StockCross® Financial Services

Monthly Newsletter

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MIDTERM

by Steven H. Weiss, CFS

The 2014 midterm elections are behind us and the new congress will be seated in January. Equity markets rallied from the sharp pullback in October. Investors are left wondering why the up trend continues when we lost just over 1000 points in less than one month from September 19th to October 16th.

Market pundits espouse many reasons to explain what happened. More important is to understand what is continuing to happen. Even though congress will change and the balance of political power may shift, there are still market forces pointing to a rally from the pullback and short term optimism for equities.

Taking monetary policy at face value, halting the bond buying stimulus would seem to cause contraction. Yet, the bond market continued to be strong in the US as Treasury yields dropped. When compared to the rest of world's developed nations, our bonds still have a higher yield. Coupled with US Dollar appreciation versus other currencies, our Treasury bonds became attractive to foreign investors. The void created in reversing the bond buyback stimulus was filled.

The next thing to consider is the hurdle rate needed for equities to appear attractive. With a strong bond market and low bank rates, large cap equities are distributing sustainable, possibly rising dividends at competitive rates. This has not changed since we marched out of the trenches after the economic crisis. Keep in mind, the Fed sets rates to expand or contract economic activity with an eye toward the unemployment rate. This is where caution exists. The Fed indicated rates may be set higher in 2015 at the September meeting. The subsequent drop in the market began shortly after. However, this wouldn't seem to be news. Talk of a rate change has been out there for quite some time. With the unemployment rate dipping lower, investors should know hikes are coming.

The big question is what will finally tip the Fed to move forward and tighten? Currently GDP growth is not commensurate with being inflationary. For the stock market to continue, we need to see economic growth and inflation through growth. Raising rates without growth indicators would be counterproductive.

Economists and stock market experts have theorized the arrival of inflation is a foregone conclusion due to loose central bank policy throughout the developed world. Money was pumped into the system to halt the worldwide meltdown that occurred in 2008/2009. When we look at many asset prices today, it appears valuations are generally close to pre-meltdown levels.

Remember 2007? Oil prices were at all-time highs and China turned inward to produce the 2008 Beijing Games. World economies depended on double digit GDP growth in China. Money also disappeared from the economy as fuel costs surged. US real estate was never more expensive and single family home costs accounted for the greatest percentage of wages in history.

Today fuel costs have dropped providing more disposable income to consumers. The decrease in unemployment means more workers have money to spend. Borrowing costs remain low. Added together, we appear to have a tailwind that will support a rising market. Remember, prices rise with inflation and that includes many stocks that are not considered interest rate sensitive.

If you believe the US market is close to fully valued, consider investing in countries that benefit from lower fuel costs, and provide some diversification to your equity portfolio. Japan is clearly one country that could be on this list. The island nation has to import fuel. That cost is always relatively high for Japan. Lower oil prices if sustained, could provide the boost needed for Japanese stocks. This is one asset class that has not yet approached pre-2008 levels. As always, do your homework and compare earnings growth with stock prices.

It will be interesting to see how the new congressional mix will play out. Wall Street does not like uncertainty. Once the election concluded, questions regarding the balance of power were answered and markets firmed. Don't be surprised when markets retreat along the way. The Midterm election and changes in congress will have less of an effect than monetary policies already in motion for more than five years. It will have less of an effect than contributions made by increased disposable income due to lower fuel costs and improvement in the unemployment rate. After all, this new congress is unlikely to raise taxes and take money out of the economy.

This is Steven Weiss, hoping all your investments are wise!

Broker Spotlight

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