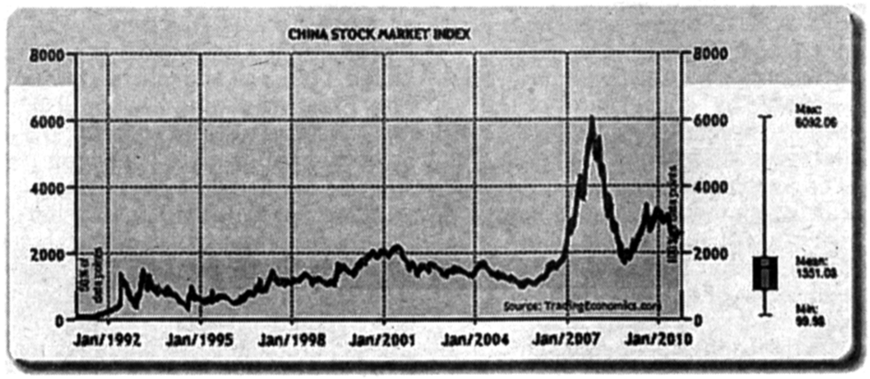
Inside Business

The Hampton Roads Business Journal | Insidebiz.com

October 18, 2010 $1.00

Third quarter 2010 – liftoff...again?

By Jim Flinchum



Well, it's official: The recession is over. In fact, it was over in June of last year. Duh... it was Oct. 12 last year in this column that we said that.

Why doesn't it feel any better? Why haven't we seen any economic "liftoff?"

Usually, an economic recovery is pretty rapid but not this one. This recession was different. It was credit-driven, not inventory-driven. There was no external shock, like an oil-boycott. It was a financial collapse, which takes longer. Deleveraging is long and painful.

The Job Market

The most painful part is our sickly job market. The quarter ended with an unemployment rate of 9.6 percent, slightly better than forecast. (We've been at 9.5 percent or higher for 14 straight months, the longest since the Great Depression.)

If you count the people who have given up finding a job or working part-time because they cannot find a job, it is 17 percent. Forgetting the human aspect, that is an enormous, permanent waste of an economic resource.

Tragically, 6.1 million people have been unemployed longer than six months. We lost almost 100,000 jobs in September alone. There was some good news in that private sector jobs increased slightly more than expected at 64,000, while government jobs decreased by 159,000, more than offsetting the private sector growth.

The Center on Budget and Policy Priorities predicts another 900,000 government employees will be fired over the next two years. For those who believe that workers for American governments need to be protected from the American economy, this is worrisome.

The Currency Markets

This is also worrisome. In just six weeks, the dollar has depreciated 7 percent, which is a huge drop. A cheaper dollar makes our exports cheaper for foreigners to buy, which is a good thing, but we are doing it too fast.

A currency war is a serious matter! Because the dollar is the world's reserve currency, we are able to finance our debt more readily, but it also imposes a heavy responsibility on us. Many other currencies are linked to the dollar, and we've been effectively depreciating their currencies and gaining no trade advantage for ourselves.

China certainly needs to let its currency appreciate, but they are doing it excruciatingly slow. While they are appreciating their currency too slowly, we are depreciating ours too rapidly.

Chairman Wen said recently he had no idea how many companies would go bankrupt if they allowed the Yuan to appreciate. They emphasize it has appreciated 55 percent over the last 16 years.

The last currency war was ended by the 1985 Plaza Accord, with Japan revaluing their currency higher. China sees how moribund the Japanese economy has been since then and will not make that mistake.

The Financial Markets

Lastly, the most important thing that did not happen in Q3 is that nobody has figured out what really caused the Flash Crash on May 6, which traumatized small investors. The psychological impact was great and partially explains why $74 billion dollars has been withdrawn from U.S. stock mutual funds since May and why so much money, estimated at $2.8 trillion, remains on the sidelines during the current market rally.

After an unusually strong September gain of 7.7 percent, the Dow was up 3.6 percent YTD. Over the last 68 years, if the market was up at the end of Q3, it ended up for the year - 94 percent of the time.

China Still Rising

I've just returned from my first trip to China since 1987. Space doesn't allow for a fuller discussion, but a few observations are mandatory. First, it is a nation about the same size of the U.S. but has four times as many people, which means it has four times as many consumers or about 20 per cent of all consumers on the planet. There is obviously a huge opportunity.

Second, while the short-term forecast is rosy and robust, they are building long-term problems by creating unfunded Social Security systems, repeating the same mistakes as the U.S. Third, since they hold $900 billion of Treasury bonds and another $400 billion in U.S. mortgage bonds, they have unimaginable economic and geo-political power. If they want to

...continued

take Taiwan/Formosa, can we really say no? Fourth, contrary to popular belief, their market has not boomed as much as their economy and is in fact down 18.8 percent this year, underperforming the U.S. market, which was up.

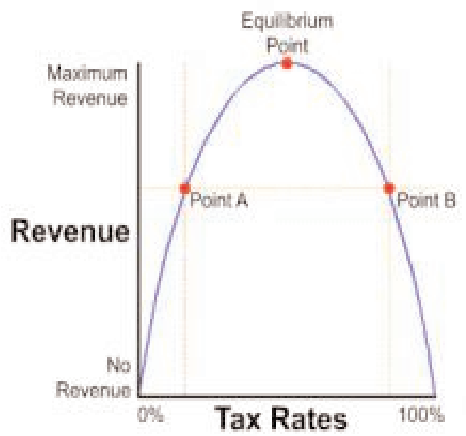
During Q3, they became the world's second largest economy, surpassing Japan. If China maintains its current double-digit growth in GDP, it is expected to pass the U.S. in 2020, a mere 10 years away.

The clearest revelation for me is their complete obsession with a "harmonious society," which means the authoritarian government must be maintained. The Chinese have made a deal-with-the-devil. They have effectively traded democracy for prosperity. If the government stops delivering prosperity, the people will start demanding democracy.

32 Years Later

Speaking of democracy, as we approach the important midterm elections, one of the most contentious issues is always the level of taxation. A basic tenet of supply-side economics is that tax cuts produce economic growth. The father of this school of economics is Arthur Laffer, who was an important adviser to President Reagan on tax cuts.

I had lunch with Laffer in Dallas in



November of 1978 and watched as he drew the now famous "Laffer Curve."

Reading along the bottom of the graphic (above), you can see that increased tax rates increase governmental revenues up to the equilibrium point. Once past that point, increased tax rates start strangling the economy and reducing GDP. In other words, increasing taxation is good, up to a point!

If tax rates drive your investing and voting behaviors, it is important to ask yourself whether we have passed the equilibrium point or not. Even if your behaviors are driven by other issues, the question still deserves your thought as you enter the voting booth.

Year-End?

There has been much concern about a rush to sell stocks before year-end when the highly preferential capital gains tax rate will increase 5 percent. While some certainly will, I don't expect that to be a major factor.

One reason is that few investors have much in the way of capital gains after the worst bear market in a generation.

Another is that most people expect some extension of the Bush tax cuts in some form and hope to be "grandfathered."

Finally, January is traditionally a good month for the markets, and investors who sell in late December will be precluded from buying back their favorite stocks for 30 days.

Financial advisers quibble about letting the tax-tail wag the investment-dog. I'm not advising my clients to sell by year-end.

I'm also advising them not to expect a liftoff, but a long, hard slog upward.

Jim Flinchum is the personal financial adviser at Bay Capital Advisors, a registered investment advisory firm in Virginia Beach. He is also a member of the National Association of Business Economics and can be reached at www.baycapitaladvice.com