Making Sense of an Erratic Week

By Michael E. Lewitt, Special Contributor, *Money Morning*

Markets were extremely volatile this week as news of the first case of Ebola in the United States, civil unrest in Hong Kong, and the continuing fallout of the PIMCO melodrama shook credit markets. By the end of the week, however, an employment report that looked better than it really was led to a rally in stocks.

Markets shrugged off rising tensions in Hong Kong, where the ghosts of Tiananmen Square hang over rising protests against China's attempts to control the 2017 elections of the territory's new leader. In the Middle East, ill-advised negotiations over Iran's nuclear program are going nowhere while the fight against ISIS isn't going as smoothly as hoped. With a world so rife in uncertainty and risk, the markets' resiliency and blind faith in central bankers' ability to fashion happy endings was once again impressive, but one can't help but marvel at the delusions behind Friday's rally.

By the Numbers

Stocks ended a volatile week with minor losses after the stronger than expected September jobs report boosted investors' spirits. The Dow Jones Industrial Average lost 103.46 points or 0.6% to end the week just over 17,000 at 17,009.69, shrugging off some big moves intraday and intraweek. The S&P 500 closed down 0.8% at 1967.17 while the Nasdaq Composite Index shed 36.57 points or 0.8% to close at 4,475.62. The small cap Russell 2000 lost 6.3 points or 0.6% to finish at 1,104.74. This was the Russell's fifth consecutive weekly loss, its worst steak since August 2011. The poor performance of small cap stocks is normally seen as a troubling sign by stock market technicians, particularly when the overall market is trading at extended valuations as it is today. Another troubling technical indicator is the narrowing breadth of the global stock market rally. The 100-day moving average of the advance/decline ratio for the MSCI World Index has collapsed to lowest level since November 2008, a sign that stocks may be running out steam.

A Global Scare Drew Nearer

Treasuries rallied this week as investors sought safety in an increasingly unsafe world. In addition to threats from geopolitical actors, investors are now worried about the threats posed by microbes. Ebola arrived in Dallas, Texas and the an administration that can't keep armed gunmen out of the White House rushed to convince the public that it can keep Ebola from crossing the borders and spreading. Late night talk show hosts and the rest of us laugh about the lies of politicians and the incompetence of government bureaucrats, but when genuine threats appear such conduct is no longer a laughing matter because it compromises the ability to govern.

We may like to downplay the odds of an Ebola epidemic in this country, but its prevention won't be the result of any great expertise on the part of our government. Ebola will be kept at bay primarily by a combination of luck and the good sense of the American people. As the weekly news cycle ended on Friday night, the latest report was that a patient exhibiting "Ebola-like" symptoms had been admitted to a Washington, D.C.-area hospital. Perhaps that will focus the minds of those charged with protecting the rest of us.

Dubious Government Numbers

Investors seeking safety drove the yield on the 10-year Treasury bond down a sharp 10 basis points on the week to 2.447%. Most importantly, the yield curve flattened significantly. The difference between the yield on 5 year and 30 year Treasuries fell to 1.40%, the narrowest range since 2009. A flattening yield curve usually indicates slower growth, which means that while the happy faces on CNBC are busy touting the economic recovery the bond traders moving trillions of dollars around the globe aren't swallowing the hogwash. In fact, traders have increased their bets on long Treasuries to their highest since July 2012, indicating that they believe rates are going to stay low for a prolonged period of time. And that wouldn't happen if economic growth were truly accelerating.

Nonetheless, the September payroll support was greeted with open arms by investors who had been battered earlier in the week by losses. September payrolls rose by 248,000 jobs, 33,000 more than expected. August was revised (as expected - August is always revised upward) to 180,000 new jobs from 142,000 and July was also revised upward by 31,000 jobs to 243,000. The three-month average was 224,000 monthly, slightly better than the last 12-month average of 220,000 jobs and the 2013 figure of 193,000 jobs. The private sector contributed 236,000 of the September jobs and the gains were broad-based among industries.

