<u>WALKING THE WALK: US STOCKS AND THE DOLLAR</u>

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In Stanley Kubrick's Vietnam war film "Full Metal Jacket", the soldier nicknamed Animal Mother speaks to Private Joker: "You talk the talk. Do you walk the walk?"

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<u>CONCLUSION</u>

The recent advance in America's broad real trade-weighted dollar index has attacked June 2012's 86.3 high (Federal Reserve Board, H.10; March 1973=100, monthly average). That key top rests near August 2008's 86.7, a level from which the dollar rallied sharply during the worldwide economic disaster that emerged in mid-2007 and accelerated during 2008. The broad real trade-weighted dollar ("TWD") probably will climb higher (even if only modestly) over the next several months given the current trends in the US Treasury 10 year note, emerging stock marketplaces, and commodities in general. For these present-day marketplaces and their interrelations, keep in mind their 2007-2009 history. Moreover, the current level and probable near term climb in the TWD, when viewed in conjunction with trends in the UST 10 year and emerging stocks and commodities, indicate that a significant plateau in the S+P 500 is or soon will be in place. A walk in the TWD toward or above September 2008's 88.8 (and especially) October 2008's 93.9 increases the likelihood of a noteworthy S+P 500 peak.

<u>ON THE RUNWAY</u>

The US dollar's recent strengthening partly reflects widespread relative optimism regarding the current and future outlook for the American economy in comparison to that of the Eurozone, Japan, and many emerging/developing nations. For example, contrast America and the Eurozone. America has offered signs of continued growth, and the Federal Reserve soon will finish shutting down its latest round of money printing. The European Central Bank a few weeks ago revealed a modest quantitative easing scheme due to deflation fears, mediocre growth, stubbornly high unemployment, and fears of social unrest.

However, this is only part of the dollar story. And relative and even further attractiveness for the dollar are not the same as beautiful prospects for the US economy. The dollar's appreciation and its stock marketplace's seemingly relentless march to new heights do not necessarily portend notable strength in the US economy. Although foreign exchange levels and relationships are important variables, picture several others alongside the dollar.

After the Fed ceased its prior rounds of money printing, the 10 year UST note yield and the S+P 500 tumbled. Although that benevolent central bank embarked on a slow tapering process in mid-December 2013, America's 10 year government note yields have meandered downhill from 1/2/04's 3.05 percent top. Shouldn't US longer term government interest rates tend to rise if significant real GDP growth or widespread hopes for it exist? In an interdependent international economy, the ongoing sideways to down trend in emerging marketplace stocks in general warns of slowing growth in advanced as well as developing nations. The retreat in the overall commodities complex roughly resembles that of emerging marketplace equities. See "Stepping Higher: UST Two Year Note Yields" (9/21/14), "Bond Yield Perspectives: Easing Comes, Easing Goes" (9/1/14), "Commodity Marketplace Travels" (8/1/14), "Exit Strategies: the Fed, US

Treasuries, and US Stocks (7/14/14), “China: Its Great Growth Story Grows Old” (6/23/14), and other essays.

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US dollar cross rates against key trading partners such as the Eurozone, Canada, China, Mexico, and Japan of course are important variables in the analysis of various financial marketplaces. However, the broad real trade-weighted dollar represents a more comprehensive benchmark for “the dollar in general” and its relationship with debt, stock, commodity, and other arenas.

WALKING BACKWARDS: SOME HISTORY

The rock group “Talking Heads” declare in “Life During Wartime”: “This ain’t no party, this ain’t no disco, this ain’t no fooling around.”

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The S+P 500’s over five year long bull leap since its gloomy 3/6/09 depth at 667 indeed has been stratospheric. Its 9/19/14 height at 2019 triples March 2009’s major bottom, doubles 7/1/10’s 1011 trough, and jumps about 50 percent over 11/16/12’s 1343 low. This monumental equity rally, its development over a rather long stretch of time (more than five years), and faith that the friendly Fed and its allies will retain very accommodative policies probably has encouraged many clairvoyants to forget or minimize the dreary times of the worldwide economic crisis that emerged in mid-2007 and accelerated during 2008 and early 2009.

