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Second quarter 2010 – from Greece with love?

By Jim Flinchum

Former Fed Chairman Alan Greenspan said the economy has run into an "invisible wall," which is common during economic recoveries. Economic data may be invisible, but it does measure real, visible things. Pending home sales were down 30 percent in June. GDP growth in Q1 was revised down, as less than earlier reported. Car sales dropped 12 percent. The ISM report of manufacturing activity came in weaker than expected, and consumer confidence just tanked, dropping 10 points to only 52.

Today, we are shellshocked from the Great Recession, frightened by a possible collapse of Greece now and Europe later, intimidated by the bizarre "flash crash" of May 6, confused by the new financial reregulation, genuinely depressed by American impotence in dealing with the greatest environmental disaster in our history, and the unrelenting pain of another "jobless" recovery.

The latest Jobs Report looked good at first, because the unemployment rate dropped from 9.7 percent to 9.5 percent. Unfortunately, that was not because we produced so many jobs, but because 650,000 people got so depressed they just stopped looking for a job and dropped out. Still, there are 14.6 million people who would like a full-time job and cannot get one. People are also economic resources, and it is a shame to waste such a vital resource.

Continental drift

Ironically, Europe, which has a long history of being more "socialistic" than the United States, is reversing course. At the G-20 meeting late last month in Toronto, it was the U.S. arguing with Europe not to stop stimulating their economies too soon. Europe was so terrified by the recent near-death experience of Greece that it agreed to cut their annual budget deficits by 50 percent within three years. Bold statements are nice, but it will take real political courage.

Any discussion of whether the U.S. should consider this approach should begin at www.usdebtclock.org.

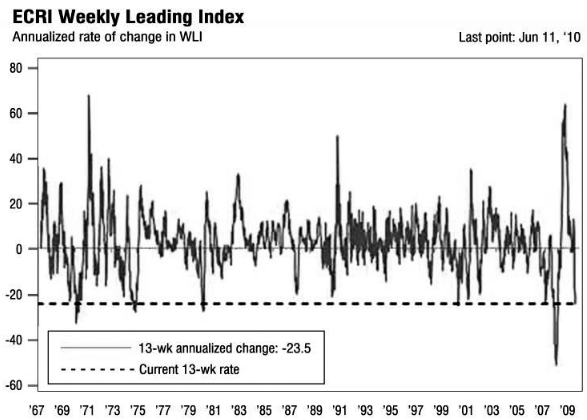
The markets

The stock market continues to be volatile, with the Dow down 10 percent in Q2 and 6 percent year to date. In fact, it was the worst 2nd quarter since 2002. Perhaps the most unnerving thing that happened in the stock market during Q2 was the bizarre "flash crash" on May 6, when the Dow dropped almost 1,000 points in what one trader called "a 30-minute free-fall into hell." While it is still unclear why it happened, it is clear that it was not related to the economy but was some technical/computer aspect of trading. The regulators have already instituted some trading changes, hopefully to preclude any recurrence.

The real problem is that it further erodes investor confidence. One of the main reasons the market has been so volatile this year is because the retail investors, who are traditionally stable, have been largely on the sidelines. Most of the light trading volume this year has been done by institutional investors and hedge-funds, who have "trigger-fingers."

However, while we are feeling sorry for ourselves, we shouldn't forget that most foreign markets did much worse. Here are some percentage declines for other stock markets this quarter:

U.S. (S&P)	-11.5
Switzerland	-12.7
England	-14
Germany	-14.6
Brazil	-14.8
Russia	-15.1
Israel	-18.6
France	-20.5
Norway	-22.4
Greece	-39.3



The economy

GDP growth in Q1 was revised down from 3 percent to 2.7 percent. It is surprising this added weakness occurred when corporate earnings beat expectations 77 percent of the time. When Q2 growth is announced, it is expected to be even less.

The question most debated currently is whether we are headed into another recession. The highly respected Economic Cycle Research Institute in New York publishes a weekly graph of its leading economic indicators. A recent one is shown on this page.

You can see the sharp improvement in the leading indicators last year, followed by a sharp, scary drop this year. Each time the index has touched the dotted line, the economy was in recession or within two months. Some believe the economy is getting over the "sugar high" from the stimulus and, they may be right.

Some argue that another recession like the Great Recession is unrealistic because (1) BP is no Lehman Brothers, (2) the Fed is stuck at zero, (3) upcoming mid-term elections will be more pro-business, (4) the CEO hiring confidence is at a three-year high, and (5) productivity is still rising, mostly due to technology.

I tend to agree with analysts like Bill Gross of giant PIMCO and John Mauldin of Frontline Thoughts that another recession is less likely than a long, sustained slow-motion recovery, as we deleverage or reduce debt.

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Lastly, we tend to overreact to recessions. We have been through many before. They are part of the normal economic cycle. Remember: The only people standing in lines these days are not waiting for bread or gas or apples... but for electronic Apples.

In 1979, President Jimmy Carter gave his famous "malaise" speech that we "can-do Americans" were suffering from an emotional depression, not an economic one - one where we were losing our self-confidence and starting to doubt ourselves. Maybe it is 1979 again?

How we're managing it

For stocks we are neutral on, we plan to sell most of those stocks that we have significant gains on, to beat the higher capital gains taxes coming next year. It is a good time to raise extra cash on hand.

Because nobody yet understands the over 2,000-page financial regulation bill, we will continue to stay away from financial stocks, like banks and insurance companies. Plus, if we do experience another economic "heart attack," it will come through the financial sector.

We like foreign currencies. The recent 14 percent YTD increase in the dollar against the euro is not sustainable. Because Europe is leading the way in dealing with their governmental balance sheets and because their exporters will benefit from the devalued euro, we are selectively interested in the stock of European exporters.

But overall, there has been no change in our appetite to increase our equity exposure right now, as we expect the stock market to trade sideways until later this year, when we expect the economy will have had a chance to catch up to the still-overly bullish stock market. Don't forget the Dow is still 3,000 points higher than March of last year. Besides, the markets usually improve after midterm elections, when political uncertainty decreases.

Two-year Treasuries recently hit an all-time low yield, because investors are paying almost anything to put their money in something "safe." We think that Treasuries are a bubble and are avoiding them.

We keep our other bond maturities short, because the rise in interest rates that will follow inflation will crush the values of those bonds now. For the income-oriented investor, we do use some closed-end bond funds with short maturities or select preferred stocks.

And we remember that Jimmy Carter was right, that Americans are a traditionally can-do people who don't doubt themselves for long.

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