Infomail

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Don’t Fear the Sequester

“Everything government touches turns to crap”

Ringo Starr, Beatles Drummer

While it’s easy to see why Ringo was rarely credited with writing any of the huge hits from the Beatles song catalogue, you have to admit he’s short, sweet, and to the point.

In less than a week on March 1st, the new date for automatic spending cuts is to take effect. Instead of “benefit cuts” or “cutbacks,” the politically correct term in Washington is known as “The Sequester.” These cuts were initially due to take effect January 1st, but were delayed by two months by the New Year’s fiscal cliff deal, which for the most part simply raised taxes on the wealthy.

The cuts now total about $85 billion for the remainder of Fiscal 2013, which ends September 30th, but would still be around $1.2 trillion over 10 years if not replaced. Because these across-the-board cuts are evenly split between military and domestic programs (other than health and retirement benefits), there is pain for both political parties.

House Republicans have tried to shift the military cuts to domestic entitlement spending, but Senate Democrats have rejected this. The rhetoric volume has begun to rise as we approach the March 1st deadline. Pessimism exists among lawmakers about a political deal, but it would not be catastrophic if these cuts went into effect. Think about it, it’s “only” $85 billion in a $15-16 trillion economy, one that has run over $1 trillion in deficits in every year of the Obama administration. It adds up to only 2% of all Federal spending.

In either case, the fiscal drag would slow U.S. economic growth in some capacity.

The whole argument about spending cuts is still based on Keynesian economics and misses the entire point in my opinion. Federal government spending in the USA is way too high. Every dime the government spends must be paid for by the private sector in the form of taxes or debt (which really is just taxes at a later date, with interest).

The bigger the federal government, the smaller the private sector, the less dynamic the economy, the fewer the jobs created, the weaker the recovery. Don't believe this simple kid from Niagara, just look at what's really going on out in the real world. We have been witnessing it for four years.

Maybe The Sequester could actually be a good thing? Unfortunately a large share of the sequester cuts fall on the military instead of entitlement programs that really are at the core of long term spending problems. Maybe it will force some lawmakers to get serious about actually fixing our problems rather than just perpetually kicking the can down the road.

With respect to financial markets, optimism seems to be winning some ground over the pessimism which has permeated thinking since 2008. Broad indices have hit the highest levels since 2007. That's the good news, the flipside of that being no one has made much in almost six years. Most economic data seems to show improvement, but enough traces of weakness exist to prevent any sort of "irrational exuberance" from developing.

The S&P 500 is up 6% since the start of the year, most if not all of that in January. The bears daily keep claiming the run-up is based on unreasonable euphoria and can't possibly last because "the fundamentals are bad." I've been hearing that since 2009. Don't get me wrong, at some point in 2013 (maybe even sooner than later) with almost absolute certainty, stock prices will fall. Maybe because of Europe, of the Middle East, or the bozos in Congress……whatever.

The markets have fallen in May each of the past three years. I'm not saying it will happen again, in fact, if too many expect it the market will go the other way, but more importantly, the time to buy after those May dips was different in each year. In 2010 it was July, in 2011 October, and June in 2012. So even if you know when to sell, you won't know when to step back in.

The secular bear market which began in March 2000 is closer to its end than its beginning. Famed Wall Street technician Ralph Acampora called an end to the secular bear two weeks ago on CNBC. Even skeptics are more likely to agree we are more likely in the 7th or 8th inning stages of the game. Only the perpetual Armageddon types who think "America 2013" is "Japan 1989" scenario think we are in the 3rd or 4th inning.

Keep in mind markets can stay overbought for a considerable amount of time and being overbought short term is not a reason to disturb long term portfolio positions.

Also keep in mind markets can sometimes work through an overbought condition without going through a correction. Sometimes they simply "back and fill" with the indices going sideways while sectors rotate within the markets. This sideways action can work through an overbought condition and potentially give the market a stronger base from which to move higher.

I remain positive on the markets because:

- Economic reports from around the globe have been improving
- US corporate earnings still showing growth trends
- The US housing has bottomed and is in recovery
- Cash on sidelines for many years has started to make its way to equities
- The asset allocation shift from bonds to equities has started

The most important thing I see is still a guarded attitude to equities. People remain pessimistic and disinterested. Investor sentiment remains negative towards equities. Investors have to decide whether they want to go with conventional bearish wisdom (so they don't feel out of step) or go into equities for long term above average returns.

No one will think you are a genius if you tell them you are fully invested in equities. Crazy yes, genius? Not a chance. In the past it's these contrarian "crazy" types who usually benefit from the powerful rallies which typically came early in the new bull cycles.

Stay tuned,

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