THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – OCTOBER

US Markets and Economy:

October was an ugly month for American stocks. A rally at the very end of the month still left the major indexes down sharply, led by the previously unstoppable NASDAQ, which dropped over 9% for the month. The Dow Jones and S+P 500 indexes also fell, although by smaller percentages. What triggered these declines? It was certainly not the state of the economy, since US real GDP is growing strongly, at an annual rate of 3% or higher this year. It was not overall corporate profits, which are still growing strongly partly in response to corporate tax cuts this year.

The culprits: first, interest rates. Short-term rates are being raised by the FOMC, and another ¼-point bump is almost certain in December. Higher short-term rates are often viewed negatively by stock traders, since they provide more competition for stocks. Of more concern is the rise in long-term rates, with the 10-year Treasury now above 3%. This rate is more sensitive to inflation expectations, which may be rising a bit, since current data shows that measures of both wage and price inflation are picking up. This is not a surprise, since by many measures the US economy is running close to flat-out, with recent reports showing unemployment staying extremely low at 3.7%, and employment growth still very strong. While this is good news for working Americans (and savers who can finally earn some interest), Wall Street fears this will lead to even more increases in short and long-term interest rates, providing more of a headwind for stocks.

A second culprit is actually corporate earnings, which, in 2019, will have a hard time matching the colossal growth rate of 2018. In addition, there were some signs of earnings/sales weakness among the FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google), which as a group can pull the NASDAQ and even the S+P 500 down all by themselves, much as they have led the markets higher all year. Apple alone accounts for about $1 trillion of US market capitalization, and the stock fell in October.

A third concern for stocks is the continuing US-China trade battle. Although it is not a war yet, it seems both sides are spoiling for one. This can spook stocks, since US exports will be hurt by Chinese restrictions (soybeans are a good example), and all US imports from China could become more expensive if the President imposes tariffs on all Chinese exports to the US, as he has threatened to do.

A fourth concern is domestic politics. The mid-term elections will be decided soon, but the partisan rancor will not disappear. If the Democrats win back the House, government will become even more divided, as attention turns to the 2020 election. Policy changes may all be blocked; at the very least political uncertainty will rule.

Yet bulls should not be discouraged, since "corrections" always occur in bull markets. Stocks can rise even in the face of rising interest rates, which in real terms, are still very low. It is in all parties' interests to avoid a trade war, so reason should prevail here (as it did for the remade NAFTA accord). And the economy and stocks can certainly survive divided government, as they have often done in the past. Bulls should also remember that we are entering the historically strongest season (November-January) for US stocks. But most of all, investors win by keeping their eyes on the long-term, since stocks almost always rise in the long run.

World Markets and Economy:

European stocks were dragged down by the falling US market, and also by domestic concerns. Germany was weak in part because long-serving Angela Merkel will be stepping down as party leader and will probably soon be out of political power. Italian stocks dropped almost 10% for the month, as fears of a budget brawl with the European Union kept growing. Since the Italian budget exceeds European guidelines, and the Italian government has a lot of debt, traders are concerned that Italy could cause much more trouble for the EU than Greece. Italian 10-year bonds have been rising in yield since the spring, and rose further during October, which also hurt stocks.

The Japanese Nikkei Index also tumbled sharply in October. In addition to being pulled down by the US selloff, Japanese stocks were on the defensive in part because the US is still threatening Japan with increased car import tariffs. Any weakness in exports could hurt Japan's economy, which is growing slowly after decades of stagnation.

OUTLOOK: US stocks remain in a bull market, although October's selloff shows us again that the upward path is never smooth. Seasonally, stocks are entering their best 3-month period. The old Wall Street saying "The bears get Thanksgiving, the bulls get Christmas" may play out again this year.