THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – SEPTEMBER

US Markets and Economy: American stocks, as measured by the Dow Jones Average and the S+P 500 Index, plowed ahead to new all-time highs in mid-September, but then fell enough to finish the month lower. Running true to form, September has historically been the worst month for stocks in the last century, even though October (1929, 1987) has often been the month that truly tests the mettle of long-term investors. Although the selloff in the second half of September was quite mild for the large-cap stocks, smaller cap stocks, as measured by the Russell 2000 Index, fell more sharply and erased their gains for the year. These smaller stocks have led the way upward since March 2009, nearly quadrupling from the March 2009 low point to the end of 2013. **The periodic divergences in performance of large caps vs small caps drive home the point that, for prudent long-term investors, true diversification of a stock portfolio requires size (large cap, mid cap, small cap) diversification as well as industry and geographic diversification**.

The economic news for the US economy was good: second quarter growth in real GDP, at 4.6% annualized, was even higher than previously estimated. Although some of this growth was the result of businesses adding to inventories, what economists call "real final sales" (real growth – inventory growth) was still strong at 3.2%. Even the increase in business inventories may reflect businesses ramping up for increased production and sales in the last two quarters of the year. This optimism has led to increased hiring, with "headline" unemployment falling to 6%. Still more encouraging, the economic strength was widespread: consumers increased purchases of both durable and nondurable goods, businesses increased spending on equipment and buildings, residential housing increased, and exports were strong. Even state and local governments began spending more as their budgets improved after years of austerity. Widespread growth like this is much more likely to be sustained in the long run, which means the Federal Reserve's aggressively easy monetary policy may finally, after five years, have succeeded in putting the US economy back on a sustainable growth path. Just as importantly, inflation remains quiescent at less than 2% per year, which is the Fed's "target" level.

Why wouldn't all this good economic news push stocks higher? **The link between stock prices and economic growth is not strong.** Stocks often lead the economy higher, and lower. In March 2009, stocks began a powerful bull market while the economy was floundering in the depths of the Great Recession. Stock prices had previously peaked in 2007, before there was any hard evidence that the Great Recession was even beginning. (This weak link appears in many other countries too: China’s stock market has far underperformed most others, even as the Chinese economy continues its breakneck growth.) More importantly, the US stock market is anticipating a gradual return to “normal” monetary policy, which means the end of zero short-term rates in the US, and probably, starting in 2015, a rise in US interest rates across the maturity spectrum. Bond investors will need to be nimble to minimize the effects of rising rates, but stock investors must also adjust to an environment of rising rates: some of this year’s small-cap underperformance could reflect the possibility that “credit-constrained” small-cap companies will be more impacted by rising rates than large-cap companies.

World Markets and Economy: The prospect of rising US interest rates has also driven the international value of the dollar sharply higher, especially against the euro. With European growth stalled near zero (even the German locomotive has slowed sharply), the ECB has responded with even easier monetary policy to stimulate Europe’s economy. In fact, the declining euro should eventually promote faster European growth, as exports denominated in euros appear cheaper to the rest of the world. Yet heavily-indebted countries like Greece and Italy are still floundering. Unemployment in Greece remains at an astounding 26.5%, and Greek stocks dropped sharply in September to their lows for the year. Italy will probably suffer another year of economic decline in 2014, which will increase the already high burden of Italy’s foreign debt, while making the adoption of necessary economic reforms that much harder. Italian stocks also were down for the month. The weakness was widespread, with Germany, France, Spain, and even England (not in the euro) falling.

In the Americas, Brazilian stocks fell sharply. A hotly contested election, combined with both economic weakness and rising inflation, pressured the Ibovespa Index all month. Yet poor economic conditions in Argentina, still reeling from the effects of its latest international default, were not enough to stop a powerful rise in the Merval Index.

Asian markets were also mixed. Hong Kong stocks took a drubbing as mass protests threatened to paralyze the economy, while the Chinese government edged closer to a violent crackdown which could further unsettle the region. Yet Chinese stocks rallied in September, even as the slowdown in Chinese growth persisted. Japan’s stocks also rallied, even though the economy took a nosedive in response to an increase in the national sales tax from 5% to 8%.

Economic and political trouble in Europe and Asia may tempt US investors to “hide” in the US, but, in the long run, all the evidence suggests that worldwide diversification reduces risk and often boosts returns.

OUTLOOK: In the short term, stocks can move higher in tandem with rising corporate profits, as long as interest rates and inflation stay low. US stocks will likely continue to outperform in the near future, as the dollar gains strength while other economies (Europe, Japan) struggle to match growth in the US. With stocks, as always, the path upward is unlikely to be smooth. Long-term investors will keep their eyes on the prize of long-term gains, and ignore the short-term fluctuations.