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## *2013 was great year despite "tapering tantrums"*

By Jim Flinchum

In this space last year, I predicted 2013 would be a good year for the stock market but was wrong.



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Instead, it was a great year. The Dow rose 26.5 percent, which is the best since 1995. The S&P 500 rose 29.6 percent, which is the best since 1997. The tech-heavy Nasdaq soared 38.3 percent. It was a great year, indeed.

As usual, smaller companies gained more than larger companies. The S&P SmallCap 600 gained 39.7 percent, compared to 31.6 percent for mid-size companies and 29.6 percent for the large companies. Of course, most analysts believe small companies are riskier than large companies and therefore deserve higher returns.

Sometimes, investors who have income as their primary objective beat those investors more interested in growth of their portfolio. But 2013 was not one of those years, and 2014 will probably favor the growth investor again. Sorry, income investors.

For the second year in a row, managed money, like mutual funds, performed worse than "dumb" money or index investors. Hedge funds are often called "smart" money, and they also under-performed the "dumb" money. The reason is that professional money managers hold some part of the portfolio as cash to buffer against sudden moves and to save for bargain shopping. In addition, professional money managers are more worried about

"risk-adjusted returns," or how much risk did you take to earn that return? They also diversify a portfolio among different asset classes, not just stocks. However, 2014 will be different and is likely to be a better year for stock-pickers than for index investors.

Because the U.S. stock market beat most of the world, 2013 was unusual. Japan was the best performer among developed nations at 56.7 percent. Europe also rebounded nicely, with Germany up 25.5 percent, Sweden up 23.2 percent, Switzerland up 20.2 percent. Even anemic France and Italy were up 18 percent and 16.6 percent respectively.

The emerging markets of Latin America have outperformed the U.S. during recent years but lost heavily last year, with Brazil down 15.5 percent and Chile down 15.8 percent.

Asia was mostly flat for 2013, except that China lost 6.7 percent.

The economic data turned strongly positive in the fourth quarter, with the manufacturing ISM at 57. Anything above 50 suggests growth. November was the best month for durable goods since May. The consumer savings rate dropped to 4.2 percent as consumer spending rose 0.5 percent. Obviously, consumer confidence is improved.

The trade deficit narrowed, to levels seen during the 2008-2009 recession, when imports crashed. This time, exports soared. In addition, the current account deficit dropped to the lowest point since 2001. Traditionally a drain on U.S. GDP growth, this looks like the smallest drain since 1998. In 2014 we should see strong GDP growth of 3.5 to 4 percent, which is a big improvement.

Approximately 160,000 to 200,000 jobs were created monthly last year until December, when the BLS reported only 74,000 new jobs. This is obviously an anomaly, inconsistent with most other



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economic data, and I expect it will be revised higher next month. Ignore it.

**Good news** - The official unemployment rate, called U-3, dropped from 7 percent to only 6.7 percent.

**Bad news** - It dropped for the wrong reason, i.e., 347,000 workers gave up. Called the Labor Force Participation Rate, it dropped to a 26-year low of 62.8 percent. That means 37.2 percent of the population is depending on the 62.8 percent that works or looks for work.

Republicans spin that this proves people won't work when entitlements are generous. Democrats spin that this shows baby boomers are retiring in greater numbers than expected, that discouraged workers are going back to school and that our under-investment in jobs training is decreasing our workforce size. Neither party argues that a lower participation rate is good for America. It is a wasted economic resource.

One BLS report with a minimal following is the JOLTS Report, which stands for Job Openings and Labor Turnover Survey. Because the data is always a month older, it is not used frequently. But, looking over the full year, it is obvious that both job openings have increased and, more importantly, quits have increased. Workers are slow to quit a job when they think they cannot find another. Increased quits reflect increased confidence by the workers, and this is good.

Increasing attention is being paid to hard-to-fill job openings. The National Association of Independent Businesses reports that the number of firms having trouble filling at least one job is the highest since January of 2008. This is because the needed skills have changed

and because worker mobility is still constrained by "underwater" mortgages. Job re-training has never been more important.

The most interesting economic event of 2013 was the stock market's reaction to quantitative easing. That is the monetary stimulus provided by the Federal Reserve, which makes them the largest buyer of government bonds issued by the U.S. Treasury. The Treasury needs to sell bonds to get cash for deficit spending. The Fed buys the bonds and credits Treasury's checking account - POOF, money is created.

All year, the Fed was buying \$85 billion of bonds every single month. In late spring, the Fed announced they were thinking about "tapering" that monthly amount, and the stock market promptly threw a "taper tantrum," terrified the market could not survive without the stimulus. All summer and into the fall, good economic news caused the stock market to fall, because that made it more likely the Fed would taper sooner rather than later. Conversely, the market went up on bad economic news, because that news might postpone the onset of tapering. Of course, this was a nonsensical reaction. Whoever said the market was always rational?

In December, the Fed made the announcement that stimulus would decrease, and analysts held their breath that the market would throw another tantrum. Mercifully, nothing happened. The market finally realized that the Fed tapered because the economy is better.

Finally, good news can be good news again.

Historically, the second year of a presidential term is subpar, rising only

5.3 percent and most of that appreciation occurs during the fourth quarter, after the November election.

Elections create uncertainty, which stocks don't like. Of course, 5.3 percent is better than I can earn at any bank.

Since the stock market did so well last year, many analysts believe we are due for a 5 to 10 percent correction, and I agree. That is when I expect to go bargain-shopping and deploy my remaining cash.

Last year, any allocation to international stock reduced overall portfolio performance. However, Nouriel Roubini, who is known as "Dr. Doom" and correctly predicted the 2008 market crash, is now bullish on the global economy. I am particularly interested in European small cap stocks, partly because dollars invested in European stocks should also benefit from an appreciating euro.

Because long-term bonds lose more value when interest rates increase than short-term bonds lose, I will continue avoiding long-term bonds. Inflation is not expected to be the problem, but rates could be. This may seem inappropriate since the Fed reassured us that they would maintain low interest rates for the foreseeable future, but any upside in long-term bonds is not nearly worth the risk. Inflation sneaks up on you, while rate increases can surprise you.

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