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Overview

The major stock indexes moved lower after setting new record highs in early August, although prices have recovered somewhat in the last few days. So was the weakness in August just an overdue correction before moving even higher? Maybe, but there are a number of things coming up in the next month or so that could rattle the markets even more, including whether or not we go to war with Syria. We’ll talk about those today.

Clearly, the stock and bond markets continue to be nervous about the Fed cutting back on its QE bond and mortgage purchases, perhaps as soon as the Fed’s next policy meeting that ends on September 18. There is also some anxiety about who will be the next Fed chairman (or woman).

Yet there are other upcoming concerns that the markets seem to be worried about, as well they should. Certainly, the continued rise in interest rates is a serious issue for the markets and the economy. The yield on 10-year Treasury notes has soared from 1.6% back in May to near 3%. Long bond yields are nearing 4%. Investors don’t know what lies ahead.

The markets are also starting to factor in the looming battle in Washington over the federal budget for FY2014, which begins on October 1. President Obama vows he won’t negotiate this time around. Also, there is another battle over the debt ceiling that will happen by mid-October according to the Treasury Department, and yet another threat of a government shutdown.

But before we get into those issues, let’s examine last Friday’s jobs report for August. The White House and the media hailed it as a success since the headline unemployment rate fell from 7.4% to 7.3%. What they failed to point out was the decline occurred because a lot more folks dropped out of the labor market. Truth is, the report was once again pretty bad.

August Jobs Report – Another Disappointment

Friday’s unemployment report for August showed that the headline unemployment rate fell to 7.3%, from 7.4% in July, which was better than the pre-report consensus calling for the number to be unchanged. However, the rate fell for all the wrong reasons, primarily because more Americans dropped out of the labor force.

The US economy added 169,000 jobs in August, according to the Bureau of Labor Statistics (BLS). Although that was an improvement from 104,000 jobs added in July, it was also slower than the average pace of job growth over the last 12 months, and missed economist expectations. Job growth for both June and July was also revised lower by a total of 74,000 jobs.

The unemployment rate fell to 7.3% last month primarily because 312,000 people dropped out of the labor force and were
not counted as unemployed. Only 63.2% of Americans now participate in the labor force – meaning they have a job or are looking for one. That’s the lowest participation rate since August 1978.

The report was closely watched for signs that the Federal Reserve will begin pulling back on its controversial bond-buying program later this month. The Fed has said that the timing of the “tapering” would depend heavily on improvement in the labor market.

Yet if the Fed looks at the jobs data since the outlier in February, they’ll see that there’s been no significant improvement in the labor markets this year. Stocks rose following the report, as investors took weak job growth as a sign that the Fed may hold off on tapering until later this year. The next FOMC meeting starts next Tuesday and concludes on September 18, with a Bernanke press conference to follow.

The August unemployment report continued to show that most new jobs came in traditionally low-paying sectors, with retailers adding 44,000 jobs and restaurants and bars adding about 21,000 jobs. Despite the housing recovery, the construction sector added no jobs overall. Other bright spots included 33,000 jobs added in health care, 23,000 jobs added in professional services and 14,000 jobs added in manufacturing.

Overall, the trend remains the same: Modest hiring has continued at a rate of about 184,000 jobs a month on average for the last year, but that’s not fast enough for the 11.3 million people who remain unemployed. The economy needs at least 200,000 new jobs a month just to keep pace with population growth.

**Lots of Bumps in the Road Just Ahead**

At the beginning of August, the Dow Jones and the S&P 500 indexes soared to all-time record highs. The Dow topped 15,600 and the S&P 1,700. But for the rest of August, it was all downhill. August was the worst month for stocks since May 2012, with the Dow losing 5.4% and the S&P 4.5%. Fortunately, stocks have recovered somewhat this month.

In the weeks since the record highs on August 2, the markets seem to have decided that there’s quite a lot to worry about over the next few months. I agree. There’s a lot that could go wrong this fall. Let’s take a closer look today.

We can start with Syria. There’s no way to know if the US is going to strike Syria militarily just ahead, and things are changing almost daily. Just yesterday, Russia suggested that Syria give up its chemical weapons and as this is written, Syria reportedly has agreed to at least considering the idea. But who knows if this is remotely an option, or if Russia and Syria are just buying time.

Most of the tallies I’ve seen suggest it’s a long-shot that Congress will approve even a limited attack, especially with the latest deal on the table. Nonetheless, President Obama continues to press for such approval from lawmakers. For now, a US attack on Syria appears to be on hold, but I don’t think this issue is nearly over or settled. It remains on the list of potential bumps in the road for at least the balance of this year.
Regardless of what ultimately happens, the Syria threat has rattled the markets, which includes the latest surge in crude oil prices. West Texas Intermediate crude broke out of the trading range it’s been in since 2010, climbing above $110 per barrel. While it has since backed off to around $107, if there is a strike on Syria, oil prices could shoot even higher, especially if Iran escalates the unrest in the region by attacking Israel. None of this is good for the economy or stocks.

Fed’s “Taper” Decision & New Fed Chairman

What the Fed decides to do with its massive quantitative easing program remains to be seen. Most Fed watchers still believe that the Fed Open Market Committee (FOMC) will vote to slow bond and mortgage purchases at the September 17-18 policy meeting. Yet as I stated above, there has been no significant improvement in the labor market this year, despite what we hear from the Obama administration and the media. So it could be that the Fed waits until the October 29-30 meeting or the last FOMC meeting of the year on December 17-18. If the Fed moves to taper, expect a negative reaction in the stock and bond markets.

