Financial Wanderings

May 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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May Market Numbers:

S&P 500: +1.05% to 2,107

NASDAQ: +2.60% to 5,070

DJIA: +0.95% to 18,011

10-Year Treasury Yield:

+3.41% to 2.12

Gold: +0.54% to $1,190/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?

As 2014 came to a close, I made this bold prediction: *"My official 2015 prediction for the markets is this: Zero. I expect a year of pushing, pulling, and grinding our way to the same place we are now."*

The S&P 500 is only up about 2%, so I'm fairly close on my prediction for zero returns. However, the phrase "pushing, pulling and grinding," was a pretty big miss. "Pushing, pulling and grinding" implies some sort of epic struggle; a back-and forth battle between powerful forces. In reality, the S&P 500 hasn't moved more than 4% in any direction since early February. That is far from an epic struggle.

I also compared the 2015 stock market to a roller coaster. Given how flat the year has been, that comparison seems ridiculous. However, I didn't specify the exact type of roller coaster.

The economy is slowing down, and so are corporate earnings. ISIS is gaining ground. Interest rates have risen significantly over the last month, and the global economy is still weak. So, why are the markets so calm?

While the economy has clearly slowed during the first half of the year, there are still bright spots. The April jobs report showed the economy gained 223,000 jobs, and more people joined the workforce. Wages also have risen 2.2% over the past 12 months, and the number of people applying for unemployment benefits (which is seen as a measurement of people losing jobs) has been near a 15-year low for many months.

Real estate is also holding strong. New home construction was up 20% in April. Home sales are up, and home prices have gained 5% over the last year according to the Case-Shiller Index.

While jobs and real estate are holding strong, the rest of the economy isn't. Retail sales, manufacturing and consumer confidence continue to be weak. To underscore that point, the first revision of 1st quarter GDP showed

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that the economy dropped 0.7% over the first quarter. Although GDP is far from a perfect measurement (for more on this, please see "GDP is Dumb" below), it's pretty clear that the economy has slowed.

So, why are the markets calm? Because nothing is changing quickly. The US economy is still growing, but it isn't booming. On the other hand, a recession seems unlikely. The global economy is weak, but it's stable and slowly improving. The Middle East is a mess, but it's been a mess for years, and the markets have already factored that in. Interest rates will probably rise, but not very quickly. There simply isn't enough new, compelling information to move the markets very far in any direction. Although a boring market is difficult to write about, it's not such a bad thing... I'm going to relax and enjoy it.

GDP is dumb

This is my interpretation of a joke I heard on NPR's Planet Money: Two economists are strolling down a trail when they come across a giant mound of horse poo. One of them is feeling strangely playful (for an economist), and challenges the other: "If you take a bite of that poo, I'll give you $10,000." The other economist considers it, determines it a worthwhile endeavor, and takes a bite. As they continue their stroll, they come across another pile. At this point, the second economist offers to return the $10,000 to the first economist if he takes a bite. After careful consideration, the first economist takes a bite, and promptly receives his $10,000 back. As they continue their stroll, both men are feeling satisfied until the first economist stops and slowly turns to the other economist and says: "You know, we both have the same amount of money we had before, and we both just ate horse poo." The second economist replies: "But look at the bright side, GDP just went up by $20,000."

That's funny because it's true. Here's another thing GDP gets completely wrong: The functionality of my smart phone blows away the computing power of a computer that would have cost thousands of dollars twenty years ago. That's incredible progress, right? But from the standpoint of GDP, it's a bad thing.

GDP is a very crude measurement. The more money changing hands, the higher GDP is. It really doesn't capture the question of whether or not the economy is growing in a way that improves the quality of our lives. Of course, that doesn't mean I'm going to stop writing about it. It's a lot like the unemployment rate. As long as you understand its limitations and look at it as part of a bigger picture, GDP can be a helpful tool.

Ten positive quarters in a row?

As of the end of the first quarter in March, the S&P 500 has gained value in nine consecutive quarters. That takes us back to the 4th quarter of 2012. According to BTN Research, that's the longest stretch of positive quarters in nearly 20 years. As a financial advisor, tasked with overseeing the portfolios of clients I care deeply about, this is ample reason to pause for a quick celebration.

So far, the S&P 500 is up almost 2% in the 2nd quarter. That's a good start towards 10 consecutive positive quarters.

