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Dow continues "scaling the Great Wall" in Third Quarter

By Jim Flinchum

Pundits tell us Wall Street is always climbing a "Wall of Worry." Sometimes, that wall is taller than usual. The third quarter began during the post-Brexit tremors and ended with fears of a systemic collapse in Europe. In between, we saw globalization get unfairly trashed, a great American bank stumbled ethically, and a great European bank stumbled financially, threatening to become a "Black Swan." Despite it all, the Dow scaled the wall, increasing 2.78 percent.

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Economists were expecting 176,000 jobs to be created in September and were disappointed only 156,000 were created. The average over the past 12 months is almost 180,000. It is a Goldilocks labor market with enough new jobs to keep the economy growing but not enough to frighten the Fed into raising interest rates any sooner.

It is better news the average hours per work week and average weekly earnings both increased. Also, the percentage of people working ticked up to 62.9 percent of the labor force. Americans who are not in the labor force dropped 207,000 to "only" 94.2 million.

The American labor market appears strong. The question becomes: If the labor market is so strong, why is GDP growth so low? Maybe the labor market is not as strong as it appears. The U-6 level of employment, which includes both the unemployed and the under-employed, still stands at 9.7 percent.

The Economy

Most economic data suggest a continued slow growth in the economy. Nothing is flashing certain recession. The Institute of Supply Management Index for both manufacturing and nonmanufacturing increased nicely last month. Revolving consumer credit (about a quarter of total consumer credit) is growing at the fastest rate since early 2008, suggesting a healthy consumer. New factory orders for both durable and nondurable goods are holding up.

Goldman Sachs expects a slow economy through next year, with GDP growth increasing from 1.5 to 2.0 percent. Bank of America sees a chance of recession in late 2017.

Normal business cycles seem to have disappeared since the 2008-09 financial crisis, when the Fed began its unprecedented campaign to save the economy. But, an economy cannot be saved by monetary policy alone, without help from fiscal policy, tax policy and trade policy – policies controlled by Congress.

The Stock Market

For Q3, small cap stocks handily outperformed large cap stocks again – 7.2 percent compared to 3.85 percent. Growth stocks outperformed value stocks – 4.76 percent compared to 2.94 percent.

These gains were driven by energy, technology, financials, materials and consumer discretionary sectors but held back by utilities, telecom, real estate and consumer staples.

The market has never had a losing year when it was positive for the first three quarters. The S&P is up 6.1 percent so far this year. History can be comforting.

Global Markets

After a successful Olympics, Brazil shook-off impeachment of its popularly elected president and its stock market has risen a stunning 34.6 percent this year. Canada and Mexico also did well – up 13.2 and 9.9 percent, respectively. Poor Europe was down 6.3 percent, with Italy down the most, at 23.4 percent. Only the Netherlands and Sweden squeezed out small gains. However, the U.K. put aside Brexit worries and rose 10.5 percent. (Of course, the pound is collapsing.)

While our Fed is likely to raise interest rates in December, Europe and Japan are experimenting with negative interest rates. So, should the Fed take our interest rates down, like Europe and Japan, rather than up?

NO! Interest rates are a powerful double-edged sword. Lower interest rates reward borrowers and punish savers. We have had exceptionally low rates for eight years, and it has barely stimulated the economy. While it was a good tool at first, we have kept them too low for too long. The economy is not weak because interest rates are too high. (Pension funds are increasingly under-funded because they cannot earn anything on their bond portfolios. This draws tax revenue from taxpayer needs to retiree needs.)

Already, we are seeing the demand for cash increase dramatically worldwide. It is better to hide a wad of $100 bills in your closet than pay the bank to hold your money for you. How crazy is that?

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High Drama?

When I taught the junior level Economics of Money and Banking at the University of Texas during the last century, I taught the economic function of banks was to allocate credit across the economy effectively and efficiently. Credit is like any other resource and should not be wasted.

As the economy expanded, banks increased the number of branches. Nonbankers thought all those branches looked like retail stores, and bankers slowly began to act like retailers. Loan approvals no longer considered the character of the borrower, because only his credit score mattered. Who needs intelligent, analytical bankers when you have computers? Banking was "dumbed-down" and became mere selling.

While it is sad, it is not surprising to read about the latest scandal at Wells Fargo, involving the fraudulent cross-selling of retail services to their customers, not to mention the possibly illegal repossession of cars from military members. Over 5,000 people were fired, but – make no mistake – they were mostly retail clerks, not senior managers. I'll assume the vast majority of those fired were essentially young victims of a corporate culture where they were "expected" (wink, wink) to open fraudulent accounts, and "everybody" was doing it.

Dirty Bathwater

Most economists support free trade because of the principle of "comparative advantage." During the NAFTA debate decades ago, economists insisted job-retraining was an expected cost of globalization. Politicians found it convenient to forget that cost. As usual, politicians sought the benefits of globalization without paying the costs, such as retraining and relocation. The WTO now predicts growth in world trade is only 1.7 percent this year, the lowest since the 2008-09 global financial crisis. Once again, thanks to pandering politicians, the baby may get thrown out with the bathwater.

To better understand blue-collar anger, read the excellent new book "Hillbilly Elegy" by J.D. Vance.

Heartstopper?

The most dangerous thing that happened in Q3 was the frightening decline of Deutsche Bank in Germany. With only $16 billion in capital, the U.S. fined it $14 billion. It was already over-leveraged with $164 billion of debt. While the fine is likely to be reduced, the massive reputational damage is already done. More importantly, it held the largest book of derivatives in Europe – a staggering $34 trillion – 14 times the entire German economy! If we have another "Black Swan," it will start in somebody's book of derivatives. Pay attention to this continuing problem.

Wall Street does not handle surprises very well.

It expects Clinton to win the presidency and has already priced it into the market.

If it is surprised, I expect the stock market will suffer an ugly fall, maybe a sudden 500 points off the Dow. However, it may be similar to the sudden drop after the Brexit vote, which quickly recovered. In the meantime, I will let cash accumulate for when the stocks go on sale.

The stock market knows Congress, not even a Republican Congress, will permit Trump to do what he has promised.

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