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In This Issue

New Problems Brewing in the East China Sea
Stat of the Week: New & Existing Home Sales Up 7.8% & 9.3%
The Fed's QE-3 Should Boost the Economy & the Market Soon

After a 10% Summer Surge, Expect a "Flight to Quality" Next

By Louis Navellier

Stocks were off fractionally last week, but we closed the summer months (June 21 to September 21) up 10.2% in the S&P 500 and +11.2% in NASDAQ. I don't think we'll match those gains in the autumn months – due to new global uncertainties, an election that seems too close to call, and a potential decline in third-quarter earnings – but the silver lining is that there should be a "flight to quality."

New Problems Brewing in the East China Sea

The old worries (like North Korea and Iran) still exist, but we added a new hot spot to the global map last week. The latest development is the resurgence of a centuries-old dispute over some uninhabited islands in the East China Sea, near Taiwan. The problem seems to be that there is oil beneath those barren isles.

Known as the Senkaku Islands (in Japan) or the Diaoyu Islands (in China), they appeared on ancient Chinese maps dating back to the 15th century, but Japan annexed the islands in 1895 and built a fish processing plant there in 1900, staffed by 200 workers. Then the islands fell under U.S. government occupation after World War II in 1945, but they were eventually returned to Japan in 1972. Case closed?

Not quite. Last week, there were violent anti-Japanese protests in scores of Chinese cities, causing many Japanese-owned factories in China to close their doors. Honda, Mazda, Nissan, and Toyota all closed their plants in China, as did Sony. In addition, General Xu Caihou, the Vice Chairman of China's Central Military Commission, said that military forces should be "prepared for any possible military conflict." This prompted U.S. Defense Secretary Leon Panetta to fly to China for emergency meetings last week.

Major stocks in Japan and China sold off as China began a boycott of Japanese goods, with calls to sell all Japanese bonds as well. On Wednesday, the Bank of Japan expanded its bond purchase program (i.e., quantitative easing) by $126.7 billion to counter any attempt by foreign creditors to sell Japanese bonds.

I don't think this border skirmish will become a real war for two basic reasons: (1) **China and Japan rely on mutually beneficial trade** with each other. Despite their historical animosities, they will find a way to solve this problem peacefully. After all, China has much closer ties to Taiwan and Hong Kong, and yet China has not gone to war to control their much more valuable real estate. Also: (2) **The price of oil is down.** There was a sharp price decline in crude oil after Saudi Arabia announced that it would produce more oil for its best customers in Asia, Europe, and the U.S. Crude oil prices are now at a six-week low.

Stat of the Week: New & Existing Home Sales Up 7.8% & 9.3%, Respectively

Last Wednesday, the National Association of Realtors announced that existing home sales rose 7.8% to a seasonally adjusted annual rate of 4.82 million in August, up from 4.47 million in July, the strongest rate of existing home sales since May 2010 and the 14th straight monthly gain. Existing home sales are now up 9.3% vs. a year ago. Even more important, the average home is now sold in 70 days, down from 92 days a year ago, so the long-standing imbalance between buyers and sellers has improved considerably.

On Thursday, we saw a mixed pair of indicators. First, the Labor Department reported that initial jobless claims fell by 3,000 in the latest week to 382,000, while the four-week moving average rose by 2,000 to 377,750, but that marks the 35th straight week of initial jobless claims staying below the 400,000 level.

Also on Thursday, the Conference Board announced that its Index of Leading Economic Indicators (LEI) declined slightly (-0.1%) in August vs. an upwardly revised gain of 0.5% in July. However, this decline in the LEI was in line with economists' consensus expectation and not a surprise. In the past six months, the LEI is up by 0.3%, signaling a slowdown in economic growth. But, as bad as that may seem, we're doing better than Europe, which is in a recession, and China, whose manufacturing sector is sputtering.

Overseas, HSBC announced on Thursday that its China Purchasing Managers Index (PMI) rose only slightly, from 47.6 in August to 47.8 in September, marking the eleventh straight month that the HSBC PMI has been stalled below 50, signaling a contraction. On the same day, Markit announced that its euro-zone PMI fell to 45.9 in September, down from 46.3 in August. The euro-zone services sector fell to a 38-month low of 46, down from 47.2 in August, while the manufacturing sector improved to 46, up from 45.1 in August. Since all these readings are below 50, the euro-zone recession shows no signs of ending.

The Fed's QE-3 Should Boost the U.S. Economy & Stock Market

In the last few years, the Fed's various rescue plans have boosted the stock market, and we believe this time should be no exception. After the March 18, 2009 FOMC meeting, when the Fed announced that an additional $750 billion would be added to its balance sheet (QE1), the S&P 500 rose by 36.9% in six months. After QE2 was announced at the August 27, 2010 Jackson Hole meeting, the S&P 500 rallied 31.1% in eight months. Then we saw a 29% rise from last October 3 through April 2, after the launch of Operation Twist.

The Fed's Zero Interest Rate Policy (ZIRP), now in effect through at least mid-2015, will also help lift the market and the overall economy. The Fed now owns one in six dollars of the national debt, the largest percentage of Fed debt holdings in history, larger than at the end of World War II. ZIRP helps keep the service costs on the federal deficit acceptably low, so I don't expect a rise in Treasury interest rates soon. After World War II, the Fed could not raise interest rates for about a decade, due to the massive war debt burden, so investors should be prepared for this ultra-low interest rate environment to last up to a decade.

Now, we are at the start of QE3, which could run for several years. These infusions of liquidity not only help the economy, they also tend to depress the U.S. dollar, which raises earnings in multinational stocks.

Stocks did well over the summer months, as we have been predicting, but I expect fourth quarter gains to be more selective. The analyst community is now estimating that the S&P 500's third quarter earnings will decline by 1.1% vs. the same quarter last year – the worst quarterly earnings since the fourth quarter of 2008. As a result, I expect so see a major flight to quality when earnings season begins in mid-October.

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