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The Year Ahead

By Jim Flinchum

Behavioral economists always warn about "recency bias," which is the natural tendency to predict more-of-the-same of whatever has been happening recently.

JIM FLINCHUM

The latest survey of economists by the National Association of Business Economists just forecast more long, slow but improving growth in the economy. GDP will grow from 1.8 percent in Q4 of 2013 to 3.0 percent in Q4 of 2014. Job growth will continue about 197,000 monthly. The majority do not expect another government shutdown or, more importantly, a default on federal debt. Continued slow tapering of quantitative easing will raise the benchmark 10-year Treasury rates only slightly, from 2.9 percent to 3.25 percent by the end of 2014. Inflation will remain tame.

As much as I would like, I cannot disagree that both the economy and the stock market will make continued improvements during next year. We can eliminate strong economic growth as a possibility, due to the fiscal drag from our dysfunctional federal government. In all probability, we can also eliminate recession, as recent economic data has been stronger than expected.

From a historical standpoint, there is an old Wall Street adage that a great year is followed by a good year, but watch out after that. 2013 was a great year. Also, in the last 114 years since 1900, the stock market has dropped 30 percent or more - 13 times.

The current recovery is far shorter and far weaker than the average. Historically, neither the economy nor the stock market is due for a recession.

Slow, steady growth in the economy is the default prediction, with the S&P 500 closing 2014 over 2000, compared to about 1800 now.

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However, there are more landmines to this prediction than normal. First, Europe is looking better all the time. Ireland has now exited its austerity program, and Greece has returned to the international bond market. Although the probability is decreasing, I will raise cash if there is a derivatives blow-up in Europe, which would be a very bad sign.

Second, if there is another "flash crash," where the Dow drops 600 points in five minutes, like it did May 6, 2010, I will do nothing. It will recover in the short term, but I will be raising cash in the long term. Third, if it looks like the U.S. will actually default on its debt, I'll start reducing risk by increasing cash.

Otherwise, enjoy the ride in 2014 - hopefully, the S&P 500 will reach 2014!

Jim Flinchum is a NAPFA-registered financial advisor in Virginia Beach and member of the National Association of Business Economics. He is also the author of the award winning "Paybacks." He can be reached via email at jim@baycapitaladvice.com