The NASDAQ index keeps rebounding to new post-recession highs only to back off again. Earnings are much improved today over a couple of years ago, but investors are much more concerned about the future than the present. The problem is that P/E ratios are relatively high at the same time interest rates are on the rise. This increase in interest rates gives investors improved alternatives, especially during these times of uncertainty. Of course, if earnings keep rising, P/E ratios could come down, but given the near-term prospects for the economy, one should be cautious about the prospects for significant earnings growth. If earnings growth stalls while interest rates rise, stocks could see a typical mid-course correction and the NASDAQ could fall back below 2000. What needs to be avoided is excessive declines that will thwart business investment, slow the economy even further, and push stocks all the way back to their old lows.
One of the more positive signs of the health of the national economy has been the steady decline in initial claims for unemployment insurance. New claims are now well below the critical 375,000/week benchmark that distinguishes economic expansion from stagnation or contraction. With initial claims pushing ever closer to 300,000 this summer, the nation’s labor market was finally breaking out of its malaise. However, there are other signs of an economic slowdown, so this statistic will be important to watch over the rest of the year. Of course, today’s problem is that this statistic is currently being impacted by the effects of Katrina and Rita. This won’t last forever. We expect that initial claims will fall back down by late October. The question is will they fall back down to pre-Katrina levels or only down to levels barely below the benchmark. If November’s initial claims average around 360,000 you can be assured that the national economic slowdown has arrived. If claims return to the 310,000 level, you can be comforted that the economy still has some momentum.
The decline in the dollar over the past 3 years has been good news for the national economy and for stocks. The weak dollar may be the single most important factor in revitalizing American manufacturing. However, the weak dollar has yet to produce the hoped for improvement in the U.S. trade imbalance. The problem is that while the dollar has stimulated U.S. exports, the economic expansion has only increased Americans’ demand for imports. In addition, the rising costs of fossil fuel imports has exacerbated the trade deficit problem. More recently we’ve seen a rebound in the dollar which along with rising interest rates and high energy costs will slow down the national economy. It would be better for the economy if the dollar declined back to last winter’s levels.
Recent money supply statistics have been both puzzling and worrisome. After strong gains last year, money growth has actually turned negative. Furthermore, all key measures (M1, M2, and M3) have shown significant weakness for more than half a year now. The longer the drought in money growth continues, the greater the chance that the robust growth in GDP over the last 2 years will come to an end and that the economy will return back to a more subdued expansion. Of all the leading indicators right now, money growth remains the single most negative signal. Typically, money growth accelerates during periods of an economically strong holiday season. If we don’t see positive money growth soon, this will be a bad omen for the next several quarters to come.