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Q2 was a bull market although trading was low

By Jim Flinchum

The most shocking event in the second quarter was the news of what happened in the first quarter, which The Wall Street Journal called a "punch-in-the-stomach report."

JIM FLINCHUM

First, the economists told us that GDP grew a tiny 0.1 percent during Q1. Then, they revised that estimate, saying the economy shrank 1 percent. Finally, on June 25, they concluded that our GDP actually shrank a whopping 2.9 percent, the largest decrease since the depths of the Global Financial Crisis in Q1 2009 and the first non-recession quarterly loss since World War II.

Obviously, the brutal winter weather was the primary cause. Flat consumer spending does suggest consumers stayed home and stayed warm instead of shopping.

Interestingly, the sector showing the biggest decline was health care, as patients were snowed-in and could not make their appointments.

A worsening trade deficit also pulled down GDP in Q1, although it has improved since then.

We had been hoping for a 2.9 percent growth in the economy for full-year 2014. However, with such a huge decrease in Q1, that now looks more difficult to achieve. The second quarter will certainly be an improvement

GLOBAL MARKETS

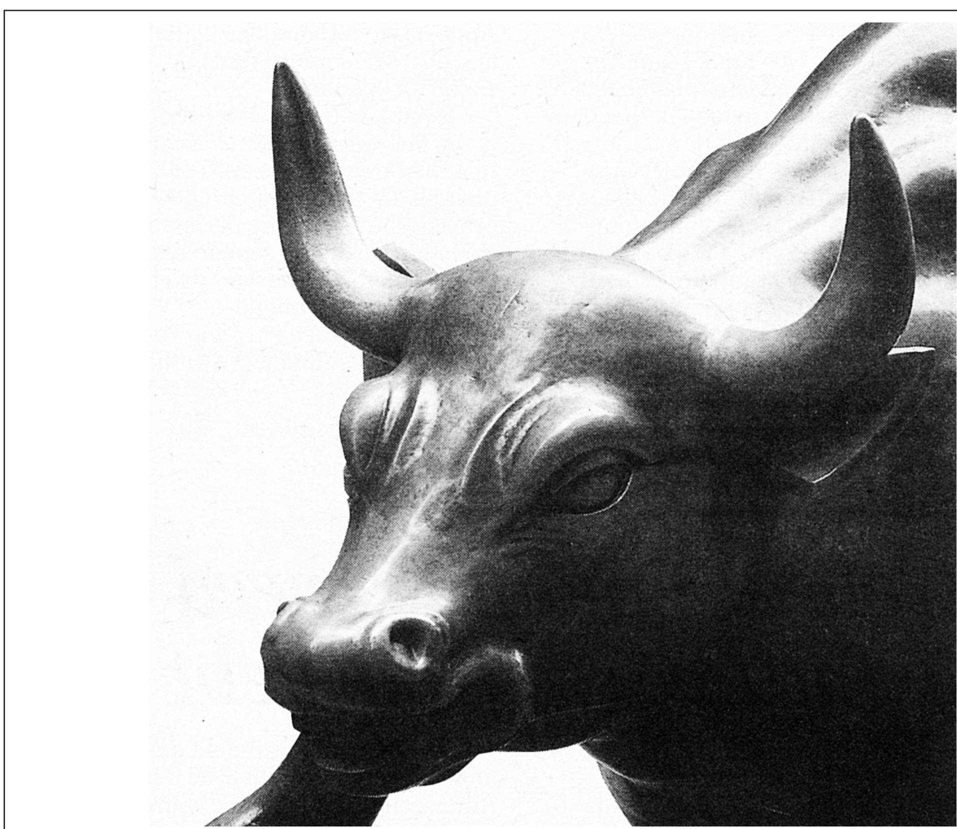
Global economic growth has been lackluster, making the U.S. look relatively strong. England has also been surprisingly strong and China appears to have bottomed out.

The most worrisome event in global finance happened in New York where a judge told Argentina that it cannot make interest payments to current bondholders unless it makes payment to all bondholders with a claim due. The Argentine stock market had been the best performing until this court decision and then instantly dropped a heart-stopping 11 percent.

Try to imagine a sudden 11 percent drop in our stock market, especially due to some foreign judge. More importantly in the long run, this U.S. court decision has clouded the market for sovereign bonds worldwide.

Historically, a nation could default and pay its bondholders a reduced amount. Now, if all bondholders don't agree to a reduced amount, the holdouts must be paid along with new bondholders. This will make bondholders much more reluctant to accept any reduction in the money owed to them and make it more difficult for nations to restructure their finances.

