Financial Wanderings

July 2015

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: +1.97% to 2,103.90

NASDAQ: +2.9% to 5,128

DJIA: +0.41% to 17,691

10-Year Treasury Yield:

-6.38% to 2.20%

Gold: -6.72% to $1,095/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.

A little dose of perspective

Listening to financial podcasts has become an obsession of mine. How cool is modern technology? I can mow the lawn, drive, or take a hike – and also be learning all kinds of interesting stuff about the financial world. But this isn't a column about podcasts, so I'll get to the point. On a recent hike, I was indulging on old episodes of NPR's Planet Money, and I received a little dose of perspective. The podcast was from September 2012, and was titled "Even If You're All-Powerful, It's Hard To Fix The Economy." The Planet Money team was working with well-known economist Mark Zandi, using his "all-powerful" financial model to figure out what it would take to get the unemployment rate from 7.8%, where it was at the time, all the way down to 5% before the presidential election in 2016.

They used Mr. Zandi's financial model to make many wildly optimistic assumptions about the economy. For example, they assumed the Fiscal Cliff and the Sequester weren't going to happen. The model also assumed Europe recovered from its crisis, there were no Middle-East wars, China and Africa grew like crazy, housing prices rose dramatically, and consumers were incredibly confident. Even with those outrageously optimistic assumptions, they couldn't get the unemployment rate to fall any lower than 5.2%. Their conclusion was that it was laughably ridiculous to think we could reach 5% unemployment by the next election.

But if you fast forward to today, our unemployment rate has dropped all the way down to 5.3%. So, we've nearly reached the goal that was laughably ridiculous back in September 2012, and we're still more than a year away from Election Day. To get here, we plowed through the Fiscal Cliff, the Sequester, multiple wars in the Middle East, Russia starting a war, continued European weakness, and China slowing down significantly. I think that is an amazing accomplishment.

Before you argue with me that the standard unemployment rate leaves out millions of workers, let me say this: You are absolutely right. However, the U6 unemployment rate is much broader and does include those people – and it has dropped from 14.7% down to 10.5% since September 2012. That's almost the exact same percentage drop as the standard unemployment rate (about 30%), which is undeniable progress.

I'm fully aware that saying good things about the economy makes me an Obama-loving Communist to many people. But the credit should go to the strength and resilience of America. Our economy has grown past even the rosiest predictions of the last few years. Go America.

The Great Wall of worry – part 兩

In one of my most amazingly timely predictions ever, here's what I wrote back in May:

The Shanghai Index is up more than 120% in less than a year. At the same time, China's economy is at its slowest pace since 2009. That's not how things are supposed to work. Does that mean there's a bubble in Chinese stocks?

Merely one month after I wrote that, the bubble officially burst – and the Shanghai Composite Index dropped more than 32% in less than 4 weeks. As much as I'd like to celebrate this as an incredible display of predictive prowess, it wasn't hard to see coming.

Just because it was easy to see coming doesn't mean it's not a big deal. China has the world's largest economy; we do not want them to fall into any sort of crisis.

As usual, there's more than one way to look at this. Here's my optimistic take: By any definition, the Chinese stock market has crashed since June. However, it's still up more than 13% in 2015 – and it's up nearly 75% over the last year. If that's a stock market "crash," I'll take it. Of course, there are still millions of Chinese people who invested near the top of the market. They've seen big losses, and aren't happy about it.

The Chinese government is in a very difficult spot. They are attempting to transition from an export-based economy ("Made in China") to a consumer-based economy ("Charge it").

Even in the best-case scenario, that transition takes time. But time is something the Chinese leadership probably doesn't have. They need economic growth to keep their massive population happy. For years, that growth was encouraged by a real estate bubble, but that bubble deflated. To fill the void, the Chinese government encouraged its people to invest in the stock market. That worked beautifully, until it didn't.

