THE WEALTH STRATEGIES GROUP
Independent Unbiased Financial Advice

# The Seven Signs of a Changing Economy™

**"What to look for, where to find it and what to do when you see trends changing!"**
**As of January 2017**

## Summary

Welcome to 2017!

As I write this month's update on January 8, 2017 it already seems like we have been through a great deal of change. We really haven't, it is just speculative news flow about how the new administration, and Congress, are going to do whatever they do, good, bad or indifferent.

Only a week into the new year and it seems like much longer! I have read economic forecasts for how long until the next market crash hits. The "key" number to watch for that will surely trigger a collapse in bond investments and the usual assortment of opinions on what investment sector will do well or poorly based on all the guesses as to what, in fact, has not even happened yet.

Hmmm…sounds like a huge waste of time!

I have a suggestion. Instead of getting caught up in the relentless flow of noise about the economy, investment sectors or index performance, let's choose to focus on you!

- Let's update your Wealth Vision future planning report for year one, three and five year goals
- Your income needs
- Your risk tolerance
- Your time horizon
- Your comfort level

No matter what happens out in the world, you can still choose to focus on what happens to your future. It is time perspective that changes our perception of risk. Risk of all kinds, i.e. market risks, interest rate risk, liquidity risk, etc. is "always" present. It is our reaction to the always present risk that impacts the fiscal outcome.

I would be willing to bet my standard $1.00 gentleman's bet that somewhere along the 2017 path we will hit a 10-20% air pocket in the values of Corporate America, as

measured by the S&P 500. It will be at that time that we will want to stay focused on each of our bigger financial futures. If the thought of that level event sends a chill through your body, now would be the time to discuss our exit strategy.

If instead you are going to focus on you, let's focus on the Rules of Clarity™ and The "Impact" of Systematically Investing™.

As a reminder, the clients of The Wealth Strategies Group understand our process for gaining clarity as: The Rules of Clarity™

1) Eliminate outstanding debt and have plenty of cash on hand to reduce worries during volatile economic times. This can include paying off your mortgage(s) for those inclined to think in terms of philosophy versus quantification.

2) Have a list of your monthly costs. Yes, a budget.

3) Know your sources of income, retirement income, social security, etc.

4) You should consider allocating and diversifying your investments to reflect your constraints for time, risk and volatility. Once that is done, ALWAYS set aside a predetermined dollar amount to invest each month. At The WSG, we refer to this as "Systematic Investing" or "Dollar Cost Averaging"* and it is how you grow assets in periods of economic volatility. If you don't understand what this is, call and we'll have a class!

*Systematic investing is The Wealth Strategies Group's version of Dollar Cost Averaging. This strategy can add impact to your investment strategy!

The intent of this strategy is to purchase more shares when prices are lower and fewer shares as prices increase, thus lowering the "average" cost per share over time.

Systematically Investing is continuous and uninterrupted additions to your investment portfolio. We don't look at this as an ongoing "blind faith" investment. Instead, all additions become part of your portfolio's compounded growth potential. Naturally, your portfolio already has a well thought out action strategy for the always changing economic cycles and investment market fluctuations.

A client with a lump sum available to invest would not want to systematically invest in an upward trending market, as that would limit their return. However, in a downward trending market this is a valid approach.

The impact of systematically investing comes from the commitment to your investment future by regularly adding to your investments over several years. Your assets will have the opportunity to grow until needed as an income source at retirement or for the purchase of a goal, for example a second home, a college education or the purchase of a business.

The economic backdrop, as measured by The Seven Signs of a Changing Economy™ remains positive. In fact, so positive my new concern, not yet a worry, is that the positive continues to spiral up causing some market heartburn related to inflation creeping into the system. A little inflation, sub 4%, not a big deal. North of 4%, well heartburn.

Thus, I will remain focused on our Seven Signs, the effect on capital markets and you, each of our clients who has entrusted our oversight to help build your bigger financial future.

This month's Seven Signs are updated below. As always, I have added some unique insight with my comments. Just scroll down to view these now.

Your thoughts, comments and discussion are welcome. Please call me at 303-933-2107 or e-mail me at Jlunney@wealthstratgroup.com.

Respectfully,

James O. Lunney, CFP®
CERTIFIED FINANCIAL PLANNER™ Professional

The Wealth Strategies Group was founded by James O. Lunney under the guiding principle that comprehensive wealth counseling combined with independent investment advice will provide high net worth clients with complete trust in our competence, execution and integrity.

