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Making it through Q4 and around the cliff

By Jim Flinchum



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Despite the spectacle of Congress stumbling around the fiscal cliff, 2012 was a good year for stocks, with the Dow up 7 percent and the S&P up 13 percent. Very few investment managers, however, did nearly that well last year.

Long considered "the smart money," hedge funds rose only 5 percent last year. Unfortunately, those investment returns don't measure the risk that an investor assumed.

Given the continuing political crisis in the U.S. and the continuing financial crisis in Europe and the current slowdown in the world's economic engine, China, it was a risky year, indeed. Most professional investment managers prudently focused on managing risk instead of chasing return.

It was also telling that small-company and midsize-company stocks substantially outperformed large-company stocks. That is because the larger companies are more exposed to the international arena, where risks were substantially higher last year. The smaller companies are more focused on the U.S. economy, which may be sputtering but sputtering better than the rest of the world.

GLOBAL MARKETS

As good as the U.S. markets were in 2012, many world markets substantially outperformed us, such as the nearly bankrupt Greece - up 33.43 percent. Healthy economies, like Germany, Austria and Denmark, enjoyed nice stock market returns of 29.06, 26.94 and 26.86 percent respectively.

Of course, if you really like to gamble by chasing performance, the leaders last

year were the completely corrupt Venezuelan stock market - up a whopping 302.81 percent - or the never-tranquil Pakistani market - up 48.98 percent. Let me know if the return is worth the risk!

THE AMERICAN WORKER

Of the almost 130 economic statistics released each month, the most closely watched is the monthly Jobs Report. The most recent showed the rate of unemployment unchanged at 7.8 percent.

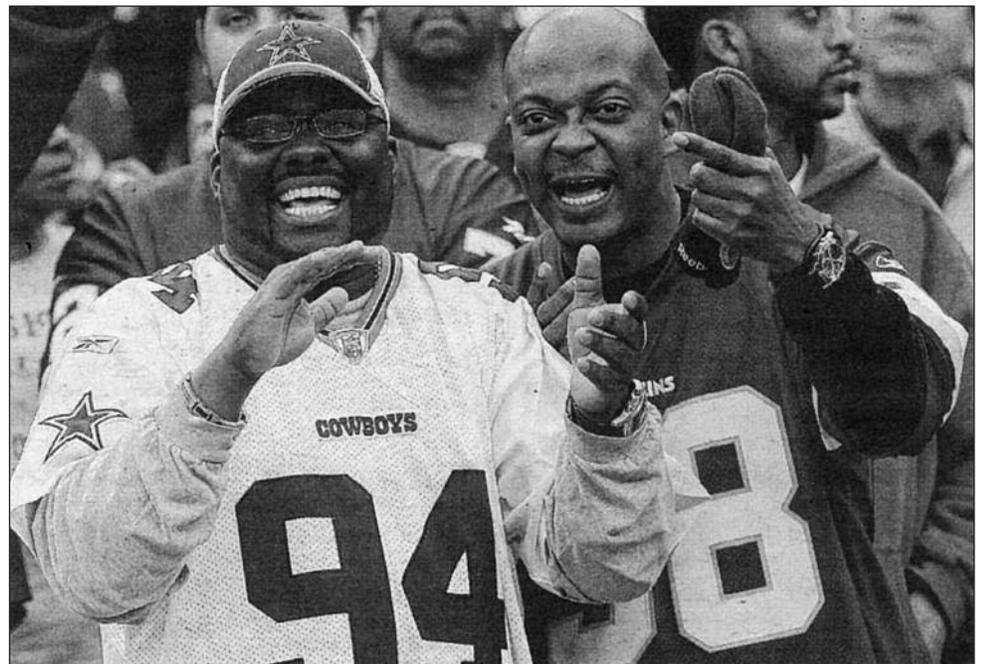
More importantly, the rate of under-employment - called the U-6 Report - is still over 14 percent. This report includes the unemployed plus those forced to work part-time, making it more descriptive of the whole workforce.

