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Q1 2014: a new face, a new worry

By Jim Flinchum

Following a great 2013, the U.S. stock market took a breather during the first quarter of 2014. The closely watched S&P 500 was up a mere 1.3 percent. The Dow was down 0.7 percent, and the Nasdaq was up 0.5 percent. B-O-R-I-N-G! As the quarter began, Janet Yellen took over for Ben Bernanke as chair of the Federal Reserve System. Arguably, she is the most qualified person in history to take that position. She has a Ph.D. in economics, as do her husband and son. In fact, her husband even has a Nobel prize in economics. More importantly, she served on the board of governors for seven years, four of which she was the vice chair. She even served as chair of the Council of Economic Advisors.

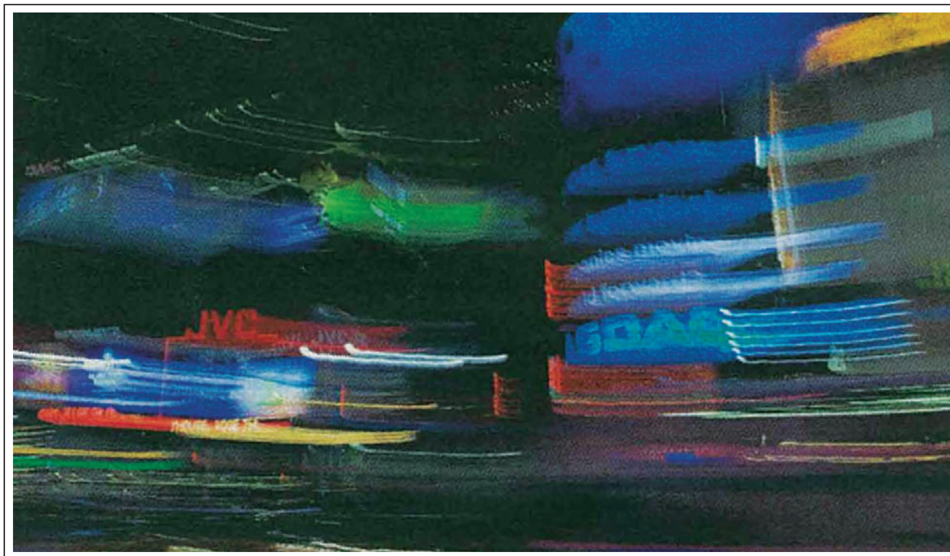
JIM FLINCHUM

The stock market likes her, because she is considered a "dove," which means she worries more about unemployment than inflation and will maintain an easy money policy of low interest rates for a longer period.

As the quarter ended, author Michael Lewis ignited a firestorm with the release of his new book "Flash Boys." It is an explanation of how "high-frequency traders" have rigged the stock market by getting buy-and-sell information literally nanoseconds before the stock exchanges. Knowing a good number of "buys" are coming in, which will drive up the price per share, they buy just ahead of the orders and then sell at the higher price to those sending in the buy orders. They might buy and then sell the same stocks in seconds.

Are buyers getting ripped off? Yes! Is it enough to matter? No!

If you are a long-term investor, it shouldn't matter if you pay an extra 2 cents per share. Is it illegal? If it isn't, it should be. Even Charles Schwab agrees it should be illegal. But, petty theft, albeit on a grand scale, is not my primary concern. Long-time readers know I've cautioned about high-frequency trading since the "flash crash" of May 6, 2010, when the Dow suddenly dropped a 1,000 points. That was because of a technology problem, only partially related to high-frequency trading. However, with high-frequency trading now representing almost 70 percent of all trades, it has become steroids for technology problems on Wall Street.



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Although the U.S. stock market beat most other countries last year, that will probably not be true this year. Remember the Cypriot crisis two years ago? Its stock market was up 31.2 percent in the first quarter of this year alone. Of course, if you invested in that market, you took enough risk to deserve an even higher return! Other "winners" were Bulgaria, up 29.5 percent, Indonesia, up 21.1 percent, and Vietnam, up 20.4 percent in one quarter - all bastions of capitalism?

