THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – OCTOBER

US Markets and Economy: October was a banner month for US stocks. Markets rose almost nonstop from the beginning of the month to the end. There was plenty of good news to drive the rally, which has brought broad indexes like the S+P 500 back within striking distance of their all-time highs set in July. The fuel for the surge in prices was based on what did not happen as much as what did. First, the US Congress and the President did not allow the US to default on its debt. Instead, an agreement was reached to fund the government until 2017, and to suspend the national debt limit so the Treasury can continue to borrow. Second, the Fed did not raise interest rates at its October meeting. While the Fed is still considering a rate hike for its December meeting, Wall Street seems convinced that there will be no rate hikes until 2016, and the markets do love zero interest rates. Third, there was no economic collapse in China, or new trouble in Greece. The Chinese are witnessing a slowdown in their breakneck growth rate, but so far, easier money has limited the slowdown to a growth rate of 7% (official numbers) or 4-5% (unofficial estimates). The Greeks returned their firebrand leader to power, but he has pledged to carry out the Greek austerity he negotiated with European lenders, as the latest act of the Greek bailout drama.

Markets were also buoyed by continued growth in US GDP, based on the first “advance” estimate for the third quarter of the year. Although the headline number showed the US real GDP growth rate slowing to 1.5%, much of the slowdown from the strong second quarter was a result of a decline in inventory growth. Economists prefer a measure called “real final sales” which strips out the effect of changes in inventories. This measure grew at a strong 3.0% in the third quarter. With underlying growth still strong, it is likely that businesses will rebuild inventories in the fourth quarter, which would add further strength to GDP growth. The corporate sector will welcome this growth, since third-quarter earnings were down again, after a weak second quarter. While some of this decline is clearly a result of weakness in the energy sector, earnings growth and revenue growth has slowed even outside energy. But the cloud over energy has a silver lining: lower gasoline, heating oil, and natural gas prices are a tonic for consumers, who have more disposable income to spend when their energy bills drop. Another benefit of lower oil prices is that measures of inflation remain near zero, which militate against monetary tightening by the Fed. Although Fed officials look more carefully at inflation measures after removing volatile food and energy prices, these alternative measure are still running below the Fed's target of 2%.

The FOMC itself is sharply divided over the significance of this long run of very low inflation: the interest rate "hawks" continue to fear that a tightening labor market will soon put upward pressure on wages, and then prices, while the "doves" are content to wait to see evidence that falling unemployment rates really do push up inflation. This battle over the Phillips Curve, which shows an inverse relationship between unemployment and inflation, will continue until at least December. **Whenever the Fed finally decides that "D-Day" has arrived (perhaps in December), and that it is time to begin increasing short-term rates, stocks will probably endure a selloff**. **Yet a single quarter-point increase will still mean that monetary policy and interest rates are strongly stimulative**. The Fed does not plan on fully "normalizing" interest rates for at least two more years.

World Markets and Economy: China's PBOC again eased monetary policy in October, to help achieve a "soft landing" for the economy as economic growth continues to slow. The yuan remained stable, which reassured financial markets throughout Asia and the world. The Chinese stock market, which had sold off sharply in the summer, responded well to the monetary easing and continued to recover slowly all month.

European stocks led the world higher in October, as bullish comments from Mario Draghi of the ECB powered an across-the board 10% rise in Eurozone stock markets. The ECB will probably increase its Quantitative Easing (QE) program, since the European economy is still in the doldrums with near-zero growth. **The history of QE in the US, Europe, and Japan shows again and again that the biggest immediate beneficiaries of QE are the stock and bond markets**.

Japan's stock market also had a strong month, even though the Japanese economy has still not managed to grow steadily. Japan's deep-seated growth problems (continuing fear of deflation, an aging workforce, and zero population growth) may be sufficient to offset the stimulus of QE by the BOJ and a large fiscal deficit. Prime Minister Abe has staked his political future on bold plans to get the economy growing again, but so far the results have been poor. Japan's economy contracted in the second quarter, and may have done so again in the third quarter. Japanese stocks could be vulnerable to a selloff if it becomes clear that QE cannot do the job.

OUTLOOK: Long-term investors can pat themselves on the back for not panicking when the stock market sold off sharply in August. The sharp rally in October is a well-earned reward for their patience and discipline in the face of adversity. But complacency is not in order. Slow growth in corporate earnings, combined with the inevitable increase in US short-term interest rates, will create headwinds for stocks. Further gains in stocks could carry markets to new all-time highs, but the path is likely to be strewn with obstacles, and investors must be prepared for more short-term volatility.