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2014's 3rd quarter performance beats the odds

By Jim Flinchum

The sensitivity of stock markets to geopolitical events varies over time. Since the global financial crisis of 2008-2009, our market has been extremely sensitive to them.

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But, over the last quarter, we have seen more Russian aggression against the Ukraine, practically assuring another recession in both Russia and Europe.

A virtually unknown "JayVee" terrorist group has drawn us back into Iraq, and it even immortalized its own barbarism by publishing videos of its war crimes.

Of course, Asia is not immune to geopolitical unrest, drawing closer to another "Tiananmen Square" in Hong Kong, which will unleash even more trade sanctions. And, the horror of Ebola suddenly popped up in America's heartland, further rattling our faith in government.

Yet, the S&P 500 rose 0.6 percent, and the Dow rose 1.3 percent during Q3. This decrease in sensitivity to geopolitical events is simply breathtaking.

The best stock market in Q3 was wildly volatile Argentina, which was up 45.5 percent, reflecting the ups and downs of court cases about past bonds and telling you nothing about their economy. After Argentina, the best performers were the UAE, Qatar, Egypt and Sri Lanka, which were up anywhere from 13.6 percent to 22.8 percent. Care to invest in any of those?

The five worst stock markets were Portugal, Greece, Latvia, Ukraine and Russia. In addition, the Russian economy will soon be in full-blown recession, and its currency lost 20 percent of its value. Yet, Putin remains wildly popular among Russians - go figure?

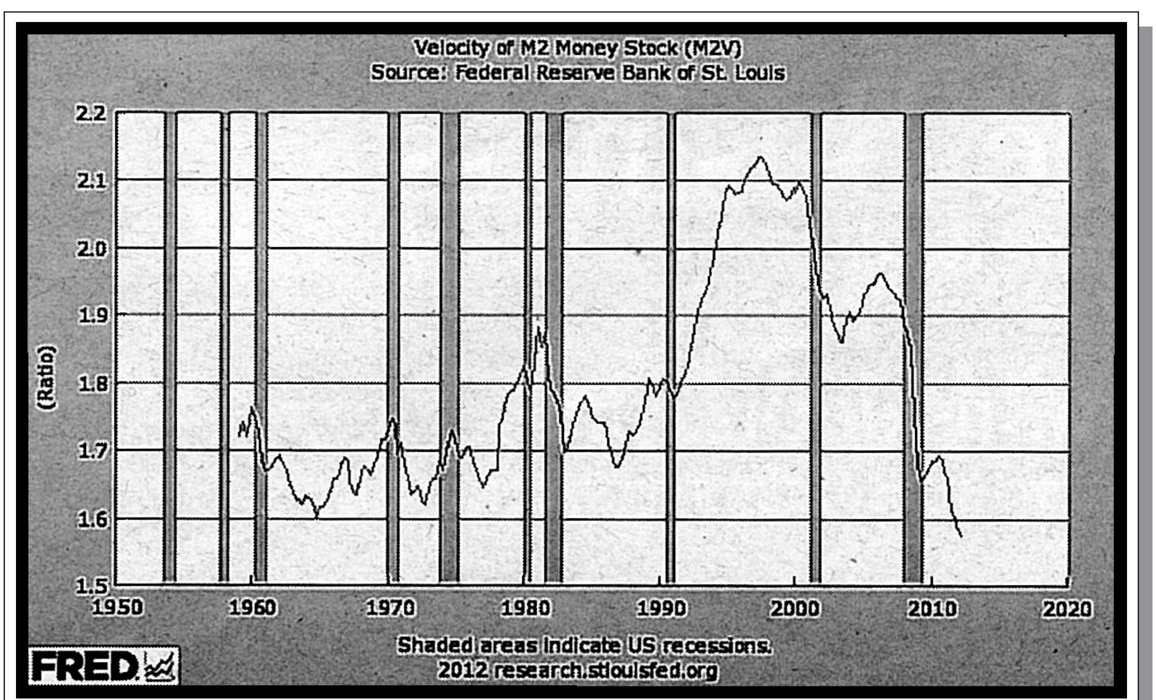
The most interesting thing that happened in the American market was the bearish turn in small-cap stocks, which usually beat large-cap stocks handily in the long run. So far this year, the S&P 500 is up 6.7 percent, while the small-cap index or Russell 2000 is down 5.3 percent.

This normally suggests the bull run is over. If mid-caps also turn down, that would be worrisome.

