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Q4: Recovery makes its way to Main Street

By Jim Flinchum

For the past few years, most investment analysts have been predicting a 5 to 10 percent bear market. In fact, they have been hoping for it, as market drops are healthy in the long run.

JIM FLINCHUM

During the past quarter, we had a stealth correction in October that nobody noticed. Do you even remember the Dow dropping 335 points on Oct. 9? It was done behind the headlines of Ebola and mid-term elections. Be glad! Media attention would have made it worse.

GLOBAL MARKETS

As good as the U.S. stock market did, China's Shanghai outshined us, enjoying a 52.9 percent jump last year. With an earthbound GDP growth rate falling below 7 percent, there is a widespread expectation that the central government will announce a significant stimulus program, plus foreigners are now allowed to purchase shares directly on an exchange.

India enjoyed the second best stock performance last year, with a 29.9 percent gain. Most of Europe was flat to slightly up, except for Belgium, Israel and Sweden, who were up 12.4 percent, 10.2 percent, and 11.9 percent, respectively. Increased volatility should be expected there.

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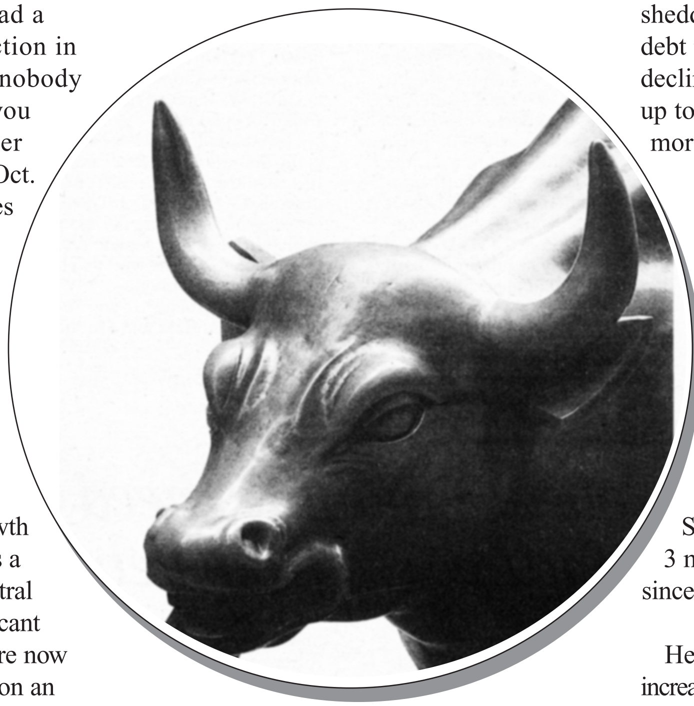
THE AMERICAN MARKET

All three major markets ended the year up significantly, but off their highs. The Dow ended up 7.5 percent for the year, marking six straight years of a bull run. The broader and more important S&P 500 rose 11.4 percent, and the Nasdaq was up 13.4 percent.



The best performing sectors were utilities, health care and technology, which were up 24.3 percent, 23.3 percent and 18.2 percent respectively. The worst performing sectors were energy, telecommunications and materials, which were down 10 percent, down 1.9 percent and up 4.7 percent, respectively.

The fall in energy shares reflects the collapse in oil prices. The fall in telecom shares reflects worries from income investors that the fat dividends are being pressured by falling margins.

ECONOMY

For the last three quarters, GDP growth has been 4.6 percent, 3.9 percent and 5 percent. The U.S. has once again become the economic engine of the world.

The economy must be doing better, as Americans are taking on debt again - after shedding debt since 2008. Total household debt reached $12.7 trillion in 2008, but declined until Q2 of 2014. Now it is back up to $11.7 trillion, with most increases in mortgage debt and car loans.

Inexplicably, student debt at $1.13 trillion continues to rise. Although it was well-intentioned, it has become a taxpayer subsidy to for-profit colleges.

THE LABOR MARKET

It looks like 2014 was the year when the economic recovery on Wall Street finally got to Main Street. Almost 3 million jobs were created, the most since 1999. That's the good news.

