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Contagion?

The second quarter closed on a note of grave uncertainty, as talks between Greek and European officials broke down, making a default almost inevitable. An exit from the euro and a return to the drachma appeared possible for Greece. Although that might relieve the pressure from Greece's creditors in the short term, the longer-term pain for Greek citizens could be severe. Those who are paid in drachmas but whose debts are denominated in euros could be crushed. Greek banks were closed for the week of June 29, as depositers attempted to retrieve their euros while they could.

The larger question is what effect a default by Greece would have on the global financial markets. No one really knows, and no one has wanted to find out. Fed Chair Janet Yellen warned: "In the event that there is not agreement, I do see the potential for disruptions that could affect the European economic outlook and global financial markets. I would say that the United States has very limited direct exposure to Greece, either through trade … or financial channels. But to the extent that there are impacts on the euro-area economy or on global financial markets, there would undoubtedly be spillovers to the United States that would affect our outlook as well."

Positive signals

After contracting in the first quarter of the year, the U.S. economy appeared to be stabilizing in the second quarter. Consumer spending jumped 0.9% in May, giving analysts hope that it could exceed an annualized 3% for the full quarter.

Household wealth is recovering from the recessionary losses. The total equity in owner-occupied housing reached $11.7 trillion, a level last seen in 2006. Home sales have been strong, with an average price for existing homes of $230,000, another 2006 parallel. As home prices have risen, the number of owners who are "underwater" on their mortgages has fallen. That bodes well for the forward momentum of the economy. As recently as 2009, the average homeowner equity was 38.7%; now it is at 55.6%.

The surging stock market has also contributed to household wealth. Some $13.6 trillion worth of corporate equity is directly owned, and another $7.9 trillion is owned through mutual funds. More wealth should mean that consumers have more confidence and will spend more, powering the economy on an upward track. What's more, 20% of the S&P 500 companies have bought back stock this year, in an amount sufficient to increase earnings per share by 4% even if earnings don't grow.

Concerns

But has the stock market gotten ahead of itself? Concerns have been expressed that prices in the tech sector are "frothy," if not as extreme as before the bursting of the dot-com bubble in 2000. Mark Cuban has publicly worried that because most of the investment in tech this time comes from private investors, there is now very little liquidity in this corner of the market. Investors will have a hard time exiting this market.

Economist Robert Shiller's cyclically adjusted price-earnings ratio (or CAPE ratio, based upon an inflation-adjusted 10-year moving average of earnings) recently has reached 27, historically very high. The three other moments the CAPE ratio has been that high were 1929, 2000 and 2007. We all know the endings of those stories.

Some stocks are already in retreat. Zerohedge.com reported at the end of June that 42% of the stocks in the S&P 500-stock index were 10% or more below their highs, the definition of a "correction."

Interest rates

When the year began, many market observers expected the Fed to begin raising interest rates in June. That didn't happen, and now many are settling on September as the inflection point. If there is no contagion from Greece, that's possible, but should the fallout be worse than expected the Fed might postpone action again.

When interest rates do finally begin to rise, bondholders will feel some pain, as bond prices necessarily will fall.

(July 2015)