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Markets Continue to Set Record Highs, Despite Fed Warnings

By Louis Navellier

The S&P 500 rose 2.07% last week, reaching another all-time high (1667). There was only one down day, Thursday, when it seemed like the Fed might decide to end quantitative easing (QE) earlier than expected, but the bulk of last week's economic news supported continuing economic growth and a bullish outlook for second-quarter GDP and corporate earnings. Still, the overall stock market seems to be looking for an excuse to correct, particularly if the Fed decides to scale back QE sometime this summer.

A Fed "Dove" Says the Full (\$85 Billion per Month) of QE May End Soon

The latest excuse for the stock market to correct came from remarks last Thursday by San Francisco Fed President John Williams, who indicated that the Fed's \$85 billion per month in quantitative easing (QE) may be reduced "as early as this summer. Then, if all goes as hoped, we could end the purchase program sometime later this year." Although he is not a voting member of the Federal Open Market Committee (FOMC), Williams pointed out that the pace of job growth has picked up, so the Fed may be able to tap on the brakes and reduce its bond buying program. This is significant because Williams is a "dove" (those who favor QE "to infinity and beyond.") Multiple "hawks" have been calling for a cutback on QE, but Williams is the first dove to openly agree, so I suspect the Fed will have an official statement soon.

Meanwhile, over in Japan, we are seeing the fruits of pedal-to-the-metal easing. On Thursday, it was announced that Japan's GDP rose at a 3.5% annual pace last quarter. This was substantially higher than economists' consensus estimate of a 2.8% increase, and the previous 23 years of near-zero growth. It is apparent that the Bank of Japan's strategy to dramatically weaken the Japanese yen to boost exports is working. Overall, Japan's example will likely cause other central banks to continue easing.

As a result of the falling euro and yen, the U.S. dollar index reached a three-year high last week. A strong U.S. dollar is crushing the overseas profits of many multi-national companies, but stocks are still rising since most stocks yield more than a bank CD or a short-term Treasury debt instrument, and companies are still borrowing money to buy back their outstanding shares, boosting their underlying earnings per share.

A New "Energy Glut" is Pushing Inflation below Zero (i.e., Deflation)

Last Tuesday, the International Energy Agency (IEA) reported that the U.S. will account for one-third of all new crude oil supplies within the next five years due to booming exploration for crude oil in shale deposits and new technologies to retrieve those deposits. Specifically, the IEA expects U.S. crude oil production to rise by 3.9 million barrels per day between 2012 and 2018, the equivalent to two-thirds of new non-OPEC production. According to the IEA, the U.S. could become the world's largest producer of crude oil by 2020 and temporally overtake Saudi Arabia. Additionally, the U.S. is also expected to pass Russia as the world's largest natural gas producer and become "all but self-sufficient" in its energy needs by 2035. The IEA also predicted that the U.S. will make a transition from a net energy importer to a net energy exporter, which will likely help further strengthen the U.S. dollar in upcoming years.

This new "energy glut" is starting to make the price at the pump decline dramatically once again. Last Wednesday, the Labor Department announced that the Producer Price Index (PPI) plunged 0.7% in April, due predominately to lower gasoline prices.

The core PPI, excluding food and energy, rose 0.1% but food prices fell 0.8% and energy prices declined 2.5%, led by a 6% decline in wholesale gasoline prices. As long as the dollar remains strong and the energy glut persists, food and energy prices will likely stay soft.

On Thursday, the Labor Department reported that the Consumer Price Index (CPI) fell 0.4% in April due predominately to a 4.3% drop in energy prices, including an 8.1% drop in gasoline prices. Excluding food and energy, the core CPI rose 0.1%, which was below economist expectations. In the past 12 months, the core CPI has risen 1.7%, the lowest 12-month rise in two years. The overall CPI is now at its lowest level since 2010, so with the lack of inflation, the Fed has a green light to continue its 0% interest rate policy.

Stat of the Week: Consumer Sentiment Hit 83.7 – its Highest Level Since 2007

Consumers tend to be happier when gas prices are going down, the value of their homes is going up, and their outlook for job security improves. All of that was reflected on Friday when the University of Michigan/Reuters reported that consumer sentiment surged to 83.7 in May, the strongest monthly reading since mid-2007, rising sharply from 76.4 in April and far above economists' consensus estimate of 77.5.

A second piece of good news was released on Friday when the Conference Board said their Leading Economic Indicators (LEI) rose 0.6% in April, substantially better than the economists' consensus of a 0.3% increase. Seven of the 10 LEI components rose. Overall, due to better-than-expected consumer sentiment and a rising LEI, economists will likely revise their second quarter GDP forecasts higher.

Most of the other economic news last week was also positive. The Commerce Department said retail sales in April rose 0.1%, substantially better than economists' consensus estimate of a 0.6% decline. Excluding sales at gas stations, which declined 4.7% due to lower fuel prices, overall retail sales actually rose by a healthy 0.7%. Vehicle sales were strong, rising 1%, while clothing sales rose 1.2% and building material sales rose 1.5%. Most retail categories, except gas stations, rose impressively in April.

On Wednesday, the Fed reported that Industrial Production declined 0.5% in April, due predominately to a big 3.7% drop in utility output, due to unusually mild weather. Once again, the negative headline has a silver lining, since a drop in utility charges generally gives consumers more money to spend elsewhere.

In the housing sector, April building permits rose 14.3%, including a 37.5% surge in apartment permits and a 3% increase in single-family permits. That means May's housing starts will likely surpass a disappointing April, when housing starts fell 16.5%. Looking beyond these monthly swings, housing starts in April were 13.1% higher than a year ago. For confirmation of the housing recovery, we will see two major April home sales surveys released this week (existing home sales Wednesday and new home sales on Thursday), plus April durable goods orders, released Friday. We'll also see minutes of the most recent Fed meetings released when Fed Chairman Ben Bernanke updates Congress on the economy. I'll cover these and other events next Tuesday, after the holiday break. Have a great Memorial Day weekend.

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

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