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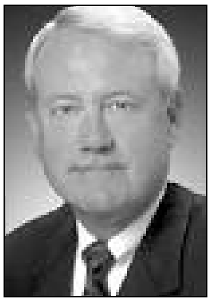
The S&P 500 – from 1257 to ... 1257

By Jim Flinchum



JIM FLINCHUM

Like a duck looking placid on the surface of the water, the S&P 500 looks equally placid. It ended the year where it started, at 1257.

However, under the surface, there was a great deal of movement. In April, it was up 8.4 percent but down almost 13 percent in October, which is a huge swing.

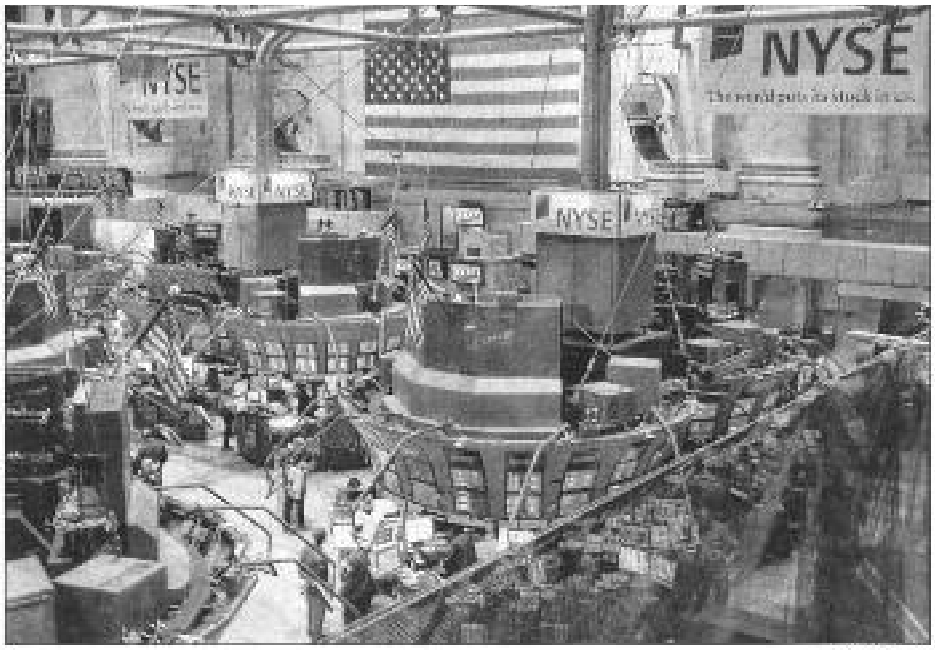
It moved, up or down, 2 percent or more on 35 days last year, compared to only 22 days the prior year. It only happened twice in 2006 and never in 2005. That trend is not our friend.

As glum as that sounds, the U.S. did better than the rest of the world, whose stock markets lost a combined $6.3 trillion. Here are some of the market percentage losses:

England	5.55
Australia	14.51
Switzerland	7.77
Japan	17.34
Spain	13.11
China	21.68
Italy	25.20
India	24.64
Greece	51.88
Argentina	30.11

THE AMERICAN WORKER

Consumption spending is about 70 percent of GDP. With fewer jobs, consumption spending decreases, depressing GDP. The good news is that the job market is improving, albeit slowly. For December, 200,000 jobs were created, bringing the unemployment rate down to 8.5 percent, the lowest since February of 2009. The economy has now produced at least 100,000 jobs every month for the last six months.



RYAN LAWLER

The New York Stock Exchange is shown in 2008.

Since 1939, each decade has produced about 20 percent more jobs. That is, there were 20 percent more jobs than when the decade began. The only exception was the last decade, the 2000s, when the number of jobs actually decreased, while population increased 10 percent.

At the current rate, this decade would create 10 percent more jobs, which is far too low. The job market is definitely improving but not fast enough.

SWIMMING IN SCHOOLS

Historically, investing was focused on finding good under-valued stocks of good companies. This was originated by Benjamin Graham and popularized by Warren Buffett.