Our stock market was unexpectedly strong during the second quarter, with the Dow up 2.2 percent, the more important S&P 500 up 4.6 percent and the Nasdaq up 4.97 percent to its highest level in 14 years.



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That's good for creditors but bad for populations. Imagine what would have happened to Greece two years ago if they could not have restructured their debt. It is not hyperbole to suggest there would have been even more blood in the streets.

THE AMERICAN MARKET

Our stock market was unexpectedly strong during the second quarter, with the Dow up 2.2 percent, the more important S&P 500 up 4.6 percent and the Nasdaq up 4.97 percent to its highest level in 14 years. The S&P has grown for six straight quarters. The Russell 2000, which measures smaller companies, has grown for a record eight straight quarters. The S&P index has closed at record highs 14 times so far this year.

This is the fourth-longest bull market in American history, even though trading volumes remain low and retail investors continue to pull money out of equity mutual funds.

One reason for this bull run's length is that money going into exchange-traded-funds, ETFs, is three times the amount coming out of mutual funds. Because ETFs are more commonly used by institutional investors - also known as "smart money" - while retail investors - also known as "dumb money" - use mutual funds, cynics suggest that is proof the bull market has legs to run more. Smart money coming in as dumb money leaves.

To an extent I've never seen before, it seems the divide between bulls and bears is increasingly along partisan lines - not completely but increasingly. Republicans tend to view the market through the lens of Austrian economics, where government budgets must be balanced every year. Democrats tend to view the market through the lens of Keynesian economics, where budgets must be balanced in the long run, not every year.

Of course, neither side is always faithful to its economic religion and strays whenever expedient. Republicans are more likely to argue the stock market is on a "sugar-high," courtesy of deficit spending and the Fed. Democrats are more likely to argue the stock market merely reflects an improving economy.

My perspective is that the Democrats are probably right in the short run. Since "the trend is my friend," it is a time to be bullish. But, the Republicans are almost certainly right in the long run. Named after Keynesian economist Hyman Minsky, the "Minsky moment" occurs when the debt bubble expands to the point it can no longer expand and then suddenly collapses. That Minsky moment will prove the Republicans were right in the long run.

THE ECONOMY

In general, the short-term economic data continues to look good. For example, both the ISM Manufacturing Index and the Non-Manufacturing Index are at a bullish 55-56. The Index of Leading Economic Indicators has been positive for four straight months. The NFIB Small Business Index has reached a post-recession high. Consumer confidence rose to a very bullish 85.2. Businesses are also more confident, increasing their inventory levels 1.1 percent in just one month.

Even the Federal budget deficit is improving, dropping from $1.5 trillion in 2009 to $680 billion last year and $492 billion this year.

In June, the economy produced 288,000 jobs, reducing the jobless rate to a more-normal 6.1 percent, which is the lowest since the global financial crisis in 2008. It was also the fifth straight month that produced over 200,000 new jobs. The number of open job listings has now increased to 4.5 million, the most since September of 2007.

SMELLING SMOKE

The most worrisome event of the quarter was the probe into the huge "dark pool" run by Barclay's. Sometimes, when large institutional investors need to buy or sell large stock positions, it can cause the stock market to move suddenly and irrationally. So, "dark pools" were developed where these positions could be traded in private, which is quite legal. Today, 37 percent of all stock trades are secret.

Secrecy breeds conspiracy theories, and there have been many. This probe also involves high-frequency trading, which was discussed in this column last quarter. High-frequency trading is also not illegal, but this unholy marriage of high-frequency trading inside secret pools keeps me awake at night.

The probe is not aimed at the practice but is instead aimed at whether Barclay's was honest about it. I wish it was instead aimed at the unholy marriage.

The "siren's song" of investing is the initial public offering. The great investment performance of a few new stocks - like GoPro - conceals the lousy performance of the vast majority of new stock offerings. There were 256 last year. How many did you hear about? There have been 169 this year, and the huge Alibaba IPO is expected in August. We will continue to resist the sexy allure of IPOs.

For years, we have reasoned that interest rates can go no lower and the next move must be upwards. At year-end 2013, 10-year Treasuries were 3.04 percent and have dropped below 2.6 percent. Predicting interest rate movements now involves less economics and more political science. We will be buying exactly zero bonds with long maturities.

Two things are sure - I won't be doing any high-frequency trading inside dark pools, and I will remain fully invested, but sleeping with my finger on the sell button.

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