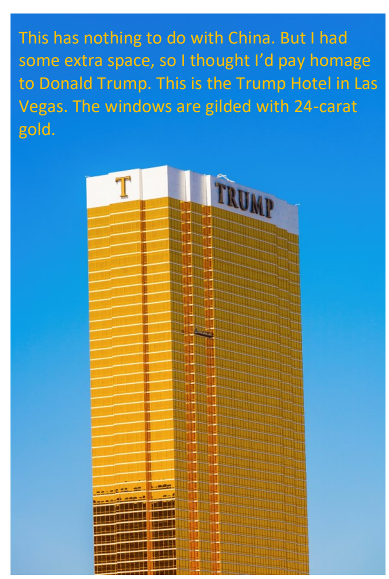
Given that the Chinese government wasn't elected, they have a significant credibility problem. To answer that problem, they have two tools. The first is to brutally squash any dissenting voices. The second is show a high level of competence to grow their economy. However, if the economy crashes, the Chinese people won't be happy, and the government may have to resort to being brutal again. Nobody wants that.

The credibility of the Chinese leadership is on the line here, and they know it. So they've performed all kinds of financial somersaults to stop the markets from falling further: They loaned Chinese brokerage firms more than $40 billion to buy stocks, they spent another $40 billion on an economic stimulus plan, they shut down trading on almost half their stocks, they dropped interest rates, and they restricted big shareholders from selling. That strikes me as desperate.

For now, it seems to have worked, because the crash stopped. On the other hand, all those gyrations made a mockery of the word "market." The Chinese government stepped into the markets in a way that's unimaginable here in America, and in doing so, they put their credibility on the line in an even bigger way. Trying to control a market is a losing game. In the coming months, if the stock market crash resumes, what will they do then? What additional ammunition do they have? There will come a time when they won't be able to save the day.

But the ultimate key isn't the Chinese stock market, it's the economy. As long as the economy continues to grow at a reasonable pace, China should be able to avoid a crisis. Of course, there's always the chance that the stock market crash will have a direct impact on the Chinese economy, but there are still a relatively small percentage of ordinary Chinese people who own stock, so that seems unlikely.

At the end of 2012, I wrote an article about China entitled "The Great Wall of Worry." In it, I optimistically argued that China wouldn't fall into a crisis anytime soon. That was nearly three years ago, and I'm starting to change my mind. I'm officially nervous.



This has nothing to do with China. But I had some extra space, so I thought I'd pay homage to Donald Trump. This is the Trump Hotel in Las Vegas. The windows are gilded with 24-carat gold.

Two bad things about our employment

I feel like I've been a little too over-the-top-optimistic when discussing employment in this newsletter. So I wanted to write something specifically for all the cynics out there. If you think Donald Trump is presidential material over someone like Carly Fiorina or Jon Huntsman, this article might be for you.

Two facts remain stubbornly true about American employment: Our workforce is historically small, and wages have barely risen. These are both significant problems; here are my best thoughts as to what's causing them.

Workforce:

When I speak about the "workforce," I'm talking about the "Labor Force Participation Rate," which measures the percentage of the population (age 16 years and older) that is either working, or actively looking for work. Even as we've seen big improvement in employment in recent years, our workforce is the smallest it's been since the late 70's. This is a major reason the unemployment rate looks so rosy – it only measures unemployed people that are in the workforce. If you've dropped out of the workforce, the unemployment rate completely ignores you. Here are the major reasons our workforce has dropped so much:

<u>Baby boomers</u>: It makes sense that as the baby boomers reach retirement age, they'll retire. Good for them! There's not much Obama or any economist can do about this, and I'm not sure they'd change it even if they could.

<u>Fewer working women</u>: The number of women joining the workforce rose dramatically since the 1950's. However, according to Vanguard, the percentage of working women has been declining since 1999. This probably has much more to do with cultural norms and personal decisions than with anything going on in the economy.

<u>College</u>: In much the same way that baby boomers and women are dropping out of the workforce, more young adults are going to college, which keeps them out of the workforce.

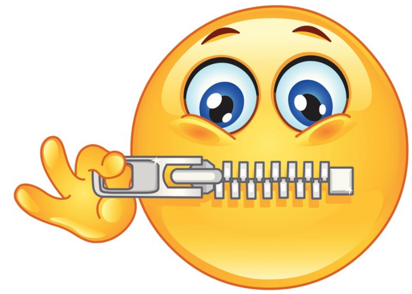
<u>The economy</u>: Cynics, this one's for you. As much as our economy has improved, there are still millions of "discouraged workers" out there. Those are people who aren't even trying to find a job because they don't believe there are jobs out there for them. This needs to change.

