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2nd quarter brings increasing uncertainty

By Jim Flinchum

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Although the gains were mostly in the first quarter, the stock market is still up 5.4 percent at the year's midpoint.

Why then are investors in Switzerland, which has long been known as home to some of the world's most sophisticated investors, holding 30 percent of their funds in cash, instead of stocks or bonds?

Analysts have always joked that the stock market is the only market where customers come when prices are rising and flee when prices are falling.

During the second quarter, the S&P fell a mere 3.3 percent and investors pulled $44 billion out of their stock funds and put $71 billion into bond funds.

Since 2007, more than $350 billion has come out of stock funds and $1 trillion has gone into bond funds.

One reason is a loss of faith in our institutions, especially on Wall Street, where incentive plans determine right and wrong. The recent disclosure of Libor rate fixing further ratifies the perception that the game is rigged. But, once the stock market begins a sustained rally, greed will overcome fear again, and money will rush back into stock funds. I expect to beat them there, but not yet.

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THE AMERICAN WORKER

Another reason for the pessimism is the tepid labor market. Job growth in the second quarter was the worst in two years. The stock market lost 1 percent every time the monthly Jobs Report was issued last quarter. No more Jobs Reports, please!

In June, unemployment remained unchanged at 8.2 percent. Only 80,000 jobs were produced. We need at least 250,000 jobs each month. The Associated Press surveyed economists last month and found that a majority don't expect unemployment to return to a more normal 6 percent until 2016. While the total jobs in this country are already more than we had in 2001, we will not get back to the 2008 high in employment until the third quarter of 2017, if we only add 80,000 jobs monthly.

However, there is some good news in another labor report called the JOLTS Report, or Jobs Openings and Labor Turnover Survey. The number of unemployed per job opening has been falling fairly consistently since the high of 6.7 in March of 2009 to only 3.8 in April of this year. The all-time low was 1.5 in May of 2007.

THE LONG CLIMB BACK

Clearly, the economy slowed down in the second quarter. GDP growth in the first quarter was revised down to only 1.9 percent, with estimates of the second quarter being less. Few analysts see much higher growth this year.

Although factory orders were up more than expected, U.S. factory production fell in June, for the first time in three years. U.S. exports also fell last month.

This economic malaise is globalized. Europe is a basket-case. China is also slowing down significantly, with factory production declining for eight straight months. Of course, they do have the ability to make tough decisions, unlike the U.S.

THE STANDOFF

Think of the OK Corral as the OK Triangle. In one corner are the Austrian economists, who scream we must balance the budget and do it now, in order for the economy to improve. In another corner are the Keynesian economists, who scream that the government must stimulate the economy by increased deficit spending. In the third corner are the Supply-Side, or Laffer, economists, who scream that we must cut taxes to fix the economy. All three corners are enjoying a shout-out instead of a shoot-out.

Who is right? All three are right, just

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not at the same time. There is increasing discussion about a "bar-bell" approach or a "now-then" approach, utilizing a Keynesian approach right now to build infrastructure, but only if securely coupled with automatic cuts in entitlements beginning in three years or so and tax cuts a year or two later.

A Keynesian approach would help get our economy out of a ditch now, but we would immediately hit the other ditch if it was not firmly coupled with both entitlement cuts and tax reform later.

Supply-Siders will argue anytime is a good time for a tax cut. When a slow economy is faced with a possible recession, I would agree. When a slow economy is faced with a possible financial crisis, a tax cut would only make things worse. There is a time for a tax cut, but it is not now.

BETTING ON UNCERTAINTY

Wall Street is always "climbing a wall of worry" or fretting continuously about something. But, this is the highest level of uncertainty that I have seen. We are facing a "fiscal cliff" in just a few months.

Unless resolved or kicked into another year, there will be a $221 billion tax increase, when the Bush tax cuts expire, a $95 billion tax increase when the Obama tax cut expires, and a relatively small $18 billion tax increase related to ObamaCare.

In addition, 2013 sequestration spending cuts are $56 billion, expiration of emergency unemployment benefits will cut spending another $26 billion and the unfortunate cuts to doctors delivering Medicare treatments will cut spending yet another $11 billion. If all this happens, next year will be a bad year for the economy.

Obviously, we are fearful of another financial crisis. While a recession can come from anywhere, any financial crisis is far more likely to come from Europe. Most American investment strategists were excited and relieved by the Long-Term Refinancing Operation in Europe late last year, thinking it would buy more than a few months for Europe to do the obvious and the painful. It did not.

Last month, Europe actually made a decision to use their European Stability Mechanism the same way we used our TARP - Troubled Asset Relief Program - which successfully invested capital directly into our banks, and it caused a nice "relief-rally," i.e., stocks went up only because an immediate crash was averted, not because the problem was fixed.

Once again, Europe merely bought more time to issue more debt without addressing the problem of cutting entitlements and reducing labor restrictions.

Sophisticated investors make investment decisions based on company fundamentals, company financials, asset class, sector allocations and the business cycle. Gamblers make betting decisions by betting they know how the Supreme Court will rule, how the American Electoral College will vote or how Congress will resolve difficult issues and when.

So, why do Swiss investors have 30 percent of their assets in cash? Because they manage increased uncertainty with increased cash.

My favorite holdings right now are cash, short-term bonds and stocks of companies making consumer staples - like toothpaste and toilet paper - most of which pay dividends. My least favorite holdings are long-term bonds and bank stocks.

The U.S. stock market is not overpriced, with a price-earnings ratio in the range of 13-14, but it remains very vulnerable to financial shocks.

There are some great buys in the stock market, but the risk is even greater right now. I look forward to buying those stocks with all this cash - later.

Jim Flinchum is a NAPFA-registered financial adviser in Virginia Beach and member of the National Association of Business Economics. He is also the author of "Paybacks," which won the 2012 International Book Award for general fiction. He can be reached via email at jim@baycapitaladvice.com.