**P.S. Please join me for our monthly conference call on The Seven Signs of a Changing Economy.** You have the option of calling in or listening live for free from your computer. To call in, simply dial **347-826-7481**. There is no access code needed. To listen live from your computer, go to our website, www.wealthstratgroup.com, and click on the **"LISTEN LIVE"** button on the home page. You will be sent directly to our page on the Blog Talk Radio website and you can click on the link there. Instead of having a live Q & A session at the end of the call, you can now e-mail your question to me prior to the call at JLunney@wealthstratgroup.com and I will address them after my commentary on The Seven Signs of Economic Change.

**The call is always on the first Thursday of each month at 1:00 p.m. MST/3:00 p.m. EST, unless otherwise noted. Please mark your calendar to join me for the next call on Thursday, March 9, 2017.**

We encourage you to invite people from your family, work and social circle to join in the call. Just forward my e-mail notification to your e-mail list. It is very timely information and in the volatile investment environment a second opinion may be greatly appreciated in these uncertain times.

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| 1) | **Indicator:** | *Personal Consumption Expenditure (PCE)* |
| | **Where to find it:** | *www.bea.gov* |
| | **What to look for:** | *Consumer spending increases or decreases for three consecutive months* |

(Positive)
Like a few of the other Seven Signs of a Changing Economy, Sign #1, the data reported from the Bureau of Economic Analysis (BEA) lags by one month. Thus, the data reported here is for November 2016. This month the BEA reported Personal Consumption Expenditure (PCE) was -.1%.

When it comes to this key sign of a changing economy, we prefer to never see a contraction, but we all know, and have come to respect the reality, that economic growth occasionally backs up before moving higher. That said, there are a few observations to be made here.

1) A contraction of -.1% is more like a "rounding error" when measuring a $19 trillion economy.
2) It is a one-month contraction before one of the normally biggest months of the year, the holiday shopping season, which I predicted here in September would be the largest ever recorded. This prediction still stands. (Actual data is reported in February)
3) The annualized trend remains above growth levels of 2014 at +2.30% and 2015 at +2.10% versus the current growth rate at 2.51%.

It is possible, but highly unlikely, that my prediction of record holiday shopping will not be true when the final report comes out in February. The reason I said highly unlikely is based on the reality that the Federal Reserve would not have raised short term interest rates on December 14, 2016, for the first time in a year, if their data suggested consumer weakness.

Key point to remember, the Federal Reserve measures the inflation rate using the annualized increase in our Sign #1, PCE, not the Consumer Price Index (PCI), See Sign #7 below, as many people think. In addition, the Fed's self-imposed mandate was to not raise interest rates until the inflation rate exceeds 2%. This is also why I wrote in Sign #1 of this update that the Fed would raise rates on December 14, 2016, as they did.

I will stick with my prediction that December PCE will be positive and growing at a higher rate than prior years. The trend here is positive, thus, Sign #1 remains positive.

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| 2) | **Indicator:** | *Institutional Money Flow* |
| | **Where to find it:** | *www.wordenbrothers.com or www.barrons.com/convictionoftraders* |

| **What to look for:** | *Increasing or decreasing prices on high volume of large block trades* |
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(Positive)
As I write this update on January 8, 2017, the Dow Jones Industrial Average (DJIA) tried to break the 20,000 level for the first time ever on January 6, 2017.

As great as that sounds for the average investor, it really isn't. Recall that last month I quoted an article from CNBC that reported record inflows of $28 billion to stock based funds and $18 billion out of bond funds. The trigger point was the trend in interest rates appeared to be up, then causing bond investments to be reduced in value.

As accurate as this detail is it appears to be a short event so far, i.e. not a trend. Per Lipper U.S. Fund Flow's report for (12/7/16 – 12/28/16) there was a net outflow of stock based funds for the period, which includes the week with $28 billion in inflows.

My conclusion remains along the same line of thought written here for the last several years. What I see in our wealth management practice, and observe in trends like this one is that the average investor is still not participating in this bull market trend. Our practice is different from most, as we focus on educating our clients about asset structure, dollar cost averaging to help build wealth and to keep a long-term perspective. Many other advisors we observe are simply a product delivery, i.e. sales operations. So, our clients are participating, but we know from observing the high cash reserves on their net worth statements that many remain fearful to one extent or another. And our clients are educated on how this works, as stated.

