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## THE ECONOMY

### *Political economics and the 2019 whipsaw*

By Jim Flinchum

2019 was a whipsaw year! First, the terrifying 17 percent drop in the stock market during the fourth quarter of 2018 set the stage, then economic data points weakened during the first half of 2019.

To make things worse, the political atmosphere was terrible, with Brexit, FBI investigation/impeachment, Korea and a very real trade war. A recession looked inevitable at that point. An inverted yield curve during the summer seemed to confirm this. Fortunately, that was wrong!



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Starting from a very low point, the stock market showed 28 percent improvement to all-time record highs. Even gold was up 18 percent, the best performance in 10 years.

The political obstacles were pushed away. Brexit may still be a problem, but for now, Wall Street appreciates the long delay, as England has had three years to prepare its contingency plans. The Mueller report was anticlimactic, but the first-ever removal of a sitting U.S. president would be a very unwelcome surprise to the market.

The long-running drama with Korea has become “white noise.” Although



*Pro Brexit demonstrators hold banners outside Parliament in London.*

phase one of the China trade deal was hollow, it was still enthusiastically received by an overly-eager market. Lastly, with the Fed dropping interest rates three times, the lower end of the yield curve dropped, ending the inversion between short- and long-term rates. That spread is now about 30 basis points, which is much better.

The most frightening event of 2019 was the near-freeze of the repo market (repurchase agreement form of short-term borrowing) in September. It was attributed to “a timing need” to cover tax payments, which is difficult to believe.

#### INJECTION OF LIQUIDITY

In response, the Fed flooded the repo market with liquidity, about \$240 billion worth, which can cure most any problem, at least temporarily. It also ended quantitative tightening, which

was draining liquidity. The Fed’s balance sheet is growing again, which increases liquidity.

The U.S. economic data is looking healthy enough to sustain a bull market. Unemployment is at a 50-year low. Inflation is still tame. Not surprisingly, personal income and consumer confidence are both rising. Worker income is finally rising faster than prices.

Holiday retail sales were strong. Small business confidence is up. The durable goods orders suggest the weakening manufacturing sector seems to have finally stabilized. This volatility index (VIX) has improved from 25 a year ago to 13 now.

However, this strong economy has been fueled by a weak Fed and massive fiscal stimulus from deficit budgets, as well as corporate earnings growth. Famed market bull Ed Yardeni expects

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earnings to increase only 5 percent in 2020.

In 2019, the combined global stock markets rose about 24 percent, a whopping \$17 trillion, to almost \$90 trillion, with Russia as the best performing stock market, up 45 percent, and Chile as the worst, down 11 percent.

## STOCK MARKET DISCONNECT?

An increasing global concern is the disconnect between economic growth and investment performance. How can stocks go up 20 percent when the economy is growing at only 2 percent? With support from deficit spending and central banks worldwide, as well as some earnings growth, that's how.

Today's greatest economic unknown is the global impact of negative interest rates, used primarily in Europe and already totaling a huge \$17 trillion. Many European asset managers have wisely abandoned asset allocation using bonds. The Fed has assured Congress it has no plans to follow the European lead. Good!

Also worrisome is the debt levels of U.S. and Chinese government and business debt, which are all at record levels. Credit rating agency Moody's just put out a major warning on junk bonds. Another debt crisis anyone? Fortunately, mortgage debt and other consumer debt are at relatively healthy levels.

Of course, there is always negative economic data, such as the Index of Leading Economic Indicators which has fallen for three straight months, for the first time since 2009. The ISM (non-manufacturing) Index is signaling slower growth. The falling monthly trade deficit looks like good news, but it

is due to rapidly falling imports, reflecting the trade war, which is a long way from being over.

The USMCA, or United States-Mexico-Canada Agreement, is still not finalized. Phase two of a China deal has not even started, and now we are threatening 100 percent tariffs on some European products.

## STABLE FOR NOW

Nonetheless, the economy appears stable for now. In comparison, the stock market looks overheated. The Relative Strength Index says it is 15 percent "over-bought." Investment giant Vanguard predicts a 50 percent probability of a 10 percent drop in 2020.

Election years tend to be bumpy for the stock market during the first half, as uncertainty rises, before it rises in the second half, as uncertainty falls. 2016 was an obvious exception to that. Wall Street currently anticipates President Trump will be re-elected.

For the last decade, the technology sector has performed the best and that is expected to continue, except those privacy-shredding companies which have been targeted by Congress. After a lost decade for energy stocks in general, it is time to reconsider noncarbon energy stocks.

After a strong 2019 for larger banks, there is still room to run for the regional banks. Recovering from years of under-performance, the emerging markets will benefit from the weakening dollar, which was inflating their dollar-denominated debt.

The last decade was one long bull market, with no recessions and only a few scares. Remember March of 2009? Many investors do not, and that worries

me! My biggest concern for the next decade is the continuing trillion-dollar annual budget deficits and our continuing inability to address it, without the usual political talking points.

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