Newsletter

State of the Economy June 2015

What gives? The S&P 500 was stuck in mud the first half of 2015. Some are calling it a malaise. The market was neither down more than 5%, nor up more than 5%, at any point this year. According to Bespoke Investment Group, this 5% phenomenon has previously only occurred three times (1952, 1993, and 2004) this far into a year. Despite overall positive economic conditions here in the US, the future uncertainty regarding interest rates and the eurozone are taking precedent. In turn, these uncertainties are preventing the market from climbing higher. Unfortunately, it appears we will not know which direction the market is heading until we obtain clarity over these variables.

After the economy stumbled in the early months of 2015, all eyes are on the Federal Reserve following positive employment news in May. A total of 280,000 jobs were created last month, bringing us closer to what the Federal Reserve considers "full" employment. The economy also added more jobs in April and March than the Labor Department initially reported. In addition to job gains, wages in America are starting to grow. Workers earnings were up 2.3% in May as compared to a year earlier. This is slightly better than the 2% annual pace of recent years and is the strongest gain since 2013.

The combination of an improving labor market with rock bottom interest rates are resulting in increased auto and home sales. The auto sales in May showed a seasonally adjusted annual sales rate of 17.8 million vehicles, which are the highest recorded since July 2005. The recent data on existing home sales showed a jump of 5.1% in May to a 5 1/2 year high. New home sales rose 2.2 percent in May to a seven year high. The favorable data is undeniable reflecting continued strength in the housing market.

The economic news outside of the United States has not been as optimistic especially with Greece potentially leaving the eurozone. As of this writing, the small nation of Greece has failed to strike a deal to stay in the eurozone. Last week, Greek Prime Minister Alexis Tsipras called a surprise referendum for July 5th on the tough economic policies the country's creditors are demanding in exchange for more rescue funding. It is questionable whether Greek citizens are willing to accept heavy austerity measures in exchange for staying in the eurozone. The creditors are asking for drastic tax hikes and sharp cuts to government spending. With the referendum set for July 5th, Greece will default on their existing IMF loans that come due Tuesday June 30th. There is a worry this decision could spook Greek bank depositors further and add to the large amounts of money that were withdrawn from Greek banks in recent weeks. The lines at banks already started to pick up again this past weekend, until the Prime Minister declared the banks and the stock market shut down. If Greece leaves the eurozone, there is a threat of contagion and a possible loss of confidence in eurozone nations. Nations with weak balance sheets, such as Italy and Portugal, could see money leaving their banks as well creating a domino effect. Either way, I expect volatility in the European and US markets over the next few weeks. Stay tuned.

In China, the People Bank of China took a rare easing step this past weekend. The Central Bank cut both its benchmark interest rates and the amount of reserves certain banks are required to hold. Chinese stocks have sunk over the past 5 months and are on the cusp of a bear market. Leveraged investors selling out of their positions and high valuations seem to be the leading causes.It is extremely rare for the Central Bank to cut both interest rates and the reserve-requirement ratio on the same day. The last time it did so was in October 2008, the height of the global financial crisis.

Back in the United States, the current state of the economy is stable. It has actually been stable for a while and it is time for the Federal Reserve to finally start raising interest rates from their rock bottom position. I do not doubt the Fed's actions over the last seven years have helped the economy recover including the areas of housing and unemployment. But, there are other consequences of holding rates down too long. Rick Reider of BlackRock recently blogged that the Federal Reserve is creating "economic distortions" leading to a transfer of wealth to the people who need it the least. He argues that the wealthy are only getting richer based on low rates allowing for borrowers, equity shareholders, and short-term investors to benefit. Lower rates were supposed to spur companies to invest in plants, research and development, and capital expenditures. However, many companies have been short-term focused. Companies spent over $2 trillion in the past 5 years on buying back their own stock, which has helped boost equity values. During this time period, capital investment has slumped from 29 percent of operating cash flow to 23 percent, while buybacks surged to 36 percent. If anything, companies are taking advantage of the "excessively accommodative monetary policy" and possibly hurting the economy in the long run. At the same time, the wealthy investors are watching their stock portfolios soar. Perhaps, there is an artificial element to the growth in the stock market over the prior 5 years.

As the rich get richer, conservative and retirement investors are stuck with measly returns from bonds, cds, and other fixed products. Retirees and baby boomers are being forced into buying higher risk investments to generate solid returns. Therefore, it is time for the training wheels to come off. The economy recovered enough to avoid depending on the Federal Reserve going forward. The improved labor market coupled with the recent increase in wages is helping to get closer to the Fed's inflation target. Additionally, if the Fed starts to raise rates, they have already stated that there would only be gradual increases to prevent economic shock.

The current interest rate environment is analogous to any investment. If you hold onto something too long it could end up biting you in the end.

Sincerely,

Matthew Bagell, CPA
Partner
BJL Wealth Management
301 Lippincott Drive, 4th Floor
Marlton, NJ 08053

Financial Director at Hardenbergh Financial Services
8000 Sagemore Drive, Suite 8101
Marlton, NJ 08053

Wealth Management Solution

P: 856-355-5905
C: 609-330-6508
F: 856-810-3995

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