I believe this is why cash assets remain at $13 trillion (source: U.S. Federal Reserve). Instead, I believe three core sources continue to push the valuations of Corporate America higher without Mr. and Mrs. Normal 401(k) Investor. The data flow supports all three:

1) Corporate America buying back their own shares. Per Goldman Sachs, <u>share buybacks</u> were near $800 billion in 2017.

2) <u>The $1 trillion short covering</u>. This is where investors reversed the order of stock ownership. They sell first, i.e. short the stock, hoping to buy the stock later and a lower price "to cover". Per Bloomberg there remain nearly $1 trillion in short positions to be "covered", i.e. bought, thus pushing valuations higher.

3) <u>The "Carry Trade":</u> This is complicated but easy to track. For our purposes here all you need to know is there are countries where their currency is trending down versus the U.S. dollar trending up. Investors from these countries sell their currency to buy ours in order to make money on the divergence. While in U.S. dollars many use the U.S. dollars to invest in Corporate America. Again, these large dollar investors cause valuations to trend higher.

These three trends will not change overnight, that is why they are trends. Because of this, it is reasonable to expect Sign #2, Money Flow, to remain positive.

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| 3) | **Indicator:** | *Leading Economic Indicators (LEI)* |
| | **Where to find it:** | *www.businesscycle.com or www.newyorkfed.org/research/global-economy/globalindicators.html* |
| | **What to look for:** | *Trends up or down for three to four months* |

(Positive)
Like Sign #1 above, the LEI data lags by one month for collection and calculation purposes. Thus, we have November 2016 unchanged. Emphasis on the month of November, like Sign #1 above, I would anticipate the December 2016 and full-year 2016 data to report positive next month.

It is important to note that the 2016 LEI data to date is very positive. The six-month moving average remains at +.7 and an annualized +1.42%, up nearly 100% year over year. This is very positive, as the data projects an expanding economy six to nine months in the future, i.e. June/September 2017.

It is also notable that manufacturers' new orders for non-defense capital goods excluding aircraft and manufacturers' new orders for consumer goods and materials remain positive.

Positive new orders for manufacturers' non-defense capital goods indicates manufacturers need new equipment and this is a good sign that demand for their products is picking up.

Positive new orders for manufacturers of consumer goods means retailers and retail sales online are ordering more goods from them, indicating demand is higher and that inventories of those goods are down and need to be replenished, as these orders pick up actual manufacturing output would begin to pick up several weeks later as orders are filled.

These two key "future" indicators are positive and strongly suggest the overall LEI is correct in suggesting economic expansion into June/September 2017.

I note these two of the ten LEI components, as they measure actual demand for goods where a few of the other indicators are, in my opinion, a little bit fluffy. Components such as stock prices, credit index and interest rate spreads, all of which are also positive, but less impactful.

Sign #3 remains positive.

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| 4) | **Indicator:** | *Employment rate and after-tax personal income* |
| | **Where to find it:** | *www.bls.gov* |

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| **What to look for:** | *A flattening, then downward trend in non-farm employment with a flattening to decreasing after-tax income would be a negative indicator. The appropriate trend would, of course, be a positive trend indication* |

(Positive)
I have no quantifiable data to support my thought that there must be a tipping point where those who want to work have a job. This tipping point is full employment and many economists suggest the number of 4% unemployment is "full employment". So, what tips at full employment? The cost of labor!

When jobs are plentiful and available to most all education levels and skillsets, employees tend to look for a similar job, or better, than their current situation, at a higher pay level. This month's employment rate and personal income data suggests we are either at or close to this tipping point.

Since the cost of labor is approximately 30% of the post WWII inflation rate, any significant increase in labor costs will start to push up the cost of goods and services we buy at the household level. We have not seen the increased labor costs push through to the final household cost level at this point, but you can expect it to be a source of anxiety for the incoming administration in D.C.

This month, 156,000 new jobs were created, putting the unemployment rate at 4.7%. The equally important input detail of jobs added by the Current Employment Statistic (CES) birth/death report showed a -28,000 jobs created. Thus, you could reasonably suggest 183,000 new jobs were added for the month.

Equally important is that worker pay was reported rising at the fastest pace since the Great Recession. This clearly reflects we are near full employment, especially with companies reporting a shortage of skilled labor to hire. Tipping point to higher inflation? Probably.

The 4-week moving average of initial claims for unemployment support this stronger jobs creation report, as it hovers around a nine-year low of 255,000.

