Weekly Update: 'We're in the midst of an international currency war' and so there is 'gold to go'

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What's ahead

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As we closed the book on Q3, analysts were lowering EPS estimates, just as they did prior to all the positive earnings surprises the previous 6 quarters. The consensus is now $20.46 on the S&P 500, lower than Q2. But the market, which just had its best September in 7 decades, was looking elsewhere this week. It was focused on gold's surge above $1,300, the race to cheapen currencies, the midterm elections—the Iowa electronic market puts the odds of Republican victories at 74% in the House and 20% in the Senate—and the likelihood of QE2. Dudack Research notes an above-average increase in the Fed's balance sheet tends to be followed by a higher market the next 6 months; the consensus is the Fed will initiate a new round of quantitative easing after the Nov. 2 election. This is a deliberate devaluation of the dollar. This is the gun going off among nations to devalue their currencies.

ISI Group says the list of countries that would like to see their currencies weakened or remain undervalued for competitive reasons keeps growing. Japan, Switzerland, South Korea and others in East Asia are the latest to act. "We are in the midst of an international currency war," Brazil's finance minister said this week. And China's premier, confronting pressure from Washington to raise the yuan's value or face sanctions, said doing so would bankrupt untold Chinese factories, producing social instability. Currency depreciation is the most politically palatable way to deal with both deficits and slow growth. Unfortunately, history suggests depreciating the dollar is the worst possible way to deal with public debt. It spawns inflation, stifles growth and eats away at earnings. And every country can't deflate its dollar, if you think about it. Some Fed governors said this week that they really don't think it's a good idea to spend another $1 trillion, the whisper number for QE2. But those hawks are in the clear minority now that the Senate has confirmed policy doves Janet Yellen and Sarah Bloom Raskin as Fed governors.

In contrast to the intensified efforts to sell currencies, central banks have been holding onto their stores of gold—selling is at its lowest since the 1999 signing of a central bank agreement to limit gold selling. As gold rises (a German company plans to introduce gold vending machines in the U.S. next year under the "Gold to Go" name) and the race to cheapen currencies continues, we're reminded that the BRICs (Brazil, Russia, India, China) are where the secular bull is. They don't need a cheapened dollar; they clearly don't need the U.S. as much as they used to. Last year, China overtook the U.S. to become Brazil's biggest trading partner. China already is India's largest trading partner. And Russia is the richest of the BRICs in per capita terms. That gives us something to think about … later. For now, ISI estimates that if the stock market continues to rally, and if QE2 works, and if the upper income tax cuts are extended, real GDP might be lifted by as much as a full percentage point. We're bullish as we head into the fall.

Positives

Expect a 'perfectly decent' holiday season Toys R Us plans to hire 45,000 temps to meet holiday demand, doubling its domestic work force, and FedEx and Delta report a pickup in shipments to U.S. stores—a FedEx vice president told Bloomberg that he's seeing signs of a "perfectly decent" holiday season. This morning's tally of August consumer spending and personal incomes surprised to the upside. ISI Group says real consumer spending is on track to advance 2% in Q3, and Deutsche Bank says income growth should fortify spending through year-end.

Good enough to avoid a double dip This morning's ISM manufacturing gauge for September dipped less than expected and remained solidly in expansion territory, but some subcomponents disappointed as new orders and employment slowed while inventories rose. The story is similar around the globe—of the 22 countries that have released September's manufacturing gauge, 60% have declined month over month, though most remain in expansion territory. Next Friday's report on September employment is the next big data point. There are signs of improvement—the Conference Board's online help-wanted index rose again in September, is up 30% since the end of the recession and is at its highest since November 2008. The ASA Staffing Index hit a 2-year high on demand for temps and contract workers, and the latest weekly jobless claims unexpectedly slipped to 453,000, dropping the 4-

week moving average to a 2-month low. This is nothing to get too excited about until claims move below 400,000.

Housing draws interest The Mortgage Bankers Association said September purchase applications were up 5.6%, and July's Case-Shiller price index fell modestly in line with forecasts, with prices in California, a bellwether, up 9% the past 12 months, three times the national average. Meanwhile, Japan's largest housing builder recently acquired 500 acres of land outside Houston, where it plans to build more than 1,200 homes, and Aussie and Canadian investors have visited the National Association of Builders in search of bargain-priced land in the U.S.

Negatives

Consumers not yet in the holiday spirit The Conference Board's monthly measure fell to a 7-month low, with the plentiful-jobs subcomponent at its low for the year and the expected-business-conditions subcomponent at levels consistent with 1.7% real GDP growth the next three quarters—matching the revised Q2 GDP final read. And even though the University of Michigan's final read on September sentiment surprised to the upside, it was still at a very low level.

Risky states Analyst Meredith Whitney said states represent the new systemic risk to financial markets. The worst in her 600-page study were California, New Jersey, Illinois, Ohio, Michigan, Georgia and New York. Her findings come as states raised taxes this year by the most since at least '79, according to the National Governors Association, and as several undertook spending reforms. New Jersey Gov. Christie cut spending 9% and took on public union pensions and benefits, Iowa in an unprecedented move was granted federal approval to scale back special education funding, Texas cut funding for a steroid testing program for high school athletes and Florida eliminated state food safety inspections at hospitals, day-care centers and nursing homes.

Costly states Speaking of states and tax increases, states with the highest per-capita tax burden states are Connecticut, New Jersey, New York, Maryland, Massachusetts and California (Pennsylvania is No. 11). The lowest tax burden states are Mississippi, Alaska, West Virginia, South Dakota, New Mexico and South Carolina (home of the Clemson Tigers, my college boy and—some day—my vacation home).

What else

Favorably correlated Since 1960, Oppenheimer notes, S&P price and EPS levels have exhibited a nearly perfect 0.95 correlation. (So I have one question for you. Do you feel lucky, punk?) What about earnings?? Corporate America is in its best fundamental shape in nearly 50 years, and the mountain of cash on balance sheets today is impressive. Also, history has shown that EPS growth can exceed 20% in sub-3% GDP growth environments, particularly given the more global nature of corporate revenue today.

The waiting game For the first time in more than 100 years, the percentage of adults age 25-34 who have never been married has exceeded those who are married (Here, I shout out to the gentleman from Wheeling, W.Va., who recently asked me a question I have never been asked before—how many grandchildren do I have. Gulp. Well, I suppose my oldest is old enough, but apparently, unlikely to give me grandchildren anytime soon).

No help from hemlines Hemlines have often mirrored Wall Street's mood, rising when stocks soared in the 1920s and 1960s and falling in the late 1940s. This year, the styles on display at New York City's Fashion Week gave a mixed message, with "hemlines all over the place," Robert Burke, president of retail consulting firm Robert Burke associates, told Bloomberg News.

Views are as of October 1, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

The Conference Board's monthly Help Wanted OnLine index measures tracks changes in job postings at more than 1,2000 Internet job sites.

The American Staffing Association (ASA) Staffing Index estimates weekly changes in the number of people employed in temporary and contract work.

The S&P/Case-Shiller Home Price Indices measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States.

The Consumer Confidence Index is based on a survey by the Conference Board that measures how optimistic or pessimistic consumers are with respect to the economy in the near future.

The ThomsonReuters/University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

Correlation expresses the strength of relationship between distribution of returns of one data series and its benchmark. The coefficient correlation is always between +1 (perfect positive correlation) and -1 (perfect negative correlation).

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