However, let’s step back and revisit scenes from that ancient era. Although the S+P 500 peaked on 10/11/07 at 1576, recall that its final high was 5/19/08 at 1440. Shortly before May 2008’s final summit, the broad real TWD in April 2008 established a crucial floor at 84.2 (prior major bottoms around 84.0 in October 1978 and July 1995). The global financial troubles worsened in late summer/early fall. Alongside this and the slump in the US and global economy, the TWD’s rally continued. It stood at about 86.7 in August 2008, hopped to 88.8 in September, and leaped to 93.9 in October. After a 15.1 percent bull ascent, the TWD’s summit occurred at 96.9 in March 2009, as did the S+P 500’s major bottom.

Alongside the entwined movements in the S+P 500 and the TWD, keep in mind those of the UST 10 year note. The 10 year’s yield peaked on 6/13/07 at 5.32 percent, not long before the S+P 500’s October 2007 summit. As UST yields eroded, note the timing of subsequent interim yield tops. The 10 year UST’s 4.72pc height on 10/13/07 occurred right around the S+P 500’s pinnacle. The UST’s tops at 4.27pc on 6/13/08 and 4.10pc on 10/5/08 connect with the TWD’s rally since April 2008 and the S+P 500’s linked downturn (S+P 500 collapsed from around 8/18/08’s 1313 and 9/19/08’s 1265). What about merging marketplaces in general (MSCI Emerging Stock Markets Index, from Morgan Stanley; “MXEF”)? The MXEF attained its major and final highs (at 1345 on 11/1/07 and 1253 on 5/19/08) alongside those in the S+P 500. In this supposedly distant past, as the TWD rallied sharply, US and other stock marketplaces raced downhill, UST (and other government) yields cratered, commodities marketplaces collapsed (broad Goldman Sachs Commodity Index peak 7/3/08 at 894).

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History of course need not repeat itself, either exactly or even in part. However, it should not be forgotten. In this regard, underline the UST 10 year note’s decline (and the narrowing of the 10 year less two year UST spread) since January 2014, the MXEF’s high 9/4/14 at 1104, and the renewed bear move in the broad GSCI since 6/23/14's 673 interim top. These assorted marketplace moves now overlap with a recent broad real TWD rally.

Emerging stock marketplaces in general, unlike the S+P 500, have not advanced to new peaks since spring 2011. Indeed, the MXEF's 2011 elevation never reached its autumn 2007 peak. However, over the past several years, several important MXEF marketplace turns have occurred around the same time as those in the S+P 500. Since around mid-2008, movements in commodities in general (broad Goldman Sachs Commodity Index) have tracked emerging marketplaces to a significant extent.

DOLLAR DANCES

Everlast sings in "Money (dollar bill)" of his desires for dollar bills, other currencies, stocks, bonds, and other goods.

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For the past several years, many marketplace observers have chanted: "Weak United States dollar equals strong US stocks (and probably at least a fairly strong or improving American economy), strong dollar equals weak US stocks (and a weak or slowing economy)". This relationship (tendency) between the broad real trade-weighted dollar and the S+P 500 often has held true, although it is not inevitable. To some extent, given the interconnected global economy and America's substantial role within it, sustained US economic strength (or weakness) encourages that elsewhere. Consequently stock and other economic gurus and policymakers should monitor US dollar levels and trends.

After the broad real TWD attained its March 2009 peak near 96.9 alongside S+P 500's major low on 3/6/09 at 667, the TWD commenced a significant bear move, with the S+P 500 travelling on a wonderful bull path. The TWD stumbled to its record low 80.5 in July 2011. Until rather recently, and thus for about three years, it remained rather feeble, which arguably encouraged rallies in the S+P 500 and helped the US (and worldwide) economy recover. Beginning in September 2011, it edged over 83.0 and stayed in a rather narrow band, promenading around the prior major lows around 84.0, touching a high of 86.3 in June 2012.

The most recent Fed update for the broad real TWD (10/1/14) did not provide the September 2014 figure (monthly average), though that information should be released in the near future. However, one can estimate September 2014's TWD level by reviewing nominal broad trade-weighted dollar index data (the H.10 released 9/29/14) and adjusting the August 2014's broad real TWD level accordingly. Nominal TWD data is for available for individual days, and currently covers September 2014 through 9/26.