Today, most investment advisers practice Modern Portfolio Theory, developed by Harry Markowitz, who won the Nobel Prize for this achievement. The short version is that returns can be maximized while risk is minimized (the "Holy Grail") when the portfolio is carefully allocated across many different asset classes, e.g., large companies that pay dividends, small companies with fast growth rates, short-term bonds, long-term bonds, commodities, cash, etc. This thinking is well-documented mathematically.

That theory didn't work well last year. For example, there were 69 days when 90 percent of all stocks moved in the same direction. That was as many days as 2009 and 2010 combined. When all asset classes move together, Modern Portfolio Theory is not very useful.

The problem is that the theory has been overwhelmed by political realities, which trumps economic realities. The markets are battered by headlines out of Washington and, more importantly, out of Europe. As a result, investment management became "risk-off/risk-on," which means the level of cash should reflect the level of anxiety or fear. I expect this style of portfolio management to persist throughout the first half of this year.

The Volatility Index is often called the "Fear Index." It began 2011 in the mid-20s and ended the year about the same place but reached a high of 48 in August

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making it even more volatile than the S&P itself. Historically, when it drops below 25, it has been followed by an 8 percent rally within four months 25 times since 1998.

That history is comforting but can quickly get overwhelmed by news out of Europe. This is a characteristic of systemic stress. These are not normal times, and normal investment practices are not appropriate.

THE TAIL WAGGING THE DOG

Europe is our biggest trading partner. It is already in recession but could be facing a systemic collapse, if its financial system fails. Everybody knows how traumatic it was for this country when Lehman was allowed to collapse. If a similar event happens in Europe, it could easily and quickly get imported into our country.

The TED Spread measures the difference between interest rates on our three-month Treasuries and the 90-day LIBOR or London Interbank Offering Rate. It is a good measure of the amount of credit risk in the European financial system.

European borrowing rates have increased substantially over U.S. rates, which explains our increased volatility as investors rush-in or rush-out of the market, depending on the news out of Europe.

When the Maastricht Treaty was signed 10 years ago, it was understood that Europe would then have a unified monetary policy, while maintaining uncoordinated and un-supervised fiscal policies. Nobody expected that arrangement to be sustainable.

It was even joked that their various fiscal policies would not be "unified" until there was a crisis.

To save the euro, nations will have to surrender a degree of sovereignty or control over their own national budgets.

The indolent countries of southern Europe will be required by the frugal countries of northern Europe to accept the austerity of increasing taxes and decreasing entitlements. We cannot even do that in the U.S. by ourselves. Now, try to imagine Canada forcing us to change our budget.

This will have to happen and happen soon. The weak southern countries will accept some loss of sovereignty to preclude the trauma of being ejected from the European Union, when their new national currencies would plummet in value, unemployment would skyrocket, and inflation would roar.

The stronger nations will have to subsidize the weaker nations somewhat. Otherwise, the euro would soar in value, exports would drop and unemployment would rise.

The timing of this deal is critical. Already, the bond vigilantes are circling. Europe has no more than six months to end this crisis.

WHAT WE EXPECT

Is a 5 percent return good or bad? If you take no risk and get 5 percent, that is good. If you take a lot of risk and get 5 percent, then that is bad.

This is not a time to take heroic risks. Most of the risk will be in the first part of the year while most of the return will be in the latter part of the year.

With such an anemic recovery, it is unlikely the Fed will raise rates this year. However, the Fed only controls short-term rates, while the supply and demand for bonds has control over long-term rates. If inflation breaks out, long-term rates will rise by year-end.

HOW WE'RE MANAGING IT

I do believe the stock market is under-valued. However, it is not under-valued enough to take the risk of being sucked into Europe's financial vortex.

It is better to miss 50 percent of the upside than to catch 51 percent of the downside.

I'm still avoiding long-term bonds, no matter how good the credit. When interest rates rise, they are certain to lose value. For income-hungry investors, dividend-paying stocks are higher than short-term bonds and master-limited partnerships are attractive for tax-deferred accounts like IRAs.

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