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Q3 approaching the cliff

By Jim Flinchum

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Wall Street pundits have long advocated that investors should "sell in May and go away" for the summer. Investors would have regretted doing so this year, as the stock market enjoyed an unusually good third quarter, with the Dow rising 4 percent and the S&P rising 6 percent.

Stocks have not been this expensive in over four years and are only a short bull run from all-time highs. Risk is fashionable again, with the value of junk bonds rising more than investment-grade bonds.

This bullish market behavior reflects a continuing slow recovery of the economy. While economic data is almost always mixed, deeper analysis does show a firmer footing. For example, capital goods ordered by companies dropped 13.2 percent, but that was almost entirely due to the wildly swinging aircraft orders.

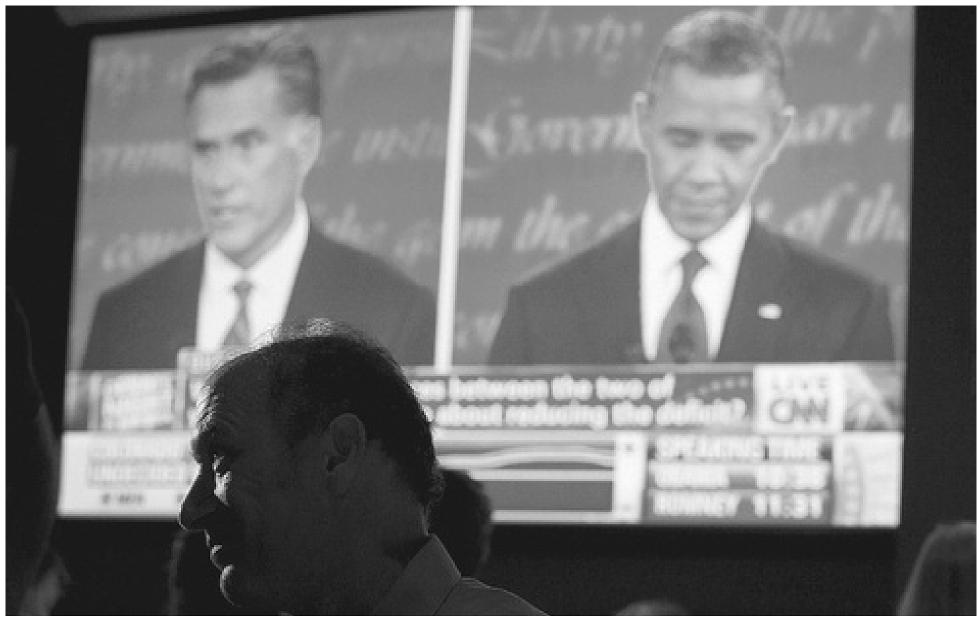
Consumer confidence is at a seven-month high. Home sales are improving, and home prices have stabilized.

From a policy standpoint, the biggest news during the third quarter was the Fed's announcement that they would launch an open-ended program of "quantitative easing," which is Fed-speak for printing money.

When we faced the serious possibility of deflation two years ago, QE was a great idea. However, an open-ended program to last until unemployment improves significantly is much more worrisome.

While inflation is still not a certainty - for technical reasons, it is clearly a high probability.

However, if there is one good thing about inflation, it doesn't sneak up on you. There will be time to adjust portfolios later. Have a plan.



According to the author, whoever wins the presidency next month will enjoy a better economy in four years.

THE AMERICAN WORKER

Of course, the single most important or highly watched economic indicator is the monthly jobs report, especially during a presidential election campaign.

The latest report showed the rate of unemployment falling to 7.8 percent, the lowest of the Obama administration. However, the U-6 report, which shows the number of unemployed plus under-employed, is unchanged at 14.7 percent.

The labor force participation rate seems to have bottomed out, and the average hours worked increased, as well as hourly earnings - not much but a little better.

Although I don't believe any tenured bureaucrat in the Bureau of Labor Statistics would risk going to jail for falsifying numbers to help his political bosses, there are some problems with the numbers.

There has been a trend to revise the number of new jobs months later. As an example, 114,000 jobs were created in September, but another 86,000 had been created in July and August that were un-reported earlier.

THE WET BLANKETS

When you look around the world, the U.S. economy doesn't look that bad. Capitalistic economies do have the ability to heal themselves, albeit with great pain to those who can afford it the least.

Our economy is growing slowly, largely because it is under three wet blankets.

First, Europe's economy is a basket-case, with manufacturing shrinking for 14 straight months and with unemployment at record highs. With youth unemployment at 50 percent, there is serious talk of a lost generation.

As bad as that is, the frightening problem is that it is more than a mere recession. It is also a severe financial crisis, which can quickly become globalized to the U.S.

As an example, we know how much the collapse of residential real estate has hurt this nation, but our collapse was nothing compared to the collapse in Spain.

While the European Central Bank is valiantly buying time, just as the Federal Reserve does here, time is running out for the legislators to fix the underlying budget

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problem.

Resolution of the problem will begin when entitlements are controlled, but that is also an invitation for street rioting. Retirement and health care benefits are great - up to a sustainable point. Getting back to that point is painful.

Second, this is the 16th presidential election of my lifetime. Every one of those elections was described as the most important election in our history. My expectation is that whoever wins next month will enjoy a better economy in four years.

Still, the election is another wet blanket that increases uncertainty, which invariably depresses the stock market. Historically, the market does well in November and December after the election. That is less likely this year, due to anxiety over the fiscal cliff.

Third, the wettest blanket on our economy and our stock market is that fiscal cliff, occurring at year-end, when we experience a huge tax increase and spending cuts. This event is just a reflection of the underlying problem, which is the inability of the gridlocked Congress to compromise on a budget package.

There are four scenarios that might occur. The most likely scenario is that Congress "kicks the can down the road" by postponing the cliff for another year, which means another year under the wet blanket of uncertainty.

The second scenario is that there is no compromise and we go over the cliff. The longer we fall before the inevitable compromise, the deeper the resulting recession. Yes, it could be worse than the last one!

The cynical scenario is that we go over the cliff, accepting the largest tax increase in history, but with a plan in place, like the "pre-packaged filing" used in bankruptcy courts.

The Democrats would immediately offer to extend all the tax cuts, except for very high-income taxpayers.

That would then be the largest tax cut in history, and Republicans could vote for it without violating their oath to Grover Norquist.

Lastly, the best scenario is that Congress behaves like responsible adults, accepting some minor tax increases in return for a multiple amount of spending cuts. (The greatest risk is that the spending cuts will come from discretionary spending like infrastructure repairs, instead of entitlements.)

Once investors believe this will happen, I expect the stock market would soar.

HOW WE'RE MANAGING IT

It is not a time for heroics. While we remain confident the nation will survive whoever is elected in November, we do worry about the ability of Washington to get out of the way of the economy.

Don't forget the reason we lost our AAA credit rating was not because we don't have the resources to pay our debt but because of our inability to make a decision in Washington.

Only the most aggressive investor is ever 100 percent in stocks. But, we think it is rarely prudent to be 100 percent out of stocks either. There is a middle ground for most investors with reduced exposure to stocks and increased exposure to short-term bonds.

The sky is definitely NOT falling. The unemployment rate is much better than the 10.1 percent in October of 2009. Housing starts have risen from 478,000 in April of 2009 to 754,000.

And, the stock market is not that far from its all-time high of S&P 1,565.

It is just a time of great uncertainty, which means owning less stock for now.

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