The nominal TWD average (daily data) from the beginning of September through 9/26/14 is about 104.7, up about 1.4 percent from its August average of 103.2. With only a couple of trading days left to be reported, and given the dollar's rally as September days passed, about 1.5 pc is a reasonable rough estimate for the nominal TWD dollar's gain during calendar September. The broad real TWD August 2014 average was just under 85.5, so a 1.5pc rally takes it to about 86.8.

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Significantly, the current advance in the broad real TWD probably has taken it above its 86.3 June 2012 resistance and up to right around August 2008's important 86.7 level. In the context of the 2007-2009 history and current trends in the UST 10 year, MXEF, and broad GSCI, this signals the probability of further strength in the broad real TWD. In addition, the current level of and probable near term ascent by the TWD warns that a significant peak in the S+P 500 may or soon will be created. Steps in the TWD near to or above September 2008's 88.8 (and especially) October 2008's 93.9 boost the likelihood of a noteworthy S+P 500 summit.

The nominal broad TWD initial take-off point on its rally road was 7/1/14's 101.9. However, underscore its climb from 103.9 on 9/5/14 to 105.9 on 9/26/14 (the most recent data point). The European Central Bank introduced its asset-backed securities quantitative easing (money printing) scheme on 9/4/14. That ECB easing helped to rally the dollar. After all, the Fed's latest round of QE will cease soon. But also note that the emerging marketplace stock world (MXEF) also topped on 9/4/14 at 1104. So given the MXEF's drop in the context of the broad real TWD's starting to sustain a breakthrough over its 86.3 barrier, how strong is the worldwide economy?

What if large quantities of "carry trades" involving borrowing in the US dollar and taking positions in emerging marketplace securities are unwound? The Financial Times in the carry trade context headlines "Emerging markets face dollar threat" (9/30/14, p2).

Note that the Euro FX cross rate against the US dollar stumbled beneath 1.300 on around 9/4-5/14. By 9/16/14, the Euro FX retraced a bit, touching a high of 1.300 (compare the timing of the S+P 500's recent high on 9/19/14); however, the Euro FX then resumed slipping downhill.

The Japanese Yen's made minor highs versus the dollar on 5/21/14 at Y100.8 and 7/10/14 at Y101.1. The Yen then deteriorated, diving toward 5/22/13's Y103.7 support floor by late August 2014. It weakened further in early September, falling decisively under Y105.0 after the ECB's action.

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As guidelines, what are some percentage measurement moves for the broad TWD as it moves along the bull road? Take the July 2011 record low slightly above 80.5 as the starting point. This TWD depth occurred not long after the MXEF's 4/27/11's significant top at 1212 and the S+P 500's 1371 interim high on 5/2/11. A five percent advance is 84.5 (recall the several key lows around 84.0), 7.5pc is 86.6 (June 2012 high 86.3) and 10pc is 88.6 (compare September 2008's average). A 15pc climb gives 92.6, with 20pc appreciation 96.6 (March 2009 high 96.9.

Currency wars and competitive devaluations may limit the extent of further rallies in the TWD, but that does not preclude an important US dollar rally.

STOCK STEPS

"Where should we put our money?" ask investors. Sustained yield repression by the Fed and its worthy central bank allies have encouraged fervent searches for "good" (or at least sufficient) yields (returns) via stock marketplaces, junk bonds, and elsewhere. Low interest rates, a relatively feeble broad real TWD, strong corporate earnings, and share buybacks have helped to propel the S+P 500 higher and higher. But in the interconnected global economy, America is not an island. Neither are its corporations. America's stock marketplace therefore ultimately is not an island either.

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The scope of the worldwide economic disaster of 2007-09 probably will not be repeated. Yet a recent speech by the International Monetary Fund's Managing Director, Christine Lagarde, nevertheless portrays unimpressive worldwide GDP growth and significant risks ("The Challenge Facing the Global Economy: New Momentum to Overcome a New Mediocre"; 10/2/14). She asserts: "Overall, the global economy is weaker than we had envisaged even six months ago. Only a modest pickup is foreseen for 2015, as the outlook for potential growth has been pared down….The bottom line? Six years after the financial crisis began, we see continued weakness in the global economy."

