Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – OCTOBER

US Markets and Economy: The US stock market took investors on a roller-coaster ride in October. A sharp selloff in the first half of the month took the Dow Jones, S+P 500, and NASDAQ Indexes down sharply as fears mounted that world economic growth was weakening, and that the danger of deflation was rising. Fears of Ebola spreading to the US also kept traders on edge. But just as quickly as stocks plummeted, share prices roared back in the last half of the month, erasing all losses and even closing at new all-time highs for the Dow and the S+P on the last trading day of October. **This volatile performance, which could continue for some months, shows the futility of trying to "time" the market. Investors who bailed out in fear in mid-October missed the subsequent strong rally.** The sharp jump in prices was partly sparked by good economic news in America: US real gross domestic product (GDP) rose strongly in the third quarter (July-September), while consumer confidence also reached a multi-year high. It is now quite likely that the US economy is taking off into self-sustaining growth, enabling the US Fed to end its third round of Quantitative Easing (QE) right on schedule. The Fed also announced after its October meeting that it would keep short-term interest rates near zero for some time, with Wall Street betting that rate increases won't start until mid-2015 at the earliest. Continued easy money, combined with steady growth and low inflation, provides strong support for stock prices.

World Markets and Economy: Stock markets outside America generally followed the US lead: sharp selloffs in the first half of the month, followed by rallies in the second half. In Europe, however, the rallies were muted, and in many countries, there were losses for the month. This weaker performance was driven by a much poorer economic outlook in Europe: economic growth is declining toward zero or worse in much of Europe, while inflation is so low that the danger of actual deflation is rising. Deflation is just as economically damaging as rapid inflation: consumers hold back on purchases, waiting for even lower prices. Debtors see the real value of their debt burden rise as prices fall, making it more difficult to repay loans. The monetary authority, unable to reduce nominal interest rates below zero, must contend with rising real rates of interest (nominal – inflation) which also hold back economic growth. Economic weakness is particularly dangerous for those European countries like Greece and Spain, where the labor market suffers from Depression-era rates of unemployment, with popular unrest liable to reappear at any time. Even the German economic powerhouse is sliding toward zero economic growth. Under these circumstances, it becomes more likely that the European Central Bank (ECB) will undertake a more aggressive form of QE to rescue the economy. Unfortunately, the politics of Eurozone countries have kept the ECB from acting. Northern Europe (led by Germany) has resisted QE, while favoring austerity, especially for the heavily-indebted Southern European states. This gridlock may end if Germany's economy continues to weaken. Even the Swedes (not in the Eurozone), who have championed austerity and even higher interest rates, have changed course: in October, the Swedish central bank cut its short-term lending rate to zero to prop up the Swedish economy.

The prospect of low rates, weak growth, and even aggressive QE in Europe, combined with economic strength in the US, has sharply weakened the euro compared to the US dollar. This weakness will in the long run help the Europeans export more, providing more support for economic growth. (In the short run, however, US investors in European stocks will see their dollar returns hurt by Euro weakness.)

The Japanese have battled deflation and stagnation for two decades. Prime Minister Abe is committed to ending this cycle, and he has gotten even more help from the Bank of Japan (BOJ). The BOJ announced at the end of October that it was sharply increasing the size of its QE program. This shocked the markets: Japanese stocks soared, even as the yen fell to multi-year lows against the dollar. This yen weakness should also help Japanese exporters, and thus GDP growth, while nudging up the rate of inflation closer to the BOJ's target. The monetary surprise was necessary to offset the sharp increase in Japan's national sales tax, which caused economic growth to stall in the second quarter of the year.

The Chinese economy continues to slow down toward a more sustainable 7.5% real growth rate, an astoundingly fast rate in almost any country other than China. The danger is that the Chinese leadership will not be able to keep the growth rate from falling even further. Since debt levels, both public and private, have been rising sharply in China, slowing growth could lead to higher rates of defaults and even slower growth. So far, however, the Chinese stock market has not been fazed by slower economic growth: the Shanghai Shenzhen Index reached its highest level in a year, and finished October strongly. This index is now up over 10% for 2014.

OUTLOOK: In the short term, US stocks still have a constructive background of easy money, steady economic growth, and rising corporate profits. The path upward, however, will likely not be smooth: the September-October decline is a common event in a bull market, and uncertainty and economic weakness across Europe could spill over into financial markets around the world. However, long-term investors must not be stampeded by the inevitable short-term gyrations in stocks.