

Along the same lines, how many more people are living far better lives today because of improvements in medical technology? Imagine being gravely ill in the 1950's, how much would you have paid for modern medical technology?

In today's world, a modest amount of money can buy experiences that were unthinkable to the richest of the rich people over the vast majority of humanity. But how do you measure that in an economics statistic? Modern economics assumes that more money changing hands is always a positive thing. But that means it's a bad thing when good stuff gets cheaper and better. But that's clearly not a bad thing.

There are important real-world implications to this: Nearly everywhere you look in this world, we hear about how horrible things are. But I'm not convinced. I think we have it pretty good.

Don't get me wrong, I'm not saying we don't have our problems. But we are living in the most incredible time in human history, and our living standards have increased dramatically. If our old economic statistics don't reflect that, it's not the economy's fault. But perhaps we should all be a little more grateful, and a little less angry.

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