In addition: "There is concern that financial sector excesses may be building up, especially in advanced economies. Asset valuations are at an all time high; spreads and volatility are at an all time low." Though the IMF Director does not refer specifically to US equities or low-grade corporate bonds, arguably her remarks apply to both. The comment about spreads probably relates at least in part to credit spreads such as those between long term US Treasuries and corporate debt securities such as junk bonds. She adds, after mentioning US monetary policy, that "the longer easy money policies continue, the greater the risk of fuelling financial excess."

The IMF/World Bank meetings are October 10-12, 2014 (with IMF releases of the World Economic Outlook and related publications before then).The Fed meets 10/28-29 and 12/16-17/14.

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The Federal Reserve has done its best to spark and sustain US stock marketplace rallies to increase household net worth and encourage economic recovery. Fed actions reveal its fears of large stock declines and its efforts to spark and sustain bull moves. Remember the timing of its introduction of several rounds of monetary accommodation, including quantitative easing.

The Fed introduced its QE1 round of November 2008/March 2009 amidst a murderous slump (57.7 percent collapse from 10/11/07's peak at 1576 to the 3/6/09 floor at 667). The Fed slashed the Fed Funds rate during the economic crisis; it has been under .25pc since December 2008 (monthly average). But note its easing measures after much smaller percentage stock retreats. The two and one half month fall from 1220 (4/26/10) to 1011 (7/1/10; 8/27/10 final low at 1040) was only 17.1 percent; the Fed unveiled QE 2 at end August/November 2010. The violent five month stagger lower from 1371 (5/2/11) to 1075 (10/4/11) was 21.6pc; the Fed introduced Operation Twist 9/21/11.

Recall the two month decline in the S+P 500 from 1422 (4/2/12) to 1267 (6/4/12) of about 10.9 percent. Although the Fed did not respond right away, the ECB gave its "whatever it takes speech" to protect the Eurozone on 7/26/12 and revealed its outright monetary transactions policy (OMT) 8/2/12. However, the Fed did act only several months after early June 2012 and probably partly in relation to that bearish April-June S+P 500 shift. The S+P 500 had commenced a new slide. It tripped down 8.9pc from 1474 (9/14/12) to 1343 (11/16/12), an 8.9pc and two months move. The Fed declared QE3 on 9/14/12 and offered policy guidance and more easing (QE4) on 12/12/12. The very slow pace of the current tapering process probably partly reflects the Fed's effort to not endanger stock marketplace strength.

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Are owners of US stocks complacent? Not only do many players in stocks and elsewhere have faith in the Fed. Over the past year and a half, the S+P 500's percentage declines have been even smaller and of increasingly short duration. This probably has mitigated marketplace fears of a large stock retreat.

For example, the fall from the interim top at 1687 (5/22/13) to 1560 (6/24/13) was 7.5 percent and one month. Compare that from 1710 (8/2/13) to 1627 (8/28/13): 4.9pc and less than a month. The slip from 1851 (1/15/14) to 1738 (2/5/14) was 6.1pc and ran about three weeks. More recently, see the drop from 1897 (4/4/14) to 1814 (4/11/14): 4.4pc and one week; the move down from 1991 (7/24/14) to 1905 (8/7/14) was 4.3pc and two weeks.

Measurement moves hint that the S+P 500 probably does not have much more room to travel upward for the near term relative to 9/19/14's recent high at 2019. The 3/6/09 major low around 667*3 equals about 2000. The 7/1/10 low at 1011 times two is 2022. The key take-off point of 1343 on 11/16/12 (various renewed easing by the ECB, Fed, and Bank of Japan within several months before or after that date) times 1.5 is 2015. All these levels are around the recent high. Also, within the context of the current long run bull move in the S+P 500, October is an important anniversary month. Recall 10/11/07's major peak 1576 and the significant 10/4/11 bottom at 1075.

A one percent move over the recent high at 2019 is about 2040, a five percent trek above it gives 2120. A five percent decline in the S+P 500 from 2019 is 1918, 10pc 1817, 15pc 1716, 20pc 1615. Weakness in junk bond prices probably will coincide with declines in the S+P 500.

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