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Client Newsletter – Quarter Ending September 30, 2014

Last month in our Daily Journal of Commerce column, we warned that September and October could be volatile months, months with a downturn. There were many reasons for this forecast. History was one, with both September and October demonstrating a tendency to be volatile and lower. Further, the market has had an over five year run up and was due for a correction. Also, there were and are many headline events to worry about: problems in Europe, specifically Ukraine; a slowing Chinese economy, with attendant pullback in commodity prices. Then there is Ebola which has taken center stage, and ISIS. These problems persisted and in some cases grew worse. September turned out to be a volatile and down month.

Historically October has been difficult too. More than 25% of the days in which the market has moved by 6% or more in a day, since 1929, have occurred in October. In recent years, the worst October was 2008, when the financial crisis began. But the economy is in much better shape than it was in 2008, having grown 18.8% since then thru September 30, 2014. Indeed the U.S. GDP grew 4.06% in the second quarter of 2014. Unemployment has dropped to 5.9% as of September 30, 2014, the lowest in 5 years.

Also weighing on the markets is the softening of the economy in Europe and China. Although China still appears to be growing at about 7%, that growth represents a slowing from recent history. Europe, on the other hand shows a distinct slowing and fear of deflation. The U.S. and the world economies have been held up by the central banks, but there appears to be global slowing with Europe suffering the worst of it. (We sold out of Europe a while ago). The market is recognizing that there is only so much that central banks can do.

When he was Fed Chairman, Ben Bernanke spoke often of the limited tools at hand for the Central bank, and sought assistance from the Legislative and Executive Branches. He received some assistance, but not enough. European Central Bank Chair Mario Draghi is suffering the same problem in Europe. Southern Europe is still suffering growth and budget issues. The Italian economy has gone back into recession. The Greek market is down about 25% from its recent highs. Spanish, Italian and Greek Sovereign debt interest rates are at high and unsustainable levels. Even Germany which has been the economic leader is slowing.

Draghi has done all he is allowed to do. So far the Germans have practiced austerity, but the time for that policy may be passing as German policies seem to be contrary to the ECB, and are dragging down the rest of Europe. The breakup of the ECU has to be back on the table after that threat had seemingly passed.

Now, we are entering earnings season. Alcoa kicked off earnings reports on October 8 with a 37% positive earnings surprise. According to Thompson Reuters it is anticipated that earnings for S&P Companies will increase 6.4% this quarter. So far reporting firms have beaten estimates 61.4% of the time, but there is still a long way to go, and the earnings reports are backward looking.

The U.S. remains the most attractive economy in which to invest, with Europe struggling. Cash, as an asset class, returns nothing, fixed income yields are down with the fixed income at risk because of rising interest rates; so equities remain the asset class of choice.

Furthermore, not all news is bad as the Federal Reserve's beige book reports that the economy is growing at a modest to moderate pace. There is some wage growth, mostly in skilled positions. The price of oil is dropping which will be good for consumers and consumer spending. Further the Fed reports that the rate of inflation is within their targets, so there is no immediate pressure to increase interest rates. Indeed, Futures show interest rate increase expectations project low interest rates for a longer period than expected even a month ago.

We have tactically raised cash, and are ready to invest when it seems opportune. We see this time as a buying opportunity.

- William D. Rutherford