US stocks fell again in September, with all major market averages down for the month and quarter, led by the NASDAQ. The NASDAQ Index led the way since it is more heavily weighted in the biotech and health care sectors than broader averages like the S+P 500 Index. These two sectors were hard hit, especially after candidate Hillary Clinton suggested that there may be a need for more regulation of these companies. The good news for chart followers was that the decline in September held above the low reached in August, which could mean that the summer correction has run its course. Further support for the US market came from the Federal Reserve’s FOMC, which decided in September to keep short-term interest rates at zero for at least a little longer.

Wall Street is transfixed by the deliberations of the FOMC, since stocks have prospered mightily during the era of zero interest rates, and the Fed has not raised rates since June 2006, more than nine years ago, an eternity by Wall Street’s standards. In 2006, the Fed was concerned that the economy was overheating, which could have led to inflation rising well above the Fed’s target. Fast forward to today, and the rate of inflation remains stubbornly below the Fed’s target of 2%, even after removing the effects of falling oil prices. Standard models of the economy suggest that inflation should be picking up steam since the US labor market, as measured by the headline unemployment rate, has dropped to 5.1%, near the level of “full” employment. At “full” employment, businesses must compete hard to fill vacancies and thus often raise wages, which can then feed into higher prices (This inverse relationship between unemployment and inflation is known as the Phillips Curve). But wage and price inflation have remained surprisingly low, which gives the Fed a chance to wait before beginning “liftoff” to higher interest rates.

But this extended waiting process creates uncertainty for Wall Street traders, who then overreact to every tidbit of news about the economy (It’s getting stronger, rates are going up! SELL… No it is getting weaker, rates are not going up! BUY) and every word uttered by any of the 15 members of the FOMC (Lacker wants to raise rates! SELL… Bullard doesn’t! BUY). These gyrations are not even consistent: a stronger economy may lead to higher interest rates, but also higher corporate profits. A weaker economy will result in just the opposite. Long-term investors are saddled with the excess volatility created by these daily overreactions, but must resist the
costly temptation to run with the herd. **Academic research shows that investors who trade more frequently do much worse than those who buy and hold, who are richly rewarded in the long run for NOT running with the herd.**

At some point, perhaps later this year, the Fed will indeed raise its target for the Fed Funds rate by ¼ percent. This is nothing to be frightened of, as Wall Street traders will eventually realize. Monetary policy will still be quite stimulative, and the Fed will have raised rates because the US economy is growing at a moderate and sustainable pace, which can easily withstand gently rising rates. **Remember that real (after subtracting inflation) short-term interest rates will still be negative, and may remain so well into 2016.** The Fed would have to raise rates five more times in 2016 just to get the real Fed Funds rate up to zero!

What Wall Street should be worried about is the sharp slowdown of US corporate profit growth. Although the energy sector is mainly responsible for this slowdown, even the growth of profits outside the energy sector has slowed. Part of this slowdown is caused by the strength of the US dollar, which makes it more difficult for US firms to grow their overseas profits in US dollars (Ironically, much of the strength of the US dollar reflects expectations that the US Fed will be raising interest rates). This profit slowdown does bear watching, though, since weak growth in corporate profits acts as a headwind for stocks. In this environment, investors will be well rewarded for emphasizing companies with good growth prospects.

**World Markets and Economy:**

China remains center stage. The world’s second-largest economy is slowing down, and this slowdown, combined with the surprise Chinese devaluation of the yuan, has kept international markets on edge. Most of China’s trading partners (Australia, Brazil) and export competitors (Japan, Indonesia) have seen their currencies decline sharply, their economic growth rates weaken, and their stock markets fall. Japan’s stock market has now given up its gains for the year, as the Japanese economy continues to struggle in spite of massive infusions from QE. Brazil’s economy is in recession (The US economy is more diversified, and not dependent on exports to China, which means that China’s slowdown has very little direct impact on the US economy).

It is hard to gauge the extent of the slowdown in China, since official data may be inaccurate. It is also hard to gauge the response of policymakers, whose decisions are shrouded in secrecy. However, there can be no doubt about the extent of China’s stock market decline, with the Shenzhen 300 Index down 40% from its summer peak. Chinese intervention has temporarily stopped the decline, but the parable of the Chinese stock market boom and bust is just the latest chapter of 500 years of financial folly. The US is certainly not exempt: A bitcoin was $1100 two years ago. Now it is $240. **Successful investors know that today’s investing craze will be tomorrow’s investing disaster.** A diversified portfolio of stocks still beats all other assets in the long run.

**OUTLOOK:** The US bull market in stocks is still intact, and the current (and healthy) correction may have run its course. Markets are also approaching the November-January period, historically the strongest of the year. A likely year-end rally could still be derailed by new tremors emanating from China, or overreactions to Fed policy by twitchy traders. Best advice (from the British): “Keep calm and carry on.”