And, you'll note this doesn't include

people-who-have-given-up, which has been estimated at another 10 percent. That means almost a quarter of our workforce is being wasted.

The economy seems to be stabilizing with 150,000 jobs produced monthly. That is nowhere near enough. One unmeasurable statistic that economists enjoy debating is the "output gap." If our GDP is \$15.8 trillion with 14 percent under-employment, what would it be with a 5 percent under-employment rate? How much greater would our national output be?

Another worrisome trend is appearing. Since the depths of our recession in 2009, over 4.2 million jobs have been created. However, contrary to popular impression, 3.5 million of those jobs have gone to people over the age of 55. Some allege the



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older workers are better educated if not more educated. While this is great for older workers, what does this suggest about our workforce in the long run?

OVERSEAS CONCERNS

The most obvious concern for a systemic collapse is the continuing four-year financial crisis in Europe. It was hoped the LTRO - Long-Term Refinancing Operation - last year by the European Central Bank would be enough to persuade the world that Europe had a mere political crisis and not a serious financial crisis. When that didn't work, the ECB chief, Mario Draghi, announced July 26 that the ECB would do "whatever it takes to preserve the euro. And believe me, it will be enough."

There is an old adage in the U.S. among traders: Don't fight the Fed. The same is true in Europe: Don't fight the ECB.

Also, Greece wiped away 53.5 percent of its debt last March and is preparing to reduce its debt even more this spring. Because the losses are taken by the bondholders, the Greek people are still somewhat insulated from the full impact of their profligate entitlements. While they have already suffered greatly, the suffering has not been evenly spread. At some point, Greek entitlements became the narcotic-of-choice, and they must now endure a long period of rehab.

Europe is now entering what appears to be a shallow recession, which is not particularly worrisome. The risk of a much more dangerous financial collapse is now reduced, especially if the ECB, which can "print" money, successfully assumes more responsibility for European banks, relieving member-nations, who cannot "print" money.

While the Chinese stock market was up a mere 3.17 percent last year, it is clear that the Chinese economy should pick up steam in 2013. As the economic engine of the world, this is critical. Fortunately, the most current economic data looks much stronger. The recent swoon in its economy should be viewed in terms of the peaceful transition of power that just took place. Just as in America, increased uncertainty drives down stock prices. With their transition behind them and reason to believe their new administration is business-friendly, I expect another economic surge by China.

Japan is an interesting case. Famous for its "government-of-the-month" rotating chief of state, its new leader is strongly pushing its central bank to "print" money on the scale of the Fed or the ECB.

As a result, the yen just hit a 27-month low and can be expected to fall even further. Of course, a cheap yen should be good for the Japanese economy and stock market, but not ours.

The underlying U.S. economy is stronger than most Americans recognize, especially with the obvious turnaround in housing.

I worry more about the ability of the government to get out-of-the-way than I do about either the economy or the market. With the fiscal cliff fiasco behind us, I am more bullish, despite the upcoming debt ceiling debacle.

HOW WE'RE MANAGING IT

Like most people, I yearn for the days when only elected officials behaved like barbarians, while Democratic and Republican voters behaved more like Redskins and Cowboys fans, who merely kidded each other, without demonizing each

other.

With the charade of redistricting and the money treadmill that politicians must run, I foresee little improvement. This means I will keep my finger near the sell button as we approach the debt ceiling vote.

A new book by Christopher Steiner is required reading for investors, especially those who subscribe to the "buy-and-hold" investment style of not increasing cash levels as risk levels increase. It is called "Automate This: How Algorithms Came to Rule Our World" and recalls that horrific "Flash Crash" in May of 2010, when the Dow dropped almost 1,000 points in minutes.

Fortunately, that was only one malfunction and could be fixed. As the importance of algorithms increases, especially with derivatives, it is another reason to keep my finger near the sell button.

Ignoring the political pollution in our economy, I expect to be more bullish this year, especially for U.S. large-cap stocks, European stocks, Asian mutual funds and possibly Mexican ETFs. While commodities were flat the last two years, they do tend to react more strongly to economic growth and should present opportunities this year.

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