



THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – OCTOBER

US Markets and Economy: US stocks fell slightly in October, but remain close to their all-time highs set this summer. The US election is now front and center for Wall Street. Traders had priced in a Clinton victory, but the surprise revelation that the FBI is once again examining Clinton-related emails has generated new uncertainty, and a slightly larger chance that Trump will pull off an upset victory. Most economists and market pundits believe that a Trump victory would, at best, create massive political and economic uncertainty, while a Clinton victory would likely lead to four more years of divided government, similar to Obama's two terms, during which time the market tripled. Not surprisingly, then, the news of the new investigation prompted a brief sharp selloff at the end of the month, which was quickly reversed. Why would Wall Street fear a Republican victory? First, Trump has stated that he would remove Janet Yellen as the head of the Fed; this would create monetary policy uncertainty, even if other Fed members did not resign in sympathy. Second, Trump has also suggested that he might abrogate America's trade treaties and impose tariffs on Chinese goods. Such actions could lead to a trade war and potentially even a recession.

The oddsmakers still give Clinton an 80-90% chance of winning, and that accounts for the quick recovery of the markets at the end of October. However, the growing fixation with the election has obscured some positive trends in the US economy: US third quarter GDP rose at almost 3% in real terms, a sharp and welcome acceleration from the first half's anemic 1% growth. Employment continues to grow steadily, and unemployment remains at around 5%, without any signs of a significant increase in inflation. Real wages and family incomes are growing, albeit slowly. Interest rates in this benign environment should remain low. The Federal Open Market Committee (FOMC) will almost certainly "punt" at its meeting in early November, so as not to appear to be interfering in politics. But the FOMC is likely to increase short-term interest rates by ¼ percent at its December meeting. (In September there were already three dissenters on the FOMC who argued for an increase.) The economy is certainly strong enough to withstand this increase, which will still leave the real Fed Funds rate below zero. With long-term rates still

extremely low (the US 10-year rate is still well below 2%), monetary policy will remain highly accommodative for the Yellen Fed.

These low rates provide strong support for stocks, and offset the weakness in corporate earnings, which have stagnated even outside of the energy sector. With oil prices stabilizing, and signs that non-oil earnings may be on the rise again, the table is set for stocks to rally in the traditionally strong November-January period, once electoral uncertainty has been resolved.

World Markets and Economy: European markets outperformed the US almost across the board. From Athens to Berlin to London, stocks rose modestly, while in Italy (still a European banking trouble spot), stocks had a very good October. Italian GDP is growing again, and deflation has temporarily been replaced by a touch of rising prices. This little bit of strength may help Italian banks struggling with balance sheets filled with problem loans. In London, big stocks (the FTSE 100) approached multiyear highs as a weak pound was expected to boost their exports. However, uncertainty over the path of Brexit may derail the rally. Standard trade theory suggests that Brexit will actually retard growth in both Britain and the EU in future years. All of Europe, however, benefits from the extremely low (or negative) interest rates engineered by the European Central Bank (ECB). The ECB shows no sign of letting up on its massive monthly Quantitative Easing, as it heroically tries to get Europe back to self-sustaining growth.

The Japanese stock market also had a strong month, as measured by the Nikkei Average. A 7% gain for October has pushed the Nikkei to a multimonth high. Markets are pleased that the economy is showing signs of growth even though the yen has been strong against the dollar, which would normally hurt exports. Two long-term factors which could hold the Japanese economy back though, are 1) that Japanese population is actually falling and will likely continue to do so as the population ages rapidly, and 2) the level of Japanese government debt is about 200% of GDP. The latter may limit the use of expansionary fiscal policy, although markets are willing to price Japanese 30-year government bonds at 0.5%, which suggests that bond traders are not very worried about deficits and debt.

OUTLOOK: The US stock market is still holding on to most of its gains for 2016, and stocks are historically very strong in the November-January period, which is now upon us. Low interest rates around the world are also supportive of share prices. Barring an election surprise, investors should be celebrating another bull market anniversary in March 2017.