Wage Growth:

The other major employment problem in America is that wages are not growing very quickly. That's a sign that the balance of power still lies with employers rather than employees, which is not a sign of a strong job market. Here are the major reasons our wages have been so stagnant:

<u>Globalization</u>: American workers are expensive; but workers in many places across the world are cheap. If American wages rise, businesses are much more likely to send jobs overseas. That keeps a firm lid on American wages.

<u>Technology</u>: In much the same way that businesses send jobs overseas if workers are too expensive, they'll also invest in new technologies to cut human workers completely out. As technologies improve, this will become an even bigger problem. Can you believe there are now computer programs trying to replace human financial advisors? Actually, never mind…



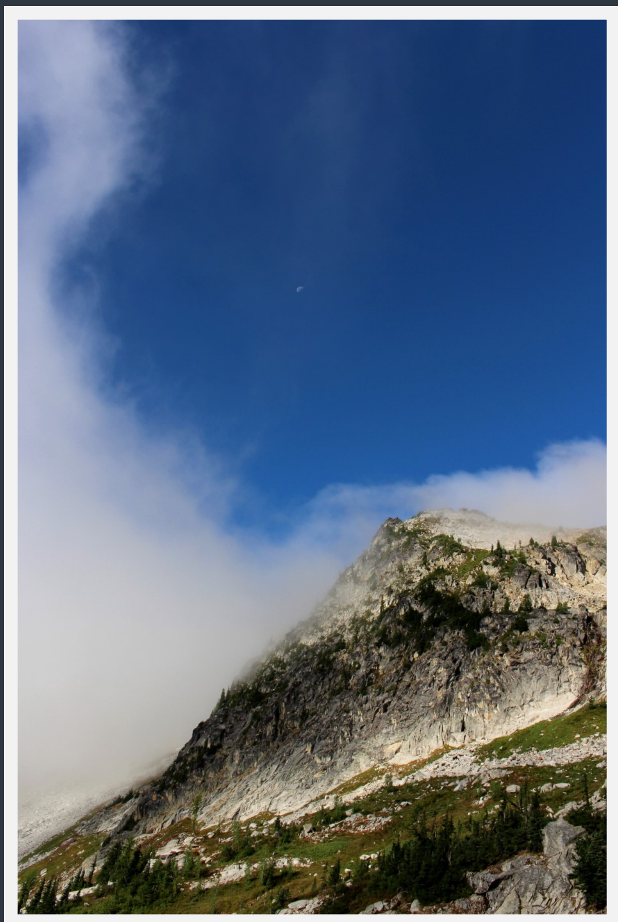
<u>The economy</u>: A booming economy creates more demand for workers, which could help drive wages up. Unfortunately, this is not a booming economy. I guess we'll have to wait until 2016 when Donald Trump will lead us to an economic boom through the power of angry slogans, being a total jerk, and a complete unwillingness to make a nuanced argument.

Conclusion

According to the Federal Reserve, "much, but not all," of the decline in the workforce since 2007 is a result of "structural" issues rather than a weak economy. That means that regardless of what's happening in the economy, our workforce would still be shrinking due to baby boomers, women, and young adults choosing not to work. So, it's not correct to completely blame the economy for the remaining weaknesses in employment. Yes, you are still free to complain about how long it took this recovery to actually take hold, but since 2013, our employment situation has improved dramatically. Go America.

Probably a Mountain or a Lake

I recently spent a day exploring the Chatter Creek trail and beyond. My original plan was to reach Doelle & Chain Lakes, which would have been nearly a 30-mile day. As it turns out, I wasn't nearly cool enough to pull that off, and only made it about 24 miles. Still, it was another gorgeous day up the Icicle. As I hiked, I watched the clouds flirt with the mountain peaks and slowly burn off.



This is Grindstone Mountain. Note the tiny moon perfectly framed by the clouds.

This is the Ladies Pass area, with Ladies peak in the background. The clouds are covering the actual pass.

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