An interesting side bar to this detail is data reported in this month's National Federation of Independent Business (NFIB) report.

- 58% reported hiring or trying to hire
- 52% reported few or no qualified applicants
- 16% reported difficulty of finding qualified workers as their "single most important business problem"

Sign #4 remains positive, but if this positive trend continues it will cause the same positive data flow to "tip" into being an overall economic negative of higher inflation.

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| 5) | **Indicator:** | *Durable goods spending* |
| | **Where to find it:** | *www.census.gov/indicator/www/m3* |
| | **What to look for:** | *An increasing or decreasing trend, especially a trend of four to five months out of six would be a positive or negative sign* |

(Positive)
These long shelf-life items like non-perishable, non-fashion items are usually the first to show signs of a slowing economy. Remember, these are items we can do without, if need be. New orders decreased -4.6%, shipments increased .1% and inventories increased +.1%. Hmmm, that doesn't look too positive!

Well it may not be positive, but it is a normal new orders number for this month of the year. After all, the new orders are in well before the holiday shopping season, as they need to be shipped, stocked and merchandised pre-holiday.

To calm my nerves around new orders I went back to compare this year with prior years. The same month in 2013 was -4.3%, 2014 -2.4%, 2015 -5.1%! So, this month is new orders input of -4.6% is pretty close to normal. No trend change here. In addition, it would be normal to expect a bounce back in the next few months, but that is not always the case. In reality, new orders roll in more slowly as there isn't much in the way of huge shopping at the household level until after the cold weather lifts and we can all see our yards again.

A little good news is that the Baltic Dry Index, which is an indicator of the cost of commodities used to create products for the end user, as well as the costs to ship the goods, has moderated over the past month. Clearly, input costs are up as this Baltic Dry Index is +117.75% since this time last year, but hopefully stabilizes here, i.e., demand for products remain high.

Another sign that consumers are not slowing down in day to day discretionary purchases, or those longer shelf life items that could be delayed, is the train, trucking and air freight tonnage report, which suggests the goods continue to move.

As noted in prior issues, this detail is positive and runs deep into purchases that "could be" delayed, but "aren't being" delayed. This suggests consumers have jobs, increasing income, feel good enough to spend and buy items that could be delayed and they show no signs of slowing.

This, too, presents itself as possible to be so positive that it hits a "tipping point" of unintended consequences, like higher inflation caused by the continuing economy's spiral up.

Sometimes too much of a good thing can cause it to become a bad thing. Let's hope that does not start happening throughout all of the Seven Signs of a Changing Economy™.

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| 6) | **Indicator:** | *S&P 500 Earnings per Share growth* |
| | **Where to find it:** | *www.standardandpoors.com* |
| | **What to look for:** | *Two quarters of S&P 500 earnings per-share growth, up being a positive trend and down being a negative trend* |

(Positive)
Those of you who read the WSG Weekly Update as well as this monthly update know about my thinking around the effect the energy sector had on the earnings of Corporate America. Part of my role as an LPL Financial investment advisor is to think about the future effect of current changes. When the energy sector "tanked" in late 2015 I suggested that it was a significant drag on the overall earnings of Corporate America, as measured by the S&P 500.

Well, now we know and can therefore quantify what I was saying. Per FactSet, the 2016 energy sector earnings were down -75.7%, thus materially dragging down overall earnings of the index. On several posts I wrote that as energy flattened out and then started the normal cyclical rebound that same drag on the earnings would become a positive wind at the back of the S&P 500 earnings. On December 30, 2016 FactSet estimated 2017 energy sector earnings would be up +343.6%. I think this will clearly qualify as a positive wind at the back of the S&P 500 earnings for 2017!

In Sign #2 above, I mentioned Corporate America buying back shares of their own stock. This very much adds to the increased earnings projected for 2017, as when they buy back shares there are "fewer shares outstanding". Thus, a smaller denominator under the S&P 500 earnings amount. To name a few and just for perspective:

- Apple, Inc. bought back 4.3% of shares outstanding for a total of $31.118 billion
- General Electric bought back 12.5% of shares outstanding for a total of $21.12 billion
- American International Group bought back 16.4% of shares outstanding for a total of $11.724 billion

Thus, expect 2017 earnings for Corporate America, as measured by the S&P 500 to trend higher. That said, let's review this month's Fair Market Value (FMV) for 2017 earnings.

Per Yardini Research, 2017 full year S&P 500 earnings are estimated to be $132.56.

