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Low Rates, Low Inflation & Slow Growth Spark a Flight to Quality

By Louis Navellier

Stocks declined steadily over the first four days of last week, mostly due to lackluster second-quarter earnings reports and growing fears of the impending "fiscal cliff." But on Friday, JPMorgan Chase reported unexpectedly high earnings of \$5 billion, despite a \$5.8 billion trading loss in May. On that news, the Dow shot up 204 points and the S&P 500 eked out a small (0.16%) weekly gain.

Low Interest Rates Drive Quality Dividend-Paying Stocks Up

Last week, even before Friday's dramatic rebound, many defensive, high-dividend stocks were at or near all-time highs due to the investor's ongoing quest for higher (and safer) income in a low-income world.

Central bankers continue to cut rates. We often see two or three such cuts per week. Last Wednesday, Brazil's central bank cut its benchmark rate by another 0.5% to 8%, an all-time low. (Last August, that benchmark rate stood at 12.5%, so it is down 450 basis points in less than a year.) Then, on Thursday, South Korea's central bank cut its key interest rates 0.25% to 3%, its first such rate cut in three years.

Bond buyers staged a massive flight to quality last week, lowering rates in countries considered to be safe havens. In the U.S., Wednesday's auction of 10-year Treasury bonds resulted in a record low yield of 1.459%. In addition, the auction had an incredibly high bid-to-cover ratio of 3.61 to 1, the highest since August 2010; 45.4% of those bids came from direct bidders, an all-time high and a sign of strong demand.

Despite all the recent gloomy news coming out of Europe, Eurostat reported last Thursday that industrial production in the euro-zone rose 0.6% in May, led by a 1.5% surge in Germany and a 0.8% rise in Italy! With the euro now near a two-year low of \$1.225 to the U.S. dollar, a weaker euro may help boost euro-zone exports this year. In addition, France sold 3-month and 6-month sovereign debt at slightly negative yields of -0.005% and -0.006%, respectively, joining Germany in the negative-yield club.

On Wednesday, the U.S. Federal Reserve released the minutes from its latest Federal Open Market Committee (FOMC) meeting held June 19-20. These minutes showed that the "doves" are driving Fed policy these days. Dovish FOMC members said that some new Fed actions "could be warranted" if economic risks "became sufficiently pronounced" or if inflation runs "persistently below" its 2% target.

Low inflation apparently gives the Fed leeway to loosen monetary policy without fear of generating new inflation. That's why some FOMC members said that it could be helpful "to explore the possibility of developing **new tools** to promote more accommodative financial conditions." Ouch! When the FOMC dares to say that it is exploring new alternatives to stimulate economic growth within a 0% interest rate environment, that reflects a kind of clueless desperation that could further undermine investor confidence.

The bottom line from all these central bank moves is that investors will likely continue to look to high-quality dividend-paying stocks to make up for the relative lack of income available in cash or in Treasury bonds.

Stat of the Week: Producer Prices Rose Only 0.7% in 12 Months

Speaking of inflation, the Labor Department announced on Friday that the Producer Price Index (PPI) rose just 0.1% in June. A sharp decline in energy costs was offset by a 0.5% gain in food prices, due to the drought and heat wave in the Midwest. In the past 12 months, the PPI has now risen by only 0.7%.

The other U.S. economic news released last week was mixed. On the negative side, the small business index compiled by the National Federation of Independent Business (NFIB) slipped to 91.4 in June, down from 94.4 in May, reaching its lowest level since October 2011. Only one of 10 index components rose. That does not bode well for future job creation, since small businesses create the vast majority of jobs.

In contrast, the best news came out on Thursday when the Labor Department reported that new weekly jobless claims declined by 26,000 to 350,000 in the latest week, while the four-week moving average declined by 9,750 to 376,500. Some seasonal adjustments and fewer auto-sector layoffs were cited as the primary reason for the decline in new claims, but any improvement in the job market is welcome.

Another positive report came from the Commerce Department on Wednesday, when they said that the U.S. trade deficit dropped 3.8% in May to \$48.7 billion, down from a revised \$50.6 billion in April, as U.S. imports declined 9.3% and exports rose 0.2%. Clearly, lower crude oil prices are helping reduce the U.S. trade deficit. This should also boost some economists' second-quarter GDP estimates.

Fears of a Chinese "Hard Landing" are Unlikely to Materialize

There was tremendous anxiety last week over the news that China's National Bureau of Statistics announced a 7.6% annual GDP growth rate in the second quarter, down from 8.1% (annual pace) in the first quarter. Even though this was the slowest GDP growth rate in over three years, China's GDP report came as a pleasant surprise to many, since some market pundits were expecting sub-7% GDP growth.

Now, consider some other China reports, which are uniformly positive. On Tuesday, we learned that China's trade surplus rose to \$31.7 billion in June, up from \$18.7 billion in May. (The consensus estimate was for only \$24.4 billion, so this was a 30% positive surprise.) China's import growth slowed to a 6.3% annual gain in June, down from 12.7% in May, while China's exports grew at an 11.3% annual pace in June vs. 15.3% in May, so China's "slowdown" is like a car "slowing" from 150 to 100 miles per hour!

Also on Friday, the National Bureau of Statistics announced that retail sales in China rose 13.7% in June (virtually identical to the 13.8% in May), while industrial production rose 9.5% in June (virtually equal to May's 9.6% growth). These growth rates are the envy of the world, not the sign of a declining economy.

With continuing slow-but-steady economic growth in the U.S. and Germany, plus an orderly retreat from red-hot growth rates in China, most multinational companies should be able to deliver rising earnings.

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

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