# 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**: -1.5% to 1,931

**NASDAQ**: -0.7% to 4,370

**DJIA**: -1.6% to 16,563

**10-Year Treasury Yield**: +1.98% to 2.58%

**Gold**: -2.95% to $1,283/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'd It Do What It Did?

*One humble man's wise interpretation of the key events of the past month. What happened, why did it matter and how did it impact the markets?*

**It's officially time to panic. I've instructed all my clients to immediately call to breathlessly demand that I SELL EVERYTHING RIGHT NOW. I know I'm supposed to be a calming influence. I know I'm supposed to shepherd my clients through these stressful times. But if you can look past my calm, wise, handsome appearance, you'll see that I'm a human just like you – and I'm terrified too.**

The classic "fake panic" gimmick is one of my favorites. Everything is going to be ok, I'm almost completely somewhat sure of it. But July was a rough month. The S&P 500 dropped 1.5% – the first monthly drop since November of 1983 (exaggerating to make a point is another favorite gimmick of mine). After years of the markets giving us a warm, gentle backrub, even a 1.5% drop can feel like a slap in the face. But there's no reason to panic. Coincidentally, this reminds me of something I heard a few months ago:

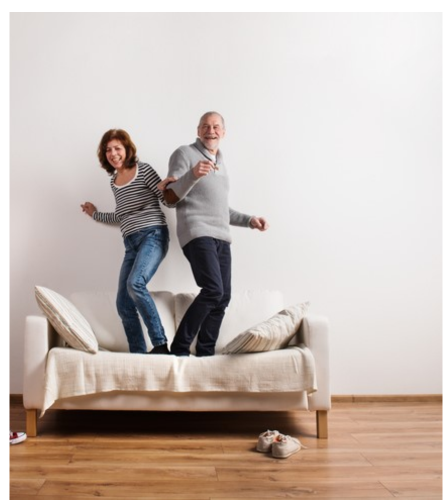
*The coming months probably won't bring a boom in the markets.*

*On the other hand, it's hard to imagine a significant market drop either.*

I wrote that at the end of May. The S&P 500 is up a measly 0.37% since then. This is what I sound like when I'm gloating.

### Jobs, the economy & the Fed:

The economy looks like it's still picking up speed and finally hitting on all cylinders. Yes, that means it's time for a happy dance.



Our employment situation is particularly strong. In June, the US economy added a whopping 288,000 jobs. But that's not all… In 2014, we are averaging

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*(Why'd It Do...Cont'd from front page)*

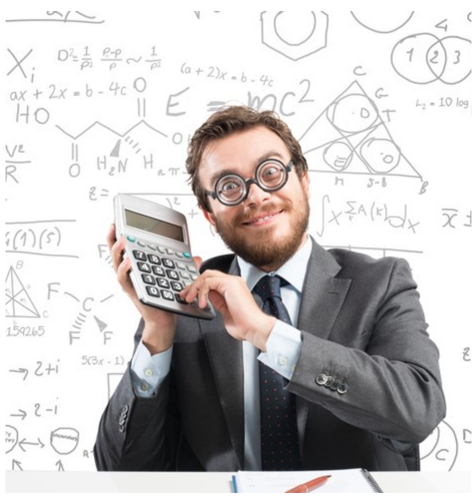
more than 230,000 new jobs a month. But that's still not all… Our job growth has been remarkably consistent: According to Blackrock, we've seen five consecutive months with more than 200,000 jobs created. That hasn't happened in more than 15 years. But we've been adding jobs consistently for years now; the problem is they tended to be lower quality jobs (low pay & part-time). So here's the best news yet: That seems to be changing. According to Marketwatch, 58% of the jobs created this year pay more than the national average hourly wage, which is $24.45/hr.

When you put it all together, we've seen strong, consistent growth of high quality jobs. That's exactly what we need. It's too bad we already did the happy dance… I'll settle for an adorable fist bump.

But there is a downside to all this good news. As the job market improves, wages are likely to increase. According to the Bureau of Labor Statistics, we're already seeing it. The "employment cost index" showed that worker pay increased the most in 6 years over the 2nd quarter. In almost every way, that is great news – we want people to make more money. But in the Fed-centered universe the markets still live in, higher wages means higher inflation – which means the Fed may have to raise rates. Cue the market panic *(for more on this, please read "This will make your eyes cross" on the next page).*

GDP

Remember all the lame excuses economists were making when our 1st quarter GDP fell more than 2%? I know it was cold outside and stuff, but how do you get a 2.1% drop in GDP when the economy was supposed to be warming up? Well, chalk one up to the smart people with calculators.



The weather warmed up a little, and 2nd quarter GDP grew at a 4% rate.

There was a lot of good news in the nitty-gritty of the report too. Consumers spent a lot more on big-ticket items, and businesses spent more on equipment and software. Of course, this report will be revised again and again and again, literally. So let's just wait a little while before we get too excited.