Let's plug full year 2017 earnings estimates into our "Rule of 2017" Fair Market Value (FMV) estimate model.

To use the "Rule of 20" you should subtract the inflation rate from 20. I will use the same inflation rate the BEA used in calculating the U.S. Gross Domestic Product for 2016, through September 2016, of +1.39%.

20 – 1.39 = 18.61

This becomes your multiplier and is multiplied by the respective year's earnings per share to calculate the estimate of Fair Market Value (FMV).

- 2017 S&P 500 earnings estimate = 132.56
- $132.56 x 18.61 = 2,466.94

As of 1/6/2017 S&P 500 trades at 2,276.98 (a 8.34% discount to FMV)

A research piece I recently read was titled "Daily Wealth" by Dr. Steve Sjuggerud. In this issue, Dr. Sjuggerud presented research that added the price/earnings (P/E) ratio to the 90-day T-bill rate. The research quantifiably showed that when the total of the two was under the historic danger zone. Based on this, I did some quick math to see the forward price earnings ratio calculated above is 17.18. The 90-day T-bill as of 12/20/2016 is .53%.

17.18 +.53 = 17.71, which is well below the average of 20 and very much below Dr. Sjuggerud's 22 level danger zone. This is interesting detail, so I thought I would share it again this month.

Sign #6 is powerfully positive!

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| 7) | **Indicator:** | *Inflation/deflation numbers* |
| | **Where to find it:** | *www.bls.gov/ppi/ or www.bls.gov/cpi/* |
| | **What to look for:** | *An interruption to the consistent but modest increase in the cost we all pay for goods and services* |

(Positive)
In Sign #1 above, I detailed how the U.S. Federal Reserve uses the Personal Consumption Expenditures (PCE) growth rate as their primary measuring stick of inflation. This month the annualized PCE was +2.55%.

Many economists tend to measure inflation at the household level using the Consumer Price Index (CPI). This month the twelve-month CPI came in at +1.70%. Those same economists also tend to closely watch input costs to the products end users purchase via the Producer Price Index (PPI). This month's twelve-month PPI came in at +1.80%

If you are normal, you might ask, what does this mean? Inflation matters. It is better than deflation, which is a contracting economy, think Great Recession! But, we all want the economy to expand at a reasonable rate with inflation in check. If labor and other input costs increase faster than the economy, we end up in "stagflation" or worse yet, an overly inflating economy. This month's CPI and PPI suggest inflation remains in check.

This is especially true in an environment where our current economic growth rate, or Gross Domestic Product (GDP) is growing at 3.50%. The reality of an economy

growing at an inflation adjusted +3.50%, as ours is, with input costs growing at about +1.80% is healthy and good.

It is the job of the U.S. Federal Reserve to maintain a stable economic backdrop for businesses and consumers to operate and live in. If inflation heats up, and I think this is possible, the Fed will need to increase interest rates in an effort to slow economic growth. If the 10-year U.S. Treasury gets much above 3%, currently 2.42% (as of 1/6/2017) it is going to cause a little heartburn for the valuation of Corporate America, as measured by the S&P 500, i.e. a likely value reduction event.

As post WWII inputs to increasing inflation are labor costs (20%), energy costs, huge rebound see Sign #6 above, (20%) and Consumer Spending, see Sign #1 (60%), I will be very carefully watching the trends.

The theme in Sign #7, as well as other signs this month is the reality of inflation starting to awaken. A slow wake up is fine, but a jump up is pretty far from fine!

For now, Sign #7 remains positive.

*The Rule of 20 is in this calculation implying, and using, a price/earnings ratio, which is the valuation ratio of a company's current share price compared to its per-share earnings. Thus, 18x the expected Earnings per Share. Both EPS and the multiple of 18 could drop. The earnings could be reduced due to the consumers spending less. The multiplier of 18 could drop to, say 8 for example, if investors were to get scared and become risk adverse. All of a sudden 8 x $132.56 turns the 2,466.94 2017 FMV into 1,060.48 and even worse if earnings were to drop below the example of $132.56/share! This is the multiplier risk and earnings risk I personally worry about. It may never occur, but what an unfortunate event it would be if it did and we had not prepared for it as a possibility. Thus, I am glad we have!

their industries and widely held by individuals and institutional investors.
•The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.
•When using dollar cost averaging an investor should consider their ability to continue purchasing through fluctuating price levels. Such a plan does not assure a profit and does not protect against loss in declining markets.
•The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.
•Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.