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Fourth-Quarter Financial Review

By Jim Flinchum

2016 started with a horrific $2 trillion loss of wealth worldwide in just four days.

First, we were frightened by the Muslim civil war between the Sunnis and Shiites, as Saudi Arabia and Iran volleyed threats at each other. Then, the leader of North Korea frightened world stock markets when he bragged about exploding a hydrogen bomb. And we got slammed by the Communist bureaucrats of China mismanaging the most capitalistic of all institutions – a stock market.

Jim Flinchum

With so much geopolitical smoke in the air, it is easy to lose sight of our American market.

The American economy

We are caught in an economic purgatory of 2.0 to 2.5 percent GDP growth, where we are doing better than most nations but far less than we are capable of doing.

While economic data is mixed, there is scant evidence of an imminent recession, even though one is long overdue.

Consumer confidence and consumer spending are up nicely. Auto sales are strong, although not as strong as expected. Manufacturing is already in a recession, suffering from the high dollar and falling worldwide demand, but it is only 12 percent of GDP. The service sector is 88 percent of GDP, and it is also slowing.

Economic historians quibble over whether we have ever imported a recession from abroad. The international part of our economy is increasing and is still not large enough to do more than marginal damage. However, there is no question that we have imported bear markets, defined as a 20 percent drop in stock markets. What happens in the Shanghai financial centers is more important to investors than what politicians do in Beijing.

The American worker

The economy continues to produce more jobs than expected. In December, 212,000 new jobs were expected, and 292,000 jobs were created. In addition, the previous two months produced 50,000 more jobs than earlier reported. It was a good month.

Even though 2.65 million jobs were created last year, 9.9 percent of our workforce is still under-employed, mostly workers working part-time jobs because they cannot find full-time jobs.

The American stock market

For the year, the Dow lost 2.2 percent, and the S&P 500 lost 0.7 percent. The tech-heavy Nasdaq actually earned a respectable 5.7 percent.

It was expected that the rise in the dollar would hurt large exporting companies, instead of smaller companies without export exposure. Instead, large-cap stocks easily beat small-cap stocks. Oddly, consumer discretionary stocks were the best performing, which usually occurs during stronger economic growth. It reflects the improving health of American consumers.

If you lost money last year, don't be too hard on your financial adviser. After all, Warren Buffett's flagship Berkshire Hathaway lost 11 percent.

Often described as the "smart money" of rich people, hedge funds underperformed the S&P for the seventh straight year, losing about 3.5 percent on average. On top of that, investors in hedge funds paid fees which are much higher than mutual funds.

Global markets

The Eurozone bounced back with a 6.8 percent increase in stock prices, led by normally sluggish Italy at 12.7 percent. Germany and France were up nicely at 9.6 percent and 8.5 percent, respectively.

Asia was very different, with Japan up 9.1 percent, while Singapore and Taiwan were down by double-digits. The most bizarre was the Shanghai market, which ended up 9.4 percent, despite being down 43 percent from its high in August.

First, China publicly encouraged the people to invest and compounded the mistake by making margin investing too easy for unsophisticated investors. The growth was hyperbolic and promptly started collapsing. Instead of allowing the market to fix itself, the government tried to help by prohibiting selling of stock. This always makes everybody want to sell even more.

The dollar rose a strong 8.62 percent last year, which makes our exports 8.62 percent more expensive for foreigners to buy from us – not a good thing for America! A stronger dollar also helped drive down overall commodity prices about 19.04 percent. Gold was down another 10.44 percent, while oil dropped a staggering 30.37 percent. One of the great minds of our time and author of "The Black Swan," Nassim Nicholas Taleb wrote recently that the next Black Swan event is not likely to be crashing banks,

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as in 2008-2009, but is more likely to be crashing commodity prices – definitely something to watch, but I am more worried about crashing Chinese banks.

Soap opera

Domestically, Wall Street continued its obsession with the Fed raising interest rates, which it finally did in December, albeit only a quarter-point. Most observers expect another three or four interest rate hikes next year, but I think the Fed is done for now. They just needed to pacify the Libertarian wing of the Republican Party that the Fed is not afraid to raise rates, and that's enough for now. For all that angst, rates on 10-year Treasuries increased a mere 12 basis points from 2.17 percent to 2.29 percent over the full year.

Remember: The Fed can control short-term rates but not long-term rates, which are more closely related to inflation. Mortgage rates have crossed above 4 percent. No big deal. The housing market should continue to look strong.

Originally mandated to manage unemployment and inflation, there is reason to believe the Fed is also paying attention to international affairs, which is a good thing in an increasingly globalized world.

Presidential Curse?

Many analysts believe the presidential election impacts the stock market. If you recall, the market hates uncertainty, and a presidential election introduces a great deal of uncertainty.

Looking at election years since 1900, the stock market churns downward the first five months before a strong rally and ends the year up about 11 percent. There doesn't seem to be any distinction whether it is won by Republicans or Democrats.

How we're managing it

I have no fear of recessions. They are a normal part of the business cycle. They come and they go. If anything, they are good for the economy and the stock market in the long run.

However, I have great fear of a financial crisis, like 2008-2009. They happen quicker and do far more damage than a recession. Normally, it comes from banks holding worthless loans or other assets. There is no indication that is about to happen in the United States, since our banks have been required to increase their capital ratios. It is probable that Chinese banks may have this problem.

It doesn't happen often, but a financial crisis can also be caused by currency issues. China probably has both a loan problem and a currency problem. In August, China began devaluing its currency, the yuan. An unintended consequence of the Fed raising interest rates in December was to put upward pressure on the dollar, forcing further depreciation in the yuan. Knowing the Obama administration was getting increasingly irate about this devaluation, China spent more than $110 billion trying to support the yuan from depreciating further, but it didn't work. I expect the yuan will continue to depreciate, as their economy slows and the Chinese continue to move their money abroad.

The currency market is the largest market in the world. Trading is dominated by hedge funds and large money-center banks. Their trades/bets tend to be very large. If I learn about some hedge fund collapsing over the next few weeks or if some large bank is forced to increase their reserves in April, I will seriously consider selling some stock to increase cash levels.

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