For the sake of conversation, let's assume the economy really is picking up. Here's the biggest question: Is this sustainable? We've seen a couple economic spurts over the last 5-6 years that didn't turn into anything. Could this be the start of something real, or will we slip back to the same old slow-growth economy once again?

Earnings

As weak as the broad economy has been since the financial crisis, corporate earnings have never been better. Our corporations are lean, mean, and creating more than $175 bazillion every quarter. Yes. I made up that statistic. The point is – corporations are earning more than ever before. That's important for investors because earnings are at the heart of what makes stocks valuable. As the economy picks up, corporate earnings will need to follow suit, or it won't help investors much.

So far, the returns are good with more than 75% of the companies that have reported so far beating their earnings expectation. Even better, according to Nuveen, earnings growth for all stocks is likely to be up a whopping 9%. Even better than that, companies have been actively telling the markets they expect improvement in coming quarters. I hope this good news continues.

So what should you make of all this?

The economy is improving, but it might not last. Even if it does last, it doesn't mean stocks are in for big gains. Here's my bold prediction: We're going to have some good times in the coming months. We're going to have some bad times in the coming months. We're also going to have some pretty boring times. In the end, I think we'll end up pretty close to where we are right now.

# This will make your eyes cross:

## What is “full employment?”

Thousands of hours of research, thought and debate are being focused on a key question in our economy: What is the real “full employment rate?” In other words, what is the smallest number of unemployed people we can have, while still enjoying a healthy economy?

On the surface, an unemployment rate of zero should be the goal. Everyone who wants to work should have a job, right? However, with so many employers chasing so few workers, that could cause steep wage growth, which could lead to rampant inflation. The trick is to find that sweet spot where plenty of people are working, but wage growth is under control. That is “full employment.”

Here’s why this is particularly relevant right now: Many economists think our current unemployment rate of just above 6% is getting close to full employment. If that is true, the Fed should immediately begin raising rates to ward off inflation. Of course, there’s another camp of economists that believe full employment is closer to 5%. If that’s true, inflation isn’t nearly as likely in the coming months, so the Fed could continue to keep rates low.

The best marker to watch to see if we’ve hit full employment is wage growth, which has been picking up for the last couple of months. If that trend continues, it could be the start of significant inflation. That could cause the Fed to raise rates sooner than the markets expect – which means the markets will probably throw a temper tantrum. At least we have that to look forward to.

# Is this a bubble?

As someone who frequents all kinds of financial media all the time, I see my share of financial headlines. My official, highly unscientific research study unequivocally supports the following conclusion: We’ve never had more headlines screaming about a stock market bubble.  If those headlines are correct, and this really is a bubble about to burst, it’s not like any other bubble we’ve seen. Almost by definition, it’s not a bubble if the vast majority of people think it’s a bubble. Therefore, if all the headlines are screaming BUBBLE – it’s probably not a bubble. Remember in the late 90’s when internet stocks couldn’t lose, and people quit their jobs to become day-traders? It was supposedly a new world, where it made sense for internet stocks that never had a single penny of profits to be worth billions of dollars. That is what a bubble looks like.

Remember back in 2005 & 2006 when real estate couldn’t lose, and people quit their jobs to flip houses? It was supposedly a new world, where new exotic financial instruments allowed huge amounts of debt like never before. That is what a bubble looks like.

A bubble is when people are so greedy, they lose sight of risk. That’s not what’s happening in today’s world. Businesses are still too scared to spend their enormous piles of cash, and huge swaths of the general public still shun stocks. Believe me, when I’m talking to my clients, none of them are begging me for the riskiest investments out there. The conversation is almost always about how to control risk. That is NOT a bubble.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So, if it's not a bubble, what is it? The less "headline worthy" description would be that stocks are merely "overvalued." Maybe by just a little, or maybe by more… However, just because stocks are overvalued, doesn't mean they'll drop from here. When people talk about a bubble, or stocks being overvalued, they are talking about paying a high stock price relative to the earnings of a company. That's the key ratio – the price you are paying for your slice of earnings. If that ratio is out of whack, there are two ways to fix it, the price of the stock can come down (which is what we worry about), OR the earnings can come up. My theory is that the great run in the markets over the last year-and-a-half was due to the markets forecasting an improving economy, and improved earnings for stocks. In other words, the markets expect the earnings side of things to improve. That's not a bubble; that's what the stock market does. Of course, if the earnings DON'T improve, the markets will probably fall – maybe a lot. But that's not a bubble – so stop calling it that.

## Probably a Mountain or a Lake

I recently took a 2-night backpacking trip into the Glacier Peak wilderness. If you are looking for variety, this is the place to go. There are picturesque rugged mountains, beautiful glacial valleys and flowery ridges in every direction. You'll be seeing more photos from this trip in future months. For now, here are two of my favorites.

This is Glacier Peak from an area called the "Glacier Peak Meadows."

This is Glacier Peak on the left, Indian Head peak to the right, and a field of lupine front and center.

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