The under-appreciated economic recovery continues. For the last three months, we have averaged 224,000 new jobs created each month. There is some evidence that it is no longer just minimum wage jobs. The unemployment rate is finally below 6 percent and getting closer to the "full-employment" rate of 5.5 percent. Even the U-6 rate of long-term, "hard-core" unemployed is decreasing.

Both the ISM Manufacturing and the Non-Manufacturing Index remain solidly in expansionary territory. Factory orders are 4.1 percent more than last year. Occupancy rates and rental rates for office space increased in Q3. Oil is below $90 a barrel again. Consumer income and consumer spending continue to inch up.

The economic enigma is the housing market.



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It should be doing better with such low interest rates. Getting a home mortgage application approved has become a painful, robotic experience, only accidently related to credit quality. Even the refinance application of Ben Bernanke was declined.

One unexpected obstacle is the high level of student debt, which is higher than the amount of credit card debt in this country. Whoever expected going to college would make you less likely to qualify for a mortgage? More interestingly, after watching the agony of uncertainty that their parents endured during 2008 and 2009, a surprising number of millennials are simply postponing marriage, household formation and first home purchases. After all, why volunteer for high anxiety?

"See you later, quantitative easing" - that has been heard often during the last few months, as it became apparent that QE would finally end this month. This was the third iteration of QE. When the first and second iterations ended, economic growth slowed, and the stock market got jittery. I doubt there will be a QE4, so the training wheels are really off for the economy. Expect a few jitters on Wall Street later this month.

Economists quibble about the differences between QE and "printing money," but it is a difference without significance. QE increases the monetary base or money supply.

So, where is the inflation that follows a significant increase in money supply? For inflation to develop, that increase in money supply needs to be spent. We call that "velocity" or how many times is the money supply spent each year.

It has dropped from almost 2.2 times to less than 1.6 times - this is a huge drop. Following the Great Recession, consumers cut back on spending. Also, as income became increasingly concentrated in the top income earners, their tendency to save and invest more than workers further reduced overall spending and therefore any chance of inflation.

When inflation does return, I expect it will return quickly, because velocity can change quickly, as the drop in 2008 demonstrates. It is nonexistent now, but watch consumer confidence. Big increases could increase velocity, causing inflation.

Everybody knows that a rowboat operates better with two oars than one. The same is true for economic policy - it works better with both monetary policy and fiscal policy.

Monetary policy is controlled by the Fed, which has done the heavy lifting to get this economy out of recession.

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Fiscal policy is controlled by Congress, which has done nothing. If the opening page to your Internet browser is not set to www.usdebtclock.org - why isn't it?

Hyman Minsky, Ph.D., was a Keynesian - read Democratic - economist from Washington University who popularized the very classical - read Republican - economic belief in the "Minsky Moment." He argued that debt will keep expanding until such time it cannot, at which point the debt markets will then collapse suddenly. The problem is that nobody knows when that moment will come. I do know that moment will be ever-closer - as long as Congress remains useless.

The borders of political districts are redrawn every 10 years, based on the latest census data. The current practice is to allow elected politicians to draw the borders to include their likely supporters and exclude unlikely supporters. Thus, elected Republicans run in purified districts that are safe for Republicans. The same is true for Democrats.

The problem is that pure districts discriminate against moderates of both parties and favor purists - read extremists. This means Congress will remain useless until the next census in 2020 at the earliest. The question is whether the Minsky Moment will occur before then?

As I predicted in the Jan. 6 of Inside Business, the S&P hit 2,014 in 2014, and it did for one fleeting moment on Sept. 19, during the Alibaba IPO. While it has fallen some since then, I still think it will end the year at 2,014 or better. Goldman Sachs predicts it will end at 2,050 and I hope they're right. This means I am not reducing my exposure to stocks.

Wall Street clearly feels that the Fed will not begin raising interest rates until Q2 of next year. I doubt it will be that soon.

Imagine Federal Reserve Chairwoman Janet Yellen saying she wants to increase government spending by $180 billion each year. That would be the increased spending on our national debt if she increases our borrowing costs by a mere 1 percent. That is not good for the economy nor the job market, and she knows it.

She is described most often as a "dove," meaning she prefers a little more inflation than a little more unemployment.

This suggests she will be slow to raise interest rates, accepting the risk of more inflation. However, when it becomes obvious that interest rates will rise, I will approach my income clients to shift out of income and into growth until the interest rate storm passes.

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