I ain't scared of rising rates (well, maybe a little)

As the markets fret over the Fed and interest rates, I thought it would be good to go back and look at how the stock market performed the last time the Fed was raising rates. That was the 2-year period from June 2004 through June 2006 during which time the Fed raised rates 17 times from 1% to more than 5%.

During that time of quickly rising rates, the S&P 500 gained more than 15%, which doesn't sound painful at all. I can't imagine the Fed raising rates that quickly over the next two years. So maybe we don't have all that much to worry about.

Is it finally time to be scared of bonds?

Three years ago, I wrote a fascinating, but terrifying, article about the perils of bonds. Like anyone else who was paying attention, I was worried that interest rates were going to rise, and rising interest rates are bad for bonds. However, since that time, rates are still near all-time lows, and bonds have averaged a gain of approximately 2% per year (per the iShares Core US Aggregate Bond Index). While a 2% gain is nothing to get excited about, it's also no reason to write scary articles. So I'm done making predictions about interest rates and bonds.

However, I do think it's good to understand why bonds are scary if interest rates ever do begin to consistently rise. First, a little background on bonds is important: If you buy a bond, you are loaning money to the issuer of that bond. You are essentially a bank, and you'll demand a higher interest rate if you perceive a higher risk. If the entity issuing the bond is the United States Government, your rate will be low; but you are very likely to get your money back (I'm resisting the urge to make a cynical joke). If, on the other hand, you buy a bond issued by the government of Greece, you'll get a much higher rate, but you might lose huge chunks of money. Most bonds, of course, lie somewhere in between the two.

So what might the future bring for bonds? Here's the key long-term trend: In the early 1980's, the 10-year U.S. Treasury bond yield was above 15%. Since then, it has fallen with remarkable consistency to where it is now, which is closer to 2%. That long-term downtrend has done wonders for the performance of bonds. Here's why: If I offered you a bond today that paid you a 15% interest rate, and also offered you the exact same bond, but with a 3% interest rate, which one would you take?

It's easy; the 3% bond is clearly less valuable than the one that pays 15%. That's why, as interest rates drop, bondholders have the wonderful decision to either continue getting a relatively high interest rate or selling for a capital gain. So, as interest rates steadily dropped over the last 30 years, bonds have been a good place to get both an interest rate and potentially a capital gain. But what does that mean if interest rates start to rise?

As rates rise, bondholders have the choice between continuing to receive a below-market interest rate or selling for a loss. That gets us to the current problem. Since interest rates are near all-time lows, they are bound to rise at some point in the future. The only questions are how soon, how much and how quickly. So if rates are eventually going to rise, and bonds tend to lose value when that happens, how can you minimize the impact to your portfolio?

That is a very difficult question, and I'm definitely not the only person struggling with the answer. This is a very difficult time to be a conservative investor. If I could find a CD that paid 5%, I'd recommend it to nearly every client. But until then, investors will just have to do the best they can do. That means keeping your expectations low, paying extra attention to being diversified, and potentially stepping out of your comfort zone a little bit.

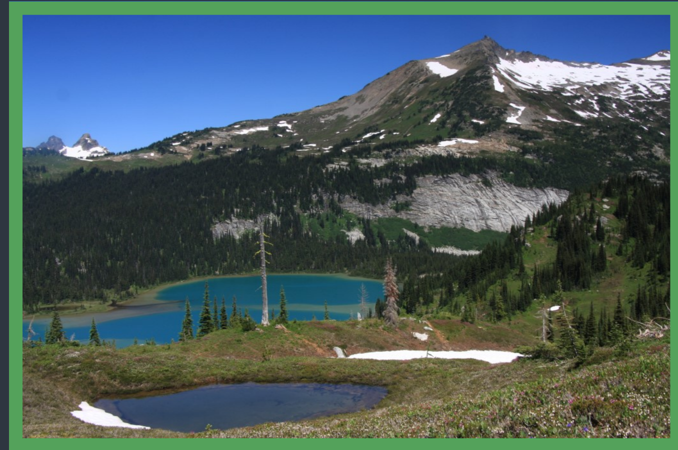
My favorite places

Hiking season is here. If you need any motivation or ideas for wonderful places to visit, here are my favorite places in our local area.

The Enchantments

Horseshoe Lake & Lake Stuart

Robin Lakes and Mt. Daniel



Lyman Lakes & Cloudy Peak

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