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Europe Returns to Austerity, while U.S. Growth Accelerates

By Louis Navellier

The euro-zone's woes took center stage again last week as the continent tried to revive its original (strict) debt quotas. Since most key members agreed to act "more like Germany," stocks rose sharply on Friday to close the week up 1%. For the two weeks since the Thanksgiving-week swoon, U.S. stocks are now up 8.4%, the best two-week run since July 2009. Otherwise, we seem to be in holiday trading mode now. That means light volume and an early "January Effect," fueling a year-end stock rally.

Euro-Zone Returns to German-style Austerity Goals

The euro-zone mess briefly dissipated last week in the wake of the news that France and Germany issued an ultimatum to all euro-zone members that they must decide whether or not they will accept greater central control over their national budgets. Essentially, French President Nicolas Sarkozy and German Chancellor Angela Merkel are trying to force the other euro-zone members to be "more German" (or at least "more French!"), adopting the stringent German-style budgetary discipline by agreeing to limit their annual budget deficits (relative to GDP) to 3%. Essentially, France and Germany are trying to get euro-zone members to reaffirm the same rules and conditions they accepted when they joined the euro-zone.

This ultimatum made some investors nervous, since there is a possibility that debtor countries may use this "new" requirement as an excuse to leave the euro-zone. However, 23 of 27 European nations agreed on Friday to a tighter enforcement of the rules on euro-zone fiscal discipline. All four southern European PIGS (i.e., Portugal, Italy, Greece, and Spain) signed on, while the four dissenters that would not agree to any new or stricter fiscal rules were Britain, the Czech Republic, Hungary, and Sweden. (Since Great Britain does not use the euro and has its own central bank, their veto is not seen as a deal breaker.)

The fact that the Italian government approved a new three-year austerity program via spending cuts, tax hikes, and pension reforms signaled that Italy is now serious about addressing its growing debt burden. Another spur to get the lagging euro-zone members to tighten their belts was Standard & Poor's threatening to downgrade 15 euro-zone countries, including France and Germany, last Tuesday. This threat of a "negative" outlook seems to have fueled greater determination by euro-zone members.

Ireland has set the standard for recovery among troubled euro-zone nations. Irish austerity has caused Irish bond yields to fall as confidence returns. As a result, France and Germany are pointing to Ireland as a positive role model. They don't want to see Italy or Spain following the Greek debt restructuring model. They want more European countries to become more Irish-like or German-like and a lot less like Greece.

In the meantime, the European Central Bank (ECB) cut its key lending rate by 0.25% to 1% on Thursday. This is the ECB's second straight monthly interest rate cut. Under new ECB President Mario Draghi, the ECB is much more accommodative, so further interest rate cuts may be forthcoming in upcoming months.

The ECB is also trying to flood the European banking system with liquidity by taking the unprecedented step of offering loans for up to three years, while remaining reluctant to aggressively buy bonds, like the Bank of England and the Fed have done. The German-influenced ECB avoids aggressive bond buying, but with euro-zone bond yields moderating a bit,

there is really no need for aggressive quantitative easing.

Despite lower bond yields and key rate cuts, the European Banking Authority rattled investors when it said that European banks must come up with an additional 114.7 billion euro ($154 billion) by next June due to capital shortfalls. Despite the ECB's interest rate cuts and three-year liquidity injection, financial markets remain on "pins and needles" due to so many euro-zone banks holding Greek or Italian bonds.

Stat of the Week: U.S. Consumer Sentiment Rises Sharply

While Europe continues to fight a brewing recession, U.S. economic news continues to be net-positive, led by Friday's sharp rise in consumer sentiment. Stocks rose strongly on Friday after the University of Michigan and Reuters reported that their preliminary reading for consumer sentiment in December rose to a six-month high of 67.7, up from 64.1 in November and well above economists' consensus expectations of 66.1. This rise in consumer sentiment obviously bodes well for the current holiday shopping season.

The other good news released on Friday was a Commerce Department report that the U.S. trade deficit narrowed for the fourth straight month to $43.5 billion in October, a 1.6% decline from September. As the trade deficit narrows, GDP growth will rise accordingly. However, the trade deficit with China grew to $28.1 billion as imports hit an all-time high. Apparently, we are importing lots of Christmas gifts from China. Our trade deficit with China will likely be a hot topic as the Presidential election season heats up.

In other news, weekly new jobless claims (released Thursday) declined to 381,000, down from a revised 404,000 in the previous week. This dramatic drop tells us that the labor market is improving each week.

On the downside of the statistical ledger, the Institute of Supply Management (ISM) reported that its non-manufacturing (service) index fell to 52 in November, down from 52.9 in October. However, new orders rose to 53 in November, up from 52.4 in October, marking the 28th monthly rise. Also, business activity rose to 56.2 in November, up from 53.8 in October, an impressive rise. All of these numbers are above 50, signaling net growth. The only reason the November service sector index number fell was a 4.4-point drop in the employment index! However, based on last week's strong ADP payroll report and household survey, plus this week's sharp drop in new jobless claims, the ISM job drop looks like a statistical fluke.

This week, several key mid-month indicators will be released, helping us confirm the positive direction of the U.S. economy. I'll report that news to you next week. In the meantime, have a happy holiday season.

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

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