Rochester Financial Services

Fee-Only® Financial Management Services

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Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Earnings Yield (S&P)	Gold	Crude Oil
16,554	1,932	4,371	1,131	2.42%	6.47%	$1,311	$97.35

Investment Strategy Report

Geopolitics Takes Its Toll on World Stock Markets

After hitting highs on July 24th, the US stock market indexes have fallen back about 3%. Not a terrible decline, but it is a bit worrisome since everyone has been waiting for a correction, and now that we see weakness, many investors want to take defensive action. In my discussions with clients the past few weeks, a common concern they have expressed is that with what's going on in Russia, Iraq, and Gaza, this can't be a good time to be invested. And my answer to them has been, forget about the headlines. As long as the economic fundamentals are sound, the market should be OK. Well it appears that as Russia has placed thousands of its troops at the Ukraine border, the threat of an invasion has put pressure on the stock market. The reason we know that this event is the cause of the market weakness is that this past Friday, when Russia seemed to indicate a willingness to reach some sort of a settlement, the markets spiked over 1% higher as the threat of an invasion subsided.

So yes, I do admit that exogenous events can have an effect on stocks. However, you need to know that stock prices might already reflect the tensions existing in the world today, and it can be just as likely that a favorable event can send stock prices higher than a negative event can send them lower.

Of course Friday's 185 point surge in the Dow does not mean that the all clear signal has been sounded. The markets have been weak ever since the 317 point decline in the Dow on July 31st. Volatility has been high and the markets are on edge. I also discussed in last month's letter that the markets might face some challenges in the months leading up to October. That is because October begins a period of favorable seasonality for the markets. Stocks might take the opportunity during the summer months to work off some of its overbought condition.

On Jim Cramer's Mad Money show this past Wednesday (8/6), he offered a list of reasons why the stock market decline should have gained more momentum to the downside. 1) The Sprint buyout didn't happen, 2) 21st Century Fox walked away from a deal with Time Warner, 3) the European economy is quickly loosing steam, with Italy officially entering a recession and the German stock market entering a correction with a 10% drop, and 4) US interest rates and oil prices continuing to drop, often a sign of a weakening economy. Why was the market demonstrating such tremendous resilience?

I'll turn to an article written this past Thursday by David Eifrig of Stansberry Research to answer this question. He cited recent headlines such as "The US economy isn't recovering, the consumer is dead, nobody can get a good job" as evidence to all the doom and gloom out there. However, he points out that the reality is very much different. 1) Consumer spending, which drives 70% of our economy, just reached an all time high. 2) Non-farm employment has also hit an all time high, recovering all the jobs lost during the recession and then some. 3) Bank commercial loans and leases surpassed the October 2008 level about a year ago and continue to climb, a good indication of business start-ups and expansions. This should lead to a slowly strengthening housing market and increasing tax revenues.

Other good economic news includes stronger than expected June factory orders, a narrower than expected US trade deficit in June, and unemployment claims dropping to an 8 1/2 year low. The economy grew at a rate of 4% in the second quarter. This growth is occurring with interest rates near historic lows, with the 10 year Treasury now sitting at 2.42%. Low rates act to stimulate the economy, motivating companies to borrow to expand their businesses.

Corrections can occur any time, whether due to exogenous events or just a weary market needing a pause to refresh. However, as long as the market fundamentals remain in tact, they should provide support for further stock market gains.
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