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Great first quarter, but a lousy recovery

By Jim Flinchum



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For the American investor, the first quarter was great.

The Dow was up 8.1 percent. The S&P was up 12 percent, and the Nasdaq soared 19 percent - all this in the best first quarter since 1991.

The Dow is now only 7 percent below its record high in October of 2007.

Of course, investors are always climbing a wall of worry. The great first quarter might be due to the relatively benign winter weather, instead of real growth.

Or, we might just be reflecting a worldwide increase in stock values, as investors put the horror of European disaster behind them and embrace risk once again.

Or, this great performance was driven too much by one company, i.e., Apple, which rose a stunning 48 percent.

Apple is the largest single component of the S&P 500 at 4 percent and the Nasdaq at 11 percent.

THE AMERICAN WORKER

For the American worker, however, the first quarter was better but certainly not great. Unemployment dropped to "only" 8.2 percent, the lowest in over three years, but only because 164 thousand people got discouraged and dropped out of the workforce in March. While more than 200,000 jobs were created in both January and February, it decreased to only 120,000 in March, far below the 203,000 jobs that were expected.

The most common explanation for the big miss in March was that the relatively mild winter weather allowed outdoor workers to be hired much earlier than usual. Thus, the good jobs report in January and February were "borrowing"



COMSTOCK

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jobs from March.

My gut feeling is that there is something wrong with the March data, and it will be revised upward. One, that was an unusually big miss from expectations. Two, retail jobs decreased at the same time retail sales went up. And, three, the weekly unemployment claims continue to fall.

THE LONG CLIMB BACK

While the Dow may be only 7 percent from its all-time high, the overall economy is nowhere near the top. Usually, the GDP growth rate is high immediately after recessions. Since the last recession was so severe, we might expect a very strong recovery. For example, growth was 6 percent for two consecutive years following the 1980-81 recession.

From 1947 until 2007, the average GDP growth rate was 3.4 percent, which is good. However, it started slowing. From 1977 until 2007, we grew at only 3 percent, which is a significant slowing.

Since the last recession bottomed in late 2009, our growth has only been 2.4

percent. If we had continued to grow at the long term trend rate of 3.4 percent, our economy would have grown 12 percent since 2007. Imagine your personal income being 12 percent more.

To explain this shortfall, Republicans complain the highest marginal tax rate is too high, and new regulation is too much.

Democrats argue that the highest marginal tax rate is too low, and that business is sitting on too much cash and not hiring enough workers. While there is certainly some truth to both arguments, the major reason this economic recovery is so slow is that it takes more time to de-leverage or to pay down debt. The last recession was not a garden-variety one, caused by an oil-shock or an inventory correction. It was caused by a financial collapse from too much debt.

The driving engine of our economy is the consumer, contributing almost 70 percent of the total GDP. When you pay down debt or save more, you are consuming less, which may be good for you but bad for the U.S. economy and world economy. This is called the Paradox of Thrift.

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Last month, consumers increased their debt burden for the sixth straight month, but they are borrowing to buy cars or education.

Despite the sultry commercials that bombard us on television to buy happiness on credit cards, Americans are reducing their credit card debt instead of consuming. This is a big change. It makes the recovery weaker now but healthier later.

THE RUNNING RECOVERY

Jim Fixx authored "The Complete Book of Running" in 1977 and is often called the "father" of the running movement. Lean and extremely fit, he was the epitome of health.

Then, he was out running one day in 1984, when he suddenly dropped dead from a heart attack.

I see the economy in a similar fashion. The stars have aligned to make this a sustained recovery. Interest rates are lower than most dividend yields. Capacity utilization remains low. Monetary policy remains stimulative. The consumer is getting healthier. Businesses have shed millions of jobs and are sitting on trillions of cash.

The U.S. economy is running down the road easily and is unlikely to fall back into recession, unless Europe pulls us into theirs or China has a very hard landing.

But, we remain vulnerable to a "Jim Fixx moment" or a financial heart attack.

Remember the Flash Crash almost two years ago? In a disquieting new book entitled "Currency Wars: The Making of the Next Global Crisis," author Jim Rickards identifies hyper-complexity as an under-estimated problem that could suddenly cripple us. If a little complexity is good, does that mean more is better? How will you know when there is too much complexity?

More significantly, despite a valiant attempt at greater self-regulation since The Crash, there is still no transparency to credit default swaps. That lack of transparency is what caused the credit markets to seize up last time, i.e., nobody knew who was holding the bag to pay the debts of Lehman.

Progress was shown in the case of Greece, because that "train-wreck" was slow enough for the swaps to be collateralized before the default. Unfortunately, we are still vulnerable to sudden defaults. An example might be the sudden collapse of a major European bank. One indicator to watch is the TED-Spread. Google it, or even better, Bing it.

WHAT WE EXPECT

We are in an economic recovery for sure, albeit a slow recovery. The stock market does not move up smoothly. It is "two-steps forward, one-step back."

Nonetheless, I expect the market to be higher at the end of the year than it is today, absent a "Jim Fixx moment."

HOW WE'RE MANAGING IT

It is a fool's hope that anyone can time the market perfectly. If I see a derivatives failure in Europe, I will increase cash in the portfolios. If the TED-Spread explodes, I'll increase cash significantly. If the Fed or ECB doesn't fix the problem within days, I might sell everything else.

As fear increases, so should cash.

Of course, I'm avoiding all financial stocks. Yes, they are relatively cheap and have much upside potential, but they are the sector most likely to get crushed in a "Jim Fixx moment." The potential gain is not worth the risk to me.

I'm still avoiding long-term bonds and especially long-term bond funds, 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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