# LFM&P

## LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

*Registered Investment Advisor, Wealth Management & Financial Planning*

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# Outlook & Trends

The stock market and economy generated some good, although not exceptional, news in the third quarter. The market's trend continued to be upward with little volatility. This was a good performance during a calendar period that has hosted several sharp declines in the recent past. Likewise, the GDP measure also improved from the first quarter, and most signs show continuing, although also not exceptional, strength. Will this benignly positive trend continue? Later in this issue we discuss the realities of trends and cycles, wealth and illusion.

**The Economy**

The economy's growth rate posted a 3.1% advance in the second quarter, up from 1.2% in the first quarter. The average of the two is not unlike our experience for most of the decade so far. It is still well below the peak growth rates that were typically over 4% in the last century. Why does this matter? Higher growth translates into more jobs, and a higher standard of living. For now, however, employment growth has tailed off slightly to about 1.5% as most of the people who were looking for work have found it. Accordingly, the official unemployment rate remains low, partly because of a lower labor force participation rate, which has been in steady decline since a peak in 2000.

Homeowners continue to cheer the rebound in single-family home prices, up 5.8% from a year ago. Would-be homebuyers are being squeezed by the increase as well as the 3% increase in rental prices over the last year. A little help for them has come from mortgage rates though, which are ½% lower from a peak earlier in the year.

**The Markets**

There is a saying that the most bullish thing the stock market can do is to make new highs. That suggests that the current market is most bullish, having set a cluster of new highs in the last quarter. The trend is clearly strong. The unknown factor is its sustainability. As prices increase, an already overvalued market continues to become more so.

Bond performance has depended on the quality of the bond. Low-quality "junk" bonds have maintained a stable uptrend like stocks over the last year. Corporate bonds are finally back to their year-ago peaks (including interest earned in the interim), while high quality, long-term treasury bonds have risen but remain well below their peak value posted last year. Adding possible insult to the last year's injury, the Fed recently confirmed that they would slow their repurchase of maturing bonds, slowly taking away the prop from under the bond (and stock?) market.

**Trends, Cycles, Wealth and Illusion**

Every day we see cycles and trends. Day and night. The tides. The seasons. We often may be tempted to mentally project trends as a continuing straight line, but are they really just part of a cycle that is beyond our immediate view? "The days are getting shorter". Is that a trend, or is it just a portion of a longer-term seasonal cycle? Cycles abound in all phases of nature and human activity with durations of multiple generations down to seconds or less.

The economy and financial markets are no different. The Kondratiev wave, observed by Nikolai Kondratiev, is an economic cycle, which lasts about 50 years. It begins with a new innovation (steam engine, railroads, mass production, electronics, information) and continues to expand until the innovation is fully exploited. Along the way jobs are displaced, and new ones develop. Sociological changes occur as humanity adapts. Productivity grows and then declines. Use of debt expands until debtors become over-committed and fail to meet their promises. The period tends to end in an economic bubble followed by a difficult and lengthy reset (1830s, 1870s, 1930s, 1970s, 20XXs?).

Along with the Kontratiev and shorter waves comes the debt cycle. There has been discussion of late that we are at the end of a long-term debt "supercycle". In the beginning of a debt cycle, following a previous economic collapse, lenders are hesitant to extend credit, so only the best innovations are funded. As the basic innovation is applied to more and more products, debt funding expands more rapidly. Eventually less worthy investments receive funding and more loans are devoted to speculative ventures. At this point, economic growth is now being fueled by the availability of financing rather than investment merit. As productive investment disappears, growth slows. People want to maintain their standard of living in the low growth environment, so they borrow from the future for consumption today. For its part, the government also borrows to help people maintain their living standard through subsidies. But the pace cannot continue. Eventually the accumulated debt and interest preclude further expansion. The economy contracts as investment and consumption borrowed from the future are no longer available to provide stabilizing growth in the present. Lenders fail or tighten standards and the cycle reverses.

During the early and middle parts of the long economic cycle, wealth is generated -- society's wealth, as well as personal. Society's wealth is reflected in increasing standards of living. Real wealth comes from production of a thing or service that is valuable to another person. Wealth is accumulated by producing more value than is consumed. Real wealth is not the same thing as financial "paper" wealth, like stock market investors are enjoying today. Financial wealth is illusory. It can disappear almost overnight, because it was never real in the first place. The price of houses that exceeded their value as a residence generated the illusion of wealth in 2008. Unhealthy financial wealth is made possible by the over-availability of money and excess debt.

Real wealth is earned. It can also be inherited on a personal or national level, but this is only a transfer of the productive value earned by an earlier generation. As a country we have been consuming inherited wealth disguised as debt financing. A government generally does not produce wealth. It acquires and distributes wealth through taxation and subsidies. It borrows today against the future productive value and the wealth of our children. The last administration ran on a promise of redistributing wealth, but the real transfer was engineered by the Fed's low interest rate policy, which redirected wealth from poor to rich, savers to spenders, from Main Street to Wall Street. Unfortunately, creation of debt that is targeted to increase consumption does not sustainably increase society's wealth and improve its standard of living over the long-term. It consumes it.

With the economic growth trend generally less than 2% per year, it is fairly clear that we are in the latter part of the long-wave. There may be breakthroughs that are in the process of beginning now that will become a force that turns the cycle around again, but these will not occur overnight. A financial reset continues to be likely at some point.

What looks like reality or a trend today may only be a point on a cycle that is moving elsewhere. It is important not to extrapolate a visible minor trend today forever into the future. Expect change. The proverbial pendulum swings. If you are a financial investor, be aware that the markets today are partly real and partly illusion. The price of the S&P 500 is partly real value, real wealth, and partly froth created by years of debt financing and speculation. At some point, market prices always return to their real value. This does not mean, however, that there may not be more froth, more illusion added before then. The questions always are, "How much? For how long?" The Fed may try to hold the pendulum back as long as possible.

LFM&P has learned that these questions cannot be answered with any certainty. The next best thing is to keep an eye on where we are in the trend and on the cycle, and to be aware of and prepare for the risk associated with the illusion. Our goal is to earn our wealth by helping clients preserve and increase theirs through risk-managed investment and financial planning.

If you would like help looking into your financial future, evaluating your risks, managing your investments, or planning to manage your income effectively, please call or e-mail.

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