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The great disconnect of the market and economy

By Jim Flinchum

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The stock market began the quarter at the precipice of the fiscal cliff and ended it at the all-time high.

It was quite a quarter indeed - the best first quarter since 1998. The Dow rose 11.3 percent, while the more important S&P rose 10 percent.

The average Q1 gain during the current three-year bull market is 7 percent. The average Q2 gain is 5 percent.

The average individual investor still has 23 percent of his portfolio in cash, which means the value of his portfolio didn't increase as much as the market did. But, it is probably not too late.

On average, the market takes a dip of 5 percent or more about five times each year, and we haven't had one since November. We are due for a dip, and that is not a bad thing.

Does this market still have upside potential? Absolutely. Ignoring the obvious inflation metrics, the last time the S&P was this high was in 2007, market shares were selling at 16.1 times annual earnings per share. Today, it is only 13.9 times. Interest rates were twice as high back then. Unemployment was only 4.7 percent then, meaning there was less growth potential.

Most importantly, in the four years preceding the last high, $585 billion flowed into equity mutual funds compared to $171 billion that have flowed out of those funds for the last four years.

In other words, the market has been swimming upstream but still reached its high.

Analysts are standing in line to raise their year-end forecast for the S&P. Goldman Sachs increased their year-end estimate from 1,575 to 1,625. Even bearish Morgan Stanley increased their forecast from 1,434 to 1,600.

THINKSTOCK

How can the stock market enjoy such robust returns when the economy remains anemic?

SELL IN MAY?

In the days before air-conditioning, it was common for Wall Street fat cats to leave for their beach houses, taking their business with them. With reduced trading, the stock market usually took a swoon during the summer. There is now a common adage to "sell in May and go away."

For the last three years, the market has topped in April or May, before taking a summer swoon of 10-20 percent. If I was a betting man, I would expect history to repeat itself this year. However, expectations for earnings growth in Q1 are so low, 1.5 percent, that some modest economic growth might re-invigorate the stock market.

THE AMERICAN ECONOMY

The U.S. economy continues to be weak but is improving more than most people think. As CNBC's Larry Kudlow likes to say "earnings is the mother's milk of stock prices," and corporate earnings for the full year are forecast to grow 9.2 percent.

But, healthy corporations does not mean healthy households. Estimates for Q1 GDP growth fall in a narrow range of 1.5-2.25 percent, pitifully insufficient to reduce unemployment.

THE AMERICAN WORKER

Just like last spring, the latest jobs report shows a weakening economy. Job growth slowed from 268,000 in February to only 88,000 last month. The drop in the unemployment rate from 7.7 percent to 7.6 percent - the lowest since December of 2008 - is NOT good news, because the labor force participation rate dropped to 63.3 percent, the lowest since May of 1979.

When 500,000 people quit looking for a job, is it because they are lazy or just defeated? Half of those workforce dropouts are under the age of 25.

THE GREAT DISCONNECT

How can the stock market enjoy such robust returns when the economy remains anemic? While the stock market does

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reflect the overall economy somewhat, it is better at predicting the economy. The old rule of thumb is that the stock market predicts the economy in six-to-nine months from now. Does that mean the U.S. economy will be as robust in six months as the stock market is today? I doubt it, but it will still be better than it is now.

Also, it indicates to me that quantitative easing clearly helps the market more than it helps the economy.

OVERSEAS CONCERNS

Actually, stock markets worldwide enjoyed a relatively good first quarter. Excluding the U.S., the world's stock markets were up 3 percent on average. Browbeat Europe as a whole was up 5 percent, even though Italy was down 5.7 percent and Spain was down 3 percent. Except for Brazil, even Latin America was up 9 percent.

Asia was a mixed bag. Overall, it was up 5.4 percent, but China, Hong Kong and South Korea were down modestly. Because the Bank of Japan has begun quantitative easing, like the U.S. Fed, its stock market was up a whopping 18.7 percent in the first quarter.

The 2013 Award for Innovative Stupidity goes to the Troika, composed of the European Union, the ECB and the IMF, who forced the island-nation of Cyprus to confiscate money from bank depositors. The moral argument is that, since much of the funds confiscated belong to the Russian mafia, there is no reason not to steal it back from them. Unfortunately, there were many other legitimate depositors who lost money.

Since the worldwide Great Depression, governments realized the necessity of preventing runs on the bank by offering deposit insurance. That insurance coverage was expanded during our financial crisis in 2008. In Cyprus, they didn't expand their deposit insurance, they just confiscated a portion of the monies above that amount.

If the Troika forced Cyprus to do this, can you really trust banks anywhere in Europe? Money will flow into the U.S., which is good for us and the dollar, but bad for Europe and the euro.

HOW WE'RE MANAGING IT

Jim Fixx is often described as the father of the running movement. Healthy, fit and lean, he nonetheless dropped dead from a sudden heart attack while running. Our stock market is healthy, fit and lean, but also vulnerable.

It is vulnerable to a sudden heart attack from a derivative blow-up (remember mortgage-backed securities in May of 2008?), a technology failure (remember the "Flash Crash" on May 5, 2010?), and the relatively new "dark pools," which are unregulated stock exchanges with no disclosure.

These "dark pools" accounted for 18 percent of all trades in 2009 but are approaching 40 percent today. Now, please note these three potential problems are market-related and not economy-related.

It is essential that each investor have a sell strategy. What has to happen before you sell 25 percent of your stocks or all your stocks? Far and away, the most commonly used sell signal is the "death cross," when the 50-moving average of the S&P falls below the 200-day moving average. The logic is that short-term market direction is reinforcing the long-term direction, causing it to accelerate. Unfortunately, it is more useful predicting long-term market trends than sudden market corrections.

The point is: Talk to your own financial adviser, develop your own sell strategy and don't rely on your gut alone.

Lastly, we are watching gold closely, in case the crazies of North Korea do something crazy.

There is another old Wall Street adage: "Buy on the rumors of war but sell when you hear the cannons."

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