Then there is the question of who will be the next chairman of the Federal Reserve. The race seems to come down to Obama advisor and former Treasury Secretary, Larry Summers, and current Fed vice-chairwoman, Janet Yellen. Both Mr. Summers and Ms. Yellen are liberal Democrats, so some analysts don’t think it makes much difference. Yet there are significant differences between these two.

I’ve included a NY Times opinion piece written by someone who has worked with both Summers and Yellen for over three decades. You’ll find this informative story in SPECIAL ARTICLES below. The White House seems to favor Summers over Yellen but there are late reports that suggest Summers might not be confirmed by the Senate Banking Committee. So we’ll see.

The Rising Interest Rate Bump in the Road

Last Thursday, the yield on the benchmark 10-year Treasury note rose to 3% briefly; remember it was only 1.6% just last May. The 30-year Treasury bond is approaching 4%; that’s up from 2.85% earlier this year. And traditional low fee mortgages reached 5%. These are huge moves in such a short time, and most forecasters are puzzled as to what’s driving rates higher.

I first began warning about this in August 2012 when I penned my Bond Bubble Special Report. At that time, I warned that with our national debt topping $16 trillion, Treasury buyers were going to demand more return on the money they were lending to Uncle Sam. I also warned that rates could rise more than expected, and I urged readers to dial-back on their bond holdings. Most bonds and bond funds have been hammered since then.

Given the dramatic increase in longer-term yields, I don’t know where rates go from here, but the trend is definitely up. Higher rates are definitely bearish for bonds and are becoming an increasing headwind for stocks as well.

The Looming Budget Battle/Debt Ceiling Bump

Here we go again. As soon as the debate over Syria is settled, Congress turns to another pressing fight – figuring out how to fund the government for the next year. Fiscal year 2014 begins on October 1. While some hope for a short-term deal without much hoopla, others are gearing up for a major battle. The latter is almost guaranteed, as usual. Only this time, President Obama has vowed that he will not budge or negotiate.
In his FY2014 budget submitted earlier this year, Obama called for nearly $1 trillion in new tax increases over the next 10 years. The proposed hikes include a cap on deductions for wealthier taxpayers and the “Buffet Rule,” a 30% minimum tax rate on million-dollar earners who have lots of investment income.

Obama’s 2014 budget would have the government spend a record $3.78 trillion in the coming year, some $63 billion more than the Senate Dem’s proposal and $247 billion more than the House GOP version. The budget deficit under Obama’s plan would go up to $744 billion, up from a projected $670 billion for FY2013.

Republicans are gearing up for another fight, pushing for spending cuts and tax relief as usual. But many Republicans go into this fight under pressure from all sides, including a part of the base that sees this battle as time to exert its strongest leverage. Many conservatives urge the defunding of Obamacare as part of any deal to keep the rest of government running. No deal means a government shutdown. That won’t be pretty for stocks. We’ve seen this movie before.

Then there’s the debt ceiling fight coming up just ahead as well. The US actually hit its $16.7 trillion borrowing limit in May, but the Treasury has been using so-called “extraordinary measures” to fund the government. Treasury Secretary Jack Lew said last week that the Treasury will not be able to pay the government’s bills past mid-October.

Congressional action to expand the debt ceiling is imperative, and with the Syria resolution taking center stage for the moment, the time for deal-making is growing short. So in addition to the budget battle, we’ll have another one shortly afterward on the debt ceiling. Here again, GOP leaders vow to get some major concessions in return for expanding the debt limit, but Speaker Boehner knows a government shutdown would be blamed squarely on the Republicans.

Here too, President Obama says he will not negotiate this time. I’m sure it will be ugly and that, too, is not good for stocks.

The September (Worst Month of the Year) Bump

Another reason to be worried about US stocks is that September has historically been the worst month for stock performance. Going back to 1896, the Dow Jones index has been down 1.1% on average in September – making it by far the worst month of the year. That compares to an average gain in the other 11 months of +0.75%.

No one knows for certain why September is the only month of the year when returns have been negative on average for over 100 years. Many have searched for such a rationale, but so far no one can explain the September dip definitively. It just is what it is.

Does the September dip mean you should get out of the market? Of course not. As of today, all of the major stock market indexes are still up nicely for the month. I mention the September dip only because I’m not sure how many investors are even aware of this statistic.

Conclusions

While the major trend in stocks still points higher, each of the factors I’ve discussed today could provide a stiff headwind. And not until the major indexes move to new record highs can we conclude that the weakness in August was just a minor correction. I think most readers would agree that an attack on Syria could send stocks lower, at least temporarily. Likewise, most of you would agree that if the Fed moves to “taper” on September 18, such a move would be negative for equities, and maybe not just temporarily.

I don’t think there’s much of a chance that the new federal budget gets passed without a fight. Ditto for the debt ceiling battle. The point is, there’s a lot that may be bad news for stocks just ahead. That’s one reason I have most of my equity portfolio invested with professional money managers that can move partly or fully to cash or hedge long positions if the trend turns down. You might want to do the same.

Hoping it’s getting cooler where you are,

Gary D. Halbert

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