DJC

THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON

MONDAY
November 9, 2009
www.djcOregon.com

Voters take whack at Obama-nomics

Stock market dips at the end of October; Republicans win gubernatorial races in New Jersey, West Virginia

SUMMING IT UP

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On the last day of October, which traditionally is a weak month for the market, the Dow Jones dropped nearly 250 points. It was its 10th triple-digit move of the month; five were increases and five were decreases. For the week, the Dow fell 2.6 percent, its second straight weekly decline. For the month, the Dow was up .45 percent; the NASDAQ and the S&P, meanwhile, ended the month in the red.

Bank of America stock declined 7.3 percent as financials led the market down on the last day of the month. Bank of America has been weak coming off a quarter in which it lost $1 billion, and questions over its business strategy linger.

The "too big to fail" doctrine is increasingly being scrutinized by leaders. Paul Volcker, former chairman of the Federal Reserve, called for the return of the Glass-Steagall Act, the repeal of which allowed bankers to take on risky business which they apparently did not understand. It is time to return banks to traditional banking where they take deposits and make loans. Financial engineering seems beyond their ken. As the last debacle shows, they took on too much risk.

An additional reason for the sharp market decline was a rethinking of the GDP numbers that had been announced just one day before to big fanfare and a sharp market rise. Analysis shows that the 3.5-percent rise in GDP was not a quality increase. Federal spending added 0.6 percent of the increase. Government stimulus programs for cars and residential property added 2.2 percent, which had expired and were probably not sustainable. So, roughly 2.8 percent of the 3.5 percent were low-quality increases. Nevertheless, the increase in GDP may serve as the unofficial confirmation that the longest and deepest recession since the Great Depression has ended.

Factory orders have increased. Institute for Supply Management numbers rose 3.1 points to 55.7 (anything over 50 is expansionary). Construction spending rose .85 percent for September, and pending home sales were up 6.1 percent, the highest level since the end of 2006, supported by the government stimulus program.

Still, concern over the quality of the GDP numbers brought a sharp market decline and saw the Chicago Board Options Exchange Volatility Index hit its highest level since July, a high of 31.25. In slightly more than a week, the VIX rose 50 percent. The sharp rise above 30 suggests that investors are becoming fearful that the recent sharp increase in stock prices may have run its course.

The impending CIT Group bankruptcy weighed on the markets as well as a decline in consumer confidence and an increase in jobless claims. Business spending fell 2.5 percent in the quarter, which even so, was its best performance since the second quarter of 2008.

In the meantime, voters in West Virginia and New Jersey elected Republican governors, in races that can be seen as a referendum on President Obama's policies.

Core inflation which omits food and energy prices, slid to 1.4 percent in the second quarter, indicating that price pressures are subdued.

The Federal Reserve met Nov. 3 and 4, and left the federal funds rate unchanged. The Fed anticipates "that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations are likely to warrant exceptionally low levels of the federal funds rate for an extended period." Additionally the Fed noted that household spending appears to be expanding, but remains constrained by job losses, sluggish income growth, lower household wealth and tight credit. "Business is still cutting back on fixed investment and staffing." Inventories are coming into "better alignment with sales." "Economic activity is likely to remain weak for some time."

The Fed also announced that it will purchase a total of $1.25 trillion of agency mortgage-backed securities, and $175 billion of agency debt. The dollar weakened by 7 percent, its worst single-session performance in two weeks. Currency markets apparently had been expecting a hint of a rate increase from the Fed, and therefore a stronger currency. They did not get it.

In the meantime, voters in West Virginia and New Jersey elected Republican governors, in races that can be seen as a referendum on President Obama's policies. To be sure, both races had local issues; the economy of New Jersey, for instance, is suffering. But Independent voters who supported Obama in the last election voted Republican, and other Obama supporters did not vote. As always, those most agitated and upset voted, and they voted against the free-spending government. Democrats in Congress can interpret this as a warning in regard to their policies. Look for the impact to reach the debate on health care.

A very cautious outlook is in order. Remain well-diversified and defensive.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the nation's leading separate account managers. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.