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Third Quarter saw us get past the abyss, almost

By Jim Flinchum

During the third quarter, July was a great month for the stock market, August a lousy month and September was both, experiencing a strong upsurge before dropping, as the probability of government shutdown increased. The fourth quarter appears to be equally volatile, especially October.

JIM FLINCHUM

The most important economic event of Q3 was something that didn't happen, i.e., no tapering of quantitative easing. The Fed has been pumping $85 billion into the economy monthly by buying bonds of the Treasury, as well as mortgage-backed bonds, to support the housing recovery. It was expected to decrease the level of support in September but apparently was worried about withdrawing support in front of a government shutdown and possible default if the debt ceiling is not raised in October. Smart move.

THE MARKET

This year, total stocks in U.S. are up 16.7 percent with the S&P up more and the Dow up less. Still, most investors will be disappointed with their portfolios.

The gold standard of investment management is the Nobel-prize-winning "Modern Portfolio Theory," by Harry Markowitz, which essentially found that superior long-term investment returns can be achieved with less risk by allocating the portfolio to various asset classes, such as big and small company stocks, foreign stocks, U.S. bonds, foreign bonds, high-yield bonds, real estate, commodities, even cash. The art of long-term investing is knowing how much to allocate to each of those asset classes.

The media reports little more than large company stocks, like the S&P, which is only one asset class but one which did great this year. Any allocation to other asset classes reduced your overall portfolio performance this year. For example, any allocation to emerging market stocks, which lost 15.2 percent, decreased your overall portfolio performance.

Don't worry about that - just keep thinking long-term.

Around the world, some weaker nations rebounded nicely, with Argentina up 36.9 percent, Spain up 25.1 percent, and even Greece up 24.8 percent. All beat the U.S., but they also carried higher risk. Cyprus was down 84 percent, and Indonesia was down 24.4 percent.

THE JOBS MARKET

Unemployment is the most commonly used measure of the economy. Unfortunately, the monthly unemployment report from the Bureau of Labor Statistics was another victim of the shutdown. The consensus forecast was about 180,000 jobs were created in September, which is about average this year. The four-week average of initial claims suggests that layoffs are decreasing faster than employment is increasing.

An interesting new econometric study by the San Francisco Federal Reserve Bank has estimated Washington gridlock is costing us two million full-time jobs and even more part-time jobs. That's right - two million - think about that - workers who could be paying taxes.

THE ECONOMY

Gross Domestic Product increased sharply from 1.1 percent in Q1 to 2.5 percent in Q2 but is expected to drop to 1.8 percent in Q3 before rising to 2.6 percent in Q4 and averaging 2.3 percent for all of next year.

While the service sector seems to be stalling somewhat, the manufacturing sector continues to look strong, according the Institute of Supply Management.

Recoveries from a financial crisis are always slower than recoveries from a garden-variety recession, and this is no exception, unfortunately.

The European financial crisis hurt the U.S. stock market for three straight years. However, this year has been better. While their banking system is still not as well capitalized as our banking system, they have made much progress and seem to realize the problem. Retail sales have increased for three straight quarters and are now at the highest level in three years. England's GDP growth for Q2 and Q3 was 2.7 percent, easily outperforming the U.S.

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With Merkel's easy reelection, she now has enough power and discretion to hold the euro together. Plus, the inconceivable

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has happened in Italy, with former president "Boom-boom" Silvio Berlusconi removed from office and headed to jail. Despite his best efforts, he failed to bring down the government. Although much work remains for the Europeans to contain their entitlements and labor restrictions, they seem to realize that problem as well.

Asia is also looking stronger, with a better-than-expected increase in Japanese business sentiment, and China's GDP growth seems to have settled at 7.5 percent, which is slower than the past but easily outperforming the U.S.

THE DEBT CEILING

Hopefully, the most important economic event of Q4 will also be if something doesn't happen, i.e., a default by the federal government. In a textbook world, default will cause a drop in the stock market. The dollar will lose value. Gold will increase. More currency traders will start thinking of the Chinese yuan as a better reserve currency. Oil will drop, as decreased economic activity can be expected. Bonds will decrease, and interest rates will increase on U.S. Treasury bonds, but decrease on debt of other countries.

The problem in the real world is that, while everybody knows what will happen, nobody, absolutely nobody, knows how large these changes will be. Default sets in motion things that cannot be controlled. Even the highly innovative Ben Bernanke would have little power to control the damage.

I can long remember the dollar being the safest credit in the world. But, already, credit-default-swaps are cheaper for Switzerland, Sweden, Denmark, Finland, Germany and even England.

No discussion of Q3 would be complete without remembering Q3 five years ago, when we witnessed the collapse of Lehman Brothers and the rapid slide into the abyss, as former Treasury Secretary Hank Paulson described it. How can we ever forget Sept. 29, 2008, when the Dow fell 777 points? I hope we never do.

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HOW WE'RE MANAGING IT

As this is written, there is no resolution to either the shutdown or the hyper-critical debt ceiling. I expect to be buying stock before either is resolved. Yes, I want the shutdown ended, as it decreases GDP cumulatively for each week of shutdown and is a significant, unnecessary economic headwind. However, "the 800-pound gorilla" is the debt ceiling increase. While the consequences could be huge, I'm relatively sanguine about it. One reason is that public opinion seems to be shifting to one side, making resolution more likely.

Secondly, if we do default, Bernanke can keep our interest costs down by increasing quantitative easing.

Third, my reading of foreign pundits convinces me that they see us as "those wacky Americans" and not just another deadbeat nation. They will continue to buy Treasury bonds.

Lastly, there is plenty of revenue to pay interest due on our bonds, but something else will not be paid. As painful as it would be morally and dangerous politically, it is far better to pay our interest bills than to pay our Social Security recipients.

Therefore, I'm continuing to buy U.S. stocks during the shutdown and think we will end the year higher, with the S&P about 1,750. I'm also buying more bio-tech and European small-cap stocks. And, of course, I'm avoiding long-term bonds.

Most importantly, I remain ready to sell stocks quickly if the derivatives market freezes.

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