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Japan (or China or Greece or the Fed) Likely Can’t Kill this Bull Market

By Louis Navellier

The S&P 500 fell 1.14% last week, but it rose 2.08% for the month of May, defeating the “Sell in May” theory this time around. The index is up over 14% for the year so far, but the last hour of trading in May was a downer, with stocks falling about 1% in the last 30 minutes before the close. Still, I am impressed that the market was able to shrug off the steep (5%) correction in Japan’s stock market on Thursday. It seems that we’ve finally realized we don’t have to catch a cold when other markets sneeze.

Investors Learn to Shrug Off their Old “Wall of Worries”

Last Thursday, I was impressed that the market shrugged off a second major (5% or more) daily drop in the Tokyo stock market in the last 10 days. Last Thursday, the Nikkei Stock Average fell 5.2%, and New York woke up to an early sell-off, but the market quickly recovered for a slim gain that day.

Japan is having problems digesting its manic version of quantitative easing. The Tokyo market surged 50% in less than six months and its Rip Van Winkle economy – fast asleep for the previous 20 years – suddenly woke up, boasting a 3.5% GDP growth. Japan thought it could buy prosperity on the cheap with rapid inflation of the yen, but it is now learning it can’t hyper-inflate its way to prosperity. Thankfully, however, Japan’s struggles didn’t cause U.S. stocks to fall very far.

The U.S. bull market has climbed a wall of worry for over four years now. For three straight Mays (in 2010, 2011, and 2012), the U.S. market fell based on problems in Greece, but last month there was no Greek crisis and no major U.S. market correction. We have also seen U.S. selloffs based on elections in Italy, a Bank of Cyprus scare, and our perennial worries about whether China will finally slow down.

Last Friday, China announced that its official Purchasing Managers Index (PMI) rose to 50.8 in May, up slightly from 50.6 in April. This is a measure of relative growth – any measure above 50 signals net expansion. Since China is already growing so rapidly, any measure over 50 is bullish. China’s PMI has now been over 50 for eight straight months, indicating a smooth, steady manufacturing recovery.

As 2013 began, the market was almost paranoid about forced “sequestration” of government spending early this year, but the June 1-2 *Wall Street Journal* featured a page 1 article titled “What Sequester? Washington Booms as a New Gilded Age Takes Root.” We also worried about state budget deficits, but revenues rose in 47 of 50 states last year, and *The New York Times* featured an article last week about a new crisis in California – how to spend all the money coming in. Clearly, growth is lifting tax revenues.

But now, we see a new worry – that a rise in long-term bond rates will kill the bond market, which will in turn bring the stock bull market to an end. I believe this theory will also be proven wrong, in time.

Today’s New Worry: The Coming Bond Crisis

In the last month, we’ve seen yields of 10-year U.S. Treasury bonds rise 50 basis points, from 1.66% to 2.16%, thereby sending the price of bonds down. Basically, this is a reaction to the fear that the Fed will scale back its quantitative easing (QE) as early as this month. Since the Federal Reserve has been buying so many bonds, traders wonder who will buy the bonds once the Fed reduces its buying volume.

Last Wednesday, the Organization for Economic Cooperation & Development (OECD) issued its semi-annual report, concluding that the eventual withdrawal of quantitative easing will likely cause a spike in government bond yields, putting the global economy at risk. Specifically, the OECD said, “a leap in U.S. government bond yields would result in capital losses for investors, and prices on other assets would most likely follow suit, with mortgage-backed securities and corporate bonds most strongly affected.”

The OECD report added that “in comparison with 1994 (when Treasury bond yields soared), this could be more disruptive, given the current higher leverage in the U.S. economy and financial system. Unless offset by portfolio shifts as investors move funds from bonds to equities, the higher long-term interest rate would weigh on equities, and property valuations could also be marked lower.”

In a CNBC interview on Wednesday, Pimco’s Bill Gross said that Fed Chairman Bernanke “has lost a little control.” Gross declared that the bull market in bonds is over. Specifically, Gross said, “I think Bernanke has a lost a little control in terms of the real economy. As a matter of a fact, he never had it. And to the extent that low interest rates reduce savings and therefore reduce consumption, to the extent that they reduce the return on investment for corporations, to the extent that they destroy business models and then technically jam up the repo market, you’ve sort of lost control of economic growth….”

It will certainly be interesting to see what happens when the Fed “taps on the brakes,” reducing its volume of bond buying, but investors have not abandoned bonds yet. According to the latest Investment Company Institute (ICI) funds flow data released last Thursday, investors added a net $673 billion to stock funds in the first four months of 2013, but they also added a net $255 billion to bonds and hybrid (bond/stock) funds. My hunch is that investors will switch from bonds to stocks as interest rates rise, fueling a rise in the stock market rather than a crash in both markets. With short-term interest rates still so low, I believe that investors will opt for the high-yields available in stocks rather than bonds or cash.

Stat of the Week: Consumer Confidence Soars to 5-to-7-Year High

On Tuesday, the Conference Board announced that its consumer confidence index rose to a five-year high of 76.2 in May, well above economists’ consensus estimate of 72.3 and up from a revised 68.1 in April. An improving job market and rising expectations fueled the surge. On Friday, we received more confirmation of rising sentiment, when the University of Michigan/Reuters’ consumer sentiment index was revised up to 84.5 in May, reaching a seven year high and surging well above April’s 76.4 reading.

Also on Tuesday, it was announced that the S&P/Case-Shiller composite home price index for 20 cities rose 1.4% in March, the largest monthly increase in almost seven years. In the past 12 months, this index has risen 10.9%, so a recovery in housing is clearly underway. I don’t believe this is a bubble: There is plenty of room for more growth, since the index is still 28% below its 2006 peak. The current tight inventory of existing homes for sale, plus relatively low interest rates, bode well for continued home appreciation.

In a similar report released Thursday, the National Association of Realtors announced that its pending home sales index is up 10.3% in the past 12 months, including a 0.3% rise in April. Pending sales are now at their highest level in three years, which bodes well for continued steady house price appreciation.

The big news this week will likely be Friday’s jobs report. I’ll be back with a full analysis on Monday.

Marketmail gets updated on Fridays and whenever the DOW closes up or down 300 points or more.

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