Nonetheless, the report showed a further shrinkage in the labor participation rate to 62.7%, a new low for this economic cycle and the lowest figure since 1978. To place this report in its proper perspective - which would take much of the bloom off the rose - the civilian labor force stood at 155.9 million in September. That compares to 154.9 million in October 2008 as the financial crisis was beginning to unfold. In other words, the U.S. economy has added a paltry one million jobs over the last six years while the working age civilian population (those over 16-years old) increased by 14 million people (from 234.6 million to 248.4 million). Stated differently, the economy is failing to provide jobs for enough of the people that need them, which is why the labor participation rate is at a 36-year low. Economic policy is moribund.

From a headline perspective, the unemployment rate hit 5.9%, the lowest since July 2008 while the broader measure U6, which includes discouraged and underemployed workers, fell to 11.8%. It's a good thing that the Federal Reserve abandoned its 6.5% target for raising rates because we are obviously well past that level and nowhere near the point when Janet Yellen is prepared to move. From the standpoint of preserving its credibility with financial markets, however, the 5-handle on the unemployment rate is significantly increasing the pressure on the Fed to do something. *The Wall Street Journal*'s Jon Hilsenrath, who is believed to have the best read on Fed intentions, wrote the following after the jobs report was released on Friday morning: "That means early interest rate increases next year - though not the Fed's expected path before today - remain on the table. In addition, officials will need to make a tough decision at their policy meeting later this month about whether to alter their guidance about the interest rate outlook, or wait until they update their economic forecasts in December before changing the guidance."

While the stock market is clearly begging the gnomes in the Eccles Building to delay that day as long as possible, the bond market is clearly nervous. The fact that bond investors are increasing their bets on rates staying low is a very important sign. There appears to be a growing belief that regardless of what the economic data says, the Fed simply won't be able to raise interest rates due to the crushing burdens of public and private sector debt not only in the United States but around the world. Sluggish growth makes it easier for bond investors to bet on lower rates. But it appears that nominal U.S. growth (real growth plus inflation) will reach at least 4.5% over the second half of this year, leaving a 2.0% gap between nominal growth and the yield on the benchmark 10-year Treasury bond. These two usually track each other closely and are likely to converge sooner rather than later. Convergence would require one of two things: growth to fall off significantly and scare equity investors, or yields to rise pretty quickly and wrong-foot bond markets (and, for that matter, stock markets as well). Either way, the uninterrupted upward move in stocks seen over the last two years is unlikely to continue much longer.

Adding Real Value

While stocks rallied, commodities continued to fall. Gold fell below $1,200 per ounce and lost all of its gains for the year. In the face of new rounds of money printing by the European Central Bank, the Bank of Japan and the Bank of China and continued reinvestment of interest proceeds by the Federal Reserve, investors should grab this opportunity to add to their holdings of the anti-fiat currency. Gold is one of the few hedges against the continuing destruction of paper currencies and looks very inexpensive at its current price. Oil also dropped further and ended the week below $88.00 per barrel, another sign of global economic weakness. With the severe instability in Russia and the Middle East, oil should be trading at well above $100 per barrel. The fact that it isn't due to the fact that outside of the United States, the rest of the world is in recession, depressing the demand for energy.

Commodity prices are also being hit by the impressive strength of the U.S. dollar, which hit a four-year high on Friday. The dollar rose to $1.25 per euro today and 109.80 yen, levels that haven't been seen in quite a while. While the dollar is likely to continue to strengthen against these two currencies, it should be noted that Europe and Japan are hopelessly bankrupt and the United States is not far behind. As such, this is a competition among economies that are heading toward crisis. While it is impossible to determine the timing, it safe to say that gold will be worth thousands of dollars an ounce in the future, not as a reflection of the inherent value of the yellow metal but as a reflection of the hollowing out of the dollar by central bankers who haven't learned a thing.

Editor's Note: Michael Lewitt publishes the highly regarded* The Credit Strategist*, and was recognized by the* Financial Times *for forecasting both the financial crisis of 2008, and also the credit crisis of 2001-2002. His 2010 book,* The Death of Capital: How Creative Policy Can Restore Stability *(John Wiley & Sons) was included in the curriculum at the University of Michigan and Brandeis University.