

Inside Business

The Hampton Roads Business Journal

Insidebiz.com

October 17, 2011

\$1.00

Q3: When Politics Trumped Economics

By Jim Flinchum



JIM FLINCHUM

The third quarter of 2011 will not be remembered fondly. The S&P 500 lost 14.3 percent of its value, which was the worst performance since the collapse of Lehman Brothers almost three years ago.

As bad as the U.S. market was, we still did better than most other markets. Here's a sample:

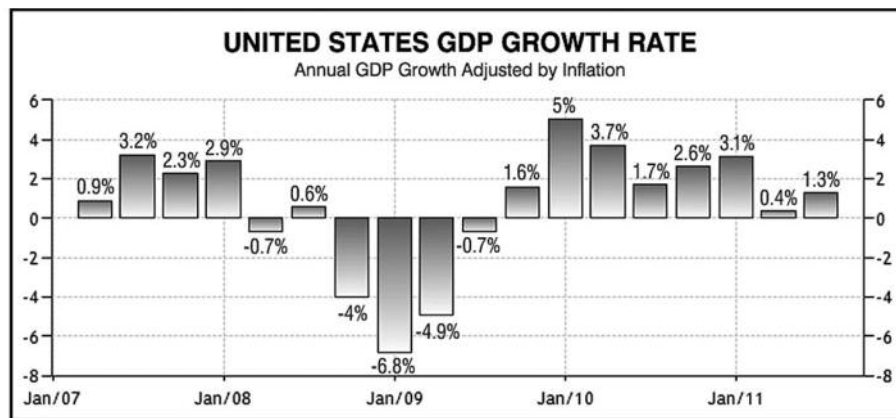
Greece.....	-45.3
Russia.....	-28.5
Italy.....	-31.2
Brazil.....	-27.2
Germany.....	-30.9
China.....	-26.1
France.....	-30
Switzerland.....	-18

While the stock markets around the world were due for a minor correction, this one was made worse by the escalating crisis in Europe, where economic confidence has dropped for seven straight months.

The Global Financial Crisis of 2008 started in the U.S. and spread around the world. This potential crisis of 2011 started in Europe and spread around the world. As difficult as the U.S. response was to our crisis (remember the TARP vote?), it is much more difficult for Europe to respond.

We have one monetary policy and one fiscal policy. Europe has one monetary policy and 17 fiscal policies, one for each country. Coordinated fiscal policy action requires the vote of 17 nations. At this writing, approval of the July decisions on the Greek bailout is still pending in two nations!

Over a year ago, the Greeks promised to



source: TradingEconomics.com; Bureau of Economic Analysis

shrink their bloated public employee rolls. Instead, they hired more employees - so much for good faith. Now, they have promised a 20-20-20 strategy. Twenty percent of the government employees, who represent 20 percent of the nation's workforce, will be terminated immediately, and the remaining employees will take a 20 percent decrease in their salaries. This will not be enough. Cuts in pensions and increases in the retirement age have been insufficient so far.

The bad news is that the necessary austerity for Greece may have created a "death spiral." They have announced that their deficit has actually increased, because their economy slowed more than expected, primarily due to the austerity measures. Greece is a lost cause! The only question is whether they will have an orderly or disorderly bankruptcy.

Incredibly, there is no mechanism to throw Greece out of the European Union, nor for Greece to leave voluntarily. The giant Swiss bank UBS has estimated the Greek GDP will drop a crushing 40 percent if they leave the European Union. (If you have relatives in Greece, send them a one-way plane ticket!)

Of course, the real problem is that banks in Europe own the bonds issued by Greece. They have already started taking 21 percent losses on the face amount of those bonds but will probably have to take at least twice that. This erodes bank

capital immensely, which means they cannot make new loans and will try to force repayment of many existing loans. Twelve British banks were recently downgraded on the same day. Maybe they need TARP?

MEANWHILE, BACK IN THE U.S.

The third quarter centered on the ugly debt ceiling debate in Washington. The winning side believes this was necessary to change the course of history and to save the country. Numerous surveys have shown Americans didn't agree, and the stock market reflected its unhappiness as well.

Because of this ugly inability to govern, Standard & Poor's reduced the credit rating of the U.S. by one notch.

Fortunately, the Federal Reserve is controlling our interest rates so tightly for now, the American taxpayer has not yet had to pay the price, but they will. In the long run, the bond vigilantes always win.

The left-wing radicals wanted to raise income taxes but were too cowardly to attack the problem of entitlements. The right-wing radicals wanted to cut discretionary spending (education and military) but were also too cowardly to attack the problem of entitlements. It was like watching drones attack the wrong village.

This was the quarter when politics drove

...continued

inability to govern in both Europe and the U.S., investors paid little attention to economics. With some notable exceptions, most of the economic data in the U.S. during the third quarter has been better than expected. For example, the GDP growth rate had to be revised upward from 1 percent to 1.4 percent.

Another example is the latest jobs report. Economists expected 60,000 jobs to be created in September. According to the Department of Labor, 103,000 were actually created. Even better, July and August produced 99,000 more jobs than previously reported. While the unemployment rate of 9.1 percent is unchanged, the average number of hours and pay per workweek increased. (If you add the people who are forced to work part-time and who have given up, the "real" unemployment rate is 16.4 percent.)

Also in this quarter, the Fed announced Operation Twist, which means they will be selling shorter-term Treasuries and buying longer-term ones. This will cause a small increase in short-term rates and decrease in long-term rates for mortgages. When the Fed did this back in 1961, all it accomplished was making interest rates flat from short-term to long-term. The Fed is out-of-bullets. Monetary policy is exhausted. The president is advocating a \$447 billion jobs bill that was D.O.A. So,

I don't expect any help from fiscal policy either.

The title of this column in the last quarter was "Stalled in the soft patch." Since then, the economy has started to pull out of that soft patch. You can see the trend in GDP growth, which increased 1.3 percent.

Estimates of third quarter GDP growth are pushing 2 percent, which would be another increase. Historically, the fourth and first quarters are the best quarters for the economy. We're due for a recovery. Now, if only European politicians don't push us into recession.

WHAT WE EXPECT

Investment strategists usually fall into two camps, i.e., technical and fundamental. The technical camp studies patterns in charts. The fundamental camp studies economics and financial statements. With notable exceptions, the general consensus from both camps is that the stock market appears ready for a nice recovery.

However, both camps ignore the train wreck still in front of us, i.e., the return of the debt debacle in December.

The "SuperCommittee" will report by Thanksgiving, and Congress must approve it by Christmas. Otherwise, the

Department of Defense, as well as other departments, will get automatically and arbitrarily gutted. The disruption will be massive.

Until the political uncertainty of the financial crisis in Europe and the fear of political apocalypse in America are reduced, I cannot foresee a bull rally. Forget the economics!

HOW WE'RE MANAGING IT

I don't think this is a time for heroic risk-taking. It is a good time to sell lower-rated stocks on market rallies and increase the level of cash.

There is a strong market rebound in front of us, and it will begin before the political uncertainty is actually decreased.

The time to increase portfolio risk will be when you believe Europe and America will soon become governable again.

Jim Flinchum is the NAPFA registered 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