Not surprisingly, the "biggest loser" was the Ukraine, down 19.8 percent. Russia was down 15.4 percent.

If the spoils went to the victorious Russia, its stock market doesn't believe it. In addition, its currency, the ruble, is down 11 percent. I sure hope Crimea was worth it for them. In fairness, Russia went from communism to cronyism and has never experienced capitalism. It shows!

If you look at the stock exchanges alone, you would think European stock markets were doing poorly, but remember that European banks were hurt worse than U.S. banks during the global financial

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crisis and still haven't been recapitalized properly. Generally speaking, the poorly performing banks now make up 22.5 percent of their market, compared to 16.1 percent of ours. In addition, only 3.3 percent of their market is technology-related, compared to 18.8 percent of ours. If you factor those out, the rest of European stocks have outperformed the U.S. for the last nine months.

In the U.S. in general, the short-term economic data continues to look good. For example, the ISM Manufacturing index jumped from 48.2 in February to 55.9 in March, probably primarily because of better weather. Remember: Anything above 50 means it is expanding. The ISM Non-Manufacturing index also jumped-to 53.1 from 47.5 in February. Factory orders have turned around and were up l.6 percent. The level of unfilled orders is at an all-time high. Housing has weakened, but consumer confidence has reached a post-recession high.

Bulls look at the short-term data and sleep well. Bears look at the long-term data and worry all night. For example, the length of the average economic recovery since World War II is 58.4 months, and we are now in the 57th month of recovery, albeit an anemic recovery. The Fed is decreasing its purchase of government bonds (quantitative easing), but it still has trillions of dollars of those bonds it would like to sell. Globalization has made stock market movements even more volatile, due to the "headline risk" of geo-political developments, keeping bears awake.

The unemployment rate of 6.7 percent in March was unchanged. The economy produced 192,000 jobs, which was slightly less than the 200,000 expected. However, it revised its January and February estimates upward by 37,000.

The good news is that the private sector has now recovered all 8.8 million jobs that it lost in the 2008-2009 recession. The bad news is the private sector still needs to recover those jobs lost in the government sector, plus the normal increases in the workforce from population growth.

The saddest unemployment rate is the U-6 rate, which includes part-time workers who cannot find full-time work. It was as high as 17.1 percent in April of 2010 but has now worked itself down to "only" 12.7 percent in March, up slightly from February.

The labor force participation rate ticked up to 63.2 percent. This was normally about 65 percent before the recession, begging the question of why are fewer people looking for work now? Republicans believe it is due to overly generous entitlements, such as Social Security disability benefits. Democrats believe it is due to demographic issues, like baby boomers retiring.

I believe the AWOL workers will come back into the workforce when they believe they have a reasonable chance of getting a real job.

An interesting piece of research is that we now have so many people in prison that it would increase our unemployment rate by 2 percent if they were released. Increases in the prison population also decrease the labor force participation rate.

Because stock market drops are healthy for the stock market in the long term and because there is a 5-10 percent correction most every year, we are due for such a correction.

In fact, there is some research that shows the longer the market rises without a correction, the more violent the correction when it finally comes. If we do not have a 5-10 percent correction this year, I will become very worried.

My favorite sector continues to be biotech. Over the last month, that sector has been "beat up" badly, primarily because of possible increased governmental involvement and profit-taking. I will probably use this period to increase my exposure to that sector. I will also increase my exposure to European small-cap mutual funds, as the market indexes over there disguise the recovery that is taking place.

l will also be preparing my clients not to panic and overreact to the possible mother of all flash crashes if/when high-frequency traders crash the computers on the stock exchanges.

It will seem like a near-death experience, but the market will survive it and rebound.

Jim Flinchum is a NAPFA-registered financial advisor in Virginia Beach and member of the National Association of Business Economics. He is also the author of the award winning "Paybacks." He can be reached via email at jim@baycapitaladvice.com