Here's the bad news: Wages are still not increasing. In December, they actually dropped.

With the falling unemployment rate - now 5.6 percent - wages should be increasing. One theory is that too many of the new jobs are minimum wage jobs, pulling the average down. Another theory is that workers are still so shell-shocked from the last recession that they are too timid to ask.

At the end of 2007, 66 percent of the labor force either had a job or was looking for one.

Today, that is about 62.7 percent, the lowest in 37 years.

Republicans allege that is because workers are too lazy or social welfare is too generous.

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Democrats allege that drop reflects the retirement of the baby boomers.

Sociologists suspect a new "slacker" subculture is developing, free from materialism and invisible to economic measurement.

Either way, it means fewer taxpayers to support government and the millions of Social Security/Medicare recipients.

We're just not manufacturing enough younger Americans to support the older Americans. Maybe, we should grant amnesty to any illegal immigrants who will change their name to Smith or Jones and pay taxes? We need more taxpayers.

THE CONTROVERSY

Thomas Piketty's densely written book, "Capital in the Twenty-First Century," burst onto the intellectual stage last quarter. The left-leaning economist forecasts increasing inequality, because the return on capital exceeds economic growth. As long as that continues to occur, inequality will increase.

He coins the clever label of "patrimonial capitalism" for inherited wealth. As a solution, he proposes the totally unworkable idea of a globally coordinated progressive wealth tax, with rates of 10 percent over $100 million. He also argues that income inequality is driven by low marginal income tax rates, because corporate executives find increasing income more attractive.

Nobody argues that increasing inequality is a good thing, but there is little agreement on how to stop it, much less reduce it.

2015 WORRIES

The U.S. remains "the only clean shirt in the dirty clothes hamper." Left to ourselves, we should experience 3.4 percent GDP growth this year. Forecasts of the S&P 500 at year-end range are from 2,050 to 2,325, which would be up another 13 percent. Consumer sentiment is at a seven-year high. Reaching 2,200 should be easily attainable. It would be only 6 to 7 percent, slightly below historical averages.

Many investors are worried about the interest rate increases expected for this year. If we have those increases, I don't expect them until near the end of the year and then in small quarter-point increments. Just as the stock market dealt with the end of the bond-buying program, known as quantitative easing, so easily last October, it should easily handle the small interest rate increases.

There is some worry that the mergers and acquisitions activity has become too hot. After all, the $3.5 trillion in 2014 was the most in seven years. That may be evidence of financial froth, but not of economic weakness.

I am far more concerned with Europe. In addition to the Russian invasion of Ukraine, Greece is "circling the drain" with an election later this month that could drive them out of the European Union, called "the Grekxit."

While there was earlier concern that the EU could shatter with the exit of one nation, that concern is much lower now. However, in the short run, I expect stock markets to suffer until that survival is obvious. I would give this a 15 percent probability, causing a 15 to 20 percent drop in the U.S. stock market - at least for a while.

As always, systemic financial collapse like 2008 remains possible as long as the world of derivatives remains hidden and unregulated.

Now that the shadow world of banking in hedge funds and non-bank financial firms has reached a record of $25.2 trillion, exceeding its pre-crisis high of $24.9 trillion, it is even more worrisome.

While it still has a low 5 percent probability, it could crush the markets by 50 percent - at least for a while.

HOW WE'RE MANAGING IT

Remembering that the third year of a presidential term has produced a bullish stock market in 88 percent of the years since 1945, with average gains of 16 percent, I remain biased in favor of stocks. The second best year is usually the fourth year.

However, while the spectacular 50 percent collapse in oil prices fattens the bottom line of many non-energy companies, it has happened too rapidly.

There will be a significant amount of economic dislocation, as ripples from oil drillers and oil field suppliers affect other industry sectors. Expect buying opportunities in the near future.

Likewise, the dollar has gotten stronger, but too quickly. Companies that export to other nations get hurt by a strong dollar.

Imports from the U.S. are now 13.6 percent more expensive in Europe, 84 percent more expensive in Russia, and 13.7 percent in Japan.

U.S companies with heavy exposure to those countries will be avoided.

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